

Workshop Outline and Learning Methodologies

| Session | Methodologies | Chapters covered | Guidance Notes |
|--------------------------------|---|-------------------------|---|
| Workshop 1 | | | |
| 1. Introduction | <ul style="list-style-type: none">• Presentation• Group discussion | | |
| 2. Property related standards | <ul style="list-style-type: none">• Case study• Group discussion | Ch. 3, 4, 5, 7 & 16 | Pg. 1 – 18 |
| 3. Resolving accounting issues | <ul style="list-style-type: none">• Case study• Group discussion | Ch. 7, 9, 10 & 12 | Pg. 19 – 29 |
| 4. Wrap up | <ul style="list-style-type: none">• Presentation• Group discussion | | |
| Workshop 2 | | | |
| 5. Reboot | <ul style="list-style-type: none">• Presentation• Group discussion | | To be released in 2 nd batch |
| 6. Financial Instrument | <ul style="list-style-type: none">• Case study• Group discussion | Ch. 17 | |
| 7. Consolidation | <ul style="list-style-type: none">• Case study• Group discussion | Ch. 14, 20, 27, 28 & 29 | |
| 8. Leading a team and teamwork | <ul style="list-style-type: none">• Group discussion | | |
| 9. Conclusion | <ul style="list-style-type: none">• Presentation• Group discussion | | |

Property related standards – recognition

Case study 1 - Investment Property Development Limited

Investment Property Development Limited (IPDL) is a company which acquires and develops significant properties. Some properties are operated by IPDL, others are rented out. It holds a diversified property portfolio, including hotels, office buildings, and leisure centres. The financial year end of IPDL is 30 June. Details of one of the properties are shown below.

Pacific Hotel Complex (PHC) is a large complex, including a 30-floor hotel, and two commercial buildings, namely Building A and Building B.

IPDL intends to operate the hotel, anticipating it will generate a high level of operating cash inflows. Building A will be rented out to commercial customers and earn rental income. Building B is customary for floors of an office building to be sold or lease separately. Under current plan, the whole building is leased to a subsidiary of IPDL, except for top floor of Building B. The top floor is a penthouse apartment, which will be rented to the chairman of IPDL for a nominal rent of HK\$1,000 per month.

Required

For each component of PHC, from the perspective of IPDL, you should:

- advise which accounting standards to be applied;
- advise the nature of different types of properties; and
- list the recognition/ derecognition criteria in accordance with the relevant HKFRSs.

Discussion points

What are the issues?

PHC contains a number of components. How should each component of PHC be accounted for in the financial statements if IPDL intended to:

- (a) operate the hotel by itself
- (b) rent out commercial building A to commercial customers
- (c) rent out commercial building B to a subsidiary and rent out the top floor to chairman of IPDL

Any different accounting treatments for the portion leased to subsidiary and Chairman in separate financial statement level and consolidated financial statement level of IPDL?

Which accounting standard(s) should be used?

HKAS 16: Property, plant and equipment

HKAS 40: Investment property

What are the requirements of the accounting standard(s)?

HKAS 16

The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

- (a) it is probable that future economic benefits associated with the item will flow to the entity;
and
- (b) the cost of the item can be measured reliably.

[HKAS 16.7 LP Ch.4 Section 2.3]

HKAS 40

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; or
- (b) sale in the ordinary course of business.

Only properties or components of properties meeting this definition should be treated as Investment Property.

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property.

[HKAS 40.5 LP Ch.5 Section 1.1]

How to apply the standard(s) to the case?

It is necessary to consider the separate components of PHC to see if each meets the definition of an investment property or owner-occupied property.

Hotel

The hotel component is being operated by IPDL. This means that the hotel is owner-occupied, and is being used in the supply of goods and services to generate operating income.

Referring to HKAS 40.12, it states that, in other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

Hence, the hotel is not investment property and should be recognised as Property, Plant and Equipment and accounted for under HKAS 16.

[HKAS 40.12]

Commercial Building A

Building A meets the definition of an investment property as it is held to earn rentals.

Commercial Building B

HKAS 40.10 states: "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."

The Case Study states that it is customary for floors of an office building to be sold or leased separately. Therefore, each portion (i.e. floor) of the building should be considered separately to determine whether it meets the definition of investment property.

Floors leased to a subsidiary

In the separate financial statement of IPDL, same as Building A, it meets the definition of an investment property as it is held to earn rentals. In IPDL, the whole building, except for top floor, are leased to a separate entity, and are not owner-occupied, so it meet the definition of an investment property, and should be accounted for under HKAS 40.

However, it will have a different accounting treatment in the consolidated financial statement level.

In the consolidated financial statements, the rented floors should be classified as property, plant and equipment and accounted for under HKAS 16. This is because from the group's point of view, it should be considered as a whole and the property should be classified as owner-occupied, assuming that the subsidiary occupied by their own without sub-leased to outsiders.

