STANDARD SETTING

Financial reporting considerations for closing out 2022

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CPA
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CONTENTS

Introduction

This publication highlights the key topics and reminders that preparers should consider in preparing their December 2022 financial statements but may also be relevant to upcoming interim period-ends and financial year-ends.

The first section discusses the amendments to HKFRSs which are mandatorily effective for annual periods beginning on or after 1 January 2022. The second section discusses topical issues including the challenges faced by Hong Kong entities in their financial reporting under the current macroeconomic environment. In the third section, we discuss the agenda decisions issued by the IFRS Interpretations Committee (IFRS IC) in 2022 that are considered to be more relevant to Hong Kong entities.

For readers' ease of reference, the Appendix provides the full lists of standards and amendments which are effective on 1 January 2022 and those new and issued standards which are not yet effective but available for early adoption as well as a full list of agenda decisions issued by the IFRS IC.

This publication is not intended to be comprehensive nor does it necessarily cover all the potential issues relevant to an entity's financial statements. Readers should refer to the HKFRSs in the HKICPA Members' Handbook for further reference.

I. Amendments to HKFRSs mandatorily effective from 1 January 2022

There are no major new standards or amendments that are applicable to financial years ending December 2022. However, there are several narrow-scope amendments the financial impact of which should be carefully assessed. Relevant disclosures are required by HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when the changes brought by the amendments have a material impact on the financial statements. This section discusses those amendments which may be more widely relevant to Hong Kong entities and the key considerations in applying the amendments.

1. Amendments to HKAS 16 Property, Plant and Equipment – Proceeds before Intended Use

An entity may produce items (Items) while bringing an item of property, plant and equipment (PPE) to the location and condition necessary for it to be capable of operating in the manner intended by management. The amendments require the proceeds from selling any such Items and the related costs be recognized in profit or loss in accordance with applicable HKFRSs (HKAS 16.20A).

The amendments are expected to have more impact on entities engaging in those industries which produce and sell items when constructing or testing items of property, plant and equipment before they are available for use, such as mining, petrochemicals and manufacturing companies (HKAS 16.BC36B). Applying the amendments, these entities are prohibited from deducting the proceeds from selling the Items from the cost of the PPE. Instead, such proceeds should be recognized in profit or loss. In addition, all the costs of those Items are required to be initially accounted for using HKAS 2 *Inventories* and recognize the proceeds and related costs in profit or loss in accordance with the applicable HKFRSs when they are sold, e.g. applying HKFRS 15 *Revenue from Contracts with Customers* if the items sold are output of the entity's ordinary activities (HKAS 16.BC16M). The amendments in essence require an entity to distinguish between the costs of producing the Items and other costs incurred in making the PPE available for use which are capitalized under HKAS 16.

The amendments require limited retrospective application. In particular, they should only be applied to those PPE that are brought to the location and condition necessary for them to be capable of operating in the manner intended by management on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments[1] (i.e. applicable to those PPE that were not yet available for use as at 1 January 2021 for entities with a December year-end). The cumulative effect of initially applying the

[1] The International Accounting Standards Board (IASB) recognized that an affected entity might find it difficult and costly to apply the amendments retrospectively to assets made available for use many years ago and therefore decided to limit the number of assets an entity is required to reassess on first applying the requirements. The transition requirements in IAS 16.80D promote consistency in application of the amendments for all periods presented (HKAS 16.BC36C).

amendments is recognized as an opening adjustment to retained earnings or other component of equity, as appropriate, at the beginning of the earliest period presented.

HKAS 16.74A requires additional disclosures including (1) the amount of proceeds and costs recognized, and (2) the relevant line items in the statement of comprehensive income that include such proceeds and costs as a result of selling the Items.

2. Amendments to HKAS 37 – Onerous Contracts: Cost of Fulfilling a Contract

HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that, if an entity has an onerous contract, it shall measure and recognize the present obligation under the contract as a provision. HKAS 37 defines an onerous contract as 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).

To address the diversity in practice regarding which costs should be included as the cost of fulfilling a contract, HKAS 37.68A was added to clarify that, for the purpose of assessing whether a contract is onerous under HKAS 37, the cost of fulfilling the contract comprises the costs that relate directly to the contract which include:

- the incremental costs of fulfilling that contract (e.g. direct labour and materials); and
- an allocation of other costs that relate directly to fulfilling contracts (e.g. depreciation charge of machinery used in fulfilling that contract).

It is expected that entities, which applied the 'incremental cost' approach in the past to identify onerous contracts, will be more impacted by the amendments. These entities should carefully reassess their contracts to identify whether there are any material contracts that have become onerous as a result of applying the amendments and provide the necessary provisions.

On transition, an entity shall apply the amendments only to contracts for which it has not fulfilled all its obligations at the date of initial application (i.e. contracts with outstanding obligations as at 1 January 2022 for an entity with a December year-end) without restating comparative information. The entity shall instead recognize the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings or other component of equity, as appropriate, at the date of initial application (i.e. 1 January 2022)[2].

Before a separate provision is recognized for an onerous contract, entities should remember to recognize any impairment loss that has occurred on the assets used in fulfilling the contract (HKAS 37.69).

[2] The IASB considered that (1) it may be difficult and costly for an entity to obtain the information needed to restate comparative amounts, and the information provided by doing so was unlikely to be sufficiently useful to justify the costs that the entity might incur and (2) the benefits of providing the option to restate comparative amounts would be limited. Accordingly, the IASB decided to require entities to apply the amendments to those contracts for which the entity has not fulfilled all its obligations (HKAS 37.BC20-21).

3. Other amendments that are effective on 1 January 2022

(a) Annual Improvements to HKFRS Standards 2018-2020

The following table lists out the HKFRSs and the topics that are amended as part of the *Annual Improvements to HKFRS Standards 2018-2020*.

