Student Notes

Module A (December 2012)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Property related standards	• Case study • Group discussion	Ch. 4, 5, 6, 8 and 17	Pg. 1 – 22
3. Resolving accounting issues	• Case study • Group discussion	Ch. 8, 10, 14 and 15	Pg, 23 – 41
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 and 21	
7. Consolidation	• Case study • Group discussion	Ch. 27, 28, 29 and 30	
8. Leading a team and teamwork	• Group discussion		
9. Conclusion	• Presentation • Group discussion		

Property related standards - recognition

Case study 1

Packer Trading Company (PTC) manufactures and sells chemicals, and has a financial year ended 30 September 2012. It has two storage facilities, Property A and Property B.

Property A is a storage facility for raw material inventories. Property A is newly constructed and includes the following elements - the building structure, a bespoke lifting system for moving items around the building, and a computerised temperature control system. The costs relating to each element of the building are shown below.

	Cost
	HK$'000
Building structure	7,000
Lifting system	1,000
Temperature control system	800

In addition, a health and safety inspection in relation to the lifting system was obtained, and PTC paid for staff training in using the two new systems in Property A. The inspection and associated operating licence cost HK$ 500,000 and the training costs were HK$ 250,000. Property A was ready for its intended use on 1 April 2012, after a period of initial testing, during which time costs of HK$ 75,000 were incurred in testing the temperature control system.

PTC also owns another, older storage facility, Property B, which is divided into 25 separate storage units. PTC stores some finished products in one of these units, but the rest are rented out under short term leases to unconnected companies. Five of the units are temporarily empty at the year end. The carrying value of Property B is HK$ 10,000,000 at 1 April 2012.

Required:

(i) Discuss whether Property A and Property B should be classified as property, plant and equipment or investment property in the financial statements of PTC.

(ii) For Property A, determine whether each element should be capitalised into the cost of the building, and discuss the accounting treatment of components of assets. No calculations are required.

Discussion points

Property related standards – Property, plant and equipment and investment property

Case Study 1 – PTC

What are the issues?

PTC owns two properties which are storage facilities. The issues to be considered are:

1. For both properties, apply the recognition criteria to determine if they are property, plant and equipment or investment property.
2. Whether the costs in respect of Property A should be treated as capital expenditure, or as revenue items.

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
- 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:

(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.

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

The standard provides the following examples of investment properties:

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

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

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

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

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

(HKAS 40 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) an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

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

Capitalisation of property, plant and equipment

Once an item of property, plant and equipment qualifies for recognition as an asset, it will initially be measured at cost. Costs which should be capitalised can include the following:

(a) Purchase price, less any trade discount or rebate

(b) Import duties and non-refundable purchase taxes

(c) Directly attributable costs of bringing the asset to working condition for its intended use, for example:

- (i) The cost of site preparation
- (ii) Initial delivery and handling costs
- (iii) Installation costs
- (iv) Testing costs
- (v) Professional fees (architects, engineers, etc)

These costs bring the asset to the location and working conditions necessary for it to be capable of operating in the manner intended by management, including those costs to test whether the asset is functioning properly.

(d) Initial estimate of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located

(e) Any borrowing costs incurred related to building the asset must be capitalised in accordance with HKAS 23

(HKAS 16 paragraphs 15-17, LP chapter 5 section 1.4.1)

HKAS 16 does not prescribe the unit of measure for recognition, i.e. what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value. For very large and specialised items, an apparently single asset should be broken down into its composite parts. This occurs where the different parts have different useful lives and different depreciation rates are applied to each part, e.g. an aircraft, where the body and engines are separated as they have different useful lives.

(HKAS 16 paragraph 9, LP chapter 5 section 1.3.3)

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part.

(HKAS 16 paragraph 43 and 44, LP chapter 5 section 1.3.3)

How to apply the standards to the case

(i) **Recognition as property, plant and equipment or investment property**

Property A

Property A meets the definition to be recognised as property, plant and equipment. It is used by PTC in its operations, and therefore should be recognised as property, plant and equipment from the date at which it became ready for use in the manner intended by management, on 1 April 2012.

Property B

Property B meets the basic definition of an investment property as it is owned by PTC and is rented out to earn income. HKAS 40 gives the example of a property which is rented out under operating lease arrangements as an example of an investment property.

However, the decision as to whether Property B can be recognised as investment property is complicated by the fact that PTC uses part of the property to store its own goods. This means that Property B is part owner occupied.

We must therefore consider whether Property B is separable, i.e. whether the units within the property can be sold or leased separately. The answer to this is clearly yes, since the units are already leased separately.

Therefore the leased and owner-occupied parts of the property are classified and accounted for separately. The one unit used by PTC is classified as property, plant and equipment and the remaining units are classified as investment property.

The fact that five of the remaining units are empty at the year end is not relevant, as the empty units still have the capacity to earn rentals and therefore are still classified as investment property.

(ii) **Recognition of costs in relation to Property A**

The key issue here is whether the costs described in relation to Property A meet the recognition criteria of HKAS 16, in particular whether the costs are directly attributable to making the property ready for use in the manner intended by management.

Building structure, lifting system, temperature control system

All of these components of the storage facility are directly attributable to the storage facility and should be capitalised at cost. The total amount to be capitalised is HK$ 8.8 million.

Health and safety inspection and licence

The licence is necessary in order for the lifting system to be operated. When items relating to health and safety are acquired they will qualify for recognition as part of property, plant and equipment where they enable future economic benefits from related assets to be obtained in excess of those that could be obtained otherwise. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Therefore, as the lifting system could not be operated without the necessary inspection and licence, its cost of HK$ 500,000 should be capitalised.

Training costs

HKAS 16 does not permit training costs to be capitalised. This is because training costs do not meet the definition of an asset as the benefits that may be obtained from training are not under the control of the entity. Therefore the costs of HK$ 250,000 must be expensed in the year ended 30 September 2012.

Testing costs

According to HKAS 16, costs of testing whether the asset is functioning properly is an example of a directly attributable cost, as it is incurred in order to bring the asset into a condition when it is ready for use in the manner intended by management. Therefore the testing costs of HK$ 75,000 should be capitalised.

Key learning points

1. *When dealing with initial recognition of property, plant and equipment, it is important to determine the types of costs that are capital expenditure, and those that are revenue items.*
2. *Significant component parts of an item of property, plant and equipment must be identified.*
3. *Where a property is part owner-occupied and part held for investment purposes:*
   - *where the parts are separable, each part is classified separately as PPE or investment property*
   - *where the parts are not separable, and the owner-occupied part is insignificant, the whole property is classified as investment property*
   - *where the parts are not separable, and the owner-occupied part is significant, the whole property is classified as PPE*

Property related standards - measurement

Case study 1 continued

Packer Trading Company (PTC) is preparing its financial statements for the year ended 30 September 2012. Property A, the chemical storage facility, became available for its intended use on 1 April 2012 and the following information is provided in respect of this property:

	Cost HK$'000	Estimated useful life
Building structure	7,000	30 years
Lifting system	1,000	See note 1 below
Health and safety inspection in relation to lifting system	500	See note 2 below
Staff training	250	
Temperature control system	800	See note 3 below
Initial testing costs of temperature control system	75	

Note 1: The lifting system is estimated to have a resale value of HK$ 250,000 when it is disposed of at the end of its useful life in 15 years time.

Note 2: An inspection is needed every 5 years in order to renew the operating licence for the lifting system.

Note 3: The temperature control system could remain operational for 15 years. However, technological developments are likely to make the system obsolete after 10 years, at which time it will have no resale value.

The two systems are not expected to become less efficient as they are used by PTC.

In addition, machinery used to seal the containers containing chemicals was purchased on 1 May 2012. The machine cost HK$ 120,000 and based on past experience management estimate that repairs and maintenance will become necessary as the asset gets older. A depreciation rate of 30% per annum on a reducing balance basis is considered appropriate.

It is PTC's accounting policy to charge depreciation on a monthly basis.

