DECEMBER 2016 AND JUNE 2017 SUPPLEMENT

Qualification Programme

Module A
Financial Reporting

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

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Introduction

This Supplement is to be used in conjunction with the fifth edition of the Learning Pack, and it will bring you fully up to date for developments that have occurred in the period since publication of the Learning Pack and 31 May 2016, the cut-off date for examinable standards and legislation for the December 2016 and June 2017 examinations. You will find a list of the standards that are examinable in your examination session by logging onto the HKICPA online QP Learning Centre.

The Supplement comprises a technical update on developments that will be examinable in December 2016 and June 2017 examination session that are not currently covered in the Learning Pack. The topics covered are listed on the contents page, and again are covered in chapter order.

In each case the text in the Supplement explains how the Learning Pack is affected by the change, for example whether the new material should be read in addition to the current material in the Learning Pack, or whether the new material should be regarded as a replacement.

Good luck with your studies!

Technical Update – Learning Pack

Chapter 2	Financial reporting framework
Section 3.2 **Page 36**	**The sentence immediately before the list of Hong Kong Accounting Standards is updated to read:** The following table shows the list of Hong Kong Accounting Standards in issue as at 31 May 2016:
Section 3.2 **Page 37**	**The list of Hong Kong Accounting Standards is extended to include HKFRS 16 *Leases***
Section 4.4 **Page 39**	**The text after the first paragraph is replaced with the following:** There are currently four ABs in issue: AB3 *Guidance on Disclosure of Directors' Remuneration* AB4 *Guidance on the Determination of Realised Profits and Losses in the Context of Distribution under the Hong Kong Companies Ordinance* AB5 *Guidance for the Preparation of a Business Review under the Hong Kong Companies Ordinance Cap 622* AB6 *Guidance on the Requirements of Section 436 of the Hong Kong Companies Ordinance Cap 622*
Section 7.3.2 **Page 46**	**The following sentence is added to the end of the first paragraph:** The SME-FRF and FRS were updated in December 2015.
Section 8.8 **Page 50**	**Section 8.8 is deleted and its updated content is incorporated into the new section 13 (see below).**
Section 13 **Page 60**	**A new section 13 is added and the current section 13 and subsequent sections are renumbered.** **13 Development of the *Conceptual Framework*** After a period of inactivity, the IASB has reactivated its *Conceptual Framework* project, and in May 2015 an Exposure Draft was issued proposing changes to the current *Conceptual Framework* in order to: • 'Fill the gaps' by providing presentation and disclosure guidance; • Update the content; and • Clarify certain areas. The proposed chapters of the *Conceptual Framework* are: 1 The objective of general purpose financial reporting 2 Qualitative characteristics of useful financial information 3 Financial statements and the reporting entity 4 The elements of financial statements 5 Recognition and derecognition 6 Measurement 7 Presentation and disclosure 8 Concepts of capital and capital maintenance Several of these chapters correspond to those completed in 2010; the Exposure Draft includes amendments to some of these most recent chapters.

13.1 The objective of general purpose financial reporting

A number of limited changes are proposed as follows:

- A greater emphasis on providing information to assess managerial stewardship of the resources of an entity;
- An explicit statement that faithful representation reports substance rather than legal form;
- Explicit reference to prudence in relation to neutrality and faithful representation (prudence was included in the 1989 *Framework* but not in the 2010 *Conceptual Framework*); and
- Identification of measurement uncertainty as a factor that can reduce the relevance of financial statements.

13.2 Qualitative characteristics of useful financial information

This Chapter was finalised in the 2010 version of the *Conceptual Framework,* and so only limited changes are proposed in the May 2015 Exposure Draft. One of these changes is the re-introduction of an explicit reference to the idea of prudence, which had been removed from the *Conceptual Framework* in 2010. Prudence is described as the exercise of caution when making judgments under conditions of uncertainty. It is explicitly stated that prudence is important in achieving neutrality, and therefore in achieving faithful representation. The IASB has further clarified that prudence works both ways: assets and liabilities should be neither overstated nor understated.

Another proposed addition clarifies that faithful representation means representation of the substance of an economic phenomenon rather than representation of its legal form.

13.3 Financial statements and the reporting entity

The IASB issued an exposure draft on the reporting entity in 2010, however, did not at that stage progress the proposals. Feedback from the 2010 Exposure Draft has, however, been incorporated into the 2015 Exposure Drafts.

A reporting entity is defined as an entity that chooses, or is required, to present general purpose financial statements. There is no requirement for a reporting entity to be a legal entity and it can be a portion of a single entity or a group or more than one entities. A reporting entity therefore includes a group within its definition.

13.4 The elements of financial statements

Amendments are proposed to the definitions of elements as follows:

- Clarification that an asset is an economic resource and a liability is a present obligation.
- Clarification that flows of economic benefits need not be certain in order for the definition of an asset or liability to be met.
- Updates to definitions of income and expenses to retain consistency with the definitions of assets and liabilities.

13.5 Recognition and derecognition

The Exposure Draft improves existing recognition guidance and includes new guidance on derecognition.

Recognition criteria are based on the qualitative characteristics. Recognition is required if it provides relevant information, a faithful representation and benefits

that exceed the cost of providing the information. The criteria may not be met if there is uncertainty over the existence of an asset or liability, a low probability of flows of economic benefits or a high level of measurement uncertainty.

Derecognition guidance aims to faithfully represent the change in assets or liabilities as a result of a transaction and those retained after the transaction. The focus here is on more complex transactions such as contract modifications.

13.6 Measurement

Two measurement bases are proposed:

- Historical cost; and
- Current value (including fair value, value in use and fulfilment value).

When selecting a measurement basis, it is proposed that the qualitative characteristics should be considered.

13.7 Presentation and disclosure

Proposals for this section of the *Conceptual Framework* are closely linked with the IASB's Disclosure Initiative. Principles for the presentation of an item within either profit or loss or other comprehensive income are included as follows:

- A rebuttable presumption exists that income and expenses form part of profit or loss;
- Items are included in other comprehensive income only if it enhances the relevance of profit or loss and the items relate to assets and liabilities remeasured to current values; and
- It is presumed that income and expenses recognised in other comprehensive income in one period are later reclassified to profit or loss.

13.8 Concepts of capital and capital maintenance

This Chapter comprises material carried forward from Chapter 4 of the existing *Conceptual Framework* with minor changes for consistency of terminology.

Section 15.1.1

Page 63

The second paragraph of section 15.1.1 is replaced with the following:

During 2015 HKEx consulted on proposed changes to upgrade the disclosure obligation of the ESG Reporting Guide. The consultation was met with strong support and as a result, the Guide will be amended to:

1 Require issuers to disclose whether they have complied with the 'comply or explain' provisions of the ESG Guide in the year, and give reasons for any non-compliance;

2 Provide more guidance on reporting within the introduction to the Guide and bring it into line with international standards;

3 Rearrange guidance by subject areas: A – Environmental and B – Social;

4 Revise general disclosure requirements to be consistent with Companies Ordinance directors' report requirements;

5 Revise the wording of the recommended voluntary disclosures to incorporate gender diversity, and so bring into line with international standards of ESG reporting;

6 Upgrade the key performance indicators in the environmental subject area to 'comply or explain'.

The amendments come into effect in two phases: amendments 1-5 were effective for financial years beginning on or after 1 January 2016 and amendment 6 is effective for financial years beginning on or after 1 January 2017.

Section 16.1 Page 66	**Section 16.1 is replaced with the following:**

16.1 Practice statement: Materiality

In October 2015 the IASB issued a draft practice statement *Application of Materiality to Financial Statements.* When a final version is issued, this will be a tool to aid management in using judgment to decide what information is material and what is not. Note that a practice statement is non-mandatory guidance and is not an IFRS (HKFRS).

The draft statement states that materiality is pervasive to the preparation of financial statements and should be considered in the context of the whole primary financial statements. Assessments of materiality should be made by considering items on both an individual and collective basis, and with regard to both qualitative and quantitative factors.

When considering **presentation and disclosure**, assessments of materiality should always be made in the context of providing information that is useful to users in assessing an entity's future prospects for cash flows and the stewardship of an entity's resources. As a result, different assessments of materiality may apply to different parts of the financial statements.

The draft practice statement proposes a three step approach:

1 An assessment of the information that should be presented in the primary statements

2 An assessment of the information that should be presented in the notes

3 A review of the financial statements as a whole to ensure appropriate balance of information

In the context of **errors or omissions**, it is suggested that materiality is assessed individually and on the basis of the whole financial statements. Intentional misstatements are always material and where material misstatements offset one another they remain material.

The practice statement states that **recognition and measurement requirements** of IFRS (HKFRS) must be applied if their effect is material. If financial statements contain either material errors or immaterial errors made intentionally to achieve a particular presentation, then they do not comply with IFRS (HKFRS). Therefore, although there is no requirement to apply IFRS (HKFRS) to immaterial items, this assessment must be made with caution.

Chapter 3	Small company reporting
Section 3.1.1 **Page 79**	**The text under the table is replaced with the following:**

Where size limits apply, in general a company will be required to pass the size tests for two consecutive years before becoming eligible in the third year. Similarly a company would have to fail the tests for two consecutive years in order to become ineligible in the third year.

Transitional requirements

The new Companies Ordinance is applicable to the first financial year beginning on or after 3 March 2014. The arrangements for the application of size limits on transition to the new Companies Ordinance are as follows: In the first financial year beginning on or after 3 March 2014, an entity qualifies for the reporting exemption if it meets the relevant size tests:

(a) In that first financial year; and/or
(b) In the immediately preceding year.

If the entity qualifies in the first financial year, it continues to qualify until disqualified (i.e. after it fails to meet the size tests in two consecutive reporting periods).

Illustration

The following information relates to a small private company that is a subsidiary of a larger company:

Reporting period	Revenue	Total assets at period end	Employees
1 July 2013 – 30 June 2014	$102 million	$101 million	91
1 July 2014 – 30 June 2015	$96 million	$102 million	90
1 July 2015 – 30 June 2016	$101 million	$105 million	92

- The first reporting period to begin after the new Companies Ordinance becomes applicable is the year ended 30 June 2015.
- In the year ended 30 June 2015, the reporting exemption criteria are met (only one of the size test thresholds is exceeded, being total assets at the reporting date). Therefore the company qualifies to apply the SME-FRF and SME-FRS. As the transitional rules are being applied, it is irrelevant that the new criteria were not met in the year ended 30 June 2014 and therefore the criteria have not been met for two previous consecutive years.
- In the year ended 30 June 2016, the reporting exemption criteria are not met because two of the size test thresholds are exceeded. However, the company qualifies to apply the SME-FRF and SME-FRS, because the tests have not been failed in two previous consecutive periods.
- If the reporting exemption criteria are not met in the year ended 30 June 2017 (i.e. for the second consecutive year), the company will qualify to apply the the SME-FRF and SME-FRS in that year, but will cease from the following year (ended 2018).
- If the reporting exemption criteria are met in the year ending 30 June 2017, the company will continue to qualify to apply the SME-FRF and SME-FRS and will do so until the criteria are not met for two previous consecutive periods.

Ineligible companies

The following types of company are not eligible for the reporting exemption and may not apply the SME-FRF and SME-FRS:

(a) Companies that carry on any banking business and hold a valid banking licence granted under the Banking Ordinance (Cap 155);

(b) Companies that accept, by way of trade or business (other than banking business), loans of money at interest or repayable at a premium other than on terms involving the issue of debentures or other securities;

(c) Companies that are licensed under Part V of the Securities and Futures Ordinance (Cap 571) to carry on a business in any regulated activity within the meaning of that Ordinance; or

(d) Companies that carry on an insurance business, other than solely as an agent.

In addition, groups that contain such companies are not eligible for the reporting exemption and cannot apply.

Section 3.2 **Page 80**	**The third paragraph of this section is replaced with the following:** The SME-FRF and SME-FRS were first issued in 2005 and were revised in 2014 as a result of the new Companies Ordinance. They were revised again in 2015, although changes were generally of a housekeeping nature.
Section 4.1.1 **Page 82**	**Point (b) is deleted.**
Section 4 **Page 82**	**A new section 4.1.2 is added:** **4.1.2 Initial comprehensive review** The *IFRS for SMEs* was revised in May 2015 subsequent to the IASB's Initial Comprehensive Review of the standard. The *HKFRS for Private Entities* was amended in September 2015 to reflect these revisions. The amendments: 1 Reflect certain changes made to full HKFRS since the initial issue of the *HKFRS for Private Entities*; 2 Increase the number of available 'undue cost and effort' exemptions that exempt an entity from applying certain requirements of the standard where application would result in undue cost or effort; and 3 Introduce a requirement to disclose use of the undue cost or effort exemption. The amendments made are effective for annual periods beginning on or after 1 January 2017 and are reflected in the content of the following sections of the LP.
Section 4.2.1 **Page 82**	**The following paragraph is added to the end of section 4.2.1:** In the case of a parent entity, eligibility to use the *HKFRS for Private Entities* should be made on the basis of the parent's own status, without consideration of whether other group entities or the group as a whole has public accountability.
Section 5.1 **Page 83**	**The reference to HKFRS 9 is deleted within the second paragraph of this section;** when HKFRS 9 supersedes HKAS 39, the option to apply HKAS 39 rather than the *HKFRS for Private Entities* in respect of financial instruments will remain.
Section 5.1.1 **Page 83**	**The following sentence is added to the end of the first paragraph of section 5.1.1:** The 2015 amendments to the *HKFRS for Private Entities* increased the number of 'undue cost or effort' exemptions available within the standard.
Section 5.2 **Page 84**	**The following text replaces the listed points within section 5.2:** **(b) Financial Instruments** Financial instruments meeting specified criteria are measured at cost or amortised cost. All others are measured at fair value through profit or loss, with an undue cost or effort exemption available in respect of the measurement of equity instruments at fair value. In addition, a simplified principle is established for derecognition and hedge accounting requirements are simplified and tailored to private entities. **(c) Property, plant and equipment and intangibles** Only the cost model is allowed for intangibles. The 2015 amendments to the standard introduced the option to apply the revaluation model to property, plant and equipment, where previously this had not been available. There is no need to review residual value, useful life and depreciation method unless there is an indication that they have changed since the most recent reporting date.

	(d) Goodwill and other indefinite-life intangibles All intangible assets (including goodwill) are considered to have a finite useful life. If a reliable estimate of useful life cannot be made, it is based on management's best estimate, which must not exceed ten years. An impairment test is performed only if there are indications of impairment (rather than annually).
Section 5.5 **Page 85**	**The table within section 5.5 is replaced with the following:**

	Treatment disallowed in *HKFRS for Private Entities*
Borrowing costs	Capitalisation of borrowing costs
Government grants	Various accounting options excluded
Investment property	Accounting policy choice
Consolidation	Measurement of the non-controlling interest at fair value

Section 5.6 **Page 86**	**The first bullet point within the second set of bullet points in this section is replaced with the following:** • There is no requirement to disclose the fair value of investment property or property, plant and equipment that is measured using the cost model.
Section 5.7 **Page 86**	**The text within section 5.7 is replaced with the following:** The IASB completed its post-implementation review of the *IFRS for SMEs* in 2015 with the issue of a number of amendments to the standard. As explained above, these were adopted by HKICPA to form amendments to the *HKFRS for Private Entities*. The IASB now anticipate that the *IFRS for SMEs* will be amended periodically, but not more than once every three years, with proposed changes issued in one go within an 'omnibus Exposure Draft'. On rare occasions amendments to the standard will be considered outside the periodic review process; but the *HKFRS for Private Entities* is clear that any changes made to full HKFRS should not be anticipated before they are included in the *HKFRS for Private Entities.* The number and frequency of amendments is therefore reduced compared to full standards and as a result, the burden on companies to keep up to date is also reduced.
Section 6.2.2 **Page 88**	**1 Under the heading 'Property, plant and equipment', the first bullet point is deleted.** **2 The heading 'Financial instruments' and the bullet point underneath it are deleted.**

Chapter 6	Investment property
Section 1 **Page 152**	**A new section 1.9 is added at the end of session 1:** **1.9 Current developments** The IASB issued ED/2015/9 *Transfers of Investment Property* in November 2015. It proposes that IAS 40 (HKAS 40) guidance on transfers to and from investment property is amended to reinforce the principles-based nature of the guidance. The proposed amendments clarify that: • A property is transferred to or from the investment property category when there is a change in use of the property, supported by evidence of that change in use. • The list of examples of evidence of a change in use currently included within the standard is not exhaustive.

Chapter 8	Intangible assets and impairment of assets
Section 3.14 **Page 207**	**This section is deleted as the IASB has suspended this project. It is likely to be incorporated into the post-implementation review of IFRS 13, which has not yet begun.**

Chapter 9	Leases
Section 7 **Page 243**	**Section 7 is replaced with the following:** **7 Current developments** The HKICPA issued HKFRS 16 *Leases* in May 2016. The standard replaces HKAS 17 with effect 1 January 2019. It is examinable as a current development rather than in full at the December 2016 and June 2017 examination sessions. The new standard adopts a single accounting model applicable to all leases by lessees, substantially retains the requirements of HKAS 17 for lessors (requiring classification of a lease as finance or operating) and refers to HKFRS 15 guidelines with respect to sale and leaseback transactions. **7.1 Lessee accounting** A single lease model is applied by all lessees, with no requirement to distinguish between operating and finance leases. At the commencement of the lease, the lessee recognises: (a) A right of use asset, which represents the right to use the underlying asset, and (b) A lease liability which represents the obligation to make lease payments. **7.1.1 Right of use asset** The right of use asset is initially measured at cost, which is: • The initial measurement of the lease liability (see below) • **Plus** any lease payments made before the commencement date • **Less** lease incentives received • **Plus** initial direct costs incurred by the lessee • **Plus** estimated dismantling and restoration costs that a lessee is obliged to pay at the end of the lease term

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The asset is subsequently measured at cost less accumulated depreciation and impairment losses unless the right of use asset is:

- A class of property, plant and equipment that is measured using the revaluation model
- An investment property and the lessee applies the fair value model

Where relevant, the asset is depreciated over the shorter of the useful life of the underlying asset and the lease term. Useful life is always the depreciation period when ownership of the underlying asset is transferred at the end of the lease term.

7.1.2 Lease liability

The lease liability is initially measured at the present value of future lease payments. The discount rate is the interest rate implicit in the lease. It is subsequently:

- Increased to reflect interest at a constant rate on the outstanding balance
- Decreased to reflect payments made
- Remeasured to reflect changes to the lease payments or lease modifications

7.1.3 Simplified accounting

A lessee can elect to apply simplified accounting to a lease with a term of 12 months or less, or a lease for a low value asset. The election is made on a lease by lease basis for leases for low value assets, and by class of underlying asset for short-term leases.

In this case, the lessee recognises lease payments on a straight line basis over the lease term.

7.2 Sale and leaseback transactions

Guidance in HKFRS 15 is applied in order to determine whether a sale has taken place.

7.2.1 Transfer is a sale

The seller (lessee) measures the lease asset at an amount equal to the right of use retained, i.e. a proportion of the previous carrying amount.

A gain or loss on disposal is therefore calculated based only on the rights transferred to the buyer (lessor).

The buyer (lessor) accounts for the purchase of the asset by applying relevant HKFRS and accounts for the lease by applying HKFRS 16 guidance on accounting by lessors.

If transfer proceeds do not equal the fair value of the transferred asset or lease payments are not at market rate, the following accounting adjustments are made:

1 Below market terms are a prepayment of lease payments

2 Above market terms are additional financing provided by the buyer (lessor) to the seller (lessee)

7.2.2 Transfer is not a sale

The seller (lessee) should not derecognise the asset and instead recognises proceeds as a financial liability, accounting for it in line with HKFRS 9.

The buyer (lessor) should not recognise the asset and instead recognises a financial asset, accounting for it in line with HKFRS 9.

Answer 4 — **The answer is replaced with the following:**

Page 248 — **Statement of profit or loss for the year ended 31 December 20X4 (extract)**

	$
Depreciation	(752,000)
Operating lease income	750,000

Statement of financial position at 31 December 20X4 (extract)

	$
Property	50,363,333
Non-current liabilities	
Deferred income	900,000
Current liabilities	
Deferred income	600,000

Note-operating lease arrangements

The company rents property out under arrangements classified as operating lease. Property rental income earned in the year was $750,000. Direct operating expenses arising on the arrangement of operating leases are added to the carrying amount of the underlying property and amortised over the lease term. The lessee does not have an option to purchase the property at the expiry of the lease period.

At the reporting date the company had contracted with tenants for the following future minimum lease payments:

	$
Within one year (12m × 75,000)	900,000
In the second to fifth years (18m × 75,000)	1,350,000
After five years	–
	2,250,000

Workings

	$
Total lease receipts (3 years × 12m × 75,000) + 1,800,000	4,500,000
Annual credit to income therefore 4,500,000/3 years	1,500,000
Income in the year 1,500,000 × 6/12m	750,000
Deferred income	
Income in the year	750,000
Cash received (6m × 75,000) + 1,800,000	2,250,000
Deferred income	1,500,000
Deferred income within one year 1,500,000 – (12 × 75,000)	600,000
Deferred income in more than one year (balance)	900,000
Non-current asset	
Property carrying amount at commencement of lease	51,000,000
Initial direct costs	136,000
	51,136,000
Depreciation [(51,000,000/34 years) + (136,000/3 years)] × 6/12m	(772,667)
Carrying amount at 31 December 20X4	50,363,333

Chapter 10	Inventories
Section 1.8 **Page 259**	**The final sentence of the solution to Example: Inventory valuation (2) and the journal is replaced with the following:** Therefore it is measured at $34.5m (W) and should be written down by $1,500,000. This is achieved by ($): DEBIT Inventory written down 1,500,000 CREDIT Inventories 1,500,000

Chapter 12	Construction contracts
	Chapter 12 in the LP is replaced with the revised version of Chapter 14 that is attached to this Supplement.

Chapter 13	Share-based payment
Section 2.1.5 **Page 320**	**The following text is added at the end of the section:** In some cases either the entity or the counterparty can choose whether a non-vesting condition is met. If this is the case and the non-vesting condition ceases to be met during the vesting period, the share-based payment is treated as cancelled. The accounting treatment for a cancellation is discussed in section 4 of this chapter. If neither the entity nor the counterparty can choose whether the non-vesting condition is met, and the non-vesting condition ceases to be met during the vesting period, the original accounting treatment continues i.e. the expenses is recognised over the remainder of the vesting period.
Self-test question 5 **Page 320**	**The second paragraph of the question is changed to the following:** At 31 December 20X4, 1 of the 20 employees has left Pannal. All employees acquired the 1,000 shares as required at the grant date; the leaver has sold his 1,000 shares as has another individual. This individual is expected to remain in the employment of Pannal until 31 December 20X6 and has achieved the required sales target. At 31 December 20X4 a total of 17 of the 19 sales employees working for Pannal at the year end had achieved the required sales target. As a result of their failure to achieve these targets, one of the remaining two employees is expected to leave the company before 31 December 20X6.
Example **Page 323**	**The following text is inserted before the requirement to the example:** Arthing Co does not recognise a liability for payment under the scheme if the share price condition is not met at a given reporting date during the vesting period.
Example **Page 335**	**The fifth paragraph of the example question is changed to the following;** In accordance with HKFRS 2, an expense of $25,000 has been charged to profit or loss in the year ended 31 December 20X0 in respect of Yip's share options, and $100,000 has been charged to profit or loss in the year ended 31 December 20X1 in respect of both Yip and Chan. The cumulative total is therefore $125,000.

Example solution

Page 335

The second part of the solution relating to the year ended 31 December 20X1 is changed to the following:

Year to 31 December 20X1

Deferred tax asset:

	$
Fair value	
(20,000 × $7.00)	140,000
(90,000 × $7.00 × 1/3)	210,000
	350,000
Exercise price of options	
(20,000 × $3.75)	(75,000)
(90,000 × $5.00 × 1/3)	(150,000)
Intrinsic value (estimated tax deduction)	125,000
Tax at 16%	20,000
Less previously recognised	(6,000)
	14,000

The cumulative remuneration expense is $125,000, which is equal to the estimated tax deduction of $125,000. Therefore:

- A deferred tax asset of $20,000 is recognised in the statement of financial position at 31 December 20X1.
- Deferred tax income of $14,000 is recognised in the statement of profit or loss in the year ended 31 December 20X1.

Answer 5

Page 341

The last three paragraphs of the answer are replaced by the following text:

HKFRS 2 requires that:

- Service conditions and non-market performance conditions are taken into account when determining the number of equity instruments expected to vest.
- Market performance conditions and non-vesting conditions are not taken into account wen determining the number of equity instruments expected to vest, but instead are inputs when determining the fair value of the equity instruments at the grant date. If a non-vesting condition ceases to be met as a result of a choice made by the reporting entity or counterparty, this is treated as a cancellation of the share- based payment transaction.

Here 18 employees are expected to meet the service condition, being the twenty employees that joined the scheme less the one that has already left less the one that is expected to leave as a result of failing to achieve the sales target. Seventeen employees are expected to meet the non-market performance target being the twenty employees that joined the scheme less the one that has already left, less the one that is expected to leave less a further employee. Of these seventeen employees, one has chosen not to meet the non-vesting condition and therefore their share-based payment is cancelled.

Therefore the total amount recognised as a staff costs expense and credit to equity is calculated as 10,000 shares × 16 employees × fair value of an equity instrument at the grant date. The amount recognised in the year ended 31 December 20X3 is a third of this total.

Chapter 14	Revenue
	Chapter 14 in the LP is replaced with the revised version of Chapter 14 that is attached to this Supplement.

Chapter 15	Income taxes

Section 4.6 **The text within this section is replaced with the following:**

Page 395

Amendments to IAS 12 were finalised in January 2016 and it is expected that identical amendments will be made to HKAS 12 during 2016.

The amendments:

- Clarify that debt instruments measured at fair value in the financial statements but at cost for tax purposes can give rise to deductible temporary differences.
- Require that when an entity assesses whether taxable profits will be available against which a deductible temporary difference can be utilised, it considers whether tax law restricts the sources of taxable profits against which deductions can be made on the reversal of a deductible temporary difference. If there is such a restriction, a deferred tax asset should be assessed in combination with other deferred tax assets of the same type.
- Clarifies that when assessing estimated future taxable profits, an entity should:
  - (i) Compare the deductible temporary differences with future taxable profit excluding tax deductions resulting from the reversal of those deductible temporary differences, and
  - (ii) Ignore taxable amounts arising from deductible temporary differences arising in future periods.

Section 11 **A new section 11.3 is added at the end of section 11:**

Page 415

11.3 Draft Interpretation: Uncertainty over income tax treatments

The IASB issued Draft IFRIC Interpretation DI/2015/1 in October 2015. It proposes guidance on accounting for current and deferred tax liabilities and assets when there is uncertainty as to the application of tax law to a transaction or circumstance.

It is proposed that in this situation, uncertainties in income tax liabilities or assets are reflected in the tax liability or asset only when it is **probable** that the entity will pay or recover the amount under consideration.

Tax uncertainties should be measured using one of two approaches:

- The most likely amount (the single most likely amount in a range of possible outcomes); or
- The expected value (the sum of probability weighted amounts in a range of possible amounts).

The draft interpretation does not include any new disclosure requirements. It does, however, refer to the IAS 1 (HKAS 1) requirement to disclose information about judgments and uncertainties.

Answer 5 **Page 419**	**Part (b) of the answer is replaced as follows:** If the entity expects to recover the carrying amount by selling the building immediately for proceeds of $15 million, the deferred tax liability will be computed as follows:

	$'000	Tax rate	$'000
Total tax depreciation allowance	3,000	30%	900
Deferred tax liability			900

Note. The additional deferred tax that arises on the revaluation is charged directly to equity. See Answer 6 below.

Chapter 16 Employee benefits

Section 5.5.2
Page 444

The second bullet point in the section is amended to read:

- The discount rate is the rate at the start of the year, determined by reference to market yields on high quality fixed-rate corporate bonds.

Example
Page 445

The sentence at the end of the table is amended to read:

The yield on a high quality corporate bond is 5% at 1 January and 31 December 20X1.

Self-test question 1
Page 446

The sentence at the end of the table is amended to read:

The yield on a high quality corporate bond at 1 November 20X7 and 31 October 20X8 was 4%.

Self-test question 2
Page 447

The second bullet point in the question is amended to read:

- Market yields on high quality corporate bonds were 4.5% at 1 January 20X2.

Section 5.8
Page 448

The third paragraph of the section is amended to read:

The standard further requires that the discount rate used to calculate the present value of future economic benefits is a rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds.

Section 5.10
Page 451

Within the table, the Net interest on net defined benefit liability (asset) row is amended to be:

Net interest on net defined benefit liability (asset)	Based on high quality corporate bond yield and net defined benefit liability (asset) at start of period. Discount rate % × net defined benefit liability (asset) b/f	DEBIT Finance cost (profit or loss) CREDIT Plan obligation And DEBIT Plan assets CREDIT Finance cost (profit or loss)

Section 5
Page 453

A new section 5.12 is added at the end of section 5:

5.12 Current developments

The IASB issued an exposure draft of proposed narrow scope amendments to IAS 19 (HKAS 19) in 2015. The proposed amendments relate to defined benefit pension schemes and provide clarification in respect of two issues:

1 The current service cost in a period before a plan amendment, settlement or curtailment is not affected by, or included in, the resulting past service cost gain or loss on settlement.

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	2 When a plan amendment, settlement or curtailment occurs and the net defined benefit asset or liability is remeasured: • Net interest for the remaining period is determined based on the remeasured net defined benefit liability or asset; • Current service cost and interest for the period after the remeasurement are determined using assumptions used for the remeasurement.
Answer 2 **Page 457**	**The second paragraph within the answer is amended to read:** Net interest is calculated using the market rate on a high quality corporate bond at the start of the year applied to the net defined benefit liability at the start of the year.
Exam practice **Page 460**	**Within the question 'Employee benefits', the final row in the table is amended to read:** Yield on corporate bonds at start of year 8% 9%

Chapter 17 Borrowing costs

Answer 1

Page 472

The first section of the answer is replaced with the following:

	$
Borrowing costs	
Initial loan: $1.5m × 8% × 6/12m	100,000
Second loan: $450,000 × 8.5% × 5/12m	15,938
	115,938

Chapter 18 Financial instruments

Chapter 18 in the LP is replaced with the revised version of Chapter 18 that is attached to this Supplement.

Chapter 20 Statements of cash flows

Section 2.4

Page 576

Existing section 2.4.2 and 2.4.3 are renumbered 2.4.3 and 2.4.4. A new section 2.4.2 is added as follows:

2.4.2 Changes in liabilities arising from financing activities

As part of the Disclosure Initiative project, HKAS 7 was amended in 2016 to require disclosure of changes in liabilities arising from financing activities.

The required disclosures also apply to financial assets to the extent that related cash flows are classified as cash flows from financing activities. This may be the case, for example, where financial assets are used to hedge liabilities arising from financing activities.

Changes may be the result of cash transactions or due to non-cash movements. Changes that should be disclosed include those due to:

- Financing cash flows
- Obtaining or losing control of subsidiaries or other businesses
- Changes in foreign exchange rates
- Changes in fair values
- Other changes

Disclosure may take the form of a reconciliation between opening and closing balances in the statement of financial position.

Section 2.4 **Page 577**	**The following text is added to the end of the Illustration at the end of section 2.4:**

Reconciliation of liabilities arising from financing activities

$'000		Long-term borrowings	Short-term borrowings	Lease liabilities	Assets held to hedge long-term borrowings	Total liabilities from financing activities
20X3		220,000	100,000	40,000	(6,750)	353,250
Cash flows		(10,000)	(5,000)	(8,000)	1,500	(21,500)
Non-cash changes	**Acquisition**	–	–	3,000	–	3,000
	Foreign exchange movement	–	2,000	–	–	2,000
	Fair value changes	–	–	–	(250)	(250)
20X4		210,000	97,000	35,000	(5,500)	336,500

Note. This example shows only current period amounts; HKAS 1 requires the presentation of corresponding amounts for the previous period.

Section 4 **Page 591**	**This section is deleted as Disclosure Initiative amendments to HKAS 7 have now been issued and the main text is amended to reflect them (see above).**
Topic recap **Page 592**	**The following text replaces that in the box at the bottom of the diagram:**

Disclose:

- Non-cash transactions
- Reconciliation of liabilities arising from financing activities
- Components of cash and cash equivalents

Chapter 27	Principles of consolidation
Section 3 **Page 739**	**A new section 3.3 is added to the end of session 3:**

3.3 Current developments

As part of the IASB's 2014-2016 Annual Improvements cycle, it is proposed that IFRS 12 (HKFRS 12) is amended to clarify that the requirements of the standard do apply to the following interests of an entity:

- Interests classified as held for sale
- Interests classified as held for distribution to owners
- Interests classified as discontinued operations

Summarised financial information is not, however, required for a subsidiary, joint venture or associate that is classified as held for sale or distribution.

Section 6 **Page 757**	**This section is deleted as the IASB has suspended this project. It is likely to be incorporated into the post-implementation review of IFRS 13, which has not yet begun.**

Chapter 28	Consolidated accounts: accounting for subsidiaries
Answer 4 **Page 805**	**Within Working 2 Goodwill, the date at which reserves are stated should be 1.1.20X2/1.1.20X3 rather than 1.12.20X2/1.12.20X3.**
Answer 4 **Page 806**	**Within part (b) Working 2 Goodwill, the date at which reserves are stated should be 1.1.20X3/1.1.20X2 rather than 1.12.20X3.**

Chapter 29	Consolidated accounts: accounting for associates and joint arrangements
Section 1.2 **Page 816**	**The final paragraph of the section is replaced with the following:** **1.2.1 Investment entities** When an investment in an associate is held (directly or indirectly) through an investment entity, the entity may elect to measure the investment at fair value through profit or loss in accordance with HKFRS 9. A minor amendment to HKAS 28 (2011) is proposed within the Annual Improvements 2014-16 cycle to clarify that this option is available on an investment by investment basis upon initial recognition. **1.2.2 Severe long-term restrictions** Even where an investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor, the accounting requirements of HKAS 28 (2011) must be applied. Significant influence must be lost before the equity method ceases to be applicable.
Section 1.7 **Page 824**	**The narrative at the start of section 1.7 is replaced with the following. The example is unchanged.** HKAS 28 (2011) sets out a list of indicators that an entity's investment in an associate is impaired. It clarifies that an investment in an associate is impaired only if there is objective evidence of impairment as the result of events that occurred after the initial recognition of the investment and those events have had an impact on the estimated future cash flows from the investment. Objective evidence of impairment may include: • The significant financial difficulty of the associate; • A breach of contract by the associate; • The investor granting the associate a concession that it would not consider but for the associate's financial difficulty; • It becoming probable that the associate will enter bankruptcy or financial reorganisation; • The disappearance of an active market for the investment because of financial difficulties of the associate. An investment in an associate is tested for impairment in accordance with HKAS 36 *Impairment of Assets*. It is treated as a single asset for the purposes of impairment testing and therefore an impairment loss is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in associate. Any impairment loss is recognised in accordance with HKAS 36 and is capable of being reversed to the extent that the recoverable amount of the investment subsequently increases.

Chapter 30	Changes in group structures
Section 1.6 **Page 854**	**The second paragraph is replaced with the following. The first and last paragraphs are unchanged.** Therefore, for example, where the subsidiary applies HKFRS 9 and holds debt instruments measured at fair value through other comprehensive income, then on disposal, the amounts of other comprehensive income recorded in the consolidated accounts in relation to these are reclassified to profit or loss and form part of the gain on disposal.
Section 1.6 **Page 855**	**The first two paragraphs of the Example that forms part of section 1.6 are replaced with the following:** In 20X7, A acquired a 100% equity interest in B for cash consideration of $125,000. B's identifiable net asset at fair value were $100,000. Goodwill of $25,000 was identified and recognised. In the subsequent years, B increased net assets by $20,000 to $120,000. Of this $15,000 was reported in profit or loss and $5,000, relating to debt instruments classified as measured at fair value through other comprehensive income was reported in other comprehensive income. A then disposed of 75% of its equity interest for cash consideration of $115,000. The resulting 25% equity interest is classified as an associate under HKAS 28 (2011) and has a fair value of $38,000.

Chapter 31	Consolidation of foreign operations
Section 2 **Page 902**	**A new section 2.5 is added at the end of section 2:** **2.5 Current developments** In October 2015 the IASB issued a draft IFRIC interpretation DI/2015/2 Foreign Currency Transactions and Advance Consideration. IAS 21 (HKAS 21) requires that a foreign currency sale, purchase or other transaction is translated at the prevailing exchange rate on the date on which the transaction is recognised. The draft interpretation proposes that where a customer pays a non-refundable foreign currency amount in advance, the exchange rate used to translate that amount is the rate at the earlier of: • The date of initial recognition of the non-refundable amount (being a prepayment for the customer or deferred income for the seller), and • The date on which income, expense or an asset is recognised in the financial statements in relation to the transaction. Therefore it is proposed that a transaction may be recognised in stages and a different exchange rate applied to each stage.

	Answers to exam practice questions
Chapter 3 **Page 922**	**Solution part (c) is replaced with the following:** (c) Although the *HKFRS for Private Entities* as originally issued prohibited use of the revaluation model for property, plant and equipment, the 2015 revisions to the standard introduced this model as an accounting policy choice. Paragraph 17.15 of the *HKFRS for Private Entities* requires that either the cost model or the revaluation model is applied to an entire class of property, plant and equipment.

