Student Notes

Module A (June 2012)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Property related standards	• Case study • Group discussion	Ch. 5, 6, 8 and 12	Pg. 1 – 27
3. Resolving accounting issues	• Case study • Group discussion	Ch. 9, 11 and 13	Pg. 28 – 52
4. Wrap up	• Presentation • Group discussion		
Workshop 2			
5. Reboot	• Presentation • Group discussion		To be released after completion of Workshop 2
6. Financial instruments	• Case study • Group discussion	Ch. 18	
7. Consolidation	• Case study • Group discussion	Ch. 20, 27, 28, 29 and 30	
8. Leading a team and teamwork	• Group discussion		
9. Conclusion	• Presentation • Group discussion		

Property related standards – recognition

Case study 1

Aston Manufacturing Limited ('AML') is a large company which designs and manufactures machinery. The company is cash rich and has been using surplus cash to expand and develop its portfolio of properties. During the year ended 31 March 2012 several events took place in relation to its properties. The details in respect of two properties are given below.

<u>Property 1 – Madison House</u>

This property was acquired in September 2011, and is a four-storey property. Three of the floors of Madison House are rented to Buzz Limited, a company which is not connected to AML. The top floor of Madison House is rented to AML employees, who pay market rent to the company. One of the terms of the acquisition of Madison House was that the floors cannot be separately sold or leased out under a finance lease.

<u>Property 2 – Stow Court</u>

This property was purchased several years ago, and until December 2011 served as AML's head office. However, at that time AML relocated its head office to a different location, and Stow Court is now empty. AML immediately began refurbishment work in Stow Court, and the property is now being developed for future rental income.

Required:

In respect of each of the two properties, determine:

(a) which accounting standards are relevant,

(b) the nature of each property, and

(c) what recognition criteria should be used.

Discussion points

Property related standards – recognition

Case Study 1 – AML

What are the issues?

In the year ended 31 March 2012, AML has two different property-related events to account for:

(1) the acquisition of a new property which is partly rented out and partly owner occupied; and

(2) the end of owner-occupation, and the commencement of redevelopment of its previous head office.

For each of these arrangements, students must determine:

(a) which accounting standard is relevant,

(b) the nature of each property, and

(c) what recognition criteria should be used.

Which accounting standards should be used?

HKAS 16 *Property, Plant and Equipment*

HKAS 40 *Investment Property*

What are the requirements of the accounting standards?

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.

(HKAS 40.5, LP Chapter 6, Section 1.1)

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.

(HKAS 40.8, LP Chapter 6, Section 1.1)

(f) A building held by an entity and leased to a parent or another subsidiary.

(HKAS 40.15, LP Chapter 6, Section 1.1)

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 (HKAS 17).

(HKAS 40. 9, LP Chapter 6, Section 1.1)

Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease) an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

(HKAS 40.10, LP Chapter 6, Section 1.1)

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 40.16, LP Chapter 6, Section 1.2)

Transfers to or from investment property are justified only when there is a change in the use of the property. HKAS 40 provides two instances when property is transferred to investment property from another category:

(a) End of owner occupation, and

(b) Commencement of an operating lease to another party, for a transfer from inventories.

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 40.57-58, LP Chapter 6, Section 1.5)

How to apply the standards to the case

Madison House

This property is used to provide rental income, so would appear to meet the definition of an investment property, as the definition of an investment property under HKAS 40 is that it is a property held for capital appreciation and / or to provide rental income.

However, one of the four floors of Madison House is rented out to employees who are paying market rate. HKAS 40 states that owner-occupied properties cannot be recognised as investment property. It also specifically states that owner occupied property includes property occupied by employees regardless of whether they pay market rent. This means that part of Madison House is deemed to be owner-occupied.

Because only one of the four floors is owner-occupied, it must be determined whether the property can be separated into components, with the owner-occupied portion recognised as property, plant and equipment, and the non owner-occupied portion recognised as investment property. There are two issues to discuss in relation to this.

Firstly, the portion which is owner-occupied is a significant portion, as it represents one quarter of the property. If the owner-occupied portion were insignificant then the whole property would be recognised as an investment property, but this is not the case for Madison House.

Secondly, if the portions could be sold separately (or leased out separately under a finance lease) they would be accounted for separately. However, the floors of Madison House cannot be rented out under a finance lease or sold separately under its terms of acquisition.

Therefore, Madison House must be treated as property, plant and equipment, as a significant portion of the property, which cannot be separately sold or leased under a finance lease, is owner-occupied.

Stow Court

Until December 2011 Stow Court served as AML's head office, and therefore would have been recognised and measured according to HKAS 16 Property, Plant and Equipment.

In December 2011 there was a change in use of the property. It ceased to be used as AML's head office and therefore ceased to be owner-occupied. HKAS 40 states that the end of owner-occupation is one of the instances when a property can be transferred into the investment property category. It is now being developed for future rental income, and it now meets the criteria to be recognised as an investment property. HKAS 40 states that property that is being constructed or developed for future use as investment property should be classified as investment property.

Therefore from December 2011 Stow Court ceases to be recognised as property, plant and equipment, and is now recognised as investment property.

HKAS 16 is applied up to the date of change of use when an owner-occupied property becomes an investment property.

Recommendation / Justification

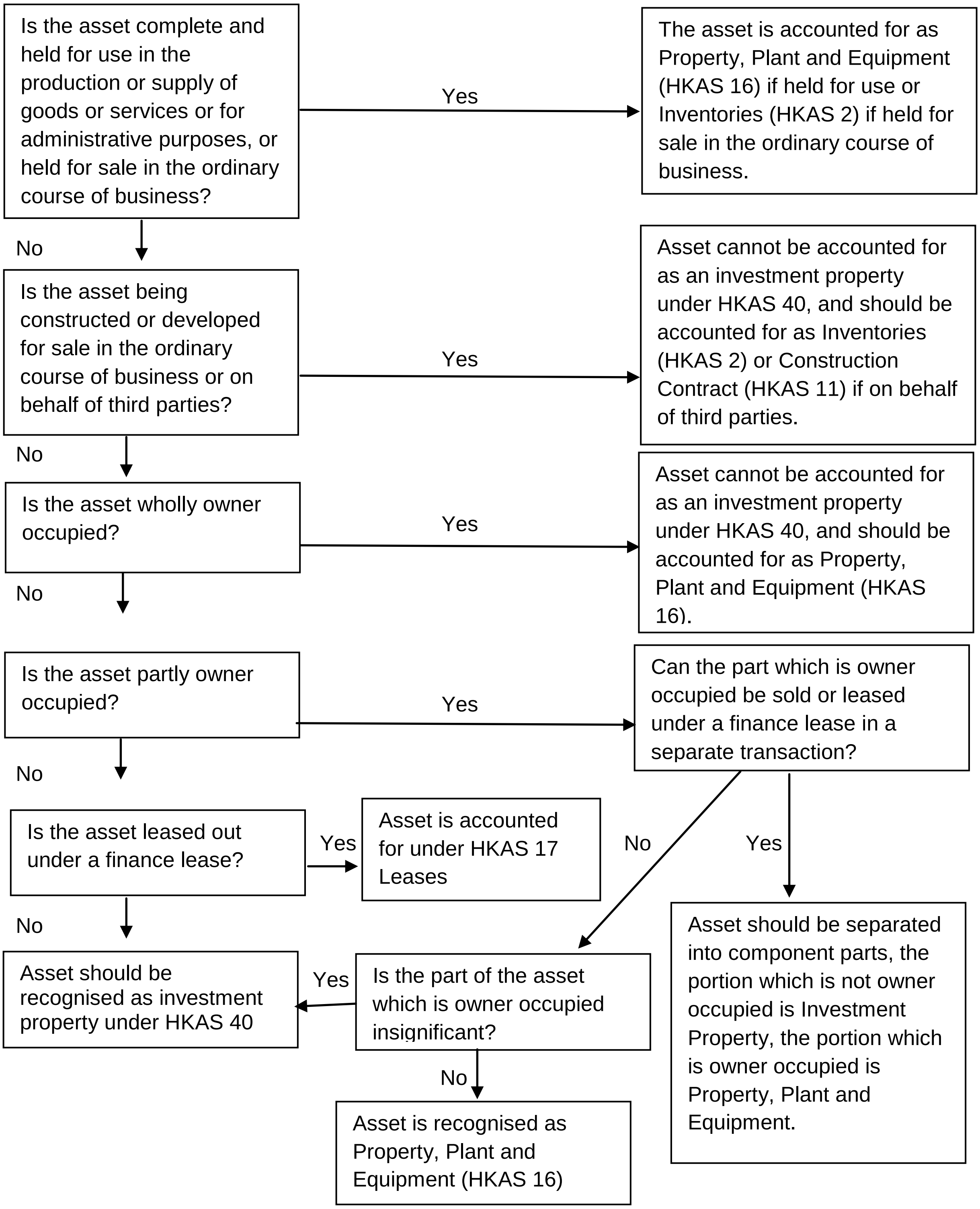
AML recognises the two properties in the following categories on its statement of financial position at 31 March 2012:

Property	Classification
Madison House	Property, plant and equipment (HKAS 16)
Stow Court	Investment property (HKAS 40)

Key Learning Points

1. Owner-occupied properties may not be classified as investment properties.
2. Where part of an investment property is owner occupied, the accounting treatment depends on the significance of the portion that is owner occupied, and whether it could be separately sold or leased under a finance lease.

Classification as investment property – decision tree



Property related standards – measurement

Case study 1 continued

Aston Manufacturing Limited ('AML') is preparing its financial statements for the year ended 31 March 2012. AML has elected to measure investment properties using the cost model. One of the properties recognised in property, plant and equipment is Madison House, which has a carrying amount (based on its cost) of HK$20 million.