Required:

(i) **For Property A, calculate the amount that should be initially recognised on 1 April 2012.**

(ii) **Discuss the method of depreciation to be applied to each element of Property A and the machinery purchased for use in Property A.**

(iii) **Calculate the carrying value to be included in Property, plant and equipment at 30 September 2012, and the depreciation expense to be recognised.**

(iv) **Draft the relevant notes to the financial statements in respect of Property A.**

Discussion points

Property related standards – measurement

Case Study 1 – PTC (continued)

What are the issues?

PTC owns Property A. Several matters need to be considered at the year end 30 September 2012:

1. The total that should be capitalised on the initial recognition of Property A on 1 April 2012
2. How should depreciation be calculated for the separate elements of Property A.
3. The carrying amount of property, plant and equipment at 30 September 2012.
4. What disclosures are necessary in the notes to the financial statements.

Which accounting standard should be used?

HKAS 16 *Property, plant and equipment*

What are the requirements of the accounting standard?

HKAS 16 does not prescribe the unit of measure for recognition, i.e. what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value. For very large and specialised items, an apparently single asset should be broken down into its composite parts. This occurs where the different parts have different useful lives and different depreciation rates are applied to each part, e.g. an aircraft, where the body and engines are separated as they have different useful lives.

(HKAS 16 paragraph 9, LP chapter 5 section 1.3.3)

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part.

To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item.

(HKAS 16 paragraphs 43 - 46 LP chapter 5 section 1.5)

The depreciable amount of an asset shall be allocated on a systematic basis over its useful life. The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount. Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

(HKAS 16 paragraphs 50, 53, 55 LP chapter 5 section 1.5.1 and 1.5.2)

The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

The estimated useful life should be subject to review at least once a year at every financial year end and depreciation rates are to be adjusted for both current and future periods if significant variations between the expected and the original estimates arise. The effect of this change should be disclosed in the accounting period in which the change takes place.

The judgment on useful life is based on the entity's past experience with similar assets or classes of assets. The task of estimating the useful life will be much more onerous when an entirely new type of asset is acquired (i.e. through technological advancement or through use in producing a brand new product or service).

(HKAS 16 paragraph 56, LP chapter 5 section 1.5.2)

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset's residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

(HKAS 16 paragraphs 60 - 62, LP chapter 5 section 1.5.4)

Disclosure requirements

HKAS 16 has a list of disclosure requirements, for each class of property, plant and equipment:

(a) Measurement bases for determining the gross carrying amount.

(b) Depreciation methods used.

(c) Useful lives or depreciation rates used.

(d) Gross carrying amount and accumulated depreciation at the beginning and end of the period.

(e) Reconciliation of the carrying amount at the beginning and end of the period showing:

  (i) Additions

  (ii) Disposals

  (iii) Acquisitions through business combinations

  (iv) Increases/decreases during the period from revaluations and from impairment losses

  (v) Impairment losses recognised in profit or loss

  (vi) Impairment losses reversed in profit or loss

(vii) Depreciation

(viii) Net exchange differences (from translation of statements of foreign entity)

(ix) Any other movements.

(HKAS 16 paragraph 73, LP chapter 5 section 1.9)

How to apply the standard to the case

(i) **Amount to be capitalised in respect of Property A**

The total to be capitalised at 1 April 2012 is:

	Cost HK$'000
Building structure	7,000
Lifting system	1,000
Temperature control system	800
Health and safety inspection and licence	500
Testing costs	75
Total	9,375

The training costs of HK$250,000 are recognised in profit or loss, included within operating expenses.

The journal for Property A (HK$):

DEBIT	Property, plant and equipment	9,375,000	
DEBIT	Operating expenses	250,000	
CREDIT	Cash		9,625,000

ii) **Depreciation**

Method of depreciation – residual value

HKAS 16 requires that each separate component of an asset with a significant cost should be assessed in order to determine its individual method of depreciation. This is to ensure that depreciation is charged as accurately as possible based on the differing costs and estimated useful lives of each component part.

HKAS 16 also requires that residual values are established for each component part. In Property A only the lifting system has a residual value, of HK$250,000, which will be taken into account when determining the depreciation on that component part. The rest of the components of Property A have no residual value, as they will have no resale value when they reach the end of their estimated useful lives.

Method of depreciation – calculation basis

The method of depreciation that should be used depends on the pattern of benefits expected from using the component of the asset. For components whose usage will provide economic benefit throughout its useful life, with no reduction in benefit obtained as the asset gets older then the straight line method of depreciation is most appropriate. This is because the depreciation charge should match with the benefits obtained from using the asset. Therefore, for an asset that generates the same economic benefit in each year of its use it is appropriate to calculate depreciation in a manner that results in the same charge to profit each year. In the case of Property A, the straight line method should be used for the building structure and the lifting and temperature control systems as they are expected to generate benefit without becoming inefficient, throughout their useful lives.

For the machine, because it will become less efficient as it is used by PTC, it will generate more economic benefit in the early years of its use, and less in the later years. The pattern of depreciation charged against the asset should match this, and therefore the diminishing balance (or reducing balance) method should be used.

Depreciation method – determination of useful life

The useful life should be based on management's judgement of how long economic benefit can be produced from an asset (or a component of an asset). Looking at each component in turn:

Building structure	This has an estimated life of 30 years on which straight line depreciation should be calculated.
Lifting system	This has an estimated life of 15 years on which straight line depreciation should be calculated.
Lifting system inspection and licence	The inspection takes place every 5 years. HKAS 16 requires that the costs associated with the inspection are capitalised and depreciated over the period until the next inspection is required. Therefore the costs should be depreciated over a 5 year period.
Temperature control system	This could generate benefit for 15 years. However, HKAS 16 requires that the estimated useful life should take account of potential obsolescence and therefore the cost of the system, including the initial testing costs should be depreciated over a 10 year period, after which time it will be obsolete.
Machine	The machine will be depreciated using the diminishing balance method. The asset will be depreciated by 30% per annum, a rate which takes into account the useful life of the asset, and should be based on management experience with similar assets.

(iii) **Calculation of amount to be recognised in Property, plant and equipment (PPE), and depreciation charge for the year ended 30 September 2012**

Depreciation is calculated for each component part of Property A, and for the machine purchased in May 2012 as follows:

		Depreciation charge HK$
Building structure	7,000,000 / 30 years x 6/12 months	116,667
Lifting system	(1,000,000 – 250,000) / 15 years x 6/12 months	25,000
Lifting system inspection and licence	500,000 / 5 years x 6/12 months	50,000
Temperature control system	875,000 / 10 years x 6/12 months	43,750
Machine	120,000 x 30% x 5/12 months	15,000
Total		250,417

Therefore Property, plant and equipment at 30 September 2012 will include:

	HK$
Cost (9,375,000 + 120,000)	9,495,000
Less: depreciation	(250,417)
Carrying value	**9,244,583**

(iv) **Disclosure requirements**

HKAS 16 requires that for each class of asset disclosure is made to enable users of the financial statements to understand the methods used to determine the amount recognised in the statement of financial position at the year end.

The accounting policy note should describe the method of depreciation, particularly the estimated useful life of each class of assets. For PTC the accounting policy note would explain that buildings are depreciated over 30 years, and plant by 10-15 years using the straight line method; and that machinery is depreciated at 30% per annum using the diminishing balance method.

There would also be a note to reconcile the opening and closing balances of each class of asset:

	Land and buildings HK$	**Machinery HK$**	**Total HK$**
Opening balance 1 October 2011	-	-	-
Additions	9,375,000	120,000	9,495,000
Depreciation	(235,417)	(15,000)	(250,417)
Closing balance 30 September 2012	9,139,583	105,000	9,244,583

Recommendation / Justification

PTC recognises the following in its financial statements at 30 September 2012:

Statement of financial position	**HK$**
Non-current assets	
Property, plant and equipment	9,244,583
Statement of profit or loss	
Depreciation – included in operating expenses	250,417
Staff training – included in operating expenses	250,000

The journal for recording the depreciation:

		HK$	**HK$**
DEBIT	Operating expenses	250,417	
CREDIT	Accumulated depreciation		250,417

Key learning points

1. *An asset that contains component parts that are significant in terms of cost and have different useful lives must be broken down to ensure that each component is depreciated over its individual useful life.*

2. *Many factors affect the determination of useful life, and these factors should be reviewed at least annually, and depreciation adjusted accordingly.*

3. *Some assets should be depreciated using straight line method, others using diminishing balance method, with the decision based on the pattern of economic benefit derived from the asset.*

4. *Disclosure relating to depreciation must be sufficiently detailed for users of the financial statements to understand the methods used to determine assets' carrying values at the year end.*

Property related standards- recognition

Case study 2

Milo Trading Company (MTC) owns Milo House. On 1 January 2012 management announced the intention to sell Milo House, and immediately began to market the property. Economic problems have depressed the property market, and there was a lack of interest from potential purchasers.