Regardless of which model is applied, the *HKFRS for Private Entities* requires that an entity measures items of property, plant and equipment after initial recognition taking into account any accumulated impairment losses. Therefore accounting for impairment is appropriate.

Question bank – answers

Answer 1

Page 1006

The first three paragraphs of part (e) of the answer are replaced with the following:

(e) According to HKFRS 15.B39-43, SNT should account for points of the loyalty programme as a separate performance obligation of the sales transactions in which they are granted (the 'initial sales').

The transaction price in respect of the initial sales is allocated between the award credits (the loyalty points) and the other component of the sale.

Since SNT supplies the awards itself, SNT recognises the consideration allocated to loyalty points as revenue only when the performance obligation (to supply awards) is satisfied ie when the loyalty points are redeemed.

Answer 2

Page 1009

Part (b) of the answer is replaced with the following:

Disclosure requirement as various HKFRSs are not early adopted

According to paragraph 30 of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, when an entity has not applied a new HKFRS that has been issued but is not yet effective, the entity shall disclose:

(a) This fact (i.e. PWE has not applied the new HKFRS because it has been issued but is not yet effective); and

(b) Known or reasonably estimable information relevant to assessing the possible impact that application of the new HKFRS will have on the entity's financial statements in the period of initial application.

Therefore PWE has to disclose:

(a) The title of the new HKFRS;

(b) The nature of the impending change or changes in accounting policy (e.g. HKFRS 9 *Financial Instruments* introduces new requirements for the classification and measurement of financial instruments, accounting for credit losses related to financial assets and hedging relationships).

(c) The date by which application of the HKFRS is required (e.g. HKFRS 9 *Financial Instruments* is effective for annual periods beginning on or after 1 January 2018, with earlier application permitted);

(d) The date at which it plans to apply the HKFRS initially; and

(e) Either:

  (i) A discussion of the impact that the initial application of the HKFRS is expected to have on the entity's financial statements; or

  (ii) If that impact is not known or reasonably estimable, a statement to that effect.

Answer 16

Page 1052

The first section of the answer under the heading 'Classification of financial assets' is amended as follows:

GII's investments are both financial assets. According to HKFRS 9, financial assets are classified as measured at either amortised cost, fair value through other comprehensive income (FVTOCI) or fair value through profit or loss

(FVTPL) depending on:

- The entity's business model for managing the financial assets, and
- The contractual cash flow characteristics of the financial assets.

In particular, a financial asset is measured at amortised cost where:

1 The asset is held within a business model where the objective is to hold assets in order to collect contractual cash flows.

2 The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

For this purpose interest is consideration for the time value of money and for the credit risk associated with the principal amount.

A financial asset is measured at FVTOCI where:

1 The asset is held within a business model whose objective is achieved by collecting contractual cash flows and selling financial assets, and

2 The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

Financial assets that do not meet the criteria to be classified as either measured at amortised cost or at FVTOCI are measured at fair value through profit or loss.

Glossary

The following definitions are added to the glossary:

Contract. An agreement between two or more parties that creates enforceable rights and obligations.

Contract asset. An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time (for example, the entity's future performance).

Contract liability. An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Customer. A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Hedge ratio. The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

Performance obligation. A promise in a contract with a customer to transfer to the customer either:

(a) A good or service (or a bundle of goods or services) that is distinct; or

(b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Stand-alone selling price (of a good or service). The price at which an entity would sell a promised good or service separately to a customer.

Transaction price (for a contract with a customer). The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Page 1065	**The definition of Hedged item is amended:** A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be a single item of a group or items and it must be reliably measurable.
Page 1066	**The definition of Hedging instrument is amended:** A designated • Derivative, or • Non-derivative financial assets or liabilities measured at fair value through profit or loss (with the exception of financial liabilities designated at fair value through profit or loss for which changes in fair value attributable to credit risk are presented in other comprehensive income).
Page 1073	**The definition of Revenue is amended:** Income arising in the course of an entity's ordinary activities.

Technical update – flashcards

Chapter 2	Financial reporting framework
Page 9	**In the HKFRSs box replace the third bullet point with the following:** • HKFRS 1-15 **In the Accounting Bulletins box replace the text with the following:** **Accounting Bulletins** – informative publications on subjects of topical interest (AB1, 3, 4, 5, 6)
Page 19	**In the Improved conceptual framework text box replace the text with the following:** • Exposure draft issued in 2015 • Proposed changes will: 1 Add general principles of presentation and disclosure and guidance on derecognition 2 Update and improve the content e.g. by relating recognition criteria to qualitative characteristics 3 Clarify certain areas
Page 19	**Add an additional text box:** **Practice statement: Materiality** Draft practice statement issued in 2015. When issued this will be a non-mandatory tool to help management to use judgment to decide what information is material and what is not.

Chapter 3	Small company reporting
Page 23	**The following should be added beneath the table**: Where size limits apply, a company must pass the size tests for two consecutive years before becoming eligible in the third year. Similarly a company must fail the tests for two consecutive years in order to become ineligible in the third year. Transitional rules applicable in the first financial year starting on or after 3 March 2014 are as follows: • An entity qualifies for the reporting exemption if it meets the relevant size tests: (a) In that first financial year; and/or (b) In the immediately preceding year. • If the entity qualifies in the first financial year, it continues to qualify until disqualified (i.e. after it fails to meet the size tests in two consecutive reporting periods).
Page 25	**Within the Public accountability box, add a third bullet point:** • Parent companies assess eligibility based on the parent's own status regardless of whether other group entities/the group has public accountability.
Page 26	**Within the Examples box, change the third bullet point to:** • All investment property is held using the cost model

Page 27	**Within the middle box in the right-hand column change the first dash to:** • The fair value model for investment property
Page 27	**Within the bottom box in the right-hand column change the second dash to:** • No fair value disclosures for PPE held under the cost model
Page 28	**Delete the first and last row of the table. Within the table amend the Investment property bullet point to:** • Cost model only

Chapter 12	Construction contracts
	This chapter is deleted.

Chapter 14	Revenue
	Chapter 14 in the Flashcards is replaced with the revised version of Chapter 14 that is attached to this Supplement.

Chapter 18	Financial instruments
Page 102	**The text within the Relevant standards box is amended to read:** HKAS 32 deals with the classification of instruments as debt or equity. HKFRS 7 provides disclosure requirements for financial instruments. HKFRS 9 has replaced HKAS 39 to deal with the recognition and measurement of financial instruments, credit losses (impairment) and hedging. (HKAS 39 remains relevant in practice for periods beginning before 1.1.2018.)
Page 104	**The text within the box at the top of the left-hand column is changed to read:** **Financial assets** are classified as measured at: • Amortised cost, or • Fair value through OCI, or • Fair value through profit or loss On the basis of the business model for managing the asset and its contractual cash flow characteristics.

Page 105

Replace the table with the following:

HKFRS 9	Initial measurement	Subsequent measurement	Related income/expense
Financial assets at amortised cost	FV of consideration given + transaction costs	Initial measurement – principal repayments +/– cumulative amortisation – impairments	Recognised in P/L
Financial assets at FVTOCI	FV of consideration given + transaction costs	Remeasured to FV at each period end	Interest, dividends, credit losses and FX differences in P/L. Other gains/losses to OCI
Financial assets at FVTPL	FV of consideration given	Remeasured to FV at each period end	Recognised in P/L
Financial liabilities at amortised cost	FV of consideration received – transaction costs	Initial measurement – principal repayments +/– cumulative amortisation – impairments	Recognised in P/L
Financial liabilities at FVTPL	FV of consideration received	Remeasured to FV at each period end	Recognised in P/L

Page 109

Replace the Impairment section of the page with the following:

Credit losses/impairment (HKFRS 9)

- Expected loss model

General approach

- 12m expected losses at initial recognition and stage 1 (effective interest calculated on gross carrying amount)
- Lifetime expected losses at stages 2 (increased credit risk, EIR calculated on gross carrying amount) and 3 (evidence of impairment, EIR calculated on carrying amount net of allowance)

Simplified approach for trade/lease receivables

- Lifetime losses at initial recognition using provision matrix

Purchased credit-impaired approach

- Initially measured at transaction price and effective interest rate applied to carrying amount is credit adjusted

Losses recognised in profit or loss with credit to:

- Allowance account for assets at amortised cost
- Accumulated impairment amount in OCI for assets at FVTOCI
- Provision (liability) account for loan commitments

Page 109	**Replace the Hedging section of this page with the following:** **Hedging (HKFRS 9)** Hedge accounting applies where a transaction qualifies as a hedge: • Hedge relationship consists of eligible hedging instruments and eligible hedged items • Formal documentation and designation of relationship at inception • Hedge effectiveness requirements met
Page 110	**Replace the content of this page with the following:** HKFRS 9 identifies three types of hedge. The type of hedge determines the accounting treatment.

Type	Hedges against	Accounting treatment
Fair value hedge	Changes in fair value of a recognised asset or liability or an unrecognised firm commitment that could affect profit or loss.	• Gain or loss on instrument recognised in P/L or OCI if hedged item is equity instrument at FVTOCI • Gain or loss on hedged item also recognised in P/L unless equity instrument at FVTOCI (in which case in OCI)
Cash flow hedge	Exposure to variability in cash flows attributable to a risk associated with a recognised asset or liability or a highly probable forecast transaction that could affect profit or loss.	• Gain or loss on effective portion of instrument recognised in OCI and reclassified to P/L when asset or liability affects P/L. If transaction results in non-financial asset or liability reclassify to adjust carrying amount instead • Gain or loss on ineffective portion recognised in P/L
Hedge of net investment in a foreign operation	Variability in value of the net investment in a foreign operation or monetary items accounted for as part of that net investment.	• Gain or loss on effective portion of instrument recognised in OCI and reclassified to P/L on disposal of foreign operation • Gain or loss on ineffective portion recognised in P/L

HKFRS 9 allows the hedge of a foreign currency firm commitment.

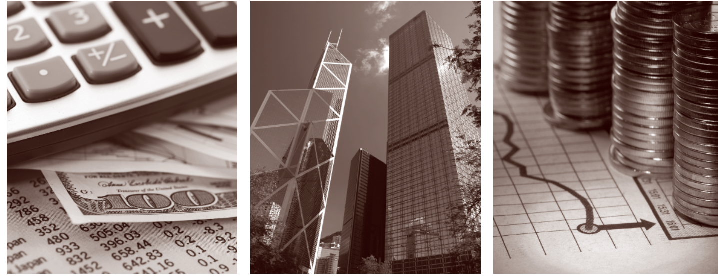
Page 112	**The bullet points within the Hedge accounting box on this page are replaced with the following bullet points:** • Explanation of risk management strategy • Effect of hedging activities on amount, timing and uncertainty of future cash flows • Effect that hedge accounting has had on amounts reported in the financial statements

Chapter 20	Statement of cash flows
Page 123	**The following additional text is added after the section on Cash equivalents:**

Changes in liabilities arising from financing activities

Disclosure of changes in liabilities from financing activities is required. This may be in the form of reconciliation between opening and closing balances:

$'000		**Long-term borrowings**	**Short-term borrowings**	**Lease liabilities**	**Assets held to hedge long-term borrowings**	**Total liabilities from financing activities**
20X3		220,000	100,000	40,000	(6,750)	353,250
Cash flows		(10,000)	(5,000)	(8,000)	1,500	(21,500)
Non-cash changes	**Acquisition**	–	–	3,000	–	3,000
	Foreign exchange movement	–	2,000	–	–	2,000
	Fair value changes	–	–	–	(250)	(250)
20X4		210,000	97,000	35,000	(5,500)	336,500



chapter 14

Revenue

Topic list

1 **Revenue recognition**
   1.1 Accrual accounting
2 **HKFRS 15 *Revenue from Contracts with Customers***
   2.1 Scope
   2.2 Definitions
   2.3 Five-step approach
   2.4 Modifications to contracts
   2.5 Changes to transaction price after contract modification
   2.6 Contract costs
   2.7 Presentation of contracts with customers
   2.8 Disclosure
3 **Application of HKFRS 15**
   3.1 Sales with a right of return
   3.2 Extended warranties
   3.3 Transactions involving an agent
   3.4 Licensing
   3.5 Royalties
   3.6 Repurchase agreements
   3.7 Consignment arrangements
   3.8 Bill and hold arrangements
   3.9 Options for additional goods and services
   3.10 Non-refundable upfront fees
4 **Comparison with HKAS 18 and effect of HKFRS 15**

Learning focus

Revenue is an important part of any commercial organisation's financial statements. You should therefore be able to explain the HKFRS 15 five-step approach and apply it in practice.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.02	**Revenue**	3
3.02.01	Explain and apply the core principle of recognition of revenue in accordance with HKFRS 15	
3.02.02	Explain and apply the criteria for recognising revenue generated from contracts where performance obligations are satisfied over time	
3.02.03	Determine the appropriate methods for measuring progress towards complete satisfaction of a performance obligation	
3.02.04	Determine the contract costs to be recognised	
3.02.05	Explain and apply the measurement principles	
3.02.06	Determine the recognition criteria for specified types of revenue items including: (a) Sales with a right of return (b) Warranties (c) Principal versus agent considerations (d) Royalties (e) Licensing (f) Consignment arrangements (g) Repurchase agreements (h) Bill-and-hold arrangements	
3.02.07	Disclose revenue from contracts with customers as appropriate in the financial statements.	

1 Revenue recognition

Topic highlights

Revenue recognition is straightforward in most business transactions, but can be complicated in some situations.

HKAS 1.28

1.1 Accrual accounting

Accrual accounting is the fundamental concept which underpins the financial statements. This requires an entity to recognise income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria of the *Conceptual Framework*, even if cash receipts and payments occur in a different period.

As a result, the point at which revenue is recognised is usually the same point at which any related costs are recognised. A simple example involves buying goods for resale: the cost of the purchases is carried as inventories in the statement of financial position until such time as they are sold and recognised as revenue; inventories are then recognised as cost of sales (an expense).

HKFRS 15 provides extensive guidance to be applied in order to recognise revenue from contracts with customers, both in simple situations and more complex cases. The standard considers goods and services provided in a contract to be performance obligations that must be satisfied before revenue can be recognised.

2 HKFRS 15 *Revenue from Contracts with Customers*

Topic highlights

HKFRS 15 establishes a single comprehensive framework for accounting for the majority of contracts that result in revenue.

HKICPA issued HKFRS 15 *Revenue from Contracts with Customers* in June 2014 to replace a number of standards and interpretations, including HKAS 11 *Construction Contracts*, HKAS 18 *Revenue*, HK(IFRIC) 13 *Customer Loyalty Programmes*, HK(IFRIC) 15 *Agreements for the Construction of Real Estate*, HK(IFRIC) 18 *Transfers of Assets from Customers* and HK(SIC) Int 31 *Revenue – Barter Transactions Involving Advertising Services*.

The new standard was issued with an effective date of 1 January 2017, later revised to 1 January 2018. Early adoption is permitted.

HKFRS 15 *Revenue from Contracts with Customers* establishes a single, comprehensive framework for accounting for the majority of contracts that result in revenue. These contracts may be for the immediate sale of goods, or relate to goods or services provided over a longer period. The standard establishes a methodology for both measuring and recognising the revenue.

HKFRS 15.5

2.1 Scope

HKFRS 15 does not apply to revenue arising from:

- Lease contracts within the scope of HKAS 17 *Leases*;
- Insurance contracts within the scope of HKFRS 4 *Insurance Contracts*;
- Financial instruments and other contractual rights or obligations within the scope of HKFRS 9 *Financial Instruments*, HKFRS 10 *Consolidated Financial Statements*, HKFRS 11 *Joint Arrangements*, HKAS 27 *Separate Financial Statements* and HKAS 28 (2011) *Investments in Associates and Joint Ventures*; and

- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

2.2 Definitions

HKFRS 15 Appendix A

The following definitions are given in the standard.

Key terms

A **contract** is an agreement between two or more parties that creates enforceable rights and obligations.

A **contract asset** is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

A **contract liability** is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

A **customer** is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

A **performance obligation** is a promise in a contract with a customer to transfer to the customer either

(a) A good or service (or a bundle of goods or services) that is distinct; or

(b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Revenue is income arising in the course of an entity's ordinary activities.

Stand-alone selling price (of a good or service) is the price at which an entity would sell a promised good or service separately to a customer.

Transaction price (for a contract with a customer) is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

(HKFRS 15)

2.3 Five-step approach

HKFRS 15 takes a five-step approach to recognising revenue:

Step 1	Identify the contract(s) with a customer.
Step 2	Identify separate performance obligations.
Step 3	Determine the transaction price.
Step 4	Allocate transaction price to performance obligations.
Step 5	Recognise revenue as or when each performance obligation is satisfied.

Revenue is therefore recognised when control over goods or services is transferred to the customer.

HKFRS 15
9-16

2.3.1 Step 1: Identify the contract(s) with a customer

As defined above, a contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. A contract may be written, verbal or implied by an entity's customary business practices, published policies or specific statements but all of the following conditions must be met:

- The contract is approved by the parties to it and they are committed to performing the relevant performance obligations.
- The contract has commercial substance.
- The parties' rights and payment terms can be identified.
- It is probable that the entity will collect the consideration to which it will be entitled (i.e. the vendor must determine that the customer has both the ability and the intention to pay the promised consideration).

If a contract does meet these criteria at contract inception, a reporting entity need not reassess the criteria unless there is a significant change in facts and circumstances. If a contract does not meet these criteria, it should be assessed on a continual basis to determine whether the criteria are subsequently met.

If a contract does not meet the criteria listed above and an entity receives consideration from the customer, this is recognised as revenue only when:

1. The entity has no remaining obligation to transfer goods or services to the customer and all, or substantially all, of the consideration has been received and is non-refundable; or
2. The contract has been terminated and the consideration received from the customer is non-refundable.

Until recognition as revenue, consideration received is a liability, representing either an entity's obligation to transfer goods or services or refund the consideration received.

Example: Collection of consideration

Z Company sells a product to a new customer in a region that is experiencing severe economic recession. The decision to trade with the customer is a strategic move as it is expected that the economic conditions will improve in the future and sales volumes from the region will increase. The contractually agreed price is $600,000, however due to the current economic problems, Z Company believes at the inception of the contract that it will recover only 75% of this price from the customer.

Required

Is this transaction within the scope of HKFRS 15?

Solution

HKFRS 15 is applied if a contract can be identified and the four conditions relating to the contract are met. In this case the issue is whether 'it is probable that the entity will collect the consideration to which it will be entitled'. As Z Company believes it will receive partial payment for performance, it can be concluded that $450,000 of the contract price will be recovered. Therefore, assuming that the other criteria to identify a contract are met, HKFRS 15 is applied.

The difference between the contract price and the consideration that Z Company expects to receive is a price concession (see section 2.3.3).

HKFRS 15.17

Contracts are combined and accounted for as a single contract. If

1 They are entered into at or near the same time;
2 They are entered into with the same customer, or related parties of the customer; and
3 One or more of the following criteria is met:

- The contracts are negotiated as a package with a single commercial objective
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract, or
- All or some of the goods or services promised in the contracts are a single performance obligation (see below).

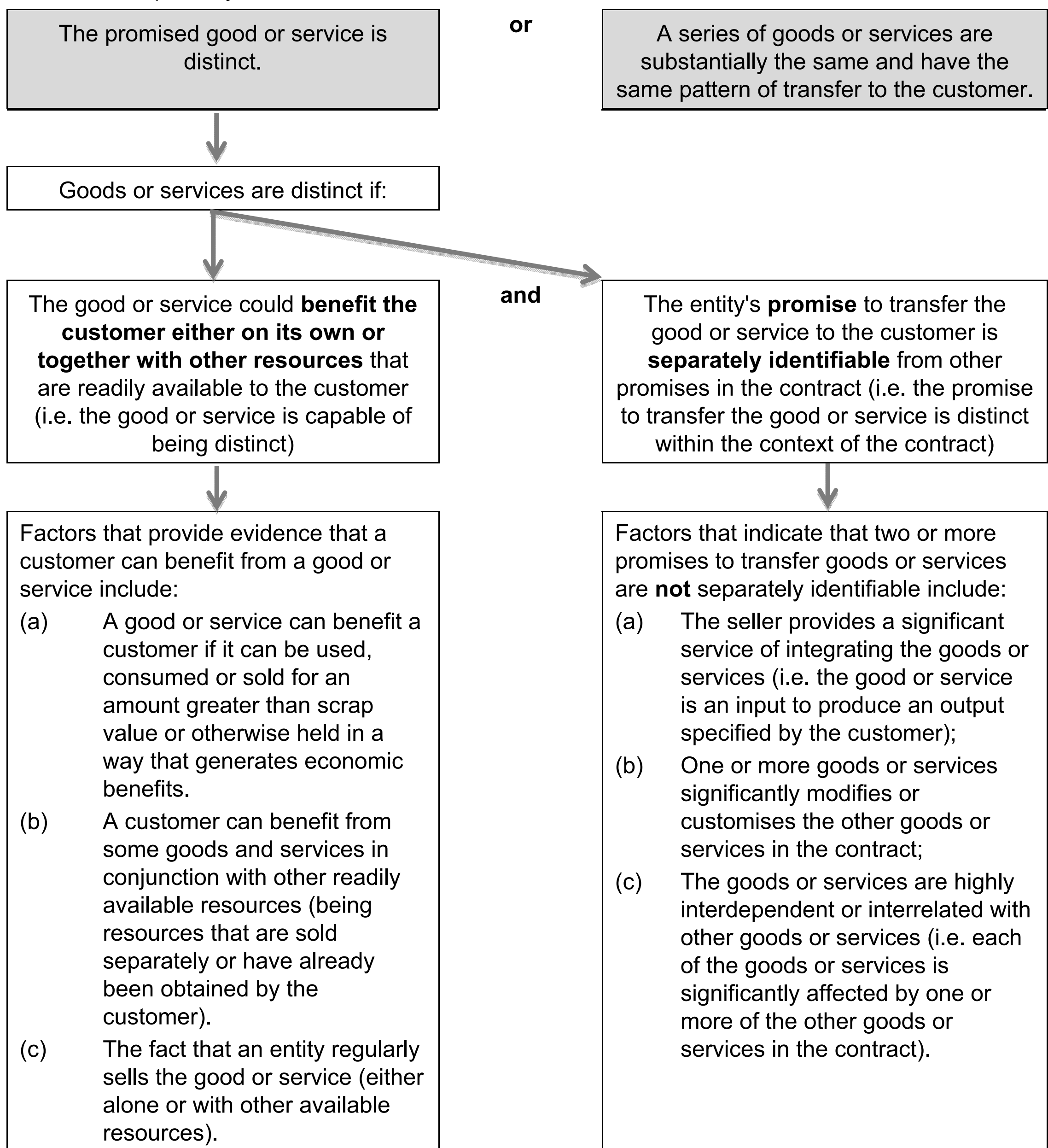
HKFRS 15 22, 27-30

2.3.2 Step 2: Identify performance obligations

Performance obligations are promises to provide goods or services to a customer.

There may be several distinct performance obligations within one contract.

These are separately identified and accounted for if:



If goods or services are not distinct, the reporting company must combine them with other promised goods or services until a bundle of goods or services that is distinct can be identified.

Example: Performance obligations 1

Monument Building Services Co (MBS) constructs properties for customers. It has recently signed a contract to build a retail outlet for Fashion Focus Co. MBS is responsible for designing the building, purchasing raw materials, site preparation, construction, wiring, plumbing and finishing.

Required

Identify the performance obligation(s) in the contract.

Solution

MBS provides Fashion Focus Co with goods and services that are capable of being distinct (e.g. building design services could be sold separately, as could the other elements of the contract).

In the context of this contract, however, MBS is contracted to provide a significant service of integrating the inputs in order to produce a single output being the retail outlet. Therefore the provision of each good or service is not separately identifiable and so not distinct. There is only a single performance obligation, being the development of the property.

Example: Performance obligations 2

Trainor Technical Services Co (TTS) supplies computer aided design packages to customers. It has recently signed a contract with Koala Design to provide a licence to use a software package, installation service (which does not involve customising the software package) and technical support for four years. TTS is not the only company that could install the software and provide technical support.

Required

Identify the performance obligation(s) in the contract.

Solution

Each element of the contract could be used by the customer individually and is separately identifiable i.e. the provision of the licence by TTC is not dependent on or highly interrelated with other goods and services promised in the contract and would not be significantly affected if Koala Design elected to use one of TTC's competitor's installation services and technical support services.

Therefore there are three distinct performance obligations in the contract, being:

1 Provision of the licence
2 Installation of the software
3 Provision of technical support.

HKFRS 15.47

2.3.3 Step 3: Determine transaction price

The transaction price is the consideration that the selling company expects to be entitled to in return for transferring goods or services. When determining transaction price, the following should be considered.

HKFRS 15 50-54

Variable consideration

Variable consideration may exist in addition to fixed consideration. The variable element of consideration may be the result of discounts, rebates, refunds, credits, price concessions,

incentives, performance bonuses or penalties. It may increase or decrease the transaction price, depending on its nature. Variable consideration is included in the transaction price based on either:

- Its expected value (the sum of probability weighted amounts in a range of possible outcomes), or
- The single most likely amount (the single most likely amount in a range of possible consideration amounts).

The expected value approach is generally appropriate if the vendor has a large number of contracts with similar characteristics.

The single most likely outcome may be appropriate if a contract has only two possible outcomes (e.g. an entity achieved a performance bonus or does not).

The chosen approach should be that which is expected to provide a better prediction of consideration.

Variable consideration is included in the transaction price only to the extent that it is highly probable that a significant amount will not be reversed when the uncertainty associated with the variable consideration is resolved. When assessing whether it is highly probable that a significant reversal will occur, an entity should consider both the likelihood and magnitude of the revenue reversal. Factors that may increase the likelihood or magnitude of reversal include **any** of the following:

(a) The amount of consideration is highly susceptible to factors outside the entity's influence e.g. market volatility or weather conditions.

(b) The uncertainty about consideration is not expected to be resolved for a long period of time.

(c) The entity's experience with similar types of contracts is limited or has limited predictive value.

(d) The entity has a practice of offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

(e) The contract has a large number and broad range of possible consideration amounts.

Example: Variable consideration

In January 20X6 College Properties Ltd (CPL) enters into a contract to build an extension to an existing warehouse for an agreed fee of $40 million. The contract terms require completion by 30 September 20X6. The price will decrease by $100,000 for each day after this that the project remains incomplete. At the year-end of 30 June 20X6, CPL expect that there is a 75% chance of the project being completed on time, a 15% chance of it being completed a day late, a 6% chance of it being completed two days late and a 4% chance of it being completed three days late.

Required

What is the transaction price?

Solution

The consideration is variable due to the price concession, i.e. the fact that CPL will accept an amount that is less than the price stated in the contract if the project overruns.

Here the calculation of transaction price is based on expected values.

	$
75% × $40,000,000	30,000,000
15% × $39,900,000	5,985,000
6% × $39,800,000	2,388,000
4% × $39,700,000	1,588,000
Transaction price	39,961,000

Example: Variable consideration 2

In March 20X6 College Properties Ltd (CPL) enters into another contract to extend a retail unit for an agreed fee of $30 million. The contract terms state that if the extension is completed by 30 November 20X6, a 10% bonus ($3 million) becomes payable. CPL expect that there is a 70% chance of the project being completed by 30 November 20X6.

Required

What is the transaction price?

Solution

The consideration is variable due to the performance bonus i.e. the fact that CPL will receive an amount that is more than the price stated in the contract if the project is completed by 30 November 20X6.

Here the calculation of transaction price could be based on expected values. However, the single most likely outcome may be more appropriate as there are only two possible outcomes.

The single most likely outcome is the receipt of $33 million, therefore this is the transaction price.

Although at the inception of the contract, CPL could have chosen to use either the expected value method or the single most likely outcome method to estimate variable consideration, it must apply the chosen method consistently throughout the contract.

Example: Variable consideration and volume discount

In January 20X5 Smeaton Traders (ST) signed a year-long contract to supply front doors to a residential construction company. The contract stipulated a price of $800 per door, which would drop to $700 per door if a minimum of 500 were purchased in the year. During the first quarter of 20X5, the construction company purchased 50 doors, and, having considered its experience with this product and the purchasing pattern of the construction company, ST determined that it was not highly probable that the customer would purchase a further 450 doors during the year. In June 20X5, the construction company purchased 110 doors and advised ST that as a result of a new contract obtained to build several apartment blocks in the second half of the year, it expected its demand for doors to increase to approximately 250 per quarter.

Required

What amount of revenue is recognised in quarter 1 and quarter 2 of 20X5?

Solution

Quarter 1

In this quarter, ST do not expect the number of doors sold to exceed the minimum threshold of 500 and therefore a significant reversal of revenue is not highly probable. Therefore revenue is recognised based on a price of $800 per door. Total revenue recognised is $40,000 ($800 × 50).

Quarter 2

In quarter 2, based on new facts available in June 20X5, ST estimates that the customers' annual purchases will exceed the threshold of 500 units, thereby triggering a price reduction to $700 per door.

Revenue in quarter 2 is therefore calculated to include a retrospective adjustment to quarter 1's revenue:

	$
Quarter 2 sales ($700 × 110)	77,000
Quarter 1 adjustment: price reduction × quantity sold ($100 × 50)	(5,000)
Quarter 2 revenue	72,000

HKFRS 15 60-65

Significant financing component

The aim of HKFRS 15 is that transaction price reflects the cash selling price when control of goods or services passes. If the timing of payments in the contract provides either the customer or seller with a significant financing benefit, the transaction price is adjusted to reflect this. In order to determine whether there is a significant financing benefit, the following should be considered:

1 The difference between promised consideration and the cash selling price of goods or services, and

2 The combined effect of the length of time between payment and provision of goods or services and the prevailing interest rates in the relevant market.

HKFRS 15 does not, however, require adjustment where receipt of payment from the customer will be one year or less from the date on which the promised goods or services are transferred.

When adjusting transaction price for a significant financing component, HKFRS 15 requires that the discount rate that would be reflected in a separate financing transaction between the seller and customer at contract inception is applied. This rate is not subsequently updated.

Example: Significant financing component – advance payment from customer

During 20X6, Snowdrop Construction Ltd (SCL) enters into a contract to build a new retail unit for a customer. Completion of the property is scheduled for one year's time and control of the unit will pass to the customer at this time (i.e. performance obligations satisfied at a point in time). Rather than pay SCL $12 million on completion, the customer agrees to pay a reduced price of $10.9 million at the inception of the contract (a year before completion). The interest rate implicit in the contract is 10% and SCL's incremental borrowing rate is 7%.

Required

What accounting entries are required to recognise the sale transaction?

Solution

The contract contains a significant financing component, i.e. the customer is providing SCL with funds at the start of the project, so removing the need for SCL to secure funding from an alternative source such as a bank. The financing component can be considered significant due to the difference between the promised consideration ($10.9 million) and cash selling price ($12 million) of the property and because of the combined effect of the expected length of time between payment and transferring the property (one year) and the prevailing interest rates in the market (7%) (HKFRS 15.61).

At the inception of the contract, the cash advance is recognised by:

DEBIT	Bank	$10,900,000	
CREDIT	Contract liability		$10,900,000

Over the one-year construction period, interest accrues at SCL's incremental borrowing rate:

DEBIT	Interest expense (10.9m × 7%)	$763,000	
CREDIT	Contract liability		$763,000

The interest rate applicable to the transaction will not always be the rate implied by the contractual terms of the sales transaction; the interest rate that would apply to a borrowing arrangement (here the rate that SCL would be charged by a bank) is required by HKFRS 15.64.

At the date on which the unit transfers to the customer:

DEBIT	Contract liability	$11,663,000	
CREDIT	Revenue		$11,663,000

As consideration is expected to be within one year, SCL can choose to take advantage of the practical expedient offered by HKFRS 15.63 and not adjust the amount of consideration for the financing component. In this case the accounting entries are as follows:

At the inception of the contract, the cash advance is recognised by:

DEBIT	Bank	$10,900,000	
CREDIT	Contract liability		$10,900,000

At the date on which the unit transfers to the customer:

DEBIT	Contract liability	$10,900,000	
CREDIT	Revenue		$10,900,000

HKFRS 15 66-69

Non-cash consideration

Non-cash consideration is measured at fair value, or, if this cannot be reasonably estimated, by reference to the stand-alone selling price of the goods or services promised to the customer in exchange for the consideration.

HKFRS 15.55

Refund liabilities

Some contracts allow the customer to return goods and receive a refund, a credit note to be applied against future transactions or another product in exchange. When a selling company expects products to be returned, it should not recognise revenue, but should instead recognise a refund liability as well as an asset representing items expected to be returned. Refund liabilities should be assessed and updated at the end of each reporting period.

HKFRS 15 70-72

Consideration payable to a customer

A seller may pay consideration to a customer in the form of cash amounts, credit or other items (such as coupons or vouchers).

Consideration paid or payable to a customer that is not in exchange for a distinct good or service is accounted for as a reduction in transaction price. The reduction in revenue is recognised at the later of:

- The point at which revenue is recognised for the transfer of related goods or services
- The point at which the entity pays or promises to pay the consideration

Example: Consideration payable to a customer

A manufacturer of reading glasses See Well Ltd (SWL) enters into a contract to sell goods to a high street chain of stores, Eye Trend. The terms of the contract require Eye Trend to purchase at least $5 million of goods from SWL over a 12-month period and also require Eye Trend to purchase specialist display cabinets for SWL products. At the start of the contract SWL makes a non-refundable payment of $500,000 to Eye Trend as contribution towards the cost of the display cabinets.

Required

How is the $500,000 payment to Eye Trend accounted for at the start of the contract and over the following 12-month period?

Solution

The payment of $500,000 to Eye Trend is not in exchange for distinct goods and services since SWL does not gain control of the display cabinets. Therefore the $500,000 is accounted for as a reduction in the selling price of glasses to Eye Trend.

At start of contract

SWL should initially recognise the payment of the $500,000 by:

DEBIT	Revenue contract asset	$500,000	
CREDIT	Bank		$500,000

Over following 12-month period

The $500,000 is released to profit or loss over the 12-month contract with Eye Trend to reduce revenue over that period:

DEBIT	Revenue	$500,000	
CREDIT	Revenue contract asset		$500,000

Self-test question 1

Wells Furniture Limited (WFL) has a year-end of 28 February and sells furniture to the general public offering interest free credit. On 12 March 20X5 the company sells furniture (for immediate delivery) with a total selling price of $250,000, payable by the customer after two years' interest free credit. A market annual rate of interest on the provision of consumer credit to similar customers is 4%.

Required

What journal entries are made to recognise the transaction in the years ended 28 February 20X6 and 20X7?

(The answer is at the end of the chapter)

HKFRS 15 73-74, 76-79

2.3.4 Step 4: Allocate transaction price to performance obligations

The transaction price determined in step 3 (section 2.3.3) must be allocated to the performance obligations identified in step 2 (section 2.3.2). Allocation is made in proportion to the individual stand-alone selling price attached to each performance obligation.

If a stand-alone selling price is not directly observable, an entity should estimate this price using a suitable method, for example:

(a) Adjusted market approach (i.e. estimating the price that a customer would be willing to pay in the market in which it operates. This may require reference to competitors' pricing, adjusted for the entity's costs and margins.)

(b) Expected cost plus margin approach (i.e. forecasting expected costs of satisfying a performance obligation and adding an appropriate margin)

(c) Residual approach (i.e. estimating the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods/ services promised in the contract). HKFRS 15 is clear that the residual approach is only appropriate if one of the following criteria is met:

  (i) The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts, meaning that a representative stand-alone selling price is not discernible; or

  (ii) The entity has not yet established a price for the good or service and it has not previously been sold on a stand-alone basis.

HKFRS 15 81-83

Allocation of discount

A customer may receive a discount for purchasing a bundle of goods and/or services. This is the case where the total price for the bundle is less than the sum of individual prices of each of the items included in the bundle. Unless there is observable evidence that the discount only relates to certain performance obligations within the contract, it is allocated proportionately to all performance obligations in the contract on the basis of their stand-alone selling prices.

The discount is allocated only to certain performance obligation(s) in the contract rather than all of them if **all** of the following conditions are met:

(a) The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis;

(b) The entity regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at discount to the stand-alone selling prices of the goods or services in each bundle; and

(c) The discount attributable to each bundle of goods or services is substantially the same as the discount in the contract and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

Example: Allocation of transaction price

The contract between Trainor Technical Services Co (TTS) and Koala Design (see previous example) is priced at $6,000. The stand-alone selling prices of each element are as follows:

	$
• Provision of a licence	5,000
• Installation service	1,500
• Provision of technical support	3,000
	9,500

Solution

Licence provision $5,000/$9,500 × $6,000 = $3,158

Installation service $1,500/$9,500 × $6,000 = $947

Technical support service $3,000/$9,500 × $6,000 = $1,895

Example: Allocation of a discount

Voss Electricals (VE) regularly sells three products HNC1, DCS11 and AB5 at stand-alone selling prices of $500, $550 and $450 respectively. The company also regularly sells DCS11 and AB5 as a bundle at a price of $600.

A customer enters into a contract with VE to purchase HNC1, DCS11 and AB5 together at a cost of $1,100. VE will deliver each product to the customer at a different time.

Explain how the transaction price of $1,100 is allocated to each of the products.