AML feels that its recent strategy to develop its portfolio of properties may not have been a wise decision, as the property market has slumped, with market values falling for most types of properties. In addition an economic recession has caused the property rental market to suffer, and to attract and retain tenants it is necessary to agree rental payments that are much lower than in previous years.

AML's management is considering what to do with Madison House. There are two options:

1. Sell Madison House

If this option were taken, management consider that they could sell Madison House for HK$18 million, and would incur selling costs of HK$250,000.

The sale would necessitate some reorganisation costs within the business, estimated to be HK$500,000.

2. Keep Madison House

In this case, AML would continue to rent out Madison House for the next four years. This would generate rental income with a present value of HK$7 million. At the end of the four year period Madison House would be sold, generating a cash inflow with a present value of HK$8 million.

Required:

In respect of the financial statements for the year ended 31 March 2012:

(a) Identify the options available to AML when considering how to measure Madison House and Stow Court.

(b) Identify and explain the indicators that Madison House may be impaired.

(c) Calculate the amount of the impairment, and discuss the necessary accounting treatment of the impairment.

(d) Determine the disclosure requirements relevant to the impairment.

Discussion points

Property related standards – measurement

Case Study 1 – AML (continued)

What are the issues?

In the first place the requirement is to identify the measurement rules which apply to both Madison House and Stow Court in the year ended 31 March 2012.

In addition, in the year ended 31 March 2012, there are indications that a property held by AML may be impaired.

In respect of the potentially impaired property, students are required to:

(a) identify and explain the indicators of impairment,

(b) calculate the amount of the impairment, and discuss the necessary accounting treatment of the impairment,

(c) determine the disclosure requirements relevant to the impairment.

Which accounting standards should be used?

HKAS 16 *Property, Plant and Equipment*

HKAS 40 *Investment Property*

HKAS 36 *Impairment of Assets*

What are the requirements of the accounting standards?

An entity shall choose as its accounting policy either the fair value model or the cost model and shall apply that policy to all of its investment property.

(HKAS 40.30, LP Chapter 6, Section 1.4)

HKAS 16 is to be applied up to the date of change of use when an owner-occupied property becomes an investment property. If the property is to be carried at fair value, then 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.

(HKAS 40.57-58, LP Chapter 6, Section 1.5)

HKAS 36 defines an impairment loss as the amount by which the carrying amount of an asset exceeds its recoverable amount.

The *recoverable amount* of an asset is the higher of its fair value less costs to sell and its value in use.

Fair value less costs to sell is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

(HKAS 36.6, LP Chapter 8, Section 4.3)

An asset is impaired when its carrying amount exceeds its recoverable amount. HKAS 36 describes some indications that an impairment loss may have occurred. If any of those indications is present, an entity is required to make a formal estimate of recoverable amount.

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

(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.

(HKAS 36.12-14, LP Chapter 8, Section 4.4.1)

Fair value less costs to sell (also known as the net selling price) is the net amount that could be obtained from the sale of the asset. Selling costs include transaction costs in sales, such as legal expenses. If an active market exists, the net selling price of the asset should be based on the market value or on the price of similar assets traded recently.

Net selling price cannot be reduced by the inclusion of any restructuring or reorganisation expenses, or any costs that have already been recognised as liabilities in selling costs.

(HKAS 36.25-29, LP Chapter 8, Section 4.5.1)

Value in use is the present value of the future cash flows expected to be derived from an asset.

The estimated 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.

(HKAS 36.30-32, LP Chapter 8, Section 4.5.2)

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 as follows:

(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.

- 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:
  - To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to revaluation surplus.
  - Any excess should be charged to profit or loss.

(HKAS 36.59-60, LP Chapter 8, Section 4.6.2)

HKAS 36 contains extensive disclosure requirements. For each class of asset the following must be disclosed in the notes to the financial statements:

(a) The amount of impairment losses recognised in profit or loss in the period and the line item in the statement of 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 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 and 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) and 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.

(HKAS 36.126-133, LP Chapter 8, Section 4.13)

How to apply the standards to the case

(a) **Measurement rules**

Madison House

Madison House is property, plant and equipment within the scope of HKAS 16. It is therefore carried either at cost or fair value (revalued amount).

Stow Court

Stow Court is transferred from property, plant and equipment to investment property in December 2011. After the transfer, AML can choose whether to measure the property at fair value or cost in accordance with the requirements of HKAS 40. If AML has other investment properties, the measurement rules must be applied consistently to all of them and therefore Stow Court will be measured using the same policy as that used for existing investment properties.

If AML adopts the fair value model for investment property, the property must be carried at fair value and the difference between the carrying amount of the asset under HKAS 16 on the date of transfer and the fair value should be treated as a revaluation under HKAS 16.

In this instance, however, the case makes it clear that AML has elected to measure investment properties using the cost model.

(b) **Impairment indicators**

HKAS 36 states that there are two types of impairment indicator – those that are external to the company, and those that are internal. Both can mean that an asset's recoverable amount is less than its carrying amount.

In the case of Madison House, an external impairment indicator is the economic recession, which has caused a **slump in the property market**. When market values of properties generally are falling, it could indicate that the market value of Madison House is now less than its carrying amount.

The recession has also affected the property rental market. Because Madison House is used to provide rental income for AML this is an important issue. The recession has forced AML to negotiate lower rental agreements, so **its income from the property is reduced.** HKAS 36 states that an internal impairment indicator is where cash inflows from an asset are significantly lower than budgeted. This is the case for Madison House.

In addition, HKAS 36 suggests that another internal impairment indicator is where **significant events have, or are likely to impact on the asset's expected use** or that its useful life will change as a result of the events. Management are considering selling the property now or in four years' time as a result of the recession. This therefore is also an impairment indicator.

(c) **Calculation of impairment loss**

The current carrying amount of Madison House is HK$20 million. The impairment test will calculate a recoverable amount for Madison House. If the recoverable amount is less than the carrying amount then the asset is impaired. The recoverable amount is the higher of Madison House's fair value less costs to sell, and its value in use.

Fair value less costs to sell

This is based on the current market value of the property of HK$18 million. The selling costs of HK$250,000 must be deducted. This gives a **fair value less costs to sell of HK$17,750,000.**

Management state that if Madison House is sold, then reorganisation costs of HK$500,000 will be incurred. According to HKAS 36 reorganisation costs must not be included in the determination of fair value less costs to sell. Therefore, these potential costs are ignored.

Value in use

This is based on the present value of future cash flows to be obtained from the continued use of the asset. HKAS 36 also requires that the present value of any cash inflows arising on the future disposal of the asset is included.

For Madison House the present value of rental income is HK$7 million, and the present value of cash flows from its disposal in four years' time is HK$8 million. Therefore, the total **value in use of the asset is HK$15 million.**

Impairment loss calculation

Fair value less costs to sell = HK$17.75 million

Value in use = HK$15 million

Recoverable amount = Higher of these two amounts, i.e. HK$17.75 million

Carrying amount = HK$20 million

Impairment loss = HK$2.25 million

Accounting treatment

The impairment loss must be recognised immediately, with the property reduced to its recoverable amount of HK$17.75 million in the statement of financial position. Madison House is held at cost, and so the impairment loss must be recognised as an expense in the statement of comprehensive income.

The impairment is recorded in the financial statements by (HK$):

DEBIT	Operating expenses	2.25m	
CREDIT	Property, plant and equipment		2.25m

Recommendation / Justification

AML's statement of financial position includes:

	HK$000
Property, plant and equipment	17,750

AML's statement of comprehensive income includes:

Operating expenses: including impairment loss	2,250

The notes to the financial statements should include the following disclosure notes:

Property, plant and equipment

	HK$000
Carrying amount based on cost	20,000
Impairment loss recognised	(2,250)
Revised carrying amount	17,750

