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

MEMBERS' HANDBOOK

Update No. 87

(Issued 28 June 2010)

Handbook Improvements only

Document Reference and Title	***Instructions***	***Explanations***

VOLUME II

Contents of Volume II	Insert the revised pages i and ii. Discard the replaced pages i and ii.	Revised contents pages

Amendments to the following Standards, Basis for Conclusions and Implementation Guidance were previously set out in the Appendix to the Standards as they were not yet effective. The Institute has taken this opportunity to incorporate the amendments applicable on 1 January 2010 in the relevant affected Standards, Basis for Conclusions and Implementation Guidance, for greater clarity.

Reference to HKAS/HKFRS contained in respective Implementation Guidance and Illustrative Examples are amended to IAS/IFRS to comply with relevant requirements contained in the International Accounting Standards Board license agreement.

This update 87 covers 6 documents set out below.

HONG KONG ACCOUNTING STANDARDS (HKAS)

HKAS 12 *Income Taxes*	Replace the Standard with revised Standard	Amendments due to - HKAS 1 (Revised) - HKFRS 3 (Revised) - HKFRS 9 - Editorial corrections to comply with IASB license agreement
HKAS 17 *Leases*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKFRS 9 - *Improvements to HKFRSs 2009*

HKAS 19 *Employee Benefits* (Basis for Conclusions)	Replace the cover page and page 2 with revised cover page and page 2. Insert page 40 after page 39	Amendments due to - HKFRS 9
HKAS 21 *The Effects of Changes in Foreign Exchange Rates*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKAS 1 (Revised) - HKAS 27 (Revised) - Amendments to HKFRS 1 and HKAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* - HKFRS 9
HKAS 40 *Investment Property*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKAS 1 (Revised) - HKFRS 9 - *Improvements to HKFRSs 2008*
HKAS 41 *Agriculture*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKAS 1 (Revised) - HKFRS 9 - *Improvements to HKFRSs 2008* - Editorial corrections to comply with IASB license agreement

GLOSSARY OF TERMS RELATING TO HONG KONG FINANCIAL REPORTING STANDARDS

New Divider GLOSSARY OF TERMS RELATING TO HONG KONG FINANCIAL REPORTING STANDARDS	Insert New Divider after HK(SIC) Interpretation 32 *Intangible Assets – Web Site Costs*.	New Divider

HONG KONG FINANCIAL REPORTING STANDARD FOR PRIVATE ENTITIES

New Divider HONG KONG FINANCIAL REPORTING STANDARD FOR PRIVATE ENTITIES	Insert New Divider after Glossary of Terms Relating to HKFRSs.	New Divider

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MEMBERS' HANDBOOK
CONTENTS OF VOLUME II

(Updated to June 2010)

HKAS 12
Revised ~~November 2004~~June 2010

Hong Kong Accounting Standard 12

Income Taxes

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D Amendments resulting from other HKFRSs

Hong Kong Accounting Standard 12 *Income Taxes* (HKAS 12) is set out in paragraphs 1-~~91~~95. All the paragraphs have equal authority. HKAS 12 shall be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 HKAS 12 is effective for accounting periods beginning on or after 1 January 2005. The major features of HKAS 12 are as follows.

IN2 HKAS 12 requires an entity to account for deferred tax using the balance sheet liability method, which focuses on temporary differences. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the statement of financial position. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

IN3 HKAS 12 requires an entity to recognise a deferred tax liability or (subject to certain conditions) asset for all temporary differences, with certain exceptions noted below.

IN4 HKAS 12 requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised. Where an entity has a history of tax losses, the entity recognises a deferred tax asset only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available.

IN5 As an exception to the general requirement set out in paragraph IN3 above, HKAS 12 prohibits the recognition of deferred tax liabilities and deferred tax assets arising from certain assets or liabilities whose carrying amount differs on initial recognition from their initial tax base.

IN6 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

(a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and

(b) it is probable that the temporary difference will not reverse in the foreseeable future.

Where this exception has the result that no deferred tax liabilities have been recognised, HKAS 12 requires an entity to disclose the aggregate amount of the temporary differences concerned.

IN7 HKAS 12 prohibits the recognition of deferred tax liabilities arising from the initial recognition of goodwill.

IN8 HKAS 12 requires an entity to recognise a deferred tax liability in respect of asset revaluations.

IN9 The tax consequences of recovering the carrying amount of certain assets or liabilities may depend on the manner of recovery or settlement, for example:

(a) in certain countries, capital gains are not taxed at the same rate as other taxable income; and

(b) in some countries, the amount that is deducted for tax purposes on sale of an asset is greater than the amount that may be deducted as depreciation.

HKAS 12 requires that the measurement of deferred tax liabilities and deferred tax assets should be based on the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities.

IN10 HKAS 12 prohibits discounting of deferred tax assets and liabilities.

IN11 HKAS 12 requires that an entity which makes the current/non-current distinction should not classify deferred tax assets and liabilities as current assets and liabilities.[1]

[1] This requirement has been moved to paragraph 56 of HKAS 1 (Revised) *Presentation of Financial Statements*.

IN12 HKAS 12 establishes more restrictive conditions on offsetting, based largely on those for financial assets and liabilities in HKAS 32 *Financial Instruments: Presentation*.

IN13 HKAS 12 requires an explanation of the relationship between tax expense and accounting profit if not explained by the tax rates effective in the reporting entity's country to take either or both of the following forms:

(a) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s); or

(b) a numerical reconciliation between the average effective tax rate and the applicable tax rate.

HKAS 12 also requires an explanation of changes in the applicable tax rate(s) compared to the previous accounting period.

IN14 [Not used]

Hong Kong Accounting Standard 12
Income Taxes

Objective

The objective of this Standard is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

(a) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's ~~balance sheet~~statement of financial position; and

(b) transactions and other events of the current period that are recognised in an entity's financial statements.

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions.

This Standard requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognised in profit or loss, any related tax effects are also recognised in profit or loss. For transactions and other events recognised outside profit or loss (either in other comprehensive income or directly in equity), any related tax effects are also recognised outside profit or loss (either in other comprehensive income or directly in equity, respectively). Similarly, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill arising in that business combination or the amount of the bargain purchase gain recognised~~any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination~~.

This Standard also deals with the recognition of deferred tax assets arising from unused tax losses or unused tax credits, the presentation of income taxes in the financial statements and the disclosure of information relating to income taxes.

General Principles

- This Standard deals with current taxes and deferred taxes. Some general principles relating to the treatment of deferred taxes in this Standard are set out below.
- The future tax consequences of transactions and other events recognised in an entity's ~~balance sheet~~statement of financial position give rise to deferred tax liabilities and assets, and are calculated in accordance with the following formulae:

Carrying amounts of assets or liabilities	-	*Tax bases of assets or liabilities*	=	*Taxable or deductible temporary differences*
Taxable or deductible temporary differences	X	*Tax rates*	=	*Deferred tax liabilities or assets*

- Deferred tax assets also arise from unused tax losses that tax law allows to be carried forward, and are calculated in accordance with the following formula:

Unused tax losses	*X*	*Tax rates*	=	*Deferred tax assets*

- The notion of temporary differences is central to understanding the requirements of this Standard. A taxable temporary difference gives rise to a deferred tax liability. A deductible temporary difference gives rise to a deferred tax asset. A taxable or deductible temporary difference arises when the carrying amount of an asset or a liability differs from its tax base. The meaning of "tax base" is of key importance to applying the requirements of this Standard. Tax base is defined in paragraph 5 of this Standard and is generally the amount that would be shown as an asset or a liability in a ~~balance sheet~~statement of financial position prepared for tax purposes. Unlike the practice in some other countries, it is not customary in Hong Kong for entities to prepare tax-based ~~balance sheets~~statements of financial position. However, the notion of a tax-based ~~balance sheet~~statement of financial position is relevant to this Standard and may be used as a basis for working papers developed for the purpose of implementing this Standard.

- This Standard generally requires an entity to recognise the tax consequences of transactions and other events consistently with the way that it recognises the transactions and other events themselves. Thus, for transactions and other events recognised in net profit or loss for the period, any related tax effects are also recognised in net profit or loss for the period. For transactions and other events that are recognised as direct credits to equity (direct debits to equity), any related tax effects are generally recognised as direct debits to equity (direct credits to equity).

Scope

1 This Standard shall be applied in accounting for income taxes.

2 For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.

3 [Deleted]

4 This Standard does not deal with the methods of accounting for government grants (see HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*) or investment tax credits. However, this Standard does deal with the accounting for temporary differences that may arise from such grants or investment tax credits.

Definitions

5 The following terms are used in this Standard with the meanings specified:

Accounting profit **is profit or loss for a period before deducting tax expense.**

Taxable profit (tax loss) **is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).**

Tax expense (tax income) **is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.**

Current tax **is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.**

Deferred tax liabilities **are the amounts of income taxes payable in future periods in respect of taxable temporary differences.**

Deferred tax assets **are the amounts of income taxes recoverable in future periods in respect of:**

(a) deductible temporary differences;

(b) the carryforward of unused tax losses; and

(c) the carryforward of unused tax credits.

Temporary differences **are differences between the carrying amount of an asset or liability in the ~~balance sheet~~statement of financial position and its tax base. Temporary differences may be either:**

(a) *taxable temporary differences*, **which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or**

(b) *deductible temporary differences*, **which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.**

The *tax base* **of an asset or liability is the amount attributed to that asset or liability for tax purposes.**

6 Tax expense (tax income) comprises current tax expense (current tax income) and deferred tax expense (deferred tax income).

Tax Base

This section provides guidance for the calculation of tax base in different circumstances. The concept of tax base is of key importance in implementing the principles in this Standard. A difference between the carrying amount of an asset or a liability and the tax base of the asset or liability is a taxable temporary difference or a deductible temporary difference that gives rise to a deferred tax liability or asset, respectively.

7 The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.

The tax base of an asset may be calculated as the asset's carrying amount, less any future taxable amounts plus any future deductible amounts that are expected to arise from recovering the asset's carrying amount as at the ~~balance sheet date~~end of the reporting period. For example, in the case of plant and equipment, the tax base is the tax written down value.

Examples

Examples of the calculation of the tax base of assets

1 A machine cost $100 and is expected to be ultimately disposed of for an amount that is equal to or less than cost. For tax purposes, depreciation of $30 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine (that is, revenue generated from recovering the carrying amount of the machine) is taxable, any gain or loss on disposal will be subject to a balancing adjustment (such as for recouped depreciation) for tax purposes. The machine has been depreciated for accounting purposes by $20.

The tax base of the machine is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$80	-	*$80*	+	*$70*	=	*$70*

2 Leasehold land with a cost of $100 and a carrying amount of $90 is revalued to $150. For tax purposes, depreciation of $20 has been deducted in the current and prior periods and the remaining cost will be deductible in future periods through depreciation. Revenue generated from the use of the leasehold land is taxable and any gain or loss on disposal will be subject to a balancing adjustment for tax purposes.

The tax base of the leasehold land is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$150	-	*$150*	+	*$80*	=	*$80*

3 Freehold land with a cost of $100 is revalued to $150. For tax purposes, there is no depreciation. Revenue generated from the use of the freehold land is taxable. However, any gain on disposal of the land at the revalued amount will not be taxable.

The tax base of the freehold land is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$150	-	*$150*	+	*$100*	=	*$100*

4 Trade receivables has a carrying amount of $100 and is expected to be recovered through payments from debtors. There are no doubtful debts. The related revenue of $100 has already been included in the calculation of taxable profit (tax loss).

The tax base of the trade receivables is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$100	-	*Nil*	+	*Nil*	=	*$100*

5 Trade receivables has a carrying amount of $100, for which specific bad debt provisions amounting to $20 have been made. These provisions have already been deducted for tax purposes.

The tax base of the trade receivables is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$100	-	*Nil*	+	*Nil*	=	*$100*

6 Trade receivables has a carrying amount of $100, for which general bad debt provisions amounting to $20 have been made. These provisions have not yet been deducted for tax purposes but are expected to give rise to future deductible amounts.

The tax base of the trade receivables is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$100	-	*Nil*	+	*$20*	=	*$120*

7 A loan receivable has a carrying amount of $100 and is expected to be recovered through payments from the borrower. The repayment of the carrying amount of the loan as at the ~~reporting date~~end of the reporting period will have no tax consequences.

The tax base of the loan is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$100	-	*Nil*	+	*Nil*	=	*$100*

8 Dividends receivable from a subsidiary have a carrying amount of $100. The dividends are not taxable.

The tax base of the dividends receivable is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*[*]
$100	-	*Nil*	+	*Nil*	=	*$100*

9 An interest receivable has a carrying amount of $100. The related interest revenue will be taxed only when received.

The tax base of the interest receivable is:

Carrying Amount		*Taxable Amounts*		*Deductible Amounts*		*Tax Base*
$100	-	*$100*	+	*Nil*	=	*Nil*

8 The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

The tax base of a liability may be calculated as the liability's carrying amount as at the ~~balance sheet date~~end of the reporting period less any future deductible amounts, plus any future taxable amounts, that are expected to arise from settling the liability's carrying amount as at the ~~balance sheet date~~end of the reporting period. The tax base of a liability that is in the nature of "revenue received in advance", however, is calculated as the liability's carrying amount less any amount of the "revenue received in advance" that has been included in taxable amounts in the current or a previous reporting period.

[*] Under this analysis, there is no taxable temporary difference. An alternative analysis is that the accrued dividends receivable have a tax base of nil and that a tax rate of nil is applied to the resulting taxable temporary difference of 100. Under both analyses, there is no deferred tax liability.

Examples

Calculation of the tax base of liabilities

1 Current liabilities include accrued wages with a carrying amount of $100. The related expense has already been deducted for tax purposes on an accrued basis (that is, the wages were deducted for tax purposes in the same year in which they were recognised as an expense for accounting purposes).

The tax base of the accrued expenses is:

Carrying Amount		*Deductible Amounts*		*Taxable Amounts*		*Tax Base*
$100	-	*Nil*	+	*NIL*	=	*$100*

2 Current liabilities include accrued fines and penalties with a carrying amount of $100. Fines and penalties are not deductible for tax purposes.

The tax base of the accrued fines and penalties is:

Carrying Amount		*Deductible Amounts*		*Taxable Amounts*		*Tax Base**
$100	-	*Nil*	+	*Nil*	=	*$100*

3 A loan payable has a carrying amount of $100. The repayment of the carrying amount of the loan as at the ~~reporting date~~end of the reporting period will not give rise to taxable or deductible amounts.

The tax base of the loan is:

Carrying Amount		*Deductible Amounts*		*Taxable Amounts*		*Tax Base*
$100	-	*Nil*	+	*Nil*	=	*$100*

4 Current liabilities include interest revenue received in advance, with a carrying amount of $100. The related interest revenue was taxed on a cash basis.

The tax base of the interest received in advance is:

Carrying Amount		*Amount of revenue received in advance that has increased taxable amount (or decreased tax loss)*		*Tax Base*
$100	-	*$100*	=	*Nil*

5 A foreign currency loan payable has a carrying amount on initial recognition of $100. Subsequently, the carrying amount is reduced to $90 to reflect the change in exchange rates (an unrealised foreign exchange gain). Exchange gains are only taxable when they are realised. The repayment of the $90 carrying amount of the loan will give rise to taxable amounts of $10.

The tax base of the loan is:

Carrying Amount		*Deductible Amounts*		*Taxable Amounts*		*Tax Base*
$90	-	*Nil*	+	*$10*	=	*$100*

* Under this analysis, there is no deductible temporary difference. An alternative analysis is that the accrued fines and penalties payable have a tax base of nil and that a tax rate of nil is applied to the resulting deductible temporary difference of 100. Under both analyses, there is no deferred tax asset.

6 An interest payable has a carrying amount of $100. The related interest will be deductible for tax purposes only when it is paid.

The tax base of the interest payable is:

Carrying Amount		*Deductible Amounts*		*Taxable Amounts*		*Tax Base*
$100	-	*$100*	+	*Nil*	=	*Nil*

9 Some items have a tax base but are not recognised as assets and liabilities in the ~~balance sheet~~statement of financial position. For example, research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset.

10 Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this Standard is based: that an entity shall, with certain limited exceptions, recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences. Example C following paragraph 52 illustrates circumstances when it may be helpful to consider this fundamental principle, for example, when the tax base of an asset or liability depends on the expected manner of recovery or settlement.

11 In consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. The tax base is determined by reference to a consolidated tax return in those jurisdictions in which such a return is filed. In other jurisdictions, the tax base is determined by reference to the tax returns of each entity in the group.

Recognition of current tax liabilities and current tax assets

12 Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.

13 The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an asset.

14 When a tax loss is used to recover current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

Recognition of deferred tax liabilities and deferred tax assets

Taxable temporary differences

15 A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination; and

(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised in accordance with paragraph 39.

16 It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39.

The recovery of the carrying amount of many assets gives rise to taxable and deductible amounts. For example, an item of equipment may be used to produce goods that are in turn used to generate revenue, and therefore taxable amounts, and give rise to depreciation that is a deductible amount. When the carrying amount of the asset (equipment) exceeds its tax base, the amount of taxable economic benefits (taxable amounts) will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to settle the resulting income taxes in future periods is a deferred tax liability. The example below illustrates a circumstance in which a deferred tax liability arises that is required to be recognised by this .

Example

An example of circumstances that give rise to a deferred tax liability that is required to be recognised

An asset that costs $150 has a carrying amount of $100. Cumulative depreciation for tax purposes is $90 and the tax rate is 30%.

	Carrying Amount	**Tax Base**	**Temporary Difference**
	$	$	$
At acquisition	150	150	
Accumulated Depreciation	50	90	
Net amount	100	60	40
Tax rate			30%
Deferred Tax Liability			12

The tax base of the asset is $60 (cost of $150 less cumulative tax depreciation of $90). In recovering the carrying amount of $100, the entity will derive taxable amounts of $100, but will only be able to deduct tax depreciation of $60. Consequently, the entity will pay income taxes of $12 (calculated as $40 x 30%) as a result of recovering the carrying amount of the asset. The difference between the carrying amount of $100 and the tax base of $60 is a taxable temporary difference of $40. Therefore, the entity recognises a deferred tax liability of $12 (calculated as $40 x 30%) representing the effect on income tax payable as a consequence of recovering the carrying amount of the asset.

17 Some temporary differences arise when income or expense is included in accounting profit in one period but is included in taxable profit in a different period. Such temporary differences are often described as timing differences. The following are examples of temporary differences of this kind which are taxable temporary differences and which therefore result in deferred tax liabilities:

(a) interest revenue is included in accounting profit on a time proportion basis but may, in some jurisdictions, be included in taxable profit when cash is collected. The tax base of any receivable recognised in the ~~balance sheet~~statement of financial position with respect to such revenues is nil because the revenues do not affect taxable profit until cash is collected;

(b) depreciation used in determining taxable profit (tax loss) may differ from that used in determining accounting profit. The temporary difference is the difference between the carrying amount of the asset and its tax base which is the original cost of the asset less all deductions in respect of that asset permitted by the taxation authorities in determining taxable profit of the current and prior periods. A taxable temporary difference arises, and results in a deferred tax liability, when tax depreciation is accelerated (if tax depreciation is less rapid than accounting depreciation, a deductible temporary difference arises and results in a deferred tax asset); and

(c) development costs may be capitalised and amortised over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred. Such development costs have a tax base of nil as they have already been deducted from taxable profit. The temporary difference is the difference between the carrying amount of the development costs and their tax base of nil.

18 Temporary differences also arise when:

(a)* ~~the cost of a business combination is allocated by recognising~~ the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with HKFRS 3 *Business Combinations*, but no equivalent adjustment is made for tax purposes (see paragraph 19);

(b) assets are revalued and no equivalent adjustment is made for tax purposes (see paragraph 20);

(c) goodwill arises in a business combination (see paragraphs 21);

(d) the tax base of an asset or liability on initial recognition differs from its initial carrying amount, for example when an entity benefits from non-taxable government grants related to assets (see paragraphs 22 and 33); or

(e) the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures becomes different from the tax base of the investment or interest (see paragraphs 38 - 45).

Business combinations

19* ~~The cost of a business combination is allocated by recognising~~With limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill (see paragraph 66).

* Amendments effective for annual periods beginning on or after 1 July 2009.

Assets carried at fair value

20 HKFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, HKAS 16 *Property, Plant and Equipment,* HKAS 38 *Intangible Assets,* HKAS 39 *Financial Instruments: Recognition and Measurement* and HKAS 40 *Investment Property*). In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises. In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted. Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will differ from the amount of those economic benefits. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. This is true even if:

(a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or

(b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

Goodwill

21* Goodwill arising in a business combination is measured as the excess of (a) over (b) below

(a) the aggregate of:

(i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;

(ii) the amount of any non-controlling interest in the acquiree recognised in accordance with HKFRS 3; and

(iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured in accordance with HKFRS 3.

~~the cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.~~ Many taxation authorities do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, in such jurisdictions, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. In such jurisdictions, goodwill has a tax base of nil. Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference. However, this Standard does not permit the recognition of the resulting deferred tax liability because goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill.

21A* Subsequent reductions in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and are therefore not recognised under paragraph 15(a). For example, if ~~goodwill acquired~~ in a business combination an entity recognises goodwill of CU100 ~~has a cost of 100 but~~ that has a tax base of nil, paragraph 15(a) prohibits the entity from recognising the resulting deferred tax liability. If the entity subsequently recognises an impairment loss of CU20 for that goodwill, the amount of the taxable temporary difference relating to the goodwill is reduced from CU100 to CU80, with a resulting decrease in the value of the unrecognised deferred tax liability. That decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill and is therefore prohibited from being recognised under paragraph 15(a).

* Amendments effective for annual periods beginning on or after 1 July 2009.

21B* Deferred tax liabilities for taxable temporary differences relating to goodwill are, however, recognised to the extent they do not arise from the initial recognition of goodwill. For example, if ~~goodwill acquired~~ in a business combination an entity recognises goodwill of CU100~~has a cost of 100~~ that is deductible for tax purposes at a rate of 20 per cent per year starting in the year of acquisition, the tax base of the goodwill is CU100 on initial recognition and CU80 at the end of the year of acquisition. If the carrying amount of goodwill at the end of the year of acquisition remains unchanged at CU100, a taxable temporary difference of CU20 arises at the end of that year. Because that taxable temporary difference does not relate to the initial recognition of the goodwill, the resulting deferred tax liability is recognised.

Initial recognition of an asset or liability

22 A temporary difference may arise on initial recognition of an asset or liability, for example if part or all of the cost of an asset will not be deductible for tax purposes. The method of accounting for such a temporary difference depends on the nature of the transaction ~~which~~ that led to the initial recognition of the asset or liability:

(a)* in a business combination, an entity recognises any deferred tax liability or asset and this affects the amount of goodwill or bargain purchase gain it recognises~~the amount of any excess over the cost of the combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities~~ (see paragraph 19);

(b) if the transaction affects either accounting profit or taxable profit, an entity recognises any deferred tax liability or asset and recognises the resulting deferred tax expense or income in ~~the income statement~~profit or loss (see paragraph 59);

(c) if the transaction is not a business combination, and affects neither accounting profit nor taxable profit, an entity would, in the absence of the exemption provided by paragraphs 15 and 24, recognise the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent. Therefore, this Standard does not permit an entity to recognise the resulting deferred tax liability or asset, either on initial recognition or subsequently (see example below). Furthermore, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated.

Example illustrating paragraph 22(c)

An entity intends to use an asset which cost $1,000 throughout its useful life of five years and then dispose of it for a residual value of nil. The tax rate is 40%. Depreciation of the asset is not deductible for tax purposes. On disposal, any capital gain would not be taxable and any capital loss would not be deductible.

As it recovers the carrying amount of the asset, the entity will earn taxable income of $1,000 and pay tax of $400. The entity does not recognise the resulting deferred tax liability of $400 because it results from the initial recognition of the asset.

In the following year, the carrying amount of the asset is $800. In earning taxable income of $800, the entity will pay tax of $320. The entity does not recognise the deferred tax liability of $320 because it results from the initial recognition of the asset.

23 In accordance with HKAS 32 *Financial Instruments: Presentation* the issuer of a compound financial instrument (for example, a convertible bond) classifies the instrument's liability component as a liability and the equity component as equity. In some jurisdictions, the tax base of the liability component on initial recognition is equal to the initial carrying amount of the sum of the liability and equity components. The resulting taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. Therefore, the exception set out in paragraph 15(b) does not apply. Consequently, an entity recognises the resulting deferred tax liability. In accordance with paragraph 61A, the deferred tax is charged directly to the carrying amount of the equity component. In accordance with paragraph 58, subsequent changes in the deferred tax liability are recognised in ~~the income statement~~profit or loss as deferred tax expense (income).

* Amendment effective for annual periods beginning on or after 1 July 2009.

Deductible temporary differences

24 A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

(a) is not a business combination; and

(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognised in accordance with paragraph 44.

25 It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. Similarly, if the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

Provisions such as guarantees, product warranties or employee entitlements (including long service payments) made for accounting purposes on an estimated basis may be deducted in determining accounting profit in the reporting period in which the liability for such items arises, but deducted in determining taxable profit when paid. The example below illustrates a circumstance in which a deferred tax asset arises.

Example

An example of circumstances that give rise to a deferred tax asset

An entity recognises a liability of $100 for accrued product warranty costs. For tax purposes, the product warranty costs will not be deductible until the entity meets claims. The tax rate is 30%.

	Carrying Amount	**Tax Base**	**Temporary Difference**
	$	$	$
Accrued Warranty Costs	100	Nil	100
Tax rate			30%
Deferred Tax Asset			30

The tax base of the liability is nil (carrying amount of $100, less the deductible amount of $100 in respect of that liability in future periods). In settling the liability for its carrying amount, the entity will reduce its future taxable amount by $100 and, consequently, reduce its future tax payments by $30 (calculated as $100 x 30%). The difference between the carrying amount of $100 and the tax base of nil is a deductible temporary difference of $100. Therefore, the entity recognises a deferred tax asset of $30 (calculated as $100 x 30%), provided that it is probable that the entity will earn sufficient taxable amounts in future periods to benefit from a reduction in tax payments.

26 The following are examples of deductible temporary differences ~~which~~ that result in deferred tax assets:

(a) retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the entity or when retirement benefits are paid by the entity. A temporary difference exists between the carrying amount of the liability and its tax base; the tax base of the liability is usually nil. Such a deductible temporary difference results in a deferred tax asset as economic benefits will flow to the entity in the form of a deduction from taxable profits when contributions or retirement benefits are paid;

(b) research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset;

(c)* ~~the cost of a business combination is allocated by recognising~~with limited exceptions, an entity recognises the identifiable assets acquired and liabilities assumed in a business combination at their fair values at the acquisition date. When a liability assumed is recognised at the acquisition date but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects goodwill (see paragraph 66); and

(d) certain assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes (see paragraph 20). A deductible temporary difference arises if the tax base of the asset exceeds its carrying amount.

27 The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

28 It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

(a) in the same period as the expected reversal of the deductible temporary difference; or

(b) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise.

29 When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:

(a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilised; or

(b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

* Amendment effective for annual periods beginning on or after 1 July 2009.

Example illustrating paragraph 29(a)

An entity has a tax loss of $1000 which can be carried forward for 5 years. The estimated cumulative taxable profits for the next five years are $600. It is estimated that $400 of the tax loss will expire unused. The tax rate is 30%.

The entity recognises a deferred tax asset of $180 ($600 x 30%)

Suppose the entity expects to buy a machine that costs $300 with a useful life for accounting purposes of 2 years, and a useful life for the purpose of calculating tax depreciation of 3 years. In year 1, a deductible temporary difference of $50 (representing the tax base of $200 less the carrying amount of $150) will arise corresponding to taxable income of $50 and a further deductible amount (and taxable income) of $50 will arise in year 2. These differences will reverse (with a reduction of $100 in taxable profit) in year 3.

The entity ignores the taxable income of $50 in years 1 and 2 when evaluating whether there is sufficient taxable profit to utilise the tax loss carried forward. This is because it merely creates another deductible temporary difference, which itself needs to be tested for recoverability.

30 Tax planning opportunities are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carryforward. For example, in some jurisdictions, taxable profit may be created or increased by:

(a) electing to have interest income taxed on either a received or receivable basis;

(b) deferring the claim for certain deductions from taxable profit;

(c) selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation; and

(d) selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or tax credit carryforward still depends on the existence of future taxable profit from sources other than future originating temporary differences.

31 When an entity has a history of recent losses, the entity considers the guidance in paragraphs 35 and 36.

32 [Deleted]

<u>Goodwill</u>

<u>32A* If the carrying amount of goodwill arising in a business combination is less than its tax base, the difference gives rise to a deferred tax asset. The deferred tax asset arising from the initial recognition of goodwill shall be recognised as part of the accounting for a business combination to the extent that it is probable that taxable profit will be available against which the deductible temporary difference could be utilised.</u>

Initial recognition of an asset or liability

33 One case when a deferred tax asset arises on initial recognition of an asset is when a non-taxable government grant related to an asset is deducted in arriving at the carrying amount of the asset but, for tax purposes, is not deducted from the asset's depreciable amount (in other words its tax base); the carrying amount of the asset is less than its tax base and this gives rise to a deductible temporary difference. Government grants may also be set up as deferred income in which case the difference between the deferred income and its tax base of nil is a deductible temporary difference. Whichever method of presentation an entity adopts, the entity does not recognise the resulting deferred tax asset, for the reason given in paragraph 22.

<u>* Amendment effective for annual periods beginning on or after 1 July 2009.</u>

Unused tax losses and unused tax credits

34 **A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.**

35 The criteria for recognising deferred tax assets arising from the carryforward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

36 An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised:

(a) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;

(b) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;

(c) whether the unused tax losses result from identifiable causes which are unlikely to recur; and

(d) whether tax planning opportunities (see paragraph 30) are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not recognised.

Reassessment of unrecognised deferred tax assets

37 At ~~each balance sheet date~~the end of each reporting period, an entity reassesses unrecognised deferred tax assets. The entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered. For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria set out in paragraph 24 or 34. Another example is when an entity reassesses deferred tax assets at the date of a business combination or subsequently (see paragraphs 67 and 68).

Investments in subsidiaries, branches and associates and interests in joint ventures

38 Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise in a number of different circumstances, for example:

(a) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;

(b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and

(c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

39 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

(a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and

(b) it is probable that the temporary difference will not reverse in the foreseeable future.

40 As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with that investment (including the temporary differences arising not only from undistributed profits but also from any foreign exchange translation differences). Furthermore, it would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability. The same considerations apply to investments in branches.

41 The non-monetary assets and liabilities of an entity are measured in its functional currency (see HKAS 21 *The Effects of Changes in Foreign Exchange Rates*). If the entity's taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss (see paragraph 58).

42 An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.

43 The arrangement between the parties to a joint venture usually deals with the sharing of the profits and identifies whether decisions on such matters require the consent of all the venturers or a specified majority of the venturers. When the venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred tax liability is not recognised.

44 An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that:

(a) the temporary difference will reverse in the foreseeable future; and

(b) taxable profit will be available against which the temporary difference can be utilised.

45 In deciding whether a deferred tax asset is recognised for deductible temporary differences associated with its investments in subsidiaries, branches and associates, and its interests in joint ventures, an entity considers the guidance set out in paragraphs 28 to 31.

Measurement

46 Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the ~~balance sheet date~~end of the reporting period.

47 Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the ~~balance sheet date~~end of the reporting period.

48 Current and deferred tax assets and liabilities are usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).

49 When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse.

50 [Deleted]

51 The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the ~~balance sheet date~~end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

52 In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

(a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and

(b) the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

Example A
An asset has a carrying amount of \$100 and a tax base of \$60. A tax rate of 20% would apply if the asset were sold and a tax rate of 30% would apply to other income. *The entity recognises a deferred tax liability of \$8 (\$40 at 20%) if it expects to sell the asset without further use and a deferred tax liability of \$12 (\$40 at 30%) if it expects to retain the asset and recover its carrying amount through use.*

Example B

An asset with a cost of $100 and a carrying amount of $80 is revalued to $150 (that is, an asset revaluation reserve is credited with an amount of $70) and has an expected residual value of zero. No equivalent or other adjustment is made for tax purposes. Cumulative depreciation for tax purposes is $30 and the tax rate is 30%. If the asset were to be sold for an amount greater than or equal to cost, the cumulative tax depreciation of $30 would be included in the taxable amount, but sales proceeds in excess of cost would not be taxable (the asset is not subject to capital gains tax).

Assuming the carrying amount of the asset will be recovered through use:

	Carrying Amount	Tax Base	Temporary Difference
	$	$	$
Cost	100	100	
Accumulated Depreciation	20	30	
Net Amount	80	70	
Revaluation	70	-	
Net Amount	150	70	80
Tax rate			30%
Deferred Tax Liability			24

If the entity's management expects to recover the carrying amount of the asset through use, it will generate an assessable amount of $150, but will only be able to deduct depreciation of $70. On this basis, there is a deferred tax liability of $24 (calculated as $80 x 30%).

Assuming the carrying amount of the asset will be recovered through sale, the tax base is:

Carrying amount	$150
Less taxable amount (recouped depreciation)	30
Add deductible amount	-
Tax Base	120

The deferred tax liability is therefore $150 - $120 = $30@ 30% = $9

(*Note: In accordance with paragraph 61A, the additional deferred tax that arises on the revaluation is recognised ~~as a debit to the asset revaluation reserve~~in other comprehensive income. Thus, if the carrying amount of the asset will be recovered through use, $21 [$24 less the opening balance of the deferred tax liability of $3] is recognised ~~as a debit to the asset revaluation reserve~~in other comprehensive income. If the carrying amount of the asset will be recovered through sale, $6 [$9 less the opening balance of deferred tax liability of $3] is recognised ~~as a debit to the asset revaluation reserve~~in other comprehensive income.*)

Example C

The facts are as in Example B, except that if the asset were to be sold for more than cost, the sales proceeds in excess of cost would be included in the taxable amount (taxed at 40% - the asset is subject to capital gains tax).

	Carrying Amount	Tax Base		Temporary Difference	
		Recovery Through Use	Recovery Through Sale	Recovery Through Use	Recovery Through Sale
	$	$	$	$	$
Cost	100	100	100		
Accumulated Depreciation	20	30	30		
Net Amount	80	70	70		
Revaluation	70	-	-		
Net Amount	150	70	70	80	80
Tax Rate				30%	30%/40% (see calculation below)
Deferred Tax Liability				24	29

If the entity's management expects to recover the carrying amount by using the asset, it will generate an taxable amount of $150, but will only be able to deduct depreciation of $70. On this basis, the tax base is $70, there is a taxable temporary difference of $80 and there is a deferred tax liability of $24 (calculated as $80 x 30%), as in Example B.

If the entity's management expects to recover the carrying amount by selling the asset immediately for proceeds of $150, the entity will be able to deduct the cost of $100. The net proceeds of $50 will be taxed at 40%. In addition, the cumulative tax depreciation of $30 will be included in the taxable amount and taxed at 30%. On this basis, the tax base is $70 (calculated as $100 - $30), there is a taxable temporary difference of $80 and there is a deferred tax liability of $29 (calculated as [$50 x 40%] + [$30 x 30%]).

If the tax base is not immediately apparent in this example, it may be helpful to consider the fundamental principle set out in paragraph 10.

(Note: In accordance with paragraph 61A, the additional deferred tax that arises on the revaluation is recognised ~~as a debit to the asset revaluation reserve~~in other comprehensive income. Thus, if the carrying amount of the asset will be recovered through use, $21 [$24 less the opening balance of deferred tax liability of $3] is recognised ~~as a debit to the asset revaluation reserve~~in other comprehensive income. If the carrying amount of the asset will be recovered through sale, $26 [$29 less the opening balance of deferred tax liability of $3] is recognised ~~as a debit to the asset revaluation reserve~~in other comprehensive income.)

52A In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.

52B In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b).

Example Illustrating Paragraphs 52A and 52B

The following example deals with the measurement of current and deferred tax assets and liabilities for an entity in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50%) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35%. At the ~~balance sheet date~~end of the reporting period, 31 December 20X1, the entity does not recognise a liability for dividends proposed or declared after the ~~balance sheet date~~ reporting period. As a result, no dividends are recognised in the year 20X1. Taxable income for 20X1 is $100,000. The net taxable temporary difference for the year 20X1 is $40,000.

The entity recognises a current tax liability and a current income tax expense of $50,000 ($100,000 at 50%). No asset is recognised for the amount potentially recoverable as a result of future dividends. The entity also recognises a deferred tax liability and deferred tax expense of $20,000 ($40,000 at 50%) representing the income taxes that the entity will pay when it recovers or settles the carrying amounts of its assets and liabilities based on the tax rate applicable to undistributed profits.

Subsequently, on 15 March 20X2 the entity recognises dividends of $10,000 from previous operating profits as a liability.

On 15 March 20X2, the entity recognises the recovery of income taxes of $1,500 (15% of the dividends recognised as a liability) as a current tax asset and as a reduction of current income tax expense for 20X2.

53 Deferred tax assets and liabilities shall not be discounted.

54 The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between entities. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities.

55 Temporary differences are determined by reference to the carrying amount of an asset or liability. This applies even where that carrying amount is itself determined on a discounted basis, for example in the case of retirement benefit obligations (see HKAS19 *Employee Benefits*).

56 The carrying amount of a deferred tax asset shall be reviewed at ~~each balance sheet date~~the end of each reporting period. An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.

Recognition of current and deferred tax

57 Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself. Paragraphs 58 to 68C implement this principle.

