Student Notes

Module A (June 2013)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Property related standards	• Case study • Group discussion	Ch. 5, 6, 10, 12	Pg. 1 – 23
3. Resolving accounting issues	• Case study • Group discussion	Ch. 11, 14, 21	Pg. 24 – 45
4. Wrap up	• Presentation • Group discussion		
Workshop 2			
5. Reboot	• Presentation • Group discussion		To be released after completion of Workshop 2
6. Financial instruments	• Case study • Group discussion	Ch. 18	
. Consolidation	• Case study • Group discussion	Ch. 15, 27, 28, 30	
8. Leading a team and teamwork	• Group discussion		
9. Conclusion	• Presentation • Group discussion		

Property related standards – recognition

Case study 1

Lowe Property Development Company (LPDC) is a company specialising in building and developing office buildings. Details are given relating to two properties:

1. Stanley Plaza is an office building being developed under a fixed price contract on behalf of Valley Holdings Company. The construction began on 1 January 2012 and is due to be completed in October 2013. The contract is for a fixed price of HK$30 million, and costs incurred to date are HK$15 million.

2. Weston Place is an office building development comprising three separate buildings. One of the buildings has been sold, but the other two are being actively marketed. The construction began on 1 April 2012 and is due to be completed in January 2014. The costs incurred so far on the development are HK$12.5 million, and the estimated total revenue to be made from the development is HK$28 million.

Required:

You should discuss the above scenario, in particular,

(i) whether Stanley Plaza and Weston Place should be classified as property developed as trading stock, or property developed under a construction contract in the financial statements of LPDC for the year ended 31 March 2013.

(ii) how each development should be recognised in the financial statements.

Discussion points

Property related standards – recognition

Case study – LPDC

What are the issues?

LPDC is working on the construction of two separate property developments. Several matters need to be considered at the year end 31 March 2013:

1. Whether the developments meet the definition of a construction contract
2. How construction contracts are recognised in the financial statements
3. How properties developed as trading stock are recognised in the financial statements

Which accounting standards should be used?

HKAS 2 *Inventories*
HKAS 11 *Construction Contracts*

What are the requirements of the accounting standards?

HKAS 11 – Definitions

A **construction contract** is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. There are two types of construction contract:

- A **fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.
- A **cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

(HKAS 11 paragraphs 3-6, LP chapter 12 section 1.3)

Due to the nature of the activity undertaken in construction contracts, the date on which the contract activity is entered into usually falls in a different accounting period from the date when the activity is completed.

(HKAS 11 objective, LP chapter 12 section 1.2)

HKAS 11 – Presentation

The amount included in the statement of financial position is a balancing amount in respect of a construction contract and is calculated as follows, and presented as either “Amounts due from customers” or “Amounts due to customers”, depending on whether the figure calculated is positive (debit balance) or negative (credit balance):

Contract costs incurred	X
Recognised profits less recognised losses	X/(X)
Progress billings	(X)
Amounts due from/to customers	**X/(X)**

- Where an amount due from customers is calculated, this is normally shown within inventories.
- Where an amount due to customers is calculated, this is normally shown as ‘payments on account’ within payables.
- Any amount invoiced but unpaid is shown as a receivable.

(HKAS 11 paragraphs 43-44, LP chapter 12 section 2.5)

HKAS 2 – Definitions and scope

Inventories are assets that are:

- Held for sale in the ordinary course of business
- In the process of production for such sale, or
- In the form of materials or supplies to be consumed in the production process or in the rendering of services

HKAS 2 applies to all inventories other than:

- work in progress under construction contracts (HKAS 11 *Construction Contracts*)
- financial instruments (HKFRS 9 *Financial Instruments*)
- biological assets (HKAS 41 *Agriculture*)

(HKAS 2 paragraphs 2, 3 and 6, LP chapter 10 section 1.1 and 1.2)

Inventories are normally classified as current assets and are measured at the lower of cost and net realisable value.

(HKAS 2 paragraph 9, LP chapter 10 section 1.3)

How to apply the standards to the case

(i) Classification as trading stock or construction contract

Stanley Plaza

Stanley Plaza is being developed for a specific customer, Valley Holdings Company. According to HKAS 11, for a development to meet the definition of a construction contract it must be a specifically negotiated contract, and the contract with Valley Holdings Company would seem to meet this definition.

HKAS 11 does not provide for a minimum duration (say 12 months) for it to be classified as a construction contract. The key issue is that contract activity starts in one accounting period and ends in another, which creates allocation concerns for the revenue and cost. The Stanley Plaza development will take place over three accounting periods, as it began in year ended 31 March 2012, continues in year ending 31 March 2013, and will be complete in year ending 31 March 2014. This means that contract activity, and resulting profit or loss, must be allocated between the three accounting periods.

Weston Place

Weston Place comprises three separate building developments. The key issue is that they are not being developed under a specifically negotiated construction contract. Rather, they are being developed for sale on the open market. This means that they cannot fall under the scope of HKAS 11 and cannot be accounted for as construction contract assets.

One of the building developments at Weston Place is already sold. The two remaining buildings are effectively work in progress and should be accounted for as inventories. This is because the buildings are being developed for sale in the ordinary course of business. HKAS 2 includes in the definition of inventories any assets that are in the process of being developed for sale, and includes work in progress.

Recommendation / Justification

(ii) Recognition in the financial statements

Stanley Plaza

An amount will be calculated and recognised in current assets or current liabilities depending on whether the overall situation on the contract in terms of costs and billings is positive or negative at the year end.

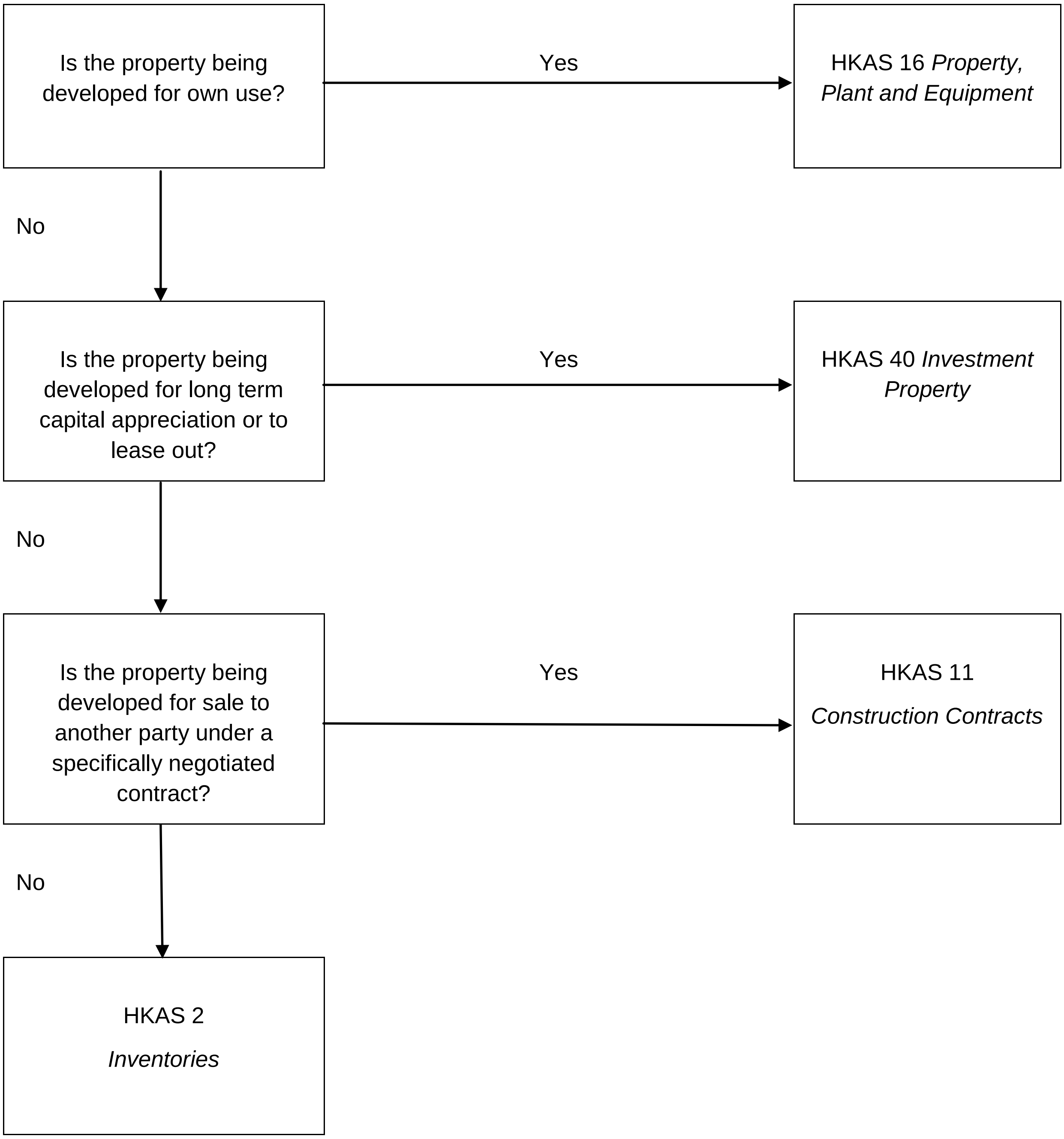
Weston Place

The buildings will be recognised as inventories under current assets and be measured at the lower of cost and net realisable value.