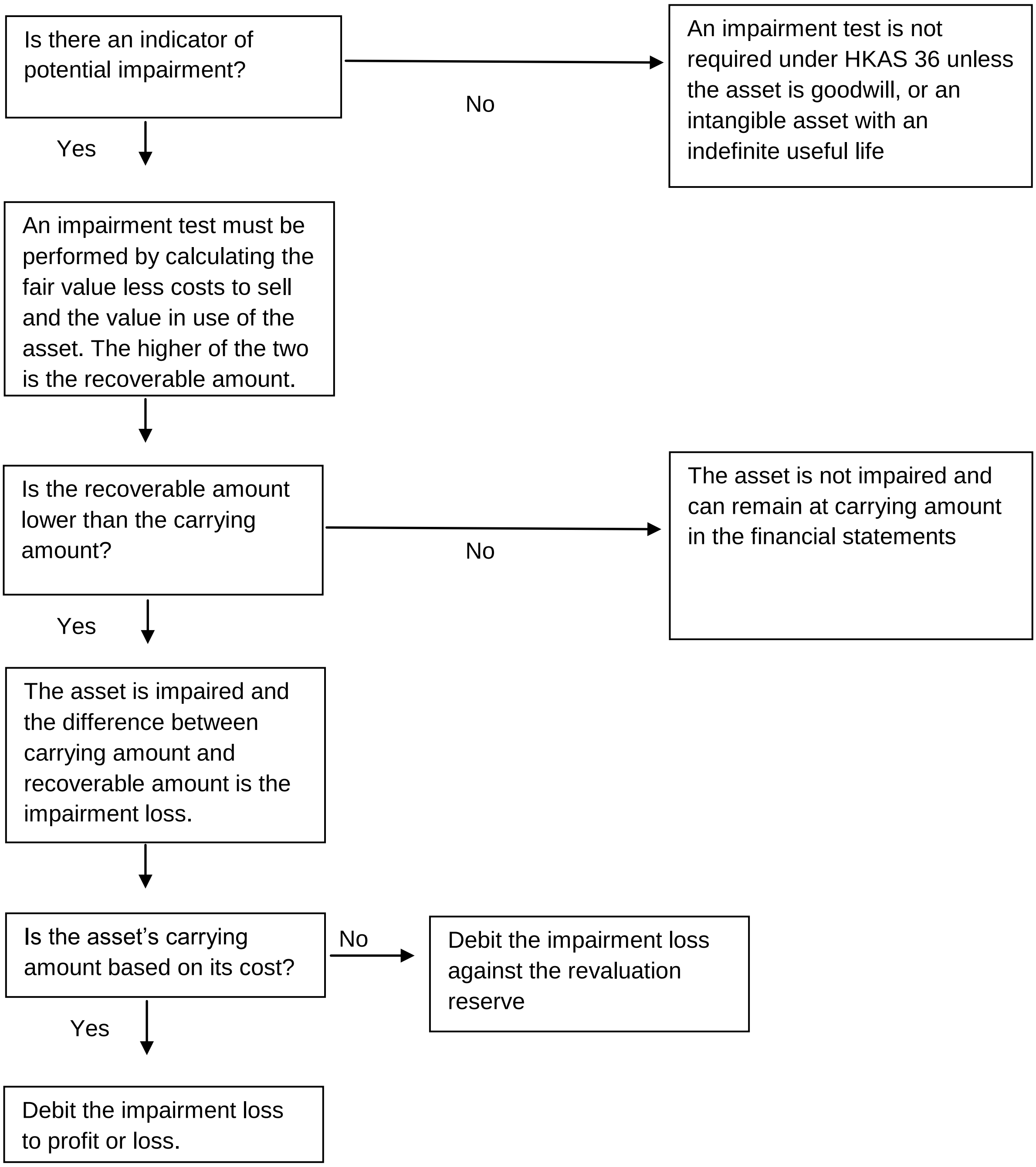
Impairment loss – description of impairment

During the year ended 31 March 2012, an economic recession caused a slump in the property market. This has affected the market value of properties in AML's property portfolio, and has caused rental income to decline.

Following an impairment review, Madison House has been reduced in value by HK$2.25 million. This loss is included in operating expenses for the year. Madison House is used wholly to generate rental income. Its recoverable amount is based on its fair value less costs to sell. This was determined using an estimate of the property's current market value, and by deducting the estimated costs of selling the property.

Key Learning Points

Impairment testing – decision tree



Property related standards – recognition

Case study 2

Hot Fawkes Limited ('HFL') is a distribution company which owns a large site on which several properties are located. The site was acquired by HFL in March 2011. The management of HFL decided to redevelop two of the properties on the site, details of which are given below:

Property A

Property A is a large industrial building which is being developed to become HFL's main manufacturing facility. The building had an initial purchase cost of HK$100 million. In March 2011, immediately after the acquisition of the site, HFL's management prepared a budget for the expenditure they estimated would be incurred in relation to the various components of the facility. Development started in April 2011.

Component	**Estimated useful life of the component**	**Estimated development costs HK$000**
Building structure	50 years	50,000
Specialist packing line	30 years	35,000
Portable wall partitions	10 years	40,000
HFL employee labour costs		2,500
Health and safety equipment	5 years	1,750
Inspection of the packing line – this is required every 3 years for regulatory reasons	3 years	5,000
HFL administration and overhead costs allocated to the development project		40,000
Total development costs		**174,250**

Property B

Property B is a smaller structure with only two floors. HFL does not wish to use Property B for its own use, and entered into a fixed price contract on 31 March 2011 to develop the building for a customer. The development was expected to take 18 months, commencing April 2011. The cost of the Property B building was HK$50 million.

Required:

In respect of the financial statements for the year ended 31 March 2011:

(a) For both properties, determine which accounting standard is relevant, and explain the classification of the property.

(b) For Property A, discuss whether the costs of the components listed will in the future be recognised as part of the cost of the asset, and whether they should be recognised as separate components. Note, you are not, at this stage, required to calculate the cost of the asset.

Discussion points

Property related standards – recognition

Case Study 2 – HFL

What are the issues?

In the year ended 31 March 2011, HFL has undertaken to develop two properties. The key accounting issues are:

(a) Property A is being developed for own use, and is an asset which contains some significant components

(b) Many different types of cost are being incurred, some of which should be recognised as an asset and capitalised into the cost of Property A

(c) Property B is being developed under a fixed-price contract with a customer, and must be recognised in HFL's financial statements accordingly.

For both properties students should determine which accounting standard is relevant, and explain the classification of the property that should be used in the financial statements for the year ended 31 March 2011.

In respect of Property A the additional requirement is to discuss whether the costs of the components listed should be recognised as part of the cost of the asset, and whether they should be treated as separate components or not.

Which accounting standards should be used?

HKAS 16 Property, Plant and Equipment

HKAS 11 Construction Contracts

What are the requirements of the accounting standards?

HKAS 16 Property, Plant and Equipment

HKAS 16 should be followed when accounting for property, plant and equipment *unless* another accounting standard requires a different treatment.

(HKAS 16.2, LP Chapter 5, Section 1.1)

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, and
- expected to be used during more than one period.

(HKAS 16.6, LP Chapter 5, Section 1.2)

The recognition of property, plant and equipment depends on two criteria:

(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

(HKAS 16.7, LP Chapter 5, Section 1.3)

Major components or spare parts should be recognised as property, plant and equipment. For very large and specialised items, an apparently single asset should be broken down into its composite parts. HKAS 16 does not prescribe the unit of measurement for recognition, i.e. what constitutes a separate component of property, plant and equipment. Thus, judgment is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

(HKAS 16.8-9, LP Chapter 5, Section 1.3.3)

Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such items does not directly increase the future economic benefits of any particular existing item of property, plant and equipment, but may be necessary for an entity to obtain the future economic benefits from its other assets. Such items qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

(HKAS 16.11, LP Chapter 5, Section 1.3.3)

An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost. The cost of a self-constructed asset is determined using the same principles as for an acquired asset.

The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

(HKAS 16.15-16, LP Chapter 5, Section 1.4.1)

Some assets will require a periodic overhaul or major inspection in order to remain capable of normal use. The costs of such major inspections or overhauls are capitalised when incurred and depreciated over the period until the next inspection or overhaul.

(HKAS 16.14, LP Chapter 5, Section 1.3.3)

HKAS 11 Construction Contracts

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets.

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.

(HKAS 11.3, LP Chapter 12, Section 1.3)

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.

(HKAS 11.42, LP Chapter 12, Section 2.4)

How to apply the standards to the case

Property A

(a) This property is being developed for own use by HFL, and should be classified as property, plant and equipment as it will bring probable future economic benefit to the company, and will be held for use in the production or supply of goods or services. The property will be sub-classified as assets under construction within property, plant and equipment.

(b) The costs to be incurred must be assessed on an individual basis to determine whether or not they should be capitalised and recognised as part of the cost of the property. Only those costs which are directly attributable to the property should be capitalised.

The **purchase cost** of the property of HK$100 million should be capitalised in the statement of financial position at 31 March 2011 as it has already been incurred.

The other costs listed have not yet been incurred, so will not be capitalised as at 31 March 2011, but we can discuss now whether they will be capitalised when they are incurred in the future.

The **building structure, specialist packing line** and **wall partitions** are all directly attributable and the relevant costs should be capitalised.

Each of the above represents a significant component of the property under development. Each also has a different estimated useful life. HKAS 16 requires that where an asset such as a property contains components that are individually significant, they should be recognised as separate components of the asset and depreciated over their individual useful lives. This is a judgmental exercise, as there is not a specific rule on what constitutes a significant component.

HFL's **employee labour costs** in relation to the development are also directly attributable, and should be capitalised. It is not the case that because the costs are not incremental that they should not be capitalised.

The **health and safety equipment** should also be capitalised. This is because without the health and safety equipment the property could not be used to generate future economic benefit. It will be up to management's judgment as to whether this is a significant enough component to warrant separate recognition.

The **inspection** that is required for the packing line should also be capitalised, and depreciated over the period to the next inspection – in this case a three year period.

The **administrative and overhead costs** allocated to the project may not be capitalised according to HKAS 16. Therefore these costs are recognised in profit or loss as incurred.

Property B

Property B is being developed on behalf of a customer under a fixed-price contract. The development is expected to take 18 months.

This means that the property falls under the scope of HKAS 11 Construction Contracts.

HKAS 11 does not specify the period of time that is necessary for a contract to be sufficiently long-term for it to fall under the scope of the standard. In the case of Property B, because the contract activity will fall into more than one accounting period, it should be accounted for under HKAS 11.

Contract activity has not started by the reporting date of 31 March 2011. Therefore there are no operating costs or revenues that need to be considered. However, Property B has a cost of HK$50 million, so it needs to be determined how this should be recognised.

The property is not under the scope of HKAS 16, so cannot be classified as property, plant and equipment.

Under HKAS 11, costs incurred under a fixed-price contract are recognised on the statement of financial position until such time that profit (or loss) is recognised on the contract. In this case there is not yet any contract activity, so nothing is recognised in the financial statements other than the cost of the property, which should be recognised as inventories. When the contract is underway, the cost of the property will be treated as a contract cost and recognised within cost of sales over the period of development in accordance with HKAS 11.

Recommendation / Justification

HFL's statement of financial position should include the following at the year end 31 March 2011:

	HK$
Non-current assets	
Property, plant and equipment (Property A)	100 million
Current assets	
Inventories (Property B)	50 million

Key Learning Points

1. Significant components should be accounted for separately. Identifying significant components is a matter of judgment.
2. Costs which are expected to provide future economic benefit must be capitalised. This includes health and safety equipment and mandatory inspections.
3. A signed customer contract for the development of a property owned by an entity moves it from the scope of HKAS 16 and under the scope of HKAS 11. Until development commences, the property is held as an item of inventory.