~~Income statement~~Items recognised in profit or loss

58 Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

(a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A to 65); or

(b) a business combination (see paragraphs 66 to 68).

59 Most deferred tax liabilities and deferred tax assets arise where income or expense is included in accounting profit in one period, but is included in taxable profit (tax loss) in a different period. The resulting deferred tax is recognised in ~~the income statement~~profit or loss. Examples are when:

(a) interest, royalty or dividend revenue is received in arrears and is included in accounting profit on a time apportionment basis in accordance with HKAS 18 *Revenue*, but is included in taxable profit (tax loss) on a cash basis; and

(b) costs of intangible assets have been capitalised in accordance with HKAS 38, and are being amortised in ~~the income statement~~profit or loss, but were deducted for tax purposes when they were incurred.

60 The carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences. This can result, for example, from:

(a) a change in tax rates or tax laws;

(b) a reassessment of the recoverability of deferred tax assets; or

(c) a change in the expected manner of recovery of an asset.

The resulting deferred tax is recognised in ~~the income statement~~profit or loss, except to the extent that it relates to items previously ~~charged or credited to equity~~recognised outside profit or loss (see paragraph 63).

Items ~~credited or charged directly to equity~~recognised outside profit or loss

61 ~~Current tax and deferred tax shall be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity.~~[Deleted]

61A Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

(a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).

(b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

62 Hong Kong Financial Reporting Standards require or permit ~~certain~~ particular items to be ~~credited or charged directly to equity~~recognised in other comprehensive income. Examples of such items are:

(a) a change in carrying amount arising from the revaluation of property, plant and equipment (see HKAS 16); and

(b) ~~an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*);~~[deleted]

(c) exchange differences arising on the translation of the financial statements of a foreign operation (see HKAS 21)~~; and~~.

(d) ~~amounts arising on initial recognition of the equity component of a compound financial instrument (see paragraph 23).~~[deleted]

62A Hong Kong Financial Reporting Standards require or permit particular items to be credited or charged directly to equity. Examples of such items are:

(a) an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*); and

(b) amounts arising on initial recognition of the equity component of a compound financial instrument (see paragraph 23).

63 In exceptional circumstances it may be difficult to determine the amount of current and deferred tax that relates to items ~~credited or charged to equity~~recognised outside profit or loss (either in other comprehensive income or directly in equity). This may be the case, for example, when:

(a) there are graduated rates of income tax and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed;

(b) a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously ~~charged or credited to equity~~recognised outside profit or loss; or

(c) an entity determines that a deferred tax asset should be recognised, or should no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously ~~charged or credited to equity~~recognised outside profit or loss.

In such cases, the current and deferred tax related to items that are ~~credited or charged to equity is~~recognised outside profit or loss are based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.

64 HKAS 16 does not specify whether an entity should transfer each year from revaluation surplus to retained earnings an amount equal to the difference between the depreciation or amortisation on a revalued asset and the depreciation or amortisation based on the cost of that asset. If an entity makes such a transfer, the amount transferred is net of any related deferred tax. Similar considerations apply to transfers made on disposal of an item of property, plant or equipment.

65 When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment of the tax base are ~~credited or charged to equity~~recognised in other comprehensive income in the periods in which they occur. However, if the revaluation for tax purposes is not related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of the adjustment of the tax base are recognised in ~~the income statement~~profit or loss.

65A When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends to taxation authorities on behalf of shareholders. In many jurisdictions, this amount is referred to as a withholding tax. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends.

Deferred tax arising from a business combination

66* As explained in paragraphs 19 and 26(c), temporary differences may arise in a business combination. In accordance with HKFRS 3 ~~*Business Combinations*~~, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria in paragraph 24) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and deferred tax liabilities affect the amount of goodwill or the bargain purchase gain the entity recognises~~the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination~~. However, in accordance with paragraph 15(a), an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.

67* As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. ~~a~~An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination~~deferred tax asset~~, but does not include it as part of the accounting for the business combination.~~, and therefore~~ Therefore, the acquirer does not take it into account in ~~determining~~ measuring the goodwill or bargain purchase gain it recognises in the business combination.~~the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination.~~

68* ~~If t~~The potential benefit of the acquiree's income tax loss carryforwards or other deferred tax assets ~~did~~ might not satisfy the criteria ~~in HKFRS 3~~ for separate recognition when a business combination is initially accounted for but ~~is~~ might be ~~subsequently~~ realised subsequently.~~, the acquirer shall recognise the resulting deferred tax income in profit or loss. In addition, the acquirer shall:~~

~~(a) reduce the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset from the acquisition date; and~~

~~(b) recognise the reduction in the carrying amount of goodwill as an expense.~~

~~However, this procedure shall not result in the creation of an excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination, nor shall it increase the amount previously recognised for any such excess.~~An entity shall recognise acquired deferred tax benefits that it realises after the business combination as follows:

(a) Acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in profit or loss.

(b) All other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).

* Amendments effective for annual periods beginning on or after 1 July 2009.

~~**Example**~~

~~An entity acquired a subsidiary that had deductible temporary differences of 300. The tax rate at the time of the acquisition was 30 per cent. The resulting deferred tax asset of 90 was not recognised as an identifiable asset in determining the goodwill of 500 that resulted from the business combination. Two years after the combination, the entity assessed that future taxable profit shall be sufficient to recover the benefit of all the deductible temporary differences.~~

~~*The entity recognises a deferred tax asset of 90 and, in profit or loss, deferred tax income of 90. The entity also reduces the carrying amount of goodwill by 90 and recognises an expense for this amount in profit or loss. Consequently, the cost of the goodwill is reduced to 410, being the amount that would have been recognised had the deferred tax asset of 90 been recognised as an identifiable asset at the acquisition date.*~~

~~*If the tax rate had increased to 40 per cent, the entity would have recognised a deferred tax asset of 120 (300 at 40 per cent) and, in profit or loss, deferred tax income of 120. If the tax rate had decreased to 20 per cent, the entity would have recognised a deferred tax asset of 60 (300 at 20 per cent) and deferred tax income of 60. In both cases, the entity would also reduce the carrying amount of goodwill by 90 and recognise an expense for that amount in profit or loss.*~~

Current and deferred tax arising from share-based payment transactions

68A In some tax jurisdictions, an entity receives a tax deduction (ie an amount that is deductible in determining taxable profit) that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense, and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for the consumption of employee services received as consideration for share options granted, in accordance with HKFRS 2 *Share-based Payment*, and not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise.

68B As with the research costs discussed in paragraphs 9 and 26(b) of this Standard, the difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. If the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it shall be estimated, based on information available at the end of the period. For example, if the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period.

68C As noted in paragraph 68A, the amount of the tax deduction (or estimated future tax deduction, measured in accordance with paragraph 68B) may differ from the related cumulative remuneration expense. Paragraph 58 of the Standard requires that current and deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from (a) a transaction or event ~~which~~ that is recognised, in the same or a different period, ~~directly in equity~~outside profit or loss, or (b) a business combination. If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity.

Presentation

Tax assets and tax liabilities

69 [Deleted]

70 [Deleted]

Offset

71 An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

72 Although current tax assets and liabilities are separately recognised and measured, they are offset in the ~~balance sheet~~statement of financial position subject to criteria similar to those established for financial instruments in HKAS 32. An entity will normally have a legally enforceable right to set off a current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation authority permits the entity to make or receive a single net payment.

73 In consolidated financial statements, a current tax asset of one entity in a group is offset against a current tax liability of another entity in the group if, and only if, the entities concerned have a legally enforceable right to make or receive a single net payment and the entities intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

74 An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:

(a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

(b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:

(i) the same taxable entity; or

(ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

75 To avoid the need for detailed scheduling of the timing of the reversal of each temporary difference, this Standard requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.

76 In rare circumstances, an entity may have a legally enforceable right of set-off, and an intention to settle net, for some periods but not for others. In such rare circumstances, detailed scheduling may be required to establish reliably whether the deferred tax liability of one taxable entity will result in increased tax payments in the same period in which a deferred tax asset of another taxable entity will result in decreased payments by that second taxable entity.

Tax expense

Tax expense (income) related to profit or loss from ordinary activities

77 The tax expense (income) related to profit or loss from ordinary activities shall be presented ~~on the face of~~in the ~~income~~ statement of comprehensive income.

77A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 *Presentation of Financial Statements* (as revised in 2007), it presents the tax expense (income) related to profit or loss from ordinary activities in that separate statement.

Exchange differences on deferred foreign tax liabilities or assets

78 HKAS 21 requires certain exchange differences to be recognised as income or expense but does not specify where such differences should be presented in the ~~income statement~~statement of comprehensive income. Accordingly, where exchange differences on deferred foreign tax liabilities or assets are recognised in the ~~income statement~~statement of comprehensive income, such differences may be classified as deferred tax expense (income) if that presentation is considered to be the most useful to financial statement users.

Disclosure

79 The major components of tax expense (income) shall be disclosed separately.

80 Components of tax expense (income) may include:

(a) current tax expense (income);

(b) any adjustments recognised in the period for current tax of prior periods;

(c) the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;

(d) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;

(e) the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;

(f) the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;

(g) deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset in accordance with paragraph 56; and

(h) the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with HKAS 8, because they cannot be accounted for retrospectively.

81 The following shall also be disclosed separately:

(a) the aggregate current and deferred tax relating to items that are charged or credited directly to equity (see paragraph 62A);

(ab) the amount of income tax relating to each component of other comprehensive income (see paragraph 62 and HKAS 1 (as revised in 2007));

(b) [deleted];

(c) an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

(i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or

(ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed;

(d) an explanation of changes in the applicable tax rate(s) compared to the previous accounting period;

(e) the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the ~~balance sheet~~statement of financial position;

(f) the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised (see paragraph 39);

(g) in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

(i) the amount of the deferred tax assets and liabilities recognised in the ~~balance sheet~~statement of financial position for each period presented;

(ii) the amount of the deferred tax income or expense recognised in ~~the income statement~~profit or loss, if this is not apparent from the changes in the amounts recognised in the ~~balance sheet~~statement of financial position;

(h) in respect of discontinued operations, the tax expense relating to:

(i) the gain or loss on discontinuance; and

(ii) the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented;~~ and~~

(i) the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements~~.~~;

(j)* if a business combination in which the entity is the acquirer causes a change in the amount recognised for its pre-acquisition deferred tax asset (see paragraph 67), the amount of that change; and

(k)* if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date (see paragraph 68), a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.

82 **An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:**

(a) the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and

(b) the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

82A **In the circumstances described in paragraph 52A, an entity shall disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable.**

83 [Deleted]

84 The disclosures required by paragraph 81(c) enable users of financial statements to understand whether the relationship between tax expense (income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in the future. The relationship between tax expense (income) and accounting profit may be affected by such factors as revenue that is exempt from taxation, expenses that are not deductible in determining taxable profit (tax loss), the effect of tax losses and the effect of foreign tax rates.

* Amendments effective for annual periods beginning on or after 1 July 2009.

85 In explaining the relationship between tax expense (income) and accounting profit, an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial statements. Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss). However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. The following example illustrates how the selection of the applicable tax rate affects the presentation of the numerical reconciliation.

Whilst in most cases, the applicable rate of tax that provides the most meaningful information to users will be the domestic rate of tax in the country in which the entity is domiciled, there will be exceptions. For example, it is common in Hong Kong for groups to have a parent entity domiciled in Bermuda with operating subsidiaries in Hong Kong. In these circumstances, the most meaningful rate of tax will be Hong Kong tax where the majority of the operations are carried out.

Example Illustrating Paragraph 85

In 20X2, an entity has accounting profit in its own jurisdiction (country A) of $1,500 (20X1: $2,000) and in country B of $1,500 (20X1: $500). The tax rate is 30% in country A and 20% in country B. In country A, expenses of $100 (20X1: $200) are not deductible for tax purposes.

The following is an example of a reconciliation to the domestic tax rate.

	20X1	*20X2*
	$	*$*
Accounting profit	*2,500*	*3,000*
Tax at the domestic rate of 30%	*750*	*900*
Tax effect of expenses that are not deductible for tax purposes	*60*	*30*
Effect of lower tax rates in country B	*(50)*	*(150)*
Tax expense	*760*	*780*

The following is an example of a reconciliation prepared by aggregating separate reconciliations for each national jurisdiction. Under this method, the effect of differences between the reporting entity's own domestic tax rate and the domestic tax rate in other jurisdictions does not appear as a separate item in the reconciliation. An entity may need to discuss the effect of significant changes in either tax rates, or the mix of profits earned in different jurisdictions, in order to explain changes in the applicable tax rate(s), as required by paragraph 81(d).

	$	*$*
Accounting profit	*2,500*	*3,000*
Tax at the domestic rates applicable to profits in the country concerned	*700*	*750*
Tax effect of expenses that are not deductible for tax purposes	*60*	*30*
Tax expense	*760*	*780*

86 The average effective tax rate is the tax expense (income) divided by the accounting profit.

87 It would often be impracticable to compute the amount of unrecognised deferred tax liabilities arising from investments in subsidiaries, branches and associates and interests in joint ventures (see paragraph 39). Therefore, this Standard requires an entity to disclose the aggregate amount of the underlying temporary differences but does not require disclosure of the deferred tax liabilities. Nevertheless, where practicable, entities are encouraged to disclose the amounts of the unrecognised deferred tax liabilities because financial statement users may find such information useful.

87A Paragraph 82A requires an entity to disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. An entity discloses the important features of the income tax systems and the factors that will affect the amount of the potential income tax consequences of dividends.

87B It would sometimes not be practicable to compute the total amount of the potential income tax consequences that would result from the payment of dividends to shareholders. This may be the case, for example, where an entity has a large number of foreign subsidiaries. However, even in such circumstances, some portions of the total amount may be easily determinable. For example, in a consolidated group, a parent and some of its subsidiaries may have paid income taxes at a higher rate on undistributed profits and be aware of the amount that would be refunded on the payment of future dividends to shareholders from consolidated retained earnings. In this case, that refundable amount is disclosed. If applicable, the entity also discloses that there are additional potential income tax consequences not practicably determinable. In the parent's separate financial statements, if any, the disclosure of the potential income tax consequences relates to the parent's retained earnings.

87C An entity required to provide the disclosures in paragraph 82A may also be required to provide disclosures related to temporary differences associated with investments in subsidiaries, branches and associates or interests in joint ventures. In such cases, an entity considers this in determining the information to be disclosed under paragraph 82A. For example, an entity may be required to disclose the aggregate amount of temporary differences associated with investments in subsidiaries for which no deferred tax liabilities have been recognised (see paragraph 81(f)). If it is impracticable to compute the amounts of unrecognised deferred tax liabilities (see paragraph 87) there may be amounts of potential income tax consequences of dividends not practicably determinable related to these subsidiaries.

88 An entity discloses any tax-related contingent liabilities and contingent assets in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets. Contingent liabilities and contingent assets* may arise, for example, from unresolved disputes with the taxation authorities. Similarly, where changes in tax rates or tax laws are enacted or announced after the ~~balance sheet date~~reporting period, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities (see HKAS 10 *Events After the ~~Balance Sheet Date~~Reporting Period*).

Effective Date

89 This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier adoption is encouraged but not required. If an entity applies this Standard for periods beginning before 1 January 2005, shall the entity shall disclose that fact and apply Hong Kong Accounting Standards Interpretation (HKAS-INT) 21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets* and HKAS-INT 25 *Income Taxes – Changes in the Tax Status of an Entity or its Shareholders* at the same time.

90 This Standard supersedes SSAP 12 *Income Taxes* (issued in August 2002).

91 [Not used]

92 HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 23, 52, 58, 60, 62, 63, 65, 68C, 77 and 81, deleted paragraph 61 and added paragraphs 61A, 62A and 77A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

93 Paragraph 68 shall be applied prospectively from the effective date of HKFRS 3 (as revised in 2008) to the recognition of deferred tax assets acquired in business combinations.

94 Therefore, entities shall not adjust the accounting for prior business combinations if tax benefits failed to satisfy the criteria for separate recognition as of the acquisition date and are recognised after the acquisition date, unless the benefits are recognised within the measurement period and result from new information about facts and circumstances that existed at the acquisition date. Other tax benefits recognised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).

95 HKFRS 3 (as revised in 2008) amended paragraphs 21 and 67 and added paragraphs 32A and 81(j) and (k). An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.

Acknowledgement

The Hong Kong Institute of Certified Public Accountants is indebted to the Australian Accounting Research Foundation for granting permission to use material from its Standard AASB 1020 "Income taxes" as some of the explanatory guidance and illustrative examples in this Standard.

Appendix A
Examples of temporary differences

The appendix accompanies, but is not part of, IAS 12.

A. Examples of circumstances that give rise to taxable temporary differences

All taxable temporary differences give rise to a deferred tax liability.

Transactions that affect ~~the income statement~~profit or loss

1 Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.

2 Revenue from the sale of goods is included in accounting profit when goods are delivered but is included in taxable profit when cash is collected. (*note: as explained in B3 below, there is also a **deductible** temporary difference associated with any related inventory*).

3 Depreciation of an asset is accelerated for tax purposes.

4 Development costs have been capitalised and will be amortised to the ~~income statement~~statement of comprehensive income but were deducted in determining taxable profit in the period in which they were incurred.

5 Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

Transactions that affect the ~~balance sheet~~statement of financial position

6 Depreciation of an asset is not deductible for tax purposes and no deduction will be available for tax purposes when the asset is sold or scrapped. (*note: paragraph 15(b) of the Standard prohibits recognition of the resulting deferred tax liability unless the asset was acquired in a business combination, see also paragraph 22 of the Standard.*)

7 A borrower records a loan at the proceeds received (which equal the amount due at maturity), less transaction costs. Subsequently, the carrying amount of the loan is increased by amortisation of the transaction costs to accounting profit. The transaction costs were deducted for tax purposes in the period when the loan was first recognised. (*notes: (1) the taxable temporary difference is the amount of transaction costs already deducted in determining the taxable profit of current or prior periods, less the cumulative amount amortised to accounting profit; and (2) as the initial recognition of the loan affects taxable profit, the exception in paragraph 15(b) of the Standard does not apply. Therefore, the borrower recognises the deferred tax liability.*)

8 A loan payable was measured on initial recognition at the amount of the net proceeds, net of transaction costs. The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods. (*notes: (1) the taxable temporary difference is the amount of unamortised transaction costs; and (2) paragraph 15(b) of the Standard prohibits recognition of the resulting deferred tax liability*.)

9 The liability component of a compound financial instrument (for example a convertible bond) is measured at a discount to the amount repayable on maturity (see IAS 32 *Financial Instruments: Presentation*). The discount is not deductible in determining taxable profit (tax loss).

Fair value adjustments and revaluations

10 Financial assets or investment property are carried at fair value which exceeds cost but no equivalent adjustment is made for tax purposes.

11 An entity revalues property, plant and equipment (under the revaluation model treatment in IAS 16 *Property, Plant and Equipment*) but no equivalent adjustment is made for tax purposes. (*note: paragraph 61A of the Standard requires the related deferred tax to be ~~charged directly to equity~~recognised in other comprehensive income.*)

Business combinations and consolidation

12* The carrying amount of an asset is increased to fair value in a business combination and no equivalent adjustment is made for tax purposes. (*Note that on initial recognition, the resulting deferred tax liability increases goodwill or decreases the amount of any bargain purchase gain recognised~~excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination~~. See paragraph 66 of the Standard.*)

13 Reductions in the carrying amount of goodwill are not deductible in determining taxable profit and the cost of the goodwill would not be deductible on disposal of the business. (*Note that paragraph 15(a) of the Standard prohibits recognition of the resulting deferred tax liability.*)

14 Unrealised losses resulting from intragroup transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.

15 Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent. (*note: paragraph 39 of the Standard prohibits recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.*)

16 Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. (*notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; and (2) paragraph 39 of the Standard prohibits recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.*)

17 The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency. (*notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; (2) where there is a taxable temporary difference, the resulting deferred tax liability is recognised (paragraph 41 of the Standard); and (3) the deferred tax is recognised in profit or loss, see paragraph 58 of the Standard.*)

Hyperinflation

18 Non-monetary assets are restated in terms of the measuring unit current at the ~~balance sheet date~~end of the reporting period (see IAS 29 *Financial Reporting in Hyperinflationary Economies*) and no equivalent adjustment is made for tax purposes. (*notes: (1) the deferred tax is ~~charged in the income statement~~recognised in profit or loss; and (2) if, in addition to the restatement, the non-monetary assets are also revalued, the deferred tax relating to the revaluation is ~~charged to equity~~recognised in other comprehensive income and the deferred tax relating to the restatement is ~~charged~~ recognised in ~~the income statement~~profit or loss.*)

* Amendment effective for annual periods beginning on or after 1 July 2009.

B. Examples of circumstances that give rise to deductible temporary differences

All deductible temporary differences give rise to a deferred tax asset. However, some deferred tax assets may not satisfy the recognition criteria in paragraph 24 of the Standard.

Transactions that affect ~~the Income Statement~~profit or loss

1 Retirement benefit costs are deducted in determining accounting profit as service is provided by the employee, but are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (*note: similar deductible temporary differences arise where other expenses, such as product warranty costs or interest, are deductible on a cash basis in determining taxable profit.*)

2 Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the ~~balance sheet date~~end of the reporting period for tax purposes.

3 The cost of inventories sold before the ~~balance sheet date~~end of the reporting period is deducted in determining accounting profit when goods or services are delivered but is deducted in determining taxable profit when cash is collected. (*note: as explained in A2 above, there is also a **taxable** temporary difference associated with the related trade receivable.*)

4 The net realisable value of an item of inventory, or the recoverable amount of an item of property, plant or equipment, is less than the previous carrying amount and an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.

5 Research costs (or organisation or other start up costs) are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.

6 Income is deferred in the ~~balance sheet~~statement of financial position but has already been included in taxable profit in current or prior periods.

7 A government grant which is included in the ~~balance sheet~~statement of financial position as deferred income will not be taxable in future periods. (*note: paragraph 24 of the Standard prohibits the recognition of the resulting deferred tax asset, see also paragraph 33 of the Standard.*)

Fair value adjustments and revaluations

8 Financial assets or investment property are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

Business combinations and consolidation

9* A liability is recognised at its fair value in a business combination, but none of the related expense is deducted in determining taxable profit until a later period. (*Note that the resulting deferred tax asset decreases goodwill or increases the amount of any bargain purchase gain recognised~~excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination~~. See paragraph 66 of the Standard.*)

10 [Deleted]

11 Unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

* Amendment effective for annual periods beginning on or after 1 July 2009.

12 Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. (*notes: (1) there may be a taxable temporary difference or a deductible temporary difference; and (2) paragraph 44 of the Standard requires recognition of the resulting deferred tax asset to the extent, and only to the extent, that it is probable that: (a) the temporary difference will reverse in the foreseeable future; and (b) taxable profit will be available against which the temporary difference can be utilised*).

13 The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency. *(notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; (2) where there is a deductible temporary difference, the resulting deferred tax asset is recognised to the extent that it is probable that sufficient taxable profit will be available (paragraph 41 of the Standard); and (3) the deferred tax is recognised in profit or loss, see paragraph 58 of the Standard.)*

C. Examples of circumstances where the carrying amount of an asset or liability is equal to its tax base

1 Accrued expenses have already been deducted in determining an entity's current tax liability for the current or earlier periods.

2 A loan payable is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.

3 Accrued expenses will never be deductible for tax purposes.

4 Accrued income will never be taxable.

Appendix B
Illustrative computations and presentation

The appendix accompanies, but is not part of, IAS 12. Extracts from ~~income statements~~statements of financial position and ~~balance sheets~~statements of comprehensive income are provided to show the effects on these financial statements of the transactions described below. These extracts do not necessarily conform with all the disclosure and presentation requirements of other Standards.

All the examples in this appendix assume that the entities concerned have no transaction other than those described.

Example 1 - Depreciable assets

An entity buys equipment for $10,000 and depreciates it on a straight line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% ~~per annum~~a year on a straight line basis. Tax losses may be carried back against taxable profit of the previous five years. In year 0, the entity's taxable profit was $5,000. The tax rate is 40%.

The entity will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the entity's current tax computation is as follows:

			Year		
	1	*2*	*3*	*4*	*5*
	$	$	$	$	$
Taxable income	2,000	2,000	2,000	2,000	2,000
Depreciation for tax purposes	2,500	2,500	2,500	2,500	0
Taxable profit (tax loss)	(500)	(500)	(500)	(500)	2,000
Current tax expense (income) at 40%	(200)	(200)	(200)	(200)	800

The entity recognises a current tax asset at the end of years 1 to 4 because it recovers the benefit of the tax loss against the taxable profit of year 0.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows:

	Year				
	1	*2*	*3*	*4*	*5*
Carrying Amount	8,000	*6,000*	*4,000*	*2,000*	*0*
Tax base	7,500	*5,000*	*2,500*	*0*	*0*
Taxable temporary difference	500	*1,000*	*1,500*	*2,000*	*0*
Opening deferred tax liability	0	*200*	*400*	*600*	*800*
Deferred tax expense (income)	200	*200*	*200*	*200*	*(800)*
Closing deferred tax liability	200	*400*	*600*	*800*	*0*

The entity recognises the deferred tax liability in years 1 to 4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's ~~income statement is as follows~~statement of comprehensive income includes the following:

	Year				
	1	*2*	*3*	*4*	*5*
Income	2,000	2,000	2,000	2,000	2,000
Depreciation	2,000	2,000	2,000	2,000	2,000
Profit before tax	0	0	0	0	0
Current tax expense (income)	(200)	(200)	(200)	(200)	800
Deferred tax expense (income)	200	200	200	200	(800)
Total tax expense (income)	0	0	0	0	0
~~Net profit for the period~~Profit for the period	0	0	0	0	0

Example 2 - Deferred tax assets and liabilities

The example deals with an entity over the two-year period, X5 and X6. In X5 the enacted income tax rate was 40% of taxable profit. In X6 the enacted income tax rate was 35% of taxable profit.

Charitable donations are recognised as an expense when they are paid and are not deductible for tax purposes.

In X5, the entity was notified by the relevant authorities that they intend to pursue an action against the entity with respect to sulphur emissions. Although as at December X6 the action had not yet come to court the entity recognised a liability of 700 in X5 being its best estimate of the fine arising from the action. Fines are not deductible for tax purposes.

In X2, the entity incurred 1,250 of costs in relation to the development of a new product. These costs were deducted for tax purposes in X2. For accounting purposes, the entity capitalised this expenditure and amortised it on the straight-line basis over five years. At 31/12/X4, the unamortised balance of these product development costs was 500.

In X5, the entity entered into an agreement with its existing employees to provide healthcare benefits to retirees. The entity recognises as an expense the cost of this plan as employees provide service. No payments to retirees were made for such benefits in X5 or X6. Healthcare costs are deductible for tax purposes when payments are made to retirees. The entity has determined that it is probable that taxable profit will be available against which any resulting deferred tax asset can be utilised.

Buildings are depreciated for accounting purposes at 5% a year on a straight line basis and at 10% a year on a straight line basis for tax purposes. Motor vehicles are depreciated for accounting purposes at 20% a year on a straight line basis and at 25% a year on a straight line basis for tax purposes. A full year's depreciation is charged for accounting purposes in the year that an asset is acquired.

At 1/1/X6, the building was revalued to 65,000 and the entity estimated that the remaining useful life of the building was 20 years from the date of the revaluation. The revaluation did not affect taxable profit in X6 and the taxation authorities did not adjust the tax base of the building to reflect the revaluation. In X6, the entity transferred $1,033 from revaluation ~~reserve~~ surplus to retained earnings. This represents the difference of 1,590 between the actual depreciation on the building (3,250) and equivalent depreciation based on the cost of the building (1,660, which is the book value at 1/1/X6 of 33,200 divided by the remaining useful life of 20 years), less the related deferred tax of $557 (see paragraph 64 of the Standard).

Current tax expense

	X5	*X6*
Accounting profit	8,775	8,740
Add		
Depreciation for accounting purposes	4,800	8,250
Charitable donations	500	350
Fine for environmental pollution	700	-
Product development costs	250	250
Healthcare benefits	2,000	1,000
	17,025	18,590
Deduct		
Depreciation for tax purposes	(8,100)	(11,850)
Taxable Profit	8,925	6,740
Current tax expense at 40%	3,570	
Current tax expense at 35%		2,359

Carrying amounts of property, plant and equipment

Cost	*Building*	*Motor vehicles*	*Total*
Balance at 31/12/X4	50,000	10,000	60,000
Additions X5	6,000	-	6,000
Balance at 31/12/X5	56,000	10,000	66,000
Elimination of accumulated depreciation on revaluation at 1/1/X6	(22,800)	-	(22,800)
Revaluation at 1/1/X6	31,800	-	31,800
Balance at 1/1/X6	65,500	10,000	75,000
Additions X6	-	15,000	15,000
	65,000	25,000	90,000
Accumulated depreciation	5%	20%	
Balance at 31/12/X4	20,000	4,000	24,000
Depreciation X5	2,800	2,000	4,800
Balance at 31/12/X5	22,800	6,000	28,800
Revaluation at 1/1/X6	(22,800)	-	(22,800)
Balance at 1/1/X6	-	6,000	6,000
Depreciation X6	3,250	5,000	8,250
Balance at 31/12/X6	3,250	11,000	14,250
Carrying amount			
31/12/X4	30,000	6,000	36,000
31/12/X5	33,200	4,000	37,200
31/12/X6	61,750	14,000	75,750

Tax base of property, plant and equipment

Cost	*Building*	*Motor vehicles*	*Total*
Balance at 31/12/X4	50,000	10,000	60,000
Additions X5	6,000	-	6,000
Balance at 31/12/X5	56,000	10,000	66,000
Additions X6	-	15,000	15,000
Balance at 31/12/X6	56,000	25,000	81,000
Accumulated depreciation	10%	25%	
Balance at 31/12/X4	40,000	5,000	45,000
Depreciation X5	5,600	2,500	8,100
Balance at 31/12/X5	45,600	7,500	53,100
Depreciation X6	5,600	6,250	11,850
Balance 31/12/X6	51,200	13,750	64,950
Tax Base			
31/12/X4	10,000	5,000	15,000
31/12/X5	10,400	2,500	12,900
31/12/X6	4,800	11,250	16,050

Deferred tax assets, liabilities and expense at 31/12/x4

	Carrying amount	*Tax base*	*Temporary differences*
Accounts receivable	500	500	-
Inventory	2,000	2,000	-
Product development costs	500	-	500
Investments	33,000	33,000	-
Property, plant & equipment	36,000	15,000	21,000
TOTAL ASSETS	72,000	50,500	21,500
Current income taxes payable	3,000	3,000	-
Accounts payable	500	500	-
Fines payable	-	-	-
Liability for healthcare benefits	-	-	-
Long term debt	20,000	20,000	-
Deferred income taxes	8,600	8,600	-
TOTAL LIABILITIES	32,100	32,100	
Share capital	5,000	5,000	-
Revaluation surplus	-	-	-
Retained earnings	34,900	13,400	
TOTAL LIABILITIES / EQUITY	72,000	50,500	
TEMPORARY DIFFERENCES			21,500
Deferred tax liability	21,500 at 40%		8,600
Deferred tax asset	-	-	-
Net deferred tax liability			8,600

Deferred tax assets, liabilities and expense at 31/12/X5

	Carrying amount	*Tax base*	*Temporary differences*
Accounts receivable	500	500	-
Inventory	2,000	2,000	-
Product development costs	250	-	250
Investments	33,000	33,000	-
Property, plant & equipment	37,200	12,900	24,300
TOTAL ASSETS	72,950	48,400	24,550
Current income taxes payable	3,570	3,570	-
Accounts payable	500	500	-
Fines payable	700	700	-
Liability for healthcare benefits	2,000	-	(2,000)
Long-term debt	12,475	12,475	-
Deferred income taxes	9,020	9,020	-
TOTAL LIABILITIES	28,265	26,265	(2,000)
Share capital	5,000	5,000	-
Revaluation surplus	-	-	-
Retained earnings	39,685	17,135	
TOTAL LIABILITIES / EQUITY	72,950	48,400	
TEMPORARY DIFFERENCES			22,550

Deferred tax liability	24,550 at 40%	9,820
Deferred tax asset	2,000 at 40%	(800)
Net deferred tax liability		9,020
Less: Opening deferred tax liability		(8,600)
Deferred tax expense (income) related to the origination and reversal of temporary differences		420

Deferred tax assets, liabilities and expense at 31/12/X6

	Carrying amount	*Tax base*	*Temporary differences*
	$	$	$
Accounts receivable	500	500	-
Inventory	2,000	2,000	-
Product development costs	-	-	-
Investments	33,000	33,000	-
Property, plant & equipment	75,750	16,050	59,700
TOTAL ASSETS	111,250	51,550	59,700
Current income taxes payable	2,359	2,359	-
Accounts payable	500	500	-
Fines payable	700	700	
Liability for healthcare benefits	3,000	-	(3,000)
Long-term debt	12,805	12,805	-
Deferred income taxes	19,845	19,845	-
TOTAL LIABILITIES	39,209	36,209	(3,000)
Share capital	5,000	5,000	-
Revaluation surplus	19,637	-	-
Retained earnings	47,404	10,341	
TOTAL LIABILITIES / EQUITY	111,250	51,550	
TEMPORARY DIFFERENCES			56,700

Deferred tax liability	59,700 at 35%	20,895
Deferred tax asset	3,000 at 35%	(1,050)
Net deferred tax liability		19,845
Less: Opening deferred tax liability		(9,020)
Adjustment to opening deferred tax liability resulting from reduction in tax rate	22,550 at 5%	1,127
Deferred tax attributable to revaluation surplus	31,800 at 35%	(11,130)
Deferred tax expense (income) related to the origination and reversal of temporary differences		822

Illustrative disclosure

The amounts to be disclosed in accordance with the Standard are as follows:

Major components of tax expense (income) (paragraph 79)

	X5	*X6*
	$	$
Current tax expense	3,570	2,359
Deferred tax expense relating to the origination and reversal of temporary differences:	420	822
Deferred tax expense (income) resulting from reduction in tax rate	-	(1,127)
Tax expense	3,990	2,054

~~Aggregate current and deferred tax~~Income tax relating to ~~items charged or credited to equity~~the components of other comprehensive income (paragraph 81(~~a~~b))

Deferred tax relating to revaluation of building	-	(11,130)

In addition, deferred tax of $557 was transferred in X6 from retained earnings to revaluation ~~reserve~~surplus. This relates to the difference between the actual depreciation on the building and equivalent depreciation based on the cost of the building.

Explanation of the relationship between tax expense and accounting profit (paragraph 81(c))

The Standard permits two alternative methods of explaining the relationship between tax expense (income) and accounting profit. Both of these formats are illustrated on the next page.

(i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed

	X5	*X6*
	$	$
Accounting profit	8,775	8,740
Tax at the applicable tax rate of 35% (X5: 40%)	3,510	3,059
Tax effect of expenses that are not deductible in determining taxable profit:		
Charitable donations	200	122
Fines for environmental pollution	280	-
Reduction in opening deferred taxes resulting from reduction in tax rate	-	(1,127)
Tax expense	3,990	2,054

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

(ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

	X5	*X6*
	%	%
Applicable tax rate	40.0	35.0
Tax effect of expenses that are not deductible for tax purposes:		
Charitable donations	2.3	1.4
Fines for environmental pollution	3.2	-
Effect on opening deferred taxes of reduction in tax rate	-	(12.9)
Average effective tax rate (tax expense divided by profit before tax)	45.5	23.5

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

An explanation of changes in the applicable tax rate(s) compared to the previous accounting period (paragraph 81(d))

In X6, the government enacted a change in the national income tax rate from 35% to 30%.

In respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

(i) the amount of the deferred tax assets and liabilities recognised in the ~~balance sheet~~statement of financial position for each period presented;

(ii) the amount of the deferred tax income or expense recognised in ~~the income statement~~profit or loss for each period presented, if this is not apparent from the changes in the amounts recognised in the ~~balance sheet~~statement of financial position (paragraph 81(g))

	X5	*X6*
Accelerated depreciation for tax purposes	9,720	10,322
Liabilities for healthcare benefits that are deducted for tax purposes only when paid	(800)	(1,050)
Product development costs deducted from taxable profit in earlier years	100	-
Revaluation, net of related depreciation	-	10,573
Deferred tax liability	9,020	19,845

(note: the amount of the deferred tax income or expense recognised in ~~the income statement~~profit or loss for the current year is apparent from the changes in the amounts recognised in the ~~balance sheet~~statement of financial position)

Example 3 – Business combinations

On 1 January X5 entity A acquired 100 per cent of the shares of entity B at a cost of 600. At the acquisition date, the tax base in A's tax jurisdiction of A's investment in B is 600. Reductions in the carrying amount of goodwill are not deductible for tax purposes, and the cost of the goodwill would also not be deductible if B were to dispose of its underlying business. The tax rate in A's tax jurisdiction is 30 per cent and the tax rate in B's tax jurisdiction is 40 per cent.

The fair value of the identifiable assets acquired and liabilities assumed (excluding deferred tax assets and liabilities) by A is set out in the following table, together with their tax bases in B's tax jurisdiction and the resulting temporary differences.

	~~Cost of~~Amounts recognised at acquisition	*Tax base*	*Temporary differences*
Property, plant and equipment	270	155	115
Accounts receivable	210	210	-
Inventory	174	124	50
Retirement benefit obligations	(30)	-	(30)
Accounts payable	(120)	(120)	-
~~Fair value of the i~~Identifiable assets acquired and liabilities assumed, excluding deferred tax	504	369	135

The deferred tax asset arising from the retirement benefit obligations is offset against the deferred tax liabilities arising from the property, plant and equipment and inventory (see paragraph 74 of the Standard).