Milo House was occupied as MTC's head office until 1 March 2012, when the head office function relocated to a new building. Management then began to consider making changes to the property to make it more saleable. After conducting a feasibility study management decided to extend Milo House and redesign the interior in order to attract buyers. This work will affect the amount at which Milo House is offered for sale.

Construction work began on 1 May 2012 and was completed on 1 August 2012. During the period of the construction Milo House remained on the market.

MTC has a financial year ended 30 September 2012. Management is confident that a buyer will purchase Milo House before 1 March 2013 as several buyers have expressed an interest in the property since the construction work was finished.

Required:

(i) **Discuss the accounting treatment for the change in use of a property classified as property, plant and equipment to a property classified as held for sale, and determine when a change in classification occurs for Milo House, analysing the situation at each critical date.**

(ii) **Outline how Milo House should be recognised in MTC's financial statements at 30 September 2012.**

Discussion points

Property related standards – Change in use / classification of a property

Case Study 2 – MTC

What are the issues?

MTC owns a head office which it occupied until 1 March 2012. The issues to be considered are:

1. Whether vacating the property causes it to have a change in use
2. How to apply criteria for classifying a property as held for sale
3. The accounting treatment on reclassification of a property as held for sale

Which accounting standards should be used?

HKAS 16 *Property, plant and equipment*

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

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.

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

A non-current asset (or disposal group) should be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

In order for this to be the case:

(a) the asset must be available for immediate sale in its present condition, and

(b) its sale must be highly probable (ie, significantly more likely than not).

(HKFRS 5 paragraph 6-7, LP chapter 4 section 2)

For an asset to qualify as being held for sale, the sale must be 'highly probable'. The following must apply:

(a) Management must be committed to a plan to sell the asset.

(b) There must be an active programme to locate a buyer.

(c) The asset must be actively marketed for sale at a price that is reasonable in relation to its current fair value.

(d) The sale should be expected to take place within one year from the date of classification.

(e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

(HKFRS 5 paragraph 8, LP chapter 4 section 2.1)

Once classified as held for sale (or part of a disposal group held for sale), a non-current asset is not depreciated or amortised.

On subsequent measurement of a disposal group, the carrying amount of those assets which are part of the disposal group but individually outside the scope of HKFRS 5 should be re-measured in accordance with the relevant HKFRS before the fair value less costs to sell of the disposal group is re-measured.

(HKFRS 5 paragraph 19, LP chapter 4 section 3.2)

Separate classifications are to be presented in the statement of financial position for non-current assets and disposal groups using the following presentation rules:

(a) Assets and liabilities held for sale should not be offset.

(b) The major classes of assets and liabilities held for sale should be separately disclosed either in the statement of financial position or in the notes.

(HKFRS 5 paragraph 38, LP chapter 4 section 4.1)

How to apply the standards to the case

(i) **Accounting treatment for the change in use of a property classified as property, plant and equipment to a property classified as held for sale**

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 a non-current asset held for sale when the criteria of HKFRS 5 have been met. These criteria state that the asset must be available for immediate sale in its present condition, and its sale must be highly probable. For the sale to be considered highly probable various conditions must be met, including that the property is likely to be sold within 12 months, that changes are not likely to occur to the sale plan, and the property is actively marketed. These criteria and conditions are now considered for Milo House according to the dates given in the case study to determine when a change in classification to held for sale occurs:

1 January 2012

At this date management announced its intention to sell Milo House and began to market the property, which may indicate that the property is held for sale. However, for two reasons Milo House is not held for sale at this point:

- Milo House is still occupied by MTC, and the owner-occupation precludes the property from being available for immediate sale in its present condition. If MTC can move out immediately, it could be argued that the property is available for sale. However, such an argument is precluded by the point below.
- There is a lack of interest in the property from potential buyers, indicating that the sale is not highly probable

Therefore the held for sale criteria have not yet been met and Milo House must still be recognised as Property, plant and equipment.

1 March 2012

At this date Milo House is vacated by MTC, so it ceases to be owner occupied. The property is being actively marketed, but it still cannot be classified as held for sale for the following reason. Management conducts a feasibility study into making changes to the property to make it more saleable, involving a change in the sale price of the property. One of the conditions of a highly probable sale is that significant changes are unlikely to be made to the sale plan. This condition clearly has not been met given management's change to the actual asset being sold and to its sale price, so the property cannot be classified as held for sale.

1 May 2012

At this date construction work begins on Milo House. This means that the asset is not available for sale in its immediate condition, as any purchaser would have to wait until construction were complete before completing the purchase of the property.

1 August 2012

At this date construction is complete and all of the HKFRS 5 criteria for classification as held for sale have been met as the property is now ready for immediate sale, and it appears that the sale is highly probable given that several buyers have expressed an interest in Milo House. One of the conditions of a highly probable sale is that it is expected to be complete within 12 months of the date of classification as held for sale. Management consider that the sale will be complete by 1 March 2013, which is 7 months after 1 August 2012.

Therefore on 1 August 2012, Milo House should be reclassified out of property, plant and equipment and into non-current assets held for sale.

(ii) **Outline the accounting treatment for Milo House at 30 September 2012**

While Milo House is classified as property, plant and equipment, it should be measured at cost or revaluation according to HKAS 16 and depreciated over its estimated useful life.

On reclassification as held for sale HKFRS 5 requires an asset to be measured at the lower of its carrying value and fair value less costs to sell. Therefore on 1 August 2012, management must conduct an impairment review on Milo House, to determine if the fair value less costs to sell is less than carrying value.

From 1 August to the year end 30 September 2012, Milo House is not depreciated.

In the statement of financial position at 30 September 2012 Milo House should be separately presented from other non-current assets and identified clearly as a non-current asset held for sale.

Recommendation / Justification

MTC recognises Milo House as property, plant and equipment in accordance with HKAS 16 until 1 August 2012, at which point the property is reclassified as a non-current asset held for sale.

It is transferred between categories at the lower of carrying value and fair value less costs to sell, and depreciation is not charged after the reclassification.

In the statement of financial position at 30 September 2012, there should be separate presentation of non-current assets held for sale.

Key learning points

If there is a lack of interest from buyers then the asset cannot be considered as held for sale because the sale is not highly probable

Potential changes to the plan to sell an asset, including changes in the selling price mean that the highly probable sale criteria have not been met

Assets cannot be classified as held for sale until they are complete and available for immediate sale

Property related standards – measurement

Case study 2 continued

Continuing the previous case study on the change in use and reclassification of Milo House, the following information is relevant to the measurement of the property in MTC's financial statements for the year ended 30 September 2012.

Milo House was recognised as Property, plant and equipment at a carrying value of HK$50 million at 1 October 2011. MTC does not revalue properties, and the carrying value comprises the original cost of HK$120 million less accumulated depreciation of HK$70 million. Milo House is depreciated on a straight line basis over 30 years.

The construction costs incurred to make Milo House more saleable amounted to HK$ 15 million. Construction began on 1 May 2012 and ceased on 1 August 2012, when Milo House was reclassified as a non-current asset held for sale. To help finance the construction, MTC took out a loan on 1 March 2012, for HK$10 million. The loan carries an interest rate of 4%, with interest payable annually in arrears.

On 1 August 2012, an external valuer was used to determine that the fair value less costs to sell of Milo House was HK$65 million at that date. Due to continued economic recession causing further depression in the property market, on 30 September 2012 the fair value less costs to sell was determined to be HK$60 million. Despite the recession, management is confident that Milo House will be sold at the new, lower selling price.