Property related standards – measurement

Case study 2 continued

Hot Fawkes Limited ('HFL') is preparing its financial statements for the year ended 31 March 2012. Details are given for the two properties which were acquired for development in March 2011 (see Handout 2.1). The development of both properties is approximately two-thirds complete.

Property A

Property A which cost HK$100 million, is being developed for own use, with development commencing 1 April 2011. In the year ended 31 March 2012 the following costs have been incurred:

Cost	**HK$000**
Building materials	35,000
HFL employee labour costs	2,000
Unforeseen costs due to industrial dispute (see note below)	500

In addition, a HK$40 million loan carrying an interest rate of 5% was taken out on 1 July 2011 for the specific purpose of financing the development of the property.

For a two-month period commencing 1 December 2011 development work on Property A ceased due to an industrial dispute. Work recommenced on 1 February 2012.

Property B

Property B is being developed under a fixed price contract with a customer. The contract price is HK$92 million, and the total costs of completing the contract are estimated to be HK$80 million (including the cost of the property which was HK$50 million). The contract is two thirds complete based on total costs incurred to date, and progress billings at 31 March 2012 are HK$55 million. To date no payment has been received from the customer. The outcome of the contract can be measured reliably.

Required:

In respect of the financial statements for the year ended 31 March 2012:

(a) **In respect of Property A, calculate the total amount to be recognised in property, plant and equipment and discuss the accounting treatment,**

(b) **In respect of Property B, calculate the amounts to be recognised in relation to the construction contract and discuss the accounting treatment.**

(c) **For both properties outline the disclosure notes that are necessary.**

Discussion points

Property related standards - measurement

Case Study 2 – HFL (continued)

What are the issues?

In the year ended 31 March 2012, HFL begins the development of two properties, in respect of which students are required to:

(a) For Property A – calculate the amount to be capitalised as property, plant and equipment

(b) For Property B – calculate the amount to be recognised as a construction contract

(c) For both – outline the necessary disclosure requirements

Which accounting standards should be used?

HKAS 16 *Property, Plant and Equipment*

HKAS 23 *Borrowing Costs*

HKAS 11 *Construction Contracts*

What are the requirements of the accounting standards?

HKAS 16 Property, Plant and Equipment

An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost. The cost of a self-constructed asset is determined using the same principles as for an acquired asset.

The cost of an item of property, plant and equipment comprises:

(a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

In the case of self-constructed assets, the same principles are applied as for acquired assets.

This means that abnormal costs (wasted material, labour or other resources) are excluded from the cost of the asset.

(HKAS 16 paragraphs 15-16, LP chapter 5 section 1.4.1)

HKAS 23 Borrowing Costs

HKAS 23 contains the following definitions:

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 paragraph 5, LP chapter 17 section 1.1)

An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably.

(HKAS 23 paragraphs 8-9, LP chapter 17 section 1.2)

Three events or transactions must be taking place for capitalisation of borrowing costs to commence:

(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

(HKAS 23 paragraph 17, LP chapter 17 section 1.2.3)

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.

(HKAS 23 paragraph 20, LP chapter 17 section 1.2.4)

An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

(HKAS 23 paragraph 23, LP chapter 17 section 1.2.5)

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.

(HKAS 23 paragraph 26, LP chapter 17 section 1.2.6)

HKAS 11 Construction Contracts

HKAS 11 contains the following definitions:

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.

(HKAS 11 paragraph 3, LP chapter 12 section 1.3)

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. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.

(HKAS 11 paragraph 22 - 25, LP chapter 12 section 2.2.1)

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.

(HKAS 11 paragraph 42, LP chapter 12 section 2.4)

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)

(HKAS 11 paragraphs 39-41, LP chapter 12 section 2.7)

How to apply the standards to the case

(a) **Property A**

Directly attributable costs

The direct costs attributable to the development of Property A include **building materials** of HK$ 35 million, and **employee labour costs** of HK$2 million. According to HKAS 16 these costs should be capitalised as they are incurred.

The unforeseen costs relating to an industrial dispute should not be capitalised. They should be expensed. HKAS 16 states that abnormal costs are not considered to be directly attributable, and so are not eligible for capitalisation.

Borrowing costs

HKAS 23 requires that an entity shall **capitalise borrowing costs** that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.

The interest payments being paid on the loan taken out with respect to the development of Property A meet the definition of borrowing costs, and Property A is a qualifying asset as it is an asset which takes a substantial time to get ready for use.

The key issue is the period in which the borrowing costs must be capitalised. HKAS 23 requires that capitalisation must begin when 3 criteria have been met:

(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

For Property A, the loan was taken out on 1 July 2011 which is when borrowing costs start to be incurred. At that time the asset had already been purchased, and its development had already started. So, the 3 criteria were met when the loan was taken out on 1 July 2011. The company's year-end is 31 March and therefore borrowing costs were incurred for 9 months of the year.

HKAS 23 states that capitalisation of borrowing costs should be suspended for any extended periods where active development is interrupted. The development of Property A was interrupted for a two-month period due to an industrial dispute, commencing 1 December 2011. Therefore no borrowing costs should be capitalised for this two-month period.

In summary, borrowing costs should be capitalised for 7 months (9 months – 2 months) of the year, and amount to be capitalised is HK$40 million x 5% x 7 months = HK$1.17 million.

Therefore the total amount capitalised in respect of Property A at 31 March 2012 is:

	HK$000
Cost of property	100,000
Building materials	35,000
HFL employee labour costs	2,000
Borrowing costs	1,170
Total cost	**138,170**

As long as this property remains an asset under construction, it will not be depreciated.

(b) **Property B**

Property B is being developed under a fixed price contract for a customer and therefore falls under the scope of HKAS 11.

The development is two thirds complete, and therefore HFL will be able to reliably measure the revenue, costs and overall outcome of the contract. This means that HFL must recognise the profit of the contract on a percentage completion basis.

Calculation of profit to be recognised in the year ended 31 March 2012

	HK$000	*HK$000*
Contract revenue	92,000 x 2/3	61,333
Contract estimated costs	80,000 x 2/3	(53,333)
Profit		**8,000**

The HKAS 11 accounting treatment is driven by the profit calculation. As shown above, for Property B, profit of HK$ 8 million should be recognised this year end.

Calculation of figures to be shown in the statement of financial position

	HK$000
Contract costs incurred (80 million x 2/3)	53,333
Recognised profits less recognised losses	8,000
Progress billings	(55,000)
Amounts due from customers	**6,333**

The figure calculated for amounts due from customers would be disclosed as a current asset, as the development is due to finish six months after the year end.

The double entry to record this is (HK$000):

DEBIT	Receivables	55,000	
DEBIT	Amounts due from customers	6,333	
CREDIT	Revenue		61,333

And

DEBIT	Cost of sales	53,333	
CREDIT	Inventory		50,000
CREDIT	Cash		3,333

Recommendation / Justification

HFL's statement of financial position at 31 March 2012 includes:

Non-current assets	*HK$000*
Property, plant and equipment (Property A)	138,170
Current assets	
Amounts due from customers (Property B)	6,333

HFL's statement of comprehensive income for the year ended 31 March 2012 includes:

Revenue (Property B)	61,333
Cost of sales (Property B)	53,333
Gross profit	8,000

(c) **The notes to the financial statements should include the following disclosure notes:**

Property, plant and equipment

Property, plant and equipment includes a property in the course of construction with a cost of HK$138.17 million. Borrowing costs of HK$1.17 million have been capitalised into the cost of this property. This figure was determined by applying an interest rate of 5% to the eligible borrowings during the eligible period.

Amounts due from customers

The amount due from customers is in respect of the construction of a property under a fixed price contract. The contract is two thirds complete at the year end, based on the percentage of costs incurred on the contract compared to total anticipated costs. The amount shown in the statement of financial position comprises the following:

	HK$000
Contract costs incurred	53,333
Recognised profits	8,000
Progress billings	(55,000)
Amounts due from customers	**6,333**

Key Learning Points

1. Borrowing costs must be capitalised for qualifying assets during the eligible period of capitalisation.
2. Borrowing costs should not be capitalised during periods when development of the asset is suspended for an extended period.
3. Construction contracts are recognised in profit on a percentage completion basis when the outcome of the contract can be reliably measured, and when the contract will be profit making.
4. HKAS 11 is unusual in that the accounting treatment is driven by the income statement.

Resolving accounting issues

Case study 1

Skye Manufacturing Limited ('SML') is a company which manufactures machinery to be used in the construction industry. Management are preparing the financial statements for the year ended 31 March 2012, and are considering how to account for three situations:

<u>Factory A</u>

Factory A is a new manufacturing plant which was constructed by SML for its own use. The plant was ready for use in March 2012. The planning permission for the construction of the plant stated that at the end of the plant's useful life, SML is required to dismantle the plant and restore the site on which it is located. SML estimates that the cost of this in 30 years' time will be HK$35 million. The present value of this amount is HK$10 million.

<u>Legal claim</u>

In December 2011 SML's former sales director was dismissed. The sales director brought a legal claim against SML in February 2012, claiming unfair dismissal, and is seeking damages of HK$5 million. SML's lawyers have advised that the claim has a 25% chance of being ruled in favour of the sales director when it goes to court in July 2012.