No deduction is available in B's tax jurisdiction for the cost of the goodwill. Therefore, the tax base of the goodwill in B's jurisdiction is nil. However, in accordance with paragraph 15(a) of the Standard, A recognises no deferred tax liability for the taxable temporary difference associated with the goodwill in B's tax jurisdiction.

The carrying amount, in A's consolidated financial statements, of its investment in B is made up as follows:

Fair value of identifiable assets acquired and liabilities assumed, excluding deferred tax	504
Deferred tax liability (135 at 40%)	(54)
Fair value of identifiable assets acquired and liabilities assumed	450
Goodwill	150
Carrying amount	600

Because, at the acquisition date, the tax base in A's tax jurisdiction of A's investment in B is 600, no temporary difference is associated in A's tax jurisdiction with the investment.

During X5, B's equity (incorporating the fair value adjustments made as a result of the business combination) changed as follows:

At 1 January X5	450
Retained profit for X5 (net profit of 150, less dividend payable of 80)	70
At 31 December X5	520

A recognises a liability for any withholding tax or other taxes that it will incur on the accrued dividend receivable of 80.

At 31 December X5, the carrying amount of A's underlying investment in B, excluding the accrued dividend receivable, is as follows:

Net assets of B	520
Goodwill	150
Carrying amount	670

The temporary difference associated with A's underlying investment is 70. This amount is equal to the cumulative retained profit since the acquisition date.

If A has determined that it will not sell the investment in the foreseeable future and that B will not distribute its retained profits in the foreseeable future, no deferred tax liability is recognised in relation to A's investment in B (see paragraphs 39 and 40 of the Standard). Note that this exception would apply for an investment in an associate only if there is an agreement requiring that the profits of the associate will not be distributed in the foreseeable future (see paragraph 42 of the Standard). A discloses the amount of the temporary difference for which no deferred tax is recognised: ie 70 (see paragraph 81(f) of the Standard).

If A expects to sell the investment in B, or that B will distribute its retained profits in the foreseeable future, A recognises a deferred tax liability to the extent that the temporary difference is expected to reverse. The tax rate reflects the manner in which A expects to recover the carrying amount of its investment (see paragraph 51 of the Standard). A ~~credits or charges~~recognises the deferred tax in other comprehensive income~~to equity~~ to the extent that the deferred tax results from foreign exchange translation differences ~~which~~ that have been ~~charged or credited directly to equity~~recognised in other comprehensive income (paragraph 61A of the Standard). A discloses separately:

(a) the amount of deferred tax ~~which~~ that has been ~~charged or credited directly to equity~~recognised in other comprehensive income (paragraph 81(a~~b~~) of the Standard); and

(b) the amount of any remaining temporary difference which is not expected to reverse in the foreseeable future and for which, therefore, no deferred tax is recognised (see paragraph 81(f) of the Standard).

Example 4 - Compound financial instruments

An entity receives a non-interest-bearing convertible loan of 1,000 on 31 December X4 repayable at par on 1 January X8. In accordance with IAS 32 *Financial Instruments: Presentation*, the entity classifies the instrument's liability component as a liability and the equity component as equity. The entity assigns an initial carrying amount of 751 to the liability component of the convertible loan and 249 to the equity component. Subsequently, the entity recognises imputed discount as interest expense at an annual rate of 10% on the carrying amount of the liability component at the beginning of the year. The tax authorities do not allow the entity to claim any deduction for the imputed discount on the liability component of the convertible loan. The tax rate is 40%.

The temporary differences associated with the liability component and the resulting deferred tax liability and deferred tax expense and income are as follows:

	Year			
	X4	*X5*	*X6*	*X7*
Carrying amount of liability component	751	826	909	1,000
Tax base	1,000	1,000	1,000	1,000
Taxable temporary difference	249	174	91	-
Opening deferred tax liability at 40%	0	100	70	37
Deferred tax charged to equity	100	-	-	-
Deferred tax expense (income)	-	(30)	(33)	(37)
Closing deferred tax liability at 40%	100	70	37	-

As explained in paragraph 23 of the Standard, at 31 December X4, the entity recognises the resulting deferred tax liability by adjusting the initial carrying amount of the equity component of the convertible liability. Therefore, the amounts recognised at that date are as follows:

Liability component	751
Deferred tax liability	100
Equity component (249 less 100)	149
	1,000

Subsequent changes in the deferred tax liability are recognised in ~~the income statement~~profit or loss as tax income (see paragraph 23 of the Standard). Therefore, the entity's ~~income statement is as follows~~profit or loss includes the following:

	Year			
	X4	*X5*	*X6*	*X7*
Interest expense (imputed discount)	-	75	83	91
Deferred tax expense (income)	-	(30)	(33)	(37)
	-	45	50	54

Example 5 - Share-based payment transactions

In accordance with IFRS 2 *Share-based Payment*, an entity has recognised an expense for the consumption of employee services received as consideration for share options granted. A tax deduction will not arise until the options are exercised, and the deduction is based on the options' intrinsic value at exercise date.

As explained in paragraph 68B of the Standard, the difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods in respect of those services), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. Paragraph 68B requires that, if the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it should be estimated, based on information available at the end of the period. If the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period. Therefore, in this example, the estimated future tax deduction (and hence the measurement of the deferred tax asset) should be based on the options' intrinsic value at the end of the period.

As explained in paragraph 68C of the Standard, if the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, paragraph 68C requires that the excess of the associated current or deferred tax should be recognised directly in equity.

The entity's tax rate is 40 per cent. The options were granted at the start of year 1, vested at the end of year 3 and were exercised at the end of year 5. Details of the expense recognised for employee services received and consumed in each accounting period, the number of options outstanding at each year-end, and the intrinsic value of the options at each year-end, are as follows:

	Employee services expense	Number of options at year-end	Intrinsic value per option
Year 1	188,000	50,000	5
Year 2	185,000	45,000	8
Year 3	190,000	40,000	13
Year 4	0	40,000	17
Year 5	0	40,000	20

The entity recognises a deferred tax asset and deferred tax income in years 1-4 and current tax income in year 5 as follows. In years 4 and 5, some of the deferred and current tax income is recognised directly in equity, because the estimated (and actual) tax deduction exceeds the cumulative remuneration expense.

Year 1

Deferred tax asset and deferred tax income:

(50,000 × 5 × 1/3[a] × 0.40) =		<u>33,333</u>

[a]The tax base of the employee services received is based on the intrinsic value of the options, and those options were granted for three years' services. Because only one year's services have been received to date, it is necessary to multiply the option's intrinsic value by one-third to arrive at the tax base of the employee services received in year 1.

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 83,333 (50,000 × 5 × 1/3) is less than the cumulative remuneration expense of 188,000.

Year 2

Deferred tax asset at year-end:

(45,000 × 8 × 2/3 × 0.40) =	96,000	
Less deferred tax asset at start of year	<u>(33,333)</u>	
Deferred tax income for year		<u>62,667*</u>

*This amount consists of the following:

Deferred tax income for the temporary difference between the tax base of the employee services received during the year and their carrying amount of nil:		
(45,000 × 8 × 1/3 × 0.40)	48,000	
Tax income resulting from an adjustment to the tax base of employee services received in previous years:		
(a) increase in intrinsic value: (45,000 × 3 × 1/3 × 0.40)	18,000	
(b) decrease in number of options: (5,000 × 5 × 1/3 × 0.40)	<u>(3,333)</u>	
Deferred tax income for year		<u>62,667</u>

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 240,000 (45,000 × 8 × 2/3) is less than the cumulative remuneration expense of 373,000 (188,000 + 185,000).

Year 3

Deferred tax asset at year-end:

(40,000 × 13 × 0.40) =	208,000
Less deferred tax asset at start of year	<u>(96,000)</u>
Deferred tax income for year	<u>112,000</u>

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 520,000 (40,000 × 13) is less than the cumulative remuneration expense of 563,000 (188,000 + 185,000 + 190,000).

Year 4

Deferred tax asset at year-end: (40,000 × 17 × 0.40) =	272,000	
Less deferred tax asset at start of year	(208,000)	
Deferred tax income for year		64,000

The deferred tax income is recognised partly in profit or loss and partly directly in equity as follows:

Estimated future tax deduction (40,000 × 17) =	680,000	
Cumulative remuneration expense	563,000	
Excess tax deduction		117,000
Deferred tax income for year	64,000	
Excess recognised directly in equity (117,000 × 0.40) =	46,800	
Recognised in profit or loss		17,200

Year 5

Deferred tax expense (reversal of deferred tax asset)	272,000	
Amount recognised directly in equity (reversal of cumulative deferred tax income recognised directly in equity)	46,800	
Amount recognised in profit or loss		225,200
Current tax income based on intrinsic value of options at exercise date (40,000 × 20 × 0.40) =	320,000	
Amount recognised in profit or loss (563,000 × 0.40) =	225,200	
Amount recognised directly in equity		94,800

Summary

	~~Income statement~~Statement of comprehensive income				~~Balance sheet~~Statement of financial position	
	Employee services expense	Current tax expense (income)	Deferred tax expense (income)	Total tax expense (income)	Equity	Deferred tax asset
Year 1	188,000	0	(33,333)	(33,333)	0	33,333
Year 2	185,000	0	(62,667)	(62,667)	0	96,000
Year 3	190,000	0	(112,000)	(112,000)	0	208,000
Year 4	0	0	(17,200)	(17,200)	(46,800)	272,0000
Year 5	0	(225,200)	225,200	0	46,800	0
					(94,800)	
Totals	563,000	(225,200)	0	(225,200)	(94,800)	0

Example 6 – Replacement awards in a business combination*

On 1 January 20X1 Entity A acquired 100 per cent of Entity B. Entity A pays cash consideration of CU400 to the former owners of Entity B.

At the acquisition date Entity B had outstanding employee share options with a market-based measure of CU100. The share options were fully vested. As part of the business combination Entity B's outstanding share options are replaced by share options of Entity A (replacement awards) with a market-based measure of CU100 and an intrinsic value of CU80. The replacement awards are fully vested. In accordance with paragraphs B56–B62 of IFRS 3 *Business Combinations* (as revised in 2008), the replacement awards are part of the consideration transferred for Entity B. A tax deduction for the replacement awards will not arise until the options are exercised. The tax deduction will be based on the share options' intrinsic value at that date. Entity A's tax rate is 40 per cent. Entity A recognises a deferred tax asset of CU32 (CU80 intrinsic value × 40%) on the replacement awards at the acquisition date.

Entity A measures the identifiable net assets obtained in the business combination (excluding deferred tax assets and liabilities) at CU450. The tax base of the identifiable net assets obtained is CU300. Entity A recognises a deferred tax liability of CU60 ((CU450 – CU300) × 40%) on the identifiable net assets at the acquisition date.

Goodwill is calculated as follows:

	CU
Cash consideration	400
Market-based measure of replacement awards	100
Total consideration transferred	500
Identifiable net assets, excluding deferred tax assets and liabilities	(450)
Deferred tax asset	(32)
Deferred tax liability	60
Goodwill	**78**

Reductions in the carrying amount of goodwill are not deductible for tax purposes. In accordance with paragraph 15(a) of the Standard, Entity A recognises no deferred tax liability for the taxable temporary difference associated with the goodwill recognised in the business combination.

The accounting entry for the business combination is as follows:

	CU	CU
Dr Goodwill	78	
Dr Identifiable net assets	450	
Dr Deferred tax asset	32	
Cr Cash		400
Cr Equity (replacement awards)		100
Cr Deferred tax liability		60

* Amendment effective for annual periods beginning on or after 1 July 2009.

On 31 December 20X1 the intrinsic value of the replacement awards is CU120. Entity A recognises a deferred tax asset of CU48 (CU120 × 40%). Entity A recognises deferred tax income of CU16 (CU48 – CU32) from the increase in the intrinsic value of the replacement awards. The accounting entry is as follows:

	CU	**CU**
Dr Deferred tax asset	16	
Cr Deferred tax income		16

If the replacement awards had not been tax-deductible under current tax law, Entity A would not have recognised a deferred tax asset on the acquisition date. Entity A would have accounted for any subsequent events that result in a tax deduction related to the replacement award in the deferred tax income or expense of the period in which the subsequent event occurred.

Paragraphs B56–B62 of IFRS 3 provide guidance on determining which portion of a replacement award is part of the consideration transferred in a business combination and which portion is attributable to future service and thus a post-combination remuneration expense. Deferred tax assets and liabilities on replacement awards that are post-combination expenses are accounted for in accordance with the general principles as illustrated in Example 5.

Appendix C

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at October 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 12.

The International Accounting Standard comparable with HKAS 12 is IAS 12 *Income Taxes*.

There are no major textual difference between HKAS 12 and IAS 12.

(Note: The explanatory guidance and illustrative examples set out in the boxes within the body of SSAP 12 contain material that may not be based on the examples in IAS 12 but based on those in Australian Standard AASB 1020, Income Taxes.)

Appendix D

Amendments resulting from other HKFRSs

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) - effective for annual periods beginning on or after 1 January 2013

In the rubric the reference to 'paragraphs 1–95' is amended to 'paragraphs 1–96'. Paragraph 20 is amended and paragraph 96 is added as follows:

20 HKFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, HKAS 16 *Property, Plant and Equipment*, HKAS 38 *Intangible Assets*, <u>HKFRS 9 *Financial Instruments*</u> ~~HKAS 39 *Financial Instruments: Recognition and Measurement*~~ and HKAS 40 *Investment Property*). In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, ...

96 HKFRS 9, issued in November 2009, amended paragraph 20. An entity shall apply that amendment when it applies HKFRS 9.

HKAS 17
Revised ~~May 2009~~June 2010

Hong Kong Accounting Standard 17

Leases

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

CONTENTS

Hong Kong Accounting Standard 17 *Leases* (HKAS 17) is set out in paragraphs 1-70 and the Appendix. All the paragraphs have equal authority. HKAS 17 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 17 *Leases* (HKAS 17) should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 17

IN2 The objectives of the HKICPA in issuing HKAS 17 were to reduce or eliminate alternatives, redundancies and conflicts within the HKFRSs, to deal with some convergence issues and to make other improvements.

IN3 [Not used]

IN4 [Not used]

The main features

Scope

IN5 Although HKAS 40 *Investment Property* prescribes the measurement models that can be applied to investment properties held, it requires the finance lease accounting methodology set out in this Standard to be used for investment properties held under leases.

Definitions

Initial direct costs

IN6 Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease. The interest rate implicit in the lease is defined as the discount rate that results in the present value of the minimum lease payments and any unguaranteed residual value equalling the fair value of the leased asset plus initial direct costs of the lessor.

Inception of the lease/commencement of the lease term

IN7 This Standard distinguishes between the inception of the lease (when leases are classified) and the commencement of the lease term (when recognition takes place).

Unearned finance income/net investment in the lease

IN8 The definitions of these terms have been simplified and articulated more explicitly to complement the changes relating to initial direct costs referred to in paragraphs IN10–IN12 and the change in the definition of the interest rate implicit in the lease referred to in paragraph IN6.

Classification of leases

IN9 When classifying a lease of land and buildings, an entity normally considers the land and buildings elements separately. The minimum lease payments are allocated between the land and buildings elements in proportion to the relative fair values of the leasehold interests in the land and buildings elements of the lease. The land element is normally classified as an operating lease unless title passes to the lessee at the end of the lease term. The buildings element is classified as an operating or finance lease by applying the classification criteria in the Standard.

Initial direct costs

IN10 Lessors include in the initial measurement of finance lease receivables the initial direct costs incurred in negotiating a lease. This treatment does not apply to manufacturer or dealer lessors. Manufacturer or dealer lessors recognise costs of this type as an expense when the selling profit is recognised.

IN11 Initial direct costs incurred by lessors in negotiating an operating lease are added to the carrying amount of the leased asset and recognised over the lease term on the same basis as the lease income.

IN12 The Standard does not permit initial direct costs of lessors to be charged as expenses as incurred.

Transitional provisions

IN13 As discussed in paragraph 68 of the Standard, an entity that has previously applied SSAP 14 (revised 2000) is required to apply the amendments made by this Standard retrospectively for all leases, or if SSAP 14 (revised 2000) was not applied retrospectively, for all leases entered into since it first applied that Standard.

Hong Kong Accounting Standard 17
Leases

Objective

1 The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

Scope

2 This Standard shall be applied in accounting for all leases other than:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and

(b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

However, this Standard shall not be applied as the basis of measurement for:

(a) property held by lessees that is accounted for as investment property (see HKAS 40 *Investment Property*);

(b) investment property provided by lessors under operating leases (see HKAS 40);

(c) biological assets held by lessees under finance leases (see HKAS 41 *Agriculture*); or

(d) biological assets provided by lessors under operating leases (see HKAS 41).

3 This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Definitions

4 The following terms are used in this Standard with the meanings specified:

A *lease* **is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.**

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

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

A *non-cancellable lease* **is a lease that is cancellable only:**

(a) upon the occurrence of some remote contingency;

(b) with the permission of the lessor;

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

The *inception of the lease* **is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:**

(a) a lease is classified as either an operating or a finance lease; and

(b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

The *commencement of the lease term* **is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (ie the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate).**

The *lease term* **is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.**

Minimum lease payments **are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:**

(a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or

(b) for a lessor, any residual value guaranteed to the lessor by:

(i) the lessee;

(ii) a party related to the lessee; or

(iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Fair value **is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**

Economic life **is either:**

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life **is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.**

Guaranteed residual value **is:**

(a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value **is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.**

Initial direct costs **are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.**

Gross investment in the lease **is the aggregate of:**

(a) the minimum lease payments receivable by the lessor under a finance lease, and

(b) any unguaranteed residual value accruing to the lessor.

Net investment in the lease **is the gross investment in the lease discounted at the interest rate implicit in the lease.**

Unearned finance income **is the difference between:**

(a) the gross investment in the lease, and

(b) the net investment in the lease.

The *interest rate implicit in the lease* **is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.**

The *lessee's incremental borrowing rate of interest* **is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.**

Contingent rent **is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (eg percentage of future sales, amount of future use, future price indices, future market rates of interest).**

5 A lease agreement or commitment may include a provision to adjust the lease payments for changes in the construction or acquisition cost of the leased property or for changes in some other measure of cost or value, such as general price levels, or in the lessor's costs of financing the lease, during the period between the inception of the lease and the commencement of the lease term. If so, the effect of any such changes shall be deemed to have taken place at the inception of the lease for the purposes of this Standard.

6 The definition of a lease includes contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

Classification of leases

7 The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

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

9 Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

10 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.[1] Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

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

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

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

12 The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

13 Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7-12 if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

14* [Deleted]~~Leases of land and of buildings are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee normally does not receive substantially all of the risks and rewards incidental to ownership, in which case the lease of land will be an operating lease. A payment made on entering into or acquiring a leasehold that is accounted for as an operating lease represents prepaid lease payments that are amortised over the lease term in accordance with the pattern of benefits provided.~~

15* [Deleted]~~The land and buildings elements of a lease of land and buildings are considered separately for the purposes of lease classification. If title to both elements is expected to pass to the lessee by the end of the lease term, both elements are classified as a finance lease, whether analysed as one lease or as two leases, unless it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership of one or both elements. When the land has an indefinite economic life, the land element is normally classified~~

[1] See also HK(SIC)-Int 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

* Amendment effective for annual periods beginning on or after 1 January 2010.

~~as an operating lease unless title is expected to pass to the lessee by the end of the lease term, in accordance with paragraph 14. The buildings element is classified as a finance or operating lease in accordance with paragraphs 7-13.~~

15A* When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7–13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.

16 Whenever necessary in order to classify and account for a lease of land and buildings, the minimum lease payments (including any lump-sum upfront payments) are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

17 For a lease of land and buildings in which the amount that would initially be recognised for the land element, in accordance with paragraph 20, is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification and classified as a finance or operating lease in accordance with paragraphs 7-13. In such a case, the economic life of the buildings is regarded as the economic life of the entire leased asset.

18 Separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with HKAS 40 and the fair value model is adopted. Detailed calculations are required for this assessment only if the classification of one or both elements is otherwise uncertain.

19 In accordance with HKAS 40, it is possible for a lessee to classify a property interest held under an operating lease as an investment property. If it does, the property interest is accounted for as if it were a finance lease and, in addition, the fair value model is used for the asset recognised. The lessee shall continue to account for the lease as a finance lease, even if a subsequent event changes the nature of the lessee's property interest so that it is no longer classified as investment property. This will be the case if, for example, the lessee:

(a) occupies the property, which is then transferred to owner-occupied property at a deemed cost equal to its fair value at the date of change in use; or

(b) grants a sublease that transfers substantially all of the risks and rewards incidental to ownership of the interest to an unrelated third party. Such a sublease is accounted for by the lessee as a finance lease to the third party, although it may be accounted for as an operating lease by the third party.

Leases in the financial statements of lessees

Finance leases

Initial recognition

20 At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their ~~balance sheets~~ statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset.

21 Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with legal form. Although the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating, at the inception of the lease, the fair value of the asset and the related finance charge.

* Amendments effective for annual periods beginning on or after 1 January 2010.

22 If such lease transactions are not reflected in the lessee's ~~balance sheet~~ statement of financial position, the economic resources and the level of obligations of an entity are understated, thereby distorting financial ratios. Therefore, it is appropriate for a finance lease to be recognised in the lessee's ~~balance sheet~~statement of financial position both as an asset and as an obligation to pay future lease payments. At the commencement of the lease term, the asset and the liability for the future lease payments are recognised in the ~~balance sheet~~ statement of financial position at the same amounts except for any initial direct costs of the lessee that are added to the amount recognised as an asset.

23 It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets. If for the presentation of liabilities ~~on the face of the balance sheet~~ in the statement of financial position a distinction is made between current and non-current liabilities, the same distinction is made for lease liabilities.

24 Initial direct costs are often incurred in connection with specific leasing activities, such as negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are added to the amount recognised as an asset.

Subsequent measurement

25 Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rents shall be charged as expenses in the periods in which they are incurred.

26 In practice, in allocating the finance charge to periods during the lease term, a lessee may use some form of approximation to simplify the calculation.

27 A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with HKAS 16 *Property, Plant and Equipment* and HKAS 38 *Intangible Assets*. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life.

28 The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the shorter of the lease term and its useful life.

29 The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognise the lease payments payable as an expense. Accordingly, the asset and the related liability are unlikely to be equal in amount after the commencement of the lease term.

30 To determine whether a leased asset has become impaired, an entity applies HKAS 36 *Impairment of Assets.*

Disclosures

31 Lessees shall, in addition to meeting the requirements of HKFRS 7 *Financial Instruments: Disclosures***, make the following disclosures for finance leases:**

(a) for each class of asset, the net carrying amount at the ~~balance sheet date~~end of the reporting period.

(b) a reconciliation between the total of future minimum lease payments at the ~~balance sheet date~~end of the reporting period, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the ~~balance sheet date~~ end of the reporting period, and their present value, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) **later than five years.**

(c) contingent rents recognised as an expense in the period.

(d) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the ~~balance sheet date~~end of the reporting period.

(e) a general description of the lessee's material leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payable is determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

32 In addition, the requirements for disclosure in accordance with HKAS 16, HKAS 36, HKAS 38, HKAS 40 and HKAS 41 apply to lessees for assets leased under finance leases.

Operating leases

33 Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.[2]

34 For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

Disclosures

35 Lessees shall, in addition to meeting the requirements of HKFRS 7, make the following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years.

(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the~~ balance sheet date~~ end of the reporting period.

(c) lease and sublease payments recognised as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments.

(d) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payable is determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

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[2] See also HK(SIC)-Int15 *Operating Leases – Incentives*.

Leases in the financial statements of lessors

Finance leases

Initial recognition

36 Lessors shall recognise assets held under a finance lease in their ~~balance sheets~~ statements of financial position and present them as a receivable at an amount equal to the net investment in the lease.

37 Under a finance lease substantially all the risks and rewards incidental to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal and finance income to reimburse and reward the lessor for its investment and services.

38 Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those incurred by a sales and marketing team. For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the finance lease receivable; there is no need to add them separately. Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease and are recognised as an expense when the selling profit is recognised, which for a finance lease is normally at the commencement of the lease term.

Subsequent measurement

39 The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.

40 A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the lessor's net investment in the finance lease. Lease payments relating to the period, excluding costs for services, are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

41 Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately.

41A An asset under a finance lease that is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* shall be accounted for in accordance with that HKFRS.

42 Manufacturer or dealer lessors shall recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales. If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged. Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be recognised as an expense when the selling profit is recognised.

43 Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) finance income over the lease term.

44 The sales revenue recognised at the commencement of the lease term by a manufacturer or dealer lessor is the fair value of the asset, or, if lower, the present value of the minimum lease payments accruing to the lessor, computed at a market rate of interest. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased property less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the entity's policy for outright sales.

45 Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit is restricted to that which would apply if a market rate of interest were charged.

46 Costs incurred by a manufacturer or dealer lessor in connection with negotiating and arranging a finance lease are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

Disclosures

47 Lessors shall, in addition to meeting the requirements in HKFRS 7, disclose the following for finance leases:

(a) a reconciliation between the gross investment in the lease at the ~~balance sheet date~~end of the reporting period, and the present value of minimum lease payments receivable at the ~~balance sheet date~~ end of the reporting period. In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the ~~balance sheet date~~end of the reporting period, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years.

(b) unearned finance income.

(c) the unguaranteed residual values accruing to the benefit of the lessor.

(d) the accumulated allowance for uncollectible minimum lease payments receivable.

(e) contingent rents recognised as income in the period.

(f) a general description of the lessor's material leasing arrangements.

48 As an indicator of growth it is often useful also to disclose the gross investment less unearned income in new business added during the period, after deducting the relevant amounts for cancelled leases.

Operating leases

49 Lessors shall present assets subject to operating leases in their ~~balance sheets~~ statements of financial position according to the nature of the asset.

50 Lease income from operating leases shall be recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.*

51 Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised on a straight-line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

* See also HK(SIC)-Int 15 *Operating Leases – Incentives.*

52 **Initial direct costs incurred by lessors in negotiating and arranging an operating lease shall be added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.**

53 **The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with HKAS 16 and HKAS 38.**

54 To determine whether a leased asset has become impaired, an entity applies HKAS 36.

55 A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

Disclosures

56 **Lessors shall, in addition to meeting the requirements of HKFRS 7, disclose the following for operating leases:**

(a) **the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:**

(i) **not later than one year;**

(ii) **later than one year and not later than five years;**

(iii) **later than five years.**

(b) **total contingent rents recognised as income in the period.**

(c) **a general description of the lessor's leasing arrangements.**

57 In addition, the disclosure requirements in HKAS 16, HKAS 36, HKAS 38, HKAS 40 and HKAS 41 apply to lessors for assets provided under operating leases.

Sale and leaseback transactions

58 A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

59 **If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised over the lease term.**

60 If the leaseback is a finance lease, the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. For this reason it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term.

61 **If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss shall be recognised immediately. If the sale price is below fair value, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value shall be deferred and amortised over the period for which the asset is expected to be used.**

62 If the leaseback is an operating lease, and the lease payments and the sale price are at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

63 **For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value shall be recognised immediately.**

64 For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with HKAS 36.

65 Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of material leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

66 Sale and leaseback transactions may trigger the separate disclosure criteria in HKAS 1 *Presentation of Financial Statements*.

Transitional provisions

67 Subject to paragraph 68, retrospective application of this Standard is encouraged but not required. If the Standard is not applied retrospectively, the balance of any pre-existing finance lease is deemed to have been properly determined by the lessor and shall be accounted for thereafter in accordance with the provisions of this Standard.

68 An entity that has previously applied SSAP 14 (revised 2000) shall apply the amendments made by this Standard retrospectively for all leases or, if SSAP 14 (revised 2000) was not applied retrospectively, for all leases entered into since it first applied that Standard.

68A An entity shall reassess the classification of land elements of unexpired leases at the date it adopts the amendments referred to in paragraph 69A on the basis of information existing at the inception of those leases. It shall recognise a lease newly classified as a finance lease retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, if an entity does not have the information necessary to apply the amendments retrospectively, it shall:

(a) apply the amendments to those leases on the basis of the facts and circumstances existing on the date it adopts the amendments; and

(b) recognise the asset and liability related to a land lease newly classified as a finance lease at their fair values on that date; any difference between those fair values is recognised in retained earnings.

Effective Date

69 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005 it shall disclose that fact and apply Hong Kong Accounting Standards Interpretation (HKAS-Int) 13 Operating Leases - Incentives at the same time.

69~~A~~a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.

69A Paragraphs 14 and 15 were deleted, and paragraphs 15A and 68A were added as part of *Improvements to HKFRSs* issued in May 2009. An entity shall apply those amendments for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Withdrawal of SSAP 14 (revised 2000)

70 This Standard supersedes SSAP 14 *Leases* (revised in 2000).

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at December 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 17.

The International Accounting Standard comparable with HKAS 17 is IAS 17 *Leases*.

There are no major textual differences between HKAS 17 and IAS 17.

Appendix

Amendments to other pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IAS 17.

HKAS 17 is based on IAS 17, *Leases*. In approving HKAS 17, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 17 (revised 2004). Accordingly, there are no significant differences between HKAS 17 and IAS 17. The IASB's Basis for Conclusions is reproduced below for reference. The paragraph numbers of IAS 17 referred to below generally correspond with those in HKAS 17.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 17 *Leases* in 2003. Individual Board members gave greater weight to some factors than to others.

BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 17. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within existing Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.

BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for leases established by IAS 17, this Basis for Conclusions does not discuss requirements in IAS 17 that the Board has not reconsidered.

Classification of leases – leases of land and buildings (2003 amendment)

BC4 Paragraph 14 of the Standard requires a lease of land with an indefinite economic life to be normally classified as an operating lease, unless title is expected to pass to the lessee by the end of the lease term. The previous version of IAS 17 (as amended in 2000) was not explicit about how to classify a lease of land and buildings.

BC5 This is a matter of concern in countries where property rights are obtained under long-term leases and the substance of those leases differs little from buying a property. Therefore, the Board decided to deal with this matter in its Improvements project in 2001 and not to defer its resolution until the more fundamental project on leases was completed.

BC6 The Board noted that two approaches are applied in practice. The first is to treat such a lease as a single unit and to classify it as an operating lease in its entirety. The second is to split the lease into two elements—a lease of land and a lease of buildings. The Board decided that the first approach does not adequately reflect the assets controlled by the entity or their usage and financing. It is also inconsistent with the classification and the measurement of other leases. Therefore, the Board rejected the first approach of classifying a lease of land and buildings as an operating lease in its entirety.

BC7 The Board agreed on the second approach of splitting the lease into two elements—a lease of land and a lease of buildings. The land element would normally be classified as an operating lease in accordance with paragraph 14 of the revised Standard and the buildings element classified as an operating or finance lease by applying the conditions in paragraphs 7-13. The Board noted that generally accepted accounting principles in Australia, Canada and the United States all explicitly require a lease of land and buildings to be split into two elements.

BC8 The Board also discussed a third approach, namely whether to delete the requirement (in paragraph 14 of the Standard) normally to classify a lease of land as an operating lease when title does not pass at the end of the lease and to require such a lease to be classified as a finance lease when all other conditions for finance lease classification in the Standard are met. The Board noted that such an accounting treatment would conflict with the criteria for lease classification in the Standard, which are based on the extent to which the risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Indeed, land normally has an indefinite economic life and hence there are significant risks and rewards associated with the land at the end of the lease term, which do not pass to the lessee. Therefore, the Board rejected this approach when issuing the amendments to IAS 17 in December 2003.

Land element in long-term leases (2009 amendment)*

BC8A As part of its annual improvements project in 2007, the Board reconsidered the decisions it made in 2003, specifically the perceived inconsistency between the general lease classification guidance in paragraphs 7–13 and the specific lease classification guidance in paragraphs 14 and 15 related to long-term leases of land and buildings. The Board concluded that the guidance in paragraphs 14 and 15 might lead to a conclusion on the classification of land leases that does not reflect the substance of the transaction.

BC8B For example, consider a 999-year lease of land and buildings. In this situation, significant risks and rewards associated with the land during the lease term would have been transferred to the lessee despite there being no transfer of title.

BC8C The Board noted that the lessee in leases of this type will typically be in a position economically similar to an entity that purchased the land and buildings. The present value of the residual value of the property in a lease with a term of several decades would be negligible. The Board concluded that the accounting for the land element as a finance lease in such circumstances would be consistent with the economic position of the lessee.

BC8D The Board noted that this amendment reversed the decision it made in amending IAS 17 in December 2003. The Board also noted that the amendment differed from the International Financial Reporting Interpretations Committee's agenda decision in March 2006 based on the IAS 17 guidance that such long-term leases of land would be classified as an operating lease unless title or significant risks and rewards of ownership passed to the lessee, irrespective of the term of the lease. However, the Board believed that this change improves the accounting for leases by removing a rule and an exception to the general principles applicable to the classification of leases.

BC8E Some respondents to the exposure draft proposing this amendment agreed with the direction of this proposal but suggested that it should be incorporated into the Board's project on leases. The Board acknowledged that the project on leases is expected to produce a standard in 2011. However, the Board decided to issue the amendment now because of the improvement in accounting for leases that would result and the significance of this issue in countries in which property rights are obtained under long-term leases. Therefore, the Board decided to remove this potential inconsistency by deleting the guidance in paragraphs 14 and 15.

BC8F Some respondents raised concerns about the proposed requirement to apply the amendment retrospectively. The land and buildings elements of a long-term finance lease may have different amortisation bases. Accordingly, entities must obtain relative fair values even when both elements are classified as finance leases. The Board noted that this information should already be available because entities would have had to obtain it to adopt the 2003 amendment to IAS 17 that required the split between land and buildings elements for the purposes of lease classification. However, the Board acknowledged that the fair values at the inception of the leases might not be available in some situations. The Board noted that determining the fair value of the land element at the inception of long-term leases in these instances would require the use of hindsight and might not achieve comparability. Accordingly, the Board decided not to require retrospective application when the necessary information is not available. The Board also rejected prospective application of the amendment because the land element in existing long-term leases would be accounted for inconsistently. Therefore, the Board decided to adopt the modified retrospective transition requirement in paragraph 68A of IAS 17.

Allocation of minimum lease payments between land and buildings

BC9 The Exposure Draft proposed that the allocation of the minimum lease payments between land and buildings should be made in proportion to their relative fair values at the inception of the lease. Respondents to the Exposure Draft questioned whether the allocation basis referred to the land and buildings components of the fair value of the property or the fair value of those components to the extent they were the subject of the lease.

* Paragraphs BC8A–BC8F were added as a consequence of amendments to IAS 17 made by *Improvements to IFRSs* issued in April 2009.

BC10 The Board noted that an allocation of the minimum lease payments by reference to the relative fair values of the land and buildings would not reflect the fact that land often has an indefinite economic life, and therefore would be expected to maintain its value beyond the lease term. In contrast, the future economic benefits of a building are likely to be used up, at the least to some extent, over the lease term. Therefore, it would be reasonable to expect that the lease payments relating to the building would be set at a level that enabled the lessor not only to make a return on initial investment, but also to recoup the value of the building used up over the term of the lease. In the case of land, the lessor would not normally need compensation for using up the land.

BC11 Therefore, the Board decided to clarify in the Standard that the allocation of the minimum lease payments is weighted to reflect their role in compensating the lessor, and not by reference to the relative fair values of the land and buildings. In other words, the weighting should reflect the lessee's leasehold interest in the land and the buildings. In the extreme case that a building is fully depreciated over the lease term, the minimum lease payments would need to be weighted to provide a return plus the full depreciation of the building's value at the inception of the lease. The leasehold interest in the land would, assuming a residual value that equals its value at the inception of the lease, have a weighting that reflects only a return on the initial investment.

Impracticability of split between land and buildings

BC12 A question that arises is how to treat leases for which it is not possible to measure the two elements reliably (eg because similar land and buildings are not sold or leased separately). One possibility would be to classify the entire lease as a finance lease. This would prevent a lessee from avoiding finance lease treatment for the buildings by asserting that it cannot separately measure the two elements. However, it may be apparent from the circumstances that classifying the entire lease as a finance lease is not representationally faithful. In view of this, the Board decided that when it is not possible to measure the two elements reliably, the entire lease should be classified as a finance lease unless it is clear that both elements should be classified as an operating lease.

Exception to the requirement to separate the land and buildings elements

BC13 The Board discussed whether to allow or require an exception from the requirement to separate the land and buildings elements in cases in which the present value of the land element at the inception of the lease is small in relation to the value of the entire lease. In such cases the benefits of separating the lease into two elements and accounting for each separately may not outweigh the costs. The Board noted that generally accepted accounting principles in Australia, Canada and the United States allow or require such leases to be classified and accounted for as a single unit, with finance lease treatment being used when the relevant criteria are met. The Board decided to allow land and buildings to be treated as a single unit when the land element is immaterial.

BC14 Some respondents to the Exposure Draft requested guidance on how small the relative value of the land element needs to be in relation to the total value of the lease. The Board decided not to introduce a bright line such as a specific percentage threshold. The Board decided that the normal provisions on materiality should apply.

Transitional provisions

BC15 The Board decided that the requirement to separate the land and buildings elements in a lease of land and buildings should be applied retrospectively. It noted that there will be cases when it will be impracticable to reassess the treatment of these leases retrospectively, because doing so requires estimating what the fair value of the two elements was at the inception of the lease, which may have been many years before. The Board also noted that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* contains guidance on when it is impracticable to apply retrospectively a change in accounting policy and therefore decided not to provide specific transitional provisions for the implementation of this revision to IAS 17.