Required:

(i) Determine the carrying value to be recognised in respect of Milo House on its reclassification as a non-current asset held for sale.

(ii) Discuss whether any adjustment is needed to the carrying value of Milo House at 30 September 2012.

(iii) Draft relevant extracts from the financial statements as at 30 September 2012.

Discussion points

Property related standards – measurement

Case Study 2 – MTC (continued)

What are the issues?

MTC owns a head office which is reclassified from property, plant and equipment to non-current assets held for sale during the year ended 30 September 2012. The property undergoes some construction work prior to the reclassification and borrowing costs are incurred. The relevant issues are:

1. The amount at which the head office is recognised as property, plant and equipment immediately prior to its reclassification.
2. The application of capitalisation rules to borrowing costs incurred.
3. The measurement of the property on its classification as non-current assets held for sale, and subsequent to the classification.
4. The extent of disclosures required in the financial statements.

Which accounting standards should be used?

HKAS 23 *Borrowing costs*

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

What are the requirements of the accounting standards?

HKAS 23 – Borrowing costs

Definitions

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

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

Borrowing costs may include interest expense calculated using the effective interest method as described in HKAS 39 *Financial Instruments: Recognition and Measurement.*

(HKAS 23 paragraphs 5-6, LP chapter 17 section 1.1)

Eligibility of borrowing costs for capitalisation

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

(HKAS 23 paragraph 8, LP chapter 17 section 1.2)

To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset.

(HKAS 23 paragraph 14, LP chapter 17 section 1.2.1)

An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

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

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

(HKAS 23 paragraph 22, LP chapter 17 section 1.2.5)

Disclosure requirements

The following should be disclosed in the financial statements in relation to borrowing costs:

(a) Amount of borrowing costs capitalised during the period.

(b) Capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

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

HKFRS 5 - Measurement of a non-current asset held for sale

An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

The carrying amount is that amount at which the asset or disposal group would have been included in the financial statements had the classification to the held for sale category not occurred. This carrying amount is measured in accordance with applicable HKFRS.

Fair value less costs to sell is equivalent to net realisable value.

(HKFRS 5 paragraph 15, LP chapter 4 section 3.1)

Once classified as held for sale (or part of a disposal group held for sale), a non-current asset is not depreciated or amortised.

(HKFRS 5 paragraph 19, LP chapter 4 section 3.2)

Separate classifications are to be presented in the statement of financial position for non-current assets and disposal groups using the following presentation rules:

(a) Assets and liabilities held for sale should not be offset.

(b) The major classes of assets and liabilities held for sale should be separately disclosed either in the statement of financial position or in the notes.

(HKFRS 5 paragraph 38, LP chapter 4 section 4.1)

Regarding impairment subsequent to classification as assets held for sale, assets held for sale are outside the scope of HKAS 36 and the guidance on impairments provided within HKFRS 5 applies instead.

Where fair value less costs to sell is lower than carrying amount, the asset or disposal group held for sale is impaired and the difference between carrying amount and fair value less costs to sell must be recognised as an impairment loss.

(HKFRS 5 paragraph 23, LP chapter 4 section 3.3)

The following disclosures are required when a non-current asset (or disposal group) is either classified as held for sale or sold during a reporting period:

(a) A description of the non-current asset (or disposal group)

(b) A description of the facts and circumstances of the disposal

(c) Any gain or loss recognised when the item was classified as held for sale

(d) If applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with HKFRS 8 *Operating Segments*

(HKFRS 5 paragraph 41, LP chapter 4 section 4.2)

How to apply the standards to the case

(i) **Carrying amount of Milo House on reclassification as held for sale**

There are two issues to consider in determining the carrying amount of Milo House at its reclassification on 1 August 2012. Firstly, prior to its classification as an asset held for sale, Milo House must be accounted for according to HKAS 16 with depreciation charged up to the point of reclassification. And secondly, the construction costs and relevant borrowing costs must be capitalised during the period of construction and redevelopment of the property. The resulting value must then be compared with the fair value less costs to sell to determine the amount to be recognised on reclassification.

Depreciation to 1 August 2012

The carrying value of Milo House at the start of the accounting period is HK$ 50 million. Depreciation should be charged based on the policy as given in the case study i.e. on a straight line basis over 30 years, pro rata until 1 August 2012, calculated as follows:

Working 1	**HK$'000**
Carrying value 1 October 2011	50,000
Depreciation 10 months to 1 August 2012:	
120 million / 30 years × 10/12	(3,333)
Carrying value 1 August 2012	**46,667**

Capitalisation of construction and borrowing costs

The construction costs are directly attributable to Milo House and therefore must be capitalised, increasing the carrying value of the property by HK$ 15 million.

In addition, the directly attributable borrowing costs must also be capitalised. HKAS 23 states that borrowing costs are directly attributable where they have been incurred for the purpose of obtaining a qualifying asset. Milo House is a qualifying asset, and the interest incurred during the period of construction should be capitalised.

HKAS 23 contains strict criteria relating to the period of capitalisation. In particular, capitalisation of borrowing costs can only commence when expenditure is incurred for the asset, borrowing costs are incurred, and activities begin that are necessary to prepare the asset for its intended use or sale.

In the case of Milo House the loan is taken out on 1 March, and borrowing costs are incurred from that date. However, construction activities do not commence until 1 May, so borrowing costs cannot be capitalised until the later date. Borrowing costs cease to be capitalised when the asset is ready for use in the manner intended by management. In the case of Milo House this is 1 August, when construction ceases and the property becomes classified as held for sale.

Therefore borrowing costs should be capitalised for the three month period 1 May to 1 August, the amount calculated being as follows:

Working 2

HK$ 10 million × 4% × 3/12 = HK$ 100,000

The rest of the borrowing costs incurred in the financial year should be expensed. This amounts to:

HK$ 10 million × 4% × 4/12 = HK$ 133,333 (interest accruing for March, April, August and September)

Therefore the total carrying amount of Milo House at 1 August 2012 is:

	HK$'000
Carrying value per working 1 above	46,667
Add: construction costs	15,000
Add: borrowing costs	100
	61,767

Reclassification as asset held for sale

On reclassification as a non-current asset held for sale, HKFRS 5 requires that the asset is measured at the lower of carrying value and fair value less costs to sell.

For Milo House, the carrying value as calculated above is HK$ 61.767 million at the date of reclassification. An external valuer estimates the fair value less costs to sell to be HK$ 65 million. Therefore Milo House should be recognised at its carrying value of HK$ 61.767 million at the point of reclassification.

(ii) **Amount to be recognised at 30 September 2012**

From 1 August to the year end 30 September 2012, Milo House is not depreciated. This is according to HKFRS 5 which requires that depreciation is not charged on assets classified as held for sale.

The only issue to consider is that Milo House is impaired at the year end. This is because the fair value less costs to sell has fallen to HK$ 60 million by 30 September 2012, which is below the carrying value of the property, which is HK$ 61.767 million as calculated above. HKFRS 5 requires that assets are written down to fair value less costs to sell when this falls below the carrying value of the asset.

Therefore an impairment loss of HK$ 1.767 million must be recognised to reduce the value of Milo House. This will be charged to profit as an operating expense.

In the statement of financial position at 30 September 2012 Milo House should be separately presented from other non-current assets and identified clearly as a non-current asset held for sale.

Recommendation / Justification

(iii) **Extract from MTC's financial statements at 30 September 2012**

Statement of financial position		**HK$'000**
Non-current assets held for sale		60,000
Statement of profit and loss		
Operating expenses:	depreciation (working 1)	3,333
	impairment loss	1,767
Finance costs	(working 2)	133

Disclosure note to financial statements

In the period 1 May to 1 August 2012, construction work on Milo House was carried out using loan finance of HK$ 10 million. During the period of construction directly attributable finance costs with a value of HK$ 100,000 were capitalised into the cost of Milo House. This was calculated using the effective rate of interest of 4% applied to the loan during the period eligible for capitalisation.