[HKAS 40.15 LP Ch.5 Section 1.1(f)]

Top floor apartment rented to the Chairman

The top floor apartment is rented to the Chairman, so is not occupied by the company. It meets the definition of an investment property as this floor is held to earn rentals. However, HKAS 40.9 provided an example that property occupied by employees, whether or not the employees pay rent at market rates, should be considered as owner-occupied. Hence, the top floor apartment should be treated as property, plant and equipment.

[HKAS 40.9(c) LP Ch.5 P. 102 (d)<iii>]

Recommendation/ justification

In separate financial statements, Hotel and top floor of Building B will be treated as property, plant and equipment. Building A and Building B (except for the top floor) should be treated as investment property.

In consolidated financial statements, Building B (except for the top floor) occupied by subsidiary should be reclassified and recognized as property, plant and equipment.

Property related standards – measurement

Additional information for case study 1

Before start to rent out Building A, IPDL redeveloped an insignificant portion. On 1 July 2009, IPDL contracted for the construction at a fixed cost of HK\$ 40 million. Construction activities commenced immediately on 1 July 2009.

Payments to the contractor made as follows:

| | <i>Amount</i> |
|-----------------|---------------|
| Payment date | HK\$'000 |
| 1 July 2009 | 10,000 |
| 1 November 2009 | 13,000 |
| 1 February 2010 | 9,000 |
| 30 June 2010 | <u>8,000</u> |
| | <u>40,000</u> |

In order to finance the construction and ordinary business, IPDL arranged borrowings during the year as follows:

- (a) 5% HK\$ 20 million 4-year loan note with simple interest payable annually, which relates specifically to the construction. The HK\$ 20 million was put on deposit before payments were made to the contractor, during which time interest income of HK\$ 250,000 was earned.
- (b) 7.5% HK\$ 10 million 15-year loan note which is part of a pool of general borrowings, on which simple interest is payable annually, and the amount of capital remained unchanged during the year.
- (c) 10% HK\$ 20 million 4-year loan note which is part of a pool of general borrowings, on which simple interest is payable annually, and the amount of capital remained unchanged during the year.

The construction activities have been suspended for four weeks due to flooding which is unfortunately a common occurrence in the geographical area in which the construction is taking place and completed on 30 June 2010.

During the year, all borrowing costs incurred have been charged to profit or loss as finance charges.

Required

Advise management how it should account for the borrowing costs for the year ended 30 June 2010, and calculate the amount of borrowing costs to be capitalised as part of the cost of the Building A.

Discussion points

What are the issues?

IPDL is incurring borrowing costs on the redevelopment of Building A.

- (a) Are the borrowing costs eligible for capitalisation?
- (b) Any different treatment for borrowing cost arising from specific borrowings and general borrowings?
- (c) The construction suspended for four weeks, is it required to suspend for capitalisation for borrowing cost during the period?
- (d) How much of the borrowing costs should be capitalised as part of the cost of the Building A?

Which accounting standard(s) should be used?

HKAS 23 (Revised): Borrowing costs

What are the requirements of the accounting standard(s)?

HKAS 23 (Revised) requires capitalisation of borrowing costs attributable to the acquisition, construction or production of a qualifying assets form part of the cost of the asset. Borrowing costs are defined as 'interest and other costs that an entity incurs in connection with the borrowing of funds'.

[HKAS 23.1&5 LP Ch16 Section 1.1]

Borrowing costs are widely defined, and include interest on overdrafts and loans, amortisation of discounts, premiums and ancillary costs related to borrowings, and exchange differences on foreign currency borrowings.

[HKAS 23.6 LP Ch 16 Section 1.1.1]

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

[HKAS 23.5 LP Ch 16 Section 1.1.2]

Both borrowings specific to a qualifying asset, and general borrowings are eligible for capitalisation. If borrowing is specifically associated with expenditure on constructing an asset, the amount of borrowing cost that can be capitalised is limited to the actual borrowing costs incurred, less any investment income received if those borrowings have yielded interest when held on deposit.

[HKAS 23.12 LP Ch16 Section 1.2.1]

For general borrowings, the amount of borrowing costs eligible for capitalisation is determined by applying a capitalisation rate to the expenditure on the asset. Expenditure on the asset must be firstly allocated to specific borrowings, and only the remainder of expenditure after that initial allocation can be used to determine the amount of general borrowing costs that can be capitalised.

[HKAS 23.14 LP Ch16 Section 1.2.1]

The capitalisation rate for general borrowings is the weighted average of the borrowing rates applicable to the borrowings of the entity that are outstanding during the period.

The amount of borrowing costs capitalised during a period must not exceed the amount of borrowing costs incurred during that period.

HKAS 23 (Revised) also provides detailed rules on the period during which borrowing costs should be capitalised. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

- (i) it incurs expenditures for the asset;
- (ii) it incurs borrowing costs; and
- (iii) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

[HKAS 23.17 LP Ch 16 Section 1.2.3]

Capitalisation of borrowing costs shall be suspended during extended periods in which active development is interrupted.