Inception of the lease and commencement of the lease term

BC16 The previous version of IAS 17 did not define the commencement of the lease term. It implicitly assumed that commencement (when the lease begins) and inception (when the agreement is entered into) are simultaneous. Some respondents questioned what should happen if there is a time lag between the two dates, particularly if the amounts change – for example, because the asset is under construction and the final cost is not known at inception. The Standard now specifies that recognition takes place at commencement, based on values measured at inception. However, if the lease is adjusted for changes in the lessor's costs between the inception of the lease and the commencement of the lease term, the effect of any such changes is deemed to have taken place at inception. These revisions are consistent with generally accepted accounting principles in Australia, Canada and the United States, and are consistent with the present accounting treatment of most ordinary purchases and sales.

BC17 In agreeing on this treatment, the Board noted that measurement at commencement would have been more satisfactory in principle. However, this cannot be done properly within the framework of IAS 17 because the Standard generally requires a finance lease receivable or payable to be recognised at an amount based on the fair value of the asset, which is inappropriate at any date after inception.

Leases in the financial statements of lessors other than manufacturers and dealers

BC18 Lessors may incur direct costs in negotiating a lease, such as commissions, brokers' fees and legal fees. The previous version of IAS 17 contained a choice on how to account for such costs—they might be either charged as an expense as incurred or allocated over the lease term. The choice of treatment applied to operating and finance leases. In the case of a finance lease, paragraph 33 of the previous version of IAS 17 stated that allocation over the lease term might be achieved by recognising the cost as an expense and, in the same period, recognising an equal amount of unearned finance income.

BC19 The Board decided that this treatment was not in accordance with the *Framework for the Preparation and Presentation of Financial Statements*. Its effect was to recognise some future finance income as income and an asset at the commencement of the lease term. However, at that date, the *Framework*'s definitions of income and assets are not met. Therefore the Board decided that if direct costs incurred by lessors are to be allocated over the lease term, this should be achieved by including them in the carrying amount of the lease asset.

BC20 The Board noted that standard-setters in Australia, Canada, France, Japan, the United Kingdom and the United States either permit or require initial direct costs to be allocated over the lease term. The Board also noted that other Standards permit or require the recognition of a range of similar costs in the carrying amount of assets, generally subject to those costs being directly attributable to the acquisition of the asset in question. Hence, for reasons of convergence and comparability with other Standards, the Board decided to require initial direct costs to be included in the carrying amount of the lease asset.

BC21 For consistency with other Standards, in particular IAS 39 *Financial Instruments: Recognition and Measurement*, the Board decided that recognition in the carrying amount of assets should be restricted to costs that are incremental and directly attributable to negotiating and arranging a lease.

Dissenting opinion

Dissent of James J Leisenring from the amendment issued in April 2009

DO1 Mr Leisenring dissents from the amendment to IAS 17 *Leases* made by *Improvements to IFRSs* issued in April 2009.

DO2 Mr Leisenring believes that the amendment inappropriately permits an accounting that does not reflect the economic position of the lessee. In his view, land normally has an indefinite economic life, unlike other properties with finite useful lives. Therefore, it is not the lessee's land at the end of the lease even if the lease term is 999 years. He does not believe that a lessee is in a position economically similar to the purchaser of the land. Any appreciation in the land value does not accrue to the lessee at the termination of the lease. Furthermore, it is unclear how long the lease term must be for the Board to conclude that a lessee and a purchaser are in the same economic position.

DO3 This amendment also reverses the decision the Board made in amending IAS 17 in December 2003 and creates a divergence from US generally accepted accounting principles. Mr Leisenring agrees with some respondents that it is best to incorporate this amendment into the Board's broader project on lease accounting.

Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) - effective for annual periods beginning on or after 1 January 2013

In the Basis for Conclusions on IAS 17 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC21 is footnoted as follows:

* In November 2009 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*.

Guidance on implementing IAS 17 *Leases*

This guidance accompanies, but is not part of, IAS 17.

Illustrative examples of sale and leaseback transactions that result in operating leases

A sale and leaseback transaction that results in an operating lease may give rise to profit or a loss, the determination and treatment of which depends on the leased asset's carrying amount, fair value and selling price. The table below shows the requirements of the Standard in various circumstances.

Sale price at fair value (paragraph 61)	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Profit	no profit	recognise profit immediately	not applicable
Loss	no loss	not applicable	recognise loss immediately

Sale price below fair value (paragraph 61)			
Profit	no profit	recognise profit immediately	no profit (note 1)
Loss <u>not</u> compensated for by future lease payments at below market price	recognise loss immediately	recognise loss immediately	(note 1)
Loss compensated for by future lease payments at below market price	defer and amortise loss	defer and amortise loss	(note 1)

Sale price above fair value (paragraph 61)			
Profit	defer and amortise profit	defer and amortise excess profit (note 3)	defer and amortise profit (note 2)
Loss	no loss	no loss	(note 1)

Note 1 These parts of the table represent circumstances dealt with in paragraph 63 of the Standard. Paragraph 63 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2 Profit is the difference between fair value and sale price because the carrying amount would have been written down to fair value in accordance with paragraph 63.

Note 3 The excess profit (the excess of sale price over fair value) is deferred and amortised over the period for which the asset is expected to be used. Any excess of fair value over carrying amount is recognised immediately.

Table of concordance

This table shows how the contents of the superseded SSAP 14 and the HKAS 17 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded SSAP 14 paragraph	Current HKAS 17 paragraph
Objective	1
1	2
2	3
3	4
4	6
5	7
6	8
7	9
8	10
9	11
10	13
11	14
12	20
13	21
14	22
15	23
16	24
17	25
18	26
19	27
20	28
21	29
22	30

Superseded SSAP 14 paragraph	Current HKAS 17 paragraph
23	31
24	32
25	33
26	34
27-29	HKAS-Int-15
30	35
31	36
32	37
33	39
34	40
35	41
36	38
37	42
38	43
39	44
40	45
41	46
42	47
43	48
44	49
45	50
46	51
47	52
48-49	HKAS-Int-15
50	53

Superseded SSAP 14 paragraph	Current HKAS 17 paragraph
51	54
52	55
53	56
54	58
55	59
56	60
57	61
58	62
59	63
60	64

Superseded SSAP 14 paragraph	Current HKAS 17 paragraph
61	65
62	66
63	67
64	69
65	70
None	5
None	12
None	15-19
None	41A
None	57
None	68
Appendix A	Implementation Guidance

Basis for Conclusions on
Hong Kong Accounting Standard 19

Employee Benefits

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

HKAS 19 is based on IAS 19 *Employee Benefits*. In approving HKAS 19, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 19. Accordingly, there are no significant differences between HKAS 19 and IAS 19. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 19 referred to below generally correspond with those in HKAS 19.

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Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) – effective for annual periods beginning on or after 1 January 2013

The Basis for Conclusions on IAS 19 is amended as described below.

In paragraph BC48W the reference to 'available-for-sale' is footnoted as follows:

> * IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of available-for-sale financial assets.

In paragraph BC75A the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' is footnoted as follows:

> * In November 2009 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

Hong Kong Accounting Standard 21

The Effects of Changes in Foreign Exchange Rates

An entity shall apply amendments resulting from *Improvements to HKFRSs* issued in May 2010 for annual periods beginning on or after 1 July 2010.

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Hong Kong Accounting Standard 21 *The Effects of Changes in Foreign Exchange Rates* (HKAS 21) is set out in paragraphs 1-62 and Appendices B and C. All the paragraphs have equal authority. HKAS 21 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 21 *The Effects of Changes in Foreign Exchange Rates* (HKAS 21) should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 21

IN2 The objectives of the HKICPA in issuing HKAS 21 were to reduce or eliminate alternatives, redundancies and conflicts within the HKFRSs, to deal with some convergence issues and to make other improvements.

IN3 For HKAS 21 the HKICPA's main objective was to provide additional guidance on the translation method and on determining the functional and presentation currencies. The HKICPA did not reconsider the fundamental approach to accounting for the effects of changes in foreign exchange rates contained in HKAS 21.

The main features

IN4 The main features of HKAS 21 are described below.

Scope

IN5 The Standard excludes from its scope foreign currency derivatives that are within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement.*

Definitions

IN6 Two notions are used:

- functional currency, ie the currency of the primary economic environment in which the entity operates.
- presentation currency, ie the currency in which financial statements are presented.

Definitions—functional currency

IN7 When a reporting entity prepares financial statements, the Standard requires each individual entity included in the reporting entity—whether it is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch)—to determine its functional currency and measure its results and financial position in that currency.

IN8 [Not used]

IN9 [Not used]

Reporting foreign currency transactions in the functional currency—recognition of exchange differences

IN10 [Not used]

Reporting foreign currency transactions in the functional currency—change in functional currency

IN11 A change in functional currency is accounted for prospectively.

Use of a presentation currency other than the functional currency—translation to the presentation currency

IN12 The Standard permits an entity to present its financial statements in any currency (or currencies). For this purpose, an entity could be a stand-alone entity, a parent preparing consolidated financial statements or a parent, an investor or a venture preparing separate financial statements in accordance with HKAS 27 *Consolidated and Separate Financial Statements*.

IN13 An entity is required to translate its results and financial position from its functional currency into a presentation currency (or currencies) using the method required for translating a foreign operation for inclusion in the reporting entity's financial statements. Under this method, assets and liabilities are translated at the closing rate, and income and expenses are translated at the exchange rates at the dates of the transactions (or at the average rate for the period when this is a reasonable approximation).

IN14 The Standard requires comparative amounts to be translated as follows:

(a) for an entity whose functional currency is not the currency of a hyperinflationary economy:

(i) assets and liabilities in each statement of financial position presented are translated at the closing rate at the date of that statement of financial position (ie last year's comparatives are translated at last year's closing rate).

(ii) income and expenses in each statement of comprehensive income or separate income statement presented are translated at exchange rates at the dates of the transactions (ie last year's comparatives are translated at last year's actual or average rate).

(b) for an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are translated into the currency of a different hyperinflationary economy, all amounts (eg amounts in a statement of financial position and statement of comprehensive income) are translated at the closing rate of the most recent statement of financial position presented (ie last year's comparatives, as adjusted for subsequent changes in the price level, are translated at this year's closing rate).

(c) for an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are translated into the currency of a non-hyperinflationary economy, all amounts are those presented in the prior year financial statements (ie not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).

This translation method, like that described in paragraph IN13, applies when translating the financial statements of a foreign operation for inclusion in the financial statements of the reporting entity, and when translating the financial statements of an entity into a different presentation currency.

Use of a presentation currency other than the functional currency—translation of a foreign operation

IN15 The Standard requires goodwill and fair value adjustments to assets and liabilities that arise on the acquisition of a foreign entity to be treated as part of the assets and liabilities of the acquired entity and translated at the closing rate.

Disclosure

IN16 [Not used]

IN17 Entities must disclose when there has been a change in functional currency, and the reasons for the change.

Hong Kong Accounting Standard 21
The Effects of Changes in Foreign Exchange Rates

Objective

1 An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In addition, an entity may present its financial statements in a foreign currency. The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

2 The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

Scope

3 This Standard shall be applied:

(a) in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement*;

(b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and

(c) in translating an entity's results and financial position into a presentation currency.

4 HKAS 39 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Standard. However, those foreign currency derivatives that are not within the scope of HKAS 39 (eg some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard. In addition, this Standard applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency.

5 This Standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. HKAS 39 applies to hedge accounting.

6 This Standard applies to the presentation of an entity's financial statements in a foreign currency and sets out requirements for the resulting financial statements to be described as complying with Hong Kong Financial Reporting Standards (HKFRSs). For translations of financial information into a foreign currency that do not meet these requirements, this Standard specifies information to be disclosed.

7 This Standard does not apply to the presentation in a statement of cash flows ~~statement~~ of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation (see HKAS 7 ~~*Cash Flow Statements*~~*Statement of Cash Flows*).

Definitions

8 The following terms are used in this Standard with the meanings specified:

Closing rate **is the spot exchange rate at the ~~balance sheet date~~end of the reporting period.**

Exchange difference **is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.**

Exchange rate **is the ratio of exchange for two currencies.**

Fair value **is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**

Foreign currency **is a currency other than the functional currency of the entity.**

Foreign operation **is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.**

Functional currency **is the currency of the primary economic environment in which the entity operates.**

A *group* **is a parent and all its subsidiaries.**

Monetary items **are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.**

Net investment in a foreign operation **is the amount of the reporting entity's interest in the net assets of that operation.**

Presentation currency **is the currency in which the financial statements are presented.**

Spot exchange rate **is the exchange rate for immediate delivery.**

Elaboration on the definitions

Functional currency

9 The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

(a) the currency:

(i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

(ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

10 The following factors may also provide evidence of an entity's functional currency:

(a) the currency in which funds from financing activities (ie issuing debt and equity instruments) are generated.

(b) the currency in which receipts from operating activities are usually retained.

11 The following additional factors are considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity (the reporting entity, in this context, being the entity that has the foreign operation as its subsidiary, branch, associate or joint venture):

(a) whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

(b) whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

(c) whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

12 When the above indicators are mixed and the functional currency is not obvious, management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, management gives priority to the primary indicators in paragraph 9 before considering the indicators in paragraphs 10 and 11, which are designed to provide additional supporting evidence to determine an entity's functional currency.

13 An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.

14 If the functional currency is the currency of a hyperinflationary economy, the entity's financial statements are restated in accordance with HKAS 29 *Financial Reporting in Hyperinflationary Economies*. An entity cannot avoid restatement in accordance with HKAS 29 by, for example, adopting as its functional currency a currency other than the functional currency determined in accordance with this Standard (such as the functional currency of its parent).

Net investment in a foreign operation

15 An entity may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation, and is accounted for in accordance with paragraphs 32 and 33. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

15A The entity that has a monetary item receivable from or payable to a foreign operation described in paragraph 15 may be any subsidiary of the group. For example, an entity has two subsidiaries, A and B. Subsidiary B is a foreign operation. Subsidiary A grants a loan to Subsidiary B. Subsidiary A's loan receivable from Subsidiary B would be part of the entity's net investment in Subsidiary B if settlement of the loan is neither planned nor likely to occur in the foreseeable future. This would also be true if Subsidiary A were itself a foreign operation.

Monetary items

16 The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; and cash dividends that are recognised as a liability. Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: amounts prepaid for goods and services (eg prepaid rent); goodwill; intangible assets; inventories; property, plant and equipment; and provisions that are to be settled by the delivery of a non-monetary asset.

Summary of the approach required by this Standard

17 In preparing financial statements, each entity—whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch)—determines its functional currency in accordance with paragraphs 9-14. The entity translates foreign currency items into its functional currency and reports the effects of such translation in accordance with paragraphs 20-37 and 50.

18 Many reporting entities comprise a number of individual entities (eg a group is made up of a parent and one or more subsidiaries). Various types of entities, whether members of a group or otherwise, may have investments in associates or joint ventures. They may also have branches. It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity presents its financial statements. This Standard permits the presentation currency of a reporting entity to be any currency (or currencies). The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with paragraphs 38-50.

19 This Standard also permits a stand-alone entity preparing financial statements or an entity preparing separate financial statements in accordance with HKAS 27 *Consolidated and Separate Financial Statements* to present its financial statements in any currency (or currencies). If the entity's presentation currency differs from its functional currency, its results and financial position are also translated into the presentation currency in accordance with paragraphs 38-50.

Reporting foreign currency transactions in the functional currency

Initial recognition

20 A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

(c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

21 A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

22 The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with ~~Hong Kong Financial Reporting Standards~~HKFRSs. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

Reporting at ~~subsequent balance sheet dates~~the ends of subsequent reporting periods

23 At ~~each balance sheet date~~the end of each reporting period:

(a) foreign currency monetary items shall be translated using the closing rate;

(b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and

(c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined.

24 The carrying amount of an item is determined in conjunction with other relevant Standards. For example, property, plant and equipment may be measured in terms of fair value or historical cost in accordance with HKAS 16 *Property, Plant and Equipment*. Whether the carrying amount is determined on the basis of historical cost or on the basis of fair value, if the amount is determined in a foreign currency it is then translated into the functional currency in accordance with this Standard.

25 The carrying amount of some items is determined by comparing two or more amounts. For example, the carrying amount of inventories is the lower of cost and net realisable value in accordance with HKAS 2 *Inventories.* Similarly, in accordance with HKAS 36 *Impairment of Assets,* the carrying amount of an asset for which there is an indication of impairment is the lower of its carrying amount before considering possible impairment losses and its recoverable amount. When such an asset is non-monetary and is measured in a foreign currency, the carrying amount is determined by comparing:

(a) the cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (ie the rate at the date of the transaction for an item measured in terms of historical cost), and

(b) the net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (eg the closing rate at the ~~balance sheet date~~end of the reporting period).

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency, or vice versa.

26 When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.

Recognition of exchange differences

27 As noted in paragraph 3(a) and 5, HKAS 39 applies to hedge accounting for foreign currency items. The application of hedge accounting requires an entity to account for some exchange differences differently from the treatment of exchange differences required by this Standard. For example, HKAS 39 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge are ~~reported~~ recognised initially in ~~equity~~ other comprehensive income to the extent that the hedge is effective.

28 Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32.

29 When monetary items arise from a foreign currency transaction and there is a change in the exchange rate between the transaction date and the date of settlement, an exchange difference results. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period.

30 When a gain or loss on a non-monetary item is recognised ~~directly~~ in ~~equity~~other comprehensive income, any exchange component of that gain or loss shall be recognised ~~directly~~ in ~~equity~~other comprehensive income. Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss.

31 Other ~~Standards~~ HKFRSs require some gains and losses to be recognised ~~directly~~ in ~~equity~~other comprehensive income. For example, HKAS 16 requires some gains and losses arising on a revaluation of property, plant and equipment to be recognised ~~directly~~ in ~~equity~~other comprehensive income. When such an asset is measured in a foreign currency, paragraph 23(c) of this Standard requires the revalued amount to be translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognised in ~~equity~~other comprehensive income.

32 Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation (see paragraph 15) shall be recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate. In the financial statements that include the foreign operation and the reporting entity (eg consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in ~~a separate component of equity and recognised in~~other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment in accordance with paragraph 48.

33 When a monetary item forms part of a reporting entity's net investment in a foreign operation and is denominated in the functional currency of the reporting entity, an exchange difference arises in the foreign operation's individual financial statements in accordance with paragraph 28. If such an item is denominated in the functional currency of the foreign operation, an exchange difference arises in the reporting entity's separate financial statements in accordance with paragraph 28. If such an item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, an exchange difference arises in the reporting entity's separate financial statements and in the foreign operation's individual financial statements in accordance with paragraph 28. Such exchange differences are ~~reclassified to the separate component of equity~~recognised in other comprehensive income in the financial statements that include the foreign operation and the reporting entity (ie financial statements in which the foreign operation is consolidated, proportionately consolidated or accounted for using the equity method).

34 When an entity keeps its books and records in a currency other than its functional currency, at the time the entity prepares its financial statements all amounts are translated into the functional currency in accordance with paragraphs 20-26. This produces the same amounts in the functional currency as would have occurred had the items been recorded initially in the functional currency. For example, monetary items are translated into the functional currency using the closing rate, and non-monetary items that are measured on a historical cost basis are translated using the exchange rate at the date of the transaction that resulted in their recognition.

Change in functional currency

35 When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.

36 As noted in paragraph 13, the functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once the functional currency is determined, it can be changed only if there is a change to those underlying transactions, events and conditions. For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency.

37 The effect of a change in functional currency is accounted for prospectively. In other words, an entity translates all items into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation previously ~~classified in equity~~recognised in other comprehensive income in accordance with paragraphs 32 and 39(c) are not ~~recognised in~~reclassified from equity to profit or loss until the disposal of the operation.

Use of a presentation currency other than the functional currency

Translation to the presentation currency

38 An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency. For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented.

39 The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

(a) assets and liabilities for each ~~balance sheet~~statement of financial position presented (ie including comparatives) shall be translated at the closing rate at the date of that ~~balance sheet~~statement of financial position;

(b) income and expenses for each ~~income statement~~statement of comprehensive income or separate income statement presented (ie including comparatives) shall be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences shall be recognised ~~as a separate component of equity~~in other comprehensive income.

40 For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example an average rate for the period, is often used to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

41 The exchange differences referred to in paragraph 39(c) result from:

(a) translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate. ~~Such exchange differences arise both on income and expense items recognised in profit or loss and on those recognised directly in equity.~~

(b) translating the opening net assets at a closing rate that differs from the previous closing rate.

These exchange differences are not recognised in profit or loss because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations. The cumulative amount of the exchange differences is presented in a separate component of equity until disposal of the foreign operation. When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to ~~minority~~ non-controlling interests are allocated to, and recognised as part of, minority interest in the consolidated ~~balance sheet~~statement of financial position.

42 The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

(a) all amounts (ie assets, liabilities, equity items, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent ~~balance sheet~~statement of financial position, except that

(b) when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (ie not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).

43 **When an entity's functional currency is the currency of a hyperinflationary economy, the entity shall restate its financial statements in accordance with HKAS 29 before applying the translation method set out in paragraph 42, except for comparative amounts that are translated into a currency of a non-hyperinflationary economy (see paragraph 42(b)). When the economy ceases to be hyperinflationary and the entity no longer restates its financial statements in accordance with HKAS 29, it shall use as the historical costs for translation into the presentation currency the amounts restated to the price level at the date the entity ceased restating its financial statements.**

Translation of a foreign operation

44 Paragraphs 45-47, in addition to paragraphs 38-43, apply when the results and financial position of a foreign operation are translated into a presentation currency so that the foreign operation can be included in the financial statements of the reporting entity by consolidation, proportionate consolidation or the equity method.

45 The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of intragroup balances and intragroup transactions of a subsidiary (see HKAS 27 and HKAS 31 *Interests in Joint Ventures*). However, an intragroup monetary asset (or liability), whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference ~~continues to be~~is recognised in profit or loss or, if it arises from the circumstances described in paragraph 32, it is ~~classified as equity~~ recognised in other comprehensive income and accumulated in a separate component of equity until the disposal of the foreign operation.

46 When the financial statements of a foreign operation are as of a date different from that of the reporting entity, the foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements. When this is not done, HKAS 27 allows the use of a different ~~reporting~~ date provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates. In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the ~~balance sheet date~~end of the reporting period of the foreign operation. Adjustments are made for significant changes in exchange rates up to the ~~balance sheet date~~end of the reporting period of the reporting entity in accordance with HKAS 27. The same approach is used in applying the equity method to associates and joint ventures and in applying proportionate consolidation to joint ventures in accordance with HKAS 28 *Investments in Associates* and HKAS 31.

47 **Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be treated as assets and liabilities of the foreign operation. Thus they shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate in accordance with paragraphs 39 and 42.**

Disposal or partial disposal of a foreign operation

48 **On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, ~~deferred~~ recognised in other comprehensive income and accumulated in the separate component of equity, ~~relating to that foreign operation~~ shall be ~~recognised in~~ reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised (see HKAS 1 *Presentation of Financial Statements* (as revised in 2007)).**

48A* In addition to the disposal of an entity's entire interest in a foreign operation, the following are accounted for as disposals even if the entity retains an interest in the former subsidiary, associate or jointly controlled entity:

(a) the loss of control of a subsidiary that includes a foreign operation;

(b) the loss of significant influence over an associate that includes a foreign operation; and

(c) the loss of joint control over a jointly controlled entity that includes a foreign operation.

48B* On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be derecognised, but shall not be reclassified to profit or loss.

48C* On the partial disposal of a subsidiary that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation the entity shall reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.

48D* A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except those reductions in paragraph 48A that are accounted for as disposals.

49# An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity. ~~The payment of a dividend is part of a disposal only when it constitutes a return of the investment, for example when the dividend is paid out of pre-acquisition profits. In the case of a partial disposal, only the proportionate share of the related accumulated exchange difference is included in the gain or loss.~~ A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the ~~deferred~~ foreign exchange gain or loss ~~is~~ recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

Tax effects of all exchange differences

50 Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. HKAS 12 *Income Taxes* applies to these tax effects.

Disclosure

51 In paragraphs 53 and 55-57 references to 'functional currency' apply, in the case of a group, to the functional currency of the parent.

52 An entity shall disclose:

(a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with HKAS 39; and

(b) net exchange differences ~~classified~~ recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

53 When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency.

54 When there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change in functional currency shall be disclosed.

* Amendments effective for annual periods beginning on or after 1 July 2009.

Amendment related to cost method is effective for annual periods beginning on or after 1 January 2009, while amendment related to partial disposal is effective for annual periods beginning on or after 1 July 2009.

55 When an entity presents its financial statements in a currency that is different from its functional currency, it shall describe the financial statements as complying with ~~Hong Kong Financial Reporting Standards~~HKFRSs only if they comply with all the requirements of ~~each applicable Standard and each applicable Interpretation of those Standards~~HKFRSs including the translation method set out in paragraphs 39 and 42.

56 An entity sometimes presents its financial statements or other financial information in a currency that is not its functional currency without meeting the requirements of paragraph 55. For example, an entity may convert into another currency only selected items from its financial statements. Or, an entity whose functional currency is not the currency of a hyperinflationary economy may convert the financial statements into another currency by translating all items at the most recent closing rate. Such conversions are not in accordance with ~~Hong Kong Financial Reporting Standards~~HKFRSs and the disclosures set out in paragraph 57 are required.

57 When an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency and the requirements of paragraph 55 are not met, it shall:

(a) clearly identify the information as supplementary information to distinguish it from the information that complies with ~~Hong Kong Financial Reporting Standards~~HKFRSs;

(b) disclose the currency in which the supplementary information is displayed; and

(c) disclose the entity's functional currency and the method of translation used to determine the supplementary information.

Effective date and transition

58 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.

58A *Net Investment in a Foreign Operation* (Amendment to HKAS 21), issued in January 2006, added paragraph 15A and amended paragraph 33. An entity shall apply those amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged.

59 An entity shall apply paragraph 47 prospectively to all acquisitions occurring after the beginning of the financial reporting period in which this Standard is first applied. Retrospective application of paragraph 47 to earlier acquisitions is permitted. For an acquisition of a foreign operation treated prospectively but which occurred before the date on which this Standard is first applied, the entity shall not restate prior years and accordingly may, when appropriate, treat goodwill and fair value adjustments arising on that acquisition as assets and liabilities of the entity rather than assets and liabilities of the foreign operation. Therefore, those goodwill and fair value adjustments either are already expressed in the entity's functional currency or are non-monetary foreign currency items, which are reported using the exchange rate at the date of the acquisition.

60 All other changes resulting from the application of this Standard shall be accounted for in accordance with the requirements of HKAS 8 Acco*unting Policies, Changes in Accounting Estimates and Errors*.

60~~A~~a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.

60A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 27, 30–33, 37, 39, 41, 45, 48 and 52. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

60B HKAS 27 (as amended in 2008) added paragraphs 48A–48D and amended paragraph 49. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendments shall be applied for that earlier period.

Withdrawal of other pronouncements

61 This Standard supersedes SSAP 11 *Foreign Currency Translation* (revised in 2001).

62 [Not used]

Appendix A

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at 9 March 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 21.

The International Accounting Standard comparable with HKAS 21 is IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

There are no major textual differences between HKAS 21 and IAS 21.

Appendix B

Amendments to Other Pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period.

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Appendix C

Amendments resulting from other HKFRSs

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) – effective for annual periods beginning on or after 1 January 2013

Paragraphs 3(a), 4 and 52(a) are amended and paragraph 60C is added as follows:

3 **This Standard shall be applied:** [footnote omitted]

(a) **in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of HKAS 39** *Financial Instruments: Recognition and Measurement* **and HKFRS 9** *Financial Instruments*;

...

4 HKFRS 9 and HKAS 39 apply ~~applies~~ to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Standard. However, those foreign currency derivatives that are not within the scope of HKFRS 9 and HKAS 39 (eg some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard. In addition, this Standard applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency.

52 **An entity shall disclose:**

(a) **the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with HKFRS 9 and HKAS 39; and**

(b) **…**

60C HKFRS 9, issued in November 2009, amended paragraphs 3(a), 4 and 52(a). An entity shall apply those amendments when it applies HKFRS 9.

Basis for Conclusions on IAS 21 *The Effects of Changes in Foreign Exchange Rates*

This Basis for Conclusions accompanies, but is not part of, IAS 21.

Paragraph BC1 was amended and paragraphs BC25A–BC25F were added in relation to the amendment to IAS 21 issued in December 2005.

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements *(as revised in 2007).*

HKAS 21 is based on IAS 21 *The Effects of Changes in Foreign Exchange Rates*. In approving HKAS 21, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 21 (as revised 2003). Accordingly, there are no significant differences between HKAS 21 and IAS 21. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 21 referred to below generally correspond with those in HKAS 21.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 21 *The Effects of Changes in Foreign Exchange Rates* in 2003, and on the amendment to IAS 21 *Net Investment in a Foreign Operation* in December 2005. Individual Board members gave greater weight to some factors than to others.

BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 21. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.

BC3 Because the Board's intention was not to reconsider the fundamental approach to accounting for the effects of changes in foreign exchange rates established by IAS 21, this Basis for Conclusions does not discuss requirements in IAS 21 that the Board has not reconsidered.

Functional currency

BC4 The term 'reporting currency' was previously defined as 'the currency used in presenting the financial statements'. This definition comprises two separate notions (which were identified in SIC-19 *Reporting Currency–Measurement and Presentation of Financial Statements under IAS '21 and IAS 29*):

- the measurement currency (the currency in which the entity measures the items in the financial statements); and
- the presentation currency (the currency in which the entity presents its financial statements).

The Board decided to revise the previous version of IAS 21 to incorporate the SIC-19 approach of separating these two notions. The Board also noted that the term 'functional currency' is more commonly used than 'measurement currency' and decided to adopt the more common term.

BC5 The Board noted a concern that the guidance in SIC-19 on determining a measurement currency could permit entities to choose one of several currencies, or to select an inappropriate currency. In particular, some believed that SIC-19 placed too much emphasis on the currency in which transactions are denominated and too little emphasis on the underlying economy that determines the pricing of those transactions. To meet these concerns, the Board defined functional currency as 'the currency of the primary economic environment in which the entity operates'. The Board also provided guidance on how to determine the functional currency (see paragraphs 9-14 of the Standard). This guidance draws heavily on SIC-19 and equivalent guidance in US and other national standards, but also reflects the Board's decision that some factors merit greater emphasis than others.

BC6 The Board also discussed whether a foreign operation that is integral to the reporting entity (as described in the previous version of IAS 21) could have a functional currency that is different from that of its 'parent'.* The Board decided that the functional currencies will always be the same, because it would be contradictory for an integral foreign operation that 'carries on business as if it were an extension of the reporting enterprise's operations'[9] to operate in a primary economic environment different from its parent.

BC7 It follows that it is not necessary to translate the results and financial position of an integral foreign operation when incorporating them into the financial statements of the parent—they will already be measured in the parent's functional currency. Furthermore, it is not necessary to distinguish between an integral foreign operation and a foreign entity. When a foreign operation's functional currency is different from that of its parent, it is a foreign entity, and the translation method in paragraphs 38-49 of the Standard applies.

BC8 The Board also decided that the principles in the previous version of IAS 21 for distinguishing an integral foreign operation from a foreign entity are relevant in determining an operation's functional currency. Hence it incorporated these principles into the Standard in that context.

BC9 The Board agreed that the indicators in paragraph 9 are the primary indicators for determining the functional currency and that paragraphs 10 and 11 are secondary. This is because the indicators in paragraphs 10 and 11 are not linked to the primary economic environment in which the entity operates but provide additional supporting evidence to determine an entity's functional currency.

Presentation currency

BC10 A further issue is whether an entity should be permitted to present its financial statements in a currency (or currencies) other than its functional currency. Some believe it should not. They believe that the functional currency, being the currency of the primary economic environment in which the entity operates, most usefully portrays the economic effect of transactions and events on the entity. For a group that comprises operations with a number of functional currencies, they believe that the consolidated financial statements should be presented in the functional currency that management uses when controlling and monitoring the performance and financial position of the group. They also believe that allowing an entity to present its financial statements in more than one currency may confuse, rather than help, users of those financial statements. Supporters of this view believe that any presentation in a currency other than that described above should be regarded as a 'convenience translation' that is outside the scope of IFRSs.

BC11 Others believe that the choice of presentation currency should be limited, for example, to the functional currency of one of the substantive entities within a group. However, such a restriction might be easily overcome—an entity that wished to present its financial statements in a different currency might establish a substantive, but relatively small operation with that functional currency.

BC12 Still others believe that, given the rising trend towards globalisation, entities should be permitted to present their financial statements in any currency. They note that most large groups do not have a single functional currency, but rather comprise operations with a number of functional currencies. For such entities, they believe it is not clear which currency should be the presentation currency, or why one currency is preferable to another. They also point out that management may not use a single currency when controlling and monitoring the performance and financial position of such a group. In addition, they note that in some jurisdictions, entities are required to present their financial statements in the local currency, even when this is not the functional currency.# Hence, if IFRSs required the financial statements to be presented in the functional currency, some entities would have to present two sets of financial statements: financial statements that comply with IFRSs presented in the functional currency and financial statements that comply with local regulations presented in a different currency.

* The term 'parent' is used broadly in this context to mean an entity that has a branch, associate or joint venture, as well as one with a subsidiary

9 IAS 21 (revised 1993), paragraph 24

\# This includes entities operating in another country and, for example, publishing financial statements to comply with a listing requirement of that country.

BC13 The Board was persuaded by the arguments in the previous paragraph. Accordingly, it decided that entities should be permitted to present their financial statements in any currency (or currencies).

BC14 The Board also clarified that the Standard does not prohibit the entity from providing, as supplementary information, a 'convenience translation'. Such a 'convenience translation' may display financial statements (or selected portions of financial statements) in a currency other than the presentation currency, as a convenience to some users. The 'convenience translation' may be prepared using a translation method other than that required by the Standard. These types of 'convenience translations' should be clearly identified as supplementary information to distinguish them from information required by IFRSs and translated in accordance with the Standard.

Translation method

BC15 The Board debated which method should be used to translate financial statements from an entity's functional currency into a different presentation currency.

BC16 The Board agreed that the translation method should not have the effect of substituting another currency for the functional currency. Put another way, presenting the financial statements in a different currency should not change the way in which the underlying items are measured. Rather, the translation method should merely express the underlying amounts, as measured in the functional currency, in a different currency.

BC17 Given this, the Board considered two possible translation methods. The first is to translate all amounts (including comparatives) at the most recent closing rate. This method has several advantages: it is simple to apply; it does not generate any new gains and losses; and it does not change ratios such as return on assets. This method is supported by those who believe that the process of merely expressing amounts in a different currency should preserve the relationships among amounts as measured in the functional currency and, as such, should not lead to any new gains or losses.

BC18 The second method considered by the Board is the one that the previous version of IAS 21 required for translating the financial statements of a foreign operation.* This method results in the same amounts in the presentation currency regardless of whether the financial statements of a foreign operation are:

(a) first translated into the functional currency of another group entity (eg the parent) and then into the presentation currency, or

(b) translated directly into the presentation currency.

BC19 This method avoids the need to decide the currency in which to express the financial statements of a multinational group before they are translated into the presentation currency. As noted above, many large groups do not have a single functional currency, but comprise operations with a number of functional currencies. For such entities it is not clear which functional currency should be chosen in which to express amounts before they are translated into the presentation currency, or why one currency is preferable to another. In addition, this method produces the same amounts in the presentation currency for a stand-alone entity as for an identical subsidiary of a parent whose functional currency is the presentation currency.

BC20 The Board decided to require the second method, ie that the financial statements of any entity (whether a stand-alone entity, a parent or an operation within a group) whose functional currency differs from the presentation currency used by the reporting entity are translated using the method set out in paragraphs 38-49 of the Standard.

* This is to translate balance sheet items at the closing rate and income and expense items at actual (or average) rates, except for an entity whose functional currency is that of a hyperinflationary economy.

BC21 With respect to translation of comparative amounts, the Board adopted the approach required by SIC-30 for:

(a) an entity whose functional currency is not the currency of the hyperinflationary economy (assets and liabilities in the comparative balance sheet are translated at the closing rate at the date of that balance sheet and income and expenses in the comparative income statement are translated at exchange rates at the dates of the transactions); and

(b) an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are being translated into the currency of a hyperinflationary economy (both balance sheet and income statement items are translated at the closing rate of the most recent balance sheet presented).

BC22 However, the Board decided not to adopt the SIC-30 approach for the translation of comparatives for an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are being translated into a presentation currency of a non-hyperinflationary economy. The Board noted that in such a case, the SIC-30 approach requires restating the comparative amounts from those shown in last year's financial statements for both the effects of inflation and for changes in exchange rates. If exchange rates fully reflect differing price levels between the two economies to which they relate, the SIC-30 approach will result in the same amounts for the comparatives as were reported as current year amounts in the prior year financial statements. Furthermore, the Board noted that in the prior year, the relevant amounts had been already expressed in the non-hyperinflationary presentation currency, and there was no reason to change them. For these reasons the Board decided to require that all comparative amounts are those presented in the prior year financial statements (ie there is no adjustment for either subsequent changes in the price level or subsequent changes in exchange rates).

BC23 The Board decided to incorporate into the Standard most of the disclosure requirements of SIC-30 *Reporting Currency–Translation from Measurement Currency to Presentation Currency* that apply when a different translation method is used or other supplementary information, such as an extract from the full financial statements, is displayed in a currency other than the functional currency (see paragraph 57 of the Standard). These disclosures enable users to distinguish information prepared in accordance with IFRSs from information that may be useful to users but is not the subject of IFRSs, and also tell users how the latter information has been prepared.