Solution

- The stand-alone selling prices of the goods total $1,500 ($500 + $550 + $450), meaning that a discount is offered in the contract of $400 ($1,500 – $1,100).
- The discount should be allocated to DCS11 and AB5 only rather than to all three products. This is because:
  1. VE regularly sells each product on a stand-alone basis, and
  2. VE regularly sells a bundle of DCS11 and AB5 at a discount to their stand-alone selling prices, and
  3. The discount attributable to a bundle of DCS11 and AB5 is $400 ($550 + $450 – $600) and this is the same as the discount in this contract
- Therefore $500 of the transaction price is allocated to HNC1. This is the same as the stand-alone selling price of HNC1, i.e. HNC1 is not allocated any discount.

- The remaining $600 of the transaction price is allocated to DCS11 and AB5. Since control of these products is transferred at different times, they represent separate performance obligations and each is allocated a proportion of the $600 based on stand-alone selling prices as follows:

  DCS11 ($550/($550 + $450) × $600) = $330
  AB5 ($450/($550 + $450) × $600 = $270

HKFRS 15 84-86

Allocation of variable consideration

Variable consideration that is promised within a contract may be related to all or only part of the contract (i.e. only specific performance obligations). Variable consideration is allocated entirely to a performance obligation or transfer of distinct goods/services if:

- The terms of the variable payment related specifically to that performance obligation or transfer, and
- Allocating the variable consideration in its entirety to the performance obligation/transfer is consistent with the objective that the selling price is allocated to each performance obligation in order to reflect the consideration to which the vendor expects to be entitled in exchange for the good or service.

HKFRS 15 87-89

Changes in contract price after contract inception

The transaction price is not fixed in some contracts, but may vary due to the outcome of certain events or changes in circumstances.

Changes in transaction price after the inception of a contract are allocated to performance obligations within the contract on the same basis as the transaction price is allocated at the start of the contract. There is no reallocation to reflect changes in stand-alone selling prices.

If the performance obligation to which variable consideration is allocated has been satisfied then revenue is recognised (or reduced) in the period in which the transaction price changes.

A change in transaction price is allocated only to certain performance obligations rather than all performance obligations in a contract only where the criteria for allocating variable consideration on this basis are met.

HKFRS 15 31-32, 35-36

2.3.5 Step 5: Recognise revenue when performance obligations are satisfied

As each performance obligation is satisfied the related element of the transaction price is recognised as revenue. A performance obligation is satisfied when a good or service is transferred to the customer i.e. when the customer obtains **control** of the asset. Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. The benefits of an asset are the potential cash inflows or reduction in cash outflows that can be obtained directly or indirectly from the asset.

Depending on the performance obligation it may be satisfied **at a single point in time** or **over a period of time**. A performance obligation is satisfied **over time** if any of the following criteria is met:

(a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (e.g. a cleaning service).

(b) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (e.g. customised software that is being written into a customer's existing IT infrastructure).

(c) The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. The seller does not have an alternative use for an asset if it cannot direct the asset for another use or if it would incur significant economic losses to do so (e.g. in a manufacturing contract if a design is unique to one customer and so to redirect goods to another customer would require significant rework).

If an entity does not satisfy a performance obligation over time (i.e. the criteria above are not met), the performance obligation is satisfied at a point in time.

HKFRS 15.38

Performance obligation satisfied at a single point in time

Where a performance obligation is satisfied at a single point in time, the following should be considered in determining when the customer obtains **control** of the asset:

1. Whether the entity has a present right to payment for the asset
2. Whether the entity has transferred legal title to the asset
3. Whether the entity has transferred physical possession of the asset
4. Whether the entity has transferred the risks and rewards of ownership of the asset to the customer
5. Whether the customer has accepted the asset

HKFRS 15 39-45, B14-B19

Performance obligation satisfied over a period of time

Revenue is only recognised when an entity can reasonably measure the outcome of a performance obligation. In the early stages of a contract this is not always possible, and in this case revenue is recognised to the extent of costs incurred that are expected to be recovered. This applies until the outcome can be reasonably measured.

Where an entity can reasonably measure the outcome of a performance obligation, revenue is recognised based on progress towards satisfaction of the performance obligation. Progress is measured by way of either an input or output method that would provide a faithful depiction of the entity's performance towards complete satisfaction of the performance obligations.

- **Input methods** may include the proportion of costs incurred, labour hours or machine hours worked or time elapsed.
- **Output methods** may include the number of units produced, work certified or contract milestones.

Where an input method is used and some inputs do not contribute towards meeting a performance obligation (such as wasted materials), then these are ignored when measuring progress towards satisfaction of the performance obligation.

The method applied to measure progress must be used consistently for each performance obligation satisfied over time, and the same method must be applied to similar performance obligations in similar circumstances.

Example: Satisfaction of performance obligation(s)

Trott Builders Ltd (TBL) is developing a shopping centre that contains a number of retail units. A customer, Retail Experts Ltd (REL) enters into a binding contract with TBL on 1 August 20X6 for a specified unit that is being constructed. All units are of similar size, however, other attributes are different e.g. some units have a larger window space due to being a corner unit.

Required

Is the performance obligation satisfied by TBL at a single point in time or over time in each of the following cases?

(a) REL pays a deposit to TBL on 1 August 20X6, with the remainder of the price payable on completion when REL has physical possession of the unit. The deposit is refundable to REL only if TBL fails to complete construction of the unit in accordance with contract terms; if REL defaults on the contract before completion of the unit, TBL can retain the deposit but has no right to further funds.

(b) REL pays a non-refundable deposit to TBL on 1 August 20X6 and must make progress payments to TBL during construction. TBL may not direct the unit to another customer during the contract and REL does not have the right to terminate the contract unless TBL fail to perform as promised. If REL fails to make the agreed progress payments and TBL complete the construction of the unit, TBL has the right to receive all payments that were due from REL. The courts have previously upheld developers' rights to payments in similar cases.

Solution

In both cases, TBL should determine on 1 August 20X6 whether the promise to construct and transfer the retail unit to the customer is a performance obligation satisfied at a point in time or over time.

(a) In this case TBL does not have a right to payment for work completed at a given point in time; TBL is only entitled to the deposit paid by the customer until construction is complete. Therefore the performance obligation is satisfied at a single point in time, being when the customer obtains control of the retail unit.

(b) In this case the unit does not have an alternative use to TBL as it cannot transfer the unit to another customer. Furthermore, TBL has the right to payment for performance completed to date as a result of the terms of the contract and legal precedent. **Therefore the performance obligation is satisfied by TBL over time.**

Example: Performance obligation satisfied over time

Peninsula Construction Company (PCC) begins the construction of a conference centre on behalf of a hotel group during 20X6. The agreed contract price is $35 million however this will be reduced by $3 million if PCC completes the centre a month or more behind schedule. During the year ended 31 December 20X6, costs incurred amounted to $9.3 million, including $500,000 material that could not be used in the project as it was of the incorrect grade to meet regulations. The total cost of the project (excluding the $500,000 in wasted material) is estimated to be $22 million. Work certified at the year-end was $12.25 million.

The construction is currently progressing in accordance with the agreed schedule.

Required

(a) What amount of revenue is recognised in profit or loss in the year ended 31 December 20X6 if an input method is used to assess progress?

(b) What amount of revenue is recognised in profit or loss in the year ended 31 December 20X6 if an output method is used to assess progress?

Solution

The transaction price is $35 million. $32 million is fixed compensation and $3 million is variable consideration. The transaction price is $35 million as the project is currently expected to be completed on time and therefore the single most likely outcome is receipt of $35 million.

(a) Input method

Using the input method the project is 40% complete:

$$\frac{\text{Costs incurred to date}}{\text{Total expected costs}} = \frac{(9{,}300 - 500)}{22{,}000} = 40\%$$

Therefore 40% × $35m = $14 million is recognised as revenue in the year.

Note that the $500,000 wasted material is not relevant to the assessment of progress, however, it must be recognised in profit or loss as a wastage expense.

(b) Output method

Using the output method the project is 35% complete:

$$\frac{\text{Work certified}}{\text{Transaction price}} = \frac{12{,}250}{35{,}000} = 35\%$$

Therefore 35% × $35m = $12.25 million is recognised as revenue in the year.

Contract costs are considered in further detail in section 2.4.

Self-test question 2

FitFast runs a number of gyms in Hong Kong. It enters into a 12-month contract with a customer on 1 February 20X5 allowing the customer to access any of its gyms in return for a $10,200 fee paid in advance.

Required

Explain how FitFast should recognise revenue from the contract with the customer in its year ended 31 December 20X5, referring to the requirements of HKFRS 15?

(The answer is at the end of the chapter)

HKFRS 15 18, 20, 21

2.4 Modifications to contracts

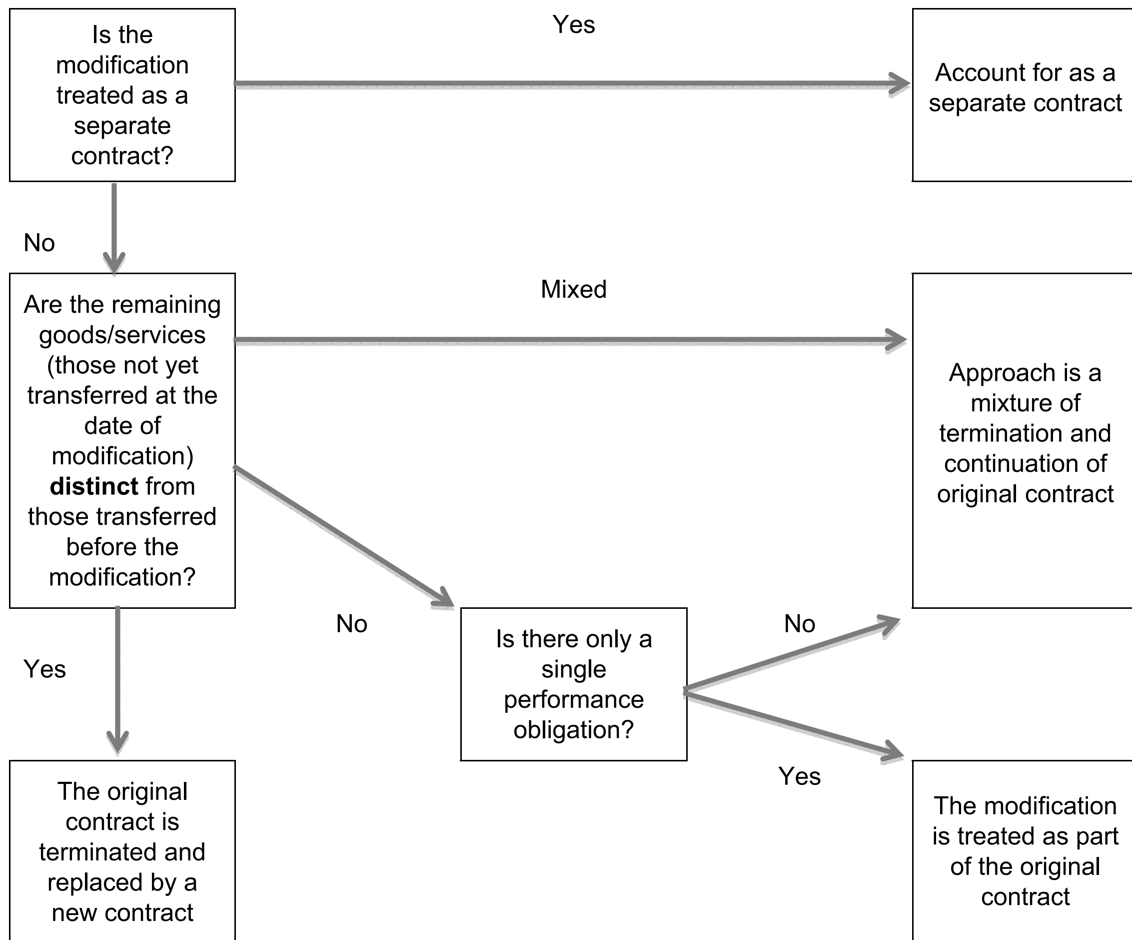
A contract modification is a change to the scope/price of a contract such that it either creates new or changes existing enforceable rights and obligations of the parties to the contract. Both parties to the contract should approve such a modification.

A contract modification is accounted for as a separate contract if:

(a) The scope of the contract changes because additional **distinct** goods or services are promised (see section 2.3.2), and

(b) The increase to the contract price reflects the stand-alone selling price of the additional goods or services promised.

The following decision tree is applied:



The concept of **distinct** goods and services is discussed in section 2.3.2.

Example: Modifications to contracts

At the start of 20X6, the Asia Luggage Company (ALC) entered into a contract to sell 6,000 leather mobile phone cases to a customer over the course of 20X6 at an agreed price of $80 per case. The cases would be supplied evenly throughout the year at a rate of 500 per calendar month.

At the end of June 20X6, the customer requests the order for each of the remaining months of the contract to be increased to 600 units. The contract is changed to require the delivery of an extra 100 units per month at a price of $65, which is the stand-alone selling price of a phone case at the modification date.

Required

(a) How is the contract accounted for?

(b) How would the contract be accounted for if the price for the additional 100 units were $65 but the stand-alone price of the units at the modification date were $75?

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Solution

(a) January – June 20X6: Revenue of 3,000 × $80 = $240,000 is recognised.

Modification:

- The scope of the contract changes because additional distinct goods are promised (i.e. the additional 600 units are not included in the original contract), and
- The increase to the contract price reflects the stand-alone price of the additional cases ($65).

Therefore the modification is accounted for as a separate contract for the additional 600 units.

July – December 20X6: Revenue of 3,000 × $80 = $240,000 is recognised in respect of the original contract.

Revenue of 600 × $65 = $39,000 is recognised in respect of the new contract,

(b) January – June 20X6: Revenue of 3,000 × $80 = $240,000 is recognised.

Modification:

- The scope of the contract changes because additional distinct goods are promised, however, the contract price does not reflect the stand-alone price ($75) of the additional cases.

Therefore the modification is not accounted for as a separate contract. The remaining goods to be provided are distinct and therefore the existing contract is treated as being terminated and a new contract deemed to exist for the remaining six months of 20X6.

July – December 20X6: The weighted average price of each case provided in the last six months of the year is:

$$\frac{(3,000 \times \$80) + (600 \times \$65)}{3,600} = \$77.50$$

Therefore revenue of 600 × $77.50 = $46,500 is recognised per month, giving total revenue of $279,000

HKFRS 15.90

2.5 Changes in the transaction price after contract modification

A change to transaction price that arises as the result of a contract modification is accounted for in accordance with section 2.4 above. A change to transaction price that arises after a contract modification is accounted for in one of the following ways:

- The change in price is allocated to the performance obligations identified in the original contract if the variable consideration was promised before the contract modification;
- The change in price is allocated to the performance obligations identified in the modified contract if the variable consideration was promised after the contract modification and the modification was not accounted for as a separate contract.

Example: changes in transaction price after a modification

Kenny Trading Ltd (KTL) enters a contract on 1 February 20X6 to transfer product A and Product B to a customer. Consideration includes a fixed element, being $1 million, and a variable element, estimated in accordance with HKFRS 15 at $200,000. Product A and Product B have the same stand-alone selling prices and the variable consideration is allocated to both in accordance with HKFRS 15. Product A is delivered immediately on 1 February 20X6 and Product B is to be delivered on 1 August 20X6.

On 1 June 20X6, the contract is modified to include the promise of a third product, Product C, to be delivered on 1 October 20X6. The price of the contract is increased by $300,000 (a fixed amount) which does not represent the stand-alone selling price of Product C. The stand-alone selling price of Product C is the same as that of Products A and B.

On 1 July 20X6, KTL revises its estimate of the variable consideration to which it expects to be entitled to $240,000. It is highly probable that a significant reversal in cumulative revenue recognised will not occur when the uncertainty is reversed.

Required

(a) What revenue is recognised by KTL on 1 February when Product A is delivered to the customer?

(b) Explain how the modification to the contract on 1 June 20X6 is accounted for.

(c) Explain how the revision to variable consideration is accounted for and therefore what revenue is recognised when the performance obligations relating to Products B and C are satisfied.

Solution

(a) The transaction price of $1.2 million is allocated equally between the promise to deliver Product A and the promise to deliver Product B, because both products have the same stand-alone selling price. Therefore $600,000 revenue is recognised by KTL on 1 February 20X6.

(b) The modification is accounted for as a termination of the existing contract and the creation of a new contract. This is because Products B and C are distinct from Product A and the promised consideration for Product C does not reflect its stand-alone selling price.

The consideration initially allocated to Product B ($600,000) and the $300,000 promised in the modification give a total transaction price for the new contract of $900,000. This is allocated equally to the promise to deliver Product B and the promise to deliver Product C. Therefore $450,000 is allocated to each performance obligation.

(c) Before the performance obligations relating to the delivery of Products B or C are satisfied, the estimated amount of variable consideration changes from $200,000 to $240,000. This consideration was promised before the modification and therefore the change in transaction price is allocated between the performance obligations to deliver Product A and Product B on the same basis as at contract inception.

Therefore an additional $20,000 revenue is recognised immediately in respect of the satisfaction of the performance obligation to deliver Product A. The remaining $20,000 of the additional consideration is allocated to the remaining performance obligations at the time of the contract modification.

The consideration initially allocated to Product B ($600,000) plus the additional variable consideration ($20,000) and the $300,000 promised in the modification now give a total transaction price for the new contract of $920,000. This is allocated equally to the promise to deliver Product B and the promise to deliver Product C. Therefore $460,000 is allocated to each performance obligation.

KTL recognises $460,000 revenue on 1 August 20X6 on satisfaction of the performance obligation relating to Product B and another $460,000 revenue on 1 October 20X6 on satisfaction of the performance obligation relating to Product C.

HKFRS 15
91, 93

2.6 Contract costs

HKFRS 15 deals with the costs of obtaining a contract and the costs of fulfilling a contract.

2.6.1 Costs of obtaining a contract

Any non-incremental costs of obtaining a contract are recognised immediately in profit or loss, unless they can be charged to the customer regardless of whether the contract is obtained.

Incremental costs of obtaining a new contract are recognised as an asset if the costs are expected to be recovered. They are amortised on a basis that reflects the transfer of goods or services to the customer. The incremental costs of obtaining a new contract can be expensed if the amortisation period would have been one year or less.

Example: Costs of obtaining a contract

Pay Day Company (PDC) enters into service contracts to manage a customer's payroll operations for five-year terms. The contracts may be subsequently renewed on a one-year rolling basis and the average customer term is eight years. PDC pays its sales staff a commission of $40,000 when a new customer signs an initial contract.

On 1 August 20X5, the PDC sales staff secured a new customer contract.

How is the cost of commission of $40,000 accounted for?

Solution

The $40,000 is an incremental cost of obtaining a new contract, and PDC expects to recover the cost through future fees charged to the customer for the provision of payroll services.

Therefore the $40,000 is recognised as an asset and amortised over a period to reflect the transfer of services to the customer. Although the original contract is for five years, this is usually extended for a further three years and so the amortisation period is eight years.

Therefore the annual amortisation charge is $5,000 ($40,000/8 years).

HKFRS 15
95-98

2.6.2 Costs of fulfilling a contract

Any costs incurred to fulfil a contract that fall within the scope of another standard are accounted for in accordance with that standard (e.g. HKAS 2, HKAS 16, HKAS 38).

HKFRS 15 requires that the following costs are recognised as an expense when incurred:

- General and administrative costs
- Abnormal costs such as wasted material that are not reflected in the cost of the contract
- Costs relating to performance obligations that have already been satisfied
- Costs that an entity cannot distinguish as relating to satisfied or unsatisfied performance obligations

Costs incurred fulfilling a contract that do not fall within the scope of another standard and are not identified above are recognised as an asset if **all** of the following conditions are met:

- The costs relate directly to a contract or anticipated contract.
- The costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future.
- The costs are expected to be recovered.

Costs that relate directly to a contract or anticipated contract include direct labour, direct materials, allocations of costs that relate directly to contract activities, costs that are explicitly chargeable to the customer under the contract and other costs that are incurred only because an entity entered into a contract e.g. subcontractor costs.

HKFRS 15 99-104

2.6.3 Amortisation and impairment

Capitalised contract costs are amortised over the period during which the goods and services to which they relate are transferred to the customer.

Amortisation is updated to reflect a significant change in the entity's expected timing of transfer to the customer of goods or services to which the asset relates. Such a change is a change in accounting estimate in accordance with HKAS 8.

Any loss for assets related to the contract that are recognised in accordance with another standard (e.g. HKAS 2) should be recognised first. After that, an impairment loss on capitalised contract costs is recognised if the carrying amount of the capitalised contract costs exceeds the following amount:

	$
Remaining amount of consideration that the entity expected to receive in exchange for the goods or services to which the asset relates (Note)	X
Less: costs that relate directly to providing those goods or services that have not been recognised as expenses	(X)
	X

Note. It follows the same principles for determining transaction price (other than the constraining estimates of variable consideration) and adjusted to reflect the customer's credit risk.

Any impairment loss is recognised in profit or loss.

An impairment loss of a contract costs asset may be reversed if the conditions that led to the impairment no longer exist or have improved. In this case:

- The reversal is recognised in profit or loss
- The carrying amount of the asset cannot exceed the carrying amount (net of amortisation) had the impairment loss not been recognised

Example: Costs of fulfilling a contract

On 1 June 20X5, Rainy Day Company (RDC) enters into a contract to manage a customer's information technology data centre for six years (average customer term is also six years) at an annual cost of $1.2 million. RDC designs and builds a technology platform for its own internal use that interfaces with the customer's systems prior to the contract commencing on 1 August 20X5. The platform is not transferred to the customer. The initial costs to set up the platform are:

Design services	$400,000
Hardware	$650,000
Software	$480,000
Migration and testing of data	$550,000
Total	$2,080,000

How should these costs be accounted for in accordance with HKFRS 15?

Solution

Any costs incurred to fulfil a contract that falls within the scope of another standard are accounted for in accordance with that standard. Therefore:

- The hardware is property, plant and equipment and the cost is accounted for in line with HKAS 16;
- The software is an intangible asset and its cost is accounted for in line with HKAS 38;
- The remaining costs (design services and migration and testing of data) should be assessed as costs to fulfil a contract under HKFRS 15. They are recognised as an asset if:
  – The costs relate directly to an identifiable contract or anticipated contract.

– The costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future.

– The costs are expected to be recovered.

In this case the costs do relate directly to an identifiable contract and generate/enhance resources used to fulfil the contract. They are expected to be recovered by virtue of the total income from the contract of $7.2 million ($12m × 6 years) exceeding the costs.

Therefore these costs are recognised as an asset and amortised over the average customer term of six years.

HKFRS 15 105-109

2.7 Presentation of contracts with customers

In the statement of financial position, a contract with customers may be recognised as any of:

Contract asset	Entity's right to consideration in exchange for goods or services that it has transferred to a customer when that right is conditional on something other than the passage of time (for example the entity's performance), i.e. if an entity transfers goods or services to a customer before the customer pays consideration, the entity shall present the contract as a 'contract asset', unless it is presented as a receivable. A contract asset is assessed for impairment in line with HKFRS 9 guidance.
Receivable	Entity's right to consideration that is unconditional, i.e. only the passage of time is required before payment is due. A receivable is accounted for in line with HKFRS 9; upon initial recognition, any difference between the measurement of the receivable and the corresponding amount of revenue is presented as an expense.
Contract liability	Entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer, i.e. if a customer pays consideration before the entity transfers goods or services to the customer, the entity shall present the contract as a 'contract liability'.

HKFRS 15 permits an entity to use a term other than 'contract asset' or 'contract liability' in its financial statements. If an alternative term is used for 'contract asset' sufficient information must be provided to distinguish this amount from receivables.

Example: Contract assets and liabilities

AB Company enters into a cancellable contract with a customer on 18 August 20X6, agreeing to transfer goods to the customer on 30 September 20X6. The contract requires the customer to pay AB Company $120,000 on 31 August 20X6; the customer pays on 7 September 20X6.

Required

(a) What journal entries are required to recognise this transaction at each relevant date?
(b) How do the entries differ if the contract is non-cancellable?

Solution

(a) **7 September – when cash is received before the entity transfers goods or services:**

DEBIT	Bank	$120,000	
CREDIT	Contract liability		$120,000

30 September – when goods or services are transferred:

DEBIT	Contract liability	$120,000	
CREDIT	Revenue		$120,000

(b) **31 August – when the entity has unconditional right to the consideration:**

DEBIT	Receivable	$120,000	
CREDIT	Contract liability		$120,000

7 September – when cash is received before the entity transfers goods or services:

DEBIT	Bank	$120,000	
CREDIT	Receivable		$120,000

30 September – when goods or services are transferred:

DEBIT	Contract liability	$120,000	
CREDIT	Revenue		$120,000

HKFRS 15.105

2.7.1 Offsetting

HKFRS 15 makes the following points about offsetting:

- A single contract is presented either as a net contract asset or a net contract liability. Any unconditional right to consideration is presented as received separately.
- Contract assets and liabilities in respect of different customers are not offset.

Self-test question 3

On 1 November 20X2, Milton Dodman (MD) entered into a written non-cancellable contract to construct an office block for a customer for promised consideration of $50 million and a bonus of $5 million if the property was completed within 30 months. The contract establishes progress payment dates as follows:

Interim payment 1	30 June 20X3	$10 million
Interim payment 2	31 October 20X3	$12 million
Interim payment 3	31 March 20X4	$12 million
Final payment	Completion	$16 million plus bonus if relevant

Milton Dodman has limited experience with this type of contract however is aware that meeting the 30-month deadline to achieve the bonus will be affected by weather conditions, particularly during the first 15 months of the project, when the majority of work required is outside.

At the inception of the contract, MD expected total costs to amount to $28 million. By 31 October 20X3, MD's year end, costs of $16.8 million have been incurred on the contract. By 31 October 20X4, costs of $26 million have been incurred.

In February 20X4 MD and its customer agreed to change the floor plan of the building, so modifying the contract. As a result of this an additional amount of consideration of $2.5 million became payable by the customer with the final payment and MD expected to incur an additional $1 million costs. At this time, MD identified that work to be completed was all indoors and not affected by weather conditions. Based on progress, the company expected to complete the project by 31 December 20X4.

The customer controls the building during the construction process.

MD assesses contract completion based on costs incurred as a proportion of total costs.

Required

Illustrate how HKFRS 15 is applied to the contract, explaining how the contract modification is accounted for, and determine amounts to be recognised in the financial statements in the years ended 31 October 20X3 and 31 October 20X4.

(The answer is at the end of the chapter)

Self-test question 4

Otto Dobson Company (ODC) operates in advertising and media. It enters into a written contract with a customer on 6 May 20X5 to provide the following:

- A ten-page marketing brochure, to be delivered in digital format on 31 August 20X5. ODC will also provide an initial 100 hard copies of the brochure on 30 September 20X5. The customer will be responsible for printing further copies of the brochure.
- A six-month media advertising campaign from 1 July 20X5 to 31 December 20X5. ODC guarantee the placing of 120 newspaper adverts during this period, at timings considered most beneficial to the customer, determined based on ODC's target market research.

The price of the brochure stated within the contract is $210,000, payable within 30 days of delivery of the hard copy brochures; the fixed fee for the advertising campaign is $880,000 with a further $120,000 being payable to ODC as a performance bonus if certain goals are met. Half of the fixed fee will be invoiced half way through the campaign with the remainder invoiced at the end together with the performance bonus, if applicable. Thirty days terms will be provided to the customer. ODC has transacted with the customer previously and has no reason to believe that payment terms will not be adhered to. Based on its experience of similar performance bonus clauses in advertising contracts, ODC assesses it is 80% likely to receive the entire performance bonus and 20% likely to receive none.

The stand-alone price to design and produce a ten-page marketing brochure in digital format is $125,000; the stand-alone price to design and produce an initial run of 100 hard copies of a marketing brochure is $175,000.

Newspaper adverts were placed by ODC on behalf of the customer as follows:

July – 12	August –18	September – 21
October – 30	November – 22	December – 17

Required

Explain how the requirements of HKFRS 15 are applied to ODC's contract with the customer, and what revenue ODC should recognise in its financial statements for the year ended 31 October 20X5.

(The answer is at the end of the chapter)

HKFRS 15.110

2.8 Disclosure

HKFRS 15 requires that an entity provides both qualitative and quantitative information about:

(a) Its contracts with customers;

(b) The significant judgments and changes in judgments made in applying HKFRS 15 to those contracts; and

(c) Any assets recognised from the costs to obtain or fulfil a contract with a customer.

HKFRS 15
113-122

2.8.1 Contracts with customers

Disclosure of the following is required:

- Revenue from contracts with customers (separately from other sources of revenue) in categories that depict how the nature, timing, amount and uncertainty of revenue and cash flows are affected by economic factors (e.g. by type of goods or geographical area). Sufficient information should be disclosed to enable users to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment (where HKFRS 8 is applied).
- Impairment losses recognised on receivables or contract assets arising from contracts with customers (by category, as above).
- The opening and closing balances of receivables, contract assets and contract liabilities and explanation of significant changes in contract assets and liabilities, including both qualitative and quantitative information.
- Revenue recognised in the reporting period that was included in the contract liability balance at the start of the period and revenue recognised in the period from performance obligations satisfied in previous periods (e.g. due to changes in transaction price).
- A description of performance obligations including:
  - When they are typically satisfied
  - Significant payment terms
  - The nature of goods or services that an entity has promised to transfer, highlighting obligations to arrange for another party to transfer goods or services
  - Obligations for returns, refunds and similar obligations
  - Types of warranties and related obligations
- The transaction price allocated to performance obligations that are unsatisfied at the end of the reporting period and an explanation of when related revenue is expected to be recognised. This information need not be disclosed if the performance obligation is part of a contract lasting 12 months or less or the entity recognises revenue from the satisfaction of the performance obligation in the amount that it has a right to invoice (because the amount that directly corresponds with the value to the customer of the entity's performance completed to date).

Example: Disaggregation of revenue quantitative disclosure

HKFRS 15 provides the following example of disclosure relating to the disaggregation of revenue:

Segments	**Consumer products** $	**Transport** $	**Energy** $	**Total** $
Primary geographical markets				
North America	990	2,250	5,250	8,490
Europe	300	750	1,000	2,050
Asia	700	260	–	960
	1,990	3,260	6,250	11,500
Major goods/service lines				
Office supplies	600	–	–	600
Appliances	990	–	–	990
Clothing	400	–	–	400
Motorcycles	–	500	–	500
Automobiles	–	2,760	–	2,760
Solar panels	–	–	1,000	1,000
Power plant	–	–	5,250	5,250
	1,990	3,260	6,250	11,500
Timing of revenue recognition				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	–	–	5,250	5,250
	1,990	3,260	6,250	11,500

Example: Disclosure of transaction price relating to remaining performance obligations

On 1 January 20X5, an entity enters into a contract with a customer to construct a commercial building for fixed consideration of $100 million. The construction of the building is a single performance obligation that the entity satisfies over time. At the year end of 31 December 20X5, the entity has recognised $32 million of revenue. The entity estimates that construction will be completed in 20X6, but it is possible that the project will be completed in the first half of 20X7.

Draft a disclosure note relating to unsatisfied performance obligations.

Solution

As at 31 December 20X5, the aggregate amount of transaction price relating to the remaining performance obligations is $68 million. The entity will recognise this as revenue over time as construction continues. If the building is completed within 12 months, the full $68 million will be recognised in the year ended 31 December 20X6; otherwise an amount relating to the stage of completion will be recognised in the year ended 31 December 20X6 and the remainder will be recognised in the year ended 31 December 20X7.

HKFRS 15 123-126

2.8.2 Significant judgments

Disclosure of judgements and changes in judgments in respect of the following should be made:

- Determining the timing of satisfaction of performance obligations.

  For performance obligations satisfied over time, the following should be disclosed:

  – Methods used to recognise revenue (input or output methods)

  – An explanation of why these methods provide a faithful depiction of the transfer of goods and services

- Determining the transaction price and amounts allocated to performance obligations.

  An entity must disclose information about methods, inputs and assumptions related to:

  – Determining the transaction price, including variable consideration, adjustments for the time value of money and measurement of non-cash consideration
  – Assessing whether an estimate of variable consideration is constrained
  – Allocating the transaction price, including estimations of stand-alone selling prices and allocation of discounts
  – Measuring obligations for returns and refunds

HKFRS 15 127-128

2.8.3 Assets recognised

The following disclosures are required:

- A description of the judgements made to determine the amount of costs incurred to obtain/fulfil a contract with a customer and the method used to determine amortisation for each period.
- The closing balances of assets recognised to obtain/fulfil a contract with a customer by main category of asset.
- Amortisation and impairment losses recognised in the period.

If an entity uses the practical expedient about the existence of a significant financing component or the incremental costs of obtaining a contract, that must be disclosed.

3 Application of HKFRS 15

HKFRS 15 Appendix B

HKFRS 15 includes Application Guidance, which explains how the provisions of the standard should be applied to a number of situations. These include:

- Sales with a right of return
- Extended warranties
- Transactions involving an agent
- Royalties
- Licensing
- Repurchase agreements
- Consignment arrangements
- Bill and hold arrangements
- Options for additional goods and services
- Non-refundable upfront fees

HKFRS 15 B20-27

3.1 Sales with a right of return

A right of return means that a customer can return goods to the seller and receive in exchange a full or partial refund, a credit note, another product or any combination of these. Rarely, a right of return may be attached to a service.

When goods are transferred with a right of return:

1. Revenue is recognised to the extent that the seller expects to be entitled to it;
2. A refund liability is recognised for the consideration received that the seller does not expect to be entitled to; and
3. An asset is recognised for the right to recover products from the customer on settling the refund liability. Corresponding adjustment is made to cost of sales.

The asset is:

- Measured at the former carrying amount of the products less any expected decreases in value and other costs to recover the products;
- Presented separately from the refund liability;
- Remeasured to reflect changes in expectations about the products to be returned at each reporting date.

Self-test question 5

Clementine Retail Ltd (CRL) operates a number of fashion outlets in Hong Kong. On 28 April 20X6, it sells 50 identical coats to different customers for $850 each. The coats cost $400 each. The customers have 28 days in which they can return purchases in return for a full refund and based on past experience, CRL expects a returns level of 6%. CRL's 'May Spectacular' sale starts on 1 May and the selling price of the coats will be reduced to 50% of the original price from that date.

Required

(a) How should CRL account for the sale of the coats?

(b) How would the accounting treatment change if the selling price of the coats was to be reduced to 40% of the original price in the May Spectacular?

(The answer is at the end of the chapter)

HKFRS 15
B28-33

3.2 Extended warranties

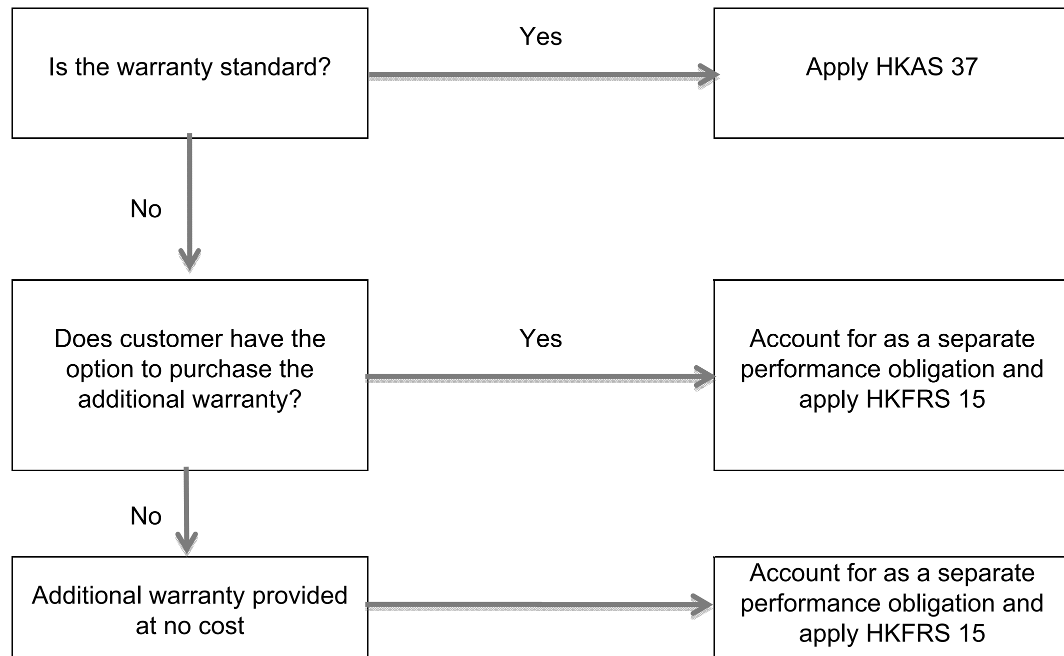
A sale transaction may include three types of warranty:

- A **standard warranty** provided by a manufacturer or retailer. This usually provides assurance that a product will function as intended (often for a specified period of coverage).

  A standard warranty is accounted for in accordance with HKAS 37.
- An **additional (or extended) warranty** that a customer has the option to purchase.

  This is accounted for as a separate performance obligation and allocated a portion of the transaction price in accordance with HKFRS 15.
- An **additional (or extended) warranty** at no cost that provides an additional service beyond the assurance that a product will function as intended.

  Again this is accounted for as a separate performance obligation and allocated a portion of the transaction price in accordance with HKFRS 15.



When considering whether a warranty is standard or extended, HKFRS 15 requires that the following factors are considered:

1 Whether the provision of the warranty is a legal requirement; this would indicate that it is a standard warranty;

2 The length of the warranty period – the longer the period, the more likely it is to be an additional or extended warranty;

3 The nature of the tasks promised within the warranty and whether they relate to providing assurance that a product will function as intended.