HKFRSs	**Subject**
HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*	*Subsidiary as a First-time Adopter* • A subsidiary that uses the exemption in HKFRS 1.D16(a) may elect, in its financial statements, to measure cumulative translation differences for all foreign operations at the carrying amount that would be included in the parent's consolidated financial statements, based on the parent's date of transition to HKFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary. • A similar election is available to an associate or joint venture that uses the exemption in HKFRS 1.D16(a).
HKFRS 9 *Financial Instruments*	*Fees in the '10 per cent' Test for Derecognition of Financial Liabilities* • The amendments clarify which fees an entity includes when it applies the '10 per cent' test[3] in assessing whether to derecognize a financial liability. An entity includes only fees paid or received between the entity (the borrower) and the lender, including fees paid or received by either the entity or the lender on the other's behalf.
Illustrative Examples accompanying HKFRS 16 *Leases*	*Lease Incentives* • The amendment simplifies Illustrative Example 13 – *Measurement by a lessee and accounting for a change in the lease term* by taking out the illustration of the reimbursement of leasehold improvements from the example. This removes the potential confusion regarding the treatment of lease incentives in the example.
HKAS 41 *Agriculture*	*Taxation in Fair Value Measurements* • The amendment removes the requirement for entities to exclude cash flows for taxation when measuring the fair value of a biological asset using a present value technique. Under the amendment, an entity is permitted to use post-tax cash flows and a post-tax discount rate in the present value calculation when determining the fair value of its biological assets.

[3] The '10 per cent' test refers to a test in HKFRS 9 that is used to quantitatively assess whether the new contractual terms between the borrower and the lender are substantially different from the original contractual terms, in determining whether the original financial liability should be derecognized. Under HKFRS 9.B3.3.6, the terms are substantially different if the discounted present value of the cash flows under the new terms is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

(b) Amendments to HKFRS 3 Business Combinations – Reference to the Conceptual Framework

The Amendments to HKFRS 3 update certain references to the *Conceptual Framework for Financial Reporting* issued in 2018 (Conceptual Framework), and add an exception to the requirement for an entity to refer to the Conceptual Framework in relation to liabilities and contingent liabilities that would have been in the scope of HKAS 37 or HK(IFRIC) Interpretation 21 *Levies* if they were incurred separately rather than assumed in a business combination.

(c) Amendment to HKFRS 16 Leases – Covid-19-Related Rent Concessions beyond 30 June 2021

Rent concessions were prevalent during the COVID-19 pandemic in certain jurisdictions. In March 2021, the IASB issued *Covid-19-Related Rent Concessions beyond 30 June 2021*, which amended the date in IFRS 16.46B(b) from 30 June 2021 to 30 June 2022 to extend the period in which lessees could apply the practical relief in accounting for qualifying COVID-19-related rent concessions. The HKICPA approved the equivalent amendment in April 2021. Readers may refer to Financial considerations for closing out 2021 for our discussions of the amendment.

Section III.2 below discusses an IFRS IC agenda decision which addresses the questions relating to a lessor's accounting for a particular type of rent concession.

II. Topical issues

This section discusses the topical issues relevant to Hong Kong entities, focusing on (1) the lingering impact of COVID-19 on financial reporting, (2) other impact on financial reporting brought by the changes in the macroeconomic environment, and (3) the current climate-related reporting landscape. To attain high quality financial reporting, regulators continually emphasize the need for transparent, complete and entity-specific disclosures that faithfully represent the underlying transactions to provide useful information to users. It is therefore important for entities to consider the issues below carefully and to provide useful disclosures in the financial statements.

1. The lingering impact of COVID-19 on financial reporting

While the impact of COVID-19 pandemic may have diminished towards the end of 2022 in Hong Kong and economic activities have gradually resumed normalcy, some industries have yet to recover fully from the adverse effects of the pandemic that have accumulated over the past few years. Accordingly, some, if not all, of the COVID-19-related accounting considerations discussed in our prior publications (2022: Financial considerations for closing out 2021; 2021: Alert Issue 37, 2020: Alert Issue 33) would remain relevant for those entities, in particular for the following aspects:

Areas	Applicable HKFRSs	Key matters for attention (not exhaustive)
Judgements and key sources of estimation uncertainties	HKAS 1 *Presentation of Financial Statements* and other applicable HKFRS for specific disclosures to which the accounting items relate	• Overarching principles set out in HKAS 1.122 & 125 • Areas which involve judgement and estimation include going concern, asset impairments, useful lives of assets, expected credit loss (ECL) of a financial asset, write down of inventories and provisions and fair value measurements involving significant unobservable inputs
Impairment considerations and disclosures	• Financial assets - HKFRS 9 *Financial Instruments* - HKFRS 7 *Financial Instruments: Disclosures* • Non-financial assets - HKAS 36 *Impairment of Assets* • Inventories - HKAS 2 *Inventories*	• Financial assets (e.g. trade receivables, lease receivables, loan receivables, and bond investments at amortized cost or fair value through other comprehensive income): - assess the staging of ECL model (Stage 1, 2 or 3), whether there has been a significant increase in credit risk since initial recognition when applying the general model

Areas	Applicable HKFRSs	Key matters for attention (not exhaustive)
		- If applicable, assess the changes in the estimation techniques or significant assumptions, and the related disclosures • Non-financial assets (e.g. PPE, intangibles and goodwill): - other than goodwill, identify impairment indicator(s) at each reporting date and perform impairment assessment as necessary - perform impairment assessment for goodwill at least annually[4] - properly calculate the recoverable amount which is the higher of fair value less costs of disposal and value in use of an asset or cash-generating unit (CGU) - assess if impairment loss recognized in the past on assets other than goodwill should be reversed • Inventories: - estimate the net realizable value of inventories based on the most reliable evidence available at the time the estimates are made - the amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overhead are recognized as an expense when incurred

[4] There have been discussions for years as to whether the amortization of goodwill should be reintroduced in view of the users' fears of the problem that goodwill was impaired 'too little, too late'. In its November 2022 meeting, the IASB decided once and for all to not reintroduce amortization of goodwill but to stick with the *impairment-only approach* for goodwill. It was believed that there would be significant costs and disruption for entities, with no real evidence that the amortization model gives any better information for the users.