On 1 August 2012 Milo House, which used to be MTC's head office but is now vacant and available for sale, was reclassified as a non-current asset held for sale. The property is being actively marketed and a sale is expected within 12 months. No gain or loss was recognised on the reclassification, but an impairment loss of HK$ 1.767 million was recognised at 30 September 2012.

Journal entries

		HK$'000	HK$'000
	Depreciation to 1 August:		
DEBIT	Operating expenses	3,333	
CREDIT	Accumulated depreciation		3,333
	Capitalisation of construction costs:		
DEBIT	Property, plant and equipment	15,000	
CREDIT	Cash		15,000
	Borrowing costs:		
DEBIT	Property, plant and equipment	100	
DEBIT	Finance costs	133	
CREDIT	Interest payable		233
	Reclassification of property:		
DEBIT	Asset held for sale	61,767	
CREDIT	Property, plant and equipment		61,767
	Impairment of asset held for sale:		
DEBIT	Operating expenses	1,767	
CREDIT	Asset held for sale		1,767

Key learning points

1. *Borrowing costs must only be capitalised once activities are being undertaken on a qualifying asset. If the finance is taken out prior to activities taking place, the borrowing cost incurred prior to activities taking place must be expensed.*
2. *Borrowing costs must cease to be capitalised once the qualifying asset is ready for use in the manner intended by management.*
3. *Prior to classification as asset held for sale, an asset is treated in accordance with the applicable accounting standard, usually HKAS 16, with depreciation charged up to the point of reclassification.*
4. *After classification as asset held for sale, depreciation is not charged on the asset.*
5. *On reclassification an impairment loss is recognised if the fair value less costs to sell is less than the carrying value of the asset.*
6. *The value of the asset should also be considered at the year end, and an impairment loss recognised at that point if necessary.*

Resolving accounting issues

Case study 1

The Hong Kong Toy Company (HKT) manufactures and sells toys and games throughout the world. Its administration and distribution functions operate from a small head office property owned by HKT, whilst its manufacturing base is a rented factory.

The finance department of HKT is currently preparing the company's financial statements for the year ended 30 September 2012, and the deferred tax treatment of a number of items remains outstanding:

1. At 30 September 2012 it was decided to increase the general provision for doubtful debts from HK$152,000 to HK$195,000. At the same time, management noted that a particular customer was experiencing trading difficulties, and as a result a specific provision was created for 50% of that customer's HK$256,000 outstanding balance. These provisions have been accounted for correctly and appear in the year end statement of financial position.
2. HKT has been required to pay a penalty fee of HK$80,000 in respect of the late filing of its annual return with the Companies Registry. This amount has been charged as an expense within 'Administration expenses' in the statement of comprehensive income.
3. HKT's head office cost HK$6.5 million to construct four years ago (excluding land). It is being depreciated over 50 years and has a carrying value at 30 September 2012 of HK$5.98m.
4. HKT own approximately half of the machines used in manufacturing toys to sell and lease the remainder under operating leases. The owned machines cost HK$958,000 when purchased (including HK$82,000 for machinery purchased in the year ended 30 September 2012) and have a carrying value at 30 September 2012 of HK$734,900.

The tax treatment of these items is as follows:

- Tax relief is given on the expense associated with a general provision for doubtful debts only when a debt becomes bad; tax relief is given on the expense associated with a specific provision for doubtful debts when the provision is made.
- Penalty fees are never allowable for tax purposes.
- Commercial buildings benefit from a 4% annual tax allowance on the non-land element of the cost.
- Plant and machinery benefits from a 60% initial allowance in the year of purchase and a 20% allowance thereafter applied using the reducing balance method.

The deferred tax liability at 30 September 2011 was HK$121,503.

The tax computation prepared by HKT's tax department is provided as an appendix.

Required:

(i) What deferred tax position should be reflected in the statement of financial position at the 30 September 2012 year end, and what is the tax charge in profit or loss for the year then ended?

(ii) Draft the tax reconciliation to be disclosed in the financial statements. You should refer to your pre-workshop research into the tax disclosures of listed companies.

(iii) List the other disclosure requirements of HKAS 12 in relation to deferred tax.

Tax computation – HKT year ended 30 September 2012 DRAFT

	HK$	HK$
Accounting profit before tax		3,340,000
Disallowable expenditure		
Depreciation – Lead office property	130,000	
Depreciation – plant and machinery	47,900	
Increase in general provision for doubtful debts	43,000	
Penalty fee	80,000	
		300,900
Capital allowances (see below)		
Head office		(260,000)
Machinery		(85,081)
Taxable profits		3,295,819
Taxed at 16%		527,331

Capital allowances – head office

	HK$
TWDV b/f	5,720,000
4% annual allowance	(260,000)
TWDV c/f	5,460,000
Qualifying cost b/f and c/f	6,500,000

Capital allowances – machinery

	HK$	HK$	Allowances HK$
TWDV b/f		179,405	
Additions	82,000		
Initial allowance (60%)	(49,200)		49,200
Annual allowance (20%)		(35,881)	35,881
TWDV of additions c/f		32,800	
TWDV c/f		176,324	85,081

Discussion points

Resolving accounting issues – Deferred tax

Case Study 1 – HKT

In the case of the latter, students must compare the tax base and carrying value of each item in turn in order to find the temporary difference and so deferred tax amount.

As well as calculating amounts to be recognised in the financial statements, students are required to provide a tax reconciliation. A requirement of the pre-workshop material was to research tax reconciliation disclosures by listed companies in Hong Kong. Before dealing with this part of the requirement, you should ensure that all students have researched the disclosure and discuss their findings.

What are the issues?

The Hong Kong Toy Company (HKT) manufactures and sells toys and games throughout the world. It operates from a rented factory and owns its head office. The following issues must be considered:

1. Which of the matters is deferred tax relevant to?
2. How is deferred tax calculated in relation to the general provision for doubtful debts?
3. How is deferred tax calculated in relation to the head office?
4. How is deferred tax calculated in relation to the machinery?
5. What amounts are reported in the financial statements in respect of deferred tax?
6. How should the tax reconciliation appear in the financial statements?
7. What disclosures are required in respect of deferred tax?

Which accounting standards should be used?

HKAS 12 *Income Taxes*

What are the requirements of the accounting standards?

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 deductible temporary differences. Temporary differences are differences between the carrying value of an item and its tax base. The tax base of an item is the amount attributable to that item for tax purposes. Taxable temporary differences are those which result in taxable amounts in future periods; deductible temporary differences are those which result in amounts which are deductible in future periods.

(HKAS 12.5 , LP Chapter 15 Section 2)

A deferred tax liability must be recognised for all taxable temporary differences, except to the extent that it arises from the initial recognition of goodwill or the initial recognition of an item in a transaction which is not a business combination and does not affect accounting or taxable profits at the time of the transaction.

(HKAS 12.15 , LP Chapter 15 Section 3)

A deferred tax asset must 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 is not a business combination and at the time of the transaction affects neither accounting nor taxable profits.

(HKAS 12.24 , LP Chapter 15 Section 4)

Deferred tax assets and liabilities should 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 end of the reporting period.

(HKAS 12.47 , LP Chapter 15 Section 5.2)

Deferred tax is recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from transactions recognised in other comprehensive income or directly in equity or a business combination.

(HKAS 12.58 , LP Chapter 15 Section 6)

An entity should 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.

(HKAS 12.74 , LP Chapter 15 Section 7)

How to apply the standard to the case

(a) **General provision for doubtful debts**

The question states that tax relief is not provided on the expense associated with an increase in the general provision for doubtful debts when that provision is made. Therefore the tax base of the general provision is nil.

	HK$
Tax base	Nil
Carrying value	(195,000)
Temporary difference	195,000

As the carrying value is less than the tax base, this is a deductible temporary difference and results in a deferred tax asset of HK$31,200 (16% x HK$195,000).

Specific provision for doubtful debts

The question states that tax relief is provided on the expense associated with an increase in the specific provision for doubtful debts when the provision is made. Therefore the tax and accounting treatment of this item are the same and there is no deferred tax impact.