Capitalisation of exchange differences

BC24 The previous version of IAS 21 allowed a limited choice of accounting for exchange differences that arise 'from a severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise directly on the recent acquisition of an asset'[*]. The benchmark treatment was to recognise such exchange differences in profit or loss. The allowed alternative was to recognise them as an asset.

BC25 The Board noted that the allowed alternative (of recognition as an asset) was not in accordance with the *Framework for the Preparation and Presentation of Financial Statements* because exchange losses do not meet the definition of an asset. Moreover, recognition of exchange losses as an asset is neither allowed nor required by any liaison standard-setter, so its deletion would improve convergence. Finally, in many cases when the conditions for recognition as an asset are met, the asset would be restated in accordance with IAS 29 *Financial Reporting in Hyperinflationary Economies*. Thus, to the extent that an exchange loss reflects hyperinflation, this effect is taken into account by IAS 29. For all of these reasons, the Board removed the allowed alternative treatment and the related SIC Interpretation is superseded.

[*] IAS 21 (revised 1993), paragraph 21

Net investment in a foreign operation

BC25A The principle in paragraph 32 is that exchange differences arising on a monetary item that is, in substance, part of the reporting entity's net investment in a foreign operation are initially recognised in a separate component of equity* in the consolidated financial statements of the reporting entity. Among the revisions to IAS 21 made in 2003 was the provision of guidance on this principle that required the monetary item to be denominated in the functional currency of either the reporting entity or the foreign operation. The previous version of IAS 21 did not include such guidance.

BC25B The requirements can be illustrated by the following example. Parent P owns 100 per cent of Subsidiary S. Parent P has a functional currency of UK sterling. Subsidiary S has a functional currency of Mexican pesos. Parent P grants a loan of 100 US dollars to Subsidiary S, for which settlement is neither planned nor likely to occur in the foreseeable future. IAS 21 (as revised in 2003) requires the exchange differences arising on the loan to be recognised in profit or loss in the consolidated financial statements of Parent P, whereas those differences would be recognised initially in equity* in the consolidated financial statements of Parent P, if the loan were to be denominated in sterling or Mexican pesos.

BC25C After the revised IAS 21 was issued in 2003, constituents raised the following concerns:

(a) It is common practice for a monetary item that forms part of an entity's investment in a foreign operation to be denominated in a currency that is not the functional currency of either the reporting entity or the foreign operation. An example is a monetary item denominated in a currency that is more readily convertible than the local domestic currency of the foreign operation.

(b) An investment in a foreign operation denominated in a currency that is not the functional currency of the reporting entity or the foreign operation does not expose the group to a greater foreign currency exchange difference than arises when the investment is denominated in the functional currency of the reporting entity or the foreign operation. It simply results in exchange differences arising in the foreign operation's individual financial statements and the reporting entity's separate financial statements.

(c) It is not clear whether the term 'reporting entity' in paragraph 32 should be interpreted as the single entity or the group comprising a parent and all its subsidiaries. As a result, constituents questioned whether the monetary item must be transacted between the foreign operation and the reporting entity, or whether it could be transacted between the foreign operation and any member of the consolidated group, ie the reporting entity or any of its subsidiaries.

BC25D The Board noted that the nature of the monetary item referred to in paragraph 15 is similar to an equity investment in a foreign operation, ie settlement of the monetary item is neither planned nor likely to occur in the foreseeable future. Therefore, the principle in paragraph 32 to recognise exchange differences arising on a monetary item initially in a separate component of equity* effectively results in the monetary item being accounted for in the same way as an equity investment in the foreign operation when consolidated financial statements are prepared. The Board concluded that the accounting treatment in the consolidated financial statements should not be dependent on the currency in which the monetary item is denominated, nor on which entity within the group conducts the transaction with the foreign operation.

BC25E Accordingly, in 2005 the Board decided to amend IAS 21. The amendment requires exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation to be recognised initially in a separate component of equity* in the consolidated financial statements. This requirement applies irrespective of the currency of the monetary item and of whether the monetary item results from a transaction with the reporting entity or any of its subsidiaries.

* As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such difference are recognised in other comprehensive income.

BC25F The Board also proposed amending IAS 21 to clarify that an investment in a foreign operation made by an associate of the reporting entity is not part of the reporting entity's net investment in that foreign operation. Respondents to the exposure draft disagreed with this proposal. Many respondents said that the proposed amendment added a detailed rule that was not required because the principle in paragraph 15 was clear. In redeliberations, the Board agreed with those comments and decided not to proceed with that proposed amendment.

Goodwill and fair value adjustments

BC26 The previous version of IAS 21 allowed a choice of translating goodwill and fair value adjustments to assets and liabilities that arise on the acquisition of a foreign entity at (a) the closing rate or (b) the historical transaction rate.

BC27 The Board agreed that, conceptually, the correct treatment depends on whether goodwill and fair value adjustments are part of:

(a) the assets and liabilities of the acquired entity (which would imply translating them at the closing rate); or

(b) the assets and liabilities of the parent (which would imply translating them at the historical rate).

BC28 The Board agreed that fair value adjustments clearly relate to the identifiable assets and liabilities of the acquired entity and should therefore be translated at the closing rate.

BC29 Goodwill is more complex, partly because it is measured as a residual. In addition, the Board noted that difficult issues can arise when the acquired entity comprises businesses that have different functional currencies (eg if the acquired entity is a multinational group). The Board discussed how to assess any resulting goodwill for impairment and, in particular, whether the goodwill would need to be 'pushed down' to the level of each different functional currency or could be accounted for and assessed at a higher level.

BC30 One view is that when the parent acquires a multinational operation comprising businesses with many different functional currencies, any goodwill may be treated as an asset of the parent/acquirer and tested for impairment at a consolidated level. Those who support this view believe that, in economic terms, the goodwill is an asset of the parent because it is part of the acquisition price paid by the parent. Thus, they believe, it would be incorrect to allocate the goodwill to the many acquired businesses and translate it into their various functional currencies. Rather, the goodwill, being treated as an asset of the parent, is not exposed to foreign currency risks, and translation differences associated with it should not be recognised. In addition, they believe that such goodwill should be tested for impairment at a consolidated level. Under this view, allocating or 'pushing down' the goodwill to a lower level, such as each different functional currency within the acquired foreign operation, would not serve any purpose.

BC31 Others take a different view. They believe that the goodwill is part of the parent's net investment in the acquired entity. In their view, goodwill should be treated no differently from other assets of the acquired entity, in particular intangible assets, because a significant part of the goodwill is likely to comprise intangible assets that do not qualify for separate recognition. They also note that goodwill arises only because of the investment in the foreign entity and has no existence apart from that entity. Lastly, they point out that when the acquired entity comprises a number of businesses with different functional currencies, the cash flows that support the continued recognition of goodwill are generated in those different functional currencies.

BC32 The Board was persuaded by the reasons set out in the preceding paragraph and decided that goodwill is treated as an asset of the foreign operation and translated at the closing rate. Consequently, goodwill should be allocated to the level of each functional currency of the acquired foreign operation. This means that the level to which goodwill is allocated for foreign currency translation purposes may be different from the level at which the goodwill is tested for impairment. Entities follow the requirements in IAS 36 *Impairment of Assets* to determine the level at which goodwill is tested for impairment.

Disposal or partial disposal of a foreign operation*

BC33 In the second phase of the business combinations project the Board decided that the loss of control, significant influence or joint control of an entity is accounted for as a disposal for the purposes of IAS 21. Accordingly, a former parent accounts for the loss of control over a subsidiary as a disposal of the subsidiary, even if the former subsidiary becomes an associate or jointly controlled entity of the former parent. Similarly an investor accounts for the loss of significant influence over an associate or the loss of joint control over a jointly controlled entity as a disposal. The Board decided that the change in the nature of the investment is a significant economic event.

BC34 The Board also decided in the second phase of the business combinations project that:

(a) changes in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions (ie transactions with owners in their capacity as owners);

(b) if a parent loses control of a subsidiary, the parent reclassifies from equity to profit or loss (as a reclassification adjustment) the parent's share of the exchange differences recognised in other comprehensive income relating to a foreign operation in that subsidiary; and

(c) if an investor loses significant influence over an associate or loses joint control over a jointly controlled entity, the investor reclassifies from equity to profit or loss (as a reclassification adjustment) the exchange differences recognised in other comprehensive income relating to a foreign operation in that associate or jointly controlled entity.

The amendments in paragraphs 48A–49 of the Standard reflect those decisions for the disposal or partial disposal of a foreign operation.

BC35 As part of *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* and IAS 27 *Consolidated and Separate Financial Statements*), issued in May 2008, the Board amended IAS 27 to remove the definition of the 'cost method'. The cost method required an entity to recognise distributions as income only if they came from post-acquisition retained earnings. Distributions received in excess of such profits were regarded as a recovery of the investment and were recognised as a reduction of its cost. Consequently, the Board amended paragraph 49 to remove the reference to pre-acquisition profits and to clarify that a dividend accounted for in accordance with paragraph 38A of IAS 27 cannot be a disposal or partial disposal of a net investment in IAS 21.

* This heading and paragraphs BC33 and BC34 were added as a consequence of amendments to IAS 27 *Consolidated and Separate Financial Statements* made as part of the second phase of the business combinations project in 2008.

HKAS 40
Revised ~~October 2008~~June 2010

Hong Kong Accounting Standard 40

Investment Property

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

CONTENTS

Hong Kong Accounting Standard 40 *Investment Property* (HKAS 40) is set out in paragraphs 1-86. All the paragraphs have equal authority. HKAS 40 ~~shall~~ should be read in the context of its objective and the IASB's Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Standards*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 40 *Investment Property* (HKAS 40) replaces SSAP 13 *Accounting for Investment Property* (revised in 2000), and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 40

IN2 The objectives of the HKICPA in issuing HKAS 40 were to reduce or eliminate alternatives, redundancies and conflicts within the HKFRSs, to deal with some convergence issues and to make other improvements.

IN3 The HKICPA did not reconsider the fundamental approach to the accounting for investment property.

The main features

IN4 The main features of HKAS 40 are described below.

IN5 A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property provided that:

(a) the rest of the definition of investment property is met;

(b) the operating lease is accounted for as if it were a finance lease in accordance with HKAS 17 *Leases*; and

(c) the lessee uses the fair value model set out in this Standard for the asset recognised.

IN6 The classification alternative described in paragraph IN5 is available on a property-by-property basis. However, because it is a general requirement of the Standard that all investment property should be consistently accounted for using the fair value or cost model, once this alternative is selected for one such property, all property classified as investment property is to be accounted for consistently on a fair value basis.

IN7 The Standard requires an entity to disclose:

(a) whether it applies the fair value model or the cost model; and

(b) if it applies the fair value model, whether, and in what circumstances, property interests held under operating leases are classified and accounted for as investment property.

IN8 When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, a reconciliation is required between the valuation obtained and the valuation included in the financial statements.

IN9 The Standard clarifies that if a property interest held under a lease is classified as investment property, the item accounted for at fair value is that interest and not the underlying property.

IN10 Comparative information is required for all disclosures.

IN11 The following have been incorporated into the Standard:

(a) to specify what costs are included in the cost of investment property and when replaced items should be derecognised;

(b) to specify when exchange transactions (ie transactions in which investment property is acquired in exchange for non-monetary assets, in whole or in part) have commercial substance and how such transactions, with or without commercial substance, are accounted for; and

(c) to specify the accounting for compensation from third parties for investment property that was impaired, lost or given up.

Summary of the approach required by the Standard

IN12 The Standard permits entities to choose either:

(a) a fair value model, under which an investment property is measured, after initial measurement, at fair value with changes in fair value recognised in profit or loss; or

(b) a cost model. The cost model is specified in HKAS 16 and requires an investment property to be measured after initial measurement at depreciated cost (less any accumulated impairment losses). An entity that chooses the cost model discloses the fair value of its investment property.

IN13 The choice between the cost and fair value models is not available to a lessee accounting for a property interest held under an operating lease that it has elected to classify and account for as investment property. The Standard requires such investment property to be measured using the fair value model.

IN14 The fair value model differs from the revaluation model that is permitted for some non-financial assets. Under the revaluation model, increases in carrying amount above a cost-based measure are recognised as revaluation surplus. However, under the fair value model, all changes in fair value are recognised in profit or loss.

IN15 The Standard requires an entity to apply its chosen model to all of its investment property. However, this does not mean that all eligible operating leases must be classified as investment properties.

IN16 In exceptional cases, when an entity has adopted the fair value model, there may be clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property following the completion of construction or development, or after a change in use) that its fair value will not be reliably determinable on a continuing basis. In such cases, the Standard requires the entity to measure that investment property using the cost model in HKAS 16 until disposal of the investment property. The residual value of the investment property is assumed to be zero.

IN17 A change from one model to the other is made only if the change results in a more relevant presentation. The Standard states that this is highly unlikely to be the case for a change from the fair value model to the cost model.

IN18 HKAS 40 depends upon HKAS 17 for requirements for the classification of leases, the accounting for finance and operating leases and for some of the disclosures relevant to leased investment properties. When a property interest held under an operating lease is classified and accounted for as an investment property, HKAS 40 overrides HKAS 17 by requiring that the lease is accounted for as if it were a finance lease. Paragraphs 14–18 of HKAS 17 apply to the classification of leases of land and buildings. In particular, paragraph 18 specifies when it is not necessary to measure separately the land and building elements of such a lease.

Hong Kong Accounting Standard 40
Investment Property

Objective

1 The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

Scope

2 This Standard shall be applied in the recognition, measurement and disclosure of investment property.

3 Among other things, this Standard applies to the measurement in a lessee's financial statements of investment property interests held under a lease accounted for as a finance lease and to the measurement in a lessor's financial statements of investment property provided to a lessee under an operating lease. This Standard does not deal with matters covered in HKAS 17 *Leases*, including:

(a) classification of leases as finance leases or operating leases;

(b) recognition of lease income from investment property (see also HKAS 18 *Revenue*);

(c) measurement in a lessee's financial statements of property interests held under a lease accounted for as an operating lease;

(d) measurement in a lessor's financial statements of its net investment in a finance lease;

(e) accounting for sale and leaseback transactions; and

(f) disclosure about finance leases and operating leases.

4 This Standard does not apply to:

(a) biological assets related to agricultural activity (see HKAS 41 *Agriculture*); and

(b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

Definitions

5 The following terms are used in this Standard with the meanings specified:

Carrying amount **is the amount at which an asset is recognised in the ~~balance sheet~~statement of financial position.**

Cost **is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other HKFRS, eg HKFRS 2 *Share-based Payment*.**

Fair value **is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.**

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.

Owner-occupied property **is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.**

6 A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model set out in paragraphs 33-55 for the asset recognised. This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model. When this classification alternative is selected, any interest so classified is included in the disclosures required by paragraphs 74-78.

7 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. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. HKAS 16 *Property, Plant and Equipment* applies to owner-occupied property.

8 The following are examples of investment property:

(a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

(b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)

(c) a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.

(d) a building that is vacant but is held to be leased out under one or more operating leases.

(e) property that is being constructed or developed for future use as investment property.

9 The following are examples of items that are not investment property and are therefore outside the scope of this Standard:

(a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see HKAS 2 *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.

(b) property being constructed or developed on behalf of third parties (see HKAS 11 *Construction Contracts*).

(c) owner-occupied property (see HKAS 16), including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal.

(d) [deleted]~~property that is being constructed or developed for future use as investment property. HKAS 16 applies to such property until construction or development is complete, at which time the property becomes investment property and this Standard applies. However, this Standard applies to existing investment property that is being redeveloped for continued future use as investment property (see paragraph 58).~~

(e) property that is leased to another entity under a finance lease.

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

11 In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

12 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.

13 It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract. The terms of such contracts vary widely. At one end of the spectrum, the owner's position may, in substance, be that of a passive investor. At the other end of the spectrum, the owner may simply have outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

14 Judgement is needed to determine whether a property qualifies as investment property. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and with the related guidance in paragraphs 7-13. Paragraph 75(c) requires an entity to disclose these criteria when classification is difficult.

15 In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary. The property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group. However, from the perspective of the entity that owns it, the property is investment property if it meets the definition in paragraph 5. Therefore, the lessor treats the property as investment property in its individual financial statements.

Recognition

16 Investment property shall be recognised as an asset when, and only when:

(a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

(b) the cost of the investment property can be measured reliably.

17 An entity evaluates under this recognition principle all its investment property costs at the time they are incurred. These costs include costs incurred initially to acquire an investment property and costs incurred subsequently to add to, replace part of, or service a property.

18 Under the recognition principle in paragraph 16, an entity does not recognise in the carrying amount of an investment property the costs of the day-to-day servicing of such a property. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the cost of labour and consumables, and may include the cost of minor parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the property.

19 Parts of investment properties may have been acquired through replacement. For example, the interior walls may be replacements of original walls. Under the recognition principle, an entity recognises in the carrying amount of an investment property the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard.

Measurement at recognition

20 An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

21 The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.

22 [Deleted]~~The cost of a self-constructed investment property is its cost at the date when the construction or development is complete. Until that date, an entity applies HKAS 16. At that date, the property becomes investment property and this Standard applies (see paragraphs 57(e) and 65).~~

23 The cost of an investment property is not increased by:

(a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),

(b) operating losses incurred before the investment property achieves the planned level of occupancy, or

(c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

24 If payment for an investment property is deferred, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit.

25 The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease by paragraph 20 of HKAS 17, ie the asset shall be recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount shall be recognised as a liability in accordance with that same paragraph.

26 Any premium paid for a lease is treated as part of the minimum lease payments for this purpose, and is therefore included in the cost of the asset, but is excluded from the liability. If a property interest held under a lease is classified as investment property, the item accounted for at fair value is that interest and not the underlying property. Guidance on determining the fair value of a property interest is set out for the fair value model in paragraphs 33-52. That guidance is also relevant to the determination of fair value when that value is used as cost for initial recognition purposes.

27 One or more investment properties may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an investment property is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

28 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred, or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange, and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

29 The fair value of an asset for which comparable market transactions do not exist is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. If the entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Measurement after recognition

Accounting policy

30 With the exception noted in paragraphs 32A and 34, an entity shall choose as its accounting policy either the fair value model in paragraphs 33-55 or the cost model in paragraph 56 and shall apply that policy to all of its investment property.

31 HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a voluntary change in accounting policy shall be made only if the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows~~will result in a more appropriate presentation of transactions, other events or conditions in the entity's financial statements~~. It is highly unlikely that a change from the fair value model to the cost model will result in a more ~~appropriate~~ relevant presentation.

32 This Standard requires all entities to determine the fair value of investment property, for the purpose of either measurement (if the entity uses the fair value model) or disclosure (if it uses the cost model). An entity is encouraged, but not required, to determine the fair value of investment property on the basis of a valuation by a valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

32A An entity may:

(a) choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and

(b) choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).

32B Some insurers and other entities operate an internal property fund that issues notional units, with some units held by investors in linked contracts and others held by the entity. Paragraph 32A does not permit an entity to measure the property held by the fund partly at cost and partly at fair value.

32C If an entity chooses different models for the two categories described in paragraph 32A, sales of investment property between pools of assets measured using different models shall be recognised at fair value and the cumulative change in fair value shall be recognised in profit or loss. Accordingly, if an investment property is sold from a pool in which the fair value model is used into a pool in which the cost model is used, the property's fair value at the date of the sale becomes its deemed cost.

Fair value model

33 After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value, except in the cases described in paragraph 53.

34 When a property interest held by a lessee under an operating lease is classified as an investment property under paragraph 6, paragraph 30 is not elective; the fair value model shall be applied.

35 A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises.

36 The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction (see paragraph 5). Fair value specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale.

37 An entity determines fair value without any deduction for transaction costs it may incur on sale or other disposal.

38 The fair value of investment property shall reflect market conditions at the ~~balance sheet date~~end of the reporting period.

39 Fair value is time-specific as of a given date. Because market conditions may change, the amount reported as fair value may be incorrect or inappropriate if estimated as of another time. The definition of fair value also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might be made in an arm's length transaction between knowledgeable, willing parties if exchange and completion are not simultaneous.

40 The fair value of investment property reflects, among other things, rental income from current leases and reasonable and supportable assumptions that represent what knowledgeable, willing parties would assume about rental income from future leases in the light of current conditions. It also reflects, on a similar basis, any cash outflows (including rental payments and other outflows) that could be expected in respect of the property. Some of those outflows are reflected in the liability whereas others relate to outflows that are not recognised in the financial statements until a later date (eg periodic payments such as contingent rents).

41 Paragraph 25 specifies the basis for initial recognition of the cost of an interest in a leased property. Paragraph 33 requires the interest in the leased property to be remeasured, if necessary, to fair value. In a lease negotiated at market rates, the fair value of an interest in a leased property at acquisition, net of all expected lease payments (including those relating to recognised liabilities), should be zero. This fair value does not change regardless of whether, for accounting purposes, a leased asset and liability are recognised at fair value or at the present value of minimum lease payments, in accordance with paragraph 20 of HKAS 17. Thus, remeasuring a leased asset from cost in accordance with paragraph 25 to fair value in accordance with paragraph 33 should not give rise to any initial gain or loss, unless fair value is measured at different times. This could occur when an election to apply the fair value model is made after initial recognition.

42 The definition of fair value refers to "knowledgeable, willing parties". In this context, "knowledgeable" means that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the ~~balance sheet date~~end of the reporting period. A willing buyer is motivated, but not compelled, to buy. This buyer is neither over-eager nor determined to buy at any price. The assumed buyer would not pay a higher price than a market comprising knowledgeable, willing buyers and sellers would require.

43 A willing seller is neither an over-eager nor a forced seller, prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in current market conditions. The willing seller is motivated to sell the investment property at market terms for the best price obtainable. The factual circumstances of the actual investment property owner are not a part of this consideration because the willing seller is a hypothetical owner (eg a willing seller would not take into account the particular tax circumstances of the actual investment property owner).

44 The definition of fair value refers to an arm's length transaction. An arm's length transaction is one between parties that do not have a particular or special relationship that makes prices of transactions uncharacteristic of market conditions. The transaction is presumed to be between unrelated parties, each acting independently.

45 The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts. An entity takes care to identify any differences in the nature, location or condition of the property, or in the contractual terms of the leases and other contracts relating to the property.

46 In the absence of current prices in an active market of the kind described in paragraph 45, an entity considers information from a variety of sources, including:

(a) current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;

(b) recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and

(c) discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

47 In some cases, the various sources listed in the previous paragraph may suggest different conclusions about the fair value of an investment property. An entity considers the reasons for those differences, in order to arrive at the most reliable estimate of fair value within a range of reasonable fair value estimates.

48 In exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property ~~following the completion of construction or development, or~~ after a change in use) that the variability in the range of reasonable fair value estimates will be so great, and the probabilities of the various outcomes so difficult to assess, that the usefulness of a single estimate of fair value is negated. This may indicate that the fair value of the property will not be reliably determinable on a continuing basis (see paragraph 53).

49 Fair value differs from value in use, as defined in HKAS 36 *Impairment of Assets*. Fair value reflects the knowledge and estimates of knowledgeable, willing buyers and sellers. In contrast, value in use reflects the entity's estimates, including the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to knowledgeable, willing buyers and sellers:

(a) additional value derived from the creation of a portfolio of properties in different locations;

(b) synergies between investment property and other assets;

(c) legal rights or legal restrictions that are specific only to the current owner; and

(d) tax benefits or tax burdens that are specific to the current owner.

50 In determining the carrying amount of investment property under the fair value model ~~fair value of investment property~~, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:

(a) equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment.

(b) if an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognise that furniture as a separate asset.

(c) the fair value of investment property excludes prepaid or accrued operating lease income, because the entity recognises it as a separate liability or asset.

(d) the fair value of investment property held under a lease reflects expected cash flows (including contingent rent that is expected to become payable). Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the ~~fair value~~carrying amount of the investment property using the fair value model~~for accounting purposes~~.

51 The fair value of investment property does not reflect future capital expenditure that will improve or enhance the property and does not reflect the related future benefits from this future expenditure.

52 In some cases, an entity expects that the present value of its payments relating to an investment property (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts. An entity applies HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether to recognise a liability and, if so, how to measure it.

Inability to determine fair value reliably

53 There is a rebuttable presumption that an entity can reliably determine the fair value of an investment property on a continuing basis. However, in exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property ~~following the completion of construction or development, or~~ after a change in use) that the fair value of the investment property is not reliably determinable on a continuing basis. This arises when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value (for example, based on discounted cash flow projections) are not available. If an entity determines that the fair value of an investment property under construction is not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, it shall measure that investment property under construction at cost until either its fair value becomes reliably determinable or construction is completed (whichever is earlier).~~In such cases, an~~ If an entity determines that the fair value of an investment property (other than an investment property under construction) is not reliably determinable on a continuing basis, the entity shall measure that investment property using the cost model in HKAS 16. The residual value of the investment property shall be assumed to be zero. The entity shall apply HKAS 16 until disposal of the investment property.

53A Once an entity becomes able to measure reliably the fair value of an investment property under construction that has previously been measured at cost, it shall measure that property at its fair value. Once construction of that property is complete, it is presumed that fair value can be measured reliably. If this is not the case, in accordance with paragraph 53, the property shall be accounted for using the cost model in accordance with HKAS 16.

53B The presumption that the fair value of investment property under construction can be measured reliably can be rebutted only on initial recognition. An entity that has measured an item of investment property under construction at fair value may not conclude that the fair value of the completed investment property cannot be determined reliably.

54 In the exceptional cases when an entity is compelled, for the reason given in ~~the previous~~ paragraph 53, to measure an investment property using the cost model in accordance with HKAS 16, it measures at fair value all its other investment property, including investment property under construction ~~at fair value~~. In these cases, although an entity may use the cost model for one investment property, the entity shall continue to account for each of the remaining properties using the fair value model.

55 If an entity has previously measured an investment property at fair value, it shall continue to measure the property at fair value until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available.

Cost model

56 After initial recognition, 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 *Non-current Assets Held for Sale and Discontinued Operations*. 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.

Transfers

57 Transfers to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by:

(a) commencement of owner-occupation, for a transfer from investment property to owner-occupied property;

(b) commencement of development with a view to sale, for a transfer from investment property to inventories;

(c) end of owner-occupation, for a transfer from owner-occupied property to investment property; or

(d) commencement of an operating lease to another party, for a transfer from inventories to investment property~~; or~~.

(e) [deleted]~~end of construction or development, for a transfer from property in the course of construction or development (covered by HKAS 16) to investment property.~~

58 Paragraph 57(b) requires an entity to transfer a property from investment property to inventories when, and only when, there is a change in use, evidenced by commencement of development with a view to sale. When an entity decides to dispose of an investment property without development, it continues to treat the property as an investment property until it is derecognised (eliminated from the ~~balance sheet~~statement of financial position) and does not treat it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment.

59 Paragraphs 60-65 apply to recognition and measurement issues that arise when an entity uses the fair value model for investment property. When an entity uses the cost model, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

60 For a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's deemed cost for subsequent accounting in accordance with HKAS 16 or HKAS 2 shall be its fair value at the date of change in use.

61 If an owner-occupied property becomes an investment property that will be carried at fair value, an entity shall apply HKAS 16 up to the date of change in use. The entity shall treat any difference at that date between the carrying amount of the property in accordance with HKAS 16 and its fair value in the same way as a revaluation in accordance with HKAS 16.

62 Up to the date when an owner-occupied property becomes an investment property carried at fair value, an entity depreciates the property and recognises any impairment losses that have occurred. The entity treats any difference at that date between the carrying amount of the property in accordance with HKAS 16 and its fair value in the same way as a revaluation in accordance with HKAS 16. In other words:

(a) any resulting decrease in the carrying amount of the property is recognised in profit or loss. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is ~~charged against that~~recognised in other comprehensive income and reduces the revaluation surplus within equity.

(b) any resulting increase in the carrying amount is treated as follows:

(i) to the extent that the increase reverses a previous impairment loss for that property, the increase is recognised in profit or loss. The amount recognised in profit or loss does not exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised.

(ii) any remaining part of the increase is ~~credited directly to equity in~~ recognised in other comprehensive income and increases the revaluation surplus within equity. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to retained earnings. The transfer from revaluation surplus to retained earnings is not made through profit or loss.

63 For a transfer from inventories to investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.

64 The treatment of transfers from inventories to investment property that will be carried at fair value is consistent with the treatment of sales of inventories.

65 When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.

Disposals

66 An investment property shall be derecognised (eliminated from the ~~balance sheet~~statement of financial position) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

67 The disposal of an investment property may be achieved by sale or by entering into a finance lease. In determining the date of disposal for investment property, an entity applies the criteria in HKAS 18 for recognising revenue from the sale of goods and considers the related guidance in the Appendix to HKAS 18. HKAS 17 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

68 If, in accordance with the recognition principle in paragraph 16, an entity recognises in the carrying amount of an asset the cost of a replacement for part of an investment property, it derecognises the carrying amount of the replaced part. For investment property accounted for using the cost model, a replaced part may not be a part that was depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed. Under the fair value model, the fair value of the investment property may already reflect that the part to be replaced has lost its value. In other cases it may be difficult to discern how much fair value should be reduced for the part being replaced. An alternative to reducing fair value for the replaced part, when it is not practical to do so, is to include the cost of the replacement in the carrying amount of the asset and then to reassess the fair value, as would be required for additions not involving replacement.

69 Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss (unless HKAS 17 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.

70 The consideration receivable on disposal of an investment property is recognised initially at fair value. In particular, if payment for an investment property is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with HKAS 18 using the effective interest method.

71 An entity applies HKAS 37 or other Standards, as appropriate, to any liabilities that it retains after disposal of an investment property.

72 Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.

73 Impairments or losses of investment property, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

(a) impairments of investment property are recognised in accordance with HKAS 36;

(b) retirements or disposals of investment property are recognised in accordance with paragraphs 66-71 of this Standard;

(c) compensation from third parties for investment property that was impaired, lost or given up is recognised in profit or loss when it becomes receivable; and

(d) the cost of assets restored, purchased or constructed as replacements is determined in accordance with paragraphs 20-29 of this Standard.

Disclosure

Fair value model and cost model

74 The disclosures below apply in addition to those in HKAS 17. In accordance with HKAS 17, the owner of an investment property provides lessors' disclosures about leases into which it has entered. An entity that holds an investment property under a finance or operating lease provides lessees' disclosures for finance leases and lessors' disclosures for any operating leases into which it has entered.

75 An entity shall disclose:

(a) whether it applies the fair value model or the cost model.

(b) if it applies the fair value model, whether, and in what circumstances, property interests held under operating leases are classified and accounted for as investment property.

(c) when classification is difficult (see paragraph 14), the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.

(d) the methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity shall disclose) because of the nature of the property and lack of comparable market data.

(e) the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.

(f) the amounts recognised in profit or loss for:

(i) rental income from investment property;

(ii) direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period;

(iii) direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period; and

(iv) the cumulative change in fair value recognised in profit or loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used (see paragraph 32C).

(g) **the existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.**

(h) **contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.**

Fair value model

76 **In addition to the disclosures required by paragraph 75, an entity that applies the fair value model in paragraphs 33-55 shall disclose a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing the following:**

(a) **additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised in the carrying amount of an asset;**

(b) **additions resulting from acquisitions through business combinations;**

(c) **assets classified as held for sale or included in a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals;**

(d) **net gains or losses from fair value adjustments;**

(e) **the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;**

(f) **transfers to and from inventories and owner-occupied property; and**

(g) **other changes.**

77 **When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, for example to avoid double-counting of assets or liabilities that are recognised as separate assets and liabilities as described in paragraph 50, the entity shall disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any recognised lease obligations that have been added back, and any other significant adjustments.**

78 **In the exceptional cases referred to in paragraph 53, when an entity measures investment property using the cost model in HKAS 16, the reconciliation required by paragraph 76 shall disclose amounts relating to that investment property separately from amounts relating to other investment property. In addition, an entity shall disclose:**

(a) **a description of the investment property;**

(b) **an explanation of why fair value cannot be determined reliably;**

(c) **if possible, the range of estimates within which fair value is highly likely to lie; and**

(d) **on disposal of investment property not carried at fair value:**

  (i) **the fact that the entity has disposed of investment property not carried at fair value;**

  (ii) **the carrying amount of that investment property at the time of sale; and**

  (iii) **the amount of gain or loss recognised.**

Cost model

79 **In addition to the disclosures required by paragraph 75, an entity that applies the cost model in paragraph 56 shall disclose:**

(a) the depreciation methods used;

(b) the useful lives or the depreciation rates used;

(c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(d) a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:

(i) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised as an asset;

(ii) additions resulting from acquisitions through business combinations;

(iii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals;

(iv) depreciation;

(v) the amount of impairment losses recognised, and the amount of impairment losses reversed, during the period in accordance with HKAS 36;

(vi) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;

(vii) transfers to and from inventories and owner-occupied property; and

(viii) other changes; and

(e) the fair value of investment property. In the exceptional cases described in paragraph 53, when an entity cannot determine the fair value of the investment property reliably, it shall disclose:

(i) a description of the investment property;

(ii) an explanation of why fair value cannot be determined reliably; and

(iii) if possible, the range of estimates within which fair value is highly likely to lie.

Transitional provisions

Fair value model

80 **An entity that has previously applied SSAP 13 (2000) and elects for the first time to classify and account for some or all eligible property interests held under operating leases as investment property shall recognise the effect of that election as an adjustment to the opening balance of retained earnings for the period in which the election is first made. In addition:**

(a) if the entity has previously disclosed publicly (in financial statements or otherwise) the fair value of those property interests in earlier periods (determined on a basis that satisfies the definition of fair value in paragraph 5 and the guidance in paragraphs 36-52), the entity is encouraged, but not required:

(i) **to adjust the opening balance of retained earnings for the earliest period presented for which such fair value was disclosed publicly; and**

(ii) **to restate comparative information for those periods; and**

(b) **if the entity has not previously disclosed publicly the information described in (a), it shall not restate comparative information and shall disclose that fact.**

80A An entity that has previously applied SSAP 13 (2000) for investment properties other than those dealt with under paragraph 80 and chooses to use the fair value model under this Standard shall report the effect of applying this Standard on its effective date (or earlier) as an adjustment to the opening balance of retained earnings for the period in which this Standard is first applied. In addition:

(a) **if the entity has previously disclosed publicly (in financial statements or otherwise) the fair value of those property interests in earlier periods (determined on a basis that satisfies the definition of fair value in paragraph 5 and the guidance in paragraphs 36-52), the entity is encouraged, but not required:**

(i) **to adjust the opening balance of retained earnings for the earliest period presented for which such fair value was disclosed publicly; and**

(ii) **to restate comparative information for those periods; and**

(b) **if the entity has not previously disclosed publicly the information described in (a), it shall not restate comparative information and shall disclose that fact.**

81 This Standard requires a treatment different from that required by HKAS 8. HKAS 8 requires comparative information to be restated unless such restatement is impracticable.

82 When an entity first applies this Standard, the adjustment to the opening balance of retained earnings includes the reclassification of any amount held in revaluation surplus for investment property.

Cost model

83 Except as provided in paragraph 83A, HKAS 8 applies to any change in accounting policies that is made when an entity first applies this Standard and chooses to use the cost model. The effect of the change in accounting policies includes the reclassification of any amount held in revaluation surplus for investment property.

83A An entity that has previously applied SSAP 13 (2000) or has previously taken advantage of the exemption under SSAP 13 (2000) from compliance with its requirements and chooses to use the cost model under this Standard is permitted to deem the carrying amount of an investment property immediately before applying this Standard on its effective date (or earlier) as the cost of that property. Any adjustments, including the reclassification of any amount previously held in revaluation reserve for investment property, shall be made to the opening balance of retained earnings for the period in which this Standard is first applied. Depreciation on deemed cost commences from the time at which this Standard is first applied.

83B Paragraph 83A may apply in cases where an entity had previously applied the transitional provisions set out in SSAP 13 (2000) to state investment property at pre September 1994 carrying amount.

84 The requirements of paragraphs 27-29 regarding the initial measurement of an investment property acquired in an exchange of assets transaction shall be applied prospectively only to future transactions.

Effective date

85 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.

85~~A~~a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period(s).

85A HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraph 62. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

85B Paragraphs 8, 9, 48, 53, 54 and 57 were amended, paragraph 22 was deleted and paragraphs 53A and 53B were added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2009. An entity is permitted to apply the amendments to investment property under construction from any date before 1 January 2009 provided that the fair values of investment properties under construction were determined at those dates. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact and at the same time apply the amendments to paragraphs 5 and 81E of HKAS 16 *Property, Plant and Equipment*.

Withdrawal of SSAP 13

86 This Standard supersedes SSAP 13 Accounting for Investment Properties (revised in 2000).

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at December 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 40.

The International Accounting Standard comparable with HKAS 40 is IAS 40 *Investment Property*.

There are no major textual differences between HKAS 40 and IAS 40.

Basis for Conclusions on IAS 40 *Investment Property*

This Basis for Conclusions accompanies, but is not part of, IAS 40.

HKAS 40 is based on IAS 40 *Investment Property*. In approving HKAS 40, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 40 (as revised 2003 and IASC's Basis for Conclusions on IAS 40 (2000). Accordingly, there are no significant differences between HKAS 40 and IAS 40. The IASB's Basis for Conclusions (as revised in 2003) and IASC's Basis for Conclusions (2000) are reproduced below for reference. The paragraph numbers of IAS 40 referred to below generally correspond with those in HKAS 40.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 40 *Investment Property* in 2003. Individual Board members gave greater weight to some factors than to others.

BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 40. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.

BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for investment property established by IAS 40, this Basis for Conclusions does not discuss requirements in IAS 40 that the Board has not reconsidered. The IASC Basis for Conclusions on IAS 40 (2000) follows this Basis.

Scope

Property interests held under an operating lease

BC4 Paragraph 14 of IAS 17 *Leases* requires a lease of land with an indefinite economic life to be classified as an operating lease, unless title is expected to pass to the lessee by the end of the lease term. Without the provisions of IAS 40 as amended, this operating lease classification would prevent a lessee from classifying its interest in the leased asset as an investment property in accordance with IAS 40. As a result, the lessee could not remeasure its interest in the leased asset to fair value and recognise any change in fair value in profit or loss. However, in some countries, interests in property (including land) are commonly—or exclusively—held under long-term operating leases. The effect of some of these leases differs little from buying a property outright. As a result, some contended that such leases should be accounted for as finance leases or investment property, or as both.

BC5 The Board discussed possible solutions to this issue. In particular, it considered deleting paragraph 14 of IAS 17, so that a long-term lease of land would be classified as a finance lease (and hence could qualify as an investment property) when the conditions for finance lease classification in paragraphs 4-13 of IAS 17 are met. However, the Board noted that this would not resolve all cases encountered in practice. Some leasehold interests held for investment would remain classified as operating leases (eg leases with significant contingent rents), and hence could not be investment property in accordance with IAS 40.

BC6 In the light of this, the Board decided to state separately in paragraph 6 (rather than amend IAS 40's definition of investment property) that a lessee's interest in property that arises under an operating lease could qualify as investment property. The Board decided to limit this amendment to entities that use the fair value model in IAS 40, because the objective of the amendment is to permit use of the fair value model for similar property interests held under finance and operating leases. Put another way, a lessee that uses the cost model for a property would not be permitted to recognise operating leases as assets. The Board also decided to make the change optional, ie a lessee that has an interest in property under an operating lease is allowed, but not required, to classify that property interest as investment property (provided the rest of the definition of investment property is met). The Board confirmed that this classification alternative is available on a property-by-property basis.

BC7 When a lessee's interest in property held under an operating lease is accounted for as an investment property, the Board decided that the initial carrying amounts of that interest and the related liability are to be accounted for as if the lease were a finance lease. This decision places such leases in the same position as investment properties held under finance leases in accordance with the previous version of IAS 40.

BC8 In doing so, the Board acknowledged that this results in different measurement bases for the lease asset and the lease liability. This is also true for owned investment properties and debt that finances them. However, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, as revised in 2003, an entity can elect to measure such debt at fair value, but lease liabilities cannot be remeasured in accordance with IAS 17.

BC9 The Board considered changing the scope of IAS 39, but concluded that this would lead to a fundamental review of lease accounting, especially in relation to contingent rentals. The Board decided that this was beyond the limited revisions to IAS 40 to facilitate application of the fair value model to some operating leases classified as investment properties. The Board did, however, indicate that it wished to revisit this issue in a later project on lease accounting. The Board also noted that this was the view of the Board of the former IASC as expressed in its Basis for Conclusions, in paragraphs B25 and B26.[*]

BC10 Finally, the Board noted that the methodology described in paragraphs 40 and 50(d) of IAS 40, whereby a fair valuation of the property that takes all lease obligations into account is adjusted by adding back any liability that is recognised for these obligations, would, in practice, enable entities to ensure that net assets in respect of the leased interest are not affected by the use of different measurement bases.[‡]

The choice between the cost model and the fair value model

BC11 The Board also discussed whether to remove the choice in IAS 40 of accounting for investment property using a fair value model or a cost model.

BC12 The Board noted that IASC had included a choice for two main reasons. The first was to give preparers and users time to gain experience with using a fair value model. The second was to allow time for countries with less-developed property markets and valuation professions to mature. The Board decided that more time is needed for these events to take place (IAS 40 became mandatory only for periods beginning on or after 1 January 2001). The Board also noted that requiring the fair value model would not converge with the treatment required by most of its liaison standard-setters. For these reasons, the Board decided not to eliminate the choice as part of the Improvements project, but rather to keep the matter under review with a view to reconsidering the option to use the cost model at a later date.

BC13 The Board did not reconsider IAS 40 in relation to the accounting by lessors. The definition of investment property requires that such a property is held by the owner or a lessee under a finance lease. As indicated above, the Board agreed to allow a lessee under an operating lease, in specified circumstances, also to be a 'holder'. However, a lessor that has provided a property to a lessee under a finance lease cannot be a 'holder'. Such a lessor has a lease receivable, not an investment property.

BC14 The Board did not change the requirements for a lessor that leases property under an operating lease that is classified and accounted for by the lessee as investment property. The Board acknowledged that this would mean that two parties could both account as if they "hold" interests in the property. This could occur at various levels of lessees who become lessors in a manner consistent with the definition of an investment property and the election provided for operating leases. Lessees who use the property in the production or supply of goods or services or for administrative purposes would not be able to classify that property as an investment property.

[*] These paragraphs in the IASC Basis are no longer relevant and have been deleted.

[†] Subcequently, the Board concluded that the drafting of paragraph 50 (d) was misleading because it implied that the fair value of an investment property asset held under a lease was equal to the net fair value plus the carrying amount of any recognised lease liability. Therefore, in *Improvements to IFRSs* issued in May 2008 the Board amended paragraph 50 (d) to clarify the intended meaning.

Scope

Investment property under construction

BC15 In response to requests for guidance, the Board revisited the exclusion of investment property under construction from the scope of IAS 40. The Board noted that investment property being redeveloped remained in the scope of this Standard and that the exclusion of investment property under construction gave rise to a perceived inconsistency. In addition, the Board concluded that with increasing experience with the use of fair value measures since the Standard was issued, entities were more able to measure reliably the fair value of investment property under construction. Therefore, in the exposure draft of *Improvements to International Financial Reporting Standards* published in 2007 the Board proposed amending the scope of the Standard to include investment property under construction.

BC16 Many respondents supported the Board's proposal. However, many expressed concern that including in IAS 40 investment property under construction might result in fewer entities measuring investment property at fair value. This was because the fair value model in the Standard requires an entity to establish whether fair value can be determined reliably when a property first becomes an investment property. If not, the property is accounted for using the cost model until it is disposed of. In some situations, the fair value of investment property under construction cannot be measured reliably but the fair value of the completed investment property can. In these cases, including in the Standard investment property under construction would have required the properties to be accounted for using the cost model even after construction had been completed.

BC17 Therefore, the Board concluded that, in addition to including investment property under construction within the scope of the Standard, it would also amend the Standard to allow investment property under construction to be measured at cost if fair value cannot be measured reliably until such time as the fair value becomes reliably measurable or construction is completed (whichever comes earlier).

CONTENTS

Basis for Conclusions on IAS 40 (2000) *Investment Property*

This Basis for Conclusions accompanies, but is not part of, IAS 40. It was issued by the Board of the former International Accounting Standards Committee (IASC) in 2000. Apart from the deletion of paragraphs B10-B20, B25 and B26, this Basis has not been revised by the IASB-those paragraphs are no longer relevant and have been deleted to avoid the risk that they might be read out of context. However, cross-references to paragraphs in IAS 40 as issued in 2000 have been marked to show the corresponding paragraphs in IAS 40 as revised by the IASB in 2003 (superseded references are struck through and new references are underlined). Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ. In addition, the text has been annotated where references to material in other standards are no longer valid, following the revision of those standards. Reference should be made to the IASB's Basis for Conclusions on the amendments made in 2003.

Background

B1 The IASC Board (the "Board") approved IAS 25 *Accounting for Investments* in 1986. In 1994, the Board approved a reformatted version of IAS 25 presented in the revised format adopted for International Accounting Standards from 1991. Certain terminology was also changed at that time to bring it into line with then current IASC practice. No substantive changes were made to the original approved text.

B2 IAS 25 was one of the standards that the Board identified for possible revision in E32 *Comparability of Financial Statements*. Following comments on the proposals in E32, the Board decided to defer consideration of IAS 25, pending further work on Financial Instruments. In 1998, the Board approved IAS 38 *Intangible Assets* and IAS 39 *Financial Instruments: Recognition and Measurement*, leaving IAS 25 to cover investments in real estate, commodities and tangible assets such as vintage cars and other collectors' items.

B3 In July 1999, the Board approved E64 *Investment Property*, with a comment deadline of 31 October 1999. The Board received 121 comment letters on E64. Comment letters came from various international organisations, as well as from 28 individual countries. The Board approved IAS 40 *Investment Property* in March 2000. Paragraph B67 below summarises the changes that the Board made to E64 in finalising IAS 40.

B4 IAS 40 permits entities to choose between a fair value model and a cost model. As explained in paragraphs B47-B48 below, the Board believes that it is impracticable, at this stage, to require a fair value model for all investment property. At the same time, the Board believes that it is desirable to permit a fair value model. This evolutionary step forward will allow preparers and users to gain greater experience working with a fair value model and will allow time for certain property markets to achieve greater maturity.

Need for a Separate Standard

B5 Some commentators argued that investment property should fall within the scope of IAS 16 *Property, Plant and Equipment*, and that there is no reason to have a separate standard on investment property. They believe that:

(a) it is not possible to distinguish investment property rigorously from owner-occupied property covered by IAS 16 and without reference to management intent. Thus, a distinction between investment property and owner-occupied property will lead to a free choice of different accounting treatments in some cases; and

(b) the fair value accounting model proposed in E64 is not appropriate, on the grounds that fair value is not relevant and, in some cases, not reliable in the case of investment property. The accounting treatments in IAS 16 are appropriate not only for owner-occupied property, but also for investment property.

B6 Having reviewed the comment letters, the Board still believes that the characteristics of investment property differ sufficiently from the characteristics of owner-occupied property that there is a need for a separate Standard on investment property. In particular, the Board believes that information about the fair value of investment property, and about changes in its fair value, is highly relevant to users of financial statements. The Board believes that it is important to permit a fair value model for investment property, so that entities can report fair value information prominently. The Board tried to maintain consistency with IAS 16, except for differences dictated by the choice of a different accounting model.

Scope

Investment Property Entities

B7 Some commentators argued that the Standard should cover only investment property held by entities that specialise in owning such property (and, perhaps, also other investments) and not cover investment property held by other entities. The Board rejected this view because the Board could find no conceptual and practical way to distinguish rigorously any class of entities for which the fair value model would be less or more appropriate.

Investment Property Reportable Segments

B8 Some commentators suggested that the Board should limit the scope of the Standard to entities that have a reportable segment whose main activity is investment property. These commentators argued that an approach linked to reportable segments would require an entity to adopt the fair value model when the entity considers investment property activities to be an important element of its financial performance and would allow an entity to adopt IAS 16 in other cases.

B9 An approach linked to reportable segments would lead to lack of comparability between investment property held in investment property segments and investment property held in other segments. For this reason, the Board rejected such an approach.

B10-B~~15~~20 [Deleted]

~~Investment Property under Construction~~

~~B16 E64 proposed that investment property under construction should be measured at fair value. E64 argued that fair value is the most relevant measure and that fair value of investment property under construction is not necessarily more difficult to measure than completed investment property. For example, where an investment property under construction is largely pre-leased, there may be less uncertainty about future cash inflows than for a completed investment property that is largely vacant.~~

~~B17 Some commentators argued that it is difficult to estimate fair value reliably for investment property under construction, because a market may not exist for property under construction. They argued that there may be considerable uncertainty about the cost to complete investment property under construction and about the income that such property will generate. Therefore, they suggested that an entity should not measure investment property at more than cost if the investment property is still under construction.~~

~~B18 The Board was persuaded by this argument and concluded that investment property under construction should be excluded from the scope of this Standard and should be covered by IAS 16.~~

~~B19 Paragraph 58 of the Standard addresses cases where an entity begins to redevelop an existing investment property for continued future use as investment property. One approach would be to require a temporary transfer out of investment property into property under development (subject to IAS 16) for the duration of the redevelopment. However, the Board felt that such temporary transfers would be confusing and would be of little or no benefit to users of financial statements. This approach would also need arbitrary rules to distinguish major redevelopments that would result in such a temporary transfer from less significant works that would not lead to such a transfer. Accordingly, paragraph 58 states that the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment.~~

~~B20 When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value, there is likely to be a difference between the fair value of the property at that date and its previous carrying amount. The Board considered two approaches to accounting for such differences under the fair value model.~~

~~(a) Under the first approach, the difference would be transferred to revaluation surplus. This approach would be consistent with the Standard's approach to transfers from owner-occupied property to investment property.~~

~~(b) Under the second approach, the difference would be recognised in net profit or loss for the period. The Board concluded that this second approach gives a more meaningful picture of performance (see paragraph 65).~~

Property Occupied by Another Entity in the Same Group

B21 In some cases, an entity owns property that is leased to, and occupied by, another entity in the same group. The property does not qualify as investment property in consolidated financial statements that include both entities, because the property is owner-occupied from the perspective of the group as a whole. However, from the perspective of the individual entity that owns it, the property is investment property if it meets the definition set out in the Standard.

B22 Some commentators believe that the definition of investment property should exclude properties that are occupied by another entity in the same group. Alternatively, they suggest that the Standard should not require investment property accounting in individual financial statements for properties that do not qualify as investment property in consolidated financial statements. They believe that:

(a) it could be argued (at least in some such cases) that the property does not meet the definition of investment property from the perspective of a subsidiary whose property is occupied by another entity in the same group—the subsidiary's motive for holding the property is to comply with a directive from its parent and not necessarily to earn rentals or to benefit from capital appreciation. Indeed, the intragroup lease may not be priced on an arm's length basis;

(b) this requirement would lead to additional valuation costs that would not be justified by the limited benefits to users. For groups with subsidiaries that are required to prepare individual financial statements, the cost could be extensive as entities may create a separate subsidiary to hold each property;

(c) some users may be confused if the same property is classified as investment property in the individual financial statements of a subsidiary and as owner-occupied property in the consolidated financial statements of the parent; and

(d) there is a precedent for a similar exemption (relating to disclosure, rather than measurement) in paragraph 4(c) of IAS 24 *Related Party Disclosures*, which does not require disclosures in a wholly-owned subsidiary's financial statements if its parent is incorporated in the same country and provides consolidated financial statements in that country.*

B23 Some commentators believe that the definition of investment property should exclude property occupied by any related party. They argue that related parties often do not pay rent on an arm's length basis, that it is often difficult to establish whether the rent is consistent with pricing on an arm's length basis and that rental rates may be subject to arbitrary change. They suggest that fair values are less relevant where property is subject to leases that are not priced on an arm's length basis.

B24 The Board could find no justification for treating property leased to another entity in the same group (or to another related party) differently from property leased to other parties. Therefore, the Board decided that an entity should use the same accounting treatment, regardless of the identity of the lessee.

B25-B26 [Deleted]

Government Grants

B27 IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* permits two methods of presenting grants relating to assets – either setting up a grant as deferred income and amortising the income over the useful life of the asset or deducting the grant in arriving at the carrying amount of the asset. Some believe that both of those methods reflect a historical cost model and are inconsistent with the fair value model set out in this Standard. Indeed, Exposure Draft E65 *Agriculture*, which proposes a fair value model for biological assets, addresses certain aspects of government grants, as these are a significant factor in accounting for agriculture in some countries.

* IAS 24 *Related Party Disclosures* as revised by the IASB in 2003 no longer provides the exemption mentioned in paragraph B22(d).

B28 Some commentators urged IASC to change the accounting treatment of government grants related to investment property. However, most commentators agreed that IASC should not deal with this aspect of government grants now. The Board decided not to revise this aspect of IAS 20 in the project on Investment Property.

B29 Some commentators suggested that IASC should begin a wider review of IAS 20 as a matter of urgency. In early 2000, the G4+1 group of standard setters published a Discussion Paper *Accounting by Recipients for Non-Reciprocal Transfers, Excluding Contributions by Owners: Their Definition, Recognition and Measurement*. The Board's work plan does not currently include a project on the accounting for government grants or other forms of non-reciprocal transfer.

Definition of Investment Property

B30 The definition of investment property excludes:

(a) owner-occupied property – covered by IAS 16 *Property, Plant and Equipment*. Under IAS 16, such property is carried at either depreciated cost or revalued amount less subsequent depreciation. In addition, such property is subject to an impairment test; and

(b) property held for sale in the ordinary course of business— covered by IAS 2 *Inventories*. IAS 2 requires an entity to carry such property at the lower of cost and net realisable value.

B31 These exclusions are consistent with the existing definitions of property, plant and equipment in IAS 16 and inventories in IAS 2. This ensures that all property is covered by one, and only one, of the three Standards.

B32 Some commentators suggested that property held for sale in the ordinary course of business should be treated as investment property rather than as inventories (covered by IAS 2). They argued that:

(a) it is difficult to distinguish property held for sale in the ordinary course of business from property held for capital appreciation; and

(b) it is illogical to require a fair value model for land and buildings held for long-term capital appreciation (investment property) when a cost model is still used for land and buildings held for short-term sale in the ordinary course of business (inventories).

B33 The Board rejected this suggestion because:

(a) if fair value accounting is used for property held for sale in the ordinary course of business, this would raise wider questions about inventory accounting that go beyond the scope of this project; and

(b) it is arguably more important to use fair value accounting for property that may have been acquired over a long period and held for several years (investment property) than for property that was acquired over a shorter period and held for a relatively short time (inventories). With the passage of time, cost-based measurements become increasingly irrelevant. Also, an aggregation of costs incurred over a long period is of questionable relevance.

B34 Some commentators suggested requiring (or at least permitting) entities, particularly financial institutions such as insurance companies, to use the fair value model for their owner-occupied property. They argued that some financial institutions regard their owner-occupied property as an integral part of their investment portfolio and treat it for management purposes in the same way as property leased to others. In the case of insurance companies, the property may be held to back policyholder liabilities. The Board believes that property used for similar purposes should be subject to the same accounting treatment. Accordingly, the Board concluded that no class of entities should use the fair value model for their owner-occupied property.

B35 Some commentators suggested that the definition of investment property should exclude property held for rentals, but not for capital appreciation. In their view, a fair value model may be appropriate for dealing activities, but is inappropriate where an entity has historically held rental property for many years and has no intention of selling it in the foreseeable future. They consider that holding property for long-term rental is a service activity and the assets used in that activity should be treated in the same way as assets used to support other service activities. In their view, holding an investment in property in such cases is similar to holding "held-to-maturity investments", which are measured at amortised cost under IAS 39.

B36 In the Board's view, the fair value model provides useful information about property held for rental, even if there is no immediate intention to sell the property. The economic performance of a property can be regarded as being made up of both rental income earned during the period (net of expenses) and changes in the value of future net rental income. The fair value of an investment property can be regarded as a market-based representation of the value of the future net rental income, regardless of whether the entity is likely to sell the property in the near future. Also, the Standard notes that fair value is determined without deducting costs of disposal—in other words, the use of the fair value model is not intended as a representation that a sale could, or should, be made in the near future.

B37 The classification of hotels and similar property was controversial throughout the project and commentators on E64 had mixed views on this subject. Some see hotels essentially as investments, while others see them essentially as operating properties. Some requested a detailed rule to specify whether hotels (and, perhaps, other categories of property, such as restaurants, bars and nursing homes) should be classified as investment property or as owner-occupied property.

B38 The Board concluded that it is preferable to distinguish investment property from owner-occupied property on the basis of general principles, rather than have arbitrary rules for specific classes of property. Also, it would inevitably be difficult to establish rigorous definitions of specific classes of property to be covered by such rules. Paragraphs ~~9-11~~11-13 of the Standard discuss cases such as hotels in the context of the general principles that apply when an entity provides ancillary services.

B39 Some commentators requested quantitative guidance (such as a percentage) to clarify whether an "insignificant portion" is owner-occupied (paragraph~~8~~10) and whether ancillary services are "significant" (paragraphs ~~9-11~~11-13 of the Standard). As for similar cases in other Standards, the Board concluded that quantitative guidance would create arbitrary distinctions.

Subsequent Expenditure

B40 Some believe that there is no need to capitalise subsequent expenditure in a fair value model and that all subsequent expenditure should be recognised as an expense. However, others believe – and the Board agreed – that the failure to capitalise subsequent expenditure would lead to a distortion of the reported components of financial performance. Therefore, the Standard requires that an entity should determine whether subsequent expenditure should be capitalised using a test similar to the test used for owner-occupied property in IAS 16.

B41 Some commentators suggested that the test for capitalising subsequent expenditure should not refer to the originally assessed standard of performance. They felt that it is impractical and irrelevant to judge against the originally assessed standard of performance, which may relate to many years in the past. Instead, they suggested that subsequent expenditure should be capitalised if it enhances the previously assessed standard of performance – for example, if it increases the current market value of the property or is intended to maintain its competitiveness in the market. The Board saw some merit in this suggestion.

B42 Nevertheless, the Board believes that a reference to the previously assessed standard of performance would require substantial additional guidance, might not change the way the Standard is applied in practice and might cause confusion. The Board also concluded that it was important to retain the existing reference to the originally assessed standard of performance* to be consistent with IAS 16 and IAS 38.

* IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 requires all subsequent costs to be covered by its general recognition principle and eliminated the requirement to reference the originally assessed standard of performance. IAS 40 was amended as a consequence of the change to IAS 16

Subsequent Measurement

Accounting Model

B43 Under IAS 25, an entity was permitted to choose from among a variety of accounting treatments for investment property (depreciated cost under the benchmark treatment in IAS 16 *Property, Plant and Equipment*, revaluation with depreciation under the allowed alternative treatment in IAS 16, cost less impairment under IAS 25 or revaluation under IAS 25).[†]

B44 E64 proposed that all investment property should be measured at fair value. Supporters of the fair value model believe that fair values give users of financial statements more useful information than other measures, such as depreciated cost. In their view, rental income and changes in fair value are inextricably linked as integral components of the financial performance of an investment property and measurement at fair value is necessary if that financial performance is to be reported in a meaningful way.

B45 Supporters of the fair value model also note that an investment property generates cash flows largely independently of the other assets held by an entity. In their view, the generation of independent cash flows through rental or capital appreciation distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not merely to property, but also to other assets used in the production or supply process. Proponents of the fair value model for investment property argue that this distinction makes a fair value model more appropriate for investment property than for owner-occupied property.

B46 Those who oppose measurement of investment property at fair value argue that:

(a) there is often no active market for investment property (unlike for many financial instruments). Real estate transactions are not frequent and not homogeneous. Each investment property is unique and each sale is subject to significant negotiations. As a result, fair value measurement will not enhance comparability because fair values are not determinable on a reliable basis, especially in countries where the valuation profession is less well established. A depreciated cost measurement provides a more consistent, less volatile, and less subjective measurement;

(b) IAS 39 does not require fair value measurement for all financial assets, even some that are realised more easily than investment property. It would be premature to consider extending the fair value model until the Joint Working Group on financial instruments has completed its work;

(c) a cost basis is used for “shorter term” assets (such as inventories) for which fair value is, arguably, more relevant than for “held for investment” assets; and

(d) measurement at fair value is too costly in relation to the benefits to users.

B47 This is the first time that the Board has proposed requiring a fair value accounting model for non-financial assets. The comment letters on E64 showed that although many support this step, many others still have significant conceptual and practical reservations about extending a fair value model to non-financial assets, particularly (but not exclusively) for entities whose main activity is not to hold property for capital appreciation. Also, some entities feel that certain property markets are not yet sufficiently mature for a fair value model to work satisfactorily. Furthermore, some believe that it is impossible to create a rigorous definition of investment property and that this makes it impracticable to require a fair value model at present.

B48 For those reasons, the Board believes that it is impracticable, at this stage, to require a fair value model for investment property. At the same time, the Board believes that it is desirable to permit a fair value model. This evolutionary step forward will allow preparers and users to gain greater experience working with a fair value model and will allow time for certain property markets to achieve greater maturity.

B49 IAS 40 permits entities to choose between a fair value model and a cost model. An entity should apply the model chosen to all its investment property. [This choice is not available to a lessee accounting for an investment property under an operating lease as if it were a finance

[†] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to ‘benchmark’ treatment and ‘allowed alternative’ treatments. They are replaced with cost model and revaluation model.

lease—refer to the IASB's Basis for Conclusions on the amendments made in 2003.] The fair value model is the model proposed in E64: investment property should be measured at fair value and changes in fair value should be recognised in the income statement. The cost model is the benchmark treatment[*] in IAS 16 *Property, Plant and Equipment*: investment property should be measured at depreciated cost (less any accumulated impairment losses). An entity that chooses the cost model should disclose the fair value of its investment property.

B50 Under IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies,*[†] a change in accounting policies from one model to the other model should be made only if the change will result in a more appropriate presentation of events or transactions.[‡] The Board concluded that this is highly unlikely to be the case for a change from the fair value model to the cost model and paragraph ~~25~~31 of the Standard reflects this conclusion.

B51 The Board believes that it is undesirable to permit three different accounting treatments for investment property. Accordingly, if an entity does not adopt the fair value model, the Standard requires the entity to use the benchmark treatment in IAS 16 and does not permit the use of the allowed alternative treatment. However, an entity may still use the allowed alternative for other properties covered by IAS 16.[⌖]

Guidance on Fair Value

B52 The valuation profession will have an important role in implementing the Standard. Accordingly, in developing its guidance on the fair value of investment property, the Board considered not only similar guidance in other IASC literature, but also International Valuation Standards (IVS) issued by the International Valuation Standards Committee (IVSC). The Board understands that IVSC intends to review, and perhaps revise, its Standards in the near future.

B53 The Board believes that IASC's concept of fair value is similar to the IVSC concept of market value. IVSC defines market value as "the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion." The Board believes that the guidance in paragraphs ~~29-30~~36, 37 and ~~32-38~~39-44 of the Standard is, in substance (and largely in wording as well), identical with guidance in IVS 1.

B54 Paragraphs ~~31~~38 and ~~39-46~~45-52 of IAS 40 have no direct counterpart in the IVSC literature. The Board developed much of this material in response to commentators on E64, who asked for more detailed guidance on determining the fair value of investment property. In developing this material, the Board considered guidance on fair value in other IASC Standards and Exposure Drafts, particularly those on financial instruments (IAS 32 and IAS 39), intangible assets (IAS 38) and agriculture (E65).

Independent Valuation

B55 Some commentators believe that fair values should be determined on the basis of an independent valuation, to enhance the reliability of the fair values reported. Others believe, on cost-benefit grounds, that IASC should not require (and perhaps not even encourage) an independent valuation. They believe that it is for preparers to decide, in consultation with auditors, whether an entity has sufficient internal resources to determine reliable fair values. Some also believe that independent valuers with appropriate expertise are not available in some markets.

B56 The Board concluded that an independent valuation is not always necessary. Therefore, as proposed in E64, the Standard encourages, but does not require, an entity to determine the fair value of all investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional qualification and who has recent experience in the location and category of the investment property being valued. This approach is consistent with the approach to actuarial valuations in IAS 19 *Employee Benefits* (see IAS 19, paragraph 57).

[*] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

[†] revised by the IASB in 2003 as IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

[‡] The IASB conformed the terminology used in paragraph 31 to the terminology used in IAS 8 by *Improvements to IFRSs* issued in May 2008.

[⌖] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

Inability to Measure Fair Value Reliably

B57 E64 included a rebuttable presumption that an entity will be able to determine reliably the fair value of property held to earn rentals or for capital appreciation. E64 also proposed a reliability exception: IAS 16 should be applied if evidence indicates clearly, when an entity acquires or constructs a property, that fair value will not be determinable reliably on a continuing basis.

B58 Some commentators opposed various aspects of this proposal, on one or more of the following grounds:

(a) the rebuttable presumption underestimates the difficulties of determining fair value reliably. This will often be impossible, particularly where markets are thin or where there is not a well-established valuation profession;

(b) the accounting model under IAS 16 includes an impairment test under IAS 36. However, it is illogical to rely on an impairment test when fair value cannot be determined using cash flow projections, because an impairment test under IAS 36 is also difficult in such cases;

(c) where fair value cannot be determined reliably, this fact does not justify charging depreciation. Instead, the property in question should be measured at cost less impairment losses; and

(d) to avoid the danger of manipulation, all efforts should be made to determine fair values, even in a relatively inactive market. Even without an active market, a range of projected cash flows is available. If there are problems in determining fair value, an entity should measure the property at the best estimate of fair value and disclose limitations on the reliability of the estimate. If it is completely impossible to determine fair value, fair value should be deemed to be zero.

B59 The Board concluded that the rebuttable presumption and the reliability exception should be retained, but decided to implement them in a different way. In E64, they were implemented by excluding a property from the definition of investment property if the rebuttable presumption was overcome. Some commentators felt that it was confusing to include such a reliability exception in a definition. Accordingly, the Board moved the reliability exception from the definition to the section on subsequent measurement (paragraphs ~~47-49~~53-55).

B60 Under E64, an entity should not stop using the fair value model if comparable market transactions become less frequent or market prices become less readily available. Some commentators disagreed with this proposal. They argued that there may be cases when reliable estimates are no longer available and that it would be misleading to continue fair value accounting in such cases. The Board decided that it is important to keep the E64 approach, because otherwise entities might use a reliability exception as an excuse to discontinue fair value accounting in a falling market.

B61 In cases where the reliability exception applies, E64 proposed that an entity should continue to apply IAS 16 until disposal of the property. Some commentators proposed that an entity should start applying the fair value model once the fair value becomes measurable reliably. The Board rejected this proposal because it would inevitably be a subjective decision to determine when fair value has become measurable reliably and this subjectivity could lead to inconsistent application.

B62 E64 proposed no specific disclosure where the reliability exception applies. Some commentators felt that disclosure would be important in such cases. The Board agreed and decided to include disclosures consistent with paragraph 170(b) of IAS 39[*] (see paragraphs ~~68 and 69(e)~~78 and 79(e) of IAS 40). Paragraph 170(b) of IAS 39 requires disclosures for financial assets whose fair value cannot be reliably measured.

[*] In August 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

Gains and Losses on Remeasurement to Fair Value

B63 Some commentators argued that there should be either a requirement or an option to recognise changes in the fair value of investment property in equity,[‡] on the grounds that:

(a) the market for property is not liquid enough and market values are uncertain and variable. Investment property is not as liquid as financial instruments and IAS 39 allows an option for available-for-sale investments;

(b) until performance reporting issues are resolved more generally, it is premature to require recognition of fair value changes in the income statement;

(c) recognition of unrealised gains and losses in the income statement increases volatility and does not enhance transparency, because revaluation changes will blur the assessment of an entity's operating performance. It may also cause a presumption that the unrealised gains are available for distribution as dividends;

(d) recognition in equity is more consistent with the historical cost and modified historical cost conventions that are a basis for much of today's accounting. For example, it is consistent with IASC's treatment of revaluations of property, plant and equipment under IAS 16 and with the option available for certain financial instruments under IAS 39;

(e) for properties financed by debt, changes in the fair value of the properties resulting from interest rate changes should not be recognised in the income statement, since the corresponding changes in the fair value of the debt are not recognised under IAS 39;

(f) under paragraphs 92 and 93 of the *Framework*, income should be recognised only when it can be measured with sufficient certainty. For example, IAS 11 *Construction Contracts* requires certain conditions before an entity can use the percentage-of-completion method. These conditions are not normally met for investment property; and

(g) results from operations should be distinguished from changes in values. For example, under IAS 21, unrealised exchange differences on a foreign entity[*] are recognised in equity.

B64 Some commentators suggested that increases should be recognised in equity and decreases should be recognised in net profit or loss. This is similar to the revaluation model that forms the allowed alternative treatment[†] in IAS 16 (except for the lack of depreciation).

B65 As proposed in E64, the Board concluded that, in a fair value model, changes in the fair value of investment property should be recognised in the income statement as part of profit or loss for the period. The arguments for this approach include the following:

(a) the conceptual case for the fair value model is built largely on the view that this provides the most relevant and transparent view of the financial performance of investment property. Given this, it would be inconsistent to permit or require recognition in equity;

(b) recognition of fair value changes in equity would create a mismatch because net rental income would be recognised in the income statement, whereas the related consumption of the service potential (recognised as depreciation under IAS 16) would be recognised in equity. Similarly, maintenance expenditure would be recognised as an expense while related increases in fair value would be recognised in equity;

(c) using this approach, there is no need to resolve some difficult and controversial issues that would arise if changes in the fair value of investment property were recognised in equity. These issues include the following:

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‡ ~~Under IAS 1 *Presentation of Financial Statements*, all such changes reported in equity are presented in a statement showing changes in equity.~~

* In IAS 21 *The Effects of Changes in Foreign Exchange Rates*, as revised by the IASB in 2003, the term 'foreign entity' was replaced by 'foreign operation'

† IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

(i) should fair value changes previously recognised in equity be transferred ("recycled") to profit or loss on disposal of investment property; and

(ii) should fair value changes previously recognised in equity be transferred ("recycled") to profit or loss when investment property is impaired? If so, how should such impairment be identified and measured; and

(d) given the difficulty in defining investment property rigorously, entities will sometimes have the option of applying the investment property standard or either of the two treatments in IAS 16. It would be undesirable to include two choices in the investment property standard, as this would give entities a choice (at least occasionally) between four different treatments.

Transfers

B66 When an owner-occupied property carried under the benchmark treatment under IAS 16 becomes an investment property, the measurement basis for the property changes from depreciated cost to fair value. The Board concluded that the effect of this change in measurement basis should be treated as a revaluation under IAS 16 at the date of change in use. The result is that:

(a) the income statement excludes cumulative net increases in fair value that arose before the property became investment property. The portion of this change that arose before the beginning of the current period does not represent financial performance of the current period; and

(b) this treatment creates comparability between entities that had previously revalued the property under the allowed alternative treatment in IAS 16 and those entities that had previously used the IAS 16 benchmark treatment.[*]

Summary of Changes to E64

B67 The most important change between E64 and the final Standard was the introduction of the cost model as an alternative to the fair value model. The other main changes are listed below.

(a) The guidance on determining fair value was expanded, to clarify the following:

(i) the fair value of investment property is not reduced by transaction costs that may be incurred on sale or other disposal (paragraph ~~30~~37 of the Standard). This is consistent with the measurement of financial assets under paragraph 69 of IAS 39.[ϕ] E64 was silent on the treatment of such costs;

(ii) measurement is based on valuation at the balance sheet date (paragraph~~31~~38);

(iii) the best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts (paragraph~~39~~45). In the absence of such evidence, fair value reflects information from a variety of sources and an entity needs to investigate reasons for any differences between the information from different sources (paragraphs ~~40-41~~46 and 47);

(iv) market value differs from value in use as defined in IAS 36 *Impairment of Assets* (paragraph ~~43~~49);

(v) there is a need to avoid double counting of investment property and separately recognised assets and liabilities. Integral equipment (such as elevators or air-conditioning) is generally included in the investment property, rather than recognised separately (paragraph ~~44~~50);

(vi) the fair value of investment property does not reflect future capital expenditure that will improve or enhance the asset and does not reflect the related future benefits from this future expenditure (paragraph ~~45~~51);

[*] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

[ϕ] Paragraph 69 was replaced by paragraph 46 when the IASB revised IAS 39 in 2003.

(vii) an entity uses IAS 37 to account for any provisions associated with investment property (paragraph ~~46~~52); and

(viii) in the exceptional cases when fair value cannot be determined reliably, measurement is under the IAS 16 benchmark treatment[*] only (in such cases, revaluation under IAS 16 would also not be reliable) and residual value is assumed to be zero (given that fair value cannot be determined reliably) (paragraphs ~~47-48~~53 and 54).

(b) In relation to the scope of the Standard and the definition of investment property:

(i) paragraph ~~3~~4 now clarifies that the Standard does not apply to forests and similar regenerative natural resources and to mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources. This wording is consistent with a similar scope exclusion in IAS 16 *Property, Plant and Equipment*. The Board did not wish to prejudge its decision on the treatment of such items in the current projects on Agriculture and the Extractive Industries;

(ii) land held for a currently undetermined future use is a further example of investment property (paragraph ~~6(b)~~8(b)), on the grounds that a subsequent decision to use such land as inventory or for development as owner-occupied property would be an investment decision;

(iii) new examples of items that are not investment property are: property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal (paragraph~~7(c)~~9(c));

(iv) property that is being constructed or developed for future use as investment property is now covered by IAS 16 and measured at cost, less impairment losses, if any (paragraph~~7(d)~~9(d)). E64 proposed that investment property under construction should be measured at fair value; and

(v) the reference to reliable measurement of fair value (and the related requirements in paragraphs 14-15 of E64) was moved from the definition of investment property into the section on subsequent measurement (paragraphs ~~47-49~~53-55).

(c) New paragraph ~~20~~23 deals with start up costs, initial operating losses and abnormal wastage (based on paragraphs 17 and 18 of IAS 16[†]). The Board considered adding guidance on the treatment of incidental revenue earned during the construction of investment property. However, the Board concluded that this raised an issue in the context of IAS 16 and decided that it was beyond the scope of this project to deal with this.

(d) There is an explicit requirement on determining gains or losses on disposal (paragraph ~~62~~69). This is consistent with IAS 16, paragraph 56.[ϕ] There are also new cross-references to:

(i) IAS 17 *Leases* and IAS 18 *Revenue*, as guidance for determining the date of disposal (paragraph ~~61~~67); and

(ii) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, for liabilities retained after disposal (paragraph ~~64~~71).

(e) The Standard states explicitly that an entity should transfer an investment property to inventories when the entity begins to develop the property for subsequent sale in the ordinary course of business (paragraphs ~~51(b) and 52~~57(b) and 58). E64 proposed that all transfers from investment properties to inventories should be prohibited. The Standard also deals more explicitly than E64 with certain other aspects of transfers.