Areas	**Applicable HKFRSs**	**Key matters for attention (not exhaustive)**
Fair value measurements	HKFRS 13 *Fair Value Measurement*	• Market-based, instead of entity-specific measurement • Apply fair value techniques that maximize the use of observable inputs and minimize the use of unobservable inputs • The extent of disclosures depends on the fair value hierarchy (i.e. Level 1, 2 & 3)
Going concern	HKAS 1	• Assess if going concern assumption is appropriate for at least 12 months after the reporting date based on all facts and circumstances • Provide the required disclosures of HKAS 1 • Other helpful reminder: IASB's educational material
Debt restructurings	HKFRS 9, HKAS 32 *Financial Instruments: Presentation*, HK (IFRIC) Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments*	• Assess if restructuring results in a substantial modification to a financial liability ('10 per cent' test[5]) and apply the relevant HKFRS 9 requirements • Assess if the financial assets involved in the debt restructuring should be derecognized • Where appropriate, refer to HK (IFRIC) Interpretation 19 for debt-to-equity swaps • Consider the substance of the intragroup debt restructuring arrangement in determining the accounting treatment
Provisions and contingent liabilities	HKAS 37	• Consider if there are applicable HKFRSs before considering to apply HKAS 37 to account for the provision • Recognize a provision only when all three criteria in HKAS 37.14 are met • Consider the need for onerous contract provision[6]

[5] See Amendments to HKFRS 9 discussed in Section I.3(a) – Annual Improvements to HKFRS Standards 2018-2020.

[6] See our discussions on the Amendments to HKAS 37 effective from 1 January 2022 in Section I.2.

We recommend that readers refer to the relevant sections in our previous publications for more details when considering the above aspects.

2. Impacts of higher inflation, rising interest rates and other macroeconomic uncertainties on financial reporting

Although the impact of COVID-19 may be lessening, many entities have been facing new challenges arising from the changes in the macroeconomic environment, for example, higher inflation and rising interest rates arising from geopolitical conflicts and uncertainties.

This part of the publication discusses how these changes generally impact the accounting for December 2022 year-end financial statements. The discussions below are not exhaustive and entities should perform their own assessment based on an evaluation of all relevant facts and circumstances.

(a) Impairment of non-financial assets applying HKAS 36

Higher inflation and rising interest rates could lead to broader consequences such as changes in customers' demand (as the purchasing power of money has lessened) and a higher cost of goods and services. Entities should consider these and other indicators of impairment carefully and test an asset for impairment as appropriate. The key points to consider for an impairment testing include, but are not limited to:

i. *Impairment indicators* – HKAS 36 requires an entity to assess whether there is any indication that an asset may be impaired at the end of the reporting period. If any such indication exists, an entity shall estimate the recoverable amount of the asset. Intangible assets with an indefinite useful life and intangible assets which are not yet available for use must be tested for impairment annually regardless of whether there is any impairment indication (HKAS 36.10)

   Entities should watch out for any changes in the macroeconomic environment that provide indications that their assets may be impaired. HKAS 36.12 provides a list of indications from external and internal sources of information that an entity needs to consider as a minimum. HKAS 36.12 explicitly states that increases in market interest rates or other rates of returns on investments during the period are potential indicators of impairment as such increases are likely to affect the discount rate used in calculating an asset's value in use and which would in turn decrease an asset's recoverable amount. Other unfavorable or uncertain economic environment such as unfavorable exchange rates, changing customer behaviour and declining growth forecasts may also trigger an impairment test.

ii. *Conditions existing at the reporting date* – Entities should keep in mind that the estimated future cash flows must be based on conditions existing at the reporting date. As conditions under an evolving macroeconomic environment may be rapidly changing, entities should carefully distinguish whether information obtained for impairment assessment reflect the conditions at, or after, the reporting date.

iii. *Discount rate* – It is common that entities use the weighted average cost of capital (WACC) formula as a starting point to determine the discount rate. WACC is a weighted average of the cost of debt and cost of equity, which are affected by rising interest rates. Inflation represents rising prices and reduces the purchasing power of money and therefore also has an impact on the time value of money. Accordingly, entities should give proper consideration to the impact of rising interest rates and inflation in determining an appropriate discount rate. See (v) and (vi) for further discussions on the discount rate.

iv. *Growth rate* – In measuring value in use, HKAS 36 requires entities to extrapolate the projections beyond the period covered by the most recent budgets/forecasts using a steady or declining long-term growth rate for subsequent years, unless an increasing rate can be justified[7]. More judgement may be required in determining the long-term growth rate when forecasts of the rate of inflation are changing. Entities should consider all relevant market information on inflation forecasts, including the short, medium and long-term market expectations, when making this judgement.

v. *Weighted average of all possible outcomes* – In determining value in use, the elements identified in HKAS 36.30(b), (d) and (e) can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate[8]. In times of uncertainty, for the purpose of impairment testing, it may be more pragmatic for entities to reflect different economic environments by constructing multiple scenarios of future cash flows and apply probability weightings to each scenario to arrive at an expected present value of cash flows ('expected cash flow approach'), rather than using a single cash flow forecast and adjusting the discount rate ('traditional approach'). Entities can refer to Appendix A to HKAS 36 which provides guidance on these two approaches and properly consider which approach would be more appropriate based on their facts and circumstances.

vi. *Use of consistent assumptions about price increases attributable to general inflation* – Estimates of future cash flows and the discount rate should reflect consistent assumptions about price increases attributable to general inflation. If the discount rate includes the effect of price increases attributable to general inflation, future cash flows should also be estimated in nominal terms (i.e. incorporating the effect of inflation). If the discount rate excludes the effect of price increases attributable to general inflation, future cash flows are estimated in real terms (i.e. excluding the effect of inflation).

vii. *Investments in subsidiaries in separate financial statements* – Entities should remember to assess whether the investments in subsidiaries in their separate financial statements

[7] See HKAS 36.33(c). The rate as referred to in this paragraph shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

[8] HKAS 36.30(b): expectations about possible variations in the amount or timing of future cash flows; 30(d): the price for bearing the uncertainty inherent in the asset; and 30(e): other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

are impaired, in particular when a goodwill impairment is recognized in the consolidated financial statements.

viii. *Disclosures* – Entities should make adequate disclosures as required by HKAS 36.126-136. Additional sensitivity disclosures (e.g. an increase / a decrease in certain % of the discount rates) would also be warranted if a reasonably possible change in a key assumption on which management has based its determination of recoverable amount would cause the CGU's (group of CGUs') carrying amount to exceed its recoverable amount[9]. In a volatile and uncertain market environment, more entities may need to provide sensitivity disclosures due to the widened range of reasonably possible changes.