<u>Division closure</u>

SML is planning to close down one of its business divisions due to declining customer demand. The closure is due to take place in June 2012, and the facts of the closure have been formalised in a detailed plan. A meeting was held on 25 March 2012 where the directors approved the plan, and the closure was announced the following day. SML's management wish to provide for the following costs of closure:

• Consulting fees to identify future corporate strategy	HK$4 million
• Retraining of remaining staff	HK$6 million
• Voluntary redundancy costs	HK$8 million
• Future identifiable losses up to the date of the closure	HK$12 million

Required:

In respect of each of the situations described above:

(a) Discuss the appropriate accounting treatment

(b) Calculate the amounts to be recognised in the financial statements

(c) Prepare the necessary disclosures to be reported in the notes to the financial statements.

Discussion points

Resolving accounting issues – provisions and contingent liabilities

Case Study 1 – SML

What are the issues?

In the preparation of the financial statements for the year ended 31 March 2012, SML's management have three situations to deal with. In each case, students must consider whether a provision should be made, contingent liability disclosed or no action taken:

(i) A property has been newly constructed for SML's own use. The planning permission given requires decommissioning at the end of the property's useful life

(ii) There is an outstanding legal claim against the company, for which lawyers state there is a 25% chance of the claim being decided in favour of the claimant, and

(iii) A business division is to be closed in the next accounting period, for which management wish to recognise a provision.

Which accounting standards should be used?

HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

HKAS 16 *Property, Plant and Equipment*

What are the requirements of the accounting standards?

Definitions

A **provision** is a liability of uncertain timing or amount.

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.

(HKAS 37.10, LP Chapter 11, Section 1.2)

Provisions – recognition, measurement and disclosure

A provision should be recognised as a liability in the financial statements when three criteria have been met:

- 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.

If these conditions are not met, no provision should be recognised.

(HKAS 37.14, LP Chapter 11, Section 2.1)

Obligations may be legal or constructive in nature. A legal obligation is where an entity is legally obliged to incur an outflow of economic benefit. A constructive obligation is where an entity has created a valid expectation that it will incur an outflow of economic benefit through its past actions, published policies or a current statement which indicates that it accepts certain responsibilities.

(HKAS 37.10, LP Chapter 11, Section 2.1.1)

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the year end. Where a single obligation is being measured, the most likely outcome may be the best estimate of the liability.

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.

(HKAS 37.36&46, LP Chapter 11, Section 2.2)

HKAS 37 requires narrative 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.

(HKAS 37.85, LP Chapter 11, Section 2.7)

Restructuring provisions

HKAS 37 deals with restructuring as a specific type of provision, and there are specific recognition criteria and measurement rules for such provisions.

The standard gives examples of the types of events that would fall under the definition of restructuring:

(a) Sale or termination of a line of business;

(b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) Changes in management structure, for example, eliminating a layer of management; and

(d) Fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

(HKAS 37.70, LP Chapter 11 Section 2.6.3)

HKAS 37 states that when a restructuring is identified, a provision can only be recognised where an obligation to restructure has arisen. A constructive obligation occurs only when the entity:

(a) has a detailed formal plan for the restructuring identifying at least:

  (i) the business or part of a business concerned;

  (ii) the principal locations affected;

  (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

  (iv) the expenditures that will be undertaken; and

  (v) when the plan will be implemented; and

(b) 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.

(HKAS 37.72, LP Chapter 11 Section 2.6.3)

When a restructuring provision is recognised, the provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity.

A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period.
Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract.

(HKAS 37.80-82, LP Chapter 11 Section 2.6.3)

Provisions for decommissioning

The cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs when the item is acquired.

(HKAS 16.16, LP Chapter 5, Section 1.4.1)

Contingent liabilities

An entity should not recognise a contingent liability, but they should be disclosed where there is a possible outflow of economic resources.

(HKAS 37.27, LP Chapter 11, Section 3)

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.

(HKAS 37.86, LP Chapter 11, Section 3.1.2)

How to apply the standards to the case

(i) **Factory A**

Recognition of a provision

The planning permission for Factory A requires that at the end of its useful life, the property is decommissioned. The recognition criteria of HKAS 37 must be applied to determine whether a provision should be recognised in respect of this. Where an obligation exists, HKAS 16.16 requires that as well as recognising a provision, SML must capitalise the same amount as part of the cost of the property in the statement of financial position.

Present obligation as a result of a past event

The granting of the planning permission means that SML has a legal obligation to incur the decommissioning costs in the future. The past event is the construction of the property. Therefore at the year end, SML has a present obligation as a result of a past event.

Probable outflow of economic benefit

The costs to be incurred in 30 years' time represent a probable outflow of benefit, as SML will have to pay to decommission the manufacturing plant. The future cash outflow is an outflow of economic benefit.

Reliable measurement

SML has estimated the future decommissioning costs. HKAS 37 states that an estimated value is acceptable as long as it is a best estimate. It is only in rare circumstances that a reliable estimate cannot be made. Therefore, the third criterion has been met and a provision should be recognised.

Measurement of a provision

Example 3 in Appendix C to HKAS 37 makes it clear that where an obligation for restoration or decommissioning arises as a result of the *construction* of a property (rather than as a result of the property's future use) then the decommissioning or restoration provision made at the time of construction (and added to the cost of the asset) is for the full estimated future cost of decommissioning or restoration. In other words, the provision does not gradually accrue over the life of the property.

Additionally, the standard requires that provisions are measured at present value where the time value of money is significant. In this case, because the provision relates to a cash flow 30 years in the future, the time value is significant, and the provision should be measured at the present value of HK$10 million.

Accounting entry

The estimated decommissioning cost is measured at fair value and recognised as a non-current liability. The other side of the accounting entry is to capitalise the decommissioning cost as part of the cost of the plant, and is therefore recognised as a non-current asset.

DEBIT	Non-current assets	HK$10 million	
CREDIT	Non-current liabilities		HK$10 million

(ii) **Legal claim**

Again, the recognition criteria of HKAS 37 should be applied to determine whether a provision needs to be recognised:

Present obligation as a result of a past event

SML has received a claim for damages arising from an event that happened during the accounting period. This means that there is a past event giving rise to a legal obligation.

Probable outflow of economic benefit

SML's lawyers consider that there is only a 25% probability of SML losing the court case and having to pay the damages. Therefore this is not a probable outflow of economic benefit, and the second recognition criterion has not been met.

HKAS 37 states that a **possible outflow** of economic benefit gives rise to a contingent liability, and a 25% probability should be considered as a possible future cash outflow. The claim is therefore a contingent liability.

Contingent liabilities are not recognised in the statement of financial position. However, HKAS 37 requires that a note is provided to the financial statements, in which the details of the contingent liability and an estimate of its possible financial effect should be disclosed.

(iii) **Closure of a division**

The closure of a division falls under the definition of a restructuring activity according to HKAS 37, which gives the "Sale or termination of a line of business" as an example of a restructuring activity.

Recognition of a provision

HKAS 37 requires that for a restructuring provision to be recognised, there must be a detailed formal plan in place, and that a valid expectation has been created before the year end.

SML does have a formal plan in place, which has been approved by the directors, and the plan was announced before the year end. Therefore, the recognition criteria have been met, and a provision for the costs of closure should be recognised in the financial statements.

Measurement of the provision

HKAS 37 states that the only costs that may be included in a restructuring provision are those that are necessarily entailed by the restructuring; and are not associated with the ongoing activities of the entity.

Consulting fees to identify future strategy cannot be provided for, as these fees are associated with the ongoing activities of the entity.

Retraining of the remaining staff is associated with the ongoing activities of the entity. These costs therefore may not be provided for. They will be expensed as they are incurred.

Voluntary redundancy costs are necessarily entailed by the restructuring, and because the staff are being made redundant, they are not associated with ongoing activities. Therefore, the HK$8 million costs of voluntary redundancy should be included in the provision.

Future identifiable losses up to the date of the closure cannot be provided for. HKAS 37 contains the recognition criteria that there must be a past event in order to recognise a provision. Clearly, future losses do not arise from a past event, so these losses cannot be provided for.

Accounting entry

Only the voluntary redundancy costs can be provided for:

DEBIT	Operating expenses	HK$8 million	
CREDIT	Provisions (current liabilities)		HK$8 million

Recommendation / Justification

SML's statement of financial position includes:

Non-current liabilities	*HK$000*
Provisions (Factory A)	10,000
Current liabilities	
Provisions (Costs of closure)	8,000

SML's statement of comprehensive income includes:

Operating expenses includes costs of closure	8,000

The notes to the financial statements should include the following disclosure notes:

Provisions

Factory A

A provision is recognised in respect of the future decommissioning of SML's newly constructed manufacturing plant. The cash outflow in respect of this provision is not expected to be incurred until 30 years' time. The provision is measured at present value of HK$10 million. The undiscounted amount is HK$35 million.

The key uncertainties affecting this provision are the amount of the costs to be incurred in 30 years' time, and the discount factor that is used to measure the provision at present value.