Key learning points:

1. HKAS 11 criteria for classification and recognition of construction contracts – in particular the existence of a fixed price contract in determining the accounting treatment.
2. HKAS 2 criteria for recognition of work in progress inventories.
3. Understanding that properties being developed for third parties are not treated as Property, Plant and Equipment.

Classification of property under development



Property related standards – measurement

Case study 1 - continued

Further details are provided for the Stanley Plaza building development being constructed by Lowe Property Development Company (LPDC) under contract for Valley Holdings Company (VHC).

The contract has a fixed price of HK$30 million. The construction began on 1 January 2012 and is due to be completed in October 2013.

The following information is available in respect of the contract at year end 31 March 2012 and 31 March 2013:

	31 March 2012	*31 March 2013*
	HK$'000	**HK$'000**
Cost incurred to date	2,500	15,000
Estimated total contract costs	25,000	26,000
Cash received from VHC in the year	1,000	12,000
Work certified by surveyor's certificate and invoiced (cumulative)	3,000	18,000

Progress on the contract is to be measured each year end based on work certified by surveyor's stage of completion certificate.

LPDC's accounting policy is that profit is not recognised on construction contracts until the outcome can be measured reliably, determined to be when a contract is 25% complete. No variations have occurred on the contract.

All construction materials purchased by LPDC in order to fulfil the contract were used in the year of purchase.

Required:

You should consider how to account for the contract, in particular,

(i) **the amounts to be recognised in the financial statements of LPDC in respect of the Stanley Plaza contract at 31 March 2012 and 31 March 2013.**

(ii) **the disclosures necessary in the financial statements in respect of the Stanley Plaza contract in the financial statements at 31 March 2013.**

Discussion points

Property related standards – measurement

Case study – LPDC

What are the issues?

LPDC is developing a fixed price contract for its customer VHC. The rules of HKAS 11 should be applied to the contract at year end 31 March 2012 and 31 March 2013 to determine:

1. Whether the contract overall is estimated to make a profit
2. The % of completion of the contract at the year end, based on work certified
3. The amount of profit that should be recognised in the income statement
4. The residual figure to be presented in the statement of financial position
5. The necessary disclosures in the notes to the financial statements (for March 2013 only)

Which accounting standard should be used?

HKAS 11 *Construction Contracts*

What are the requirements of the accounting standard?

Recognition of profit or loss

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period.

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

Profit can only be recorded on a construction contract when a reliable estimate of the outcome of the contract can be made. Specific guidance is given on fixed price contracts, stating that the outcome of a fixed price construction contract can be estimated reliably when all of the following conditions are satisfied:

- Total contract revenue can be reliably measured.
- It is probable that economic benefits of the contract will flow to the entity.
- Stage of contract completion at the period end and costs to complete the contract can be reliably measured.
- Costs attributable to the contract can be identified clearly and be reliably measured so that actual costs can be compared to previous estimates.

(HKAS 11 paragraph 23, LP chapter 12 section 2.1)

Stage of completion

In order to meet the criteria listed above, it must be possible to determine the stage of completion of the contract at the year end. HKAS 11 does not require a specific method to be used to determine % of completion, but typically it is done by reference to the proportion of costs incurred or work performed on the contract by the year end. For a fixed price contract it is most common to use the work performed method, also known as the work certified measure, which is calculated as follows:

$$\text{\% of completion based on work performed} = \frac{\text{Work certified}}{\text{Total revenue} + \text{variation}} \times 100\%$$

Work certified is typically determined by a surveyor who will issue a stage of completion certificate at the year end.

(HKAS 11 paragraph 30, LP chapter 12 section 2.1.1)

When the outcome of a construction contract cannot be estimated reliably:

- revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and
- contract costs shall be recognised as an expense in the period in which they are incurred**.**

During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no profit is recognised.

(HKAS 11 paragraphs 32 and 33, LP chapter 12 section 2.3)

Presentation and disclosure

The amount included in the statement of financial position is a balancing amount in respect of a construction contract calculated as follows, and presented as either "Amounts due from customers" or "Amounts due to customers", depending on whether the figure calculated is positive (debit balance) or negative (credit balance):

Contract costs incurred	X
Recognised profits less recognised losses	X/(X)
Progress billings (amounts invoiced)	(X)
Amounts due from/to customers	X/(X)

- Where an amount due from customers is calculated, this is recognised as an asset.
- Where an amount due to customers is calculated, this is recognised as a liability and normally shown as 'payments on account' within payables.
- Any amount invoiced but unpaid is shown as a receivable.

(HKAS 11 paragraphs 43-44, LP chapter 12 section 2.5)

The following should be disclosed in respect of construction contracts:

- The amount of contract revenue recognised as revenue in the period
- The methods used to determine the contract revenue recognised in the period
- The methods used to determine the stage of completion of contracts in progress

In addition, the following should be disclosed for contracts in progress at the reporting date:

- The aggregate amount of costs incurred and recognised profits (less recognised losses) to date
- The amount of advances received (amounts received before the related work is performed)
- The amount of retentions (amounts billed but unpaid until defects are rectified or conditions specified in the contract are met)

(HKAS 11 paragraphs 39-40, LP chapter 12 section 2.8)

How to apply the standard to the case

Step 1 - Determine whether the contract is profit making or loss making

One of the HKAS 11 criteria to be considered in determining the accounting treatment of a contract is whether it is probable that economic benefits of the contract will flow to the entity (HKAS 11 paragraph 23). Therefore the overall estimated profit should be calculated at each year end:

	31 March 2012	**31 March 2013**
	HK$'000	**HK$'000**
Contract price	30,000	30,000
Estimated total contract costs	(25,000)	(26,000)
Estimated profit	5,000	4,000

Therefore at both year ends the contract is estimated to be profit making. The next stage is to determine how much profit can be recognised at each year end.

Step 2 - Determine the stage of completion at each year end

According to HKAS 11, profit can only be recorded when the outcome can be measured reliably. When a contract is at an early stage of completion there may be too many uncertainties for a reliable outcome to be measured. For LPDC it is necessary to determine the % of completion at each year end. The company uses the work certified method to calculate % of completion as follows:

HK$'000

31 March 2012: $\frac{3,000}{30,000} \times 100\% = 10\%$

31 March 2013: $\frac{18,000}{30,000} \times 100\% = 60\%$

Step 3 - Determine the amount of profit to be recorded at 31 March 2012 and at 31 March 2013

According to LPDC's accounting policy, profit is only recognised when a contract reaches 25% completion. Therefore no profit can be recognised at 31 March 2012, but profit can be recognised at 31 March 2013.

In the 2012 financial statements, an equal amount of revenue and expense should be recognised in the income statement, to ensure that contract activity is recognised, but that no overall profit is recorded. In according to the HKAS 11 para. 32(a), *revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recovable.* Therefore, the revenue recognised should be limited to the actual cost incurred, i.e. HK$2.5million.

In the 2013 financial statements, revenue is recognised based on the actual work, and costs recognised should be calculated based on the % of completion. Because the amounts recognised are spread over several accounting periods, it is necessary to calculate the cumulative figures, and then the amounts to be recognised in each accounting period (which are the cumulative figures less any amounts previously recognised).

Cumulative figures:

	31 March 2012 HK$'000	31 March 2013 HK$'000
Revenue ()		
2012: Limited to costs incurred	2,500	
2013: 60% × HK$30 million		18,000
Contract cost to recognise:		
2012: Costs incurred	(2,500)	
2013: 60% x HK$26 million		(15,600)
Profit recognised	–	2,400

Income statement amounts for each year:

	31 March 2012 HK$'000	31 March 2013 HK$'000
Revenue (limited to costs incurred)	2,500	
2013: 18,000 – 2,500		15,500
Contract cost:	(2,500)	
2013: 15,600 – 2,500		(13,100)
Profit recognised	–	2,400

Step 4 - Determine the amounts to be presented in the statement of financial position

These are calculated based on a comparison of the contract costs incurred, the recognised profit, and the amounts invoiced in relation to the contract:

	31 March 2012 HK$'000	31 March 2013 HK$'000
Contract costs incurred	2,500	15,000
Recognised profits less recognised losses	–	2,400
Amounts invoiced	(3,000)	(18,000)
Amounts due to customers	(500)	(600)

The amounts due to customers at 31 March would be presented under current liabilities.

There will also be a **trade receivable balance** for the amounts outstanding from VHC at each year end as follows:

31 March 2012: HK$2 million (HK$3 million invoiced to date – HK$1 million cash received to date)

31 March 2013: HK$5 million (HK$18 million invoiced to date – HK$13 million cash received to date)

Required journals

The following journals are required in each year to recognise the construction contract:

Year ended 31 March 2012

		HK$'000	HK$'000
DEBIT	Amounts invoiced (trade receivables)	3,000	
CREDIT	Revenue		2,500
CREDIT	Amounts due to customers		500

To recognise revenue (limited to the costs incurred) and the amount invoiced to customers in the year.