(b) ECL assessment under HKFRS 9

HKFRS 9 requires ECL to be measured in a way that takes into account the time value of money, using reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions[10]. In light of this requirement, entities should pay attention to the following areas when undertaking an ECL assessment:

i. *Credit risk assessment* – Higher inflation and rising interest rates may cause the credit risk of a financial asset to increase. For example, the repayment ability of a debtor of a floating-rate instrument may deteriorate if the inflation and interest rate keep rising. Similarly, if a debtor intends to repay its loans through refinancing, the high interest rate environment might make it difficult for the debtor to obtain refinancing due to its failure to meet the requirements for refinancing (e.g. interest cover ratio), hence increasing the probability of default on the loan. This issue is more pronounced for shorter term loans as there may not be sufficient time for the debtor's earnings to adjust to the higher inflation environment (e.g. through charging sufficiently higher prices) to meet the necessary requirements for refinancing. If there is a significant increase in credit risk since initial recognition, financial assets that are accounted for under the general approach may need to move from Stage 1 ECL to Stage 2 or even Stage 3. The resulting financial impact could be significant as the amount of ECL recognized in Stage 1 is 12-month ECL but increases to life-time ECL in Stage 2 and Stage 3[11]. Determining whether credit risk has increased significantly since initial recognition requires judgment. Entities are advised to refer to HKFRS 9.5.5.9-5.5.11 and HKFRS 9.B5.5.15-B5.5.24 for the relevant guidance.

ii. *Determination of ECL rates* – This formula is commonly used for estimating the ECL: *ECL = Probability of default (PD) * Loss given default (LGD) * Exposure at default (EAD)*. The impact of rising interest rate and inflation on these three elements should be

[9] See HKAS 36.134(f) & 135(e) for details.

[10] See HKFRS 9.5.5.17.

[11] Stage 2 financial assets are those financial assets which have significant increase in credit risk but do not have objective evidence of impairment. Stage 3 financial assets are credit-impaired financial assets which have objective evidence of impairment (see HKFRS 9.Appendix A for the definition of credit-impaired financial asset).

separately assessed. For example, PD is an estimate of the likelihood of a default over a specified time period. As discussed in (i), PD may increase as rising interest rate and inflation may negatively affect a debtor's ability to pay. LGD, which is the estimated loss in the event of default, may also increase when there is a decrease in the value of the collaterals pledged for the financial asset. EAD is the expected outstanding balance of the receivable at the point of default. In difficult times, a debtor's payment patterns may change resulting in a higher outstanding balance (EAD).

iii. *Provision matrix* – Entities should reassess whether the groupings of financial assets (e.g. groupings of trade receivables from different customers) in the provision matrix used for determining the ECL of trade receivables[12] are still appropriate to ensure that the financial assets in the same group share similar credit risk characteristics. Entities may consider further stratifying the provision matrix as customers from different industries may be affected by rising inflation and interest rates to varying extents. Entities should also critically reassess whether historical loss rates remain appropriate in light of the changes in the current and forecast economic conditions from those of the past.

iv. *Forward-looking information* – Entities may find it more challenging in obtaining reasonable and supportable forward-looking information for incorporating into the measurement of ECL for financial assets during the times of macroeconomic uncertainty. In assessing the forward-looking information, entities should ensure the correlation of the information obtained with the financial assets being assessed. Entities should critically analyze all relevant market information at the reporting date, including the short, medium and long-term market expectations of the future macroeconomic conditions.

v. *Disclosures* – Entities may need to enhance their disclosures, particularly those relating to liquidity risk, market risk, credit risk and sensitivity as required by HKFRS 7 to explain how the effects of inflation, rising interest rates and other macroeconomic issues are managed by management and reflected in the financial statements.

The assessment of ECL has long been a subject of regulatory scrutiny in Hong Kong[13] and elsewhere due to its prevalence and the repeated deficiencies found in audit work in this area. It is expected that it will continue to be one of the key areas of focus in the foreseeable future. Preparers and auditors should refer to the standard to obtain a sufficient understanding of how to apply the ECL requirements. Entities are also recommended to calibrate their ECL models by comparing the ECL amounts with actual outcomes.

(c) Leases applying HKFRS 16

HKFRS 16.27 sets out the lease payments that are required to be included in the measurement of lease liability at the commencement date. Apart from fixed lease payments,

[12] HKFRS 9.B5.5.35 provides a practical expedient by which entities could use a provision matrix as the basis for measurement of ECL for trade receivables.

[13] As set out in [AFRC 2022 Interim Inspection Report](), the auditor's evaluation of the entity's application of accounting standards for revenue recognition and ECL will continue to be key areas of inspection focus given the prevalence of deficiencies identified in their inspection.

they also include variable lease payments which depend on an index or a rate. HKFRS 16.28 further explains that variable lease payments that depend on an index or rate include payments linked to a consumer price index (CPI), payments linked to a benchmark interest rate or payments that vary to reflect changes in market rental rates.

Accordingly, leases for which the rentals include variable lease payments that are contingent on an index or a rate (such as CPI and market interest rates) would be particularly affected under the current economic environment. To reflect the change in rate or index used, lessee shall remeasure the lease liability with an equivalent adjustment made to the right-of-use asset. HKFRS 16.39-43 provide further guidance on reassessment of lease liability.