[*] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

[†] In IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003, paragraph 17 and 18 were replaced by paragraphs 19-22.

[ϕ] In IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003, paragraph 56 was replaced by paragraphs 68 and 71.

(f) New disclosure requirements include:

- (i) extension of the required disclosure on methods and significant assumptions, which are now to include disclosure of whether fair value was supported by market evidence, or whether the estimate is based on other data (which the entity should disclose) because of the nature of the property and the lack of comparable market data (paragraph ~~66(b)~~75(d));
- (ii) disclosures of rental income and direct operating expenses (paragraph ~~66(d)~~75(f)); and
- (iii) disclosures in the exceptional cases when fair value is not reliably determinable (paragraphs ~~68 and 69(e)~~78 and 79(e)).

(g) E64 proposed a requirement to disclose the carrying amount of unlet or vacant investment property. Some commentators argued that this disclosure was impracticable, particularly for property that is partly vacant. Some also felt that this is a matter for disclosure in a financial review by management, rather than in the financial statements. The Board deleted this disclosure requirement. It should be noted that some indication of vacancy levels may be available from the required disclosure of rental income and from the IAS 17 requirement to disclose cash flows from non-cancellable operating leases (split into less than one year, one to five years and more than five years).

(h) E64 included no specific transitional provisions, which means that IAS 8 would apply. There is a risk that restatement of prior periods might allow entities to manipulate their reported profit or loss for the period by selective use of hindsight in determining fair values in prior periods. Accordingly, the Board decided to prohibit restatement in the fair value model, except where an entity has already publicly disclosed fair values for prior periods (paragraph ~~70~~80).

Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) – effective for annual periods beginning on or after 1 January 2013

BCA17 The Basis for Conclusions on IAS 40 *Investment Property* is amended as described below.

In paragraph BC8 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' and in paragraph BC9 the reference to 'IAS 39' are footnoted as follows:

> * In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.

BCA18 The Basis for Conclusions on IAS 40 (2000) *Investment Property* is amended as described below:

In paragraph B35 the reference to 'IAS 39' is footnoted as follows:

> * IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the held-to-maturity category.

In paragraph B63(a) the reference to 'IAS 39' is footnoted as follows:

> * IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of available-for-sale financial assets.

The footnote to paragraph B67(a)(i) is amended as follows (new text underlined):

> † Paragraph 69 was replaced by paragraph 46 when the IASB revised IAS 39 in 2003. <u>In 2009 paragraph 46 of IAS 39 was replaced by paragraph 5.2.1 of IFRS 9 *Financial Instruments*.</u>

HKAS 41
Revised ~~October 2008~~June 2010

Hong Kong Accounting Standard 41

Agriculture

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CONTENTS

Hong Kong Accounting Standard 41 *Agriculture* (HKAS 41) is set out in paragraphs 1-~~59A~~60. All the paragraphs have equal authority. HKAS 41 shall be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 41 *Agriculture* (HKAS 41) prescribes the accounting treatment, financial statement presentation, and disclosures related to agricultural activity, a matter not covered in other Standards. Agricultural activity is the management by an entity of the biological transformation of living animals or plants (biological assets) for sale, into agricultural produce, or into additional biological assets.

IN2 HKAS 41 prescribes, among other things, the accounting treatment for biological assets during the period of growth, degeneration, production, and procreation, and for the initial measurement of agricultural produce at the point of harvest. It requires measurement at fair value less costs to sell from initial recognition of biological assets up to the point of harvest, other than when fair value cannot be measured reliably on initial recognition. However, HKAS 41 does not deal with processing of agricultural produce after harvest; for example, processing rapes into wine and wool into yarn.

IN3 There is a presumption that fair value can be measured reliably for a biological asset. However, that presumption can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available and for which alternative estimates of fair value are determined to be clearly unreliable. In such a case, HKAS 41 requires an entity to measure that biological asset at its cost less any accumulated depreciation and any accumulated impairment losses. Once the fair value of such a biological asset becomes reliably measurable, an entity should measure it at its fair value less costs to sell. In all cases, an entity should measure agricultural produce at the point of harvest at its fair value less costs to sell.

IN4 HKAS 41 requires that a change in fair value less costs to sell of a biological asset be included in profit or loss for the period in which it arises. In agricultural activity, a change in physical attributes of a living animal or plant directly enhances or diminishes economic benefits to the entity. Under a transaction-based, historical cost accounting model, a plantation forestry entity might report no income until first harvest and sale, perhaps 30 years after planting. On the other hand, an accounting model that recognises and measures biological growth using current fair values reports changes in fair value throughout the period between planting and harvest.

IN5 HKAS 41 does not establish any new principles for land related to agricultural activity. Instead, an entity follows HKAS 16 *Property, Plant and Equipment* or HKAS 40 *Investment Property*, depending on which standard is appropriate in the circumstances. HKAS 16 requires land to be measured either at its cost less any accumulated impairment losses, or at a revalued amount. HKAS 40 requires land that is investment property to be measured at its fair value, or cost less any accumulated impairment losses. Biological assets that are physically attached to land (for example, trees in a plantation forest) are measured at their fair value less costs to sell separately from the land.

IN6 HKAS 41 requires an unconditional government grant related to a biological asset measured at its fair value less costs to sell to be recognised in profit or loss when, and only when, the government grant becomes receivable. If a government grant is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity should recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met. If a government grant relates to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses, the entity applies HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

IN7 HKAS 41 is effective for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.

IN8 HKAS 41 does not establish any specific transitional provisions. The adoption of HKAS 41 is accounted for in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

IN9 The Appendix provides illustrative examples of the application of HKAS 41. The Basis for Conclusions summarises the Board's reasons for adopting the requirements set out in HKAS 41.

Hong Kong Accounting Standard 41
Agriculture

Objective

The objective of this Standard is to prescribe the accounting treatment and disclosures related to agricultural activity.

Scope

1 **This Standard shall be applied to account for the following when they relate to agricultural activity:**

(a) biological assets;

(b) agricultural produce at the point of harvest; and

(c) government grants covered by paragraphs 34~~-~~ and 35.

2 This Standard does not apply to:

(a) land related to agricultural activity (see HKAS 16 *Property, Plant and Equipment* and HKAS 40 *Investment Property*); and

(b) intangible assets related to agricultural activity (see HKAS 38 *Intangible Assets*).

3 This Standard is applied to agricultural produce, which is the harvested product of the entity's biological assets, only at the point of harvest. Thereafter, HKAS 2 *Inventories*, or another applicable Standard is applied. Accordingly, this Standard does not deal with the processing of agricultural produce after harvest; for example, the processing of grapes into wine by a vintner who has grown the grapes. While such processing may be a logical and natural extension of agricultural activity, and the events taking place may bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity in this Standard.

4 The table below provides examples of biological assets, agricultural produce, and products that are the result of processing after harvest:

Biological assets	**Agricultural produce**	**Products that are the result of processing after harvest**
Sheep	Wool	Yarn, carpet
Trees in a plantation forest	~~Logs~~Felled trees	Logs, lumber
Plants	Cotton	Thread, clothing
	Harvested cane	Sugar
Dairy cattle	Milk	Cheese
Pigs	Carcass	Sausages, cured hams
Bushes	Leaf	Tea, cured tobacco
Vines	Grapes	Wine
Fruit trees	Picked fruit	Processed fruit

Definitions

Agriculture-related definitions

5 **The following terms are used in this Standard with the meanings specified:**

Agricultural activity **is the management by an entity of the biological transformation and harvest of biological assets for sale~~,~~ or for conversion into agricultural produce~~,~~ or into additional biological assets.**

Agricultural produce **is the harvested product of the entity's biological assets.**

A *biological asset* **is a living animal or plant.**

Biological transformation **comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.**

Costs to sell **are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.**

A *group of biological assets* **is an aggregation of similar living animals or plants.**

Harvest **is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.**

6 Agricultural activity covers a diverse range of activities; for example, raising livestock, forestry, annual or perennial cropping, cultivating orchards and plantations, floriculture, and aquaculture (including fish farming). Certain common features exist within this diversity:

(a) *Capability to change*. Living animals and plants are capable of biological transformation;

(b) *Management of change*. Management facilitates biological transformation by enhancing, or at least stabilising, conditions necessary for the process to take place (for example, nutrient levels, moisture, temperature, fertility, and light). Such management distinguishes agricultural activity from other activities. For example, harvesting from unmanaged sources (such as ocean fishing and deforestation) is not agricultural activity; and

(c) *Measurement of change*. The change in quality (for example, genetic merit, density, ripeness, fat cover, protein content, and fibre strength) or quantity (for example, progeny, weight, cubic metres, fibre length or diameter, and number of buds) brought about by biological transformation or harvest is measured and monitored as a routine management function.

7 Biological transformation results in the following types of outcomes:

(a) asset changes through (i) growth (an increase in quantity or improvement in quality of an animal or plant), (ii) degeneration (a decrease in the quantity or deterioration in quality of an animal or plant); or (iii) procreation (creation of additional living animals or plants); or

(b) production of agricultural produce such as latex, tea leaf, wool, and milk.

General definitions

8 **The following terms are used in this Standard with the meanings specified:**

An *active market* **is a market where all the following conditions exist:**

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

Carrying amount **is the amount at which an asset is recognised in the ~~balance sheet~~statement of financial position.**

Fair value **is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**

Government grants **are as defined in HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.**

9 The fair value of an asset is based on its present location and condition. As a result, for example, the fair value of cattle at a farm is the price for the cattle in the relevant market less the transport and other costs of getting the cattle to that market.

Recognition and measurement

10 An entity shall recognise a biological asset or agricultural produce when, and only when:

(a) the entity controls the asset as a result of past events;

(b) it is probable that future economic benefits associated with the asset will flow to the entity; and

(c) the fair value or cost of the asset can be measured reliably.

11 In agricultural activity, control may be evidenced by, for example, legal ownership of cattle and the branding or otherwise marking of the cattle on acquisition, birth, or weaning. The future benefits are normally assessed by measuring the significant physical attributes.

12 A biological asset shall be measured on initial recognition and at ~~each balance sheet date~~the end of each reporting period at its fair value less ~~estimated point-of-sale~~ costs to sell, except for the case described in paragraph 30 where the fair value cannot be measured reliably.

13 Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less ~~estimated point-of-sale~~ costs to sell at the point of harvest. Such measurement is the cost at that date when applying HKAS 2 *Inventories* or another applicable Standard.

14 [Deleted]~~Point-of-sale costs include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. Point-of-sale costs exclude transport and other costs necessary to get assets to a market.~~

15 The determination of fair value for a biological asset or agricultural produce may be facilitated by grouping biological assets or agricultural produce according to significant attributes; for example, by age or quality. An entity selects the attributes corresponding to the attributes used in the market as a basis for pricing.

16 Entities often enter into contracts to sell their biological assets or agricultural produce at a future date. Contract prices are not necessarily relevant in determining fair value, because fair value reflects the current market in which a willing buyer and seller would enter into a transaction. As a result, the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract. In some cases, a contract for the sale of a biological asset or agricultural produce may be an onerous contract, as defined in HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. HKAS 37 applies to onerous contracts.

17 If an active market exists for a biological asset or agricultural produce in its present location and condition, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an entity has access to different active markets, the entity uses the most relevant one. For example, if an entity has access to two active markets, it would use the price existing in the market expected to be used.

18 If an active market does not exist, an entity uses one or more of the following, when available, in determining fair value:

(a) the most recent market transaction price, provided that there has not been a significant change in economic circumstances between the date of that transaction and the ~~balance sheet date~~end of the reporting period;

(b) market prices for similar assets with adjustment to reflect differences; and

(c) sector benchmarks such as the value of an orchard expressed per export tray, bushel, or hectare, and the value of cattle expressed per kilogram of meat.

19 In some cases, the information sources listed in paragraph 18 may suggest different conclusions as to the fair value of a biological asset or agricultural produce. An entity considers the reasons for those differences, in order to arrive at the most reliable estimate of fair value within a relatively narrow range of reasonable estimates.

20 In some circumstances, market-determined prices or values may not be available for a biological asset in its present condition. In these circumstances, an entity uses the present value of expected net cash flows from the asset discounted at a current market-determined ~~pre-tax~~ rate in determining fair value.

21 The objective of a calculation of the present value of expected net cash flows is to determine the fair value of a biological asset in its present location and condition. An entity considers this in determining an appropriate discount rate to be used and in estimating expected net cash flows. In determining the present value of expected net cash flows, an entity includes the net cash flows that market participants would expect the asset to generate in its most relevant market.~~The present condition of a biological asset excludes any increases in value from additional biological transformation and future activities of the entity, such as those related to enhancing the future biological transformation, harvesting, and selling.~~

22 An entity does not include any cash flows for financing the assets, taxation, or re-establishing biological assets after harvest (for example, the cost of replanting trees in a plantation forest after harvest).

23 In agreeing an arm's length transaction price, knowledgeable, willing buyers and sellers consider the possibility of variations in cash flows. It follows that fair value reflects the possibility of such variations. Accordingly, an entity incorporates expectations about possible variations in cash flows into either the expected cash flows, or the discount rate, or some combination of the two. In determining a discount rate, an entity uses assumptions consistent with those used in estimating the expected cash flows, to avoid the effect of some assumptions being double-counted or ignored.

24 Cost may sometimes approximate fair value, particularly when

(a) little biological transformation has taken place since initial cost incurrence (for example, for fruit tree seedlings planted immediately prior to ~~a balance sheet date~~the end of a reporting period); or

(b) the impact of the biological transformation on price is not expected to be material (for example, for the initial growth in a 30-year pine plantation production cycle).

25 Biological assets are often physically attached to land (for example, trees in a plantation forest). There may be no separate market for biological assets that are attached to the land but an active market may exist for the combined assets, that is, for the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to determine fair value for the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

Gains and losses

26 **A gain or loss arising on initial recognition of a biological asset at fair value less ~~estimated point-of-sale~~ costs to sell and from a change in fair value less ~~estimated point-of-sale~~ costs to sell of a biological asset shall be included in profit or loss for the period in which it arises.**

27 A loss may arise on initial recognition of a biological asset, because ~~estimated point-of-sale~~ costs to sell are deducted in determining fair value less ~~estimated point-of-sale~~ costs to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

28 **A gain or loss arising on initial recognition of agricultural produce at fair value less ~~estimated point-of-sale~~ costs to sell shall be included in profit or loss for the period in which it arises.**

29 A gain or loss may arise on initial recognition of agricultural produce as a result of harvesting.

Inability to measure fair value reliably

30 **There is a presumption that fair value can be measured reliably for a biological asset. However, that presumption can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available and for which alternative estimates of fair value are determined to be clearly unreliable. In such a case, that biological asset shall be measured at its cost less any accumulated depreciation and any accumulated impairment losses. Once the fair value of such a biological asset becomes reliably measurable, an entity shall measure it at its fair value less ~~estimated point-of-sale~~ costs to sell. Once a non-current biological asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it is presumed that fair value can be measured reliably.**

31 The presumption in paragraph 30 can be rebutted only on initial recognition. An entity that has previously measured a biological asset at its fair value less ~~estimated point-of-sale~~ costs to sell continues to measure the biological asset at its fair value less ~~estimated point-of-sale~~ costs to sell until disposal.

32 In all cases, an entity measures agricultural produce at the point of harvest at its fair value less ~~estimated point-of-sale~~ costs to sell. This Standard reflects the view that the fair value of agricultural produce at the point of harvest can always be measured reliably.

33 In determining cost, accumulated depreciation and accumulated impairment losses, an entity considers HKAS 2 *Inventories*, HKAS 16 *Property, Plant and Equipment* and HKAS 36 *Impairment of Assets*.

Government grants

34 **An unconditional government grant related to a biological asset measured at its fair value less ~~estimated point-of-sale costs~~costs to sell shall be recognised ~~as income~~in profit or loss when, and only when, the government grant becomes receivable.**

35 **If a government grant related to a biological asset measured at its fair value less ~~estimated point-of-sale costs~~costs to sell is conditional, including when ~~where~~ a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant ~~as income~~in profit or loss when, and only when, the conditions attaching to the government grant are met.**

36 Terms and conditions of government grants vary. For example, a ~~government~~ grant may require an entity to farm in a particular location for five years and require the entity to return all of the ~~government~~ grant if it farms for ~~less~~ a period shorter than five years. In this case, the ~~government~~ grant is not recognised ~~as income~~in profit or loss until the five years have passed. However, if the terms of the ~~government~~ grant allow~~s~~ part of ~~the government grant~~ it to be retained ~~based on the passage of time~~according to the time that has elapsed, the entity recognises ~~the government grant as income on a time proportion basis~~that part in profit or loss as time passes.

37 If a government grant relates to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses (see paragraph 30), HKAS 20 is applied.

38 This Standard requires a different treatment from HKAS 20, if a government grant relates to a biological asset measured at its fair value less ~~estimated point-of-sale~~ costs to sell or a government grant requires an entity not to engage in specified agricultural activity. HKAS 20 is applied only to a government grant related to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses.

Disclosure

39 [Deleted]

General

40 An entity shall disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less ~~estimated point-of-sale~~ costs to sell of biological assets.

41 An entity shall provide a description of each group of biological assets.

42 The disclosure required by paragraph 41 may take the form of a narrative or quantified description.

43 An entity is encouraged to provide a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate. For example, an entity may disclose the carrying amounts of consumable biological assets and bearer biological assets by group. An entity may further divide those carrying amounts between mature and immature assets. These distinctions provide information that may be helpful in assessing the timing of future cash flows. An entity discloses the basis for making any such distinctions.

44 Consumable biological assets are those that are to be harvested as agricultural produce or sold as biological assets. Examples of consumable biological assets are livestock intended for the production of meat, livestock held for sale, fish in farms, crops such as maize and wheat, and trees being grown for lumber. Bearer biological assets are those other than consumable biological assets; for example, livestock from which milk is produced, grape vines, fruit trees, and trees from which firewood is harvested while the tree remains. Bearer biological assets are not agricultural produce but, rather, are self-regenerating.

45 Biological assets may be classified either as mature biological assets or immature biological assets. Mature biological assets are those that have attained harvestable specifications (for consumable biological assets) or are able to sustain regular harvests (for bearer biological assets).

46 If not disclosed elsewhere in information published with the financial statements, an entity shall describe:

(a) the nature of its activities involving each group of biological assets; and

(b) non-financial measures or estimates of the physical quantities of:

(i) each group of the entity's biological assets at the end of the period; and

(ii) output of agricultural produce during the period.

47 An entity shall disclose the methods and significant assumptions applied in determining the fair value of each group of agricultural produce at the point of harvest and each group of biological assets.

48 An entity shall disclose the fair value less ~~estimated point-of-sale~~ costs to sell of agricultural produce harvested during the period, determined at the point of harvest.

49 **An entity shall disclose:**

(a) the existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities;

(b) the amount of commitments for the development or acquisition of biological assets; and

(c) financial risk management strategies related to agricultural activity.

50 **An entity shall present a reconciliation of changes in the carrying amount of biological assets between the beginning and the end of the current period. The reconciliation shall include:**

(a) the gain or loss arising from changes in fair value less ~~estimated point-of-sale~~ costs to sell;

(b) increases due to purchases;

(c) decreases attributable to sales and biological assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5;

(d) decreases due to harvest;

(e) increases resulting from business combinations;

(f) net exchange differences arising on the translation of financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity; and

(g) other changes.

51 The fair value less ~~estimated point-of-sale~~ costs to sell of a biological asset can change due to both physical changes and price changes in the market. Separate disclosure of physical and price changes is useful in appraising current period performance and future prospects, particularly when there is a production cycle of more than one year. In such cases, an entity is encouraged to disclose, by group or otherwise, the amount of change in fair value less ~~estimated point-of-sale~~ costs to sell included in profit or loss due to physical changes and due to price changes. This information is generally less useful when the production cycle is less than one year (for example, when raising chickens or growing cereal crops).

52 Biological transformation results in a number of types of physical change - growth, degeneration, production, and procreation, each of which is observable and measurable. Each of those physical changes has a direct relationship to future economic benefits. A change in fair value of a biological asset due to harvesting is also a physical change.

53 Agricultural activity is often exposed to climatic, disease and other natural risks. If an event occurs that gives rise to a material item of income or expense, the nature and amount of that item are disclosed in accordance with HKAS 1 *Presentation of Financial Statements*. Examples of such an event include an outbreak of a virulent disease, a flood, a severe drought or frost, and a plague of insects.

Additional disclosures for biological assets where fair value cannot be measured reliably

54 **If an entity measures biological assets at their cost less any accumulated depreciation and any accumulated impairment losses (see paragraph 30) at the end of the period, the entity shall disclose for such biological assets:**

(a) a description of the biological assets;

(b) an explanation of why fair value cannot be measured reliably;

(c) if possible, the range of estimates within which fair value is highly likely to lie;

(d) the depreciation method used;

(e) the useful lives or the depreciation rates used; and

(f) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period.

55 If, during the current period, an entity measures biological assets at their cost less any accumulated depreciation and any accumulated impairment losses (see paragraph 30), an entity shall disclose any gain or loss recognised on disposal of such biological assets and the reconciliation required by paragraph 50 shall disclose amounts related to such biological assets separately. In addition, the reconciliation shall include the following amounts included in profit or loss related to those biological assets:

(a) impairment losses;

(b) reversals of impairment losses; and

(c) depreciation.

56 If the fair value of biological assets previously measured at their cost less any accumulated depreciation and any accumulated impairment losses becomes reliably measurable during the current period, an entity shall disclose for those biological assets:

(a) a description of the biological assets;

(b) an explanation of why fair value has become reliably measurable; and

(c) the effect of the change.

Government grants

57 An entity shall disclose the following related to agricultural activity covered by this Standard:

(a) the nature and extent of government grants recognised in the financial statements;

(b) unfulfilled conditions and other contingencies attaching to government grants; and

(c) significant decreases expected in the level of government grants.

Effective date and transition

58 This Standard becomes operative for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for periods beginning before 1 January 2005, it shall disclose that fact.

59 This Standard does not establish any specific transitional provisions. The adoption of this Standard is accounted for in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

59A This Standard supersedes SSAP 36 *Agriculture* (issued in November 2002).

60 Paragraphs 5, 6, 17, 20 and 21 were amended and paragraph 14 deleted by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Appendix

Illustrative examples

This appendix, accompanies, but is not part of, IAS 41. It has been updated to take account of the changes made by IAS 1 Presentation of Financial Statements *(as revised in 2007) and* Improvements to IFRSs *issued in 2008.*

A1 Example 1 illustrates how the disclosure requirements of this Standard might be put into practice for a dairy farming entity. This Standard encourages the separation of the change in fair value less ~~estimated point-of-sale~~ costs to sell of an entity's biological assets into physical change and price change. That separation is reflected in Example 1. Example 2 illustrates how to separate physical change and price change.

A2 The financial statements in Example 1 do not conform to all of the disclosure and presentation requirements of other Standards. Other approaches to presentation and disclosure may also be appropriate.

Example 1 XYZ Dairy Ltd

~~Balance Sheet~~Statement of financial position

XYZ Dairy Ltd ~~Balance Sheet~~Statement of financial position	Notes	31 December 20X1	31 December 20X0
ASSETS			
Non-current assets			
Dairy livestock - immature[1]		52,060	47,730
Dairy livestock - mature[1]		372,990	411,840
Subtotal - biological assets	3	425,050	459,570
Property, plant and equipment		1,462,650	1,409,800
Total non-current assets		**1,887,700**	**1,869,370**
Current assets			
Inventories		82,950	70,650
Trade and other receivables		88,000	65,000
Cash		10,000	10,000
Total current assets		**180,950**	**145,650**
Total assets		**2,068,650**	**2,015,020**
EQUITY AND LIABILITIES			
Equity			
Issued capital		1,000,000	1,000,000
~~Accumulated profits~~Retained earnings		902,828	865,000
Total equity		**1,902,828**	**1,865,000**
Current liabilities			
Trade and other payables		165,822	150,020
Total current liabilities		**165,822**	**150,020**
Total equity and liabilities		**2,068,650**	**2,015,020**

[1] An entity is encouraged, but not required, to provide a quantified description of each group of biological assets, distinguishing between consumable and bearer biological assets or between mature and immature biological assets, as appropriate. An entity discloses the basis for making any such distinctions.

~~Income Statement~~Statement of comprehensive income[2]

XYZ Dairy Ltd ~~Income Statement~~Statement of comprehensive income	Notes	Year Ended 31 December 20X1
Fair value of milk produced		518,240
Gains arising from changes in fair value less ~~estimated point-of-sale~~ costs to sell of dairy livestock	3	39,930
		558,170
Inventories used		(137,523)
Staff costs		(127,283)
Depreciation expense		(15,250)
Other operating expenses		(197,092)
		(477,148)
Profit from operations		**81,022**
Income tax expense		(43,194)
~~Net profit for the period~~Profit/comprehensive income for the year		**37,828** **=====**

Statement of changes in equity[3]

XYZ Dairy Ltd Statement of Changes in Equity	Share capital	~~Accumulated Profits~~Retained earnings	Year Ended 31 December 20X1 Total
Balance at 1 January 20X1	1,000,000	865,000	**1,865,000**
~~Net profit for the period~~Profit/comprehensive income for the year		37,828	**37,828**
Balance at 31 December 20X1	**1,000,000** **=======**	**902,828** **======**	**1,902,828** **=======**

2 This ~~income statement~~statement of comprehensive income presents an analysis of expenses using a classification based on the nature of expenses. IAS 1 *Presentation of Financial Statements* requires that an entity present, either ~~on the face of~~in the ~~income statement~~statement of comprehensive income or in the notes, an analysis of expenses using a classification based on either the nature of expenses or their function within the entity. IAS 1 encourages presentation of an analysis of expenses ~~on the face of~~in the ~~income statement~~statement of comprehensive income.

3 ~~This is one of several formats for the statement of changes in equity permitted by IAS 1.~~

~~Cash Flow Statement~~Statement of cash flows[4]

XYZ Dairy Ltd ~~Cash Flow Statement~~Statement of cash flows	Notes	Year Ended 31 December 20X1
Cash flows from operating activities		
Cash receipts from sales of milk		498,027
Cash receipts from sales of livestock		97,913
Cash paid for supplies and to employees		(460,831)
Cash paid for purchases of livestock		(23,815)
		111,294
Income taxes paid		(43,194)
Net cash from operating activities		**68,100**
Cash flows from investing activities		
Purchase of property, plant and equipment		(68,100)
Net cash used in investing activities		**(68,100)**
Net increase in cash		**0**
Cash at beginning of ~~period~~the year		**10,000**
Cash at end of ~~period~~the year		**10,000**

Notes

1 Operations and principal activities

XYZ Dairy Ltd ('the Company') is engaged in milk production for supply to various customers. At 31 December 20X1, the Company held 419 cows able to produce milk (mature assets) and 137 heifers being raised to produce milk in the future (immature assets). The Company produced 157,584kg of milk with a fair value less ~~estimated point-of-sale~~ costs to sell of 518,240 (that is determined at the time of milking) in the year ended 31 December 20X1.

4 This ~~cash flow statement~~statement of cash flows reports cash flows from operating activities using the direct method. IAS 7 *~~Cash Flow Statements~~Statement of Cash Flows* requires that an entity report cash flows from operating activities using either the direct method or the indirect method. IAS 7 encourages use of the direct method.

2 Accounting policies

Livestock and milk

Livestock are measured at their fair value less ~~estimated point-of-sale~~ costs to sell. The fair value of livestock is determined based on market prices of livestock of similar age, breed, and genetic merit. Milk is initially measured at its fair value less ~~estimated point-of-sale~~ costs to sell at the time of milking. The fair value of milk is determined based on market prices in the local area.

3 Biological assets

Reconciliation of carrying amounts of dairy livestock	**20X1**
Carrying amount at 1 January 20X1	**459,570**
Increases due to purchases	26,250
Gain arising from changes in fair value less ~~estimated point-of-sale~~ costs to sell attributable to physical changes [5]	15,350
Gain arising from changes in fair value less ~~estimated point-of-sale~~ costs to sell attributable to price changes [5]	24,580
Decreases due to sales	(100,700)
Carrying amount at 31 December 20X1	**425,050**
	=======

4 Financial risk management strategies

The Company is exposed to financial risks arising from changes in milk prices. The Company does not anticipate that milk prices will decline significantly in the foreseeable future and, therefore, has not entered into derivative or other contracts to manage the risk of a decline in milk prices. The Company reviews its outlook for milk prices regularly in considering the need for active financial risk management.

[5] Separating the increase in fair value less ~~estimated point-of-sale~~ costs to sell between the portion attributable to physical changes and the portion attributable to price changes is encouraged but not required by this Standard.

Example 2 Physical change and price change

The following example illustrates how to separate physical change and price change. Separating the change in fair value less ~~estimated point-of-sale~~ costs to sell between the portion attributable to physical changes and the portion attributable to price changes is encouraged but not required by this Standard.

A herd of 10 2 year old animals was held at 1 January 20X1. One animal aged 2.5 years was purchased on 1 July 20X1 for 108, and one animal was born on 1 July 20X1. No animals were sold or disposed of during the period. Per-unit fair values less ~~estimated point-of-sale~~ costs to sell were as follows:

2 year old animal at 1 January 20X1	100	
Newborn animal at 1 July 20X1	70	
2.5 year old animal at 1 July 20X1	108	
Newborn animal at 31 December 20X1	72	
0.5 year old animal at 31 December 20X1	80	
2 year old animal at 31 December 20X1	105	
2.5 year old animal at 31 December 20X1	111	
3 year old animal at 31 December 20X1	120	
Fair value less ~~estimated point-of-sale~~ costs to sell of herd at 1 January 20X1 (10 x 100)		1,000
Purchase on 1 July 20X1 (1 x 108)		108
Increase in fair value less ~~estimated point-of-sale~~ costs to sell due to price change:		
10 x (105 - 100)	50	
1 x (111 - 108)	3	
1 x (72 - 70)	2	55
Increase in fair value less ~~estimated point-of-sale~~ costs to sell due to physical change:		
10 x (120 - 105)	150	
1 x (120 - 111)	9	
1 x (80 - 72)	8	
1 x 70	70	237
Fair value less ~~estimated point-of-sale~~ costs to sell of herd at 31 December 20X1		
11 x 120	1,320	
1 x 80	80	1,400

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at December 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 41.

The International Accounting Standard comparable with HKAS 41 is IAS 41 *Agriculture*.

There are no major textual differences between HKAS 41 and IAS 41.

HKAS 41 BC
Revised ~~October 2008~~June 2010

Basis for Conclusions
Hong Kong Accounting Standard 41

Agriculture

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

Basis for Conclusions on
IAS 41 *Agriculture*

This Basis for Conclusions accompanies, but is not part of, IAS 41.

HKAS 41 is based on IAS 41 Agriculture. In approving HKAS 41, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 41. Accordingly, there are no significant differences between HKAS 41 and IAS 41. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 41 referred to below generally correspond with those in HKAS 41.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on amending IAS 41 *Agriculture* by *Improvements to IFRSs* in May 2008. Individual Board members gave greater weight to some factors than to others.

BC2 Because the Board's intention was not to reconsider the fundamental approach to the accounting for agriculture established by IAS 41, this Basis for Conclusions does not discuss requirements in IAS 41 that the Board has not reconsidered. The IASC Basis for Conclusions on IAS 41 follows this Basis.

Scope

Costs to sell (paragraph 5)

BC3 Before the *Improvements to IFRSs* issued in May 2008, IAS 41 used the term 'point-of-sale costs'. This term was not used elsewhere in IFRSs. The term 'costs to sell' is used in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 36 *Impairment of Assets*. The Board decided that 'point-of-sale costs' and 'costs to sell' meant the same thing in the context of IAS 41. The word 'incremental' in the definition of 'costs to sell' excludes costs that are included in the fair value measurement of a biological asset, such as transport costs. It includes costs that are necessary for a sale to occur but that would not otherwise arise, such as commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. Both terms relate to transaction costs arising at the point of sale.

BC4 Therefore, the Board decided to replace the terms 'point-of-sale costs' and 'estimated point-of-sale costs' with 'costs to sell' to make IAS 41 consistent with IFRS 5 and IAS 36.

Recognition and measurement

Discount rate (paragraph 20)

BC5 As part of the annual improvements project begun in 2007, the Board reconsidered whether it is appropriate to require a pre-tax discount rate in paragraph 20 when measuring fair value. The Board noted that a fair value measurement should take into account the attributes, including tax attributes, that a market participant would consider when pricing an asset or liability.

BC6 The Board noted that a willing buyer would factor into the amount that it would be willing to pay the seller to acquire an asset (or would receive to assume a liability) all incremental cash flows that would benefit that buyer. Those incremental cash flows would be reduced by expected income tax payments using appropriate tax rates (ie the tax rate of a market participant buyer). Accordingly, fair value takes into account future income taxes that a market participant purchasing the asset (or assuming the liability) would be expected to pay (or to receive), without regard to an entity's specific tax situation.

BC7 Therefore, the Board decided to keep the requirement to use a current market-based discount rate but in *Improvements to IFRSs* issued in May 2008 removed the reference to a pre-tax discount rate in paragraph 20.

Additional biological transformation (paragraph 21)

BC8 Sometimes the fair value of an asset in its current location and condition is estimated using discounted cash flows. Paragraph 21 could be read to exclude from such calculations increases in cash flows arising from 'additional biological transformation'. Diversity in practice had developed from different interpretations of this requirement. The Board decided that not including these cash flows resulted in a carrying amount that is not representative of the asset's fair value. The Board noted that an entity should consider the risks associated with cash flows from 'additional biological transformation' in determining the expected cash flows, the discount rate, or some combination of the two. Therefore, the Board decided to amend IAS 41 to remove the prohibition on an entity taking into account the cash flows resulting from 'additional biological transformation' when estimating the fair value of a biological asset.

BC9 In its exposure draft of proposed *Improvements to International Financial Reporting Standards* published in 2007, the Board proposed changing the definition of biological transformation to include harvest. This was because the Board wished to make clear that harvest altered the condition of a biological asset. Some commentators objected to this change on the basis that harvest is a human activity rather than a biological transformation. The Board agreed with this argument and decided not to include the harvest in the definition of biological transformation. Instead, the Board amended the Standard to refer to biological transformation or harvest when applicable to make clear that harvest changes the condition of an asset.

BC10 Because applying the changes discussed in paragraphs BC8 and BC9 retrospectively might require some entities to remeasure the fair value of biological assets at a past date, the Board decided that these amendments should be applied prospectively.

CONTENTS

Basis for IASC's Conclusions on HKAS 41 *Agriculture*

This Basis for Conclusions accompanies, but is not part of, IAS 41. It was prepared by the IASC Staff in 2000 but was not approved by the IASC Board. It summarises the Board's reasons for:

(a) initiating and proposing an International Accounting Standard on agriculture; and

(b) accepting or rejecting certain alternative views.

Individual Board members gave greater weight to some factors than to others.

This Basis has not been revised by the IASB and the terminology has not been amended to reflect the changes made by Improvements to IFRSs *issued in May 2008.*

Background

B1 In 1994, the IASC Board (the 'Board') decided to develop an International Accounting Standard on agriculture and appointed a Steering Committee to help define the issues and develop possible solutions. In 1996, the Steering Committee published a Draft Statement of Principles ('DSOP') setting out the issues, alternatives, and the Steering Committee's proposals for resolving the issues and inviting public comment. In response, 42 comment letters were received. The Steering Committee reviewed the comments, revised certain of its recommendations, and submitted them to the Board.

B2 In July 1999, the Board approved Exposure Draft E65 *Agriculture* with a comment deadline of 31 January 2000. The Board received 62 comment letters on E65. They came from various international organisations, as well as from 28 individual countries. In April 2000, the IASC Staff sent a questionnaire to entities that undertake agricultural activity in an attempt to determine the reliability of the fair value measurement proposed in E65 and received 20 responses from 11 countries. In December 2000, after considering the comments on E65 and responses to the questionnaire, the Board approved IAS 41 *Agriculture* (the Standard). Paragraph B82 below summarises the changes that the Board made to E65 in finalising the Standard.

The need for an International Accounting Standard on agriculture

B3 A main objective of the IASC is to develop International Accounting Standards that are relevant in the general purpose financial statements of all businesses. While most International Accounting Standards apply to entities in all activities, some International Accounting Standards, for example IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions** and IAS 40 *Investment Property*, deal with issues that arise in particular activities. IASC has also undertaken industry-specific projects on insurance and extractive industries.

B4 Diversity in accounting for agricultural activity has occurred because:

(a) prior to the development of the Standard, assets related to agricultural activity and changes in those assets were excluded from the scope of International Accounting Standards:

(i) IAS 2 *Inventories* excluded 'producers' inventories of livestock, agricultural and forest products... to the extent that they are measured at net realisable value in accordance with well established practices in certain industries';

(ii) IAS 16 *Property, Plant and Equipment* did not apply to 'forests and similar regenerative natural resources';

(iii) IAS 18 *Revenue* did not deal with revenue arising from 'natural increases in herds, and agricultural and forest products' and

* In August 2005, IFRS 7 *Financial Instruments: Disclosure* supersedes IAS 30.

(iv) IAS 40 *Investment Propert*y did not apply to 'forests and similar regenerative natural resources';

(b) accounting guidelines for agricultural activity developed by national standard setters have, in general, been piecemeal, developed to resolve a specific issue related to a form of agricultural activity of significance to that country; and

(c) the nature of agricultural activity creates uncertainty or conflicts when applying traditional accounting models, particularly because the critical events associated with biological transformation (growth, degeneration, production, and procreation) that alter the substance of biological assets are difficult to deal with in an accounting model based on historical cost and realisation.