Costs of closure

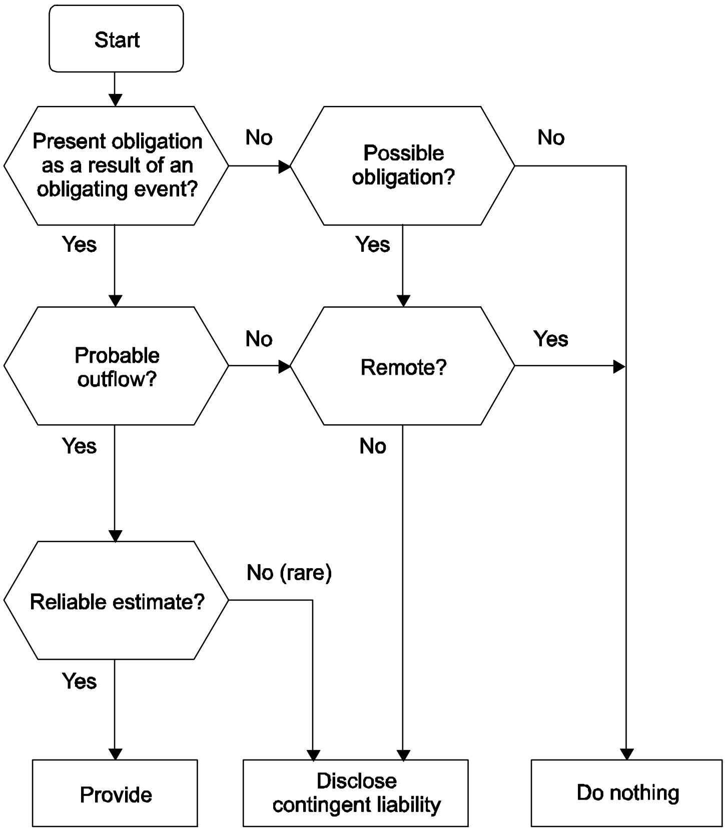
The costs that have been provided are in respect of voluntary redundancy costs associated with the closure of a business division. The costs will be incurred in the next accounting period when the division is due to be closed.

There are no key uncertainties in respect of this provision.

Contingent liability

SML is currently facing a legal claim, and having taken legal advice, it is considered that the legal claim gives rise to a possible, but not a probable, future cash outflow. The amount that has been claimed is HK$5 million.

HKAS 37 Key Learning Points



Resolving accounting issues

Case study 2

Motormouth Manufacturing Limited ('MML') manufactures and sells auto parts from its production facility in Hong Kong.

In recent years the company has identified a surge in worldwide consumer demand for hybrid and fuel efficient vehicles, and in response, it is currently implementing an expansion strategy in order to improve its presence in the components market for such vehicles.

As part of this strategy, MML acquired a new manufacturing machine by way of a lease agreement on 1 April 2011. The fair value of the machine acquired was HK$750,000 and the useful life of the machine to MML was assessed to be seven years at this date. The terms of the lease agreement require the payment of an initial deposit of HK$53,160 and six annual payments in arrears of HK$160,000, with the first payment being on 31 March 2012. At the end of the lease term, MML has the option to extend the arrangement for a further two years at a cost of HK$20,000 per annum. The company currently anticipates that it will take up the option. The initial costs of setting up the lease amounted to HK$6,000 and the interest rate implicit within it is 10%.

The expansion strategy is to be part-financed through a sale and leaseback agreement whereby MML sold a major item of plant to LLHK Bank on 1 April 2011. The proceeds of the sale were HK$20 million, and this was equal to the fair value of the plant. The plant will be leased back by MML over a five year term; with HK$5.2 million payable annually, starting on 1 April 2011. The agreement contains a clause to transfer title of the plant back to MML at the end of the lease term, at which time the plant is expected to be used by MML further. At 31 March 2011, prior to the sale, the carrying value of the item of plant in MML's financial statements was HK$17 million. The interest rate implicit within the leaseback agreement is 15.15%.

Required:

(a) Consider what types of lease MML has entered into and discuss how the lease arrangement and sale and leaseback agreement should be accounted for.

(b) Calculate amounts to be recognised in the financial statements of MML in the year ended 31 March 2012 in respect of each arrangement.

(c) Draft the relevant disclosures required by HKAS 17, basing these on your pre-workshop research into lease disclosures for listed companies.

Discussion points

Resolving accounting issues – Leases

Case Study 2 – MML

What are the issues?

In the year ended 31 March 2012, MML has entered into two lease arrangements:

1. The acquisition of machinery by way of lease
2. The sale and subsequent leaseback of a major item of plant.

For each of these arrangements, students must:

(a) consider whether the arrangement constitutes an operating or finance lease,

(b) discuss how the arrangement should be accounted for,

(c) calculate amounts to be included in MML's financial statements for the year ended 31 March 2012, and

(d) draft the relevant disclosure requirements.

Which accounting standards should be used?

HKAS 17 *Leases*

What are the requirements of the accounting standards?

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An operating lease is a lease other than a finance lease.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

(HKAS 17.4&8, LP Chapter 9, Section 1.2.1)

Examples of situations which would normally lead to a lease being classified as a finance lease are:

(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 that is expected to be sufficiently lower than the fair value for it to be 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 such a specialised nature that only the lessee can use them without major modifications.

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(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 accrue to the lessee, and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

(HKAS 17.10-11, LP Chapter 9, Section 1.2.2)

Classification is made at the inception of a lease, being the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease.

(HKAS 17.4&13, LP Chapter 9, Section 1.2.3)

At the commencement of a finance lease term, an asset and corresponding liability are recognised in the statement of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease. Any initial direct costs of the lessee are added to the amount recognised as an asset.

(HKAS 17.20, LP Chapter 9, Section 2.2.1)

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease.

(HKAS 17.4, LP Chapter 9, Section 1.3)

The finance lease asset is depreciated over the shorter of the lease term and its useful life.

(HKAS 17.27, LP Chapter 9, Section 2.2.1)

The lease term is 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.

(HKAS 17.25, LP Chapter 9 Section 1.3)

Minimum lease payments are allocated between repayment of the outstanding liability and a finance charge. The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

(HKAS 17.4, LP Chapter 9 Section 2.2.1)

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

(HKAS 17.58, LP Chapter 9 Section 4)

If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount of the asset is recognised as deferred income and released to profit over the lease term.

(HKAS 17.59, LP Chapter 9 Section 4)

The following disclosures are required by HKAS 17:

(a) For each class of asset, the net carrying amount at the end of the reporting period.

(b) A reconciliation between the total of future minimum lease payments at the end of the reporting period and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the end of the reporting period and their present value, 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.

(c) A general description of the lessee's material leasing arrangements including the existence and terms of renewal options.

(HKAS 17.31, LP Chapter 9 Section 2.2.4)

Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions.

(HKAS 17.65, LP Chapter 9 Section 4)

How to apply the standard to the case

Lease arrangement on new machine

The lease arrangement must initially be classified as either an operating or finance lease.

The risks and rewards associated with the arrangement are complicated in the scenario, however two situations cited by HKAS 17 as being indicative of a finance lease can be identified:

(a) The lease term of eight years (six years' initial lease term plus a two-year secondary period) exceeds the seven-year useful life of the machine;

(b) There is a secondary lease term for an amount that is substantially lower than market rental.

Equally, as can be seen in the calculation below, the present value of the minimum lease payments associated with the lease is equal to the fair value of the machine acquired. It should therefore be concluded that the lease is a finance lease.

As the lease is a finance lease, an asset and corresponding liability are initially recognised, measured at the lower of the fair value of the asset and the present value of the minimum lease payments discounted using the rate implicit in the lease:

Present value of minimum lease payments

Date	*Cash flow HK$*	*Discount factor*	*Present value HK$*
1.4.11	53,160	1	53,160
31.3.12	160,000	1/1.1	145,455
31.3.13	160,000	$1/1.1^2$	132,231
31.3.14	160,000	$1/1.1^3$	120,210
31.3.15	160,000	$1/1.1^4$	109,282
31.3.16	160,000	$1/1.1^5$	99,347
31.3.17	160,000	$1/1.1^6$	90,316
			750,001

Therefore the leased asset and liability are initially recognised at fair value of HK$750,000 on 1 April 2011 by (HK$):

DEBIT	PPE: leased machine	750,000	
CREDIT	Finance lease obligation		750,000

The initial deposit paid on 1 April 2011 is recognised as an immediate reduction to the outstanding liability (HK$):

DEBIT	Finance lease obligation	53,160	
CREDIT	Cash		53,160

The finance lease obligation is therefore reduced immediately to HK$696,840 (750,000 – 53,160).

The direct costs of setting up the lease agreement are recognised on 1 April 2011 as part of the initial cost of the asset in accordance with HKAS 17.20 (HK$):

DEBIT	PPE: leased machine	6,000	
CREDIT	Cash		6,000

Depreciation on the machine is calculated for the year ended 31 March 2012 as:

$$\frac{\text{HK\$}(750{,}000 + 6{,}000)}{7 \text{ years}} = \text{HK\$}108{,}000$$

This is recorded by (HK$):

DEBIT	Depreciation expense	108,000	
CREDIT	Accumulated depreciation		108,000

The finance cost for the year and the year end lease liability are calculated using a lease liability table:

Period	*b/f liability*	*Finance cost (10%)*	*c/f total*	*Payment*	*c/f liability*
	HK$	HK$	HK$	HK$	HK$
y/e 31 March 2012	696,840	69,684	766,524	(160,000)	606,524
y/e 31 March 2013	606,524	60,652	667,176	(160,000)	507,176
y/e 31 March 2014	507,176	50,718	557,894	(160,000)	397,894
y/e 31 March 2015	397,894	39,789	437,683	(160,000)	277,683
y/e 31 March 2016	277,683	27,768	305,451	(160,000)	145,451
y/e 31 March 2017	145,451	14,549*	160,000	(160,000)	-
		263,160			

*difference due to rounding

For the year ended 31 March 2012 the finance cost for the period is recorded by (HK$):

DEBIT	Finance cost	69,684	
CREDIT	Finance lease obligation		69,684

The payment of HK$160,000 is recorded by (HK$):

DEBIT	Finance lease obligation	160,000	
CREDIT	Cash		160,000

The year end lease obligation is HK$606,524, however in accordance with the requirements of HKAS 1 this must be split between current and non-current liabilities:

	HK$
Finance lease obligation – current (160,000 – 60,652)	99,348
Finance lease obligation – non-current (from table)	507,176

Sale and leaseback

Again, in the first instance the lease must be classified as either an operating or finance arrangement. In this case, the fact that the lease agreement contains a clause to transfer title of the plant back to MML at the end of the lease term is a clear indicator that this is a sale and finance leaseback.