(d) Revenue recognition

Some of the impacts of the volatile economic environment on revenue recognition are:

i. *Identifying the contract* – Customers' financial position and their purchasing power may deteriorate in light of inflation and rising interest rates. An entity should assess at contract inception whether it is probable that it will collect consideration from the customer after providing the goods or services. This is important as it is one of the criteria in HKFRS 15.9 for assessing whether a contract with a customer as defined in HKFRS 15 exists in the first place.

   HKFRS 15.13 states that an entity shall not reassess the criteria in HKFRS 15.9 if a contract with a customer meets those criteria at contract inception, unless there is an indication of a change in facts and circumstances. However, if a customer's ability to pay the consideration deteriorates significantly, an entity will need to reassess whether it is still probable that the entity will collect the consideration for future goods and services. If, on reassessment, an entity determines that the criteria are no longer met, then it ceases to apply the revenue model to the contract from that date. Accordingly, entities are advised to reassess the collectability of the amount of consideration from their major customers for future provision of goods and services.

ii. *Significant financing component* – Under HKFRS 15, the transaction price is adjusted for the effects of the time value of money if the contract includes a significant financing component[14]. As inflation and rising interest rate have an impact on the time value of money, they should be considered when identifying significant financing component[15].

   In addition, when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. HKFRS 15 requires such rate to reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer

[14] See HKFRS 15.60.

[15] An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract. See HKFRS 15.61 for the detailed requirements.

or the entity[16]. It is worth pointing out that the discount rate is determined at contract inception and generally is not updated for subsequent changes in interest rate or other circumstances after contract inception[17].

iii. *Onerous contracts* – Sales and cost of sales of an entity may change because of rising/higher inflation and other macroeconomic factors. The combined effect of changes in revenue and cost of sales (e.g. rising cost but declining sales) may lead to onerous contracts if the unavoidable costs of fulfilling the performance obligations in a contract with a customer exceed the economic benefits expected to be received.

(e) Events after the reporting date applying HKAS 10 Events after the Reporting Period

We emphasized in (a)(ii) above the fundamental principle that the financial statements need to reflect conditions that exist at the reporting date. In an evolving economic environment, events which occur after the year end may provide evidence about the conditions at year end which would require an entity to adjust the amounts recognized in its financial statements, or to recognize items that were not previously recognized (i.e. adjusting events after the reporting period) (HKAS 10.8-9).

Information and events reflecting circumstances that arise subsequent to the year-end should be disclosed if material (i.e. non-adjusting events after the reporting period) (HKAS 10.10-11, 21).

(f) Other considerations

i. *Recognition of deferred tax assets* – Rising interest rates and higher inflation might influence the future profitability of an entity and therefore the recoverability of deferred tax assets recognized. Entities are reminded to disclose (1) the nature of evidence to support the recognition of deferred tax assets if there is a recent history of loss making (paragraph 82 of HKAS 12 *Income Taxes*) and (2) the judgement and estimates applied on deferred tax assets recognition such as sensitivity information for the possible outcomes in the next financial year (HKAS 1.129).

ii. *Going concern* – Contrary to asset impairment for which the assessment shall be based on conditions which existed at the reporting date, going concern assessment takes account of events and conditions that exist after the reporting date. Entities should review and update the assumptions for financial forecasts up until the financial statements are authorized for issue in assessing their ability to continue as a going concern. In assessing whether the going concern assumption is appropriate, management assesses all available information about the future for at least, but not limited to, twelve months from the reporting date. An entity should not prepare its financial statements on a going

[16] See HKFRS 15.64.

[17] See HKFRS 15.64.

concern basis if the events after the reporting date indicate that it is no longer a going concern[18].

iii. *Estimation uncertainty and judgment applied* – As discussed throughout this section on all affected areas, rising market interest rates and inflation increase estimation uncertainty and bring in more challenges when making accounting estimates in the measurement. Financial and non-financial assets as well as liabilities with a longer term would be more significantly affected than those with a shorter term. Entities should review all material areas in their financial statements that are subject to significant judgement and estimation uncertainty and consider expanding the disclosures on those areas based on the relevant requirements in HKAS 1. See Section II.1.

3. Climate-related reporting

In recent years, climate change has attracted increasing attention from investors and other stakeholders worldwide including Hong Kong. We discussed climate-related reporting in our last year's publication – Financial considerations for closing out 2021. In our view, Hong Kong entities' exposure to climate-related risks might not have changed significantly since last year and so those discussions should continue to be relevant for 2022 financial reporting.

For entities to whom the financial impact of climate-related risks is material, they should continue to perform a robust assessment of such impact in preparing their financial statements and provide updated disclosures. Although HKFRSs do not set out any specific disclosure requirements on climate-related reporting, there is an overarching principle in HKAS 1[19] that requires an entity to disclose information which enables investors to understand the effects of particular transactions, other events and conditions on its financial position and financial performance. As mentioned in our publication last year, we recommend that entities refer to the two IASB educational materials published in November 2020 and November 2019 in determining how to report climate-related matters in their financial statements under IFRS Accounting Standards. Entities are reminded to ensure consistency between financial and non-financial information on the climate-related matters being reported.

In March 2022, the International Sustainability Standards Board (ISSB) issued its first two exposure drafts (EDs) on IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*. These two potential standards are intended to provide a global baseline for climate and other environmental, social and governance (ESG) reporting. The HKICPA[20] responded to the EDs in July 2022. It is expected that the final standards will be issued by the ISSB towards the end of June 2023. Entities which are required to prepare sustainability reports should monitor the latest developments of the sustainability disclosures standards and ESG reporting in Hong Kong and globally.

[18] See HKAS 10.1 and 14.

[19] See HKAS 1.15, 17(c) and 31.

[20] The HKICPA is the only body authorized by law to set and promulgate standards for professional standards accountants in Hong Kong, including financial reporting, auditing, ethics and sustainability disclosures standards.