[HKAS 23.20 LP Ch 16 Section 1.2.4]

Capitalisation of borrowing costs must cease when substantially all the activities necessary to prepare the asset for its intended use or sale are complete.

[HKAS 23.22 LP Ch 16 Section 1.2.5]

How to apply the standard(s) to the case?

The Building A redeveloped by IPDL meets the definition of a qualifying asset as its construction takes a considerable time.

The activities necessary to prepare the asset, i.e. the construction work, commence on 1 July 2009, the same date as expenditures for the asset begin to be incurred, triggering the commencement of the period during which borrowing costs should be capitalised. Where borrowing had been taken out before this date, the costs of those borrowings must not be capitalised into the cost of the asset.

Delay cause by flooding

Judgment needs to be exercised to consider if the four weeks delay caused by flooding represents sufficient cause to suspend capitalisation during that period. Capitalisation should not cease due to a temporary delay, if the cause of the cessation of activities is normal. In this case, it seems that flooding is a common occurrence, not an unusual reason for an interruption of construction activities, and so borrowing costs should continue to be capitalised during that period.

[HKAS 23.21]

Specific borrowings

Borrowing costs eligible for capitalisation on specific borrowings are the actual costs incurred. In this case the interest cost of the specific borrowing is calculated using the interest rate specific to the loan of 5%. Any interest earned on specific borrowings taken out and then put on deposit should be deducted in calculating the amount of borrowing costs to be capitalised, per HKAS 23.12: "To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity should determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings."

General borrowings

When considering borrowing costs eligible for capitalisation on general borrowings, the actual expenditure on the asset should be considered, with actual expenditure allocated first to specific borrowings, per HKAS 23.14: "To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset."

Total borrowing costs incurred:

| Loan type | Use of the loan | | HK\$'000 |
|-------------------------|-------------------------------------|----------------|--------------|
| 5% \$20m 4-year loan | Specific to Building A construction | (5% x \$20m) | 1,000 |
| 7.5% \$10m 15-year loan | General | (7.5% x \$10m) | 750 |
| 10% \$20m 4-year loan | General | (10% x \$20m) | 2,000 |
| | | | <u>3,750</u> |

Borrowing costs to be capitalised:

| | HK\$'000 |
|---|--------------|
| Borrowing costs on specific loan (5% × HK\$ 20 million) | 1,000 |
| Less: interest income on specific borrowings | (250) |
| General borrowings (5,750 [W1] × 9.17% [W2]) | 527 |
| | <u>1,277</u> |

[W1] *Weighted average general borrowings applied to the construction*

| Date of expenditure | Expenditure HK\$'000 | Amount allocated to specific borrowings HK\$'000 | Amount allocated to general borrowings HK\$'000 | | Weighted for the period outstanding HK\$'000 |
|---------------------|-------------------------|---|--|---------------------|--|
| 1 Jul 2009 | 10,000 | 10,000 | - | | - |
| 1 Nov 2009 | 13,000 | 10,000 | 3,000 | $3,000 \times 8/12$ | 2,000 |
| 1 Feb 2010 | 9,000 | - | 9,000 | $9,000 \times 5/12$ | 3,750 |
| 30 Jun 2010 | 8,000 | - | 8,000 | $8,000 \times 0/12$ | - |
| | <u>40,000</u> | <u>20,000</u> | <u>20,000</u> | | <u>5,750</u> |

[W2] *Weighted average borrowing cost*

$$7.5\% \times (10/30) + 10\% \times (20/30) = 9.17\%$$

Recommendation/ justification

A borrowing cost of HK\$ 1.277 million should be capitalised into the cost of the Building A.

As all finance costs have been expensed, a correcting journal must be made to remove the finance costs expensed which should have been capitalised.

The correcting journal entries for borrowing cost is as follows:

| | |
|--|-----------|
| Dr. Qualifying assets (construction in progress) | 1,277,000 |
| Cr. Finance cost | 1,277,000 |

Any finance costs incurred subsequent to the completion of the asset should be expensed in the statement of comprehensive income.

Property related standards – recognition

Case study 2 - Furnishings Retail Limited

Furnishings Retail Limited (FRL) is a company which sells furniture to customers from its luxury showrooms. All of the showrooms are owned by the company, and have been constructed specifically for FRL. FRL's accounting policy is to use the cost model to value properties, including investment properties, and depreciation is charged at 3% per annum. The financial year end of FRL is 30 June.

In recent years, demand for FRL's furniture has declined, causing the company to consider the best use of its property portfolio. At 30 June 2010, the following information is available with regard to two of FRL's showrooms.