Therefore, on 1 April 2011, proceeds should be recorded, the plant should be derecognised and the profit on disposal recognised as deferred income (HK$):

DEBIT	Cash	20,000,000	
CREDIT	PPE: plant		17,000,000
CREDIT	Deferred income		3,000,000

On this date, an asset and finance lease obligation are also recognised (HK$):

DEBIT	PPE: leased plant	20,000,000	
CREDIT	Finance lease obligation		20,000,000

During the year ended 31 March 2012:

1. The deferred income is released to profit on a straight line basis, therefore HK$300,000 per annum (HK$3m/5 years) (HK$):

DEBIT	Deferred income	600,000	
CREDIT	Income		600,000

2. The asset is depreciated over the shorter of the lease term (5 years) and its useful life, therefore HK$4,000,000 (HK$20m/5 years) (HK$):

DEBIT	Depreciation charge	4,000,000	
CREDIT	Accumulated depreciation		4,000,000

3. Interest arises on the finance lease obligation, calculated using a finance lease liability table as follows:

Period	*b/f liability*	*Payment*	*b/f total*	*Finance cost* (15.15%)	*c/f liability*
	HK$	HK$	HK$	HK$	HK$
y/e 31 March 2012	20,000,000	(5.200,000)	14,800,000	2,242,000	17,042,000
y/e 31 March 2013	17,042,000	(5.200,000)	11,842,000	1,794,063	13,636,063
y/e 31 March 2014	13,636,063	(5.200,000)	8,436,063	1,278,064	9,714,127
y/e 31 March 2015	9,714,127	(5.200,000)	4,514,126	685,873*	5,198,016
y/e 31 March 2016	5,198,016	(5.200,000)*	-	-	-
				6,000,000	

* difference due to rounding

The payment in the year is recorded by (HK$):

DEBIT	Finance lease obligation	5,200,000	
CREDIT	Cash		5,200,000

The finance cost in 2012 is recorded by (HK$):

DEBIT	Finance cost	2,242,000	
CREDIT	Finance lease obligation		2,242,000

As before, in accordance with HKAS 1, the year end finance lease obligation of HK$17,042,000 is split between current and non-current liabilities:

	HK$
Finance lease obligation – current	5,200,000
Finance lease obligation – non-current	11,842,000

Recommendation / Justification

Statement of financial position for MML as at 31 March 2012

	HK$
Property, plant and equipment	
Leased plant and machinery	
(750,000 + 6,000 – 108,000) + (20,000,000 – 4,000,000)	16,648,000
Non-current liabilities	
Finance lease obligation (507,176 + 11,842,000)	12,349,176
Current liabilities	
Finance lease obligation (99,348 + 5,200,000)	5,299,348

Statement of comprehensive income for MML for the year ended 31 March 2012

	HK$
Depreciation of leased assets (108,000 + 4,000,000)	4,108,000
Finance cost (69,684 + 2,242,000)	2,311,684
Release of deferred income	(600,000)

Notes to the accounts

1. Obligations under finance leases

Amounts payable under finance leases	*Minimum lease payments* HK$	*Present value of minimum lease payments* HK$
Within one year (160,000 + 5.200,000) / (99,348+ 5,200,000)	5,360,000	5,299,348
In the second to fifth years inclusive (640,000 + 15,600,000)/ (507,176+11,842,000)	16,240,000	12,349,176
After five years	–	–
	21,600,000	17,648,524
Less: future finance costs (263,160 – 69,684) + (6,000,000 – 2,242,000)	(3,951,476)	n/a
Present value of lease obligations	17,648,524	17,648,524
Amount due for settlement within 12 months		(5,299,348)
Amount due for settlement in more than 12 months		12,349,176

2. Significant leasing arrangements

It is the company policy to lease certain of its machinery under finance leases. These typically run for an average initial period of six years, however in certain cases may be extended by a further two years for nominal payment. All leases are on a fixed repayment basis and no arrangements have been entered into for contingent rental payments.

All lease obligations are denominated in HK$.

The fair value of the company's lease obligations is approximately equal to their carrying amount.

Student Notes

Key Learning Points

1. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. HKAS 17 provides examples of particular situations which are indicative of a finance lease.
2. In the case of a finance lease, an asset and corresponding liability are initially recognised, measured at the lower of the fair value of the asset and the present value of the minimum lease payments discounted using the rate implicit in the lease.
3. Any direct costs of setting up the lease agreement are recognised as part of the initial cost of the asset; any deposit paid is deducted from the initial measurement of the liability.
4. The leased asset is depreciated over the shorter of the useful life and the lease term, including any secondary period.
5. The lease liability is amortised by applying the interest rate implicit within the lease; lease repayments include an element of capital each year and an element of finance cost.
6. In the case of a sale and finance leaseback, disposal proceeds should be recorded, the plant should be derecognised and the profit on disposal recognised as deferred income. The deferred income is released to profit on a straight line basis over the lease term. The asset leased back is recognised in accordance with the basic HKAS 17 recognition and measurement principles.
7. HKAS 17 requires the disclosure of the finance lease obligation split into amounts payable within one year, in the second to fifth years and beyond five years. This information should be presented on a gross and net basis i.e. inclusive of finance costs and exclusive of finance costs.

Resolving accounting issues

Case study 3

Sutcliffe Thomson Ling ('STL') is a listed Hong-Kong based manufacturer of fashion garments. It had 7 million ordinary shares in issue at 1 October 2008 and these have a nominal value of HK$50 each. The share premium account on 1 October 2008 amounted to HK$100m. No issues of shares have arisen since 2008 other than those associated with the company's share option schemes. It operates two share option schemes for the benefit of key employees as part of their remuneration package. Details of the schemes are as follows:

Scheme 1

On 1 October 2008, STL granted 1,000 options to each of 200 key employees. The options vest on 30 September 2011 on the condition that the workers continue to be employed by STL on this date and the share price of STL increases at 20% per annum compound over the three year period to vesting. The options can be exercised any time between the vesting date and 30 September 2012.

Period	Number of employees who left in period	Estimated number of employees who will leave before vesting	Share price movement (compound annual movement since 1 October 2008)
y/e 31.3.09	10	15	↑ 18%
y/e 31.3.10	5	12	↑ 19%
y/e 31.3.11	7	8	↑ 22%
6m/e 30.9.11	6	-	↑ 21%

On 1 October 2008 the fair value of each option was estimated to be HK$72, taking into account the estimated probability that the necessary share price growth would be achieved.

By 31 March 2012, none of the employees had exercised their vested share options.

Scheme 2

On 1 April 2009, STL granted 5,000 options to each of the five directors of the company when the average quoted market price of one share was HK$120. Half of these vest on 31 March 2011 and half on 31 March 2012 on the condition that the directors continue to be employed by STL on the relevant vesting date. The options may be exercised as soon as they vest or at any stage during the 12 month period thereafter.

It was expected that all of the directors would continue to be employed to 31 March 2012, however on 30 November 2010, 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 April 2009, the fair value of each option was estimated to be HK$65.

STL accumulates charges in relation to equity-settled share-based payments in a share-based payment reserve.

In both schemes, the options are exercisable at a price equal to the average quoted market price of the company's shares on the date of grant.

Required:

(a) Discuss the accounting treatment of share options issued by a company.

(b) Calculate amounts to be recognised in the financial statements of STL in respect of the share options in the years ended 31 March 2009, 2010, 2011 and 2012.

(c) Draft the relevant disclosures required by HKFRS 2 in respect of the share-based payment arrangements.

Note:

You are not required to provide disclosures in relation to weighted average exercise price or how fair value of the options is established.

Discussion points

Resolving accounting issues – Share based payments

Case Study 3 – STL

What are the issues?

STL has two share option schemes:

Scheme 1 1,000 options have been granted to each of 200 key employees. These vest three years after issue, on 30 September 2011, dependent upon the individuals continuing to be employed by STL and the share price of the company increasing at 20% per annum compound over the three years to vesting.

Scheme 2 5,000 options have been granted to each of the five directors of STL. Half of these vest two years after issue on 31 March 2011, and half three years after issue on 31 March 2012, conditional upon the directors continuing to be employed by the company on these dates.

For each of these schemes, students must:

(a) consider how the share option scheme should be accounted for,

(b) calculate amounts to be included in STL's financial statements for the years ended 31 March 2009 to 2012, and

(c) draft the relevant disclosure requirements of HKFRS 2.

Which accounting standards should be used?

HKFRS 2 *Share-Based Payment*

What are the requirements of the accounting standards?

Goods and services received in a share-based payment transaction must be recognised when they are received. Unless they qualify for recognition as an asset, they are recognised as an expense. There is a corresponding increase in equity if the share-based payment transaction is equity-settled.

(HKFRS 2.7-8, LP Chapter 13, Section 2)

An equity-settled share-based payment transaction is one in which an entity receives goods or services as consideration for its own equity instruments or share options.

(HKFRS 2 Appendix A, LP Chapter 13, Section 1.3)

The asset or expense and increase to equity are measured at the fair value of the goods or services received. If this cannot be estimated reliably, which is normally the case in respect of employee services provided, they are measured by reference to the fair value on the grant date of the equity instruments granted.

(HKFRS 2.10-11, LP Chapter 13, Section 2.1)

If the equity instruments granted do not vest until the employee (or other counterparty) completes a specified period of service, the associated expense is recognised over the vesting period. For example, if an employee is granted share options conditional upon the completion of three years' service, then the expense associated with the options is recognised over the three year vesting period.