III. Agenda decisions issued by the IFRS IC in 2022 that are relevant to Hong Kong entities[21]

This section highlights the IFRS IC agenda decisions issued in 2022 that are relevant to companies reporting in Hong Kong. As HKFRSs are fully converged with IFRS Accounting Standards, entities are advised to assess the impact of the agenda decisions[22] issued by IFRS IC and implement the explanatory materials therein on a timely basis where material.

1. *Demand Deposits with Restrictions on Use arising from a Contract with a Third Party*

In order to ensure the collectability of the amounts receivable from the customers or borrowers, it is not uncommon that a seller or lender requests its customers or borrowers to place a specified amount of cash as demand deposits in a bank which is contractually agreed to be used only for settling the transactions. Questions arise as to whether such demand deposits meet the definition of 'cash and cash equivalent' in IAS 7 *Statement of Cash Flows*.

The IFRS IC issued an agenda decision in April 2022 which clarifies the classification of demand deposits in the statements of cash flows and financial position when such deposit is subject to contractual restrictions on use as agreed with a third party but the entity can still access those amounts on demand.

Considering that both IAS 1 and IAS 7 indicate that amounts included in cash and cash equivalents may be subject to restrictions, the IFRS IC reached the following conclusion regarding the submitted fact pattern:

Cash and cash equivalents in the statement of cash flows	***Presentation in the statement of financial position***	***Disclosures***
• Restriction on use of a demand deposit does not result in the demand deposit no longer being cash, unless those restrictions change the nature of the deposit such that it would no longer meet the definition of cash in IAS 7. • In the submitted fact pattern, the contractual restrictions on the use of the amounts held	• Pursuant to IAS 1.54(i), the entity presents the demand deposit in a line item 'cash and cash equivalents' in its statement of financial position. • The entity may disaggregate the 'cash and cash equivalent' line item and present the demand deposit separately in an additional line item applying IAS 1.55.	• Applying IAS 7.45, the entity discloses the demand deposit as a component of cash and cash equivalent. • The entity considers disclosing additional information: - IFRS 7: liquidity risk from the financial instruments and

[21] Agenda decisions (including any explanatory material contained therein) cannot add or change requirements in IFRSs. Instead, explanatory material explains how the applicable principles and requirements of IFRSs apply to the fact pattern described in the agenda decision. Explanatory material derives its authority from IFRSs themselves and accordingly, an entity is required to apply the applicable IFRSs reflecting the explanatory material in an agenda decision, subject to it having sufficient time to implement that accounting. (Paragraphs 8.4 and 8.5 to the IASB Due Process Handbook).

[22] See Appendix to this publication for the list of all agenda decisions issued by the IFRS IC in 2022.

in the demand deposit do not change the nature of the deposit because the entity can still access those amounts on demand. • The entity includes the demand deposit as a component of 'cash and cash equivalents' in its statement of cash flows.	• The demand deposit shall be classified as current asset applying IAS 1.66(d) unless the deposit is 'restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period'.	how it manages that risk; - IAS 1.31: if information provided in applying IAS 7 and IFRS 7 is insufficient to enable users to understand the impact of restrictions on the entity's financial position.

Entities that have entered into the arrangements as described in the submitted fact pattern should assess if their current accounting policy for demand deposits needs to be changed to be in line with the IFRS IC agenda decision.

2. Lessor Forgiveness of Lease Payments

The IFRS IC published an agenda decision in October 2022 to clarify the accounting for a particular type of rent concession from the perspective of a lessor. In the submitted fact pattern, the lessor forgives certain lease payments due from the lessee, some of which are contractually due but not paid (i.e. the lessor has already recognized these amounts as operating lease receivable) and some of which are not yet contractually due. No other changes are made to the lease contract, nor are there any other negotiations between the lessor and the lessee that might affect the accounting for the rent concession.

The agenda decision addresses the following two questions:

(a) How the lessor applies the ECL model in IFRS 9 to the operating lease receivable before the rent concession is granted if it expects to forgive payments due from the lessee under the lease contract; and

(b) Whether the lessor applies the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 when accounting for the rent concession.

The IFRS IC concluded that the lessor accounts for the rent concession described in the fact pattern under both IFRS 9 and IFRS 16 – it applies the ECL model and derecognition requirements in IFRS 9 to the operating lease receivable forgiven, and the lease modification requirements in IFRS 16 to future forgiven lease payments (which had not been recognized as an operating lease receivable). This is further explained below:

Total lease payments forgiven	
Operating lease receivable (applying IFRS 9)	***Future lease payments (applying IFRS 16)***
Before forgiveness of lease payments (rent concession) is granted	
• The ECL on the operating lease receivable is measured on a probability-weighted basis, by evaluating a range of possible outcomes, including its expectation of forgiving lease payments recognized as part of that operating lease receivable. The expectation of forgiving the lease payments reflects a potential cash shortfall which should be considered in the ECL model. • The lessor estimates the ECL to include <u>all</u> cash shortfalls, being the difference between: - all contractual cash flows due under the lease contract with the lessee that are included in the gross carrying amount of the operating lease receivable, and - all cash flows the lessor expects to receive, using 'reasonable and supportable information' about 'past events, current conditions, and forecasts of future economic conditions'.	N/A
On the date the rent concession is granted	
• Immediately prior to the date the lease payments are forgiven, the lessor remeasures the ECL on the operating lease receivable and recognizes any changes to the ECL in profit or loss. • The rent concession legally releases the lessee from its obligation to make specified identified lease payments. The lessor applies the derecognition requirements in IFRS 9 to derecognize the operating lease receivables relating to the forgiven lease payments including any associated ECL allowance.	• As the rent concession in the fact pattern was not included in the original lease, it is a lease modification under IFRS 16 and the modified lease is accounted for as a new lease. • The lessor applies the lease modification requirements in IFRS 16.87 to future lease payments, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease[23]. Operating lease receivables are not accrued lease payments.