Showroom X was used as a showroom until 31 May 2010, at which time the showroom was closed. It is currently being redeveloped and refurbished as an office unit. When the redevelopment is complete, the office will be rented out to commercial customers. The carrying value of showroom X was HK\$12 million at 31 May 2010, and HK\$1million has been spent on the redevelopment, of which 50% relates to property improvements, and 50% related to repair and maintenance. Depreciation has been charged up to 31 May 2010. The redevelopment was completed on 30 June 2010.

Showroom Y is currently used by the company as a showroom. On 31 March 2010, management decided to sell the property. It is located on a prime piece of real estate in the city centre, and FRL is actively marketing the property, intending to transfer it to a buyer after the company vacates the property. Showroom Y had a carrying value of HK\$10 million at 31 March 2010, it is being marketed for HK\$15 million, and its estimated fair value is HK\$17 million. Estimated selling costs are HK\$200,000. Depreciation had been charged up to 31 March 2010.

Required

Based on the information provided above, you should:

- **advise which accounting standards to be applied;**
- **advise the nature of different types of properties at 30 June 2010; and**
- **list the recognition/ derecognition criteria in accordance with the relevant HKFRSs.**

Discussion points

What are the issues?

FRL changed the intension for the use of two properties, Showroom X and Showroom Y, following declining sales.

Showroom X was closed and is now under refurbishment as an office unit which will be rented out to commercial customers.

Showroom Y is currently used by the FRL but Management decided to dispose on 31 March 2010.

How should showroom X and Y be accounted for in the financial statements as at 30 June 2010?

Which accounting standard(s) should be used?

HKAS 16 : Property, plant and equipment

HKAS 40: Investment property

HKFRS 5 : Non-current assets held for sale and discontinued operations

What are the requirements of the accounting standard(s)?

HKAS 16

The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

- (a) it is probable that future economic benefits associated with the item will flow to the entity;
and
- (b) the cost of the item can be measured reliably.

[HKAS 16.7 LP Ch.4 Section 2.3]

HKAS 40

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; or
- (b) sale in the ordinary course of business.

Only properties or components of properties meeting this definition should be treated as Investment Property.

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property.

[HKAS 40.5 LP Ch.5 Section 1.1]

HKFRS 5

An entity shall classify a non-current asset as held for sale if:

- (a) its carrying amount will be recovered principally through a sale transaction rather than through continuing use.
- (b) the asset must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.

[HKFRS 5.6-7 LP Ch.3 section 2]

How to apply the standard(s) to the case?

Showroom X

Showroom X will provide future economic benefits, as the office space will be rented out for a high return, so criteria (a) of HKAS 16 above is met. The cost of the property, and its refurbishment costs are known. Therefore criteria (b) is met. Although the property is not currently generating economic benefit as it is not in use by FRL, in the future it will, so the property should not be derecognised.

Examples provided in HKAS 40, property that is being constructed or developed for future use as investment property will be immediately recognised as investment property. [HKAS 40.8(e)]

Hence, the Showroom X should be transferred from Property, Plant and Equipment to Investment Property on 31 May 2010.

Showroom Y

On 31 March 2010, management of FRL decided to dispose the showroom Y. Principally it fulfilled the criteria (a) of HKFRS 5 which is expected to be recovered through a sale transaction.

Showroom Y should only be treated as held for sale if it also met the criteria (b) of HKFRS 5. *i.e. available for immediate sale and its sale must be highly probable.*

Although FRL still occupies the property and uses it for trading purposes, normally the time necessary to vacate a property on its sale is usual and customary for the sale of such assets. It could be assumed that it could be available for immediate sale.

In addition, Showroom Y is subject of a highly probable sale transaction for the following reasons:

- Management has committed to a plan to sell;
- The property is being actively marketed; and
- The asset is being marketed at a price which is reasonable compared to its fair value.

Based on the available information mentioned above, Showroom Y fulfilled the criteria (b) of HKFRS 5.

Recommendation/ justification

Showroom X should be accounted for using HKAS 40 at the time it is intended to use as an investment property although the construction or redevelopment have not yet been completed.

For Showroom Y, HKAS 16 should be ceased to apply from 31 March 2010, and HKFRS 5 should be applied thereafter.

Property related standards – measurement

Additional information for case study 2

In order to perform the impairment assessment, Management has obtained the following data.

| | <i>Value</i> HK\$'000 |
|---|--------------------------|
| If Showroom X is sold: | |
| Current market price | 10,000 |
| Disposal costs – lawyer's fees and other transaction cost | 200 |
| Reorganisation costs | 150 |
| If Showroom X is not sold: | |
| Present value of estimated cash inflows | 10,500 |
| Present value of estimated maintenance costs | 128 |
| Capital expenditure to enhance the property | 1,000 |
| Finance costs per annum | 400 |

Required

Using the information provided in case study 2, advise management of FRL, whether Showroom X is impaired, and calculate the amount of any impairment loss to be recognised as at 30 June 2010.