DEBIT	Cost of sales	2,500	
CREDIT	Cash		2,500

To recognise costs associated with the construction contract.

DEBIT	Cash	1,000	
CREDIT	Amounts invoiced (trade receivables)		1,000

To recognise amounts received from the contract customer in the year.

Year ended 31 March 2013

DEBIT	Amounts due to customers	500	
DEBIT	Amounts invoiced (trade receivables)	15,000	
CREDIT	Revenue		15,500

To recognise work certified as revenue and the amount invoiced to customers in the year.

DEBIT	Cost of sales	13,100	
CREDIT	Amounts due to customers		600
CREDIT	Cash (15,000 – 2,500)		12,500

To recognise cost of sales associated with the construction contract arising in the year and costs incurred in the year.

DEBIT	Cash	12,000	
CREDIT	Amounts invoiced (trade receivables)		12,000

To recognise amounts received from the contract customer in the year.

Recommendation / Justification

Recognition in the financial statements:

	31 March 2012 HK$'000	31 March 2013 HK$'000
Income statement		
Revenue	2,500	15,500
Cost of sales	(2,500)	(13,100)
Gross profit	–	2,400
Statement of financial position		
Current assets:		
Trade receivables	2,000	5,000
Current liabilities:		
Amounts due to customers for contract work	500	600

Disclosure

The following would be disclosed in the notes to the financial statements at 31 March 2013.

Disclosure note

Amount due to customers for contract work

	31 March 2012 HK$'000	31 March 2013 HK$'000
Contract costs incurred	2,500	15,000
Recognised profits less recognised losses	-	2,400
	2,500	17,400
Progress billings	3,000	18,000
Amount due to customers	(500)	(600)

The amount of contract revenue recognised as revenue in the year was HK$15.5 million. The revenue was determined using the work certified method to calculate a % of completion for the contract at the year end.

There are no advances received or retentions relating to these contract.

Key learning points:

1. Explain when contract revenue and costs should be recognised
2. Explain how contract revenue and costs should be measured and apply these principles
3. The presentation and disclosures that are necessary in relation to construction contracts
4. Understanding how to account for a loss making contract and for changes in estimates that arise as a contract progresses

The following is a step by step approach to dealing with construction contracts:

Step 1 Determine overall profit or loss

Expected profit or loss is determined as follows:

Contract price	X
Estimated total costs	(X)
Expected profit / loss	X/(X)

Step 2 Determine stage of completion

Stage of completion may be calculated by:

1. Taking costs incurred to date as a proportion of estimated total costs, or
2. Taking work certified to date as a proportion of contract price, or
3. Physical stage of completion

Step 3 Establish whether outcome of contract can be estimated reliably and determine amounts to be recognised in the income statement

The outcome of a profitable contract can normally be estimated reliably once a certain percentage of completion has been achieved.

Can't be estimated reliably

- Contract costs are recognised in the period in which incurred
- Revenue is recognised to the extent that contract costs incurred are probably recoverable
- No profit recognised

Can be estimated reliably

- Profit recognised = % complete x expected profit

Loss making

Loss is recognised in full immediately

Step 4 Determine amounts to be recognised in the statement of financial position

Costs incurred to date	X
Recognised profits less recognised losses	X
Progress billings (amounts invoiced)	(X)
Amounts due from / to customers	X/(X)

If costs are used to determine the stage of completion, cost of sales = costs incurred and revenue is a balancing figure: if work certified is used to determine the stage of completion, revenue = work certified and cost of sales is a balancing figure

Property related standards – recognition

Case study 2

Kipling Holding Company (KHC) is a manufacturing company. KHC owns a storage facility, Warehouse A, used for storing finished goods for resale.

In August 2012 KHC acquired a new storage facility, Warehouse B, and Warehouse A was no longer required for the company's use.

Management decided to rent out Warehouse A to other companies, to generate rental income, as demand for storage facilities is strong. Warehouse A began to be advertised as a storage facility to customers on 1 September 2012. Warehouse A can be subdivided for the purpose of rental agreements, but it would not be possible to sell (or lease under a finance lease) separate portions of Warehouse A.

Before the first rental agreement could commence, a new access road had to be built to enable easier transport in and out of the building. This road was constructed between 1 November 2012 and 1 January 2013.

The first rental agreement was signed on 12 February 2013 and the customer began to use Warehouse A under that agreement on 1 March 2013.

On 1 December 2012 KHC removed all of its finished goods for resale from Warehouse A.

However, KHC retained a small part of Warehouse A, approximately 5% of its total floor space, for its own use, to store some spare parts for machinery.

KHC has a financial year ended 31 March 2013.

KHC's accounting policy is to measure property, plant and equipment using the cost model, and investment properties using the fair value model.

Required:

You should discuss the impact of the change in the use of Warehouse A, in particular,

(i) the accounting treatment for the change in use of the property, and

(ii) determine when a change in classification occurs for Warehouse A.

Discussion points

Property related standards — recognition

Case study – KHC

What are the issues?

KHC owns a warehouse which was used as a storage facility for its own use. In the year ending 31 March 2013, the warehouse undergoes a change in use. The matters to consider are:

1. Whether the warehouse meets the definition of investment property when it has undergone a change in use
2. When does the change in use actually occur
3. The accounting treatment necessary for investment property.

Which accounting standards should be used?

HKAS 16 *Property, Plant and Equipment*

HKAS 40 *Investment Property*

What are the requirements of the accounting standards?

Definitions and recognition criteria

Property, plant and equipment are tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period.

(HKAS 16 paragraph 6, LP chapter 5 section 1.2)

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:

- use in the production or supply of goods or services or for administrative purposes
- sale in the ordinary course of business.

(HKAS 40 paragraph 5, LP chapter 6 section 1.1)

HKAS 40 provides the following examples of investment properties:

(a) Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

(b) Land held for a currently undetermined future use.

(c) A building owned by the reporting entity (or held by the entity under a finance lease) and leased out under an operating lease.

(d) A building that is vacant but held to be leased out under one or more operating leases.

(e) Property that is being constructed or developed for future use as investment property.

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

(HKAS 40 paragraph 8, LP chapter 6 section 1.1)

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

(HKAS 40 paragraph 10, LP chapter 6 section 1.1)

Change in use

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.

(HKAS 40 paragraph 57, LP chapter 6 section 1.5.1, 1.5.2)

How to apply the standards to the case

(i) Determining whether a change in use has occurred

While a property is owner occupied and used in the operations of a company it meets the definition of property, plant and equipment according to HKAS 16. While classified as property, plant and equipment the property is measured according to HKAS 16 either using the cost or revaluation model, and depreciation is charged over the estimated useful life of the asset.

A property ceases to be classified as property, plant and equipment and becomes classified as an investment property when the definitions and recognition criteria of HKAS 40 have been met. To be classified as investment property, the property must be held for rental income or capital appreciation. It should not be owner occupied. HKAS 40 states that where an investment property is partly owner occupied, the accounting treatment depends on whether the parts of the investment property could be sold separately. If this is not the case then the property can only be classified as investment property if an insignificant part of the property is owner occupied.

Warehouse A does undergo a change in use. It ceases to be wholly owner occupied during the year to 31 March 2013, and even though KHC does retain a small area for storing spare parts for machinery, this amounts to only 5% of the total floor space. 5% is insignificant to the property as a whole, and therefore Warehouse A meets the definition of investment property. The next step is to determine when the change in use occurs.

(ii) When does a change in use occur?

HKAS 40 states that for a transfer from owner-occupied property to investment property to take place, the determining factor is the end of owner occupation (HKAS 40 paragraph 57 (c)).

Therefore the dates given in the scenario must be examined to see when owner occupation ceases:

1 September 2012

At this date management clearly has the intention to use Warehouse A as an investment property in the future, as they begin to advertise it as a rental facility. However at this point Warehouse A is still occupied by KHC and therefore cannot be treated as investment property. It must still be treated as property, plant and equipment.

1 November 2012

At this date, management begin to create the access road which will facilitate the use of Warehouse A as investment property. But Warehouse A is still owner occupied, so it does not meet the definition of investment property at this point. It must still be treated as property, plant and equipment.

1 December 2012

At this point KHC ceases to use Warehouse A as a storage facility, other than an insignificant portion as discussed above. Therefore this is the point when owner occupation ceases. To determine whether Warehouse A can be treated as investment property at this point, the definition of investment property must be applied. The key issue is that at this point the access road is still being constructed, and this is not complete until 1 January 2013. However, according to HKAS 40 (paragraph 8(e)) property that is being constructed or developed for future use as investment property does meet the definition of investment property.

Therefore on 1 December 2012, Warehouse A ceases to be owner occupied, and also meets the definition of investment property. This is when the change in use occurs and it must cease to be accounted for as property, plant and equipment.

Recommendation / Justification

Recognition in the financial statements

1 April 2012 – 30 November 2012

In this period, Warehouse A must be accounted for as property, plant and equipment under HKAS 16.