(HKFRS 2.15, LP Chapter 13, Section 2.1.3)

Vesting conditions are the conditions that determine whether an entity receives the services that entitle the counterparty to receive equity instruments (or assets) of the entity. They are either service conditions in which the counterparty is required to complete a specified period of service, or performance conditions, which require specified performance targets to be met. Performance conditions which are related to the market price of an entity's shares are market conditions.

(HKFRS 2 Appendix A, LP Chapter 13, Section 1.3)

Non-market vesting conditions are not taken into account when estimating the fair value of shares or share options at the measurement date (grant date). Instead, such vesting conditions are taken into account by adjusting the number of share options included in the measurement of the transaction so that only those expected to vest are included. This estimate should be revised as necessary at each reporting date and again on the vesting date.

(HKFRS 2.19-20, LP Chapter 13, Section 2.1.3)

Market vesting conditions such as a target share price are taken into account when estimating the fair value of equity instruments granted. Therefore, the number of share options expected to vest is not adjusted for such vesting conditions.

(HKFRS 2.21, LP Chapter 13, Section 2.1.3)

After the vesting date, no subsequent adjustment to equity is required if the share options are not exercised. However an entity may recognise a transfer from one component of equity to another.

(HKFRS 2.23, LP Chapter 13, Section 2.1.3)

The following should be disclosed in respect of share options:

1. A description of each type of share-based payment arrangement that existed at any time in the period, including general terms and conditions such as vesting requirements, maximum term of options granted and method of settlement.
2. The number and weighted average exercise prices of share options:
   (a) outstanding at the start of the period
   (b) granted in the period
   (c) forfeited in the period
   (d) exercised in the period
   (e) expired in the period
   (f) outstanding at the end of the period
   (g) exercisable at the end of the period.

3. For share options exercised in the period, the weighted average share price at the date of exercise.

4. For share options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life.

(HKFRS 2.45, LP Chapter 13, Section 4.1)

An entity shall disclose information that enables users of the financial statements to understand how the fair value of the equity instruments granted during the period was determined.

(HKFRS 2.46, LP Chapter 13, Section 4.2)

An entity must also disclose the total expense recognised for the period arising from share-based payment transactions including separate disclosure of the expense arising from equity-settled share-based payment transactions.

(HKFRS 2.51, LP Chapter 13, Section 4.3)

How to apply the standard to the case

Scheme 1

The scheme 1 options granted have both market and non-market vesting conditions attached to them.

The market vesting condition is the requirement for a 20% per annum compound share price increase and the non-market vesting condition is the requirement for an individual to be employed by STL on the vesting date.

In accordance with HKFRS 2.21, the **market-based** vesting condition is not used in the apportionment of amounts to be charged to profit or loss in each year of the vesting period. The probability of STL attaining the required increase in share price is already incorporated in the fair value of the option at the grant date, as provided in the question.

The **non-market based** vesting condition must, however be taken into account when calculating the number of shares expected to vest, and the charge to profit or loss:

Y/e 31 March	*Options expected to vest*	*FV of option HK$*			*Charge to profit or loss HK$*
2009	1,000 × (200 - 10 - 15)				
	= 175,000	× 72	= 12,600,000	× 6m/36m	2,100,000
2010	1,000 × (200 - 10 - 5 - 12)				
	= 173,000	× 72	= 12,456,000	× 18m/36m	6,228,000
					(2,100,000)
					4,128,000
2011	1,000 × (200 - 10 - 5 - 7 - 8)				
	= 170,000	× 72	= 12,240,000	× 30m/36m	10,200,000
					(6,228,000)
					3,972,000
2012	1,000 × (200 - 10 - 5 - 7 - 6)				
	= 172,000	× 72	= 12,384,000		12,384,000
					(10,200,000)
					2,184,000

The expense is recognised by (HK$):

2009	DEBIT	Wages and salaries	2,100,000	
	CREDIT	Share-based payment reserve		2,100,000
2010	DEBIT	Wages and salaries	4,128,000	
	CREDIT	Share-based payment reserve		4,128,000
2011	DEBIT	Wages and salaries	3,972,000	
	CREDIT	Share-based payment reserve		3,972,000
2012	DEBIT	Wages and salaries	2,184,000	
	CREDIT	Share-based payment reserve		2,184,000

At the vesting date of 30 September 2011, the share-based payment reserve in respect of the employee share scheme therefore had a balance of HK$12,384,000.

By 31 March 2012, none of the members of the scheme had exercised their options, however they still may do so in the period to 30 September 2012. Therefore the balance on the share-based payment reserve is retained.

Scheme 2

Scheme 2 has two different vesting dates, and therefore the 2,500 options relating to each vesting date should be accounted for separately:

Options vesting in 2011

Y/e 31 March	*Options expected to vest*	*FV of option HK$*			*Charge to profit or loss HK$*
2010	2,500 × 5 = 12,500	× 65	= 812,500	× 1yr/2yrs	406,250
2011	2,500 × 4 = 10,000	× 65	= 650,000		650,000
					(406,250)
					243,750

Options vesting in 2012

Y/e 31 March	*Options expected to vest*	*FV of option HK$*			*Charge to profit or loss HK$*
2010	2,500 × 5 = 12,500	× 65	= 812,500	× 1yr/3yrs	270,833
2011	2,500 × 4 = 10,000	× 65	= 650,000	× 2yrs/3yrs	433,333
					(270,833)
					162,500
2012	2,500 × 4 = 10,000	× 65	= 650,000		650,000
					(433,333)
					216,667

The expense in relation to scheme 2 is recognised by (HK$):

2010	DEBIT	Directors' remuneration (406,250 + 270,833)	677,083	
	CREDIT	Share-based payment reserve		677,083
2011	DEBIT	Directors' remuneration (243,750 + 162,500)	406,250	
	CREDIT	Share-based payment reserve		406,250
2012	DEBIT	Directors' remuneration	216,667	
	CREDIT	Share-based payment reserve		216,667

When the options vest, and new shares are issued to the four directors remaining in employment, the share-based payment reserve is transferred to share capital and share premium.

At 31 March 2011, the first vesting date, 10,000 options are exercised and therefore 10,000 new shares are issued (4 directors × 2,500 options) for a total of HK$1.2 million (10,000 × $120). The entry to record this is (HK$):

DEBIT	Cash	1,200,000	
DEBIT	Share-based payment reserve	650,000	
CREDIT	Share capital (10,000 × HK$50)		500,000
CREDIT	Share premium		1,350,000

At 31 March 2012, the second vesting date, a further 10,000 options are exercised for a total of HK$1.2 million and shares issued. The entry to record this is (HK$):

DEBIT	Cash	1,200,000	
DEBIT	Share-based payment reserve	650,000	
CREDIT	Share capital (10,000 × HK$50)		500,000
CREDIT	Share premium		1,350,000

Recommendation / Justification

Statement of financial position for STL as at 31 March

	2009	*2010*	*2011*	*2012*
	HK$000	*HK$000*	*HK$000*	*HK$000*
Equity and liabilities				
Share capital	350,000	350,000	350,500	351,000
Share premium	100,000	100,000	101,350	102,700
Share based payment reserve	2,100			
(2,100,000 + 4,128,000 + 406,250 + 270,833)		6,905.083		
(6,905,083 + 3,972,000 + 243,750 + 162,500 – 650,000)			10,633.333	
(10,633,333 + 2,184,000 + 216,667 - 650,000)				12,384

Statement of comprehensive income for STL for the years ended 31 March

	2009	*2010*	*2011*	*2012*
	HK$	*HK$*	*HK$*	*HK$*
Directors' remuneration – equity-settled share-based payments	-	677,083	406,250	216,667
Wages and salaries – equity-settled share-based payments	2,100,000	4,128,000	3,972,000	2,184,000

Notes to the accounts

1. Equity-settled share option schemes

STL has two share option schemes: one for key employees of the company and another for directors of the company. Options are exercisable at a price equal to the average quoted market price of the company's shares on the grant date. The vesting period is three years in the case of the key employee scheme. In respect of the directors' share option scheme, an equal number of shares vest after two and three years. If the options remain unexercised after a period of 12 months from the vesting date, the options expire. Options are forfeited if the employee leaves the company before the options vest. Details of the share options outstanding are as follows:

Scheme 1

31 March	*2009*	*2010*	*2011*	*2012*
	No	*No*	*No*	*No*
Outstanding at beginning of period	-	190,000	185,000	178,000
Granted during the period	200,000	-	-	-
Forfeited during the period	(10,000)	(5,000)	(7,000)	(6,000)
Exercised during the period	-	-	-	-
Expired during the period	-	-	-	-
Outstanding at the end of the period	190,000	185,000	178,000	172,000
Exercisable at the end of the period	-	-	-	172,000

Scheme 2

31 March	*2010*	*2011*	*2012*
	No	*No*	*No*
Outstanding at beginning of period	-	25,000	10,000
Granted during the period	25,000	-	-
Forfeited during the period	-	(5,000)	-
Exercised during the period	-	(10,000)	(10,000)
Expired during the period	-	-	-
Outstanding at the end of the period	25,000	10,000	-
Exercisable at the end of the period	-	-	-

Key Learning Points

1. Where share options are issued as part of an employee's remuneration package, an expense must be recognised in profit or loss in the same way that it is where salary is paid. The corresponding credit is made to equity.

2. Where the options vest over an extended period of time (the vesting period), the expense is recognised over the vesting period.

3. The total expense recognised over the vesting period is equal to the fair value of share options issued on the grant date and which are expected to vest.

4. Non-market conditions are taken into account when considering how many options will vest; market conditions e.g. conditions related to share price are not.

5. On exercise of the share options, cash proceeds are recognised and any share option equity reserve is eliminated; the corresponding credit is to share capital and share premium.

6. If options are not exercised and lapse, the balance on any share option equity reserve may be transferred to another reserve, although HKFRS 2 does not specify which.