Discussion points

What are the issues?

Showroom X is being redeveloped and subject to perform impairment assessment at 30 June 2010.

- (a) Which costs should be capitalised into Showroom X after change of use?
- (b) What is the carrying value before impairment test as at 30 June 2010?
- (c) Any impairment is required for Showroom X?

Which accounting standard(s) should be used?

HKAS 40: Investment Property

HKAS 16 : Property, plant and equipment

HKAS 36: Impairment of Assets

What are the requirements of the accounting standard(s)?

HKAS 40

An entity that chooses the cost model shall measure all of its investment properties in accordance with HKAS 16's requirements for that model other than those that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) in accordance with HKFRS 5. Investment properties that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) shall be measured in accordance with HKFRS 5.

[HKAS 40.56 LP Ch.5 Section 1.4]

HKAS 16

Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

[HKAS 16.55 LP Ch.4 Section 2.5]

HKAS 36

HKAS 36 requires that assets are recognised at no more than their recoverable amount. Recoverable amount is the higher of the amount to be realised through the asset's sale or continued use. Where the carrying amount exceeds the recoverable amount, the asset is impaired, and an impairment loss must be recognised.

[HKAS 36.1 LP Ch.7 section 4.5]

The amount to be realised through an asset's sale is defined as its fair value less costs to sell (FVLCTS), being the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

The fair value of an asset can be based on its price in a binding sale agreement, or the latest transaction price determined in an active market. If neither of those are available, fair value can be estimated using evidence from recent transactions for similar assets in the same industry or by using market price less costs of disposal.

Costs of disposal which are deducted from an asset's fair value to arrive at FVLCTS may include legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale.

Termination benefits and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

[HKAS 36.25-28 LP Ch.7 section 4.5.1]

The amount to be realised through continued use is defined as the value in use (VIU), being the present value of the future cash flows expected to be derived from an asset.

The determination of VIU is subjective, involving:

- (i) estimating future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal;
- (ii) determining an appropriate discount rate; and
- (iii) applying the appropriate discount rate to those future cash flows.

[HKAS 36.31 LP Ch.7 section 4.5.2]

How to apply the standard(s) to the case?

Carrying value of Showroom X as at 30 June 2010

FRL's accounting policy is to use the cost model to value properties, including investment properties. i.e. Showroom X shall be accounted for using the cost model in accordance with HKAS 16 after transfer to investment property. It should charge depreciation on the property after change the intended use. i.e. June 2010 depreciation should be provided for.

Refurbishment costs should be capitalised if they will provide future economic benefit. Costs should be spilt between the property, and repair and maintenance expense. It is important that costs are allocated correctly as HKAS 16 requires assets to be separated into component parts for the purpose of depreciation.

Depreciation should be charged over the estimated useful life of an asset separated into component parts, commencing when the asset is ready for its intended use by management. Redevelopment costs are a separable component part, but are not yet ready for use in the manner intended by management. Hence, depreciation has not been charged on the redevelopment costs.

At 30 June 2010, before impairment assessment, Showroom X should be valued as follows:

| | HK\$'000 |
|---|---------------|
| Value at 31 May 2010 transferred from PPE | 12,000 |
| Less: Depreciation for the month of June (12 million × 3%)/12 | (30) |
| Add: Redevelopment costs (1 million × 50%) | <u>500</u> |
| Carrying value at 30 June 2010 | <u>12,470</u> |

Impairment assessment

The current carrying amount of Showroom X of HK\$ 12.47 million should be tested for impairment. The fair value less cost to sell (FVLCTS) and value in use (VIU) should be calculated to determine the recoverable amount of the property.

Fair Value Less Cost to Sell

The current market price of HK\$ 10 million is the starting point for the calculation.

As stated above, costs of disposal which are deducted from an asset's fair value to arrive at FVLCTS may include legal costs. Hence, the lawyer's fees should be deducted in the calculation.

However, the reorganisation costs, HK\$150,000, involved in the event of Showroom X being sold may not be included in the FVLCTS calculation, as these costs are specifically prohibited.

[W1] *Fair value less costs to sell*

| | HK\$'000 |
|----------------------|--------------|
| Current market price | 10,000 |
| Less: disposal costs | <u>(200)</u> |
| FVLCTS | <u>9,800</u> |

Value in Use

Because future cash flows are estimated for the asset in its current condition, value in use does not reflect future cash outflows that will improve or enhance the asset's performance or the related cash inflows that are expected to arise from such outflows.

The capital expenditure planned to enhance the property, HK\$1,000,000, is not included in the value in use calculation as this is future expenditure which will enhance the asset's performance, and so is specifically excluded from the VIU calculation.

[HKAS 36.44]

Additionally, finance costs, HK\$400,000, may not be included in the value in use calculation, according to HKAS 36.