1 December 2012 – 31 March 2013

In this period, Warehouse A must be accounted for as investment property under HKAS 40.

Key learning points:

1. Application of HKAS 40 criteria to determine whether a property should be classified as investment property.
2. Application of accounting rules used for the change in use of a property, including the end of owner-occupation.

Property related standards – measurement

Case study 2 - continued

Further information is now provided relating to the measurement of Warehouse A, owned by Kipling Holding Company (KHC). Warehouse A underwent a change in use on 1 December 2012 from property, plant and equipment to investment property.

Estimated remaining useful life at 1 April 2012	15 years
Carrying value at 1 April 2012	HK$3,250,000
Market value at 1 April 2012	HK$3,750,000
Market value at 1 December 2012	HK$4,000,000
Market value at 31 March 2013 (assuming Warehouse A continues to be used as a storage facility)	HK$4,300,000
Market value at 31 March 2013 (assuming Warehouse A were redeveloped for alternative use)	HK$4,100,000

KHC's accounting policy is to measure property, plant and equipment using the cost model, and investment properties using the fair value model. Under the cost model, properties are depreciated on a straight line basis.

The market values given for Warehouse A do not include the market value of the access road. The road cost HK$200,000 to construct and was initially recognised as investment property at this amount, being equal to its fair value, on completion in January 2013. At 31 March 2013 the road has a market value of HK$250,000.

Market values of Warehouse A and the access road were determined by an independent specialist and are based on the principal market for each asset.

Since KHC reclassified Warehouse A as investment property, rental income generated from the property in the period to 31 March 2013 is HK$15,000.

Required:

You should consider how to account for Warehouse A as at 31 March 2013, in particular,

(i) **calculate the amounts to be recognised in KHC's financial statements for the year ended 31 March 2013 when Warehouse A undergoes a change in use.**

(ii) **determine the amount at which Warehouse A should be recognised at 31 March 2013.**

(iii) **outline the disclosures necessary in the notes to the financial statements as at 31 March 2013.**

Discussion points

Property related standards – measurement

Case Study 2 – KHC

What are the issues?

KHC owns a warehouse which undergoes a change in use on 1 December 2012, changing from property, plant and equipment to investment property. The matters to consider are:

1. The calculation of the carrying value of the property at 1 December 2012.
2. Whether the change in use causes a revaluation gain or loss to be recognised, and how it should be accounted for.
3. The subsequent accounting treatment for the investment property including the determination of fair value and disclosure requirements.

Which accounting standards should be used?

HKAS 16 *Property, Plant and Equipment*

HKAS 40 *Investment Property*

HKFRS 13 *Fair Value Measurement*

What are the requirements of the accounting standards?

HKAS 16 measurement rules

After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

(HKAS 16 paragraph 30, LP chapter 5 section 1.5)

Generally, property, plant and equipment with the exception of land must be depreciated. HKAS 16 states that:

- The depreciable amount of an item of property, plant and equipment should be allocated on a systematic basis over its useful life.
- The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the entity.
- The depreciation charge for each period should be recognised as an expense unless it is included in the carrying amount of another asset.

(HKAS 16 paragraphs 50 and 60, LP chapter 5 section 1.5.1)

Measurement rules on change in use

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. This means that assuming that there has not been a previous revaluation gain or loss on the property, the gain will be recognised in equity and disclosed in the statement of other comprehensive income.

(HKAS 40 paragraph 61, LP chapter 6 section 1.5.2)

Measurement rules for investment property

After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value.

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.

In determining the carrying amount of investment property under the fair value model, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example 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.

(HKAS 40 paragraphs 33, 35 and 50, LP chapter 6 section 1.4.1)

The requirements of HKFRS 13 *Fair Value Measurement* apply in measuring the fair value of investment properties. The two considerations from HKFRS 13 that are relevant to the measurement of an investment property are that the fair value should be based on:

- The principal market (i.e. that where the most activity takes place) or where there is no principal market, the most advantageous market (i.e. that in which the best price could be achieved) in which an orderly transaction would take place for the asset
- The highest and best use of the asset and whether it is used on a stand-alone basis or in conjunction with other assets

(HKFRS 13 paragraphs 16 and 27, LP chapter 6 section 1.4.1)

Disclosure requirements

The following must be disclosed for all investment properties:

- Whether an entity applies the cost model or fair value model
- Whether property interests held as operating leases are included in investment property
- Criteria for classification as investment property
- Use of independent professional valuer (encouraged but not required)
- Amounts recognised in profit or loss for:
  - rental income
  - direct operating expenses from property that did generate rental income
  - direct operating expenses from property that did not generate rental income
  - cumulative change in fair value recognised in profit or loss on sale of an investment property from a pool of assets in which the cost model is used to a pool in which the fair value model is used
- Any restrictions or obligations associated with the investment property

An entity that adopts the fair value model must also disclose a reconciliation of the carrying amount of the investment property at the beginning and end of the period, including separate details for those properties for which reliable fair value cannot be determined.

(HKAS 40 paragraphs 75 and 76, LP chapter 6 section 1.8)

How to apply the standards to the case

(i) Accounting treatment at the change in use

HKAS 40 requires that up to the point at which the change in use of a property occurs, the property is accounted for under HKAS 16. Warehouse A therefore needs to be depreciated over its remaining useful life, based on its carrying value, in the period 1 April 2012 to 1 December 2012 (8 months).

At the date of the change in use, the carrying value at that time must be compared with the fair value of the asset. Any revaluation gain must be accounted for in accordance with HKAS 16, and therefore a revaluation gain will be recognised in equity.

Working 1	**HK$'000**
Carrying value b/d 1 April 2012	3,250
Depreciation: 3,250 / 15 years x 8/12	(144)
Carrying value 1 December prior to change in use	3,106
Revaluation gain	894
Fair value at 1 December	4,000

Therefore on 1 December 2012, a revaluation gain of HK$894,000 is recognised immediately prior to the property being reclassified as investment property:

		HK$'000	**HK$'000**
DEBIT	Property, plant and equipment	894	
CREDIT	Revaluation surplus		894

And the asset is then reclassified:

		HK$'000	**HK$'000**
DEBIT	Investment property	4,000	
CREDIT	Property, plant and equipment		4,000

The revaluation surplus arising on the revaluation of Warehouse A is an unrealised amount within equity. This amount becomes realised on the eventual disposal of the investment property and at this time is transferred to retained earnings by way of a reserves transfer.

(ii) Accounting treatment subsequent to the change in use

KHC's accounting policy is to measure investment property using the fair value model. Therefore, following the reclassification to investment property, Warehouse A should not be depreciated and should be re-measured to fair value at the end of the accounting period (according to HKAS 40 paragraph 33).

There are two issues to consider in relation to measuring the market value at the year end. The first is which market value should be used as the fair value of the property. Warehouse A has two potential market values based on different assumptions about its future use. According to HKFRS 13, the fair value should be based on the principal market for the asset, and on its highest and best use (paragraphs 16 and 27). Therefore for Warehouse A, the highest and best market value of HK$4,300,000 should be used as its year end valuation.

Second, the issue of the access road should be considered. The road was initially recognised as investment property at its cost (fair value) of HK$200,000 on completion in January 2013.

		HK$'000	**HK$'000**
DEBIT	Investment property	200	
CREDIT	Cash		200

Generally, assets should be accounted for as their separate components, meaning that assets are broken down into component parts with each part being treated separately for the purpose of depreciation. However, when investment properties are measured using the fair value model the issue of components becomes irrelevant as the asset is not being depreciated. According to HKAS 40, to avoid double counting, assets which form an integral part of the investment property, in this case such as the access road, should be treated as part of the fair value of the asset as a whole.

Therefore at 31 March 2013, Warehouse A and the road should be re-measured from carrying value of HK$4.2 million (HK$4 million plus HK$200,000) to fair value of HK$4.55 million (HK$4.3 million plus HK$250,000). The fair value gain is recognised as part of profit for the year:

Working 2		**HK$'000**	**HK$'000**
DEBIT	Investment property	350	
CREDIT	Income statement		350

Recommendation / Justification

(iii) Presentation and disclosure in the financial statements

Statement of comprehensive income	**HK$'000**
Operating expenses: depreciation (W1)	(144)
Other operating income: rental income	15
Gain on fair value re-measurement (W2)	350
Other comprehensive income: revaluation gain (W1)	894

Statement of financial position (extract):	
Non-current assets: Investment property	4,550
Equity: Revaluation surplus (W1)	894

Extracts from notes to the financial statements:

Warehouse A is recognised as an investment property from 1 December 2012. The property meets the criteria to be recognised as an investment property because it is held for rental income, and it generated rental income of HK$15,000 in the year ended 31 March 2013.

Warehouse A is measured using the fair value model, in accordance with KHC's accounting policy. Its market value at 31 March 2013 was provided by an independent valuer, and the fair value was based on the highest and best use of the asset in its principal market.