Penalty fee

The penalty fee will never be an allowable expense for tax purposes, and it is therefore treated as a permanent difference. There is no deferred tax impact of permanent differences.

Head office

Deferred tax arises on the construction cost of the head office. The temporary difference at 30 September 2012 is calculated as:

	HK$
Tax base (T.W.D.V in appendix to case study)	5,460,000
Carrying value (case study)	5,980,000
Temporary difference	520,000

As the carrying value is more than the tax base, this is a taxable temporary difference and results in a deferred tax liability of HK$83,200 (16% x HK$520,000).

Machinery

Again the temporary difference is calculated as the difference between the tax base and carrying value of the machinery:

	HK$
Tax base (T.W.D.V in appendix to case study)	176,324
Carrying value (case study)	734,900
Temporary difference	558,576

As the carrying value is more than the tax base, this is a taxable temporary difference and results in a deferred tax liability of HK$89,372 (16% x HK$558,576).

Summary

All of the elements of deferred tax relate to the same jurisdiction (Hong Kong), and it is assumed that there is a right to set off the asset and liability. Therefore the net deferred tax liability at the year end is:

	HK$
General provision for doubtful debts	(31,200)
Head office	83,200
Machinery	89,372
	141,372

The net provision has therefore increased by HK$19,869 (141,372 – 121,503). This is recognised in profit or loss for the period.

Recommendation / Justification

The following journal records the movement in deferred tax provision for the year ended 30 September 2012 (HK$):

DEBIT	Tax charge	19,869	
CREDIT	Deferred tax liability		19,869

Statement of financial position for HKT as at 30 September

	2012	**2011**
	HK$	HK$
Deferred tax liability	141,372	121,503

Statement of comprehensive income for HKT for the year ended 30 September 2012

	HK$
Income tax charge	
Tax on profits for the year	527,331
Deferred tax	19,869
	547,200

(b) Reconciliation between tax expense and accounting profit at applicable tax rate

	HK$
Profit before tax	3,340,000
Notional tax at the domestic income tax rate of 16%	534,400
Tax effect of expenses that are not deductible in determining taxable profit:	
Penalty fee (80,000 × 16%)	12,800
Actual tax expense	547,200

The reconciliation may also be presented as a numerical reconciliation between the average effective tax rate and the applicable tax rate:

	%
Applicable tax rate	16.00
Tax effect of expenses that are not deductible for tax purposes:	
Penalty fee (12,800/3,340,000 × 100%)	0.38
Average effective tax rate	16.38

HKAS 12 disclosure requirements

HKAS 12 requires HKT to make the following disclosures in relation to income taxes:

1. The major components of the tax expense, including:
   - The current tax expense
   - The deferred tax expense (income) relating to the origin and reversal of temporary differences
2. An explanation of the relationship between the tax expense and accounting profit.
3. In respect of each type of temporary difference:
   - The amount of deferred tax assets and liabilities recognised in the statement of financial position for each period presented, and
   - The amount of deferred tax income or expense recognised in profit or loss.

Key learning points

1. *Deferred tax arises in relation to temporary differences. There is no deferred tax impact where the accounting treatment and tax treatment of an item are identical or in relation to permanent differences (accounting income or expense items which are never taxable / tax allowable).*
2. *A temporary difference is calculated as the difference between the tax base and carrying value of an item.*
3. *A deferred tax amount is calculated by applying the relevant tax rate to a temporary difference. Tax rates which have been enacted or substantively enacted by the period end should be applied.*
4. *Deferred tax liabilities arise in relation to taxable temporary differences; deferred tax assets arise in relation to deductible temporary differences.*
5. *A tax reconciliation shows the relationship between the tax expense and accounting profit.*

Resolving accounting issues

Case study 2

Homeland Jewels Company (HJC) designs and manufactures items of fashion jewellery which are sold under a consignment stock arrangement with external vendors. Under the terms of the arrangement HJC retains legal title to the jewellery until the external vendor has made a sale to a customer. The price at which the external vendors can sell the items of jewellery to customers is determined by HJC and cannot be changed by the vendors unless prior approval is obtained from HJC.

The external vendors hold the items of jewellery for 6 months, after which time they can return any unsold items to HJC.

At 30 September 2012, items with a cost of HK$500,000 are held at external vendors.

In October 2012 external vendors returned items to HJC with a cost of HK$75,000, which were items they had been unable to sell in the previous six months. HJC determines that three quarters of these items can be re-designed and converted into items with an estimated selling price of HK$60,000. The cost of this conversion will be HK$10,000. The remaining one quarter of the returned items will be scrapped.

Required:

(i) Discuss the accounting treatment of the consignment stock arrangement in HJC's financial statements.

(ii) Determine the amount of inventory to be recognised in the financial statements of HJC for the year ended 30 September 2012.

Discussion points

Resolving accounting issues – Consignment stock arrangement and inventory valuation

Case Study 2 – HJC

What are the issues?

HJC has a consignment stock arrangement in place for its jewellery. The goods can be returned if they remain unsold, and HJC retains the right to determine the selling price of the goods. The key issues to consider are:

1. The application of sale of goods criteria to the consignment stock arrangement
2. Whether the goods should be recognised in inventory of HJC or the external vendors
3. How the items of inventory should be measured at the year-end given that some are obsolete

Which accounting standards should be used?

HKAS 2 *Inventories*

HKAS 18 *Revenue*

What are the requirements of the accounting standards?

Recognition of revenue

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

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

(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 measured reliably.

(HKAS 18 paragraph 14, LP chapter 14 section 2.5)

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. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

(b) 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;

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

(HKAS 18 paragraph 16, LP chapter 14 section 2.5.1)

Measurement of inventory

Inventories shall be measured at the lower of cost and net realisable value.

(HKAS 2 paragraph 9, LP chapter 10 section 1)

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

(HKAS 2 paragraph 6, LP chapter 10 section 1)

How to apply the standards to the case

(i) **Accounting treatment for the consignment stock arrangement**

When accounting for the consignment stock arrangement, the sale of goods criteria from HKAS 18 must be applied in order to determine whether HJC has the right to recognise the revenue, and to derecognise the inventory. HKAS 18 states that five criteria, known as the "sale of goods criteria" must be met for revenue to be recognised. In this case, the first two criteria are the most significant.

Risk and reward

The first of the criteria relates to risk and reward. The terms of the consignment stock arrangement must be analysed to determine whether HJC has transferred the risks and rewards of ownership of the goods. In this case, HJC retains the legal title to the inventory, but this is irrelevant in determining whether the risks and rewards have passed. Instead, the substance of the arrangement should be considered.

The main risk factor in this scenario is the potential for goods to be obsolete. The goods are fashion items, so there is great potential for goods to become quickly obsolete. In the consignment stock arrangement, HJC bears the obsolescence risk as any items unsold after six months can be returned by the external vendors, leaving HJC to bear the cost of any conversion or write off of obsolete items.

Continued managerial involvement

The second of the criteria deals with whether HJC continues to have managerial involvement over the goods. In this case, HJC determines the selling price of the goods and has to approve any changes to the selling price of the goods when they are held by external vendors. This indicates that HJC retains control over the revenue stream of the goods, and therefore continues to control the reward or benefit of the goods.

The conclusion therefore is that the sale of goods criteria have not been met, and HJC cannot recognise revenue at the point at which goods are despatched to external vendors under the consignment stock arrangement. The goods must therefore remain recognised as inventory of HJC, until such time as they are sold by the external vendor to a customer, at which point legal title passes to the customer, and the sale of goods criteria have been met.

Conclusion

Therefore at the year-end, before dealing with the obsolete goods, HJC's statement of financial position would include inventory at cost of HK$ 500,000.

(ii) **Measurement of inventory**

At 30 September 2012, goods with a cost price of HK$ 500,000 are held at external vendors. As discussed above, these must remain in inventory of HJC.

After the year end, goods with a cost of HK$ 75,000 are returned to HJC. These goods are obsolete, and HJC must determine the value of these goods to be recognised at the year-end. This is an adjusting event according to HKAS 10, as the return of the goods indicates that they were overvalued at the year-end.