As noted from the agenda decision, the accounting for the rent concession in the submitted fact pattern (i.e. the application of IFRS 9 versus IFRS 16) depends on whether there is an operating lease receivable on the date the rent concession is granted. Lessors which have

[23] All future lease payments are determined and subsequently recognized by the lessor as income on a straight-line basis or another systematic basis over the remaining lease term.

previously granted rent concessions and/or intend to grant rent concessions in future should pay particular attention to the accounting implication of this agenda decision. They should revisit their accounting policy and consider reasonable and supportable information about expectations of forgiveness of lease payments as at the reporting date for the purpose of ECL assessment of operating lease receivable.

3. Principal versus Agent: Software Reseller

HKFRS 15.B34-B38 set out a framework to determine whether an entity is a principal or an agent in a transaction with a customer. When another party is involved in providing goods or services to a customer, an entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself (the entity is a principal) or to arrange for those goods or services to be provided by the other party (the entity is an agent).

In the submitted fact pattern, the IFRS IC was asked about whether a reseller of standard software licenses is acting as a principal or an agent for the purposes of recognizing revenue under IFRS 15.

Fact pattern
• Reseller has the right to sell software licenses to customers. • Reseller must provide pre-sale advice, e.g. the type and number of licenses required. There is no charge to customer for the pre-sale advice. • Reseller has a discretion in setting the sales prices and negotiates with customers. • Reseller places orders with the software manufacturer on behalf of customers (and pays the manufacturer) if the customer decides to buy a specified type and number of software licenses. • Reseller invoices the customers for the agreed price. • Software manufacturer provides the customer with the software licenses ordered via a software portal and key activation. • If Reseller advises the customer to buy an incorrect type or number of licenses, the customer may not accept the licenses. The Reseller cannot return these licenses to the software manufacturer nor sell them to another customer.

With regard to the fact pattern, the following key points are set out in the agenda decision:

- *Step 1:* Reseller should first identify the specified goods or services to be provided to the customer. It is considered that the pre-sale advice is not a separate performance obligation because the Reseller has already provided such service before the inception of the contract with the customer. Consequently, at the time of entering the contract with the customer, there is no valid expectation of the customer that the Reseller will transfer a good or service to the customer other than the standard software licenses. Accordingly, the IFRS IC concluded that the promised goods in the Reseller’s contract with the customer are the standard software licenses.

- *Step 2:* Reseller should assess whether it controls the standard software licenses before they are transferred to the customer. The conclusion of whether the Reseller is a principal or an agent in the transaction depends on the specific facts and circumstances, including the terms and conditions of the relevant contracts. Reseller would apply judgement in making its overall assessment within the context of the framework and requirements set out in IFRS 15.B34-B38.

- Reseller would disclose (a) material accounting policy information (IAS 1.117), (b) information required by IFRS 15 including information about its performance obligations (IFRS 15.119) and the significant judgements regarding the principal versus agent assessment (IFRS 15.123).

No conclusion was given in the agenda decision on whether the Reseller is a principal or an agent in the submitted fact pattern. However, the agenda decision explains the thought process of how to apply the requirements of IFRS 15. We recommend preparers refer to the agenda decision if they encounter similar circumstances as described in the fact pattern.

IV. Other reminders

The following sets out a few other reminders that may be relevant for financial periods ending on or after 31 December 2022:

- A new major standard, HKFRS 17 *Insurance Contracts* (including the October 2020 and February 2022 Amendments to HKFRS 17), became effective from 1 January 2023. HKFRS 17 introduces new and comprehensive accounting requirements on insurance contracts that affect not only insurers but also entities that issue insurance contracts. Entities in particular insurers are reminded to disclose information including those relevant to assessing the possible impact of applying HKFRS 17 for the first time as required by HKAS 8 in its 2022 financial statements. They should also be prepared to disclose robust and entity-specific information about the application of this new standard in their 2023 financial statements based on the relevant requirements in HKAS 8 and HKFRS 17.

- The Russo-Ukrainian conflict and the ensuing sanctions imposed on/by Russia and other countries have disrupted multinational entities that have businesses in Russia, Ukraine and other parts of the world that have been affected by the spill over effect of the conflict. Entities should carefully consider the accounting implications arising from the conflict which may include, but are not limited to, changes in foreign exchange exposure under HKAS 21 *The Effects of Changes in Foreign Exchange Rates*, classification of cash and cash equivalents (in relation to restricted cash) under HKAS 7, going concern consideration under HKAS 1, onerous contract provisions under HKAS 37, fair value measurement under HKFRS 13 and impairment of assets under HKAS 36.

- At the end of 2022, over 135 countries and jurisdictions have joined the two-pillar plan of the Organisation for Economic Co-operation and Development (OECD) to reform international taxation rules to ensure multinational enterprises pay a fair share of tax wherever they operate, with a global minimum tax rate of 15%. The exact timing of implementation of the Pillar Two model rules varies between jurisdictions[24], with some expected to enact the rules as early as 2023. In response to the imminent implementation of the rules, the IASB undertook a standard-setting project and published an ED *International Tax Reform – Pillar Two Model Rules* in January 2023 which proposes amendments to IAS 12 to introduce a mandatory temporary exception from accounting for deferred taxes arising from application of the Pillar Two model rules. The IASB will start deliberating the feedback received on the ED in April 2023 and aims to issue the amendments as soon as practicable. Hong Kong entities engaging in multinational operations should monitor the latest developments of the international tax reform and the proposed amendments to IAS 12 for future financial reporting purposes.

[24] The Hong Kong Government has announced in its 2023-2024 Budget Speech that Hong Kong plans to apply the global minimum effective tax rate on the relevant large multinational enterprise groups and implement the domestic minimum top-up tax starting from 2025 onwards. See paragraph 200 of the 2023-2024 Budget Speech by the Financial Secretary, the Hon Paul MP Chan.