A reconciliation of the movement in the fair value of the property is given below:

	HK$'000
Fair value at date of classification as investment property	4,000
Fair value of access road on completion	200
Fair value gain recognised in profit	350
Fair value at 31 March 2013	4,550

Key learning points:

1. Application of HKAS 40 rules to determine the revaluation gain or loss when an asset is transferred from property, plant and equipment to investment property.
2. Application of HKAS 40 and HKFRS 13 rules to determine the appropriate fair value for an investment property at the year end, and the treatment of fair value gains.
3. The presentation and disclosure requirements of HKAS 40.

Resolving accounting issues

Case study 1

Posy Parker Company (PPC) has 3 directors, each of whom has an equal shareholding in the company. PPC owns 75% of Company B, 40% of Company C and holds a 50% investment in a joint venture arrangement (JVA). One of the directors of PPC, Bob Marshall, is also a director and 80% shareholder of Marshall Mugs Company (MMC) and his wife Sue Marshall owns 100% of Sue Stubbs Company (SSC).

The following transactions took place in the year to 31 March 2013:

1. PPC supplied Company B, Company C and JVA with raw materials. The amounts supplied to each company had a sales price of HK$500,000, HK$300,000 and HK$350,000 respectively.
2. Company B also supplied Company C and JVA with components, supplying each company with HK$125,000 components in the year.
3. PPC leased an office space from SSC and paid HK$700,000 in respect of this operating lease during the year. PPC also leased a car parking space from SSC, paying HK$5,000 for this.
4. PPC paid HK$300,000 to MMC during the year, in respect of management consultancy fees.
5. PPC sold a car to Bob Marshall on 1 January 2013. The car had a fair value of HK$175,000 and the amount is still outstanding.
6. PPC's profit before tax for the year to 31 March 2013 is HK$3 million.

Required:

(i) Identify the related parties of PPC, explaining why each is a related party.

(ii) Identify the related party transactions that need to be disclosed, and

(iii) Recommend the necessary disclosures to be made in PPC's individual financial statements for the year ended 31 March 2013.

Discussion points

Resolving accounting issues – Related party transactions

Case Study 1 - PPC

What are the issues?

PPC has several companies to which it is connected, and details are given about the owners and management of the company. Using the definitions and disclosure requirements from HKAS 24, the following should be determined:

1. Which persons and entities are related parties to PPC?
2. Which transactions meet the definition of a related party transaction?
3. For the related party transactions identified, what disclosure is necessary in PPC's financial statements?

Which accounting standard should be used?

HKAS 24 *Related Party Disclosures*

What are the requirements of the accounting standard?

Key definitions

Related party is a person or entity that is related to the entity that is preparing its financial statements.

Related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

A person or a close member of that person's family is related to a reporting entity if that person:

(i) has control or joint control over the reporting entity;

(ii) has significant influence over the reporting entity; or

(iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

An entity is related to a reporting entity if any of the following conditions applies:

(i) the entity and the reporting entity are members of the same group

(ii) one entity is an associate or joint venture of the other entity (or an associate or joint venture of a group of which the other entity is a member)

(iii) both entities are joint ventures of the same third party

(iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity

(v) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity

(vi) the entity is controlled or jointly controlled by a person identified in the list above

(vii) the person with control or joint control over the reporting entity has significant influence over the entity or is a member of the key management personnel of the entity (or a parent of the entity)

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner.

(HKAS 24 paragraph 9, LP chapter 21 section 1.3)

When considering each possible related party relationship, attention must be paid to the substance of the relationship, not merely the legal form.

(HKAS 24 paragraph 10, LP chapter 21 section 1.3.1)

Types of related party transactions

HKAS 24 provides examples of transactions which may take place between related parties:

- purchases or sales of goods (finished or unfinished)
- purchases or sales of property and other assets
- rendering or receiving of services
- leases
- transfer of research and development
- transfers under licence agreements
- provision of finance
- provisions of guarantees and collateral security
- settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

(HKAS 24 paragraph 21, LP chapter 21 section 1.3.3)

Disclosure requirements in respect of related party transactions

Where related party transactions have occurred during the period, the nature of the related party relationship should be disclosed together with (as a minimum):

(a) The amount of the transactions

(b) The amount of outstanding balances, including commitments, and

 (i) their terms and conditions including whether they are secured and the nature of the consideration to be provided in settlement; and

 (ii) details of any guarantees given or received

(c) Provisions for doubtful debts related to the amount of outstanding balances, and

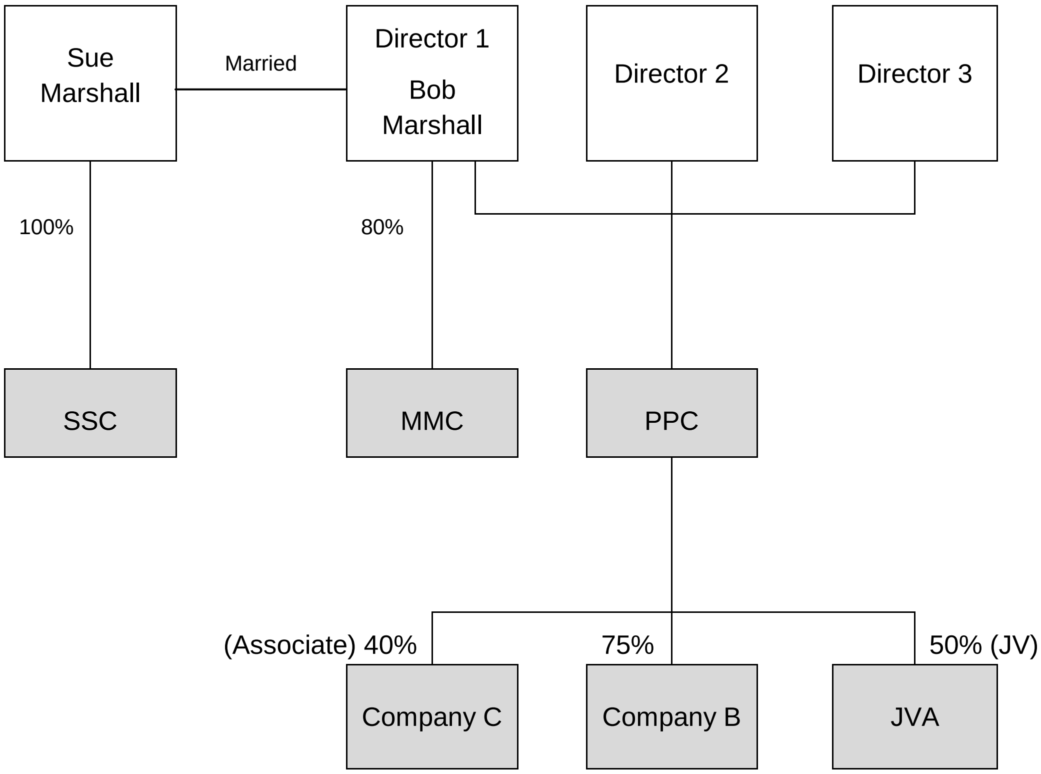
(d) The expense recognised during the period in respect of bad and doubtful debts due from related parties.

(HKAS 24 paragraph 18, LP chapter 21 section 1.4)

How to apply the standard to the case

(i) Identify the related parties of PPC

The related parties should be identified by looking at each entity and person for which information is given in the case study and applying the definitions of HKAS 24.



Company B

- According to HKAS 24 paragraph 9 (bi), a company is related to the reporting entity if it is part of the same group.
- Company B therefore is a related party of PPC because it is under the control of PPC, which owns 75% of the shares of Company B.

Company C and the Joint Venture Arrangement (JVA)

- According to HKAS 24 paragraph 9 (b)(ii) associates and joint ventures are related to the reporting entity.
- Therefore Company C is a related party of PPC because it is an associate, with PPC having significant influence over Company C through its 40% shareholding. Similarly, JVA is a related party to PPC because PPC has a 50% holding and therefore shares control of JVA with a third party.

PPC's directors

- According to HKAS 24 paragraph 9 (a), a person or a close member of that person's family is related to a reporting entity if that person has control or joint control over the reporting entity, has significant influence over the reporting entity or is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
- The directors have joint control and influence over PPC, as they each have one third of the company's shares. And in addition, they are all members of key management personnel. Therefore all of the directors are related parties of PPC.

Sue Marshall

- The rules on related parties extend to close family members of those who have control or influence over a company, either through shareholding or through being a member of key management personnel. A close family member includes a person's spouse. Therefore Sue Marshall, being the wife of one of PPC's directors is a related party to PPC.

Marshall Mugs Company (MMC) and Sue Stubbs Company (SSC)

- HKAS 24 paragraph 9 (bvi) states that an entity is a related party to the reporting entity if the entity is controlled or jointly controlled by a person identified in paragraph (a), in other words if that person is a related party of the reporting entity.
- MMC is controlled by Bob Marshall, one of PPC's directors, who is a related party of PPC. SSC is controlled by Sue Marshall, who is also a related party of PPC. Therefore both MMC and SSC are related parties of PPC.

(ii) Identify the related party transactions that need to be disclosed in PPC's financial statements

Each transaction should be examined to see if it should be disclosed. HKAS 24 paragraph 9 defines a related party transaction as a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged. Therefore, almost all transactions between a reporting entity and its related parties will need to be disclosed.