B5 Most business organisations involved in agricultural activity are small, independent, cash and tax focused, family-operated business units, often perceived as not being required to produce general purpose financial statements. Some believe that because of this an International Accounting Standard on agriculture would not have widespread application. However, even small agricultural entities seek outside capital and subsidies, particularly from banks or government agencies, and these capital providers increasingly request financial statements. Moreover, an international trend towards deregulation, an increasing number of cross-border listings and more investment have resulted in increasing scale, scope, and commercialism of agricultural activity. This has created a greater need for financial statements based on sound and generally accepted accounting principles. For the above reasons, in 1994 the Board added to its agenda a project on agriculture.

B6 The DSOP specifically asked for views on the feasibility of developing a comprehensive International Accounting Standard on agriculture. Some commentators felt that the diversity of agricultural activity prevents the development of a single International Accounting Standard on accounting for all agricultural activities. Others said that different principles should attach to agricultural activity with short and long production cycles. Some cited the need to develop International Accounting Standards that are simple to apply and broad in application. Commentators on the DSOP also noted that agriculture is a significant industry in many countries, particularly in developing and newly industrialised countries. In many such countries it is the most important industry.

B7 After considering the comments on the DSOP, the Board reaffirmed its conclusion that an International Accounting Standard is needed. The Board believes that the principles set forth in the Standard have wide application and provide a clear set of principles.

Scope

B8 The Standard prescribes, among other things, the accounting treatment for biological assets and for the initial measurement of agricultural produce harvested from an entity's biological assets at the point of harvest. However, the Standard does not deal with the processing of agricultural produce after harvest, since the Board did not consider it appropriate to undertake a partial revision of IAS 2 *Inventories* which deals with the accounting treatment for inventories under the historical cost system.[*] The processing after harvest is accounted for under IAS 2 or another applicable International Accounting Standard (for example, if an entitiy harvests logs[‡] and decides to use them for constructing its own building, IAS 16 *Property, Plant and Equipment* is applied in accounting for the logs).

B9 Some may think of such processing as agricultural activity, particularly if it is done by the same entity that developed the agricultural produce (for example, the processing of grapes into wine by a vintner who has grown the grapes). While such processing may be a logical and natural extension of agricultural activity, and the events taking place may bear some similarity to biological transformation, such processing is not included within the definition of agricultural activity in the Standard.

* The term 'historical cost system' is no longer applicable owing to revisions made to IAS 2 in December 2003.

† As the result of an amendment by the IASB, contained in *Improvements to IFRSs* issued in May 2008, 'logs' is an example of produce that has been processed rather than an example of unprocessed produce.

B10 In particular, the Board considered whether to include circumstances where there is a long ageing or maturation process after harvest (for example, for wine production from grapes and cheese production from milk) in the scope of the Standard. Those who believe that the Standard should cover such processing argue that:

(a) such a long ageing or maturation process is similar to biological transformation and fundamental to assessing the performance of an entity; and

(b) many agricultural entities are vertically integrated and involved in, for example, producing both grapes and wine.

B11 The Board decided not to include such circumstances in the scope of the Standard because of concerns about difficulties in differentiating them from other manufacturing processes (such as conversion of raw materials into marketable inventories as defined in IAS 2). The Board concluded that the requirements in IAS 2 or another applicable International Accounting Standard would be suited to accounting for such processes.

B12 The Board also considered whether to deal with contracts for the sale of a biological asset or agricultural produce and government grants related to agricultural activity in the Standard. These issues are discussed below (see paragraphs B47-54 and B63-73).

Measurement

Biological assets

Fair value versus cost

B13 The Standard requires an entity to use a fair value approach in measuring its biological assets related to agricultural activity as proposed in the DSOP and E65, except for cases where the fair value cannot be measured reliably on initial recognition.

B14 Those who support fair value measurement argue that the effects of changes brought about by biological transformation are best reflected by reference to the fair value changes in biological assets. They believe that fair value changes in biological assets have a direct relationship to changes in expectations of future economic benefits to the entity.

B15 Those who support fair value measurement also note that the transactions entered into to effect biological transformation often have only a weak relationship with the biological transformation itself and, thus, a more distant relationship to expected future economic benefits. For example, patterns of growth in a plantation forest directly affect expectations of future economic benefits but differ markedly, in timing, from patterns of cost incurrence. No income might be reported until first harvest and sale (perhaps 30 years) in a plantation forestry entity using a transaction-based, historical cost accounting model. On the other hand, income is measured and reported throughout the period until initial harvest if an accounting model is used that recognises and measures biological growth using current fair values.

B16 Further, those who support fair value measurement cite reasons for concluding that fair value has greater relevance, reliability, comparability, and understandability as a measurement of future economic benefits expected from biological assets than historical cost, including:

(a) many biological assets are traded in active markets with observable market prices. Active markets for these assets provide a reliable measure of market expectations of future economic benefits. The presence of such markets significantly increases the reliability of market value as an indicator of fair value;

(b) measures of the cost of biological assets are sometimes less reliable than measures of fair value because joint products and joint costs can create situations in which the relationship between inputs and outputs is ill-defined, leading to complex and arbitrary allocations of cost between the different outcomes of biological transformation. Such allocations become even more arbitrary if biological assets generate additional biological assets (offspring) and the additional biological assets are also used in the entity's own agricultural activity;

(c) relatively long and continuous production cycles, with volatility in both the production and market environment, mean that the accounting period often does not depict a full cycle. Therefore, period-end measurement (as opposed to time of transaction) assumes greater significance in deriving a measure of current period financial performance or position. The less significant current year harvest is in relation to total biological transformation, the greater the significance of period-end measures of asset change (growth and degeneration). In relatively high turnover, short production cycle, highly controlled agricultural systems (for example, broiler chicken or mushroom production) in which the majority of biological transformation and harvesting occurs within a year, the relationship between cost and future economic benefits appears more stable. This apparent stability does not alter the relationship between current market value and future economic benefits, but it makes the difference in measurement method less significant; and

(d) different sources of replacement animals and plants (home-grown or purchased) give rise to different costs in a historical cost approach. Similar assets should give rise to similar expectations with regard to future benefits. Considerably enhanced comparability and understandability result when similar assets are measured and reported using the same basis.

B17 Those who oppose measuring biological assets at fair value believe there is superior reliability in cost measurement because historical cost is the result of arm's length transactions, and therefore provides evidence of an open-market value at that point in time, and is independently verifiable. More importantly, they believe fair value is sometimes not reliably measurable and that users of financial statements may be misled by presentation of numbers that are indicated as being fair value but are based on subjective and unverifiable assumptions. Information regarding fair value can be provided other than in a single number in the financial statements. They believe the scope of the Standard is too broad. They also argue that:

(a) market prices are often volatile and cyclical and not appropriate as a basis of measurement;

(b) it may be onerous to require fair valuation at each balance sheet date, especially if interim reports are required;

(c) the historical cost convention is well established and commonly used. The use of any other basis should be accompanied by a change in the IASC *Framework for the Preparation and Presentation of Financial Statements* (the '*Framework*'). For consistency with other International Accounting Standards and other activities, biological assets should be measured at their cost;

(d) cost measurement provides more objective and consistent measurement;

(e) active markets may not exist for some biological assets in some countries. In such cases, fair value cannot be measured reliably, especially during the period of growth in the case of a biological asset that has a long growth period (for example, trees in a plantation forest);

(f) fair value measurement results in recognition of unrealised gains and losses and contradicts principles in International Accounting Standards on recognition of revenue; and

(g) market prices at a balance sheet date may not bear a close relationship to the prices at which assets will be sold, and many biological assets are not held for sale.

B18 The *Framework* is neutral with respect to the choice of measurement basis, identifying that a number of different bases are employed to different degrees and in varying combinations, though noting that historical cost is most commonly adopted. The alternatives specifically identified are historical cost, current cost, realisable value, and present value. Precedents for fair value measurement exist in other International Accounting Standards.

B19 The Board concluded that the Standard should require a fair value model for biological assets related to agricultural activity because of the unique nature and characteristics of agricultural activity. However, the Board also concluded that, in some cases, fair value cannot be measured reliably. Some respondents to the questionnaire, as well as some commentators on

E65, expressed significant concern about the reliability of fair value measurement for some biological assets, arguing that:

(a) active markets do not exist for some biological assets, in particular for those with a long growth period;

(b) present value of expected net cash flows is often an unreliable measure of fair value due to the need for, and use of, subjective assumptions (for example, about weather); and

(c) fair value cannot be measured reliably prior to harvest.

Some commentators on E65 suggested that the Standard should include a reliability exception for cases where no active market exists.

B20 The Board decided there was a need to include a reliability exception for cases where market-determined prices or values are not available and alternative estimates of fair value are determined to be clearly unreliable. In those cases, biological assets should be measured at their cost less any accumulated depreciation and any accumulated impairment losses. In determining cost, accumulated depreciation and accumulated impairment losses, an entity considers IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 36 *Impairment of Assets*.

B21 The Board rejected a benchmark treatment of fair value and an allowed alternative treatment of historical cost because of the greater comparability and understandability achieved by a mandatory fair value approach in the presence of active markets. The Board is also uncomfortable with options in International Accounting Standards.

Treatment of point-of-sale costs

B22 The Standard requires that a biological asset should be measured at its fair value less estimated point-of-sale costs. Point-of-sale costs include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. Point-of-sale costs exclude transport and other costs necessary to get assets to a market. Such transport and other costs are deducted in determining fair value (that is, fair value is a market price less transport and other costs necessary to get an asset to a market).

B23 E65 proposed that pre-sale disposal costs that will be incurred to place an asset on the market (such as transport costs) should be deducted in determining fair value, if a biological asset will be sold in an active market in another location. However, E65 did not specify the treatment of point-of-sale costs. Some commentators suggested that the Standard should clarify the treatment of point-of-sale costs, as well as pre-sale disposal costs.

B24 Some argue that point-of-sale costs should not be deducted in a fair value model. They argue that fair value less estimated point-of-sale costs would be a biased estimate of markets' estimate of future cash flows, because point-of-sale costs would in effect be recognised as an expense twice if the acquirer pays point-of-sale costs on acquisition; once related to the initial acquisition of biological assets and once related to the immediate measurement at fair value less estimated point-of-sale costs. This would occur even when point-of-sale costs would not be incurred until a future period or would not be paid at all for a bearer biological asset that will not be sold.

B25 On the other hand, some believe that point-of-sale costs should be deducted in a fair value model. They believe that the carrying amount of an asset should represent the economic benefits that are expected to flow from the asset. They argue that fair value less estimated point-of-sale costs would represent the markets' estimate of the economic benefits that are expected to flow to the entity from that asset at the balance sheet date. They also argue that failure to deduct estimated point-of-sale costs could result in a loss being deferred until a sale occurs.

B26 The Board concluded that fair value less estimated point-of-sale costs is a more relevant measurement of biological assets, acknowledging that, in particular, failure to deduct estimated point-of-sale costs could result in a loss being deferred.

Hierarchy in fair value measurement

B27 The Standard requires that, if an active market exists for a biological asset, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an active market does not exist, an entity uses market-determined prices or values (such as the most recent market transaction price) when available. However, in some circumstances, market-determined prices or values may not be available for a biological asset in its present condition. In these circumstances, the Standard indicates that an entity uses the present value of expected net cash flows* from the asset.

B28 E65 proposed that, if an active market exists for a biological asset, an entity should use the market price in the active market. If an active market does not exist, E65 proposed that an entity should consider other measurement bases such as the price of the most recent transaction for the same type of asset, sector benchmarks, and present value of expected net cash flows. E65 did not set a hierarchy in cases where no active market exists; that is, E65 did not indicate which basis is preferable to the other bases.

B29 The Board considered setting an explicit hierarchy in cases where no active market exists. Some believe that using market-determined prices or values; for example, the most recent market transaction price, would always be preferable to present value of expected net cash flows. On the other hand, some believe that market-determined prices or values would not necessarily be preferable to present value of expected net cash flows, especially when an entity uses market prices for similar assets with adjustment to reflect differences.

B30 The Board concluded that a detailed hierarchy would not provide sufficient flexibility to appropriately deal with all the circumstances that may arise and decided not to set a detailed hierarchy in cases where no active market exists. However, the Board decided to indicate that an entity uses all available market-determined prices or values since otherwise there is a possibility that entities may opt to use present value of expected net cash flows from the asset even when useful market-determined prices or values are available. Of the 20 companies that responded to the questionnaire, six companies used present value of expected net cash flows as a basis of fair value measurement and, in addition, two companies indicated that it was impossible to measure their biological assets reliably since the present value of expected net cash flows would not be reliable (as they would need to use present value as a basis).

B31 When an entity has access to different markets, the Standard indicates that the entity uses the most relevant one. For example, if an entity has access to two active markets, it uses the price existing in the market expected to be used. Some believe that the most advantageous price in the accessible markets should be used. The Standard reflects the view that the most relevant measurement results from using the market expected to be used.

Frequency of fair value measurement

B32 Some argue that less frequent measurement of fair value should be permitted because of concerns about burdens on entities. The Board rejected this approach because of the:

(a) continuous nature of biological transformation;

(b) lack of direct relationships between financial transactions and the outcomes of biological transformation; and

(c) general availability of reliable measures of fair value at reasonable cost.

* Paragraph 20 of the previous version of IAS 41 required entities to use a pre-tax discount rate when measuring fair value. The IASB decided to maintain the requirement to use a current market-based discount rate but removed the reference to a pre-tax discount rate by *Improvements to IFRSs* issued in May 2008.

Independent valuation

B33 A significant number of commentators on the DSOP indicated that, if present value of expected net cash flows is used to determine fair value, an external independent valuation should be required. The Board rejected this proposal since it believes that external independent valuations are not commonly used for certain agricultural activity and it would be burdensome to require an external independent valuation. The Board believes that it is for entities to decide how to determine fair value reliably, including the extent to which independent valuers need to be involved.

Inability to measure fair value reliably

B34 As noted previously, the Board decided to include a reliability exception in the Standard for cases where fair value cannot be measured reliably on initial recognition. The Standard indicates a presumption that fair value can be measured reliably for a biological asset. However, that presumption can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available and for which alternative estimates of fair value are determined to be clearly unreliable. In such a case, that biological asset should be measured at its cost less any accumulated depreciation and any accumulated impairment losses. Once the fair value of such a biological asset becomes reliably measurable, the Standard requires that an entity should start measuring the biological asset at its fair value less estimated point-of-sale costs.

B35 Some believe that, if an entity was previously using the reliability exception, the entity should not be allowed to start fair value measurement (that is, an entity should continue to use a cost basis). They argue that it could be a subjective decision to determine when fair value has become reliably measurable and that this subjectivity could lead to inconsistent application and, potentially, abuse. The Board noted, however, that in agricultural activity, it is likely that fair value becomes measurable more reliably as biological transformation occurs and that fair value measurement is preferable to cost in those cases. Thus, the Board decided to require fair value measurement once fair value becomes reliably measurable.

B36 If an entity has previously measured a biological asset at its fair value less estimated point-of-sale costs, the Standard requires that the entity should continue to measure the biological asset at its fair value less estimated point-of-sale costs until disposal. Some argue that reliable estimates may cease to be available. The Board believed that this would rarely, if ever, occur. Accordingly, the Board decided to prohibit entities from changing their measurement basis from fair value to cost, because otherwise an entity might use a reliability exception as an excuse to discontinue fair value accounting in a falling market.

B37 If an entity uses the reliability exception, the Standard requires additional disclosures. The additional disclosures include information on biological assets held at the end of the period such as a description of the assets and an explanation of why fair value cannot be measured reliably. The additional disclosures also include the gain or loss recognised for the period on disposal of biological assets measured at cost less any accumulated depreciation and any accumulated impairment losses, even though those biological assets are not held at the end of the period.

Gains and losses

B38 The Standard requires that a gain or loss arising on initial recognition of a biological asset and from a change in fair value less estimated point-of-sale costs of a biological asset should be included in net profit or loss* for the period in which it arises. Those who support this treatment argue that biological transformation is a significant event that should be included in net profit or loss because:

(a) the event is fundamental to understanding an entity's performance; and

(b) this is consistent with the accrual basis of accounting.

* IAS 1 *Presentation of Financial Statements* (revised in 2003) replaced the term 'net profit or loss' with 'profit or loss'.

B39 Some commentators on the DSOP and E65 argued that fair value changes should be included directly in equity, through the statement of changes in equity, until realised, arguing that:

(a) the effects of biological transformation cannot be measured reliably and, therefore, should not be reported as income;

(b) fair value changes should only be included in net profit or loss when the earnings process is complete;

(c) recognition of unrealised gains and losses in net profit or loss increases volatility of earnings;

(d) the results of biological transformation may never be realised, particularly given the risks to which biological assets are exposed; and

(e) it is premature to require recognition of fair value changes in net profit or loss, until performance reporting issues are resolved.

B40 The Board rejected requiring changes in fair value to be included directly in equity since it is difficult to find any conceptual basis for reporting any portion of the changes in fair value of biological assets related to agricultural activity directly in equity. No distinction is made in the *Framework* between recognition in the balance sheet and recognition in the income statement.

Agricultural produce

B41 The Standard requires that agricultural produce harvested from an entity's biological assets should be measured at its fair value less estimated point-of-sale costs at the point of harvest. Such measurement is the cost at that date when applying IAS 2 *Inventories* or another applicable International Accounting Standard.

B42 The Board noted that the same basis of measurement should generally be applied to agricultural produce on initial recognition and to the biological asset from which it is harvested. Because the fair value of a biological asset takes into account the condition of the agricultural produce that will be harvested from the biological asset, it would be illogical to measure the agricultural produce at cost when the biological asset is measured at fair value. For example, the fair value of a sheep with half fleece will differ from the fair value of a similar sheep with full fleece. It would be inconsistent and distort reporting of current period performance if, upon shearing, the shorn fleece is measured at its cost when the fair value of the sheep is reduced by the fair value of the fleece.

B43 As noted previously, certain biological assets are measured at their cost less any accumulated depreciation and any accumulated impairment losses, if the reliability exception is applied. Some argue that a reliability exception should exist for measurement of agricultural produce. The Board rejected this view because many of the arguments for a reliability exception do not apply to agricultural produce. For example, markets more often exist for agricultural produce than for biological assets. The Board also noted that it is generally not practicable to reliably determine the cost of agricultural produce harvested from biological assets.

B44 With regard to measurement after harvest, some argue that agricultural produce should be measured at its fair value both at the point of harvest and at each balance sheet date until sold, consumed, or otherwise disposed of. They argue that this approach would ensure that all agricultural produce of a similar type is measured similarly irrespective of date of harvest, thus enhancing comparability and consistency.

B45 The Board concluded that fair value less estimated point-of-sale costs at the point of harvest should be the cost when applying IAS 2 or another applicable International Accounting Standard, since this is consistent with the historical cost accounting model applied to manufacturing processes in general and other types of inventory.

B46 In reaching the above conclusion, the Board noted that entities undertaking agricultural activity sometimes purchase agricultural produce for resale, and other entities often engage in processing purchased agricultural produce into consumable products. If agricultural produce would be measured at its fair value after harvest, a desire for consistency would suggest revaluing purchased inventories as well, and such a treatment would be inconsistent with IAS 2. The Board did not consider it appropriate to undertake a partial revision of IAS 2.

Sales contracts

B47 Entities often enter into contracts to sell at a future date their biological assets or agricultural produce. The Standard indicates that contract prices are not necessarily relevant in determining fair value and that the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a contract.

B48 E65 did not propose how to account for a contract for the sale of a biological asset or agricultural produce. Some commentators suggested prescribing the treatment of sales contracts since such sales contracts are common in certain agricultural activity. Some commentators also pointed out that certain sales contracts are not within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* and that no other International Accounting Standards deal with those contracts.

B49 Some argue that contract prices should be used in measuring the related biological assets when an entity expects to settle the contract by delivery and believe this would result in the most relevant carrying amount for the biological asset. Others argue that contract prices are not necessarily relevant in measuring the biological assets at fair value since fair value reflects the current market in which a willing buyer and seller would enter into a transaction.

B50 The Board concluded that contract prices should not be used in measuring related biological assets, because contract prices do not necessarily reflect the current market in which a willing buyer and seller would enter into a transaction and therefore do not necessarily represent the fair value of assets. The Board wished to maintain a consistent approach to the measurement of assets. The Board instead considered whether it might require that sales contracts be measured at fair value. It is logical to measure a sales contract at fair value to the extent that a related biological asset is also measured at fair value.

B51 However, the Board noted that to achieve symmetry between the measurement of a biological asset and a related sales contract the Standard would have to carefully restrict the sales contracts to be measured at fair value. An entity may enter into a contract to sell agricultural produce to be harvested from the entity's biological assets. The Board concluded that it would not be appropriate to require fair value measurement for a contract to sell agricultural produce that does not yet exist (for example, milk to be harvested from a cow), since no related asset has yet been recognised or measured at fair value and to do so would be beyond the scope of the project on agriculture.

B52 Thus, the Board considered restricting the sales contracts to be measured at fair value to those for the sale of an entity's existing biological assets and agricultural produce. However, the Board noted that it is difficult to differentiate existing agricultural produce from agricultural produce that does not exist. For example:

(a) if an entity enters into a contract to sell fully-grown wheat at a future date and has half-grown wheat at a balance sheet date, it seems clear that the wheat to be delivered under the contract does not yet exist at the balance sheet date; but

(b) on the other hand, if an entity enters into a contract to sell mature cattle at a future date and has mature cattle at a balance sheet date, it could be argued that the cattle exist in the form in which they will be sold at the balance sheet date. However, it could also be argued that the cattle do not yet exist in the form in which they will be sold at the balance sheet date since further biological transformation will occur between the balance sheet date and the date of delivery.

B53 The Board also noted that the Standard would have to require an entity to stop fair value measurement for sales contracts once agricultural produce to be sold under the contract is harvested from an entity's biological assets, since accounting for agricultural produce is not dealt with in the Standard except for initial measurement and IAS 2 *Inventories* or another applicable International Accounting Standard applies after harvest. It would be illogical to continue fair value measurement when the agricultural produce is measured at historical cost. The Board noted that it would be anomalous to require an entity to start measuring a contract at fair value once the related asset exists and to stop doing that at a later date.

B54 The Board concluded that no solution is practicable without a complete review of the accounting for commodity contracts that are not within the scope of IAS 39. Because of the above difficulties, the Board concluded that the Standard should not deal with the measurement of sales contracts that are not within the scope of IAS 39. Instead, the Board decided to include an observation that those sales contracts may be onerous contracts under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Land related to agricultural activity

B55 The Standard does not establish any new principles for land related to agricultural activity. Rather, an entity follows IAS 16 *Property, Plant and Equipment*, or IAS 40 *Investment Property*, depending on which standard is appropriate in the circumstances. IAS 16 requires land to be measured either at its cost less any accumulated impairment losses, or at a revalued amount. IAS 40 requires land that is investment property to be measured at its fair value, or cost less any accumulated impairment losses.

B56 Some argue that land attached to biological assets related to agricultural activity should also be measured at its fair value. They argue that fair value measurement of land results in consistency of measurement with the fair value measurement of biological assets. They also argue that it is sometimes difficult to measure the fair value of such biological assets separately from the land since an active market often exists for the combined assets (that is, land and biological assets; for example, trees in a plantation forest).

B57 The Board rejected this approach, primarily because requiring the fair value measurement of land related to agricultural activity would be inconsistent with IAS 16.

Intangible assets

B58 The Standard does not establish any new principles for intangible assets related to agricultural activity. Rather, an entity follows IAS 38 *Intangible Assets*. IAS 38 requires an intangible asset, after initial recognition, to be measured at its cost less any accumulated amortisation and impairment losses, or at a revalued amount.

B59 E65 proposed that an entity should be encouraged to follow the revaluation alternative in IAS 38 for intangible assets related to agricultural activity, to enhance consistency of measurement with the fair value measurement of biological assets. Some commentators on E65 disagreed with having the encouragement. They argued that a unique treatment for intangible assets related to agricultural activity is not warranted.

B60 The Board did not include the encouragement in E65 in the Standard. The Board concluded that IAS 38 should be applied to intangible assets related to agricultural activity, as it is to intangible assets related to other activities.

Subsequent expenditure

B61 The Standard does not explicitly prescribe how to account for subsequent expenditure related to biological assets. E65 proposed that costs of producing and harvesting biological assets should be charged to expense when incurred and that costs that increase the number of units of biological assets owned or controlled by the entity should be added to the carrying amount of the asset.

B62 Some believe that there is no need to capitalise subsequent expenditure in a fair value model and that all subsequent expenditure should be recognised as an expense. Some also argue that it would sometimes be difficult to prescribe which costs should be recognised as expenses and which costs should be capitalised; for example, in the case of vet fees paid for delivering a calf. The Board decided not to explicitly prescribe the accounting for subsequent expenditure related to biological assets in the Standard, because it believes to do so is unnecessary with a fair value measurement approach.

Government grants

B63 The Standard requires that an unconditional government grant related to a biological asset measured at its fair value less estimated point-of-sale costs should be recognised as income when, and only when, the government grant becomes receivable. If a government grant is conditional, including where a government grant requires an entity not to engage in specified agricultural activity, an entity should recognise the government grant as income when, and only when, the conditions attaching to the government grant are met.

B64 The Standard requires a different treatment from IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* in the circumstances described above. IAS 20 is to be applied only to government grants related to biological assets measured at cost less any accumulated depreciation and any accumulated impairment losses.

B65 IAS 20 requires that government grants should not be recognised until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received.

IAS 20 also requires that government grants should be recognised as income over the periods necessary to match them with the related costs that they are intended to compensate, on a systematic basis. In relation to the presentation of government grants related to assets, IAS 20 permits two methods—setting up a government grant as deferred income or deducting the government grant from the carrying amount of the asset.

B66 The latter method of presentation—deducting a government grant from the carrying amount of the related asset—is inconsistent with a fair value model in which an asset is measured and presented at its fair value. Using the deduction from carrying value approach, an entity would first deduct the government grant from the carrying amount of the related asset and then measure that asset at its fair value. In effect, an entity would recognise a government grant as income immediately, even for a conditional government grant. This conflicts with the requirement in IAS 20 that government grants should not be recognised until there is reasonable assurance that the entity will comply with the conditions attaching to them.

B67 Because of the above, the Board concluded that there was a need to deal with government grants related to biological assets measured at their fair value. Some argued that IASC should begin a wider review of IAS 20, rather than provide special rules in individual International Accounting Standards. The Board acknowledged that this might be a more appropriate approach, but concluded that such a review would be beyond the scope of the project on agriculture. Instead, the Board decided to deal with government grants in the Standard, since the Board noted that government grants related to agricultural activity are common in some countries.

B68 E65 proposed that, if an entity receives a government grant in respect of a biological asset that is measured at its fair value and the grant is unconditional, the entity should recognise the grant as income when the government grant becomes receivable. E65 also proposed that, if a government grant is conditional, the entity should recognise it as income when there is reasonable assurance that the conditions are met.

B69 The Board noted that, if a government grant is conditional, an entity is likely to have costs and ongoing obligations associated with satisfying the conditions attaching to the government grant. It may be possible that the inflow of economic benefits is much less than the amount of the government grant. Given that possibility, the Board acknowledged that the criterion for recognising income from a conditional government grant in E65, when there is reasonable assurance that the conditions are met, may give rise to income recognition that is inconsistent with the *Framework*. The *Framework* indicates that income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably. The Board also noted that it would inevitably be a subjective decision as to when there is reasonable assurance that the conditions are met and that this subjectivity could lead to inconsistent income recognition.

B70 The Board considered two alternative approaches:

(a) an entity should recognise a conditional government grant as income when it is probable that the entity will meet the conditions attaching to the government grant; and

(b) an entity should recognise a conditional government grant as income when the entity meets the conditions attaching to the government grant.

B71 Proponents of approach (a) argue that this approach is generally consistent with the revenue recognition requirements in IAS 18 *Revenue*. IAS 18 requires that revenue should be recognised, among other things, when it is probable that the economic benefits associated with the transaction will flow to the entity.

B72 Proponents of approach (b) believe that, until the conditions attaching to the government grant are met, a liability should be recognised under the Framework rather than income since an entity has a present obligation to satisfy the conditions arising from past events. They also argue that income recognition under approach (a) would still be subjective and inconsistent with the recognition criteria indicated in the *Framework*.

B73 The Board concluded that approach (b) is more appropriate. The Board also decided that a government grant that requires an entity not to engage in specified agricultural activity should also be accounted for in the same way as a conditional government grant related to a biological asset measured at its fair value less estimated point-of-sale costs.

Disclosure

Separate disclosure of physical and price changes

B74 The Standard encourages, but does not require, separate disclosure of the effects of the factors resulting in changes to the carrying amount of biological assets, physical change and price change, when there is a production cycle of more than one year. Physical change is attributable to changes in the assets themselves while price change is attributable to changes in unit fair values.

B75 Some argue that the separate disclosure should be required since it is useful in appraising current period performance and future prospects in relation to production from, and maintenance and renewal of, biological assets. Others argue that it may be impracticable to separate these elements and the two components cannot be separated reliably.

B76 The Board concluded that the separate disclosure should not be required because of practicability concerns. However, the Board decided to encourage the separate disclosure, given that such disclosure may be useful and practically determinable in some circumstances. The separate disclosure is not encouraged when the production cycle is less than one year (for example, when raising broiler chickens or growing cereal crops) since that information is less useful in that circumstance.

B77 Some argue that physical changes should be included in net profit or loss and that price changes should be included directly in equity, through the statement of changes in equity. The Board rejected this approach because both components are indicative of management's performance.

Disaggregation of the gain or loss

B78 The Standard requires that an entity should disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less estimated point-of-sale costs of biological assets. The Standard does not require or encourage disaggregating the gain or loss, except that the Standard encourages separate disclosure of physical changes and price changes as discussed above.

B79 The Board considered requiring, or encouraging, disclosure of the gain or loss on a disaggregated basis; for example, requiring separate disclosure of the gain or loss related to biological assets and the gain or loss related to agricultural produce. Those who supported disaggregating the gain or loss believe that such information is useful in appraising current period performance in relation to biological transformation. Others argued that disaggregation would be impracticable and require a subjective procedure.

Other disclosures

B80 E65 proposed disclosing the:

(a) extent to which the carrying amount of biological assets reflects a valuation by an external independent valuer, or if there has been no valuation by an external independent valuer, that fact;

(b) activities that are unsustainable with an estimated date of cessation of the activities;

(c) aggregate carrying amount of an entity's agricultural land and the basis (cost or revalued amount) on which the carrying amount was determined under IAS 16 *Property, Plant and Equipment*; and

(d) carrying amount of agricultural produce either on the face of the balance sheet or in the notes.

B81 The Board did not include the above disclosures in the Standard. The Board noted that requiring item (a) above would not be appropriate since external independent valuations are not commonly used for assets related to agricultural activity, unlike for certain other assets such as investment property. The Board also noted that item (b) is not required in other International Accounting Standards and a unique disclosure requirement is not warranted for agricultural activity. Items (c) and (d) would be outside the scope of the Standard and covered by other International Accounting Standards (IAS 16 or IAS 2 *Inventories*).

Summary of changes to E65

B82 The Standard made the following principal changes to the proposals in E65:

(a) The Standard includes a reliability exception for biological assets on initial recognition. If the exception is applied, the biological asset should be measured at its cost less any accumulated depreciation and any accumulated impairment losses (paragraph 30 of the Standard). As a consequence, the Standard includes disclosure requirements consistent with paragraph 170(b) of IAS 39 *Financial Instruments: Recognition and Measurement*[*], and paragraph 68 of IAS 40 *Investment Property*[⌖] (paragraphs 54(a)-(c) and 55 of the Standard), and consistent with paragraphs 60(b)-(d) and 60(e)(v)-(vii) of IAS 16 *Property, Plant and Equipment*[✦] (paragraphs 54(d)-(f) and 55).

(b) If the reliability exception is applied but fair value subsequently becomes reliably measurable and, therefore, an entity has started measuring the biological assets at their fair value less estimated point-of-sale costs, the Standard requires the entity to disclose a description of the biological assets, an explanation of why fair value has become reliably measurable, and the effect of the change (paragraph 56).

(c) E65 did not specify how to account for point-of-sale costs (such as commissions to brokers). The Standard requires that biological assets and agricultural produce should be measured at their fair value less estimated point-of-sale costs (paragraphs 12-13).

[*] Paragraph 170(b) of IAS 39 was replaced by paragraph 90 of IAS 32 *Financial Instruments: Disclosure and Presentation* when the IASB revised those standards in 2003. In 2005, the IASB relocated all disclosures relating to financial instruments to IFRS 7 *Financial Instruments: Disclosures*.

[⌖] Paragraph 68 of IAS 40 was replaced by paragraph 78 when the IASB revised IAS 40 in 2003.

[✦] Paragraph 60 of IAS 16 was replaced by paragraph 73 when IAS 16 was revised in 2003.

(d) E65 included net realisable value as one of the measurement bases in cases where no active market exists. Net realisable value was deleted from the bases since it is not a market-determined value.

(e) The Standard indicates that market-determined prices or values are used when available. The Standard also indicates that, in some circumstances, market-determined prices or values may not be available for an asset in its present condition. In these circumstances, an entity uses the present value of expected net cash flows (paragraphs 18-20).

(f) Guidance on the performance of present value calculations was added (paragraphs 21-23).

(g) E65 did not specify how to account for contracts for the sale of a biological asset or agricultural produce. The Standard indicates that the fair value of a biological asset or agricultural produce is not adjusted because of the existence of a sales contract (paragraph 16).

(h) E65 did not explicitly indicate that a gain or loss may arise on initial recognition of agricultural produce. The Standard clarifies that a gain or loss may arise on initial recognition of agricultural produce; for example, as a result of harvesting and that such a gain or loss should be included in net profit or loss[⌘] for the period in which it arises (paragraphs 28-29)

(i) E65 proposed that costs of producing and harvesting biological assets should be charged to expense when incurred, and that costs that increase the number of units of biological assets owned or controlled by the entity should be added to the carrying amount of the asset. The Standard does not explicitly prescribe how to account for subsequent expenditure related to biological assets.

(j) E65 proposed that an entity should recognise a conditional government grant as income when there is reasonable assurance that the conditions are met. The Standard requires that a conditional government grant related to a biological asset measured at its fair value less estimated point-of-sale costs, including where a government grant requires an entity not to engage in specified agricultural activity, should be recognised as income when, and only when, the conditions attaching to the government grant are met. The Standard also indicates that IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* is applied to a government grant related to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses (paragraphs 34-35 and 37).

(k) E65 provided the following encouragements specific to agricultural activity with regard to alternative treatments allowed in other International Accounting Standards, to achieve consistency with the accounting treatment of activities covered by E65:

  (i) analysing expenses by nature, as set out in IAS 1 *Presentation of Financial Statements*; and

  (ii) revaluing certain intangible assets used in agricultural activity if an active market exists, as set out in IAS 38 *Intangible Assets*.

  The Board did not include these encouragements in the Standard. The Board noted that IAS 1 and IAS 38 apply to entities that undertake agricultural activity, as well as to those in other activities.

(l) New disclosure requirements include disclosing the:

  (i) basis for making distinctions between consumable and bearer biological assets or between mature and immature biological assets, when an entity provides a quantified description of each group of biological assets (paragraph 43);

[⌘] IAS 1 *Presentation of Financial Statements* (revised in 2003) replaced the term 'net profit or loss' with 'profit or loss'.

(ii) methods and significant assumptions applied in determining the fair value of each group of agricultural produce at the point of harvest (paragraph 47);

(iii) fair value less estimated point-of-sale costs of agricultural produce harvested during the period, determined at the point of harvest (paragraph 48);

(iv) increases resulting from business combinations in the reconciliation of the carrying amount of biological assets (paragraph 50(e)); and

(v) significant decreases expected in the level of government grants related to agricultural activity covered by the Standard (paragraph 57(c)).

(m) E65 proposed disclosing the:

(i) extent to which the carrying amount of biological assets reflects a valuation by an external independent valuer or, if there has been no valuation by an external independent valuer, that fact;

(ii) activities that are unsustainable with an estimated date of cessation of the activities;

(iii) aggregate carrying amount of an entity's agricultural land and the basis (cost or revalued amount) on which the carrying amount was determined under IAS 16; and

(iv) carrying amount of agricultural produce either on the face of the balance sheet or in the notes.

The Standard does not include the above disclosures.

(n) The amendment to IAS 17 *Leases* now clarifies that IAS 17 should not be applied to the measurement by:

(i) lessees of biological assets held under finance leases; and

(ii) lessors of biological assets leased out under operating leases.

Biological assets held under finance leases and those leased out under operating leases are measured under the Standard rather than IAS 17. A lease of a biological asset is classified as a finance lease or operating lease under IAS 17. If a lease is classified as a finance lease, the lessee recognises the leased biological asset under IAS 17 and thereafter measures and presents it under the Standard. In that case, the lessee makes disclosures both under the Standard and IAS 17. A lessor of a biological asset under an operating lease measures and presents the biological asset under the Standard, and makes disclosures both under the Standard and IAS 17.

Appendix

Amendments resulting from other Basis for Conclusions

The following sets out amendments required for this Basis for Conclusions resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) – effective for annual periods beginning on or after 1 January 2013

The Basis for IASC's Conclusions on IAS 41 is amended as described below.

In paragraph B48 the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' and in paragraph B54 the first reference to 'IAS 39' are footnoted as follows:

* In November 2009 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all assets within the scope of IAS 39.