Self-test question 6

Optimum Manufacturing Ltd (OML) sells a piece of machinery to a customer for $400,000. The sale contract provides a warranty giving the customer assurance that the machine complies with agreed specifications and will function for 12 months. As the customer represents new business, as an incentive, the sale contract also provides access to up to three days of training services on the operation of the machine within the first six months of ownership. Such training is usually charged at $2,000 per day, however, in this case, access to the training services is not reflected in the $400,000 transaction price, which is the stand-alone selling price of the machine.

Required

How is the sale transaction accounted for?

(The answer is at the end of the chapter)

HKFRS 15 B34-38

3.3 Transactions involving an agent

In a sales transaction the seller may be the principal or an agent, selling goods on behalf of another party:

- A **principal** controls the goods or services before they are transferred to the customer.
- An **agent** does not have control over the goods or services, but arranges for them to be provided to the customer by another party.

Where a contract contains more than one specified good or service, the seller may be principal for some and agent for others. The seller should therefore identify the specified goods and services within the contract and assess whether it controls each before transfer to the customer.

When another party is involved in providing goods or services to a customer, the principal obtains control of any of the following:

(a) A good or another asset from the other party that it then transfers to the customer

(b) A right to a service to be performed by the other party, which gives the principal the ability to direct that party to provide the service to the customer on the principal's behalf

(c) A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer

Indicators that the seller controls the goods or services before transfer to the customer (and is therefore a principal) include the following:

1 The seller is primarily responsible for fulfilling the promise to provide the specified goods or services, e.g. it has the responsibility for the goods or services meeting customer specifications.

2 The seller has inventory risk before the specified good or service has been transferred to the customer or after transfer of control to the customer.

3 The seller has discretion in setting prices for the specified goods or services (although an agent may have some flexibility in setting prices).

These indicators may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract.

Note that where a seller obtains legal title to goods or services momentarily before they are transferred to the customer, the seller does not necessarily control the goods or services.

3.3.1 Accounting treatment

In the case of a **principal**, the performance obligation is to provide goods or services and it is satisfied when the relevant goods or services are transferred to the customer. Revenue is recognised at this point (or over this period of time) and is measured as the gross amount of consideration expected to be entitled and received from the customer.

In the case of an **agent**, the performance obligation is arranging for goods/services to be provided by another party. Revenue is measured at the fee or commission that the seller expects to be entitled to in exchange for arranging for the provision of goods/services to the customer.

Self-test question 7

1 FlyByNight.com purchases tickets for less popular night time or 'red eye' flights from airlines at a discount and sells these directly to the public through its website. FlyByNight.com agrees to buy a specific number of tickets per month from each airline that it deals with, and is charged for the tickets regardless of whether it resells them. FlyByNight.com sets its selling prices to make a profit of 25%, however the prices remain cheaper than they would be if customers purchased tickets directly from the airlines. Individual airlines are responsible for fulfilling obligations associated with the flight itself; however FlyByNight.com assists customers in resolving complaints with the airlines. In the year ended 31 December 20X5, FlyByNight.com sold flight tickets for a total of $8,930,000. The tickets had originally cost FlyByNight $6,697,500.

2 Unusualfinds.com provides a 'shopfront' website, linking customers to sellers of unusual gifts. The individual seller sets the price that is to be charged for an item on the website, however, payment is made to Unusualfinds.com, which then forwards the receipt, net of 8% commission, to the seller. Unusualfinds.com does not hold goods in stock; when an order is placed, it advises the seller of the order and the delivery address. Unusualfinds.com retains control of the design of its website and reserves the right to 'display' goods as it sees fit. In the year ended 31 December 20X5, Unusualfinds.com sold goods for a total of $1,340,000.

Required

Explain how much revenue is recognised in the year ended 31 December 20X5 in each of the situations detailed above.

(The answer is at the end of the chapter)

HKFRS 15 B52-62

3.4 Licensing

When an entity grants a licence, it allows a customer to access intellectual property such as software, patents, trademarks, franchises, copyrights and media (e.g. films).

The promise to grant a licence may be accompanied by the promise to transfer other goods or services:

- Where the promise to grant a licence is not distinct from the promised goods and services, the goods, services and licence are combined as one single performance obligation (e.g. software that requires ongoing upgrade services in order to function or a software hosting agreement on an internet site). This performance obligation may be satisfied at a point in time or over time and this should be determined in accordance with HKFRS guidance (see section 2.4.5).
- Where the promise to grant a licence is distinct, it forms a separate performance obligation from that for goods and services.

  Where the promise to grant a licence is a separate performance obligation, revenue is either recognised at a point in time or over time depending on the nature of the contract.

Where the licence allows the customer access to the vendor's intellectual property as it exists at any given time in the licence period (i.e. the vendor continues to support and update the intellectual property), this is a performance obligation satisfied over time.

Where the licence allows the customer access to the vendor's intellectual property as it exists at the date the licence is granted, this is a performance obligation satisfied at a point in time.

Example: Licensing

1. A film company licences a short animated film to a customer for a period of three years under a non-cancellable contract. During this time, the customer can use the film in all types of marketing campaigns within a specified geographical region. The contract requires the customer to pay the film company $25,000 per month.
2. A fast food company 'PizzaTheAction' grants a franchise licence to a customer, allowing the customer to use the brand 'PizzaTheAction' and sell company products for a ten-year period. During the ten-year period, PizzaTheAction management will perform customer analysis, continuously improve the product and advertise the brand, all of which will affect the franchise licence.

Required

Explain how the revenue arising from these transactions is recognised.

Solution

1. The film company is providing access to the animated film in its condition at the start of the contract. The film company will not provide further services in relation to the film (e.g. improving or updating it). Therefore the film company recognises all of the revenue at the point in time at which the customer is able to use (and so receive the benefits of) the animated film.

2 PizzaTheAction is providing access to its intellectual property as it exists throughout the licence period (i.e. the customer will benefit from continuous improvements and marketing etc). Therefore the performance obligation is satisfied over time and PizzaTheAction recognises revenue over the licence period.

3.5 Royalties

Consideration in a contract to licence intellectual property may be a royalty that is measured by reference to sales or usage. In this case, the seller recognises revenue when the later of the following events occurs:

- The subsequent sale or usage arises.
- The performance obligation to which some or all of the sales or usage based royalty has been allocated has been satisfied (or partially satisfied).

HKFRS 15 B64-76

3.6 Repurchase agreements

In order to release funds, a company may sell an asset to another party with an agreement (or option) to repurchase it at a future date, often at a higher price. The repurchased assed may be:

- The original asset that was sold to the other party,
- An asset that is substantially the same as the original asset that was sold to the other party, or
- Another asset of which the original asset that was sold is a component.

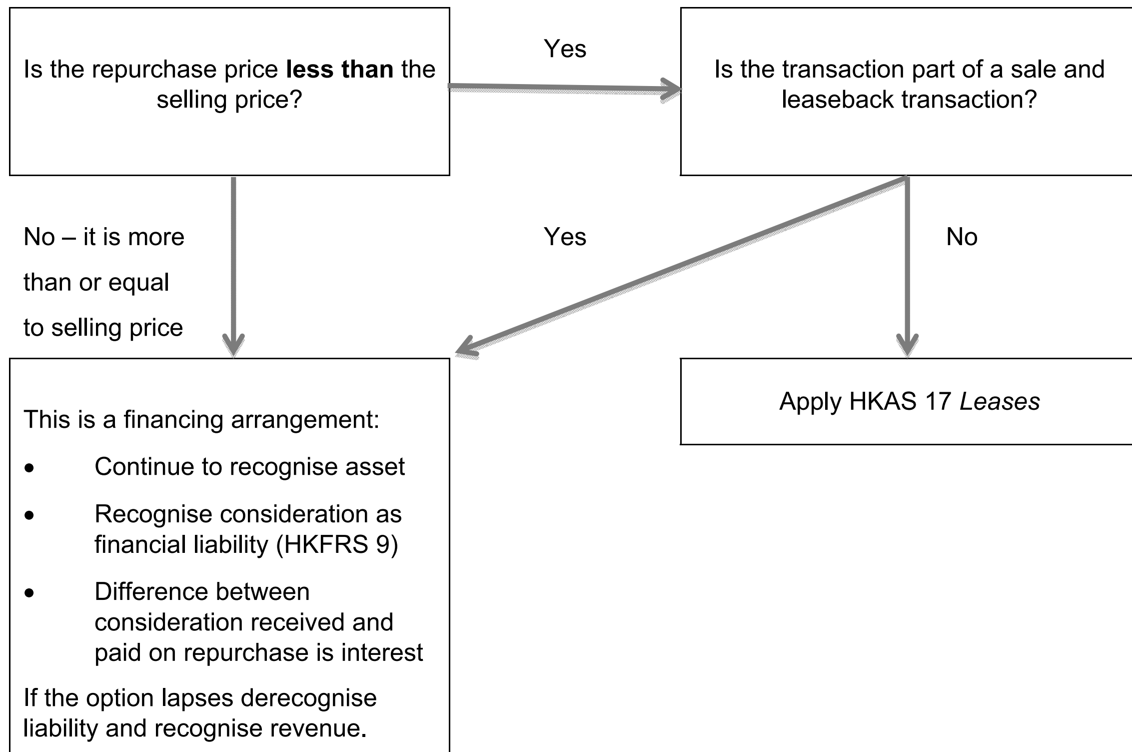
This is common in industries where stocks take a period of time to mature, such as malt whisky production. In this case, vats of whisky are sold to a bank for the period that they take to mature.

Repurchase agreements may be one of three types:

1 The **selling entity has an obligation** to repurchase the asset
2 The **selling entity has the right** to repurchase the asset (a call option)
3 The **customer has the right** to make the selling entity repurchase the asset (a put option)

3.6.1 Selling entity has obligation or right to repurchase

In either of the first two types of arrangement, control of the asset does not transfer to the customer because they have limited ability to use the asset and obtain its benefits. Here the accounting treatment depends on the repurchase price in relation to the selling price:



When comparing repurchase price with selling price, the time value of money should be considered.

3.6.2 Customer has right to enforce repurchase

The accounting treatment depends on the relationship between the original selling price and the repurchase price and whether the customer would have a significant economic incentive to force repurchase at the start of the arrangement. When considering whether there is a significant economic incentive, various factors should be considered, including the relationship of the repurchase price to the market value of the asset at the date of repurchase.

Repurchase price less than selling price

- If the customer **would not** have a significant economic incentive to force a repurchase (e.g. because the repurchase price is lower than the expected market value), the contract is accounted for as a sale with a right of return (section 3.1).
- If the customer **would** have a significant economic incentive to force a repurchase (e.g. because the repurchase price is equal to or more than the expected market value), and the contract is not part of a sale and leaseback transaction, the contract is accounted for as a lease in accordance with HKAS 17.
- If the customer **would** have a significant economic incentive to force a repurchase and the contract is part of a sale and leaseback transaction, the asset is not derecognised and consideration received from the customer is recognised as a financial liability in accordance with HKFRS 9.

Repurchase price equal to or greater than selling price

- If the repurchase price is more than the expected market value, the contract is a financing arrangement and accounted for as described in section 3.6.1.
- If the repurchase price is less than or equal to the expected market value and the customer doesn't have a significant economic incentive to exercise their right, the contract is accounted for as the sale of a product with a right of return.

Example: Sale and repurchase

Denton Developments Ltd (DDL) sold a property to Bay Bank on 1 March 20X5 for $12 million; DDL has the right to repurchase the property on or before 28 February 20X8 for $13.5 million. The applicable effective rate is 4%.

Required

Explain how the sale and repurchase transaction is accounted for.

Solution

DDL has the right to repurchase the property for a price in excess of the selling price. Therefore this is a financing arrangement and is accounted for as follows:

- The property is retained in DDL's statement of financial position and continues to be accounted for in line with applicable accounting standards;
- A loan of $12 million is recognised at 1 March 20X5.
- The $12 million loan balance is wound up to $13.5 million over the four-year period based on the effective rate:

y/e	b/f	Interest at 4%	c/f
28 Feb 20X6	12,000,000	480,000	12,480,000
28 Feb 20X7	12,480,000	499,200	12,979,200
28 Feb 20X8	12,979,200	520,800*	13,500,000

* difference due to rounding

HKFRS 15 B77-78

3.7 Consignment arrangements

Consignment arrangements are common in the motor industry. Often a car manufacturer will enter into an arrangement with a car dealer such that the dealer takes and displays vehicles with a view to selling them to a customer. In a situation such as this, the dealer does not obtain control of the cars at the point of delivery and therefore the manufacturer cannot recognise any revenue.

Indicators that an arrangement is a consignment arrangement include:

- The product is controlled by the seller (manufacturer) until a specified event occurs (e.g. the product is sold onwards or a specified period of time expires).
- The seller (manufacturer) can require the return of the product or transfer it to another party.
- The customer (dealer) does not have an unconditional obligation to pay for the product.

HKFRS 15 B79-82

3.8 Bill and hold arrangements

A bill and hold arrangement is a contract under which a customer is billed for a product but it is physically retained by the seller until it is transferred to the customer in the future.

In order for the seller to recognise revenue in this situation, control of the goods must have passed to the customer. Control may pass at the point of delivery or when the product is shipped or at an earlier date i.e. the customer may obtain control even though the seller has physical possession of the product.

In a bill and hold arrangement, in order for control to have passed, HKFRS 15 requires that the following criteria must all have been met:

1. The reason for the bill and hold must be substantive (e.g. requested by the customer).
2. The product must be identified as belonging to the customer.
3. The product must be ready for physical transfer to the customer.
4. The entity cannot be able to use the product or transfer it to another customer.

If revenue is recognised on a bill and hold basis (i.e. control passes but the seller retains physical possession of the product), the seller should consider whether to allocate a proportion of the transaction price to the provision of a storage service.

Self-test question 8

Allister Components Ltd (ACL) sells a specialised machine and related spare parts to a customer on 1 August 20X5. The machine and parts take six months to manufacture and the customer pays for them on 31 January 20X6. On this date the customer inspects and accepts the order and takes delivery of the machine, however requests that the spare parts are stored at ACL's warehouse.

Required

When is revenue recognised in respect of the transaction?

(The answer is at the end of the chapter)

HKFRS 15
B39-43

3.9 Options for additional goods and services

3.9.1 Additional goods and services for free or at discounted price

A contract with a customer may include a customer option to acquire additional goods or services either free or at a discounted price.

This is often achieved through the seller providing a customer with award credits or 'points' in a **loyalty scheme** when they make a purchase. Such schemes are commonly provided by airlines.

The option to acquire additional goods or services is a separate performance obligation in the initial sale contract when it provides a **material right** to the customer that they wouldn't receive otherwise.

When this is the case, the proportion of consideration received from the customer that relates to the future goods or services to be supplied is deferred and recognised as revenue at the earlier of:

- The date on which the future goods and services are provided, or
- The date on which the option to acquire the additional goods and services expires.

Allocation of consideration is based on stand-alone selling prices of the goods or services, which may have to be estimated for future potential goods or services. The estimate should take into account the discount that the customer would obtain on the exercise of the option, adjusted for:

(a) Any discount that the customer could receive without exercising the option, and
(b) The likelihood that the option will be exercised.

3.9.2 Additional goods and services at stand-alone selling price

A customer may have the option to acquire an additional good or service at a price that reflects the stand-alone selling price. In this case, that option does not provide the customer with a material right, even if the option can only be exercised by entering into a previous contract. Here the entity has made a marketing offer that is accounted for in accordance with HKFRS 15 when the customer exercises the option to purchase additional goods and services.

Example: Customer loyalty scheme

Wake Up Coffee Ltd (WUCL) operates a customer loyalty scheme whereby if a customer buys nine coffees and has their loyalty card stamped, the tenth coffee is provided free of charge. During 20X5 customers buy 94,995 coffees for an average of $35 each, so earning the right to a maximum of 10,555 free coffees, each of which has an average stand-alone price of $35. WUCL expects 7,400 of the free coffees to be claimed and by 31 December 20X5, 5,250 have been claimed.

Required

Explain how revenue is recognised on the sale of coffees.

Solution

The loyalty scheme provides customers with a material right that they would not benefit from if they had not bought coffees in a normal sale transaction. Therefore the promise to provide a free tenth coffee is a performance obligation, and total revenue of $3,324,825 (94,995 × $35) is allocated between the sale of coffees and the loyalty scheme.

Revenue is allocated to the provision of 'stamps' based on the expected take up rate and the stand-alone selling price basis i.e. based on a total stand-alone selling price of $259,000 (7,400 × $35):

		$
Coffee sales	$3,324,825 × (3,324,825/(3,324,825 + 259,000))	3,084,543
Loyalty stamps	$3,324,825 × (259,000/(3,324,825 + 259,000))	240,282
		3,324,825

At 31 December 20X5, 5,250 of the expected 7,400 free coffees have been claimed, therefore of the $240,282 transaction price allocated to loyalty stamps:

- $170,470 (5,250/7,400 × $240,282) is recognised as revenue.
- $69,812 is recognised as a contract liability for the unredeemed loyalty stamps.

Therefore total revenue recognised in 20X5 is $3,255,013 (3,084,543 + 170,470).

HKFRS 15 B48-51

3.10 Non-refundable upfront fees

A customer may be charged an upfront fee at the start of a contract to provide goods or services e.g. a health club joining fee.

In this case, the seller is required to assess whether the upfront fee relates to the transfer of a promised good or service.

Often this is not the case and the upfront fee is a prepayment for the goods or services that are provided over the length of the contract (and possibly beyond this if there is an option to renew the contract). In this case, the upfront fee is recognised over the initial contract period, and any optional extension period if the option to extend provides the customer with a material right that would not otherwise be available.

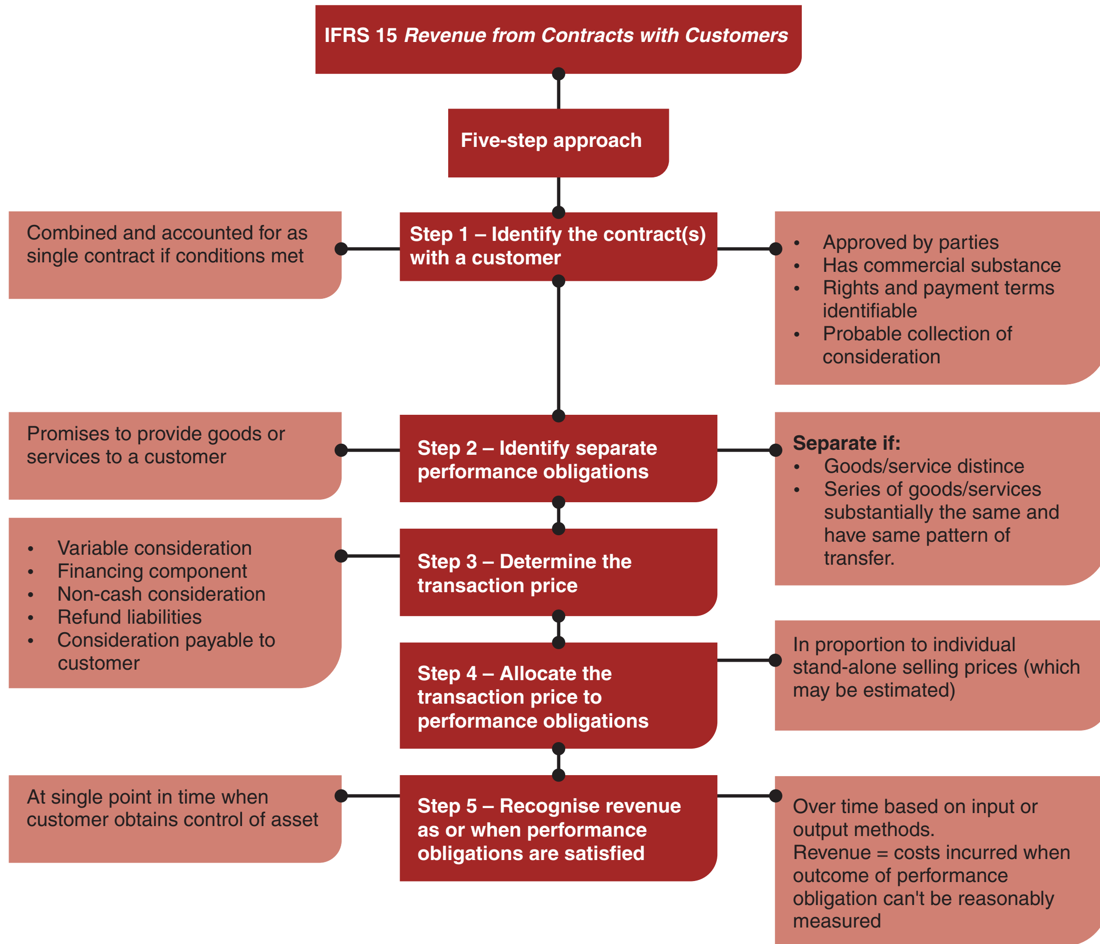
4 Comparison with HKAS 18 and effect of HKFRS 15

The effect that HKFRS 15 will have on the amount and timing of revenue recognition will differ by industry and transaction type. In some cases there will be no change to the amount and timing of recognition, whereas in other cases changes may be significant. Differences between the two standards are as follows:

- Under HKFRS 15 revenue is recognised when control transfers to the customer (regardless of whether the transaction relates to goods or services), HKAS 18 required that revenue was recognised when risks and rewards transferred to the customer. This subtle difference may result in a difference in timing of revenue recognition for example when goods are shipped to customers, depending on the shipping arrangements.
- HKFRS 15 provides more extensive guidance than HKAS 18 on the identification of performance obligations within a contract, the allocation of transaction price to these and the recognition of related revenue. In particular, HKFRS 15 requires the allocation of transaction price based on stand-alone selling prices. For some companies that provide 'bundles' goods and services, this will have a major effect. For example, companies that issue customers with a 'free' mobile phone at the start of a contract to provide a phone service, must now recognise revenue based on the phone's stand-alone selling price when the phone is provided; previously widespread practice in this situation was to recognise revenue on the provision of the handset only up to the amount of cash received from the customer at the time.

- Payments to customers that are not in exchange for distinct goods or services are required by HKFRS 15 to be accounted for as a reduction in revenue. This may result in change from previous practice when, in the absence of specific guidance, such costs were often accounted for as a marketing expense.
- Whilst a financing component within a transaction has previously been accounted for when the customer is provided with beneficial finance (i.e. payment is after the transaction), there has not previously been guidance in respect of accounting for financing components for the benefit of the seller (i.e. where payment is received before the transaction).
- HKAS 18 provided no guidance on accounting for extended warranties and as a result, divergent practice has emerged. Guidance contained within HKFRS 15 now requires that revenue is allocated to and recognised for subsequent services such as extended warranties.

Topic recap



Modifications: account for as a new contract if scope of contract changes and increase in price reflects stand-alone price of additional goods/services promised

Contract costs
- Incremental costs of obtaining contract capitalised if costs expected to be recovered.
- Costs of fulfilling contract accounted for in line with relevant standard.
- If no other standard applies, capitalise if direct costs that generate/enhance resources and expected to be recovered.

SOFP
- Contract asset
- Receivable
- Contract liability

Application
- Sales with right of return
- Extended warranties
- Principal/agent
- Licensing
- Royalties
- Repurchase agreements
- Consignment agreements
- Bill and hold arrangements
- Options for additional goods/services
- Upfront fees

Answers to self-test questions

Answer 1

There is a significant financing component in the contracts for sale. The transaction price should reflect the cash selling price on 1 March 20X5.

The transaction price is therefore:

$250,000/1.04^2 = $231,139.

12 March 20X5

The day's sales are recognised by:

DEBIT	Receivable	$231,139	
CREDIT	Revenue		$231,139

The balance of money receivable of $18,861 ($250,000 – $231,139) accrues to the receivable balance and is recognised as finance income over the credit period as follows:

Year ended 28 February 20X6

DEBIT	Receivable (231,139 × 4%)	$9,246	
CREDIT	Interest income		$9,246

To unwind the first year's interest.

The receivable is now stated at $240,385 ($231,139 + $9,246).

Year ended 28 February 20X7

DEBIT	Receivable (240,385 × 4%)	$9,615	
CREDIT	Interest income		$9,615

To unwind the second year's interest.

The receivable is now stated at $250,000 ($240,385 + $9,615).

28 February 20X7

DEBIT	Cash	$250,000	
CREDIT	Receivable		$250,000

To recognise receipt of payment from the customer.

Answer 2

FitFast's promise to its customer is to make its gym facilities available to the customer over the 12 month period for the customer to use as they wish. The customer therefore simultaneously receives and consumes the benefits provided by FitFast as FitFast performs its promise. Therefore this is a performance obligation satisfied over time.

Regardless of the pattern of use of the gyms by the customer, the service provided by FitFast (i.e. making the gyms available) is provided evenly throughout the year. Therefore the best measure of progress towards satisfaction of the performance obligation is an input method, being time elapsed.

It is therefore appropriate for FitFast to recognise the $10,200 revenue in an equal monthly amount of $850 ($10,200/12).

At the inception of the contract, FitFast recognises receipt of $10,200 by:

DEBIT	Cash	$10,200	
CREDIT	Deferred income (contract liability)		$10,200

Thereafter each month, an equal proportion of the deferred income is released and recognised as revenue by:

DEBIT	Deferred income (contract liability)	$850	
CREDIT	Revenue		$850

Revenue recognised in the year ended 31 December 20X5 therefore totals $9,350 ($850 × 11) and deferred income (a contract liability) of $850 is reported in FitFast's statement of financial position at that date.

Note that the practical expedient applies and the amount of consideration need not be adjusted for a significant financing component because the period between payment and transfer of the service is a year.

Answer 3

Identify the contract

This is a written contract with commercial substance, in which payment terms can be identified. There is no reason to believe that MD will not collect the consideration to which it is entitled.

Identify performance obligations

There is a single performance obligation, being the promise to construct the office block.

Determine transaction price

The contract price includes a fixed $50 million and $5 million bonus. The bonus is variable consideration and is included in the transaction price only to the extent that it is highly probable that it will not be reversed.

At 31 October 20X3, MD should not include the $5 million bonus in the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. This is because the project's progress remains reliant on weather conditions at this stage and the company has limited experience of this type of project. The transaction price is therefore $50 million.

From February 20X4 MD should include the $5 million bonus in the transaction price because from this date it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. This is because the remainder of work to be completed is indoors and so not affected by the weather and progress is such that the project is expected to be completed within 30 months. The transaction price from this date also includes the price of the modification. Therefore the total price is $57.5 million ($50m + $5m + $2.5m).

Allocate transaction price to performance obligation

As there is a single performance obligation, the transaction price is allocated in full to the construction of the building.

Recognise revenue as performance obligations are satisfied.

The performance obligation is satisfied over time because MD's performance creates an asset that the customer controls as it is created.

31 October 20X3

The performance obligation is 60% satisfied at this date based on costs incurred as a proportion of total expected costs ($16.8m/$28m), i.e. input method.

Therefore revenue of $30 million ($50m × 60%) is recognised.

The costs incurred to date to fulfil the contract are recognised as an expense. They do not qualify as an asset in accordance with HKFRS 15 because they do not generate resources of MD that will be used to satisfy future performance obligations (i.e. they relate to past performance obligations).

By 31 October 20X3, $22 million ($10m + $12m) of progress payments have been made by the customer. The remaining $8 million ($30m – $22m) of revenue recognised to date is recognised as a receivable in the statement of financial position.

31 October 20X4

During this year, a modification to the contract took place. The modification is not accounted for as a new contract because it did not promise distinct new goods or services. As there is only a single performance obligation in the original contract, the modification is treated as part of the original contract.

The performance obligation is 90% satisfied at this date based on costs incurred as a proportion of total expected costs ($26m/($28m + $1m).

Therefore revenue of $51.75 million ($57.5m × 90%) is recognised on a cumulative basis and $21.75 million ($51.75m – $30m) is recognised in the year.

Costs incurred to fulfill the contract are recognised as an expense; on a cumulative basis these are $26 million, and $9.2 million ($26m – $16.8m) are recognised in the year.

At the year end a total of $34 million ($10m + $12m + $12m) of progress payments have been made by the customer. Cumulative revenue exceeds this by $17.75 million ($51.75m – $34m) meaning that a receivable of $17.75 million is recognised. This is a receivable rather than contract asset because there is an unconditional right to the consideration.

Statement of profit or loss for the years ended

	31 October 20X4	**31 October 20X3**
	$'000	$'000
Revenue	21,750	30,000
Cost of sales	(9,200)	(16,800)
Profit	12,550	13,200

Statement of financial position at

	31 October 20X4	**31 October 20X3**
	$'000	$'000
Receivables	17,750	8,000

Answer 4

Identify the contract with the customer

There is a written contract in place that has commercial substance and identifies each parties' rights and payment terms. It is assumed that the contract is approved by both parties by virtue of the fact that both have agreed to it. OTC assess that it is probable that consideration due will be collected from the customer based on past experience.

Identify separate performance obligations

There are three performance obligations in the contract:

1 A promise to deliver the marketing brochure in digital format
2 A promise to deliver 100 hard copies of the marketing brochure
3 A promise to deliver a six-month television advertising campaign

These are all distinct services because:

- Each could benefit the customer on its own without the other services in the contract being provided. For example, the customer would benefit from using the digital marketing brochure through onward digital distribution or printing without having received the print copies or the advertising campaign; and

- ODC's promise to transfer each service to the customer is separately identifiable alone and within the context of the contract.

Determine the transaction price

The transaction price of the digital and hard copy marketing brochures bundle is $210,000.

The fixed fee for the advertising campaign is $880,000, however a further $120,000 may become receivable by ODC if certain goals are met. The $120,000 represents variable consideration, which is included in the transaction price only to the extent that it is highly probable that a significant amount will not be reversed when the uncertainty associated with the variable consideration is resolved. ODC has significant experience in these types of arrangements and in estimating the performance bonus outcome. Furthermore the uncertainty will be resolved in a short time frame. Therefore ODC can determine that it is probable that a significant reversal will not occur and should include the performance bonus in the transaction price. As there are only two possible outcomes (consideration of $880,000 excluding the bonus or $1 million including the bonus), ODC should use the 'most likely approach' to include variable consideration. In this case the most likely outcome is that the performance bonus will be received and therefore it is included in full. The transaction price for the advertising campaign is therefore $1 million.

Allocate transaction price to performance obligations

The digital and hard copy brochure performance obligations are included in the contract as a bundle at a cost of $210,000, which represents a discount of $90,000 compared to the stand-alone selling price of these two elements ($125,000 + $175,000). There is no observable evidence that the discount only relates to one of two brochure performance obligations and therefore it is allocated proportionately to both on the basis of stand-alone selling prices:

Digital brochure $87,500 ($210,000 × 125/300)
Hard copy brochures $122,500 ($210,000 × 175/300)

The transaction price for the advertising campaign performance obligation is identifiable as $1 million.

Recognise revenue as each performance obligation is satisfied

Both of the brochure performance obligations are satisfied at single points in time, on the date that the customer obtains control of the asset. Therefore:

- $87,500 is recognised as revenue by ODC on 31 August 20X5, on the date that the digital copy brochure is delivered to the customer. This is initially recognised as a receivable on 31 August 20X5 by:

DEBIT	Receivable	$87,500	
CREDIT	Revenue		$87,500

To recognise revenue from the sale of the digital copy brochure.

- $122,500 is recognised as revenue by ODC on 30 September 20X5, on the date that the hard copy brochure are delivered to the customer. This is initially recognised as a receivable on 30 September 20X5 by:

DEBIT	Receivable	$122,500	
CREDIT	Revenue		$122,500

To recognise revenue from the sale of the hard copy brochures.

- Payment is expected from the customer by 31 October 20X5. This is recognised by:

DEBIT	Cash	$210,000	
CREDIT	Receivable		$210,000

To recognise payment from the customer.

The advertising campaign is a performance obligation that is satisfied over a six-month period. Revenue is therefore recognised based on progress towards satisfaction of the performance obligation. An output method based on the number of adverts placed is appropriate in this case. Therefore revenue recognised in the year ended 31 October 20X5 is calculated as:

		$
July	12/120 × $1 million	100,000
August	18/120 × $1 million	150,000
September	21/120 × $1 million	175,000
October	30/120 × $1 million	250,000
		675,000

The journal entries to record transactions related to the advertising campaign are as follows:

31 July 20X5

DEBIT	Contract asset (amounts recoverable on contracts)	$100,000	
CREDIT	Revenue		$100,000

To recognise monthly revenue from the advertising campaign.

31 August 20X5

DEBIT	Contract asset (amounts recoverable on contracts)	$150,000	
CREDIT	Revenue		$150,000

To recognise monthly revenue from the advertising campaign.

30 September 20X5

DEBIT	Contract asset (amounts recoverable on contracts)	$175,000	
CREDIT	Revenue		$175,000

To recognise monthly revenue from the advertising campaign.

DEBIT	Receivable	$440,000	
CREDIT	Contract asset (amounts recoverable on contracts) (100 + 150 + 175)		$425,000
CREDIT	Contract liability		$15,000

To recognise a receivable at the first invoice date.

31 October 20X5

DEBIT	Contract liability	$15,000	
DEBIT	Contract asset (amounts recoverable on contracts)	$235,000	
CREDIT	Revenue		$250,000

To recognise monthly revenue from the advertising campaign.

DEBIT	Cash	$440,000	
CREDIT	Receivable		$440,000

To recognise the first payment from the customer.

Therefore in the year ended 31 October 20X5 the following amounts are reported in ODC's financial statements:

- Revenue of $885,000 (87,500 + 122,500 + 100,000 + 150,000 + 175,000 + 250,000).
- A contract asset (amount recoverable on contracts) of $235,000.

Answer 5

(a)

- CRL expects 3 coats (6% × 50) to be returned.
- Therefore on 28 April 20X6 revenue is recognised in relation to 47 coats, giving a total of $39,950 (47 × $850).
- A refund liability of $2,550 (3 × $850) is recognised.
- The cost of 47 coats of $18,800 (47 × $400) is transferred to cost of sales. The remaining 3 coats are recognised as an asset (the right to recover the coats) at cost of $1,200 (3 × $400). The 'right to recover' asset is measured at the original cost of the coats that are expected to be returned because, even in the 'May Spectacular' sale, they are capable of being sold for $425 (50% × $850) ie more than cost.

The required accounting entries are:

DEBIT	Bank (50 × $850)	$42,500	
CREDIT	Revenue		$39,950
CREDIT	Refund liability		$2,550

To recognise the sale of coats and expectation that 6% will be returned.

DEBIT	Asset (right to recover inventory)	$1,200	
DEBIT	Cost of sales (47 × $400)	$18,800	
CREDIT	Asset (inventory)		$20,000

To recognise the transfer of items of inventory that are not expected to be returned to become cost of sales and that are expected to be returned to become assets (the right to recover the 3 coats).

(b) If the selling price of the coats were reduced to $340 (40% × $850):

- The revenue and refund liability would be recorded as before.
- The retained asset would be measured at $1,020 (3 × $340), so resulting in a write down of the carrying amount of inventory in profit or loss.

Answer 6

The contract includes three elements: the machine, a 12-month warranty and access to training services.

The 12-month warranty is a standard warranty and as such is accounted for in accordance with HKAS 37, i.e. provision is made at the point of sale for the expected costs to be incurred as a result of the warranty offered.

In this contract, the access to training services is not offered as a chargeable extra to the customer, but is included within the sale contract. It does, however, represent an additional service, and as such forms a separate performance obligation.

Therefore there are two performance obligations: the provision of the machine and the provision of training services.

The transaction price of $400,000 is allocated between these on the basis of their stand-alone prices, therefore:

- Provision of machine 400/(400 + 6) × $400,000 = $394,089
- Provision of training services 6/(400 + 6) × $400,000 = $5,911

$394,089 is recognised as revenue when control of the machine transfers to the customer; $5,911 is deferred and recognised when the training services are provided to the customer, or after six months (when the option to benefit from the training lapses).

Answer 7

1 FlyByNight.com is a principal, indicated by the following facts:

- FlyByNight.com sets the price of the flight tickets and earns a profit (being the difference between the selling price it sets and the cost of a ticket negotiated with the airline).
- FlyByNight.com is responsible for providing the right to fly (the ticket) even though it is not responsible for providing the flight itself.
- FlyByNight.com has inventory risk in that tickets may go unsold but a cost is still incurred.

Therefore in the year ended 31 December 20X5, FlyByNight.com recognises the gross amount of consideration as revenue of $8,930,000 plus related costs of $6,697,500 (75% × $8,930,000). Further costs will be recognised for any unsold tickets purchased by the company.

2 Unusualfinds.com is an agent for the individual sellers, indicated by the following facts:

- The seller is responsible for shipping and so inventory risk.
- The seller sets the price of an item.
- The seller is responsible for providing the goods.
- Unusualfinds.com receives consideration in the form of commission.

The issue of who bears credit risk is not relevant in this case, because customers are required to make payment in advance of goods being sent to them. Therefore there is no risk of non-payment.

Therefore in the year ended 31 December 20X5, Unusualfinds.com recognises revenue of 8% × $1,340,000 = $107,200.

Answer 8

Three performance obligations can be identified:

1 The provision of the machine
2 The provision of the spare parts
3 The storage of the spare parts

Therefore the transaction price is allocated to each of these performance obligations based on the stand-alone selling price of each.