Looking at each transaction from the case study in turn:

1. The supply of raw materials to Company B, Company C and JVA. This needs to be disclosed because they are all related parties to PPC, and the transaction is between PPC and its related parties.
2. The supply of raw materials from Company B to Company C and JVA is not disclosed in PPC's financial statements, because the transaction is not recorded in PPC's individual financial statements.
3. The lease of an office space and car parking space from SSC would need to be disclosed as a related party transaction. Even though the lease of the car park space is immaterial at less than 1% of profit before tax, it should be disclosed because related party transactions are material by nature.
4. The management consultancy fees paid to MMC need to be disclosed as a related party transaction. HKAS 24 makes it clear that related party transactions include the rendering of services.

5. The sale of a car to one of PPC's directors needs to be disclosed as a related party transaction. This is despite the fact the amount has not been paid, and effectively there has been no exchange of cash to date between PPC and the director.

(iii) Recommend the necessary disclosures

For each of the transactions identified above as a related party transaction of PPC, a note should be provided in the financial statements to provide details on:

- The nature of the related party relationship
- The amounts involved
- Whether any amounts are outstanding at the year end
- Any relevant terms and conditions
- Any information in respect of bad debts

Recommendation / Justification

Note to the financial statements: Related party transactions

PPC was involved with the following related party transactions in the year to 31 March 2013:

Company B, Company C and JVA

Each of these companies is a related party to PPC due to PPC having control or significant influence over them. During the year PPC supplied each company with raw materials, with a sales value as follows:

Company B	HK$500,000
Company C	HK$300,000
JVA	HK$350,000

None of the amounts are outstanding at the year end.

SSC

SSC is a related party of PPC due to it being controlled by a close family member of one of PPC's directors. During the year PPC paid to SSC HK$705,000 in respect of operating leases.

MMC

MMC is a related party of PPC due to it being controlled by one of PPC's directors. During the year PPC paid to MMC HK$300,000 in respect of management consultancy fees.

Key management personnel

During the year, PPC sold a vehicle with a fair value of HK$175,000 to a member of key management personnel. The amount is outstanding at 31 March 2013.

Key learning points:

1. How to apply the definitions of related party transactions to determine which persons and entities are related to the reporting entity.
2. To determine the disclosures that are necessary in respect of related party transactions.
3. To consider the importance of related party disclosures for the financial statements.

Resolving accounting issues

Case study 2

Rishworth Gleddings Company (RGC) operate a chain of health clubs and gyms throughout South-east Asia from their head office in Hong Kong. The following information relates to the year ended 31 March 2013:

1. RGC has been sued by a customer who alleges that she was injured whilst using a faulty machine at one of the company's health clubs in Singapore. The customer is claiming HK$800,000 in compensation. At the year end, the case has not been concluded, but RGC's legal team have advised that there is a 75% probability that the company will win the case. An estimated HK$9,000 in legal fees has been incurred by RGC to date, although no invoice has been received.

2. On 1 April 2006, RGC signed a ten-year lease on a property in Bangkok in order to open a new health club. The contract required lease payments in advance of HK$500,000 on 1 April and 1 October each year, with the final payment due on 1 October 2015. The club was opened in October 2006 and reported a healthy profit during the five years ended 31 March 2011. In August 2011, a well-known Thai chain of health clubs opened a state of the art facility close to RGC's club and as a result, the RGC club membership levels fell by more than half. RGC therefore closed the Bangkok club on 30 September 2012, however was unable to negotiate a release from the lease.

3. RGC also operates a health club in Kuala Lumpur. This club has been loss-making for some years and RGC management have therefore announced that the club will be closing on 30 June 2013. A formal plan detailing the closure has been drawn up and this reveals that 15 staff will lose their jobs and as a result, RGC will be required to pay HK$2.5 million in redundancy costs. Operating losses from 1 April 2013 until the closure of the club are expected to amount to HK$1 million. RGC must also pay a penalty of HK$1.5 million in order to be released from a supply agreement with the company which provides gym equipment used in the Kuala Lumpur health club.

Required:

(i) Discuss the accounting treatment to be applied to each scenario.

(ii) Calculate amounts to be recognised in the financial statements of RGC for the year ended 31 March 2013. Ignore the discounting of future amounts to present values.

Discussion points

Resolving accounting issues –Provisions and contingent liabilities

Case Study 2 - RGC

What are the issues?

RGC runs health clubs throughout South-east Asia. In the preparation of the financial statements for the year ended 31 March 2013, RGC's management have three situations to deal with. In each case, students must consider whether a provision should be made, contingent liability disclosed or no action taken:

1. There is an outstanding legal claim against the company, for which legal advisors state there is a 25% chance of the claim being decided in favour of the claimant.
2. RGC is bound by a ten year tenancy agreement to a property in Bangkok. Competition has, however, resulted in RGC pulling out of this location. The company has been unable to negotiate a release from the lease.
3. A health club is to be closed in the next accounting period. This will result in the payment of redundancy costs and a penalty fee. Operating losses are expected until the closure.

Which accounting standard should be used?

HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

What are the requirements of the accounting standard?

Definitions

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

A **contingent liability** is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or

(b) a present obligation that arises from past events but is not recognised because:

- (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- (ii) the amount of the obligation cannot be measured with sufficient reliability.

An **onerous contract** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

(HKAS 37 paragraph 10, LP chapter 11 section 1.2)

Provisions – recognition, measurement and disclosure

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

(i) an entity has a present obligation (legal or constructive) as a result of a past event;

(ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) a reliable estimate can be made of the obligation.

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

(HKAS 37 paragraph 14, LP chapter 11 section 2.1)

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(i) where the settlement of the obligation can be enforced by law (a legal obligation); or

(ii) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

(HKAS 37 paragraph 17, LP chapter 11 section 2.1.1)

For a liability to qualify for recognition, it must be probable that there will be an outflow of economic resources embodying economic benefits. An outflow of resources is regarded as probable if the event is more likely than not to occur.

(HKAS 37 paragraph 23, LP chapter 11 section 2.1.2)

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

(HKAS 37 paragraphs 36, 45, LP chapter 11 section 2.2)

HKAS 37 requires narrative disclosure of the background to the making of the provision and the uncertainties affecting its outcome, including for each class of provision:

(i) A brief description of the nature of the obligation and expected timing of any resulting outflows of economic benefits

(ii) An indication of the uncertainties about the amount or timing of outflows

(iii) The amount of any expected reimbursement stating the amount of any asset that has been recognised for the expected reimbursement.

(HKAS 37 paragraph 85, LP chapter 11 section 2.7)

Onerous contracts

If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

An onerous contract is defined by HKAS 37 as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

(HKAS 37 paragraphs 66, 68, LP chapter 11 section 2.6.2)

Restructuring provisions

HKAS 37 deals with restructuring as a specific type of provision, and there are specific recognition criteria and measurement rules for such provisions. The standard gives examples of the types of events that would fall under the definition of restructuring:

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

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

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

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

(HKAS 37 paragraph 70, LP chapter 11 section 2.6.3)

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

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

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

  (ii) the principal locations affected;

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

  (iv) the expenditures that will be undertaken; and

  (v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

(HKAS 37 paragraph 72, LP chapter 11 section 2.6.3)

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

(a) necessarily entailed by the restructuring; and

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

A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

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

(HKAS 37 paragraphs 80-82, LP chapter 11 section 2.6.3)

Contingent liabilities

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

(HKAS 37 paragraph 27, LP chapter 11 section 3)

A brief description must be provided of all material contingent liabilities unless the possibility of an outflow of resources is remote. In addition, the following should be provided for each class of contingent liability, where practicable:

(i) An estimate of their financial effect

(ii) Details of any uncertainties relating to the amount or timing of the outflow

(iii) The possibility of any reimbursement.

(HKAS 37 paragraph 86, LP chapter 11 section 3.1.2)

How to apply the standard to the case

Scenario 1 – Legal claim

Recognition of a provision

The recognition criteria of HKAS 37 must be applied in order to establish whether a provision is required in respect of the legal claim:

Present obligation as a result of past event

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

Probable outflow of economic benefits

RGC's legal team considers that there is only a 25% probability of RGC losing the court case and having to pay compensation to the customer. This is not 'more likely than not' and therefore this does not qualify as a probable outflow of economic benefits, and the second recognition criterion has not been met.

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

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

In contesting the compensation case, RGC has incurred HK$9,000 legal fees, which have not yet been invoiced. These must be accrued for at the period end by:

DEBIT	Legal expenses	HK$9,000	
CREDIT	Accrual		HK$9,000

Scenario 2 – Bangkok lease

Onerous lease

RGC is committed to paying HK$1 million per annum in respect of the Bangkok property lease until 2016 (with the final contractual payment being in October 2015). The company closed the club which ran from these premises on 30 September 2012. At the point of closure, the lease contract meets the definition of an onerous contract ie a contract in which the future unavoidable costs of the contract exceed the future benefits of the contract.

Recognition of a provision

HKAS 37 requires that the present obligation under an onerous contract is recognised and measured as a provision. Therefore RGC should provide for the future costs associated with the contract. As RGC has been unable to negotiate a release from the contract this is the costs of fulfilling the lease.