HKAS 2 *Inventories* states that goods must be measured at the lower of cost and net realisable value. The returned goods had a cost of HK$ 75,000 and this amount needs to be analysed in two parts:

1. One quarter of the returned goods, with a cost of HK$ 18,750 will be scrapped. The realisable value therefore is nil, and the amount must be written off in full.
2. Three quarters of the returned goods, with a cost of HK$ 56,250 can be converted into new goods, and therefore have a realisable value. The net realisable value is calculated as the estimated selling price of an item of inventory less estimated costs to complete and sell it. Therefore the net realisable value for these goods is:

	HK$
Estimated selling price	60,000
Less: costs to convert	(10,000)
	50,000

The inventory therefore needs to be written down by HK$ 6,250 (HK$ 56,250 - 50,000).

The total value of inventory recognised in HJC's statement of financial position is therefore measured as HK$ 475,000 (HK$500,000 – 18,750 – 6,250).

The amount written off the inventory of HK$ 25,000 (18,750 + 6,250) is recognised within the statement of profit or loss, and would be classified as cost of sales, therefore reducing gross profit by HK$ 25,000.

Recommendation / Justification

HJC recognises the following in its individual financial statements as at 30 September 2012:

Statement of financial position	**HK$**
Current assets	
Inventory	475,000
Statement of profit or loss	
Inventory write off - included in cost of sales	25,000

The journal to effect the write off is (HK$):

DEBIT	Cost of sales	25,000	
CREDIT	Inventory		25,000

Key learning points

1. *The sale of goods criteria must be applied to determine the point at which revenue can be recognised, and inventory derecognised.*

2. *HKAS 18 uses the concept of substance over form to ensure that revenue is only recognised where risks and rewards of goods have been transferred.*

3. *Inventories are measured at the lower of cost and net realisable value. Material expenses incurred in a write off should be separately disclosed according to HKAS 1.*

Resolving accounting issues

Case study 3

Hanson Collins Simpson (HCS) is a pharmaceutical company which is engaged in research and development projects on an ongoing basis in order to retain its competitive position in the market.

When HCS first develops a drug, prior to clinical testing and receiving regulatory approval, it registers a 20 year patent over the formula. This patent protects the formula for 20 years after patent registration, however after this period, the formula is no longer protected and competitors will be able to produce and market their own generic copies of the treatments. When patent protection is lost the revenues associated with a specific drug reduce dramatically. Treatments cannot be launched to market without receiving regulatory approval.

Management assess the useful life of a drug to be equal to the period for which it is protected by patent.

The company currently has a number of projects in the research phase, and in accordance with the requirements of HKAS 38, has written off all expenses associated with these to profit or loss. It also has one development project which was concluded in the year ended 30 September 2012 with the launch of 'Ardomol'.

Ardomol

The project to develop a treatment 'Ardomol' for type 1 diabetes commenced on 1 November 2009, with milestones met as follows:

31 January 2010	Management are assured of the technical feasibility of completing the project and as a result commit to providing continuing funding and other support to see the project to completion.
1 April 2010	Patent is registered
1 November 2010	Clinical trials commence to test the new drug
15 January 2012	Clinical trials are successfully concluded and HCS applies for regulatory approval for the new treatment.
1 June 2012	Ardomol receives regulatory approval for the new drug.
1 October 2012	Ardomol is launched to market, with an expected revenue generating life of up to 20 years.

Costs have been incurred in relation to this project as follows:

y/e 30 September 2010	HK$2,840,000
y/e 30 September 2011	HK$12,670,000
y/e 30 September 2012	HK$16,760,000

With the exception of HK$1,260,000 marketing and promotional costs incurred in the last quarter of the year ended 30 September 2012 (included in the above amount), all costs have accrued evenly over the relevant reporting period.

Although the HCS financial controller expensed all Ardomol costs in the years ended 30 September 2010 and 2011, she is unsure how to treat the costs incurred in the year ended 30 September 2012 and as a result has capitalised all of them.

Year end management accounts reveal that the projected future cash flows associated with Ardomol, discounted to present value amount to HK$10,430,000, and management assess that a competitor would pay a similar amount to acquire the patent rights to the drug.

Ranicillin

In addition, HCS completed development of 'Ranicillin', a drug available on prescription to treat inflammatory diseases in the year ended 30 September 2009. The drug had been patented on 1 October 2007 and was launched to market on 1 October 2009, at which date capitalised costs amounted to HK$17,316,000. The revenue generating life of the drug was assessed to be equal to the remaining life of the patent.

In the year ended 30 September 2012, a competitor launched a rival drug which treats the same condition. As a result, Ranicillin has lost market share. At 30 September 2012 the discounted future cash flows associated with Ranicillin were calculated to be HK$13,250,000. Management have estimated that if they were to sell the rights to Ranicillin, they would achieve a price of HK$13,600,000, but would incur HK$500,000 in legal costs associated with the sale and transfer of the patent.

Required:

(a) Calculate the amounts to be included in the financial statements for the year ended 30 September 2012 in respect of the Ardomol development project and the Ranicillin asset.

(b) List the necessary disclosures in relation to the intangible assets and impairment.

Discussion points

Resolving accounting issues – Intangibles and impairment

Case Study 3 – HCS

What are the issues?

Hanson Collins Simpson (HCS) is a pharmaceutical company which is engaged in a number of research projects as well as a project to develop a new treatment for type 1 diabetes. Details of the development project are provided together with information about a completed development project and associated capitalised costs. The issues which must be considered are:

(a) At what stage should the development costs associated with the Ardomol project be capitalised?

(b) How much of the development costs associated with the Ardomol project should be capitalised?

(c) What is the subsequent accounting treatment of Ardomol?

(d) Is an impairment test required in respect of the Ranicillin development costs?

(e) What is the recoverable amount of Ranicillin?

(f) What amount is reported in the financial statements in respect of Ranicillin?

(g) What disclosures are required in respect of the intangible assets and impairment?

Which accounting standards should be used?

HKAS 36 *Impairment of assets*

HKAS 38 *Intangible assets*

What are the requirements of the accounting standards?

The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

1. the definition of an intangible asset
2. the recognition criteria

(HKAS 38.18 , LP Chapter 8 Section 1)

An intangible asset is an identifiable non-monetary asset without physical substance. An asset is identifiable if it is separable (capable of separate sale) or arises from contractual or other legal rights.

(HKAS 38.8,12 , LP Chapter 8 Section 1.3)

An intangible asset is recognised only if:

1. it is probable that the expected future economic benefits associated with the asset will flow to the entity, and
2. the cost of the asset can be measured reliably.

(HKAS 38.21 , LP Chapter 8 Section 1.4)

An intangible asset is initially measured at cost.

(HKAS 38.24 , LP Chapter 8 Section 1.5)

To assess whether an internally generated intangible asset meets the criteria for recognition, an entity should classify it as either research or development.

(HKAS 38.52 , LP Chapter 8 Section 2)

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge or understanding. Expenditure on research should be recognised as an expense when incurred.

(HKAS 38.8,54 , LP Chapter 8 Section 2.1,2.2)

Development is the application of research findings to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use. Development costs are recognised as an intangible asset only where all of the following are demonstrated:

(a) the technical feasibility of completing the intangible asset so that it will be available for sale

(b) an intention to complete the intangible asset and sell it

(c) how the intangible asset will generate probable future economic benefits

(d) the availability of technical, financial and other resources to complete the development and sell the intangible asset

(d) the ability to measure reliably the development costs of the intangible asset.

(HKAS 38.8,57 , LP Chapter 8 Section 2.1,2.2)

The cost of an internally generated intangible asset is the sum of expenditure incurred from the date that the recognition criteria were first met. The reinstatement of expenditure previously recognised as an expense is not allowed.

(HKAS 38.65,71 , LP Chapter 8 Section 2.3)

The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and general overhead expenditure unless it can be directly attributed to preparing the asset for use

(b) inefficiencies and operating losses incurred before the asset achieves planned performance

(c) expenditure on staff training to operate the asset.

(HKAS 38.67 , LP Chapter 8 Section 2.4)

Expenditure on an intangible asset is recognised as an expense when incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.