Appendix – New and revised Hong Kong Financial Reporting Standards as well as Agenda Decisions issued by the IFRS IC

The following amendments to HKFRSs and Accounting Guideline became effective as of 1 January 2022:

Standards	**Description**
Annual Improvements to HKFRS Standards 2018-2020: • Amendment to HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* • Amendment to HKFRS 9 *Financial Instruments* • Amendment to Illustrative Examples accompanying HKFRS 16 *Leases* • Amendment to HKAS 41 *Agriculture*	Annual Improvements to HKFRS Standards 2018-2020 (amendments) address the following topics: • Subsidiary as a First-time Adopter • Fees in the ‘10 per cent’ Test for Derecognition of Financial Liabilities • Lease Incentives • Taxation in Fair Value Measurements
Amendments to HKFRS 3 *Business Combinations – Reference to the Conceptual Framework*	The amendments update a reference in HKFRS 3 to the *Conceptual Framework for Financial Reporting* issued in 2018 (Conceptual Framework). The amendments also add to HKFRS 3 an exception to its requirement for an entity to refer to the *Conceptual Framework* to determine what constitutes an asset or a liability.
Amendments to HKAS 16 *Property, Plant and Equipment – Proceeds before Intended Use*	The amendments clarify the accounting requirements for proceeds received by an entity from selling items produced while testing an item of property, plant or equipment before it is used for its intended purpose.
Amendments to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets – Onerous Contracts – Cost of Fulfilling a Contract*	The amendments clarify that for the purpose of assessing whether a contract is onerous under HKAS 37, the cost of fulfilling the contract comprises the costs that relate directly to the contract. Costs that relate directly to a contract include both the incremental costs of fulfilling that contract and an allocation of other costs that relate directly to fulfilling contracts.
Amendments to HKFRS 16 *Leases – Covid-19-Related Rent Concessions beyond 30 June 2021*	The amendments extend the availability of the practical expedient in HKFRS 16.46A so that it applies to rent concessions for which any reduction in lease payments affects only payments originally due on or before 30 June

Standards	Description
	2022, provided the other conditions for applying the practical expedient are met.
Accounting Guideline 5 (Revised) *Merger Accounting for Common Control Combinations* [25]	AG 5 was amended in several aspects to respond to the feedback received from the post-implementation review of AG5.

The following new and amended standards, interpretation and practice statement have been issued but are not yet effective as of 1 January 2022. They are available for early adoption.

Effective from annual periods beginning on or after:	New and Amended Standards, Interpretation and Practice Statement
New Standard	
1 January 2023	HKFRS 17 *Insurance Contracts*
1 January 2023	Amendments to HKFRS 17 *Insurance Contracts*
1 January 2023	Initial Application of HKFRS 17 and HKFRS 9 – *Comparative Information*
Amended Standards, Interpretation, Practice Statement and Accounting Guideline	
1 January 2023	Amendments to HKAS 1 *Presentation of Financial Statements* and HKFRS Practice Statement 2 *Making Materiality Judgements – Disclosure of Accounting Policies*
1 January 2023	Amendments to HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors – Definition of Accounting Estimates*
1 January 2023	Amendments to HKAS 12 *Income Taxes – Deferred Tax related to Assets and Liabilities arising from a Single Transaction*
1 January 2024[26]	Amendments to HKAS 1 *Presentation of Financial Statements – Classification of Liabilities as Current or Non-current*
1 January 2024[26]	Amendments to HKAS 1 *Presentation of Financial Statements – Non-current Liabilities with Covenants*
Should only be applied when an entity applies the Amendments to HKAS 1 as referred to in the above	Hong Kong Interpretation 5 (Revised) *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*

[25] This Accounting Guideline is effective for common control combinations that occur on or after the beginning of the first annual reporting period beginning on or after 1 January 2022.

[26] Both amendments are to be applied as a package.

Effective from annual periods beginning on or after:	**New and Amended Standards, Interpretation and Practice Statement**
1 January 2024	Amendments to HKFRS 16 *Leases – Lease Liability in a Sale and Leaseback*
Effective date to be determined by the IASB but early adoption is permitted	Amendments to HKFRS 10 *Consolidated Financial Statements* and HKAS 28 *Investments in Associates and Joint Ventures – Sale or Contribution of Assets between an Investor and its Associate or Joint Venture*

The following agenda decisions were published by the IFRS IC in 2022:

IFRS IC Update	**Agenda Decisions**
March 2022	• TLTRO III Transactions – IFRS 9 *Financial Instruments* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
April 2022	• Demand Deposits with Restrictions on Use arising from a Contract with a Third Party – IAS 7 *Statement of Cash Flows*
May 2022	• Principal versus Agent: Software Reseller – IFRS 15 *Revenue from Contracts with Customers*
July 2022	• Negative Low Emissions Vehicle Credits – IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* • Special Purpose Acquisition Companies (SPAC): Classification of Public Shares as Financial Liabilities or Equity – IAS 32 *Financial Instruments: Presentation* • Transfer of Insurance Coverage under a Group of Annuity Contracts – IFRS 17 *Insurance Contracts*
October 2022	• Lessor Forgiveness of Lease Payments – IFRS 9 *Financial Instruments* and IFRS 16 *Leases* • Multi-currency Groups of Insurance Contracts – IFRS 17 *Insurance Contracts* and IAS 21 *The Effects of Changes in Foreign Exchange Rates* • Special Purpose Acquisition Companies (SPAC): Accounting for Warrants At Acquisition

About the Standard Setting Department

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorized by law to set and promulgate standards relating to financial reporting, auditing, ethics and sustainability disclosures for professional accountants in Hong Kong. The due process documents of the Standard Setting Department (SSD) explain the processes and procedures for developing local standards and adopting international standards.

To find out more about how SSD contributes to international standard-setting, please visit: https://www.hkicpa.org.hk/en/Standards-setting/Standards/How-we-set-standards-and-contribute-to-international-standards

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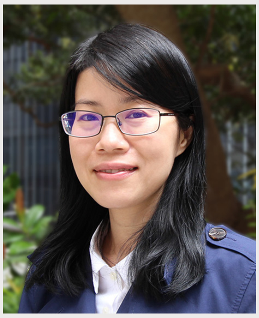

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