Measurement of the provision

At 30 September 2012, 7 lease payments of HK$500,000 are outstanding (those due on 1 October 2012, 1 April 2013, 1 October 2013, 1 April 2014, 1 October 2014, 1 April 2015 and 1 October 2015).

A provision should therefore be made for HK$3.5 million.

Subsequently, each time that a lease payment is made, the debit entry is made to the provision rather than profit or loss. The first lease payment is made on 1 October 2012 and therefore the year end provision is HK$3 million.

Presentation of the provision

In accordance with the requirements of HKAS 1, the provision should be disclosed as current / non-current depending on when the lease payments are to be made. As at 31 March 2013, two lease payments are due within one year and a further four are due after one year. Therefore HK$1 million of the provision is classified as current and HK$2 million as non-current.

Accounting entries

30 September 2012

DEBIT	Operating expenses	HK$3.5 million	
CREDIT	Provisions		HK$3.5 million

To record the initial provision for seven future lease payments of HK$500,000 each.

1 October 2012

DEBIT	Provisions	HK$0.5 million	
CREDIT	Cash		HK$0.5 million

To record the lease payment made on 1 October 2012.

Scenario 3 – Closure of the Kuala Lumpur club

Closure

The closure of a division (or in this case individual health club) falls under the definition of a restructuring activity according to HKAS 37, which gives the “Sale or termination of a line of business” as an example of a restructuring activity.

Recognition of a provision

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

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

Measurement of the provision

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

Redundancy costs are necessarily entailed by the restructuring, and because staff are being made redundant, they are not associated with ongoing activities. Therefore, the HK$2.5 million costs of redundancy should be included in the provision.

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

The penalty to be incurred in order to be released from the agreement with the gym equipment supplier is necessarily entailed by the restructuring and not associated with ongoing activities. Therefore, the HK$1.5 million penalty should be included in the provision.

Presentation of the provision

As the redundancy costs and penalty fee will be paid within 12 months of the reporting date, the provision is recognised as a current liability.

Accounting entry

DEBIT	Operating expenses (2.5 + 1.5)	HK$4 million	
CREDIT	Provisions (current liabilities)		HK$4 million

To record a provision in respect of future redundancy costs and penalty fee associated with the closure of a health club.

Recommendation / Justification

RGC's statement of financial position at 31 March 2013 includes:

Non-current liabilities	HK$'000
Provisions	
Onerous lease	2,000
Current liabilities	
Accrual	9
Provisions	
Costs of closure	4,000
Onerous lease	1,000

RGC's statement of comprehensive income for the year ended 31 March 2013 includes:

Operating expenses includes:	HK$'000
Costs of closure	4,000
Onerous lease	3,500
Legal expenses	9

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

Provisions

Onerous lease

A provision is recognised in respect of future lease payments for the property from which the Bangkok club was run. This club ceased to operate on 30 September 2012, however management have been unable to secure a release from the lease contract. A total year end provision of HK$3 million is recognised in the statement of financial position which is equal to the total future lease payments for the remaining three years of the lease.

There are no key uncertainties in respect of this provision.

Costs of closure

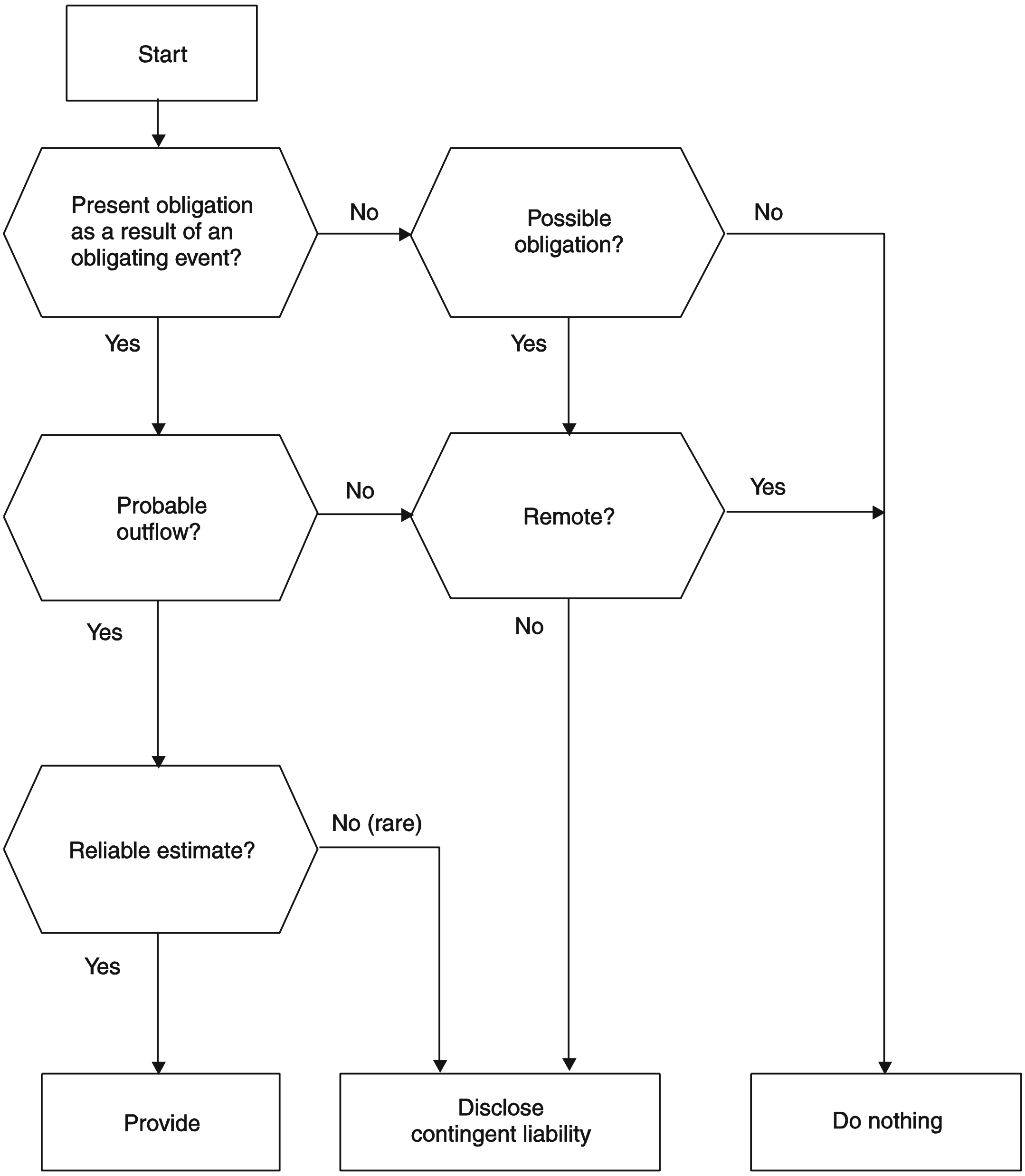
The costs that have been provided are in respect of redundancy costs and a penalty fee associated with the closure of the Kuala Lumpur health club. The costs will be incurred in the next accounting period when the club is due to be closed.

There are no key uncertainties in respect of this provision.

Contingent liability

RGC is currently facing a legal claim, and having taken legal advice, it is considered that the legal claim gives rise to a possible, but not a probable, future cash outflow. The amount that has been claimed is HK$800,000.

HKAS 37 Key Learning Points



Key learning points:

1. The provision recognition criteria must be applied to determine whether a provision is recognised in each case.
2. A provision is never recognised in respect of future operating losses.
3. A provision is recognised at the best estimate of the expenditure required to settle the present obligation at the reporting date; it is discounted to present value if the time value of money is material.
4. Where a provision is recognised, it must be recognised as current/non-current in accordance with the requirements of HKAS 1.
5. Where a provision is not recognised but there is a contingent liability, this should be disclosed unless the possibility of an outflow of economic resources is remote.

Resolving accounting issues

Case study 3

The Barnett Company (TBC) is a diversified company within the hairdressing and beauty sector. As well as operating a number of hair and beauty salons, TBC runs the Hair Training Academy and manufactures and distributes a range of hair and beauty products. The following information relates to the year ended 31 March 2013:

1. TBC distributes its exclusive hair products on a sale or return basis to a number of hair salons other than those operated by the company itself. A clause in the contract stipulates that TBC will reduce the range of products available to a salon in the event of a returns level in excess of 5% goods supplied. A further clause prevents the salons from returning stock that they have held for a period of longer than 6 months. Despite this restriction and the impact on product range available, average returns levels are 8%. At 31 March 2013, salons throughout Hong Kong and China held TBC products under the sale or return agreement. These products cost TBC HK$2 million and have a sales value of HK$3 million. TBC pays the salons 10% of the sales value on all sales. None of these products have been held by the salons for longer than 6 months.