Revenue in respect of the provision of the machine and the spare parts is recognised when control passes to the customer on 31 January 20X6. The spare parts are sold under a bill and hold arrangement, with all four HKFRS 15 criteria met:

- The customer requests that ACL stores the spare parts.
- The spare parts belong to the customers.
- The spare parts can be transferred at any point in time.
- ACL cannot transfer the spare parts to another customer.

The storage of the spare parts is a performance obligation satisfied over time (i.e. the customer simultaneously receives and consumes the benefits provided by ACL's performance as it performs); revenue is recognised by ACL over the period during which the parts are stored.

Exam practice

Nero Fashion **29 minutes**

Nero Fashion Limited (NFL) is a clothing manufacturer in mainland China and distributes its products through the following channels:

- Counter sales at department stores – walk-in customers purchase and collect the goods upon the issue of an invoice by the department stores and make cash or credit card payments to them. In accordance with the consignment contract, signed between the department store and NFL, the selling price is determined and inventory is managed by NFL, the sales teams are employed by NFL while the cashier service is provided by the department stores. The department stores pay 80% of the retail price of the goods sold to NFL on a monthly basis. The department stores accept returns or exchanges of goods within seven days of the invoice date and all these items are returned to NFL and the amounts deducted from the total remitted to NFL.
- Distributors – NFL ships the goods to the designated location in accordance with the instructions of the distributors, including the items and quantity requested. Distributors can open their own retail store to sell the goods, but NFL will determine the retail prices for the goods, which are normally the same as the prices offered in counter sales at department stores. Goods are not returnable except for items with quality problems which can be returned within seven days of delivery. The distributors have to sign and return an acceptable confirmation at the completion of quality inspection or seven days of delivery, whichever is earlier. NFL will issue an invoice to the distributors at 50% of the pre-determined retailing price of items delivered on a monthly basis.

Based on the past three years historical data, less than 0.1% of sales were returned from customers of department stores within the seven-day period and around 5% of sales were returned from distributors before signing the confirmation under the above return policies.

Required

(a) Discuss how NFL should account for the sales revenue through these channels, with reference to HKFRS 15 *Revenue from Contracts with Customers*.

(i) Counter sales at department stores **(7 marks)**
(ii) Distributors **(6 marks)**

(b) Discuss how NFL should account for monthly revenue if it gives a 10% discount of the invoiced amount to the distributors when the respective annual quantity delivered is above 100,000 pieces. **(3 marks)**

Total = 16 marks

HKICPA June 2012 (amended)

Yammy Company Limited **36 minutes**

Yammy Company Limited (YCL) is the sole distributor of Kammer trucks in Asia. The trucks are manufactured in Europe and shipment is made monthly to Hong Kong based on the purchase orders placed by YCL to Kammer. YCL offers its customers buying truck model 6.0 the following payment plans:

Plan I: an initial deposit of $50,000 upon signing the provisional sales order, and $400,000 upon delivery of the truck.

Plan II: an initial deposit of $30,000 upon signing the provisional sales order and 24 monthly instalments of $20,000 each in arrears commenced from the date of delivery of the truck.

A customer choosing Plan II is required to enter into an insurance contract for two years at a pre-paid premium of $6,000 per truck with Grant Insurance Inc. (GCC), an independent insurance company, which takes full obligation of the insurance arrangement. The customer pays the full insurance premium to YCL upon collection of the truck and YCL pays $5,500 to GCC on the same date.

Sales orders of 12 trucks under Plan I and 20 trucks under Plan II were signed on 15 October 20X3. The trucks were delivered to customers on 30 November 20X3.

Required

(a) Prepare the journal entries to be entered in October, November and December 20X3 for these two sales transactions. The effective interest rate is estimated to be 13%. **(12 marks)**

(b) YCL is planning to expand its business to Guangzhou in co-operation with Best Trade Vehicle Limited (BT), a local car dealer. Discuss the factors for consideration in the contractual arrangement with BT so that BT will only act as an agent of YCL in selling the trucks. **(8 marks)**

Total = 20 marks

HKICPA June 2014

Chapter 14 Revenue

Question 1

(a) (i) **Counter sales at department stores:**

NFL has the primary responsibility for providing the goods to the customers of department stores with its sales team.

NFL retains inventory risk as the ownership of the goods has not been transferred to department stores.

NFL has latitude in establishing prices while the department stores will only share 20% of the invoice amounts for the service provided.

Customers' credit risk is borne by the department stores but it is considered as a weak indicator for department store operation.

Taking into consideration the features listed above, it is considered that NFL acts as a principal because it controls the goods before they are transferred to customers. The department stores act as an agent and service provider rather than customers of NFL.

Legal title is momentarily transferred to the department store customers when they acquire possession of the goods and invoices are issued by the department store. HKFRS 15 is clear that this does not mean that the department stores control the goods.

Revenue is therefore recognised by NFL at the time of sale to the department store customers.

The amount recognised as revenue of NFL is the gross selling price charged to the customers. As NFL expects 0.1% of goods to be returned for a refund, a refund liability should be recognised in respect of these sales rather than revenue.

The 20% of the retail prices retained by the department stores is a selling and distribution expense of NFL and is not offset against the revenue.

(ii) **Distributors:**

NFL has no primary responsibility for providing the goods to the distributors' retail store customers.

NFL does not bear inventory risk after the delivery of goods to distributors as the goods are non-returnable unless there are quality problems.

Although NFL has latitude in establishing price charges for the goods to be sold by the distributors at their own retail store, it is the distributors to bear their customers' credit risk.

Taking into consideration the features listed above, we can conclude that the distributors are acting as principal rather than agent of NFL as they control the goods prior to onward sale to customers. The distributors are therefore considered to be the customers of NFL.

The sales to distributors are made with a right of return, therefore when control of the goods passes to the distributors, NFL should recognise revenue only to the extent that it expects to be entitled to it i.e. in respect of 95% of the goods provided that are not expected to be returned. The corresponding debit entry is a contract asset as NFL's right to consideration is conditional on acceptance of the goods. No accounting entry is made in respect of the 5% goods that are expected to be returned.

After the quality inspection or after the seven days return period has elapsed, recognised revenue is adjusted if more or less than 5% goods are returned by distributors. At this stage the contract asset is transferred to become a receivable as NFL's right to consideration is conditional only on the passage of time.

The amount recognised as the revenue of NFL is the invoice price of retained goods, i.e. 50% of the pre-determined retail price of the items delivered and accepted by the distributors.

(b) The provision of a discount when delivery quantity reaches a certain level is variable consideration in accordance with HKFRS 15. This may decrease the transaction price and is included in the transaction price if it is highly probable that the discount will be given. NFL should use expected values to determine the amount of discount to include in the total transaction price with distributors. HKFRS 15 states that this method is appropriate to a large number of contracts with similar characteristics, as is the case here.

Question 2

(a) **On 15 October 20X3:**

		$'000	$'000
DEBIT	Bank	1,200	
CREDIT	Contract liability (12 trucks × $50,000 + 20 trucks × $30,000)		1,200

On 30 November 20X3:

		$'000	$'000
DEBIT	Bank (12 trucks × $400,000 + 20 trucks × $6,000)	4,920	
DEBIT	Contract liability	1,200	
DEBIT	Trade receivable (20 trucks × ($450,000 – $30,000))	8,400	
CREDIT	Sales (12 trucks + 20 trucks) × $450,000		14,400
CREDIT	Other revenue (commission income) ($6,000 – $ 5,500) × 20 trucks		10
CREDIT	Bank – Paid to insurance company ($5,500 × 20 trucks)		110

On 31 December 20X3:

		$'000	$'000
DEBIT	Bank (20 trucks × $20,000)	400	
CREDIT	Trade receivable		400
DEBIT	Trade receivable	91	
CREDIT	Interest income ($8,400,000 × 13%/12)		91

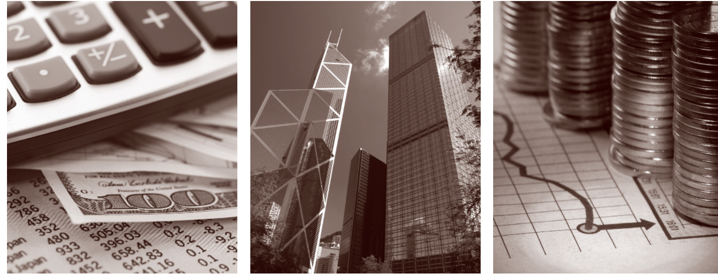
(b) HKFRS 15 states that in an agency relationship, an entity is acting as a principal when it controls good or services prior to transfer to the customer.

The features of the contractual arrangement between YCL and BT which would indicate that YCL is acting as a principal and BT is acting as an agent of YCL include:

- YCL has the primary responsibility for fulfilling the order and providing the trucks to the customer and YCL is the final decision maker as to whether to accept an order for the trucks by the customers solicited by BT;
- YCL has inventory risk before or after the customer order, during shipping or on return. For instance, trucks are just consigned to BT, or trucks are sold to BT subject to return, or all trucks will be delivered to BT upon confirmation of the order from the final customer or delivered to the customer by YCL directly;

- YCL has latitude in establishing the selling prices of the trucks, either directly or indirectly. For instance YCL can provide a standard price list or payment plans for BT to follow, any discount to be offered by BT to customers is subject to the approval of YCL or the pre-determined range agreed by YCL; and
- YCL bears the customer's credit risk for the amount receivable from the customer. For instance, BT can be responsible for the collection of payment and/or chasing the settlement from the customer but not for the uncollected amount.

In terms of the remuneration or share of profit for the services to be provided by BT, one feature indicating that BT is acting as an agent is that the amount BT earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.



chapter 18

Financial instruments

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Learning focus

This is a highly controversial and very complex topic. You should concentrate on the essential points. It is also the subject of ongoing change, as over a period of time HKAS 39 is being replaced by HKFRS 9.

You need plenty of practice on the topics in this chapter in order to familiarise yourself with this difficult area.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.11	**Financial assets, financial liabilities and equity instruments**	2
3.11.01	Discuss and apply the criteria for the recognition and de-recognition of a financial asset or financial liability	
3.11.02	Discuss and apply the rules for the classification of a financial asset, financial liability and equity, and their measurement (including compound instrument)	
3.11.03	Discuss and apply the treatment of gains and losses arising on financial assets or financial liabilities	
3.11.04	Discuss the circumstances that give rise to and apply the appropriate treatment for the impairment of financial assets	
3.11.05	Account for derivative financial instruments and simple embedded derivatives, including the application of own-use exemption	
3.11.06	Disclose relevant information with regard to financial assets, financial liabilities and equity instruments	
3.17	**Hedge accounting**	2
3.17.01	Identify fair value hedges, cash flow hedges and hedges for net investment in accordance with HKFRS 9	
3.17.02	Account for fair value hedges, cash flow hedges and hedges for net investment	

1 Financial instruments

Topic highlights

Accounting guidance on financial instruments is provided in four standards:

- HKAS 32 *Financial Instruments: Presentation*
- HKAS 39 *Financial Instruments: Recognition and Measurement*
- HKFRS 7 *Financial Instruments: Disclosures*
- HKFRS 9 *Financial Instruments*

1.1 Background

Financial instruments have, in recent years, become increasingly complex. They vary from straightforward, traditional instruments, such as loan stock or shares through to complex 'derivative instruments'.

The emergence of more complex instruments towards the end of the 20th century created a problem in that existing accounting guidance was insufficient. Accounting standards boards worldwide were forced to address this through the development of lengthy and detailed standards. In Hong Kong the relevant standards were:

- **HKAS 32** *Financial Instruments: Presentation*, issued in 2004, which originally dealt with:
  - The classification of financial instruments between liabilities and equity
  - Presentation of certain compound instruments
  - Disclosure of financial instruments
- **HKAS 39** *Financial Instruments: Recognition and Measurement*, issued in 2006, which dealt with:
  - Recognition and derecognition of financial instruments
  - The measurement of financial instruments
  - Hedge accounting

Both of these standards have, subsequent to their original issue, been amended numerous times as the topic to which they relate continually evolves. In addition, two new standards have been issued:

- **HKFRS 7** *Financial Instruments: Disclosures*, issued in 2005 replaced the part of HKAS 32 dealing with disclosure. In doing so, it revised, simplified and added to financial instrument disclosure requirements.
- **HKFRS 9** *Financial Instruments*, originally issued in 2009 replaced certain parts of HKAS 39, in particular with respect to the classification of financial assets. HKFRS 9 was expanded in 2010 to include guidance on the classification and measurement of financial liabilities and the derecognition of financial assets and liabilities. This standard was subsequently expanded again in 2013 and finally completed in 2014.

This chapter is based on the requirements of HKAS 32, HKAS 39, HKFRS 7 and HKFRS 9. From the December 2016 exam session onwards, HKFRS 9 is examinable rather than HKAS 39, however some discussion of HKAS 39 requirements is retained in this chapter as this standard remains effective in practice for annual accounting periods beginning on or before 31 December 2017.

1.1.1 Examinable topics

The issue of which topics are examinable under which standard(s) is summarised in the table below.

✓ = fully examinable. Blank = not applicable.

Topic	IAS 32	IFRS 7	IFRS 9
Classification	✓		✓
Offsetting	✓		
Interest, dividends, losses and gains	✓		
Disclosure		✓	
Recognition			✓
Derecognition			✓
Measurement			✓
Reclassification			✓
Embedded derivatives			✓
Impairment of financial assets			✓
Hedging			✓

HKAS 32.11, HKFRS 9, Appendix A

1.2 Definitions

A number of definitions are common to all financial instruments standards.

Key terms

Financial instrument. Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset. Any asset that is:

(a) Cash;

(b) An equity instrument of another entity;

(c) A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity; or

(d) A contract that will or may be settled in the entity's own equity instruments and is a:

  (i) Non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments

  (ii) Derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

Financial liability. Any liability that is a:

(a) Contractual obligation to:

  (i) Deliver cash or another financial asset to another entity

  (ii) Exchange financial instruments with another entity under conditions that are potentially unfavourable

(b) Contract that will or may be settled in the entity's own equity instruments and is a:

(i) Non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments

(ii) Derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

Equity instrument. Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Derivative. A financial instrument or other contract with all three of the following characteristics:

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying')

(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

(c) It is settled at a future date *(HKAS 32 and HKFRS 9)*

HKAS 32 13-14

Some of the terms used within the definitions themselves need defining:

(a) A '**contract**' need not be in writing, but it must comprise an agreement that has 'clear economic consequences' and which the parties to it cannot avoid, usually because the agreement is enforceable in law.

(b) An '**entity**' here could be an individual, partnership, incorporated body or government agency.

HKAS 32 AG4, AG8, AG11-12, AG20-21

1.2.1 Financial assets and liabilities

The definitions of **financial assets and financial liabilities** may seem complicated, but the essential point is that while there may be a chain of contractual rights and obligations, it will lead ultimately to the receipt or payment of cash **or** the acquisition or issue of an equity instrument.

Examples of financial assets and liabilities may include:

Financial assets	Financial liabilities
Trade receivables	Trade payables
An investment in shares	Loans payable
A loan made to another party	Redeemable preference shares

HKAS 32 makes it clear that the following items are *not* financial assets or liabilities:

- **Physical assets**, e.g. inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc.)
- **Prepaid expenses**, deferred revenue and most warranty obligations
- Liabilities or assets that are **not contractual** in nature e.g. income taxes that are the result of statutory requirements imposed by governments.
- Contractual rights/obligations that **do not involve transfer of a financial asset**, e.g. commodity futures contracts, operating leases

Self-test question 1

Why do you think that physical assets and prepaid expenses do not qualify as financial instruments?

(The answer is at the end of the chapter)

Contingent rights and obligations meet the definition of financial assets and financial liabilities respectively, even though many do not qualify for recognition in financial statements. This is because the contractual rights or obligations exist because of a past transaction or event (e.g. assumption of a guarantee).

HKAS 32.AG15

1.2.2 Primary and derivative instruments

The examples of financial assets and liabilities given in the previous section may be referred to as 'primary instruments'. You should also be aware of derivative financial instruments.

A **derivative** is a financial instrument that **derives** its value from the price or rate of an underlying item. Common **examples** of derivatives include the following:

- **Forward contracts** which are agreements to buy or sell an asset at a fixed price at a fixed future date.
- **Futures contracts**, which are similar to forward contracts except that contracts are standardised and traded on an exchange.
- **Options**, which are rights (but not obligations) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised.
- **Swaps**, which are agreements to swap one set of cash flows for another (normally interest rate or currency swaps).

A simple example of a forward contract may help you to understand how it derives its value from an underlying item. Say a forward contract exists to sell an asset for $8 on a given date. At today's date the market price of the asset is $5 and therefore it would be fair to say that the contract is worth $3. This value cannot, however, be established without reference to the price of the underlying item, being the market price of the asset. If the underlying item is volatile, then the settlement of the derivative can lead to a very different result from the one originally envisaged.

Derivatives usually have no, or very little, initial cost. Therefore, before the development of HKAS 32 and HKAS 39, they may not have been recognised in the financial statements at all, or recognised at a value bearing no relation to the current value. This is obviously misleading and leaves users of the accounts unaware of the uncertainty and risk to which a company holding derivatives is exposed.

Part of the reason why HKAS 32 and HKAS 39 were developed was in order to correct this situation.

2 HKAS 32: Presentation of financial instruments

HKAS 32.2

2.1 Objective

The objective of **HKAS 32** is:

To establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

(*HKAS 32*)

HKAS 32.4

2.2 Scope

HKAS 32 should be applied in the presentation of **all types of financial instruments**, whether recognised or unrecognised.

Certain items are **excluded**:

(a) Interests in subsidiaries, associates and joint ventures, unless these are accounted for using HKFRS 9 as allowed by HKFRS 10, HKAS 27 or HKAS 28.

(b) Employers' rights and obligations under employee benefit plans (**HKAS 19**: Chapter 16)

(c) Insurance contracts

(d) Financial instruments, contracts and obligations under share-based payment transactions (**HKFRS 2**: Chapter 13)

2.3 Classification of financial instruments as financial assets, financial liabilities and equity

Topic highlights

Financial instruments are classified as financial assets, financial liabilities or equity. Financial instruments issued to raise capital must be classified as **liabilities** or **equity**.

The **critical feature of a financial liability** is the contractual obligation to deliver cash or another financial instrument.

HKAS 32 requires that the issuer of a financial instrument classifies it, or its component parts, as a financial asset, financial liability or equity based on:

- The substance of the contractual arrangement on initial recognition
- The definitions in the Key terms provided in section 1.2 above

The classification of the financial instrument is made when it is **first recognised** and this classification will continue until the financial instrument is removed from the entity's statement of financial position.

HKAS 32.16

2.3.1 Distinguishing financial liabilities and equity

Distinguishing a financial liability from equity may not be straightforward and therefore HKAS 32 provides additional guidance. The underlying principle is that of substance over form. Although substance and legal form are often **consistent with each other**, this is not always the case.

An instrument is an equity instrument only if there is **no contractual obligation to deliver cash or another financial asset** to another entity or to exchange another financial instrument with the holder under potentially unfavourable conditions to the issuer.

Therefore, for example, a redeemable preference share is classified as a liability, rather than equity, as there is an obligation to deliver cash at the redemption date. On the other hand, ordinary shares are classified as equity as, although the holder of an equity instrument may be entitled to a *pro rata* share of any distributions out of equity, the issuer does **not** have a contractual obligation to make such a distribution.

A financial liability exists **regardless of the way in which the contractual obligation to deliver cash or a financial asset will be settled**. The issuer's ability to satisfy an obligation may be restricted, e.g. by lack of access to foreign currency, but this is irrelevant as it does not remove the issuer's obligation or the holder's right under the instrument.

Self-test question 2

During the financial year ended 31 December 20X5, Kim issued the financial instrument described below. Identify whether it should be classified as liability or equity, **explaining in not more than 40 words** the reason for your choice. You should refer to the relevant Hong Kong Accounting Standards.

Redeemable preference shares with a coupon rate 5%. The shares are redeemable on 31 December 20X9 at premium of 20%.

(The answer is at the end of the chapter)

2.4 Specific classification rules

As well as providing the general classification rules explained in the section above, HKAS 32 also provides guidance on the classification of specific instruments and instruments with specific characteristics. They are:

- Puttable financial instruments and obligations arising on liquidation
- Financial instruments with contingent settlement provisions
- Financial instruments with settlement options
- Compound instruments
- Rights issues

The remainder of this section deals with each in turn.

HKAS 32 16A-B, E

2.4.1 Puttable financial instruments and obligations arising on liquidation

HKAS 32 was amended in 2008 to introduce criteria for certain puttable instruments and obligations arising on liquidation to be classified as equity. Prior to these amendments, these instruments would have been classified as financial liabilities.

Puttable financial instruments

A puttable financial instrument is an instrument where the holder can 'put' the instrument i.e. require the issuer to redeem it in cash. For example, some ordinary shares are puttable, and prior to the revision to HKAS 32, these were classified as liabilities. They are now classified as equity, but only if:

(a) The holder is entitled to a pro-rata share of the entity's net assets on liquidation.

(b) The instrument is in the class of instruments that is the most subordinate and all instruments in that class have i**dentical** features.

(c) The instrument has no other characteristics that would meet the definition of a financial liability.

(d) The total expected cash flows attributable to the instrument over its life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of the instrument itself). Profit or loss or change in recognised net assets for this purpose is as measured in accordance with relevant HKFRS.

In addition to the criteria set out above, the entity must have no other instrument that has terms equivalent to (d) above and that has the effect of substantially restricting or fixing the residual return to the holders of the puttable financial instruments.

Where the specified criteria are no longer met, or when they are subsequently met, the instrument should be reclassified. If the instrument presented as equity is reclassified as a financial liability, it will be measured at fair value at the date of reclassification with any difference between the fair value and the carrying amount to be recognised in equity. When the inverse applies, the financial liability will be reclassified to equity at its carrying amount at the date of reclassification.

HKAS 32.16C

Obligations arising on liquidation

As a result of the amendment mentioned above, instruments imposing an obligation on an entity to deliver to another party a pro-rata share of the net assets on liquidation should be classified as equity.

The following examples illustrate the types of instruments impacted by the new requirements:

Issued financial instrument	Classification under HKAS 32 before amendment	Classification under amended HKAS 32
Share puttable throughout its life at fair value, that is also the most subordinate, does not contain any other obligation, with discretionary dividends based on profits of the issuer	Liability	Equity
Share puttable at fair value, that is not the most subordinate	Liability	Liability
Share puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed non-discretionary dividend	Liability	Compound (part equity, part liability)
Share puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed discretionary dividend and does not contain any other obligation	Liability	Equity
Any of the instruments described above issued by a subsidiary held by non-controlling parties, in the consolidated financial statements	Liability	Liability

As identified above, puttable financial instruments or instruments that provide the holder with a pro rata share of the net assets of the entity on liquidation should be classified as equity in the separate financial statements of the issuer if they represent the residual class of instruments (and all the relevant requirements are met).

Such instruments are not considered to be the residual interest in the consolidated financial statements and therefore, as identified in the table above, non-controlling interests that contain an obligation to transfer a financial asset to another entity should be classified as a financial liability in the consolidated financial statements.

Even though the amendments permit certain instruments that were previously presented as financial liabilities to now be presented as equity, derivatives over such equity instruments may not be presented as equity.

Puttable instruments and instruments puttable only on liquidation that are classified as equity in the separate or individual financial statements of the issuing entity and represent non-controlling interests should be classified as financial liabilities in the consolidated financial statements of the group.

HKAS 32.25

2.4.2 Financial instruments with contingent settlement provisions

The settlement of some financial instruments depends on events which are beyond the control of both the holder and issuer of the instrument:

(a) The occurrence or non-occurrence of uncertain future events
(b) The outcome of uncertain circumstances

For example, an entity might have to deliver cash instead of issuing equity shares. In this situation it is not immediately clear whether the entity has an equity instrument or a financial liability.

Such financial instruments should be classified as **financial liabilities** unless:

(a) The part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;

(b) The issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or

(c) The instrument is a puttable instrument classified as equity in accordance with HKAS 32.

HKAS 32.26

2.4.3 Financial instruments with settlement options

When a derivative financial instrument gives one party a **choice** over how it is settled (e.g. the issuer can choose whether to settle in cash or by issuing shares) the instrument is a **financial asset** or a **financial liability** unless **all the alternative choices** would result in it being an equity instrument.

HKAS 32 28, 29, 30, 32

2.4.4 Compound financial instruments

Topic highlights

Compound instruments are split into equity and liability parts and presented accordingly in the statement of financial position.

Where a financial instrument contains both a liability and an equity element, HKAS 32 requires that these component parts are classified separately according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

A common type of compound instrument is convertible debt. On the issue of such debt, the holder is granted an option to convert it into an equity instrument (usually ordinary shares) of the issuer rather than redeem it. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

In this case the instrument is presented as part liability, part equity, and the usual way to calculate the split is to:

(a) Calculate the value for the liability component based on similar instruments with no conversions rights, and

(b) Deduct this from the instrument as a whole to leave a residual value for the equity component.

The reasoning behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities.

The **sum of the carrying amounts** assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument **as a whole**.

The following example should make this split clearer.

Example: Valuation of compound instruments

Strauss Co. issues 1,000 convertible bonds at the start of 20X0. The bonds have a three-year term, and are issued at par with a face value of $2,500 per bond, giving total proceeds of $2,500,000. Interest is payable annually in arrears at a nominal annual interest rate of 5%. Each bond is convertible at any time up to maturity into 300 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 8%. At the issue date, the market price of one common share is $2. The dividends expected over the three-year term of the bonds amount to 11 cents per share at the end of each year. The risk-free annual interest rate for a three-year term is 4%.

Required

What is the value of the equity component in the bond issue?

Solution

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 8%, the market interest rate for similar bonds having no conversion rights, as shown.

	$
Present value of the principal: $2,500,000 payable at the end of three years ($\$2.5m \times 1/1.08^3$)*	1,985,000
Present value of the interest: $125,000 payable annually in arrears for three years ($\$125,000 \times (1/1.08 + 1/1.08^2 + 1/1.08^3)$)	322,137
Total liability component	2,307,137
Equity component (balancing figure)	192,863
Proceeds of the bond issue	2,500,000

* **Note.** Both the present value figures can be found using tables using an 8% discount factor for the principal of 0.794 and for the interest of 2.577. In the case of the second (present value of the interest), if tables are used, the present value is $322,125, giving an equity component balancing figure of $192,875. The difference is due to rounding.

The split between the liability and equity components remains the same throughout the term of the instrument, even if there are changes in the **likelihood of the option being exercised**. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payments until conversion, maturity of the instrument or some other relevant transaction takes place.

Self-test question 3

On 1 January 20X1, an entity issued 100,000 6% convertible bonds at their par value of $20 each. The bonds will be redeemed on 1 January 20X6. Each bond is convertible at the option of the holder at any time during the five-year period. Interest on the bond will be paid annually in arrears.

The prevailing market interest rate for similar debt without conversion options at the date of issue was 8%.

Required

At what value should the equity element of the hybrid financial instrument be recognised in the financial statements of the entity at the date of issue?

(The answer is at the end of the chapter)

At maturity a compound instrument may be redeemed or converted. Where the instrument is redeemed for cash, the liability element of the instrument is derecognised and cash payment recognised; where the instrument is converted, the liability element is derecognised and instead recognised as equity. The original equity element of the instrument remains within equity, however may be transferred to a different account within equity.

Convertible instruments that are not compound instruments

Certain types of convertible debt instrument meet the definition of a financial liability and therefore are not compound instruments and do not require the split-accounting approach described above.

As we have seen the definition of a financial liability includes a contract that will or may be settled in the entity's own equity instruments and is a:

(i) Non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments

(ii) Derivative that will or may be settled other than by the exchange of a fixed amount of cash or other financial asset for a fixed number of the entity's own equity instruments.

Where the 'fixed for fixed test' described in (ii) is failed, i.e. a fixed amount of cash (or other financial asset) is not exchanged for a fixed number of equity instruments, the convertible debt instrument is classified as a liability in its entirety.

The 'fixed for fixed' test is always failed in the following circumstances, and may be failed in others:

- Where the conversion ratio changes based on the issuing entity's share price, since the number of equity instruments issued on conversion is not fixed
- Where the convertible debt instrument is denominated in a foreign currency, since the amount of cash exchanged for shares on conversion is not fixed in the functional currency of the issuing entity

Where the conversion option is not classified as equity it is an embedded derivative. Although the convertible instrument is classified in its entirety as a liability, it is therefore made up of two liability elements:

(i) A financial liability host instrument
(ii) A financial liability embedded derivative

For such instruments the entity must assess whether the embedded derivative should be separated from its host contract and accounted for as a derivative (at fair value through profit or loss). The accounting treatment applied to embedded derivatives and their host instruments is considered in more detail in section 7 of this chapter.

HKAS 32.16

2.4.5 Rights issues

A 2009 amendment to HKAS 32 (effective for periods starting on or after 1 February 2010) requires that **rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.**

This is a very narrow amendment and does not extend to other instruments that grant the holder the right to purchase the entity's own equity instruments such as the conversion feature in convertible bonds.

Example: Rights issue

Background

On 1 December 20X2, ABC offered all of its existing shareholders rights to acquire one new common share for every three common shares held at a price of $15 per share. ABC's functional currency is Y, and ABC has only one class of shares outstanding. There were a total of 3,000 rights offered and they initially traded at $2 each.

The rights were subject to expiry on 31 December 20X2 and were fully subscribed on that date. On 31 December 20X2, the common share price was $18 per share and the closing fair value of the rights was $3 per share (i.e. $18 – $15).

Exchange rate: $/Y = 1.5/1

Accounting treatment prior to amendment

The rights offered in $ would have been accounted for as derivative liabilities. On 1 December 20X2, a liability of Y4,000 ($2 × 3,000 ÷ 1.5) would have been recognised with a corresponding debit to equity, representing the distribution of the rights to common shareholders. Subsequently, the liability would have been re-measured at fair value, increasing to Y6,000 (3,000 × $3 ÷ 1.5), and a loss of Y2,000 (Y6,000 – Y4,000) would have been recognised in profit or loss. On exercise of the rights, the cash proceeds of Y30,000 ($15 × 3,000 ÷ 1.5) and the closing fair value of the rights of Y6,000 would have been credited to equity.

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Accounting treatment after the amendment

The rights offered in $ would be classified as equity. Hence, no liability or gain or loss would be recognised in respect of the rights. On exercise of the rights, the cash proceeds of $30,000 would be credited to equity.

Journal entries for accounting treatment prior to amendment

		Y	Y
1 December 20X2			
DEBIT	Equity (statement of changes in equity)	4,000	
CREDIT	Derivative liability		4,000
Being the issue of rights			
31 December 20X2			
DEBIT	Profit or loss	2,000	
CREDIT	Derivative liability		2,000
Being the remeasurement of the liability to fair value			
31 December 20X2			
DEBIT	Derivative liability	6,000	
DEBIT	Cash	30,000	
CREDIT	Equity		36,000
Being the exercise of rights in full			

Journal entries for accounting treatment after the amendment

		Y	Y
31 December 20X2			
DEBIT	Cash	30,000	
CREDIT	Equity		30,000
Being the exercise of rights in full			

HKAS 32 42, AG38A-F

2.5 Offsetting a financial asset and a financial liability

Financial assets and liabilities are normally presented separately in the statement of financial position. A financial asset and financial liability should **only** be **offset**, with the net amount reported in the statement of financial position, when:

(a) There is a legally enforceable right of set off that is:

- Available immediately (rather than being contingent on a future event), and
- Exercisable by either counterparty.

(b) The entity intends to settle on a net basis, or to realise the asset and settle the liability simultaneously, i.e. at the same moment

This will reflect the expected **future cash flows** of the entity in these specific circumstances. In all other cases, financial assets and financial liabilities are presented separately.

HKAS 32 35, 36, 40, 41

2.6 Interest, dividends, losses and gains

Topic highlights

Interest, dividends, losses and gains are treated according to whether they relate to an equity instrument or a financial liability.

The HKAS 32 guidance considered so far all relates to the classification of financial instruments for presentation in the statement of financial position. The standard also considers how financial instruments are presented in the statement of profit or loss and other comprehensive income and statement of changes in equity:

Financial liabilities	Equity instruments
Interest, dividends, gains and losses are recognised in profit or loss.	Dividends are recognised directly in equity (and so disclosed in the statement of changes in equity). Transaction costs are a deduction from equity.

You should look at the requirements of **HKAS 1** *Presentation of Financial Statements* for further details of disclosure, and **HKAS 12** *Income Taxes* for disclosure of tax effects.

2.7 Section summary

- Financial instruments issued to raise capital must be classified as **liabilities** or **equity**.
- The **substance** of the financial instrument is more important than its **legal form**.
- The **critical feature of a financial liability** is the contractual obligation to deliver cash or another financial instrument.
- **Compound instruments** are split into equity and liability parts and presented accordingly.
- **Interest, dividends, losses and gains** are treated according to whether they relate to an equity instrument or a financial liability.

3 HKFRS 9: Recognition of financial instruments

Topic highlights

HKFRS 9 applies to the recognition of financial assets and liabilities with effect from 1 January 2018 and may be early adopted.

3.1 Scope

Entities that early adopt HKFRS 9 are required to apply it to all types of financial instruments with the exception of the following:

(a) Investments in **subsidiaries, associates, and joint ventures** that are accounted for under **HKFRS 10 , HKAS 27 or HKAS 28** (other than where those standards require or permit the use of all or part of HKFRS 9 to account for an interest in a subsidiary, associate or joint venture).

(b) **Leases** covered in **HKAS 17**.

(c) **Employee benefit plans** covered in **HKAS 19**.

(d) Equity instruments **issued by the entity** e.g. ordinary shares issued, or options and warrants.

(e) **Insurance contracts, including financial guarantee** contracts to which **HKFRS 4** is applied.

(f) **Forward contracts between an acquirer and a seller** in a business combination, covered in **HKFRS 3**.

(g) **Loan commitments** that cannot be settled net in cash or another financial instrument.

(h) Financial instruments, contracts and obligations under **share-based payment transactions,** covered in **HKFRS 2**.

(i) **Rights to reimburse** the entity for expenditure required to settle a provision recognised in accordance with HKAS 37.

(j) Rights and obligations under **HKFRS 15** *Revenue from Contracts with Customers.*

HKFRS 9.3.1.1

3.2 Initial recognition

Topic highlights

Financial instruments are recognised when the entity becomes a party to the contractual provisions of the instrument.

Financial assets are classified as measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss. Financial liabilities are classified at fair value through profit or loss or amortised cost.

HKFRS 9 requires that financial instruments are recognised in the statement of financial position when the entity becomes a party to the **contractual provisions of the instrument**.

Notice that this is **different** from the recognition criteria in the *Conceptual Framework* and in most other standards. Items are normally recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

HKFRS 9 4.1.1-4.1.4

3.2.1 Classification of financial assets

On recognition, HKFRS 9 requires that financial assets are classified as measured at either:

- Amortised cost, or
- Fair value through other comprehensive income (FVTOCI), or
- Fair value through profit or loss (FVTPL).

This classification is made on the basis of both:

(a) The entity's business model for managing the financial assets, and
(b) The contractual cash flow characteristics of the financial asset.

A financial asset is classified as measured at **amortised cost** where:

(a) The objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

A financial asset is classified as measured at **fair value through other comprehensive income** where:

(a) The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, and

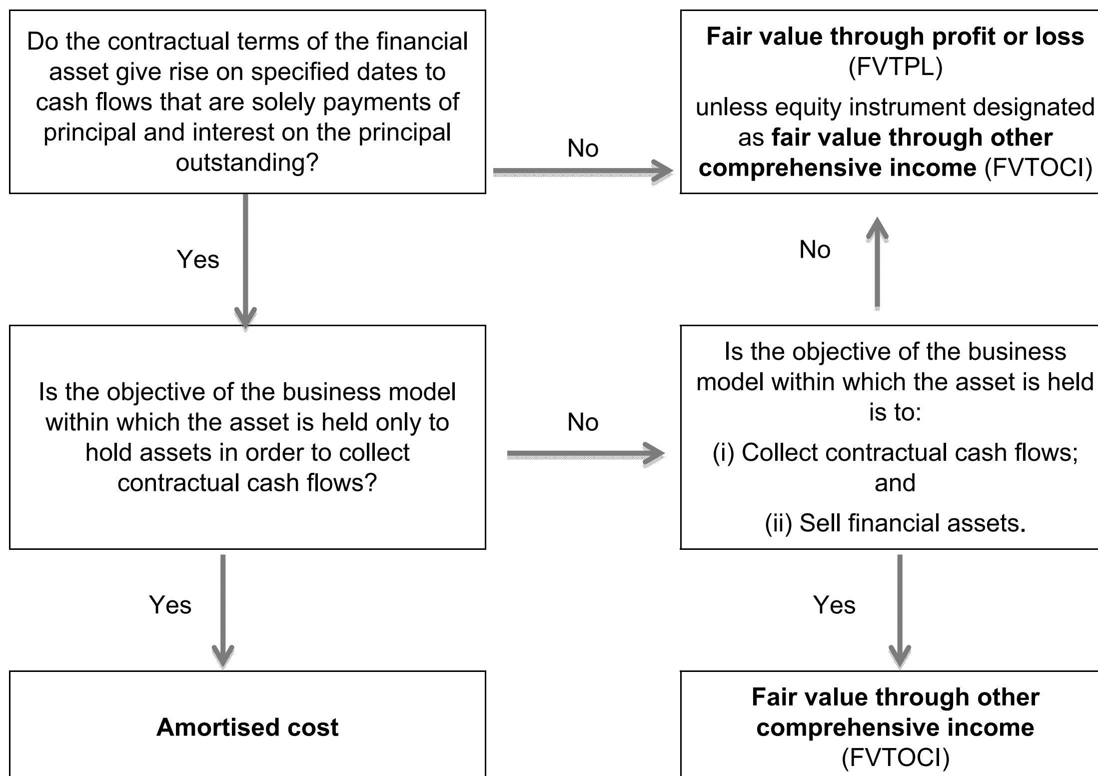
(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Where financial assets meet the amortised cost or FVTOCI criteria they must be classified as such unless an irrevocable election is made at initial recognition to designate them as measured at FVTPL in order to eliminate or significantly reduce an accounting mismatch.