[HKAS 36.50]

[W2] *Value in use*

| | HK\$'000 |
|------------------------------|---------------|
| Estimated cash inflows | 10,500 |
| Maintenance costs | <u>(128)</u> |
| Total estimated value in use | <u>10,372</u> |

Recommendation/ justification

The results of the impairment test on Showroom X are as follows:

Carrying amount = HK\$ 12.47 million

Fair value less costs to sell = HK\$ 9.8 million [W1]

Value in use = HK\$ 10.372 million [W2]

Hence, the recoverable amount of Showroom X is HK\$ 10.372 million (i.e. the higher of FVLCTS & VIU) and the asset is impaired by HK\$ 2.098 million.

The impairment loss should be charged to the statement of comprehensive income.

Dr expense HK\$ 2,098,000

Cr Investment property HK\$ 2,098,000

Resolving accounting issues

Case study 3 – Rosie Services Limited

Rosie Services Limited (RSL) establishes a share option plan on 1 July 2007. Each of its 100 employees is awarded share options, the number of which each employee will be entitled to depends on growth in RSL's earnings per share, as follows:

| Average annual growth in EPS over 3 years to 30 June 2010 | Number of share options per employee |
|---|--------------------------------------|
| < 20% | No share options |
| 20% | 100 share options |
| 25% | 200 share options |
| 30% | 300 share options |

The employees must remain in service at the end of the three year period, at which time the share options vest.

The fair value of a share option in RSL at 1 July 2007 is HK\$ 15. This had increased to HK\$ 18 at 30 June 2008, but fell to HK\$ 10 at 30 June 2009. By 30 June 2010, the fair value of a share option had increased to HK\$ 17.

The growth in EPS at each year end was:

| | |
|-------------------------|-----|
| Year ended 30 June 2008 | 27% |
| Year ended 30 June 2009 | 18% |
| Year ended 30 June 2010 | 24% |

At the grant date, management predicted that 10% of employees would leave before the end of 2010. This estimate was revised to 8% at 30 June 2009. At the end of the three year period, there were 91 eligible employees.

Required

Advise management of RSL as to the accounting treatment for the share-based payment plan over the three year period to 30 June 2010. Provide calculations to show the impact on the financial statements at the end of each reporting date. Journal entries should be prepared.

Discussion points

What are the issues?

RSL has established a share option plan on 1 July 2007. What would be the accounting treatment for the share-based payment plan over the three year period to 30 June 2010?

Which accounting standard(s) should be used?

HKFRS 2: Share-based payment

What are the requirements of the accounting standard(s)?

HKFRS 2 requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.

[HKFRS 2.1 LP Ch 12 Section 1.2]

An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction.

[HKFRS 2.7 LP Ch 12 Section 1.2]

Vesting conditions are conditions which determine whether the employee is entitled to receive the share options at the end of the vesting period. Vesting conditions are either service conditions or performance conditions. Service conditions require the counterparty to complete a specified period of service. Performance conditions require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).

Vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest.

[HKFRS 2.19 LP Ch 12 Section 2.1.2- 2.1.3]

How to apply the standard(s) to the case?

RSL has established an equity-settled share-based payment. The fundamental accounting principle is that RSL should recognise an expense which represents the services acquired from employees. The corresponding entry is to equity. HKFRS 2 required that an entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction.

[HKFRS 2.7]

The amount to be recognised should be based on the fair value of the share options at the grant date, in this case HK\$ 15. Changes to the fair value of the share options and the underlying equity subsequent to the grant date are ignored.

The expense of the share-based payment plan should be spread over the vesting period, which is three years in this case.

In calculating the expense, vesting conditions must be taken into account. In this case, there are two conditions to take into account:

- the fact that employees must remain in service to be eligible at the vesting date, and
- the target average growth in EPS which impacts the number of options to be awarded to eligible employees.

In predicting the number of eligible employees, management should use their best estimate of staff turnover in the first two years of the plan. At year end 30 June 2010, the vesting date, the actual number of eligible employees will be known.

[W1] Calculation of share-based payment expense

| Year ending | No. of employees | Average growth in EPS | No. of share options per employee | Fair value of share | Calculation of cumulative expense | Cumulative expense/ amount recognised | Expense for the year |
|-------------|------------------------|-----------------------------|-----------------------------------|---------------------|--------------------------------------|---------------------------------------|----------------------|
| | | | | HK\$ | HK\$ | HK\$ | HK\$ |
| 30.06.08 | $100 \times 90\% = 90$ | 27% | 200 | 15 | $90 \times 200 \times 15 \times 1/3$ | 90,000 | 90,000 |
| 30.06.09 | $100 \times 92\% = 92$ | 22.5% $(27\%+18\%)/2$ | 100 | 15 | $92 \times 100 \times 15 \times 2/3$ | 92,000 | 2,000 |
| 30.06.10 | 91 | 23% $(27\%+18\%+24\%)/3$ | 100 | 15 | $91 \times 100 \times 15$ | 136,500 | 44,500 |

Recommendation/ justification

From the calculation above, it can be seen that the expense fluctuates over the three year vesting period, from HK\$ 90,000 in the year to 30 June 2008, to HK\$ 2,000 in the year to 30 June 2009, and HK\$ 44,500 in the year to 30 June 2010.