2. TBC salons offer a reward scheme whereby customers are awarded one ‘Barnett point’ for every HK$20 they spend on hairdressing services. Customers are required to pay for hairdressing services prior to leaving the salon and are credited with their points at this time. These points can be exchanged for TBC hair and beauty products. ‘Barnett points’ are valid for use for three years from the date on which they are awarded and 2 points are worth HK$1. During the year ended 31 March 2013, TBC has awarded 3 million points in connection with sales of HK$60 million. Historically 75% of points awarded have been redeemed for products by customers and TBC expects this level of redemption to continue. A third of the expected points have been redeemed by 31 March 2013. TBC expect a further 1 million points to be redeemed in the year ended 31 March 2014.

Required:

(i) Discuss how the revenue recognition requirements of HKAS 18 are applied to each scenario.

(ii) Calculate amounts to be recognised in the financial statements of TBC for the year ended 31 March 2013.

(iii) State any further disclosures that may be required.

Discussion points

Resolving accounting issues – Revenue recognition

Case Study 3 - TBC

What are the issues?

TBC operates within the hair and beauty sector. In the preparation of the financial statements for the year ended 31 March 2013, TBC's management have two scenarios to deal with. In each case, students must consider how the HKAS 18 revenue recognition requirements are applied, calculate amounts for inclusion in the financial statements and consider whether further disclosure is required.

1. TBC distributes its hair products to salons on a sale or return basis. There is a penalty if more than 5% of goods are returned and any products held for more than six months may not be returned. At 31 March 2013, salons hold stock with a cost to TBC of HK$2 million.
2. TBC provides customers with one reward point for every HK$20 spent on hairdressing services in its own salons. During the year 3 million reward points have been awarded in connection with sales of HK$60 million.

Which accounting standards should be used?

HKAS 18	*Revenue*
HK(IFRIC)Int-13	*Customer Loyalty Programmes*

What are the requirements of the accounting standards?

Definitions

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increase in equity other than increases relating to contributions from equity participants.

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.

(HKAS 18 paragraph 7, LP chapter 14 section 2.2)

Recognition of revenue – sale of goods

Revenue from the sale of goods is recognised when all of the following conditions have been satisfied:

(a) The entity has transferred to the buyer the significant risks and rewards of ownership

(b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold

(c) The amount of revenue can be measured reliably

(d) It is probable that the economic benefits associated with the transaction will flow to the entity, and

(e) The costs incurred or to be incurred in respect of the transaction can be reliably measured.

If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways. An example of a situation in which the entity may retain the significant risks and rewards of ownership is when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods.

(HKAS 18 paragraphs 14, 16, LP chapter 14 section 2.5)

Recognition of revenue – rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction is recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all of the following conditions are satisfied:

(a) The amount of revenue can be measured reliably

(b) It is probable that the economic benefits associated with the transaction will flow to the entity

(c) The stage of completion of the transaction at the end of the reporting period can be measured reliably, and

(d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The stage of completion of a transaction may be determined by a variety of methods including services performed to date as a percentage of services to be performed.

(HKAS 18 paragraphs 20, 24, LP chapter 14 section 2.6)

Measurement of revenue

Revenue is measured at the fair value of the consideration received or receivable.

(HKAS 18 paragraph 9, LP chapter 14 section 2.3)

Disclosure of revenue

An entity must disclose the following in respect of revenue:

(a) The accounting policies adopted for the recognition of revenue, including methods applied to determine the stage of completion of transactions involving the rendering of services

(b) The amount of each significant category of revenue recognised in the period including revenue arising from the sale of goods and the rendering of services.

(HKAS 18 paragraph 35, LP chapter 14 section 2.10)

Customer loyalty programmes

An entity should account for award credits as a separately identifiable component of the sales transactions in which they are granted. The fair value of consideration receivable on such transactions is allocated between the award credits and other components of the sale.

(HK(IFRIC)Int-13 paragraph 5, LP chapter 14 section 3.2.2)

The consideration allocated to the award credits is measured by reference to their fair value. If the entity itself supplies the awards, it recognises the consideration allocated to award credits as revenue when award credits are redeemed and it fulfils its obligation to supply awards. The amount of revenue recognised is based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

(HK(IFRIC)Int-13 paragraphs 6, 7, LP chapter 14 section 3.2.2)

How to apply the standards to the case

Provision of hair products on sale or return basis

Recognition of revenue

The criteria for the recognition of revenue in respect of the sale of goods must all be satisfied in order for TBC to recognise the HK$3 million as revenue in the year ended 31 March 2013:

(a) The entity has transferred to the buyer the significant risks and rewards of ownership	The risk of return is shared by TBC and the individual salons: TBC has the risk of return of unsold / slow-moving goods, however the individual salons are commercially compelled not to exercise their right of return as this will reduce the range of TBC products available to them in the future. Equally the salons may not return goods that they have held for more than 6 months. Equally it can be argued that the risks and rewards associated with selling price are shared: TBC's income is affected by a lower or higher than expected final selling price, however so is the individual salons' income, which is a percentage of sales value.
(b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold	TBC retains involvement in the stock in that the stock may be returned. Historic levels of returns (8%) are relatively high, despite the resulting impact on product range.
(c) The amount of revenue can be measured reliably	Revenue is measured at HK$3 million.
(d) It is probable that economic benefits associated with the transaction will flow to the entity	Economic benefits are dependent on sales to third parties; this cannot be assumed to be probable.
(e) The costs incurred or to be incurred in respect of the transaction can be measured reliably	Costs are measured at HK$2 million cost of the products plus HK$300,000 sales commission.

Therefore the revenue recognition conditions are not all met and TBC should not record revenue in the year ended 31 March 2013 in respect of the hair products provided to salons on a sale or return basis.

Instead the goods will be recognised in TBC's statement of financial position as inventory at their cost of HK$2 million. Revenue will be recognised by TBC at such time as the hair products are sold by the individual salons to third party customers. At this time the risks and rewards of ownership are transferred to the third parties, TBC ceases to have managerial involvement in the goods and economic benefits are probable. Therefore the conditions for revenue recognition are met.

Hairdressing services and Barnett points

Revenue in respect of the provision of services is measured when the outcome of the transaction can be estimated reliably. Therefore the following conditions must be met in order for TBC to recognise revenue in respect of the provision of hairdressing services in the year ended 31 March 2013:

(a) The amount of revenue can be measured reliably	Total revenue is measured as HK$60 million; a proportion is deferred in accordance with HK(IFRIC)Int-13 (see below).
(b) It is probable that economic benefits associated with the transaction will flow to the entity	Payment is received before customers leave the salon.
(c) The stage of completion of the transaction at the end of the reporting period can be measured reliably	Due to their nature, all transactions are complete prior to the period end.
(d) The costs incurred or to be incurred in respect of the transaction can be measured reliably	This is assumed to be the case.

All criteria are met and therefore TBC should recognise revenue in respect of the provision of hairdressing services in the year ended 31 March 2013.

Measurement of revenue

HK(IFRIC)Int-13 requires that a proportion of the revenue received is allocated to the Barnett points provided to customers. This revenue is deferred until such time as the points are redeemed. When the points are redeemed, the deferred revenue is credited to profit or loss and matched to the costs associated with providing the reward products.

The deferred revenue is measured at fair value, taking into account the number of points expected to be redeemed, as follows:

Total fair value of points awarded in the year	3 million/2 x HK$1=	HK$1.5 million
Fair value of the points expected to be redeemed	75% x HK$1.5m =	HK$1,125,000

Therefore the HK$60 million received by TBC in respect of hairdressing services where Barnett points are awarded is split as follows:

Revenue recognised on provision of hairdressing services (bal. fig.)	HK$58,875,000
Deferred revenue to be recognised when points are redeemed	HK$1,125,000

(i) Accounting entries

As the sales are made, they are accounted for by (HK$'000):

DEBIT	Cash	60,000	
CREDIT	Revenue		58,875
CREDIT	Deferred revenue		1,125

One third of the Barnett points have been redeemed by the year end. The redemption is accounted for by (HK$'000):

DEBIT	Deferred revenue (1/3 × 1,125)	375	
CREDIT	Revenue		375

(ii) Disclosure

The amount of revenue recognised in respect of sale of goods and provision of services should be disclosed separately in accordance with HKAS 18.

At 31 March 2013 there is a deferred revenue liability balance of HK$750,000 (1,125-375). In accordance with HKAS 1, this must be split between current and non-current amounts. As TBC expects 1 million Barnett points to be redeemed in the year ended 31 March 2014, the current liability is HK$500,000 (1m/2 × HK$1).

Recommendation / Justification

TBC's statement of financial position at 31 March 2013 includes:

	HK$'000
Current assets	
Inventories	2,000
Current liabilities	
Deferred revenue	500
Non-current liabilities	
Deferred revenue (750 – 500)	250

TBC's statement of comprehensive income for the year ended 31 March 2013 includes:

	HK$'000
Revenue	
Sale of goods (redemption of Barnett points for products)	375
Provision of services	58,875

Key learning points:

1. The revenue recognition criteria must be applied to determine whether revenue is recognised in respect of sale of goods or provision of services.
2. Where customers are provided with award credits on the sale of goods or provision of services, the associated revenue is split between revenue relating to the goods or service provided and the award credits. That revenue relating to award credits is deferred until such time as the credits are redeemed.
3. Award credits are measured at fair value, taking into account the expected number of credits which will be redeemed.