Financial assets that do not meet these criteria are measured at fair value through profit or loss.

3.2.2 Decision tree

The following decision tree will help with the classification of financial assets:



Note that Appendix B to HKFRS 9 provides examples of:

- Financial instruments with contractual cash flows that are solely payments of principal and interest on the principal outstanding.
- Business models with the objective of collecting contractual cash flows from financial assets.
- Business models with the objective of collecting contractual cash flows and selling financial assets.

HKFRS 9 4.1.4-4.1.5

3.2.3 Application of classification criteria

An application of the HKFRS 9 rules means that:

- Equity investments must generally be measured at fair value through profit or loss. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. Where an equity instrument is not held for trading, an entity may make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income.
- All derivatives are measured at fair value.
- A debt instrument may be classified as measured at either amortised cost or fair value depending on whether it meets the criteria above. Even where the criteria are met at initial recognition, a debt instrument may be classified as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

HKFRS 9.4.2

3.2.4 Classification of financial liabilities

On initial recognition, HKFRS 9 require that financial liabilities are classified as either:

(a) At fair value through profit or loss, or
(b) Financial liabilities at amortised cost

A financial liability is classified at fair value through profit or loss if:

(a) It is held for trading, or
(b) Upon initial recognition it is designated at fair value through profit or loss. HKFRS 9.4.4.1-4.4.2

Derivatives are always measured at fair value through profit or loss.

HKFRS 9 4.4.1-4.4.2

3.3 Reclassification of financial instruments

Topic highlights

Financial assets may be reclassified from one category to another in certain circumstances.

HKFRS 9 requires that when an entity changes its business model for managing financial assets, it should reclassify all affected financial assets. This reclassification applies only to debt instruments, as equity instruments must be classified as measured at fair value.

HKFRS 9 prohibits the reclassification of financial liabilities.

HKFRS 9 3.2.3-3.2.6

3.4 Derecognition

Topic highlights

Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire** or where **substantially all the risks and rewards of ownership are transferred** to another party.

Financial liabilities should be de-recognised when they are extinguished.

Derecognition refers to the removal of a previously recognised financial instrument from an entity's statement of financial position.

HKFRS 9.B3.3.6

3.4.1 Derecognition of financial assets

A financial asset should be derecognised by an entity when:

(a) The **contractual rights** to the cash flows from the financial asset **expire, or**

(b) The entity **transfers substantially all the risks and rewards of ownership** of the financial asset to another party

The following are examples of the transfer of substantially all risks and rewards of ownership:

- An unconditional sale of a financial asset
- A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase

The standard also provides examples of situations where the risks and rewards of ownership have not been transferred:

- A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return
- A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity
- A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur

HKFRS 9.B3.3.6

3.4.2 Derecognition of financial liabilities

A financial liability is derecognised when it is extinguished i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Where an existing borrower and lender of debt instruments exchange one financial instrument for another with substantially different terms, this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

Similarly, a substantial modification of the terms of an existing financial liability or a part of it should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

For this purpose, a modification is 'substantial' where the discounted present value of cash flows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the cash flows of the original financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

Example: Derecognition

A number of years ago Beijing Company issued loan stock with the following terms:

- Interest to be paid annually in arrears at a rate of 5.5%
- Loan to be repaid on 31 December 20X7

Taking into account the transaction costs, the effective interest rate was 6%. Beijing had paid all interest and capital due up to 31 December 20X1, and at that date the carrying amount of the loan was $10 million.

During 20X1, the worldwide economic recession caused Beijing to suffer financial difficulties, and an agreement to revise the terms of the loan stock from 20X2 onwards was reached with lenders. The revised terms included an extension to the term of the loan and an increase to the coupon rate.

The effective interest rate of the revised terms, excluding transaction costs was 8% per annum.

The present value of the cash flows, excluding transaction costs, under the revised terms was $10.5 million at 6% and $9.5 million at 8%.

Transaction costs of $700,000 were payable on 1 January 20X2 in respect of the negotiations for the revised terms.

How should the revision to the terms of the loan be treated in Beijing's financial statements?

Solution

The revised terms negotiated by Beijing are such that the original loan should be derecognised and a new financial liability recognised.

Derecognition of the old loan and recognition of the new liability is required if the present value of the cash flows under the new terms is 10% or more different from the present value of the original loan. The cash flows under the new terms must be discounted at the 6% effective interest rate of the original loan and include the $700,000 transaction costs.

With transaction costs payable at the start of the period of the revised terms, they are added on in full to the $10.5 million present value, giving a total of $11.2 million. This is 12% different from the $10.0 million present value of the old loan, so the original loan should be derecognised and the new financial liability recognised.

Self-test question 4

Discuss whether the following financial instruments would be derecognised.

(a) ABC sells an investment in shares, but retains a call option to repurchase those shares at any time at a price equal to their current market value at the date of repurchase.

(b) DEF enters into a stocklending agreement where an investment is lent to a third party for a fixed period of time for a fee.

(c) XYZ sells title to some of its receivables to a debt factor for an immediate cash payment of 90% of their value. The terms of the agreement are that XYZ has to compensate the factor for any amounts not recovered by the factor after six months.

(The answer is at the end of the chapter)

A financial liability which is extinguished, i.e. when the obligation specified in the contract is discharged or cancelled or expires, should be derecognised by an entity.

HKFRS 9.3.2.2

3.4.3 Partial derecognition

Partial derecognition of a financial asset or liability is possible on condition that the derecognised part comprises only:

(a) Identifiable cash flows
(b) A share of the total cash flows on a fully proportionate (pro rata) basis

For example, a holder of bonds has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could retain the right to receive the principal and sell the right to receive interest to another party.

Where only part of a financial asset is derecognised, the carrying amount of the asset should be allocated between the part retained and the part transferred based on their relative fair values on the date of transfer. A gain or loss should be recognised based on the proceeds for the portion transferred.

On derecognition, the amount to be included in net profit or loss for the period is calculated as follows:

	$	$
Carrying amount of asset/liability (or the portion of asset/liability) transferred		X
Less: proceeds received/paid	X	
any cumulative gain or loss reported as other comprehensive income	X	
		(X)
Profit or loss		X

3.5 Section summary

- HKFRS 9 applies to the recognition of financial assets and liabilities where it is early adopted. Financial instruments are recognised when the entity becomes a party to the contractual provisions of the instrument.
- HKFRS 9 requires that financial assets are classified as measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss and financial liabilities are classified at fair value through profit or loss or amortised cost.
- Financial assets are reclassified from one category to another in certain circumstances. Financial liabilities may not be reclassified.
- Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire** or where **substantially all the risks and rewards of ownership are transferred** to another party.
- Financial liabilities should be derecognised when they are extinguished.

4 HKFRS 9 : Measurement of financial instruments

Topic highlights

Financial instruments are initially measured at fair value. Transaction costs increase this amount for financial assets classified as measured at amortised cost or fair value through other comprehensive income and decrease this amount for financial liabilities classified as measured at amortised cost.

The classification of financial assets and financial liabilities is of particular importance in terms of how they are measured throughout their life.

HKFRS 9 5.1.1, 5.1.2A

4.1 Initial measurement

Financial assets

HKFRS 9 requires that financial assets are initially measured at the transaction price, i.e. the fair value of consideration given, except where part of the consideration given is for something other than the financial asset. In this case the financial asset is initially measured at fair value evidenced by a quoted price in an active market for an identical asset (i.e. an HKFRS 13 level 1 input) or based on a valuation technique that uses only data from observable markets. The difference between the fair value at initial recognition and the transaction price is recognised as a gain or loss.

In the case of financial assets not measured at fair value through profit or loss (FVTPL), transaction costs directly attributable to the acquisition of the financial asset increase this amount.

The correct journal entry to initially recognise a financial asset is therefore:

Financial assets NOT at FVTPL

DEBIT	Financial asset	Fair value + transaction costs
CREDIT	Cash/bank/payable	Fair value
CREDIT	Cash/bank/payable	Transaction costs

Financial assets at FVTPL

DEBIT	Financial asset	Fair value
CREDIT	Cash/bank/payable	Fair value
and		
DEBIT	Transaction costs (profit or loss)	Transaction costs
CREDIT	Cash/bank/payable	Transaction costs

Financial liabilities

HKFRS 9 require that financial liabilities are initially measured at transaction price, i.e. the fair value of consideration received except where part of the consideration received is for something other than the financial liability. In this case the financial liability is initially measured at fair value determined as for financial assets (see above). Transaction costs are deducted from this amount for financial liabilities unless they are measured at fair value through profit or loss.

Financial liabilities NOT at FVTPL

DEBIT	Cash/bank/receivable	Fair value
CREDIT	Cash/bank/payable	Transaction costs
CREDIT	Cash/bank/payable	Fair value – transaction costs

Financial liabilities at FVTPL

DEBIT	Cash/bank/receivable	Fair value
CREDIT	Financial liability	Fair value
and		
DEBIT	Transaction costs (profit or loss)	Transaction costs
CREDIT	Cash/bank/payable	Transaction costs

HKFRS 9.5.2

4.2 Subsequent measurement of financial assets

Topic highlights

Financial assets are subsequently measured at:

- Fair value with changes in value recognised in other comprehensive income or profit or loss, or
- Amortised cost with interest recognised in profit or loss.

As the classifications suggest, financial assets are measured, subsequent to initial recognition at:

- Fair value, or
- Amortised cost.

HKFRS 9.5.7.1

4.2.1 Financial assets measured at fair value

Where a financial asset is measured at fair value, the gain or loss resulting from remeasurement at each reporting date is recognised in other comprehensive income or profit or loss depending on the classification of the asset.

The exception to this is where a financial asset is part of a hedging relationship.

Note that on disposal of an equity instrument that is measured at fair value through other comprehensive income, cumulative fair value changes are not reclassified to profit or loss.

Example: Asset measurement

On 6 November 20X3 Stripe Co. acquires a listed equity investment with the intention of holding it in the long term. The investment cost $500,000 which was paid in cash. At Stripe Co.'s year end of 31 December 20X3, the market price of an identical investment is $520,000. How is the asset initially and subsequently measured?

Stripe Co. has elected to present changes in the fair value of the equity investment in other comprehensive income.

Solution

- The asset is initially recognised at the fair value of the consideration, being $500,000 by:

DEBIT	Equity investment	$500,000	
CREDIT	Cash/bank		$500,000

- At the period end it is remeasured to $520,000 by:

DEBIT	Equity investment	$20,000	
CREDIT	Other comprehensive income		$20,000

- This results in the recognition of $20,000 in other comprehensive income.

HKFRS.9 HKFRS 9.5.4.1, Appendix A

4.2.2 Financial assets measured at amortised cost

HKFRS 9 does not itself define amortised cost, however it does refer to the definition of this and other relevant terms within HKAS 32 and HKAS 39. The example which follows the definitions will help you to understand their application.

Key terms

Amortised cost of a financial asset or financial liability is the amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and, for financial assets, adjusted for any loss allowance.

The **effective interest method** is the method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.
The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.

(*HKFRS 9*)

Example: Financial asset measured at amortised cost

On 1 January 20X5 Abacus Bee Co. (ABC) purchases a debt instrument for its fair value of $100,000. Abacus paid in cash and incurred no transaction costs. The debt instrument is due to mature on 31 December 20X9. The instrument has a principal amount of $125,000 and the instrument carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

How should ABC account for the debt instrument over its five-year term?

Solution

ABC will receive interest of $5,900 (125,000 × 4.72%) each year and $125,000 when the instrument matures.

ABC must allocate the discount of $25,000 and the interest receivable over the five-year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years:

Year	Amortised cost at beginning of year	Profit or loss: Interest income for year (@ 10%)	Interest received during year (cash inflow)	Amortised cost at end of year
	$	$	$	$
20X5	100,000	10,000	(5,900)	104,100
20X6	104,100	10,410	(5,900)	108,610
20X7	108,610	10,861	(5,900)	113,571
20X8	113,571	11,357	(5,900)	119,028
20X9	119,028	11,872	(125,000 + 5,900)	–

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year. In the year ended 31 December 20X5 this is recorded by:

DEBIT	Financial asset – debt	$100,000	
CREDIT	Cash/bank		$100,000

To recognise the acquisition of the instrument on 1 January 20X5.

DEBIT	Cash/bank	$5,900	
DEBIT	Financial asset – debt	$4,100	
CREDIT	Investment income		$10,000

To recognise investment income in respect of the debt instrument.

Investments whose **fair value cannot be reliably measured** should be measured at cost.

Note that interest income is recognised in profit or loss each year, being the amount of interest actually received plus the interest income related to the winding up of the financial asset to its redemption value.

HKFRS 9 5.2.1-5.2.3

4.2.3 Summary of measurement rules

HKFRS 9 measurement rules are applied to categories of financial asset as follows:

	Amortised cost	FVTOCI (Debt)	FVTOCI (Equity)	FVTPL
Interest /dividend revenue	Profit or loss	Profit or loss	Profit or loss	Profit or loss
Expected credit losses (see section 6)	Profit or loss	Profit or loss	Profit or loss	Profit or loss
Foreign exchange gains/losses	Profit or loss	Profit or loss	Profit or loss	Profit or loss
Other gains/losses on remeasurement	–	OCI	OCI	Profit or loss
Gain/loss on derecognition	Profit or loss	Profit or loss with amounts previously recognised in OCI reclassified to profit or loss	Profit or loss but OCI is not reclassified.	Profit or loss

Classifying financial assets in accordance with HKFRS 9 should result in the provision of more useful information in the financial statements. For example:

- Where a debt instrument is held in the long term to collect contractual cash flows, the fair value of that instrument is of limited relevance to users.
- Where the purpose of holding an instrument is to collect income but also to sell the asset, the fair value gives an indication of selling price and so becomes more relevant.

Example: Measurement of financial assets

On 1 July 20X1 Booker Williams (BW) acquired $40 million 5% loan stock at a cost of $38 million. Further information is as follows:

- Interest is payable annually in arrears.
- The loan stock will be redeemed at a 5% premium on 30 June 20X4.
- The effective interest rate attached to the loan stock is 8.49%.
- The fair value of the loan stock is $38.8 million at 30 June 20X2 and $40.8 million at 30 June 20X3.
- The loan stock is held by BW within a business model whose objective is achieved both by collecting contractual cash flows and selling financial assets.

Required

(a) Calculate amounts to be recognised in the financial statements of BW for the years ended 30 June 20X2 and 20X3.

(b) State the relevant journal entries in the years ended 30 June 20X2 and 30 June 20X3.

(c) State the relevant journal entries to recognise the disposal of the loan stock on 1 July 20X3 for $41 million.

Solution

(a) The loan stock is classified as FVTOCI and initially measured at fair value of $38 million.

At amortised cost the loan stock would be measured as:

y/e	b/f	Interest at 8.49% × c/f	Cash flow	c/f
	$'000	$'000	$'000	$'000
20X2	38,000	3,226	(2,000)	39,226
20X3	39,226	3,330	(2,000)	40,556
20X4	40,556	3,444	(44,000)	–

(20X4 is shown for completeness)

Applying the same interest and cash flows, but remeasuring the asset to fair value at each period end:

y/e	b/f	Interest at 8.49% × c/f	Cash flow	Carrying amount before fair value change	Fair value change	c/f
	$'000	$'000	$'000	$'000	$'000	$'000
20X2	38,000	3,226	(2,000)	39,226	(426)	38,800
20X3	38,800	3,330	(2,000)	40,130	670	40,800

(b) Journal entries in respect of the loan stock in 20X2 are as follows ($'000):

DEBIT	Financial asset at FVTOCI	$38,000	
CREDIT	Cash		$38,000

To recognise the loan stock at fair value (consideration)

DEBIT	Financial asset at FVTOCI	$3,226	
CREDIT	Finance income		$3,226

To recognise finance income for the year

DEBIT	Cash	$2,000	
CREDIT	Financial asset at FVTOCI		$2,000

To recognise the receipt of 5% interest

DEBIT	Other comprehensive income	$426	
CREDIT	Financial asset at FVTOCI		$426

To remeasure the financial asset to fair value

Journal entries in respect of the loan stock in 20X3 are as follows ($'000):

DEBIT	Financial asset at FVTOCI	$3,330	
CREDIT	Finance income		$3,330

To recognise finance income for the year

DEBIT	Cash	$2,000	
CREDIT	Financial asset at FVTOCI		$2,000

To recognise the receipt of 5% interest

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	DEBIT	Financial asset at FVTOCI	$670	
	CREDIT	Other comprehensive income		$670
	To remeasure the financial asset to fair value			
(c)	DEBIT	Cash	$41,000	
	DEBIT	Other comprehensive income (670,000 – 426,000)	$244	
	CREDIT	Financial asset at FVTOCI		$40,800
	CREDIT	Gain on disposal (profit or loss)		$444

To derecognise the loan stock, recognise the gain on disposal and reclassify cumulative amounts recognised in other comprehensive income to profit or loss

Self-test question 5

St Ives purchased a $20 million 6% debenture at par on 1 January 20X1 when the market rate of interest was 6%. Interest is paid annually on 31 December. The debenture is redeemable at par on 31 December 20X2.

The market rate of interest on debentures of equivalent term and risk changed to 7% on 31 December 20X1.

Required

Show the charge or credit to profit or loss for each of the two years to 31 December 20X2 if the debentures are classified as:

(a) Financial assets at amortised cost.
(b) Financial assets at fair value through profit or loss.

Fair value is to be calculated using discounted cash flow techniques.

(The answer is at the end of the chapter)

HKFRS 9 5.6.1-5.6.3

4.2.4 Reclassification

In section 3.3 we saw that in some circumstances an entity must reclassify financial assets from one category to another.

Where financial assets are reclassified, that reclassification is applied prospectively from the reclassification date. Previously recognised gains, losses or interest are not restated.

If an entity reclassifies a financial asset so that it is now measured at fair value, its fair value is determined at the reclassification date. Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss.

If an entity reclassifies a financial asset so that it is now measured at amortised cost, its fair value at the reclassification date becomes its new carrying amount.

HKFRS 9.5.3.1

4.3 Subsequent measurement of financial liabilities

Topic highlights

Financial liabilities are subsequently measured at fair value or amortised cost with gains and losses recognised in profit or loss.

Except for financial liabilities at fair value through profit or loss (including most derivatives), all financial liabilities should be recognised and measured at amortised cost. The exceptions should be measured at fair value. However, if the fair value cannot be measured reliably, they should then be measured at cost.

HKFRS 9.5.7.1

4.3.1 Financial liabilities measured at amortised cost

The definitions seen above in relation to financial assets at amortised cost remain relevant here. Again, their application is best seen through examples.

Example: Finance cost

On 1 January 20X5 a company issued $200,000 loan notes. Issue costs were $320. The loan notes do not carry interest, but are redeemable at a premium of $41,613 on 31 December 20X6. The effective finance cost of the loan notes is 10%.

(a) What is the finance cost in respect of the loan notes for the year ended 31 December 20X6, and what is the carrying amount of the loan notes at that date?

(b) What journal entries are required in respect of the loan notes in 20X5 and 20X6?

Solution

(a) The premium on redemption of the loan notes represents a finance cost. The effective rate of interest must be applied so that the debt is measured at amortised cost.

At the time of issue, the loan notes are recognised at their net proceeds of:

$199,680 (200,000 – 320).

The finance cost for the year ended 31 December 20X6 is calculated as follows:

	B/f	**Interest @ 10%**	**C/f**
	$	$	$
20X5	199,680	19,968	219,648
20X6	219,648	21,965	241,613

(b) The issue of the loan notes is initially recognised by:

DEBIT	Cash/bank	$199,680	
CREDIT	Financial liability		$199,680

Interest in 20X5 is recognised by:

DEBIT	Finance costs	$19,968	
CREDIT	Financial liability		$19,968

Interest in 20X6 is recognised by:

DEBIT	Finance costs	$21,965	
CREDIT	Financial liability		$21,965

Self-test question 6

On 1 January 20X2, an entity issued a debt instrument with a coupon rate of 5% at a par value of $1,000,000. The directly attributable costs of issue were $30,000. The debt instrument is repayable on 31 December 20X8 at a premium of $260,000.

Required

What is the total amount of the finance cost associated with the debt instrument?

A $294,000
B $318,000
C $514,000
D $640,000

(The answer is at the end of the chapter)

Self-test question 7

Grumble Co. issues a bond for $839,619 on 1 January 20X2. No interest is payable on the bond, but it will be held to maturity and redeemed on 31 December 20X4 for $1 million. The bond has not been designated as at fair value through profit or loss.

Required

Calculate the charge to profit or loss of Grumble Co. for the year ended 31 December 20X2 and the balance outstanding at 31 December 20X2.

(The answer is at the end of the chapter)

HKFRS 9.B5.7.16

4.3.2 Financial liabilities at fair value through profit or loss

A financial liability which is held for trading and classified as fair value through profit or loss is remeasured to fair value each year in accordance with HKFRS 13 (see Chapter 19) with any gain or loss recognised in profit or loss unless it is part of a hedging relationship (see section 8).

HKFRS 9 introduces rules specific to financial liabilities that are designated as measured at fair value through profit or loss. In this case the gain or loss in a period must be classified into:

- Gain or loss resulting from credit risk; and
- Other gain or loss.

The gain or loss resulting from credit risk is established either:

1 As the amount of change in the fair value that is not attributable to changes in market conditions giving rise to market risk, or

2 Using an alternative method which an entity believes to more faithfully represent changes in value due to credit risk.

The gain or loss as a result of credit risk is recognised in other comprehensive income, unless it creates or enlarges an accounting mismatch (in which case it is recognised in profit or loss). The other gain or loss is recognised in profit or loss.

On derecognition any gains or losses recognised in other comprehensive income are **not** reclassified to profit or loss.

HKFRS 9 3.1.2-3.1.6, Appendix A

4.4 Trade date vs settlement date accounting

A regular way purchase or sale of financial assets shall be recognised and derecognised using trade date accounting or settlement date accounting.

Key terms

A **regular way purchase or sale** is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

HKFRS 9 refers to two methods of accounting, being **trade date** and **settlement date accounting**. An entity shall apply the same method consistently for all purchase and sales of financial assets that are classified in the same way in accordance with HKFRS 9. For this purpose, assets that meet the definition of held for trading form a separate classification from assets designated as measured at fair value through profit or loss. In addition, investments in equity instruments accounted for using the option provided in HKFRS 9 (irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument) form a separate classification.

The **trade date** is the date on which an entity commits to purchase or sell an asset, and trade date accounting results in:

- The recognition of an asset to be received and liability to pay for it on the trade date, and
- The derecognition of an asset to be sold and corresponding receivable on the trade date (together with any gain or loss).

The **settlement date** is the date on which an asset is delivered to or by an entity, and settlement date accounting results in:

- The recognition of an asset on the settlement date and
- The derecognition of an asset on the settlement date.

When trade date accounting is used interest does not start to accrue until the settlement date when title passes.

When settlement date accounting is used:

(a) An asset subsequently measured at amortised cost is recognised initially at its fair value on the trade date.

(b) Any change in the fair value of the asset to be received between the trade and settlement date is not recognised for assets measured at amortised cost.

(c) Any change in the fair value of the asset to be received between the trade and settlement date is recognised in profit or loss or other comprehensive income for assets measured at fair value.

Example: Trade date and settlement date accounting

Gaylord entered into a contractual commitment on 27 December 20X4 to purchase a financial asset for $1,000. On 31 December 20X4, the entity's reporting date, the fair value was $1,005. The transaction was settled on 5 January 20X5 when the fair value was $1,007. The entity has classified the asset as at fair value through profit or loss in accordance with HKFRS 9.

Required

How should the transactions be accounted for under trade date accounting and settlement date accounting?

Solution

Trade date accounting

- On 27 December 20X4, the entity should recognise the financial asset and the liability to the counterparty at $1,000.
- At 31 December 20X4, the financial asset should be remeasured to $1,005 and a gain of $5 recognised in profit or loss.
- On 5 January 20X5, the liability to the counterparty of $1,000 will be paid in cash. The fair value of the financial asset should be remeasured to $1,007 and a further gain of $2 recognised in profit or loss.

Settlement date accounting

- No transaction should be recognised on 27 December 20X4.
- On 31 December 20X4, a receivable of $5 should be recognised (equal to the fair value movement since the trade date) and the gain recognised in profit or loss.
- On 5 January 20X5, the financial asset should be recognised at its fair value of $1,007. The receivable should be derecognised, the payment of cash to the counterparty recognised and the further gain of $2 recognised in profit or loss.

4.5 Section summary

- Financial instruments are initially measured at fair value. Transaction costs increase this amount for financial assets that are not measured at FVTPL and decrease this amount for financial liabilities that are not measured at FVTPL.
- Financial assets are subsequently measured at fair value with changes recognised in profit or loss or other comprehensive income or at amortised cost with interest recognised in profit or loss.
- Financial liabilities are subsequently measured at fair value or amortised cost with gains and losses recognised in profit or loss.

5 HKAS 39: Recognition and measurement rules

Topic highlights

Unless an entity early adopts HKFRS 9, HKAS 39 remains applicable until it is withdrawn in 2018. It is therefore important that you understand the HKAS 39 recognition and measurement rules too as you are likely to see these in the workplace. You should remember, however, that HKFRS 9 is the primary examinable standard.

HKAS 39.2

5.1 Scope

The scope of HKAS 39 is identical to that of HKFRS 9 (see section 3.1).

HKAS 39 14, 17, 39

5.2 Recognition and derecognition

HKAS 39 requires that financial instruments are recognised in the statement of financial position when the entity becomes a party to the contractual provisions of the instrument. This is the same as the requirements of HKFRS 9.

HKAS 39 also includes substantially the same derecognition rules as HKFRS 9.

HKAS 39.9

5.3 Classification and measurement of financial assets

The HKFRS 9 classification rules for financial assets seen in section 3.2 are a significant simplification of the HKAS 39 rules. HKAS 39 requires financial assets to be classified as one of four types, being:

Fair value through profit or loss (FVTPL)	Financial assets that are: (a) Held for trading, i.e. it is: • Acquired principally for the purpose of sale in the short-term, • Part of a portfolio of financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking, or • A derivative. (b) Designated as such. This is only allowed where: • It eliminates or significantly reduces an accounting mismatch • A group of assets is managed and its performance evaluated on a fair value basis

Held to maturity (HTM)	Financial assets with fixed or determinable payments and fixed maturity that: • A company has the intention and ability to hold to maturity • Do not meet the definition of loans and receivables • Are not designated as fair value through profit or loss or available-for-sale
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: • Those that the entity intends to sell immediately or in the near term, which should be classified as held for trading and those that the entity upon initial recognition designates as at fair value through profit or loss, • Those that the entity upon initial recognition designates as available-for-sale, or • Those for which the holder may not recover substantially all of the initial investment, other than because of credit deterioration, which shall be classified as available-for-sale.
Available for sale (AFS)	Non-derivative financial assets designated as available-for-sale or not classified under any of the other three headings

HKAS 39 43, 46

5.3.1 Initial and subsequent measurement

The following table summarises the measurement requirements of HKAS 39 in respect of financial assets:

Classification	Initial measurement	Transaction costs	Subsequent measurement	Gains and losses recognised in:
FVTPL	Fair value	Expense	Fair value	Profit or loss
HTM	Fair value	Add to initial measurement	Amortised cost	Profit or loss
Loans and receivables	Fair value	Add to initial measurement	Amortised cost	Profit or loss
AFS	Fair value	Add to initial measurement	Fair value	Other comprehensive income

FVTPL and AFS financial assets are remeasured to fair value at each reporting date. Fair value is determined in accordance with HKFRS 13 *Fair Value Measurement* (see Chapter 19). Note that on the disposal of an AFS financial asset, cumulative amounts recognised in other comprehensive income are reclassified to profit or loss.

HTM financial assets and loans and receivables are measured at amortised cost, calculated as discussed in section 4 of this chapter.

Self-test question 8

Raincloud Trading Co (RTC) acquires a listed equity investment on 6 May 20X1 with the intention of holding it for the long term. The investment cost $13 million and RTC incurred transaction costs of $500,000. At RTC's year-end of 31 December 20X1 the market price of an identical investment is $14.6 million.

Required

How is the asset initially and subsequently measured?

(The answer is at the end of the chapter)

Self-test question 9

On 1 January 20X1 Monsoon Machinery Co (MMC) purchases a quoted debt instrument for its fair value of $10 million. The debt instrument is due to mature on 31 December 20X5 and the entity has the intention to hold the debt instrument till maturity. The instrument has a principal amount of $12.5 million and the instrument carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

Required

How should MMC account for the debt instrument over its five-year term?

(The answer is at the end of the chapter)

HKAS 39.9

5.4 Classification and measurement of financial liabilities

The requirements of HKAS 39 and HKFRS 9 are converged in terms of the classification and measurement of financial liabilities. HKAS 39 requires that financial liabilities are classified as either:

(a) At fair value through profit or loss (FVTPL), or
(b) Financial liabilities at amortised cost.

A financial liability is classified at fair value through profit or loss if:

(a) It is held for trading, or
(b) Upon initial recognition it is designated at fair value through profit or loss.

Derivatives are always measured at fair value through profit or loss.

HKAS 39 43, 47

5.4.1 Initial and subsequent measurement

The following table summarises the measurement requirements of HKAS 39 in respect of financial liabilities:

Classification	Initial measurement	Transaction costs	Subsequent measurement	Gains and losses recognised in:
FVTPL	Fair value	Expense	Fair value	Profit or loss
Other financial liabilities	Fair value	Deduct from initial measurement	Amortised cost	Profit or loss

Unlike HKFRS 9, HKAS 39 does not split the gain or loss arising on financial liabilities that are designated as FVTPL and account for that part arising from credit risk separately.

HKAS 39 50-54

5.5 Reclassification of financial instruments

In limited circumstances HKAS 39 requires or permits that non-derivative financial assets are reclassified.

5.5.1 Reclassification out of the HTM category

If an entity no longer has the ability or intention to hold a held-to-maturity financial asset to maturity it is reclassified to the available for sale category.

On reclassification:

- It is remeasured to fair value
- Any gain or loss is recognised in other comprehensive income

Such a reclassification, or the sale of a held-to-maturity asset before the maturity date triggers a penalty in accordance with the HKAS 39 'tainting rules'. The held-to-maturity category is now deemed to be tainted and as a result:

1 All remaining held-to-maturity financial assets are reclassified as available for sale and remeasured to fair value, and

2 The held-to-maturity category is unavailable to the entity for the remainder of the financial year and the two subsequent financial years.

This penalty is avoided only where the financial asset sold or reclassified is insignificant compared to the total amount of held-to-maturity assets or the reclassification was:

- Within three months of maturity, or
- After the entity has collected substantially all amounts of principal, or
- Outside the entity's control.

Example

On 1 January 20X3, Ramsey Smith Co (RSC) classifies a portfolio of eight newly issued ten-year bonds as held-to-maturity investments. On 30 April 20X4, the entity sells half of the assets for their fair value of $2,500 each. At that date the amortised cost of each financial asset using the effective interest method was $2,100. On 1 January 20X7, the fair value of each bond was $2,750. The entity has a 31 December reporting date.

Required

How should the above be accounted for?

Solution

On 30 April 20X4 the held-to-maturity category becomes tainted when RSC sells more than an insignificant amount (50%) of the held-to-maturity financial assets.

At that date, the remaining financial assets must be reclassified as available-for-sale. They should be measured at $10,000 (4 × $2,500) and the gain of $1,600 (4 × ($2,500 – $2,100)) recognised in other comprehensive income.

The category of held-to-maturity investments is unavailable for classification for the remainder of the 20X4 financial year and the two following financial years.

The financial assets may be reclassified as held-to-maturity on 1 January 20X7 when the classification is cleansed.

On that date, the fair value of $11,000 (4 × $2,750) becomes the new amortised cost and the total gain of $2,600 (4 × ($2,750 – $2,100)) recognised in other comprehensive income is amortised to profit or loss over the remaining six-year term to maturity, using the effective interest rate method.

5.5.2 Reclassification out of the FVTPL and AFS categories

Reclassification out of the fair value through profit or loss and available for sale categories is allowed in limited circumstances. It is not allowed for:

- Derivatives
- Financial assets that are designated as fair value through profit or loss on initial recognition.

The criteria for reclassification are as follows.

(a) If a debt instrument would have met the definition of loans and receivables, had it not been required to be classified as held for trading at initial recognition, it may be reclassified out of fair value through profit or loss provided the entity has the intention and ability to hold the asset for the foreseeable future or until maturity.

(b) If a debt instrument was classified as available for sale, but would have met the definition of loans and receivables if it had not been designated as available for sale, it may be reclassified to the loans and receivables category provided the entity has the intention and ability to hold the asset for the foreseeable future or until maturity.

(c) Other debt instruments or any equity instruments may be reclassified from fair value through profit or loss to available for sale or, in the case of debt instruments only from fair value through profit or loss to held to maturity if the asset is no longer held for selling in the short term. Such cases will be rare.

Reclassified assets must be measured at fair value at the date of reclassification and this becomes the new cost, or amortised cost of the financial asset. Previously recognised gains and losses cannot be reversed.

For assets reclassified out of AFS, amounts previously recognised in other comprehensive income must be reclassified to profit or loss.

5.5.3 Accounting subsequent to reclassification

After the reclassification date, the normal HKAS 39 requirements apply. For example, in the case of financial assets measured at amortised cost, a new effective interest rate will be determined. If a fixed rate debt instrument is reclassified as loans and receivables and held to maturity, this effective interest rate will be used as the discount rate for future impairment calculations.

Reclassified debt instruments are treated differently. If, after the instrument has been reclassified, an entity increases its estimate of recoverability of future cash flows, the carrying amount is not adjusted upwards (in accordance with existing HKAS 39 rules). Instead, a new effective interest rate must be applied from that date on. This enables the increase in recoverability of cash flows to be recognised over the expected life of the financial asset.

6 HKFRS 9: Credit losses

HKAS 39.58

Topic highlights

HKFRS 9 provides detailed guidance on the measurement and recognition of credit (impairment) losses in relation to financial assets. The requirements of the standard also apply to certain other assets.

HKFRS 9 5.5.1-5.5.11

The impairment requirements of HKFRS 9 are applied to:

- Debt instruments measured at amortised cost or FVTOCI
- Lease receivables (HKAS 17)
- Contract assets (HKFRS 15)
- Loan commitments within the scope of HKFRS 9 and not measured at FVTPL
- Financial guarantee commitments not measured at FVTPL

Debt and equity instruments measured at FVTPL are not within the scope of HKFRS 9 credit loss guidance because they are measured at fair value with gains and losses recognised in profit or loss in the same way as an impairment loss.

Equity instruments measured at FVTOCI are also scoped out of the guidance because changes in fair value, including those arising as a result of impairment are recognised in other comprehensive income.

6.1 Approach to impairment

HKFRS 9 applies an 'expected loss' model to impairment, in other words, credit losses are recognised when expected rather than when incurred. There are three approaches to impairment given in the standard:

1 A general approach

2 A simplified approach (relevant to trade receivables)

3 A purchased (or originated) credit impaired approach, which is applicable where a financial asset is credit impaired when initially recognised

HKFRS 9
5.5.1-5.5.8

6.2 General approach

Under the general approach:

At initial recognition

Recognise 12-month expected credit losses

After initial recognition, a three stage approach is taken:

Stage 1

Credit risk has not increased significantly since initial recognition

Recognise 12-month expected credit losses

Stage 2

Credit risk has increased significantly since initial recognition

Recognise lifetime expected credit losses

Interest calculated on gross amount of asset

Stage 3

There is objective evidence of impairment at the reporting date

Recognise lifetime expected credit losses

Interest calculated on net amount of asset

HKFRS 9
B5.5.28-
5.5.29

6.2.1 Credit losses

Expected credit losses are a probability-weighted estimate of credit losses over the expected life of a financial instrument.

- Twelve month credit losses are the lifetime expected credit losses arising from a default that occurs within the **next 12 months** after the reporting date.
- Lifetime credit losses are the lifetime expected credit losses that would arise if a default occurred at **any time in the term** of a financial asset.

The measurement of credit losses is based on the present value of cash shortfalls calculated as:

Present value of principal and interest cash flows that are contractually due to an entity	X
Present value of cash flows an entity expects to receive	(X)
Credit losses	X

HKFRS 9 does not prescribe specific approaches to estimate expected credit losses, and therefore a degree of judgment is required; the standard does, however, require the following to be reflected:

1 The time value of money

2 An unbiased and probability-weighted amount, determined by considering a range of possible outcomes

3 Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions

Note that because the timing of payments is considered as well as the amount, a credit loss arises even if all contractual payments are expected to be received, however at a later date than the contract provides for.