The amount recognised in equity accumulates over the vesting period, ultimately reaching HK\$136,500 at 30 June 2010.

Journal entries

| | <i>DR operating expense</i> | <i>CR equity</i> |
|---------|-----------------------------|------------------|
| | HK\$ | HK\$ |
| 30.6.08 | 90,000 | 90,000 |
| 30.6.09 | 2,000 | 2,000 |
| 30.6.10 | 44,500 | 44,500 |

Resolving accounting issues

Case study 4 – Janus Energy Limited

Janus Energy Limited (JEL) supplies energy to the national grid. JEL has contracted to purchase 10 million units of gas at 15 cents per unit, as part of a fixed price contract with a value of HK\$ 1.5 million. There is a fixed penalty of HK\$ 200,000 for cancelling the purchase contract. The current market price of a similar contract is 14 cents per unit. JEL has also entered into a sales contract to sell the 10 million units of gas at 12 cents per unit, as the gas purchased has been found to be in excess of the company's requirements.

JEL also holds a 10 year operating lease on a property at a rental of HK\$ 100,000 per annum. JEL no longer occupies the property and it is not being used in the business. JEL has arranged to sub-lease the property for HK\$ 60,000 per annum. The penalty for exiting the operating lease is HK\$ 350,000. An appropriate risk-free interest rate for JEL is 5%.

Required

Advise JEL on the accounting treatment for the gas purchase contract, and for the operating lease, with reference to relevant accounting standards. You are required to prepare the journal entries and specify the disclosure requirements, if any.

Discussion points

What are the issues?

JEL has entered into a contract which appears loss making, and also holds an operating lease which appears onerous. Should a provision be recognised for any losses to be suffered?

Which accounting standard(s) should be used?

HKAS 37: Provisions, contingent liabilities and contingent assets

What are the requirements of the accounting standard(s)?

Future operating losses do not meet the definition of a liability, and cannot meet the recognition criteria for a provision. This is because one of the recognition criteria for a provision is that there must be an obligation as a result of a past event. A future loss cannot be a past event, so the recognition criterion is not met.

[HKAS 37.63-64 LP Ch10 section 2.6.1]

However, in some circumstances, the onerous element (ie loss making element) of certain contracts should be provided for. An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

[HKAS 37.68 LP Ch10 section 2.6.2]

Provisions should be made for losses arising under an onerous contract. This is because signing a contract is a past event, and if the contract becomes onerous, an obligation may exist as a result of this past event.

Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

[HKAS 37.45 LP Ch10 section 2.2.3]

How to apply the standard(s) to the case?

Gas purchase contract

The purchase contract represents an onerous contract and a provision should be recognised for onerous contracts in respect of the present obligation that arises under the contract.

Long term purchase contracts, such as JEL's gas purchase contract establish rights and obligations for both parties to the contract and so can fall under the scope of a potentially onerous contract. The obligation is created at the signing of the contract.

The gas purchase contract appears to be onerous, because JEL is paying more (15 cents per unit) than the current market price (14 cents per unit) for gas under a contract that cannot be cancelled without incurring a financial penalty, and gas is to be sold on at a loss (12 cents per unit). At the point when the contract becomes onerous, a probable outflow of economic benefits exists.

In this case, a provision should be measured based on the least cost of either fulfilling the contract, or cancelling it.

If the contract were fulfilled, proceeds from the sale of the gas would be HK\$ 1.2 million, and the cost of purchasing the gas HK\$ 1.5 million. This creates a loss of HK\$ 300,000, representing the onerous element of the contract.

If the contract were cancelled, a penalty of HK\$ 200,000 is payable. As this is the least cost, this should be the amount provided for.

Operating lease

HKAS 37 recognises that operating leases sometimes become onerous leases. As discussed above with reference to the gas purchase contract, a provision should be recognised representing the least cost of fulfilling the contract, or its cancellation.

In this case, the penalty for cancelling the lease is HK\$ 350,000.

The maximum benefit to be derived from continuing with the lease is the cash inflows generated from sub-letting the property for HK\$ 60,000 per annum. This should be deducted from the cash outflows of HK\$ 100,000 per annum to arrive at a net cash outflow of HK\$ 40,000 per annum.

This should then be discounted using a risk-free rate to calculate the present value of the maximum benefit. Hence, net cost of fulfilling the contract at present value is $40,000 \times 7.722 = \text{HK\$ } 308,880$. (Note 7.722 is the 5% 10 year annuity factor).

On comparison, the least cost is HK\$ 308,880, which should be provided for.