(HKAS 38.68 , LP Chapter 8 Section 2.4)

After recognition, an intangible asset held under the cost model is carried at cost less accumulated depreciation less accumulated impairment.

(HKAS 38.74 , LP Chapter 8 Section 2.5)

An intangible asset which has a finite life is amortised over that life. Amortisation begins when the asset is available for use. The amortisation method used should reflect the pattern in which future economic benefits are expected to be consumed by the entity, or if that pattern cannot be determined reliably, the straight line method is used.

(HKAS 38.97 , LP Chapter 8 Section 2.6)

To determine whether an intangible asset is impaired, HKAS 36 should be applied.

(HKAS 38.111 , LP Chapter 8 Section 4)

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. Recoverable amount is the higher of fair value less costs of disposal and value in use. Value in use is the present value of the future cash flows expected to be derived from an asset.

(HKAS 36.6 , LP Chapter 8 Section 4.3)

An entity should assess at each period end whether there are indications that an asset is impaired, and if indications exist, the recoverable amount should be estimated. Irrespective of indications of impairment, any intangible asset not yet available for use should be tested for impairment annually. If such an intangible asset was initially recognised during the current annual period, that intangible asset must be tested for impairment before the end of the current annual period.

(HKAS 36.9,10 , LP Chapter 8 Section 4.4)

If the recoverable amount of an asset is less than the carrying amount, then the carrying amount is reduced to recoverable amount and an impairment loss is recognised. Where the asset is held under the cost model, the impairment loss is recognised in profit and loss.

(HKAS 36.59,60 , LP Chapter 8 Section 4.6)

After the recognition of an impairment loss, the amortisation charge for the asset is adjusted to allocate the revised carrying amount on a systematic basis over the remaining useful life.

(HKAS 36.63 , LP Chapter 8 Section 4.7)

How to apply the standards to the case

(a) ***Ardomol***

Ardomol is a development project, and in accordance with HKAS 38 all associated costs must be written off to profit or loss until such time as the recognition criteria are met. After this date, all associated costs must be capitalised.

The recognition criteria and date on which each is met are as follows:

(a)	Technically feasible	31 January 2010
(b)	Intention to complete	31 January 2010
(c)	Commercially viable – future economic benefits	1 June 2012
(d)	Resources available to complete	31 January 2010
(e)	Ability to reliably measure expenditure	Assumed to be from commencement, as costs are provided from this date.

The date on which all of the criteria are met is therefore 1 June 2012. This is the date on which regulatory approval is received. Until this date, even though the clinical trials were successful, HCS cannot be certain that Ardomol will be launched to market and so generate future economic benefits.

Therefore costs must be capitalised from 1 June 2012. Any costs incurred prior to this date are charged to profit or loss as an expense. Therefore the financial controller's treatment of the costs incurred in the years ended 30 September 2010 and 2011 is correct.

The financial controller is, however, incorrect to capitalise all costs in the year ended 30 September 2012. These costs must be pro-rated in order to establish what amount should be capitalised as an intangible asset and what amount should be expensed to profit or loss.

Firstly the HK$1.26 million marketing and promotional costs should be considered. HKAS 38 is clear that advertising and promotional costs do not form part of the cost of an intangible asset as they do not meet the criteria for recognition. These have been incorrectly capitalised and are therefore written off to profit or loss:

DEBIT	Marketing costs	1,260,000	
CREDIT	Development costs - Ardomol		1,260,000

The remaining HK$15.5 million (16.76m - 1.26m) is split between the period prior to 1 June 2012 and the period after this date:

1 October 2011 – 31 May 2012	15,500,000 × 8/12	HK$10,333,333
1 June 2012- 30 September 2012	15,500,000 × 4/12	HK$5,166,667

Costs incurred from 1 October 2011 to 31 May 2012 have been incorrectly capitalised and should be written off to profit or loss (HK$):

DEBIT	Development expenditure	10,333,333	
CREDIT	Development costs - Ardomol		10,333,333

Costs incurred from 1 June 2012 to 30 September 2012 have been capitalised by the financial controller and this is the correct treatment, meaning that at the year end the capitalised cost of the intangible asset 'Ardomol' is HK$5,166,667.

Amortisation of an intangible asset commences when the asset is 'available for use'. Development costs are 'available for use' when the product is launched to market. As Ardomol is launched to market on 1 October 2012, amortisation should commence on this date. Therefore no amortisation is charged in the year ended 30 September 2012.

As Ardomol is recognised as an intangible asset in the period, however is not available for use by the period end, HKAS 36 requires that it is tested for impairment. The recoverable amount is the higher of value in use and fair value less costs of disposal. In the case of Ardomol, both are HK$10.43million. This is considerably greater than the carrying amount of the asset and therefore no impairment has occurred.

Ranicillin

Ranicillin is recognised as an intangible asset in the statement of financial position based on the cost model. The useful life of the asset at product launch was 18 years – this being the remaining life of the patent protection, and therefore amortisation is calculated as HK$962,000 per annum (17,316,000/18years). Amortisation for the year ended 30 September 2012 is recognised by:

DEBIT	Amortisation expense	962,000	
CREDIT	Accumulated amortisation – Ranicillin		962,000

Therefore at 30 September 2012 (prior to the recognition of any impairment) the carrying amount is:

	HK$'000
Cost	17,316
Amortisation y/e 30 September 2010	(962)
Amortisation y/e 30 September 2011	(962)
Amortisation y/e 30 September 2012	(962)
Carrying amount	14,430

The recoverable amount of Ranicillin is the higher of its value in use and fair value less costs of disposal:

- Value in use HK$13,250,000
- Fair value less costs of disposal (13,600 – 500) HK$13,100,000

Therefore value in use of HK$13.25 million is the recoverable amount.

The recoverable amount is lower than the carrying amount at 30 September 2012, and therefore an impairment loss must be recognised. The loss of HK$1.18 million (14,430 – 13,250) is recognised in profit or loss in the year:

DEBIT	Impairment loss	1,180,000	
CREDIT	Development costs – Ranicillin		1,180,000

Therefore at the period end, the carrying amount of Ranicillin is equal to its value in use of HK$13.25 million.

Recommendation / Justification

Statement of financial position for HCS as at 30 September 2012

	HK$'000
Intangible assets	
Development costs - Ardomol	5,167
Development costs - Ranicillin	13,250

Statement of comprehensive income for HCS for the year ended 30 September 2012

	HK$000
Amortisation charge - Ranicillin	962
Impairment loss - Ranicillin	1,180

(b) **HKAS 38 disclosure requirements**

The following should be disclosed in respect of the capitalised development costs:

- useful lives
- amortisation methods applied
- gross carrying amount and accumulated amortisation / impairment at the start and end of the period
- the line item within which the amortisation of intangible assets is included
- a reconciliation of the carrying amount at the beginning and end of the period.

In addition, the aggregate amount of research and development costs recognised as an expense in the period should be disclosed.

HKAS 36 disclosure requirements

The following should be disclosed in respect of the impairment of 'Ranicillin':

- The amount of impairment loss recognised in profit or loss and the line item in which that loss is included.
- Assuming that the loss is considered to be material:
  - The circumstances that led to the recognition of the impairment loss
  - The nature of the asset
  - Whether recoverable amount was fair value less costs of disposal or value in use
  - The discount rate used in the estimate of value in use.

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Key learning points

1. *Development costs are capitalised only when all of the recognition criteria of HKAS 38 are met.*

2. *Development costs which were expensed prior to meeting the recognition criteria cannot be reinstated as part of the cost of the intangible asset.*

3. *Amortisation of an intangible asset commences when the asset is available for use.*

4. *An intangible asset which is not yet available for use or has an indefinite life should be tested for impairment annually and before the end of the first accounting period in which the asset is first recognised; other intangible assets are tested when there are indications of impairment.*

5. *An impairment loss has occurred where the carrying amount of an asset exceeds the recoverable amount.*

6. *The recoverable amount of an asset is the higher of its value in use (present value of future cash flows) and fair value less costs of disposal.*

7. *An impairment loss is recognised in profit or loss in respect of assets held under the cost model.*