HKFRS 9.B5.5.55

Expected cash flows

Estimates of cash flows expected to be received should include cash flows expected from collateral that is part of the contractual terms and is not recognised separately by the holder of the financial asset. For example in the case of a mortgage loan, collateral is the mortgaged property, and proceeds from its sale in the case of foreclosure (net of selling costs) are included in expected cash flows when assessing credit losses. This is regardless of whether foreclosure is probable. Where proceeds exceed the amount of the loan, this may mean that expected credit losses are zero.

HKFRS 9.B5.5.44

Time value of money

Expected credit losses are discounted to the reporting date rather than expected default date, using the effective interest rate determined at initial recognition (or an approximation to this). The current effective rate is used for financial instruments with a variable interest rate.

HKFRS 9 B5.5.41-5.5.43

Probability weighting

The estimate of expected credit losses should reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes.

In simple cases there may be no more than two possible outcomes (a credit loss occurs and a credit loss does not occur), whereas in other, more complex cases, a number of scenarios will be identified in which the amount and timing of expected cash flows, and so the amount of credit loss, varies.

A probability is assessed for each possible outcome or scenario and applied to the credit loss arising in each scenario in order to calculate a probability-weighted expected credit loss.

HKFRS 9 B5.5.49-B5.5.54

Reasonable and supportable information

When measuring credit losses, an entity must consider reasonable and supportable information, that is available without undue cost or effort at the reporting date, about past events, current conditions and forecasts of future economic conditions.

Historic information is usually used as a starting point to estimate expected credit losses, with adjustment made to factor in effects that were not present in the past or remove effects that are not relevant in the future.

Sources of information should include borrower-specific factors, general economic conditions and forecast conditions. Internal and external data should be considered, e.g. internal historic credit loss experience, internal ratings, external ratings, reports and statistics.

An entity should regularly review its inputs, assumptions, methodology and estimation techniques used in the determination of expected credit losses.

Example

Ranger Cann Company (RCC) advanced an interest-bearing loan to a supplier on 1 January 20X5.

The following information relates to this loan at 1 January and 31 December 20X5:

	1 January 20X5	31 December 20X5
	$	$
Present value of contractual cash flows	8,000,000	7,650,000
Present value of expected cash flows and associated probability of default within 12 months	8,000,000 – 95% 7,750,000 – 5%	7,650,000 – 85% 5,500,000 – 8% 1,000,000 – 7%

Required

What is the impairment loss at each date, assuming that credit risk has not increased significantly since initial recognition

Solution

1 January 20X5

	Possible outcomes	
	$'000	$'000
Present value of principal and interest cash flows that are contractually due to an entity	8,000	8,000
Present value of cash flows an entity expects to receive	8,000	7,750
Credit loss	0	250
Probability	95%	5%
Weighted credit loss	0	12.5

Therefore an impairment loss of $12,500 (0 + $12,500) is recognised.

31 December 20X5

	Possible outcomes		
	$'000	$'000	$'000
Present value of principal and interest cash flows that are contractually due to an entity	7,650	7,650	7,650
Present value of cash flows an entity expects to receive	7,650	5,500	1,000
Credit loss	0	2,150	6,650
Probability	85%	8%	7%
Weighted credit loss	0	172	465.5

Therefore an impairment loss of $637,500 (0 + $172,000 + $465,500) is recognised.

HKFRS 9 B5.5.15-5.5.21

6.2.2 Significantly increased credit risk (stage 1 to stage 2)

Stage 2 is reached when there is a significant increase in credit risk (i.e. the risk a borrower will default); the Application Guidance to HKFRS 9 provides information that should be considered when assessing credit risk, for example:

- An actual or expected downgrade in the borrower's credit rating
- Adverse changes in business, financial or economic conditions that affect the borrower e.g. increased interest rates
- An actual or expected decline in the operating results of the borrower
- An actual or expected change in the regulatory, economic or technological environment of the borrower such as a decline in sales demand

In addition there is a rebuttable presumption that the credit risk of a financial asset has increased significantly when contractual payments are more than 30 days past due.

The movement from stage 1 to stage 2 is not irreversible; where credit losses have previously been measured at a lifetime amount, at a subsequent reporting date they are measured at a 12-month amount if a significant increase in credit risk is no longer evident.

6.2.3 Evidence of impairment (stage 2 to stage 3)

HKFRS 9 provides examples of evidence of impairment, including the significant financial difficulty of the borrower and breach of contract.

6.2.4 Interest

For financial assets at stages 1 and 2, interest is calculated on the gross carrying amount of the financial asset (before credit losses are taken into account).

For financial assets at stage 3 interest is calculated on the financial asset's carrying amount net of credit losses.

Example

On 1 January 20X4 Lord Robinson (LR) acquired an investment in $600,000 8% loan stock. The investment is measured at amortised cost.

At 1 January 20X4 there is a 6% probability that the borrower will default on the loan during 20X4 resulting in a 100% loss.

At 31 December 20X4 there is 1% probability that the borrower will default on the loan before 31 December 20X5 resulting in a 100% loss.

At 31 December 20X5 the borrower is expected to breach its covenants as a result of cash flow problems. There is a 40% probability of the loan defaulting over the remainder of its term.

At 31 December 20X6 the borrower breached its covenants and there is a 70% probability of default over the remainder of the loan term.

Required

What impairment loss and interest revenue are recognised at initial recognition and in each of the years ended 31 December 20X4, 20X5 and 20X6?

Solution

	Impairment allowance	**Interest revenue**
1 January 20X4 (Initial recognition)	6% × $600,000 = $36,000	–
31 December 20X4 (stage 1)	1% × $600,000 = $6,000	$600,000 × 8% = $48,000
31 December 20X5 (stage 2)	40% × $600,000 = $240,000	$600,000 × 8% = $48,000
31 December 20X6 (stage 3)	70% × $600,000 = $420,000	($600,000 – $420,000) × 8% = $14,400

An impairment loss on a financial asset at amortised cost is recognised in profit or loss, with a corresponding entry to an allowance account, which is offset against the carrying amount of the financial asset in the statement of financial position.

1 January 20X4		$	$
DEBIT	Profit or loss	36,000	
CREDIT	Impairment allowance		36,000

31 December 20X4		$	$
DEBIT	Impairment allowance (36,000 – 6,000)	30,000	
CREDIT	Profit or loss		30,000
31 December 20X5		$	$
DEBIT	Profit or loss (240,000 – 6,000)	234,000	
CREDIT	Impairment allowance		234,000
31 December 20X6		$	$
DEBIT	Profit or loss (420,000 – 240,000)	180,000	
CREDIT	Impairment allowance		180,000

HKFRS 9 B5.5.25-5.5.27

6.3 Modified financial assets

If the contractual cash flows on a financial asset have been renegotiated or modified, the financial asset may be derecognised and a new financial asset recognised in its place. In this case, the date of modification is treated as the date of initial recognition for the purpose of applying HKFRS 9 guidance on credit losses.

Where the original financial asset is not derecognised, it is not automatically considered to have lower credit risk. An assessment as to whether there is a significant increase in credit risk is made on the basis of all reasonable and supportable information (see section 6.2.1) by comparing:

- The risk of a default occurring at the reporting date, based on the modified contractual terms, and
- The risk of a default occurring at initial recognition, based on the original, unmodified contractual terms.

Normally consistently good payment behaviour over a period of time would be required before credit risk is considered to have decreased, e.g. a history of missed payments pre-modification would not be erased by one payment on time post-modification.

HKFRS 9 5.5.15, B.5.5.35, B5.5.46

6.4 Simplified approach – trade and lease receivables

For trade receivables and contract assets that do not have an HKFRS 15 financing element, the loss allowance is measured as lifetime expected credit losses from initial recognition.

This is the same as 12-month credit losses as the maturity of these assets is generally 12 months or less.

In the case of lease receivables, the appropriate discount rate to apply to future expected cash flows when determining credit losses is the discount rate used to measure the lease receivable.

For other trade receivables and for lease receivables, the entity can choose (as a separate accounting policy for trade receivables and for lease receivables) to either:

- Apply the three-stage general approach described in section 6.2, or
- Recognise an allowance for lifetime expected credit losses from initial recognition.

A provision matrix may be used to calculate lifetime credit losses for trade receivables/contract assets. This involves grouping trade receivables (or contract assets) based on customer bases or groupings with different historical loss patterns (e.g. region, type of customer, product type). Historical provision rates are then applied, although these may be adjusted to reflect relevant current information.

Example:

	Expected default rate	Gross carrying amount	Credit loss allowance
Current	0.5%	$560,000	$2,800
1 – 30 days past due	1.2%	$490,000	$5,880
31 – 60 days past due	3.4%	$250,000	$8,500
61 – 90 days past due	4.0%	$90,000	$3,600
Over 90 days past due	10.8%	$55,000	$5,940
			$26,720

HKFRS 9.5.5.13

6.5 Purchased credit-impaired approach

A financial asset is described as 'credit-impaired' when one or more events that have a negative effect on future expected cash flows have already occurred.

Where financial assets are already credit-impaired when they are purchased/originated, the following approach is taken:

- Purchased credit-impaired financial assets are initially measured at the transaction price without an allowance for expected contractual cash shortfalls that are implicit in the purchase price.
- Lifetime credit losses are included in the estimated cash flows for the purposes of calculating the effective interest rate.
- Interest revenue is calculated on the net carrying amount at the credit-adjusted effective interest rate.
- Expected credit losses are discounted using the credit-adjusted effective interest rate determined at initial recognition.
- Subsequent changes from the initial expected credit losses are recognised immediately in profit or loss.

HKFRS 9 5.5.8, B8E, HKFRS 7.16A

6.6 Recognition of credit losses

Impairment losses are recognised in profit or loss with a corresponding credit entry as follows:

Financial assets at amortised cost	An allowance account, which is offset against the carrying amount of the financial asset so that a net position is presented in the statement of financial position.
Financial assets at FVTOCI	An 'accumulated impairment amount' in other comprehensive income. The carrying amount remains at fair value in the statement of financial position.
Loan commitments and financial guarantee contracts	A provision account, which is presented as a separate liability

6.7 Approach to impairment of financial assets: HKFRS 9 vs HKAS 39

HKAS 39 uses an 'incurred loss' model for the impairment of financial assets. This model assumes that all loans will be repaid until evidence to the contrary exists, that is until the occurrence of an event that triggers an impairment indicator. Only at this point is the impaired loan written down to a lower value.

As we have seen, the HKFRS 9 approach differs in that an 'expected loss' model is applied. There is no longer a need for a 'credit event' to have occurred before losses are recognised and instead an entity must always account for expected credit losses, updating expectations to reflect changes in credit risk at each reporting date. Entities must therefore take into account more forward-looking information and will recognise losses at an earlier point in time. The application of HKFRS 9 will require a high level of judgment and may result in a higher level of volatility in amounts charged to profit or loss in respect of impairment.

7 HKFRS 9: Embedded derivatives

Topic highlights

Embedded derivatives are derivative instruments that are embedded within a host contract that may or may not be a financial instrument.

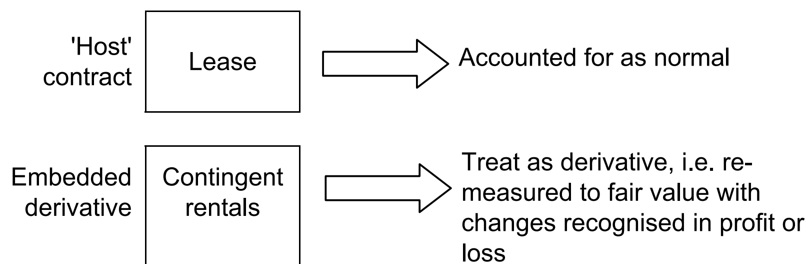
Derivative contracts may be 'embedded' in contracts that are not themselves derivatives (and may not be financial instruments). These non-derivatives are known as host contracts, and may comprise:

- Leases
- Sale or purchase contracts
- Insurance contracts
- Construction contracts
- A debt or equity instrument

7.1 Examples of embedded derivatives

Possible examples include:

(a) Contingent rentals based on inflation where a lease contract includes a term preventing rent increases from exceeding the local inflation:



(b) A bond which is redeemable in five years' time with part of the redemption price based on the increase in the Hong Kong Index.

(c) An embedded derivative caused by changes in the foreign exchange can be found in a construction contract which is priced in a foreign currency.

HKFRS 9
4.3.2-4.3.4

7.2 Accounting treatment of embedded derivatives

Under HKFRS 9, if the host contract is a financial asset within the scope of the standard, the classification and measurement rules of the standard are applied to the entire hybrid contract.

Where the host contract is not a financial asset within the scope of HKFRS 9, an entity must assess whether the embedded derivative should be separated from its host contract and accounted for as a derivative (at fair value through profit or loss). It must separate the embedded derivative if:

(a) The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract, and

(b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and

(c) The hybrid instrument is not measured at fair value with changes recognised in profit or loss (in which case there is no benefit to separating the embedded derivative).

Earlier in the chapter we saw that where convertible debt is denominated in a foreign currency or has a variable conversion ratio based on share price, then it is not split into equity and liability components for accounting purposes. Instead the conversion option is treated as an embedded derivative within a financial liability host contract.

Applying the HKFRS 9 guidance detailed above, the embedded derivative is separated from the debt instrument host and accounted for separately since:

(a) The economic characteristics and risks of a debt contract are not closely related to those of a share warrant

(b) A separate share warrant meets the definition of a derivative

(c) The debt instrument is not measured at fair value through profit or loss (unless specifically designated as such to provide more relevant information)

Therefore two financial liabilities are recognised:

(i) A debt instrument measured at amortised cost, and

(ii) An embedded derivative (representing the conversion option) measured at fair value through profit or loss.

HKFRS 9
B4.3.1

7.3 Reassessment of embedded derivatives

An entity is not permitted to reassess the treatment of an embedded derivative throughout the life of a contract unless there is a significant change to the terms of the contract.

7.4 Embedded derivatives: HKFRS 9 vs HKAS 39

HKAS 39 requires that in all cases an entity must assess whether an embedded derivative should be separated from its host contract and accounted for as a derivative. The conditions to do so are the same as the HKFRS 9 conditions. HKAS 39 does not permit classification and measurement rules to be applied to the entire hybrid contract on an automatic basis where the host contract is a financial asset.

8 HKFRS 9: Hedging

Topic highlights

Hedge accounting means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.

HKFRS 9 guidance on hedge accounting aligns the accounting treatment closely with the risk management activities of an entity.

8.1 Introduction

It is normal business practice for a company to engage in hedging activities in order to reduce its exposure to risk and uncertainty, such as changes in prices, interest rates or foreign exchange rates. For example, an entity may have a fixed amount of foreign currency to pay on a particular date, and hedge against unfavourable exchange rate movements by taking out a forward contract to purchase the currency it needs to meet its obligation from a third party at a particular exchange rate.

In this instance the forward contract is a derivative and so measured at fair value with changes in value recognised in profit or loss. An accounting hedge involves recognising these changes in value at the same time as any opposite gain or loss on a year end revaluation and then settlement of the payable so as to minimise the impact on profit or loss of the transaction. This is an example of a hedge that happens automatically.

HKFRS 9 provides guidance relating to hedging and **allows hedge accounting** where there is a **designated hedging relationship** between a hedging instrument and a hedged item. It is **prohibited otherwise**. Hedge accounting is therefore not mandatory.

8.2 Key terms

Hedging, for accounting purposes, means designating one or more **hedging instruments** so that their change in fair value is offset, in whole or in part, to the change in fair value or cash flows of a **hedged item**.

HKAS 9 6.2.1-3

HKAS 6,2, .1-3

8.2.1 Hedging instrument

Contracts that can be designated as hedging instruments include:

- Derivatives
- Non-derivative financial assets or liabilities measured at fair value through profit or loss (with the exception of financial liabilities designated at fair value through profit or loss for which changes in fair value attributable to credit risk are presented in OCI)

For the hedge of a foreign currency risk, the foreign currency risk component of a non-derivative financial asset or liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument measured at FVTOCI by election.

HKFRS 9.6 3.1-6

8.2.2 Hedged item

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be a single item of a group or items and it must be reliably measurable.

8.2.3 Groups and hedge accounting

Generally a hedging instrument and hedged item must both arise from contracts with parties external to the reporting entity. Therefore, whilst hedge accounting can be applied to transactions between entities in the same group, this is only in the separate financial statements of those entities and not in the consolidated financial statements.

Exceptions to this are as follows:

1. Hedge accounting can be applied to transactions between entities in the same group and reported in the consolidated financial statements of an investment entity, where transactions between the investment entity and its subsidiaries are not eliminated.
2. The foreign currency risk of an intragroup monetary item (e.g. payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. This can happen (per **HKAS 21**) when the transaction is between entities with different functional currencies.
3. The foreign currency risk of a highly probable group transaction may qualify as a hedged item if it is in a currency other than the functional currency of the entity and the foreign currency risk will affect profit or loss (e.g. a forecast sale of inventories from one member of a group to another, followed by onward sale to a third party external to the group).

HKFRS 9.6.5.2

8.3 Types of hedge

There are three types of hedge covered by HKFRS 9:

Fair value hedge. A hedge of the exposure to changes in the fair value of a recognised asset or liability or an unrecognised **firm commitment**, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

Cash flow hedge. A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable **forecast transaction**, and could affect profit or loss.

Hedge of a net investment in a foreign operation. **HKAS 21** defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation.

Key terms

A **forecast transaction** is an uncommitted but anticipated future transaction.

A **firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

(HKFRS 9)

We shall consider each type of hedge in detail in a moment, but first it is important to understand the conditions for hedge accounting.

HKFRS 9.6.4.1

8.4 Conditions for hedge accounting

Topic highlights

Hedge accounting is permitted in certain circumstances, provided the hedging relationship is clearly defined, measurable and actually effective.

Before a hedging relationship qualifies for hedge accounting, **all** of the following **conditions** must be met:

(a) The hedging relationship must consist only of eligible hedging instruments and eligible hedged items.

(b) At the inception of the hedge, there must be formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. Documentation must include identification of the hedged item, the hedging instrument, the nature of the hedged risk and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

(c) The hedging relationship meets all of the hedge effectiveness requirements:

- An economic relationship exists between the hedged item and the hedging instrument, i.e. the hedging instrument and the hedged item are expected to have offsetting changes in fair value;
- The effect of credit risk does not dominate the fair value changes, i.e. the fair value changes due to credit risk are not a significant driver of the fair value changes of either the hedging instrument or the hedged item; and
- the hedge ratio of the hedging relationship (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

Key terms

Hedge ratio is the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

(*HKFRS 9*)

For many hedging relationships the hedge ratio is 1:1 as the hedging instrument perfectly matches the designated hedged risk. This is not, however, always the case – risk managers set the hedge ratio. The HKFRS 9 condition for hedge accounting is that the hedge ratio used for accounting purposes is the same as that used for risk management purposes and there is no deliberate imbalance in order to achieve an inappropriate accounting outcome (e.g. deliberate under-hedging by designating the amount of the hedging instrument to be lower than the amount of the hedged item to artificially reduce hedge effectiveness).

Example: Hedge ratio

A company purchases raw material at a discounted price compared to the commodity price. This discount reflects the fact that the raw material is not processed to the same level as the commodity. Management note there is a correlation between the raw material price and commodity price such that on average the commodity price is 1.5 times the raw material price. At the start of year 1, the company therefore uses a notional 1 tonne of forward contract for the commodity to hedge highly probable forecast purchases of 1.5 tonnes of the raw material. The hedge ratio is therefore set at 1 : 1.5.

HKFRS 9.6.5.5

8.4.1 Rebalancing

Rebalancing refers to adjustments (where there is already a hedging relationship) to the designated quantities of the hedged item or the hedging instrument for the purpose of maintaining a hedge ratio that complies with the hedge. It can be achieved by:

- Increasing or decreasing the volume of the hedged item or
- Increasing or decreasing the volume of the hedging instrument.

Rebalancing must be undertaken if the risk management objective remains the same but the hedge effectiveness requirements are no longer met. Where the risk management objective for a hedging relationship has changed, rebalancing does not apply and the hedging relationship must be discontinued.

Example: Rebalancing

Continuing with the previous example, assume that the relationship between the commodity price and raw material price changes over year 1 such that by the end of the year the commodity price has decreased to an average 1.3 times the raw material price. In this case, management of the reporting entity might reset the hedge ratio to 1 : 1.3. Therefore to rebalance the hedging relationship management can either:

- Increase the raw material that forms the hedged item so that the hedged item is 1.15 tonnes (1/1.3 × 1.5)
- Decrease the commodity that forms the hedging instrument, so that the hedging instrument is 1.3 tonnes.

Example: Conditions for hedge accounting

Green Smith Company (GSC) plans to issue $100 million loan stock on 1 July 20X5 with a term of 20 years. Interest on the loan stock will be paid at a rate of 3m HIBOR.

GSC has an interest rate risk management policy under which interest rate swaps are used to hedge interest rate risk. On 1 June 20X5 it enters an interest rate swap at nil consideration to pay a fixed interest rate of 2.2% and receive 3m HIBOR on a notional $100 million. The effective date of the swap is 1 July 20X5 and the maturity date is 20 years later.

The hedge is formally designated on 1 June 20X5 as a cash flow hedge of the variability of the highly probable interest cash flows on the forecast loan stock issue up to 1 July 20X5 and on the actual bond issued to maturity for changes in 3m HIBOR.

Assess whether HKFRS 9 hedge effectiveness conditions are met.

Solution

At inception and at each reporting date GSC must demonstrate that it meets the three components of the HKFRS 9 hedge effectiveness requirements.

There is an economic relationship between the hedged item and the hedging instrument.	The hedging instrument and hedged item should have values that generally move in the opposite direction. In this case the terms of the hedged item and hedging instrument match and the fair value of the swap is nil at inception, therefore it can be determined that an economic relationship exists i.e. if 3m HIBOR exceeds 2.2%, the fair value of the liability (loan stock) will increase but will be offset by the fair value of the financial asset derivative; if 3m HIBOR is less than 2.2%, the fair value of the liability (loan stock) will decrease but will be offset by fair value of the financial liability derivative.
The effect of credit risk does not dominate the value changes that result from the economic relationship.	A change in the credit risk of the hedged item or hedging instrument could impact their fair values and so negate the economic relationship between the two. In this case until the debt is issued it is not necessary to consider credit risk on the hedged item as it is a forecast transaction; after issue, GSC should determine its own credit standing and that of the counterparty. Assuming that both are of high standing, it may conclude that changes in credit risk would not dominate fair value changes.
The hedge ratio is consistent with that used for risk management purposes and s not imbalanced.	GSC is hedging loan stock with a principal of $100 million using a swap with matched maturity based on a notional $100 million. This actual hedge ratio is not imbalanced and is therefore an eligible hedge ratio. (Note that if only $80 million of the $100 million notional of the swap were designated, this would be regarded as a deliberate under hedge and so not meet the effectiveness requirements and not be eligible for hedge accounting.)

8.5 Accounting treatment

Topic highlights

There are three types of hedge: fair value hedge; cash flow hedge; hedge of a net investment in a foreign operation. The accounting treatment of a hedge depends on its type.

HKFRS 9.6.5.8

8.5.1 Fair value hedges

In a fair value hedge:

- The gain or loss on the hedging instrument is recognised in profit or loss (or OCI if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI), and
- The gain or loss on the hedged item is recognised in profit or loss. This also applies if the hedged item is a financial asset debt instrument measured at FVTOCI. If the hedged item is an equity instrument for which an entity has elected to present changes in fair value in OCI, then the gain or loss is recognised in OCI.
- When the hedged item is an unrecognised firm commitment, the cumulative change in fair value of the hedged item subsequent to designation as a hedged item is recognised as an asset or liability and a corresponding amount is recognised in profit or loss.

Example: Fair value hedge (1)

A company owns inventories of 30,000 gallons of oil which cost $660,000 on 1 December 20X8.

In order to hedge the fluctuation in the market value of the oil the company signs a futures contract to deliver 30,000 gallons of oil on 31 March 20X9 at the futures price of $25 per gallon.

The market price of oil on 31 December 20X8 is $27 per gallon and the futures price for delivery on 31 March 20X9 is $30 per gallon.

Required

Explain the impact of the transactions on the financial statements of the company:

(a) Without hedge accounting
(b) With hedge accounting

Solution

The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the contract.

Without hedge accounting

The futures contract is a derivative and therefore must be remeasured to fair value at 31 December 20X8 under **HKFRS 9**. The loss on the futures contract is recognised in profit or loss:

		$	$
DEBIT	Profit or loss (30,000 × (30 – 25))	150,000	
CREDIT	Financial liability		150,000

With hedge accounting

The loss on the futures contract is recognised in profit or loss as before, however with hedge accounting, the inventories are also remeasured to fair value:

	$
Fair value at 31 December 20X8 (30,000 × 27)	810,000
Cost	(660,000)
Gain	150,000

The gain is also recognised in profit or loss:

		$	$
DEBIT	Inventory	150,000	
CREDIT	Profit or loss		150,000

With hedging the net effect on profit or loss is zero compared with a loss of $150,000 without hedging.

Example: Fair value hedge (2)

As at 1 January 20X3, a company purchases a debt instrument that has a principal amount of $1 million at a fixed interest rate of 6% per year. The instrument is classified as a financial asset measured at fair value through other comprehensive income. The fair value of the instrument is $1 million.

The company is exposed to a risk of the decline in the fair value of the instrument if the market interest rate increases because of the fixed interest rate.

The company enters into an interest rate swap. It exchanges the fixed interest rate payments it receives on the bond for floating interest rate payments, in order to offset the risk of a decline in fair value. If the derivative hedging instrument is effective, any decline in the fair value of the bond should be offset by opposite increases in the fair value of the derivative instrument. The company designates and documents the swap as a hedging instrument. On entering into the swap, the swap has a fair value of zero.

Assuming market interest rates have increased to 7%, the fair value of the bond will have decreased to $960,000.

At the same time, the company determines that the fair value of the swap has increased by $40,000. Since the swap is a derivative, it is measured at fair value with changes in fair value recognised in profit or loss. The changes in fair value of the hedged item and the hedging instrument exactly offset each other and the net effect on profit or loss is zero. Assume all hedging conditions have been met.

Required

Explain the impact of the transactions on the financial statements of the company with hedge accounting.

Solution

Statement of financial position

	1 January 20X3	**Change in FV**	**31 December 20X3**
	$'000	$'000	$'000
Debt instrument (hedged item)	1,000	(40)	960
Derivative asset (hedging instrument)	–	40	40
Cash	(1,000)		

Statement for profit or loss

	$'000
Loss on debt instrument	(40)
Gain on derivative	40
No ineffectiveness	–

Gains and losses on hedged item and hedging instrument are both recognised in the statement of profit or loss.

Journal entries

On 1 January 20X3

		$	$
DEBIT	Financial asset	1,000,000	
CREDIT	Cash/bank/payable		1,000,000

To recognise the debt instrument at its fair value.

On 31 December 20X3

		$	$
DEBIT	Profit or loss	$40,000	
CREDIT	Financial asset		$40,000

To remeasure the debt instrument to fair value at the reporting date.

And

		$	$
DEBIT	Financial asset – derivative	$40,000	
CREDIT	Profit or loss		$40,000

To measure the interest swap at fair value at the reporting date.

Example: Fair value hedge (3)

Assuming the information is the same as above. However, the company determines that the fair value of the swap has increased by $45,000 instead of $40,000. Assume all hedging conditions have been met.

Required

Explain the impact of the transactions on the financial statements of the company.

Solution

Statement of financial position

	1 January 20X3	**Change in FV**	**31 December 20X3**
	$'000	$'000	$'000
Debt instrument (hedged item)	1,000	(40)	960
Derivative asset (hedging instrument)	–	45	45
Cash	(1,000)		

Statement for profit or loss

	$'000
Loss on debt instrument	(40)
Gain on derivative	45
Ineffective hedge	5

This results in an ineffective hedge of $5,000 gain recognised in profit or loss.

Journal entries

On 1 January 20X3

		$	$
DEBIT	Financial asset	1,000,000	
CREDIT	Cash/bank/payable		1,000,000

To recognise the debt instrument at its fair value.

On 31 December 20X3

		$	$
DEBIT	Profit or loss	$40,000	
CREDIT	Financial asset		$40,000

To remeasure the debt instrument to fair value at the reporting date.

And

		$	$
DEBIT	Financial asset - derivative	$45,000	
CREDIT	Profit or loss		$45,000

To measure the interest swap at fair value at the reporting date.

HKFRS 9.6.5.11

8.5.2 Cash flow hedges

A cash flow hedge involves hedging future cash flows. Initially therefore, only the hedging instrument (the derivative) is recognised.

The part of the gain or loss arising from an **effective** hedge of a hedging instrument is **recognised in other comprehensive income** while the **ineffective portion** of the gain or loss on the hedging instrument should **be recognised in profit and loss**.

Amounts recognised in other comprehensive income are accumulated in a cash flow hedge reserve. At a given reporting date this will be the lower of:

(i) The cumulative gain or loss on the hedging instrument from the inception of the hedge, and

(ii) The cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge.

When the separate component of equity has been adjusted to this amount, any remaining gain or loss on the hedging instrument is recognised in profit or loss.

In the period in which the hedged expected future cash flows affect profit or loss, the amount accumulated in the cash flow hedge reserve is reclassified to profit or loss with the following exception:

If the hedged transaction results in the recognition of a non-financial asset or liability, the amount accumulated in the cash flow hedge reserve is transferred to be included in the initial cost or carrying amount of the non-financial item. This is not a reclassification adjustment and does not affect the OCI of the period.

Example: Basic cash flow hedge

Randall Co. expected to purchase an item of plant for 20 million South African rand in one year's time on 31 August 20X2. In order to offset the risk of movement in the exchange rate, Randall enters into a forward contract to purchase rand 20 million in one year for a fixed amount ($20,500,000). The forward contract is designated as a cash flow hedge and has an initial fair value of zero.

At the year end (31 December 20X1), the rand has appreciated and the value of rand 20 million is $20,650,000. The machine will still cost rand 20 million so the company concludes that the hedge is 100% effective. Thus the entire change in the fair value of the hedging instrument is recognised directly in other comprehensive income:

		$	$
DEBIT	Forward contract	150,000	
CREDIT	Other comprehensive income (cash flow hedge reserve)		150,000

The effect of the cash flow hedge is to lock in the price of rand 20 million for the item of plant.

When it is purchased on 31 August 20X2, the cash flow hedge reserve is deducted from the initial carrying amount of the machine.

Example: Cash flow hedge

Sparkle is a manufacturer and retailer of gold jewellery.

On 31 October 20X1, the cost of Sparkle's inventories of finished jewellery was $8.280 million with a gold content of 24,000 troy ounces. At that date their sales value was $9.938 million.

The selling price of gold jewellery is heavily dependent on the current market price of gold (plus a standard percentage for design and production costs).

Sparkle's management wished to reduce their business risk of fluctuations in future cash inflow from sale of the jewellery by hedging the value of the gold content of the jewellery. In the past this has proved to be an effective strategy.

Therefore, it sold futures contracts for 24,000 troy ounces of gold at $388 per troy ounce at 31 October 20X1. The contracts mature on 30 October 20X2.

On 30 September 20X2 the fair value of the jewellery was $9.186 million and the forward price of gold per troy ounce for delivery on 30 October 20X2 was $352.

Required

Explain how the above transactions would be treated in Sparkle's financial statements for the year ended 30 September 20X2.

Solution

Sparkle is hedging the volatility of the future cash inflow from selling the gold jewellery. The futures contracts can be accounted for as a cash flow hedge in respect of those inflows, providing the criteria for hedge accounting are met.

The gain on the forward contract should be calculated as:

	$
Forward value of contract at 31.10.X1 (24,000 × $388)	9,312,000
Forward value of contract at 30.9.X2 (24,000 × $352)	8,448,000
Gain on contract	864,000

The change in the fair value of the expected future cash flows on the hedged item (which is not recognised in the financial statements) should be calculated as:

	$
At 31.10.X1	9,938,000
At 30.9.X2	9,186,000
	752,000

As this change in fair value is less than the gain on the forward contract, the hedge is not fully effective and only $752,000 of the gain on the forward should be recognised in other comprehensive income. The remainder should be recognised in profit or loss:

		$	$
DEBIT	Financial asset (Forward a/c)	864,000	
CREDIT	Other comprehensive income		752,000
CREDIT	Profit or loss		112,000

A hedging relationship continues to qualify for hedge accounting if it is effective. In this case:

- An economic relationship continues to exist between the hedged item and hedging instrument (since they are both gold); and
- The effect of credit risk does not dominate the value changes that result from the economic relationship.

The third criteria for hedge effectiveness is that the hedge ratio of the hedging relationship is the same as that resulting from the quantity of hedged item that the entity actually hedges and the quantity of hedging instrument that the entity actually uses to hedge that quantity of hedged items.

Since this hedge relationship results in a gain on futures contract of $864,000 but a loss on hedged item of only $752,000, it appears that the relationship should be rebalanced,

The current hedge ratio is 1:1 (with hedged item and hedging instrument both based on 24,000 troy ounces of gold); to maintain 100% effectiveness this should be reset by reducing the quantity of hedging instrument to 20,889 troy ounces (752/864 × 24,000) or increasing the quantity of hedged item to 27,574 troy ounces (864/752 × 24,000).

Example: Cash flow hedge – interest rate swap

On 1 January 20X1, Arlington Co. lends $10 million to another entity, with a maturity date of three years later on 31 December 20X3. The interest rate attached to the loan is variable at HIBOR + 2%, and interest is due annually on 31 December.

Arlington expects interest rates to decline and so simultaneously enters an interest rate swap on 1 January 20X1 in order to hedge its position.

The terms of the swap are as follows:

- There is no initial cost.
- The notional principal is $10 million.
- Arlington will receive fixed interest at 7%.
- Arlington will pay variable interest at HIBOR.
- Net settlement is made annually on 31 December, and the swap is also repriced on this date.

The fair value of the swap, determined by projecting future settlement amounts using the current year's variable rate and discounting these to present value is:

31 December 20X1	$300,000
31 December 20X2	$125,000
31 December 20X3	nil

HIBOR at each of these dates is:

31 December 20X1	7%
31 December 20X2	6%
31 December 20X3	5%

All criteria for cash flow hedge accounting have been met and the hedging relationship is expected to be 100% effective at inception and on an ongoing basis.

What journal entries are required in respect of the loan and cash flow hedge throughout the three-year term?

Solution

The purpose of the cash flow hedge is to fix the interest receivable at 9%. Interest receivable per the terms of the loan agreement is:

31 December 20X1	$10m × (7% + 2%) =	$900,000
31 December 20X2	$10m × (6% + 2%) =	$800,000
31 December 20X3	$10m × (5% + 2%) =	$700,000

The net settlement in respect of the swap on each of these dates is:

Date	Swap receipt at 7%	Swap payment at HIBOR	Swap net
	$	$	$
31 December 20X1	700,000	(700,000)	Nil
31 December 20X2	700,000	(600,000)	100,000
31 December 20X3	700,000	(500,000)	200,000

Therefore, in each of the three years, the total amount of the interest income (i.e. loan interest income + net position on the swap) is $900,000.

The journal entries are as follows:

1 January 20X1

		$	$
DEBIT	Loan receivable	10,000,000	
CREDIT	Cash		10,000,000

To record the inception of the loan.

(**Note**. No entry is required in respect of the swap as it was acquired at no cost.)

31 December 20X1

DEBIT	Cash	900,000	
CREDIT	Interest income		900,000

To record the receipt of interest in respect of the loan.

DEBIT	Interest rate swap	300,000	
CREDIT	Other comprehensive income		300,000

To record the fair value of the interest rate swap.

31 December 20X2

DEBIT	Cash	800,000	
CREDIT	Interest income		800,000

To record the receipt of interest in respect of the loan.

DEBIT	Cash	100,000	
CREDIT	Other comprehensive income		100,000

To record the cash received on net settlement of the interest rate swap.

DEBIT	Other comprehensive income	100,000	
CREDIT	Interest income		100,000

To recycle into earnings amounts in OCI on account of the cash flow hedge, so that they are matched with the relevant cash flow.

DEBIT	Other comprehensive income	175,000	
CREDIT	Interest rate swap		175,000

To reduce the carrying value of the interest rate swap from its initial fair value of $300,000 to current fair value of $125,000.

31 December 20X3

		$	$
DEBIT	Cash	700,000	
CREDIT	Interest income		700,000

To record the receipt of interest in respect of the loan.

DEBIT	Cash	200,000	
CREDIT	Other comprehensive income		200,000

To record the cash received on net settlement of the interest rate swap.

DEBIT	Other comprehensive income	200,000	
CREDIT	Interest income		200,000

To recycle into earnings amounts in OCI on account of the cash flow hedge, so that they are matched with the relevant cash flow.

DEBIT	Other comprehensive income	125,000	
CREDIT	Interest rate swap		125,000

To adjust the carrying value of the interest rate swap to current fair value.

DEBIT	Cash	10,000,000	
CREDIT	Loan receivable		10,000,000

To record repayment of the loan at the maturity date.

HKFRS 9
6.5.13-14

8.5.3 Hedges of a net investment

Hedges of a net investment arise in the consolidated accounts where a parent company takes a foreign currency loan in order to buy shares in a foreign subsidiary. The loan and the investment need not be denominated in the same currency, however, assuming that the currencies perform similarly against the parent company's own currency, it should be the case that fluctuations in the exchange rate affect the asset (the net assets of the subsidiary) and the liability (the loan) in opposite ways, hence gains and losses are hedged.

In this type of accounting hedge, the hedging instrument is the foreign currency loan rather than a derivative.