Recommendation/ justification

The journal to record to provisions are as follows:

Gas purchase contract

| | |
|-----------------------|-------------|
| DR operating expenses | HK\$200,000 |
| CR provision | HK\$200,000 |

Onerous lease

| | |
|-----------------------|-------------|
| DR operating expenses | HK\$308,880 |
| CR provision | HK\$308,880 |

In future periods the provision for the onerous lease must be 'unwound' to eliminate the effect of discounting to present value.

Disclosure requirement

The onerous contracts will represent a separate class of provision (if material in the context of JEL's financial statements). For each class of provision, a company should disclose:

- (a) the carrying amount at the beginning and end of the period;
- (b) additional provisions made in the period, including increases to existing provisions;
- (c) amounts used (ie incurred and charged against the provision) during the period;
- (d) unused amounts reversed during the period; and
- (e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

There must also be narrative disclosure including a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.

[HKAS 37.84 LP Ch.10 Section 2.7]

Resolving accounting issues

Case study 5 – Piper Beta Limited

Piper Beta Limited (PBL) is a whiskey manufacturer. Its product is prestigious, and renowned for its special taste, a result of the whiskey being stored in oak barrels. The following information relates to the production of whiskey during the year to 30 June 2010. The cost of inventories are calculated using the first-in first-out method.

| | |
|----------------------------|---------------------|
| Total barrels produced | 9,500 barrels |
| Opening inventory | 1,250 barrels |
| Closing inventory | 1,500 barrels |
| Normal capacity (per year) | 10,000 labour hours |
| Actual capacity (per year) | 9,500 labour hours |
| Direct cost | HK\$ 250 per barrel |

Fixed production overheads:

| | |
|--------------------------------------|--------------|
| Depreciation of production equipment | HK\$ 330,000 |
| Supervisor's salary | HK\$ 300,000 |
| Storage costs (prior to bottling) | HK\$ 570,000 |

Required

Advise management of PBL as to the accounting treatment for the valuation of the whiskey inventory, including a calculation of the amount to be recognised as closing inventory. Journal entries should be prepared.

Discussion points

What are the issues?

PBL holds a significant amount of manufactured inventory and includes direct and indirect costs. How should the inventory be measured at the end of reporting date?

Which accounting standard(s) should be used?

HKAS 2: Inventories

What are the requirements of the accounting standard(s)?

Inventories should be valued at the lower of cost and net realisable value. Cost is defined as all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

[HKAS 2.9 LP Ch 9 Section 1.3]

The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

[HKAS 2.12 LP Ch 9 Section 1.4.2]

This means that all direct costs must be included in the cost of inventory. Direct costs include production materials, production labour and normal amounts of material wastage.

Fixed production costs may include indirect materials, indirect wages and salaries, depreciation of production assets and indirect factory overheads such as rent and electricity.

The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities.

[HKAS 2.13]

How to apply the standard(s) to the case?

Each barrel must include both direct and indirect costs.

Indirect costs comprise production overheads of depreciation HK\$ 330,000 + supervisor's salary HK\$ 300,000 + storage costs HK\$ 570,000 = HK\$ 1,200,000.

Production overheads allocated over labour hours based on normal capacity = $1,200,000/10,000$ hours = HK\$ 120 per hour

Each barrel in closing inventory takes 1 hour to produce (9,500 labour hours incurred and 9,500 barrels produced).

So, production overhead recognised as part of closing inventory is $1,500 \text{ barrels} \times 1 \text{ hour} \times \text{HK\$ } 120 = \text{HK\$ } 180,000$.

Hence, the total cost of closing inventory = direct costs $1,500 \text{ barrels} \times \text{HK\$ } 250 = \text{HK\$ } 375,000$ + production overhead capitalised HK\$ 180,000 = HK\$ 555,000.

Depreciation of production equipment, and the supervisor's salary should be included as production overheads and allocated to the cost of inventory.

Storage costs normally do not meet the definition of production overheads in accordance with HKAS 2.16(b). However, in this case the storage of the whiskey in oak barrels is effectively part of the production process, as the period of storage of the product in the barrels is integral to the finished product.

PBL's normal capacity is 10,000 labour hours, so overheads should be allocated on that basis. Any unallocated overheads are recognised as an expense in the period in which they are incurred.

Hence, PBL should recognise inventory at HK\$ 555,000 at 30 June 2010.

Recommendation/ justification

The journal entries are as follows:

During the year as expenses are incurred:

| | |
|------------------|----------------|
| Dr cost of sales | HK\$3,575,000* |
| Cr cash | HK\$3,575,000 |

*(direct cost = $250 \times 9,500 \text{ barrels}$) + 1,200,000 (indirect cost) = 3,575,000.

At year end perform closing inventory adjustment:

| | |
|--------------------------------------|-------------|
| Dr inventory (asset) | HK\$555,000 |
| Cr closing inventory (cost of sales) | HK\$555,000 |