You may understand this type of hedge better after studying Chapter 31, Consolidation of foreign operations, but in a simple sense, without applying hedging rules:

(a) The loan would be retranslated to the parent's own currency at the year end using the spot exchange rate; any resultant gain or loss would be recognised in profit or loss.

(b) Prior to consolidation, the subsidiary's accounts would be translated into the parent's own currency with any gain or loss recognised in other comprehensive income.

(c) On consolidation, the gain or loss on the loan would affect consolidated profit or loss and the loss or gain on the translation of the subsidiary's net assets would affect consolidated reserves.

The net investment hedge ensures that the gains and losses are both recognised in other comprehensive income and accumulated in reserves by:

- Recognising the portion of the gain or loss on the hedging instrument that is determined to be effective in other comprehensive income
- Recognising the ineffective portion in profit or loss

Any gain or loss recognised in other comprehensive income is reclassified to profit or loss on the disposal or partial disposal of the foreign operation.

Example: Hedge of a net investment

Tree Traders (TT) acquired a majority share of Branch Stores (BS) on 1 January 20X5 at a cost of HK$200 million. BS is an Australian company and the acquisition was financed by way of an Australian dollar loan for A$34 million. The exchange rate on the date of acquisition was HK$1: A$0.17 and this had moved to HK$1: A$0.19 by the reporting date, 31 December 20X5.

BS reports its financial statements in Australian dollars and these are translated to Hong Kong dollars for the purpose of preparing the consolidated financial statements. The exchange loss arising on the translation of BS financial statements for the year ended 31 December 20X5 was HK$18.5 million.

(a) Assuming that the loan is a designated hedging instrument to hedge exchange differences on the investment in the subsidiary and hedge effectiveness tests have been met, explain how the hedge is accounted for in the year ended 31 December 20X5.

(b) How would your answer differ if the exchange loss on the translation of BS financial statements for the year ended 31 December 20X5 was HK$22.5 million?

Solution

(a)
- The exchange loss on retranslation of the BS financial statements is HK$18,500,000 and this is recognised in consolidated other comprehensive income.
- The loan is initially measured at HK$200,000,000 (A$34,000,000/0.17); at the year end it is measured at HK$178,947,268 (A$34,000,000/0.19), resulting in an exchange gain of HK$21,052,632. Of this:
  - HK$18,500,000 is effective and is recognised as other comprehensive income to net against the exchange loss on retranslation of the BS financial statements;
  - HK$2,552,632 is ineffective and is recognised in profit or loss.

(b)
- The exchange loss on retranslation of the BS financial statements is HK$22,500,000 and this is recognised in consolidated other comprehensive income.
- The exchange gain on the loan is HK$21,052,632 (as above). The whole gain is effective and is recognised in other comprehensive income, netting off with the exchange loss on retranslation of the BS financial statements to leave a net loss of HK$1,447,368 (HK$22,500,000 – HK$21,052,632).

HKFRS 9 B6.5.17-6.5.20

8.5.4 The effect of rebalancing on hedge accounting

We saw in section 8.4.1 that a hedge relationship may have to be rebalanced in order to maintain a hedge ratio that complies with hedge effectiveness requirements. This may be achieved by:

- Increasing or decreasing the volume of hedged item
- Increasing or decreasing the volume of the hedging instrument

The effect of a rebalancing on the accounting treatment described in the sections above is as follows:

Volume of hedged item increased	No effect on measurement of changes in fair value of hedging instrument. No effect on measurement of changes in fair value of original volume of hedged item. Changes in value of additional volume of hedged item are measured starting from the date of rebalancing rather than from the date on which the hedging relationship was designated.
Volume of hedged item decreased	No effect on measurement of changes in fair value of hedging instrument. No effect on measurement of changes in fair value of volume of hedged item that continues to be designated part of the hedge. The volume by which the hedged item was decreased is not part of the hedge from the rebalancing date, and is accounted for as a discontinuation of hedge accounting (see section 8.5.5).
Volume of hedging instrument increased	No effect on measurement of changes in fair value of hedged item. No effect on measurement of changes in fair value of original volume of hedging instrument. Changes in value of additional volume of hedging instrument are measured starting from the date of rebalancing rather than from the date on which the hedging relationship was designated.
Volume of hedging instrument decreased	No effect on measurement of changes in fair value of hedged item. No effect on measurement of changes in fair value of volume of hedging instrument that continues to be designated part of the hedge. The volume by which the hedging instrument was decreased is no longer part of the hedging relationship. The reporting entity therefore retains a derivative, but only part of it is a hedging instrument in the hedge relationship. The undesignated part of the derivative is accounted for in accordance with normal HKFRS 9 requirements ie at fair value through profit or loss.

Example: Rebalancing

At 1 June 20X5, Watson Brown Company (WBC) expects to purchase 1 million barrels of West Texas crude oil in 12 months' time. WBC designates a futures contract of 1.05 million barrels of Brent crude oil in a cash flow hedge to hedge this highly probable forecast purchase. The hedge ratio is 1.05:1.

At 31 December 20X5, the cumulative change in the fair value of the hedged item is $190,000 and the cumulative change in the fair value of the hedging instrument is $205,000.

WBC's treasurer rebalances the hedging relationship and resets the hedge ratio to 0.98:1. This is achieved by de-designating part of the hedging instrument.

What accounting entries are required at 31 December 20X5?

Solution

The hedging relationship at 31 December 20X5 is accounted for by

		$	$
DEBIT	Other comprehensive income (effective hedge)	190,000	
DEBIT	Profit or loss (ineffective hedge)	15,000	
CREDIT	Derivatives – hedging instruments		205,000

To record the inception of the loan.
To account for the fair value change in the hedging instrument.

The hedge ratio is rebalanced to 0.98:1. Therefore of the 1.05 million barrels of West Texas crude oil that formed part of the original hedge, only 980,000 barrels will remain a designated hedging instrument. The remaining 70,000 will be de-designated and hedge accounting will not apply.

The part of the futures contract that is no longer a designated hedging item is therefore transferred to be a held for trading derivative by:

		$	$
DEBIT	Derivatives – hedging instruments (7/105 × 205,000)	13,667	
CREDIT	Derivatives – held for trading		13,667

To account reflect the fact that part of the forward contract is no longer part of a hedging relationship.

HKFRS 9 6.5.6, 6.5.7, 6.5.10, 6.5.12

8.5.5 Discontinuation of hedge accounting

Hedge accounting is discontinued in circumstances including the following:

1 The risk management objective of an entity has changed.

2 As a result of rebalancing (see previous section).

3 If the hedged item or hedging instrument no longer exists or is sold.

4 If there is no longer an economic relationship between the hedged item and the hedging instrument.

An entity cannot discontinue a hedging relationship that still meets the risk management objective and continues to meet all other qualifying criteria (after taking into account any rebalancing).

At the point of discontinuation, the following accounting treatment is applied:

Fair value hedge

Any adjustment to the carrying amount of a hedged item that is a financial instrument at amortised cost is amortised to profit or loss. This is based on a recalculated effective interest rate at the date that amortisation begins.

In respect of a hedged item that is a financial asset measured at fair value through other comprehensive income, the amount that represents the cumulative gain or loss previously recognised is amortised in the same manner.

Cash flow hedge

Any amounts accumulated in the cash flow reserve are accounted for as follows:

- If the hedged future cash flows are still expected to occur, the amount remains in the reserve until the future cash flows occur. When the cash flows occur, the amount is recognised in profit or loss or transferred to form part of the initial cost or carrying amount of an asset or liability as normal (see section 8.5.2).

- If the hedged future cash flows are no longer expected to occur, the amount is immediately reclassified to profit or loss as a reclassification adjustment.

8.6 Hedge accounting: HKFRS 9 vs HKAS 39

The HKFRS 9 model for hedge accounting differs from that in HKAS 39 in the following key areas:

	HKAS 39	HKFRS 9
Eligibility of hedging instruments	Derivatives may be designated as hedging instruments. Non-derivatives may be designated as hedging instruments only for hedge of foreign currency risk.	Any financial instrument may be a hedging instrument if it is measured at fair value through profit or loss.
	Therefore, non-derivative items can be more widely used as hedging instruments under HKFRS 9.	
Eligibility of hedged items	Recognised assets, liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations may be designated as hedged items. In some circumstances, risk components of a financial asset or liability may be designated as a hedged item.	In addition to HKAS 39 eligible hedged items, HKFRS 9 allows a risk component of a non-financial asset or liability to be designated as a hedged item in some circumstances.
	Therefore more items can be designated as hedged items under HKFRS 9.	
Qualifying criteria for applying hedge accounting	A hedging relationship only qualifies for hedge accounting if certain criteria are met, including a quantitative hedge effectiveness test under which hedge effectiveness must fall in the range 80% – 125%.	Hedge effectiveness criteria are principles-based and aligned with risk management activities.
	Therefore, genuine hedging relationships are accounted for as such under HKFRS 9 whereas HKAS 39 rules sometimes prevented this.	
Rebalancing	The concept of rebalancing does not exist within HKAS 39.	Rebalancing is required by HKFRS 9 in some circumstances (see above).
	As a result of guidance on rebalancing, hedge accounting may continue whereas it would not have been able to under HKAS 39.	
Discontinuation of hedging relationships	Hedge accounting may be discontinued at any time.	Hedge accounting may not be discontinued where the hedging relationship continues to meet qualifying criteria. Can only discontinue when qualifying criteria are no longer met.
Accounting for the time value component of options and forward contracts	The part of an option that reflects time value and the forward element of a forward contract are treated as derivatives held for trading purposes.	The time value component of an option is a cost of hedging presented in OCI. The forward element of a forward contract may also be presented in OCI
	HKFRS 9 therefore decreases volatility in profit or loss.	

HKFRS 9 retains the three types of hedge recognised in HKAS 39: fair value hedges, cash flow hedges and hedges of a net investment.

The accounting for these has generally not changed, with the following exceptions:

- In a fair value hedge, if the hedged item is an investment in an equity instrument held at fair value through other comprehensive income, the gains and losses on both the hedged investment and the hedging instrument are recognised in other comprehensive income. This ensures that hedges of investments of equity instruments held at fair value through other comprehensive income can be accounted for as hedges.
- In a cash flow hedge of a forecast transaction, if a non-financial asset or liability is recognised, an entity must remove the effective portion of the hedge recognised in other comprehensive income and include it in the initial cost or carrying amount of the non-financial item. Under HKAS 39 there is an option to reclassify the effective portion to profit or loss when the hedged item affects earnings.

8.7 Section summary

- **Hedge accounting** means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.
- **Hedge accounting** is permitted in certain circumstances, provided that hedging criteria are met.
- There are three types of hedge: **fair value** hedge; **cash flow** hedge; hedge of a **net investment in a foreign operation**.
- The accounting treatment of a hedge **depends on its type**.

9 HKFRS 7: Disclosure of financial instruments

Topic highlights

HKFRS 7 specifies the **disclosures** required for financial instruments. In addition, HKFRS 13 disclosures are applied where financial instruments are measured at fair value. HKFRS 7 requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

HKFRS 7 was issued in 2005 to replace the disclosure requirements of HKAS 32. In doing so it has revised and enhanced disclosure requirements in response to new techniques and approaches to measuring risk management. The standard requires **qualitative and quantitative disclosures about exposure to risks** arising from financial instruments, and specifies minimum disclosures about **credit risk**, **liquidity risk** and **market risk**.

The HKICPA maintains that users of financial instruments need information about an entity's exposures to risks and how those risks are managed, as this information can **influence a user's assessment of the financial position and financial performance of an entity** or of the amount, timing and uncertainty of its **future cash flows**.

In June 2011 HKFRS 13 *Fair Value Measurement* was issued. As a result, disclosures in relation to financial instruments measured at fair value were relocated from HKFRS 7 to HKFRS 13.

HKFRS 7.1

9.1 Objective

The objective of HKFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) The significance of financial instruments for the entity's financial position and performance.

(b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The principles in **HKFRS 7** complement the principles for recognising, measuring and presenting financial assets and financial liabilities in HKAS 32 *Financial Instruments: Presentation*, and HKFRS 9 *Financial Instruments*.

HKFRS 7.6

9.2 Classes of financial instruments and levels of disclosure

When HKFRS 7 requires disclosures by class of financial instrument, an entity must group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. Sufficient information should be provided to permit reconciliation to the line items presented in the statement of financial position.

HKFRS 7 7-19

9.3 Statement of financial position disclosures

The following must be disclosed in the notes to the financial statements:

(a) **Carrying amount** of financial assets and liabilities by **HKFRS 9** category.

(b) Details of financial instruments designated as at fair value through profit or loss and equity instruments designated as at fair value through other comprehensive income.

(c) **Reason for any reclassification** between financial asset categories.

(d) The **carrying amount** of financial assets the entity has **pledged as collateral** for liabilities or contingent liabilities and the associated terms and conditions.

(e) The amount of a loss allowance related to financial assets measured at fair value through other comprehensive income.

(f) The **existence of multiple embedded derivatives**, where compound instruments contain these.

(g) Defaults and breaches.

HKFRS 7.13C

Information about rights of offset and related arrangements should be disclosed, including, as a minimum:

(a) The gross amounts of financial assets and financial liabilities under an enforceable master netting agreement (i.e. an agreement whereby a single net settlement of all financial instruments covered by the arrangement may be made) or similar;

(b) Amounts offset in accordance with the HKAS 32 criteria;

(c) Net amounts presented in the statement of financial position;

(d) Amounts subject to an enforceable master netting agreement not included in (b);

(e) The net amount after deducting (d) from (c).

HKFRS 7.20

9.4 Statement of profit or loss and other comprehensive income disclosures

The entity must disclose the following **items of income, expense, gains or losses**, either on the face of the financial statements or in the notes:

(a) Net gains/losses by **HKFRS 9** category (broken down as appropriate: for example, interest, fair value changes, dividend income)

(b) Interest income/expense

(c) Impairment losses by class of financial asset

HKFRS 7.21

9.5 Other disclosures

Entities must disclose in the summary of **significant accounting policies** the measurement basis used in preparing the financial statements and the other accounting policies that are relevant to an understanding of the financial statements.

HKFRS 7 22-24

9.5.1 Hedge accounting

Disclosures must be made relating to **hedge accounting**, as follows:

(a) An explanation of risk management strategy and how it is applied to manage risk.

(b) How the entity's hedging activities may affect the amount, timing and uncertainty of future cash flows.

(c) The effect that **hedge accounting has had on the entity's statement of financial position,** statement of profit or loss and comprehensive income and statement of changes in equity.

HKFRS 7 25, 26, 29

9.5.2 Fair value

HKFRS 7 retains the following general requirements in relation to the disclosure of fair value for those financial instruments measured at amortised cost:

(a) For each class of **financial assets** and **financial liabilities** an entity shall disclose the **fair value** of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

(b) In disclosing **fair values**, an entity shall group **financial assets** and **financial liabilities** into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.

It also states that disclosure of fair value is not required where:

- Carrying amount is a reasonable approximation of fair value
- For investments in equity instruments that do not have a quoted market price in an active market for an identical instrument, or derivatives linked to such equity instruments

HKFRS 13 91, 93, 95, 97

HKFRS 13 has additional disclosure requirements in respect of the fair value of financial instruments. These are discussed in more detail in Chapter 19.

9.6 Nature and extent of risks arising from financial instruments

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of **different types of financial risk** as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

Credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
Liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
Loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
Market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.
Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
Past due	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

HKFRS 7.33

9.6.1 Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose:

(a) The **exposures to risk** and how they arise.

(b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk.

(c) Any changes in (a) or (b) from the previous period.

9.6.2 Quantitative disclosures

HKFRS 7 34-38

For each financial instrument risk, **summary quantitative data** about risk exposure must be disclosed. This should be based on the information provided internally to key management personnel. More information should be provided if this is unrepresentative of an entity's exposure to risk.

Information about **credit risk** must be disclosed by class of financial instrument:

(a) Maximum exposure at the year end without taking account of collateral held or other credit enhancements. (This disclosure is not required where the carrying amount of financial instruments best represents the maximum exposure to credit risk.)

(b) A description of collateral held as security and of other credit enhancements, and their financial effect, in respect of the maximum exposure to credit risk (whether as disclosed in (a) or represented by carrying amount).

(c) Information about the credit quality of financial assets that are neither **past due** nor impaired.

(d) Information about the credit quality of financial assets whose terms have been renegotiated.

(e) An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired.

(f) An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.

(g) Collateral and other credit enhancements obtained during the reporting period and held at the reporting date, including the nature and carrying amount of the assets and policy for disposing of assets not readily convertible into cash.

Example: Credit risk disclosure (1)

An entity holds equity investments in other entities. Its management asserts that the **HKFRS 7** credit risk disclosures are not relevant.

Do the credit risk disclosures required by **HKFRS 7** apply to an entity's holdings of equity investments?

Solution

The definition of equity in **HKAS 32** requires the issuer to have no obligation to pay cash or transfer other assets. It follows that such equity investments are subject to price risk, not credit risk. Most of the **HKFRS 7** credit risk disclosures are not therefore relevant to investments in equity instruments.

However, **HKFRS 7** requires entities to disclose an analysis of financial assets that are impaired. This disclosure is relevant and should be given for impaired equity investments that are available for sale.

Example: Credit risk disclosure (2)

HKFRS 7 defines credit risk as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. If an entity issues a financial guarantee, the financial loss will not result from a default by the other party of the contract (the holder), but from a default by the third party (the debtor). Does this mean that the credit risk of financial guarantees can be excluded from the disclosure of the maximum exposure to credit risk?

Solution

No, the credit risk of financial guarantees should be included in the disclosures, as **HKFRS 7** clarifies that the definition of credit risk includes that arising from financial guarantees.

HKFRS 7.39

9.6.3 Liquidity risk

For **liquidity risk** entities must disclose:

- A maturity analysis of both derivative and non-derivative financial liabilities
- A description of the way risk is managed

Within the maturity analysis, any amounts repayable under a loan agreement that includes a clause giving the lender the unconditional right to demand repayment at any time must be classified in the earliest time bracket.

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Example: Liquidity risk (1)

HKFRS 7 requires the disclosure of a maturity analysis for financial liabilities that shows the remaining contractual maturities.

Should the following financial instruments be shown in one maturity bracket, or split across the maturity brackets in which the cash flows occur?

(a) A derivative which has multiple cash flows
(b) A loan which has annual contractual interest payments
(c) A loan which has annual contractual interest and principal repayments

Solution

All the financial instruments should be split across the maturity brackets in which the cash flows occur. The requirement is to disclose each of the contractual payments in the period when they are due (including principal and interest payments). The objective of this particular disclosure is to show the liquidity risk of the entity.

Example: Liquidity risk (2)

HKFRS 7 requires entities to disclose (a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and (b) a description of how it manages the liquidity risk inherent in (a).

Does this mean that a maturity analysis for financial assets based on remaining contractual maturities, is no longer required?

Solution

Yes, **HKFRS 7** requires a maturity analysis based on the remaining contractual maturity only for financial liabilities. Management can choose to disclose the maturity analysis showing remaining contractual maturity for financial assets also as one of the disclosures to comply with the requirement in HKFRS 7. However, it is not obligatory.

In practice, an entity should disclose a maturity analysis of financial assets and financial liabilities showing expected maturity if this is the information provided to key management personnel to manage the business. However, a maturity analysis based on the remaining contractual maturity for financial liabilities should be disclosed.

HKFRS 7
40-41

9.6.4 Market risk: sensitivity analysis

An entity shall disclose a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date; the methods and assumptions used in preparing the sensitivity analysis; and changes from the previous period in the methods and assumptions used, and the reasons for such changes.

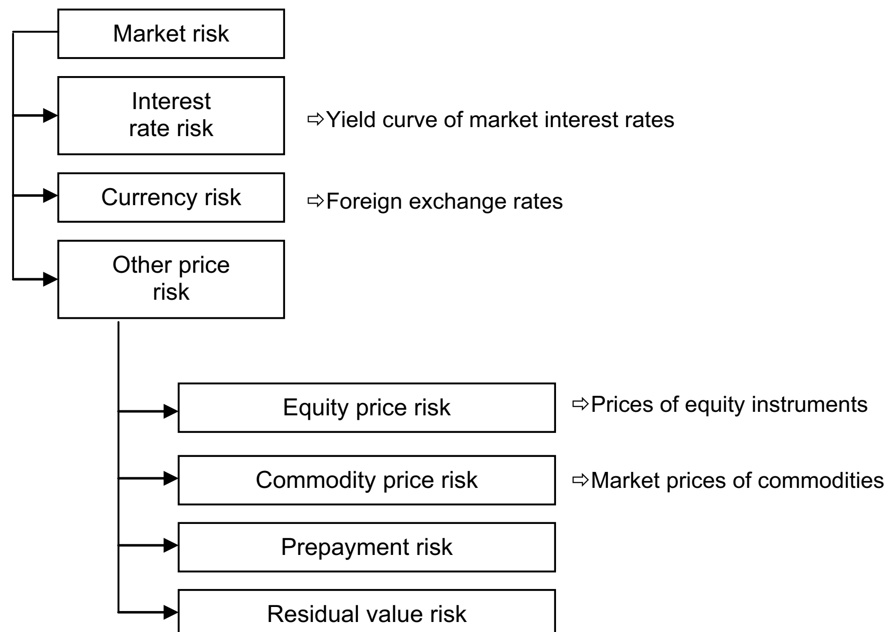
Assuming that a reasonably possible change in the relevant risk variable had occurred at the reporting date and had been applied to the risk exposures in existence at that date:

Disclosures required in connection with **market risk** are:

(a) Sensitivity analysis, showing the effects on profit or loss of changes in each market risk.

(b) If the sensitivity analysis reflects interdependencies between risk variables, such as interest rates and exchange rates the method, **assumptions and limitations** must be disclosed.

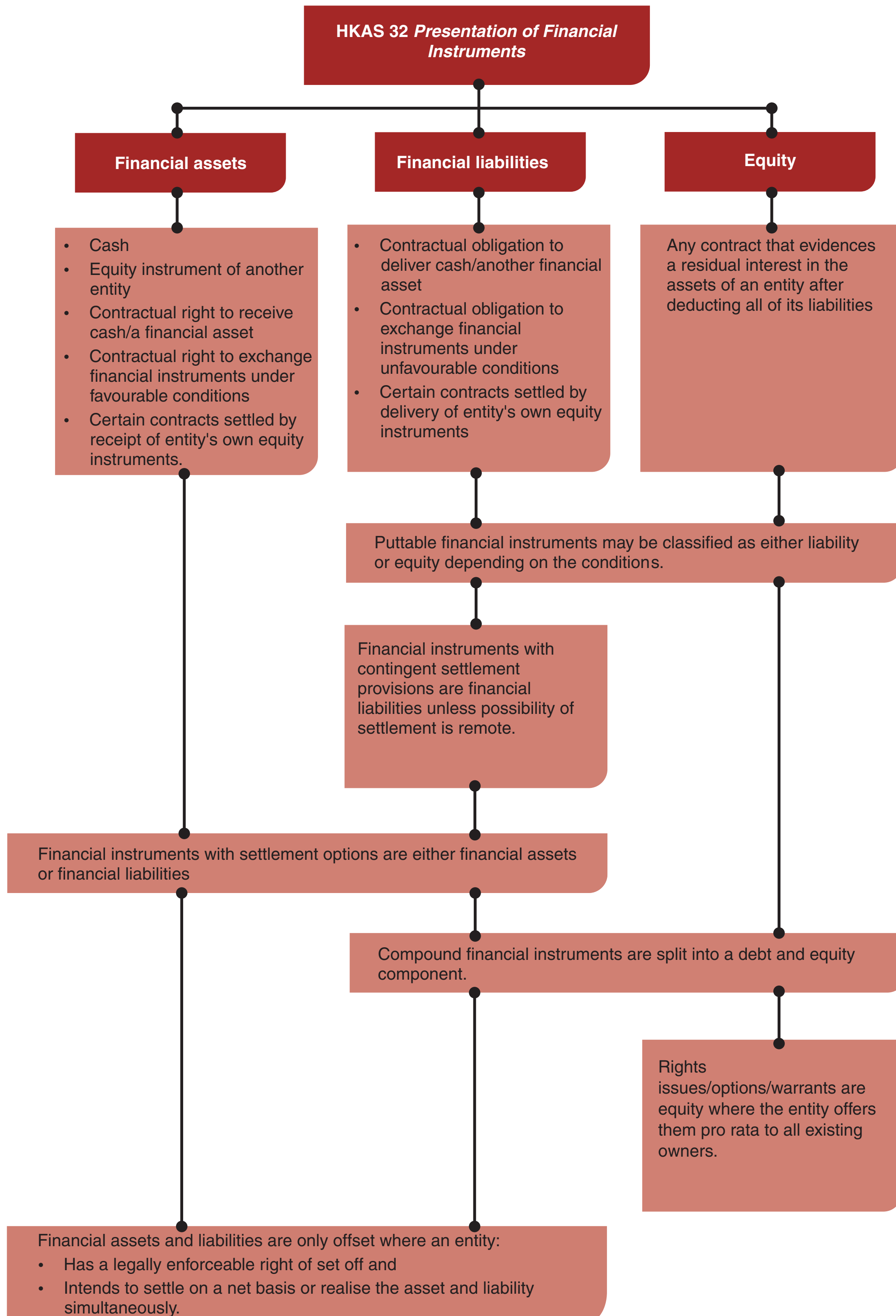
9.6.5 Risk variables that are relevant to disclosing market risk

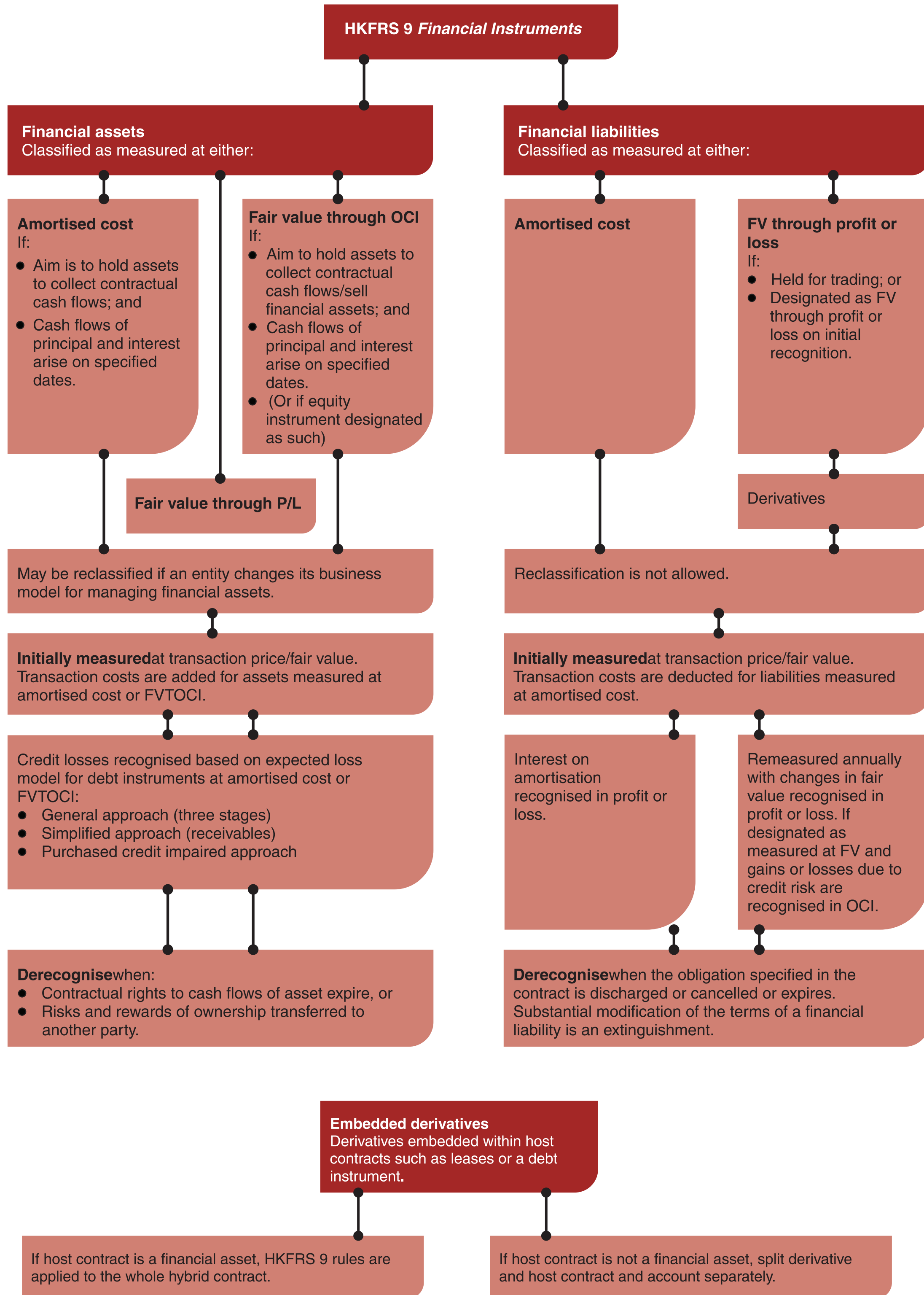


9.7 Capital disclosures

Certain disclosures about **capital** are required. An entity's capital does not relate solely to financial instruments, but has more general relevance. Accordingly, those disclosures are included in **HKAS 1**, rather than in **HKFRS 7**.

Topic recap

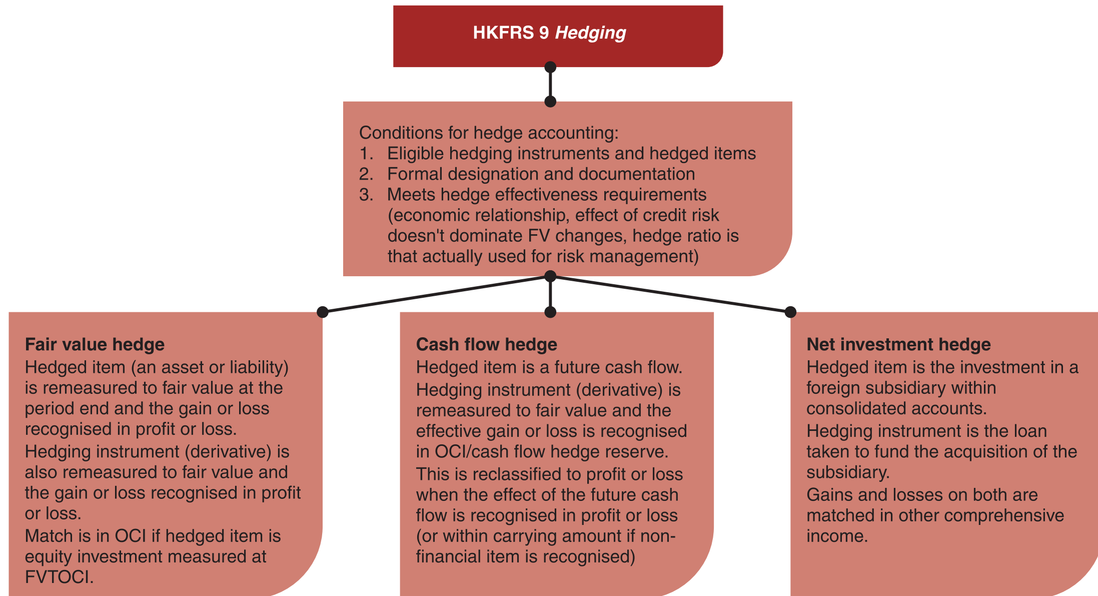


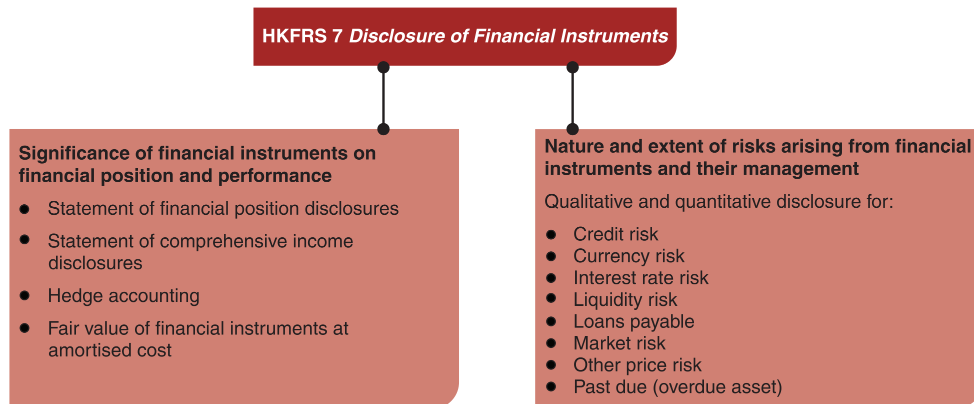


Embedded derivatives
Derivatives embedded within host contracts such as leases or a debt instrument.

If host contract is a financial asset, HKFRS 9 rules are applied to the whole hybrid contract.

If host contract is not a financial asset, split derivative and host contract and account separately.


HKFRS 9 Hedging
Conditions for hedge accounting:
1. Eligible hedging instruments and hedged items
2. Formal designation and documentation
3. Meets hedge effectiveness requirements (economic relationship, effect of credit risk doesn't dominate FV changes, hedge ratio is that actually used for risk management)
Fair value hedge
Hedged item (an asset or liability) is remeasured to fair value at the period end and the gain or loss recognised in profit or loss.
Hedging instrument (derivative) is also remeasured to fair value and the gain or loss recognised in profit or loss.
Match is in OCI if hedged item is equity investment measured at FVTOCI.
Cash flow hedge
Hedged item is a future cash flow.
Hedging instrument (derivative) is remeasured to fair value and the effective gain or loss is recognised in OCI/cash flow hedge reserve.
This is reclassified to profit or loss when the effect of the future cash flow is recognised in profit or loss (or within carrying amount if non-financial item is recognised)
Net investment hedge
Hedged item is the investment in a foreign subsidiary within consolidated accounts.
Hedging instrument is the loan taken to fund the acquisition of the subsidiary.
Gains and losses on both are matched in other comprehensive income.


HKFRS 7 Disclosure of Financial Instruments
Significance of financial instruments on financial position and performance
Statement of financial position disclosures
Statement of comprehensive income disclosures
Hedge accounting
Fair value of financial instruments at amortised cost
Nature and extent of risks arising from financial instruments and their management
Qualitative and quantitative disclosure for:
Credit risk
Currency risk
Interest rate risk
Liquidity risk
Loans payable
Market risk
Other price risk
Past due (overdue asset)

Answers to self-test questions

Answer 1

Refer to the definitions of financial assets and liabilities given in section 1.2:

(a) **Physical assets**: control of these creates an opportunity to generate an inflow of cash or other assets, but it does not give rise to a present right to receive cash or other financial assets.

(b) **Prepaid expenses**: the future economic benefit is the receipt of goods/services rather than the right to receive cash or other financial assets.

Answer 2

Liability. The preference shares require regular distributions to the holders but more importantly have the debt characteristic of being redeemable. Therefore, according to **HKAS 32** *Financial Instruments: Presentation* they must be classified as liability.

Answer 3

Note. The method to use here is to find the present value of the principal value of the bond, \$2m (100,000 × \$20) and the interest payments of \$120,000 annually (6% × \$2m) at the market rate for non-convertible bonds of 8%, using the discount factor tables. The difference between this total and the principal amount of \$2m is the equity element.

	\$
Present value of principal \$2m × 0.681	1,362,000
Present value of interest \$120,000 × 3.993	479,160
Liability value	1,841,160
Principal amount	2,000,000
Equity element	158,840

Answer 4

(a) ABC should derecognise the asset as its option to repurchase is at the prevailing market value.

(b) DEF should not derecognise the asset as it has retained substantially all the risks and rewards of ownership. The stock should be retained in its books even though legal title is temporarily transferred.

(c) XYZ has received 90% of its transferred receivables in cash, but whether it can retain this amount permanently is dependent on the performance of the factor in recovering all of the receivables. XYZ may have to repay some of it and therefore retains the risks and rewards of 100% of the receivables amount. The receivables should not be derecognised. The cash received should be treated as a loan.

The 10% of the receivables that XYZ will never receive in cash should be treated as interest over the six-month period; it should be recognised as an expense in profit or loss and increase the carrying amount of the loan.

At the end of the six months, the receivables should be derecognised by netting them against the amount of the loan that does not need to be repaid to the factor. The amount remaining is bad debts which should be recognised as an expense in profit or loss.

Answer 5

	(a) Amortised cost		(b) FV through P/L	
	20X1	**20X2**	**20X1**	**20X2**
	$'000	$'000	$'000	$'000
Profit or loss				
Interest income (W1)/(W2)	1,200	1,200	1,200	1,387
Gain/(loss) due to change in FV (W2)	–	–	(187)	–
	1,200	1,200	1,013	1,387
Statement of financial position				
Financial asset (W1)/(W2)	20,000	–	19,813	–

Workings

1 **Amortised cost**

	$'000
Cash – 1.1.20X1	20,000
Effective interest at 6% (same as nominal as no discount on issue/premium on redemption)	1,200
Coupon received (nominal interest 6% × 20m)	(1,200)
At 31.12.20X1	20,000
Effective interest at 6%	1,200
Coupon and capital received ((6% × 20m) + 20m)	(21,200)
At 31.12.20X2	–

2 **Fair value**

	$'000
Cash	20,000
Effective interest (as above)	1,200
Coupon received (as above)	(1,200)
Fair value loss (balancing figure)	(187)
At 31.12.20X1 (W3)	19,813
Interest at 7% (7% × 19,813)	1,387
Coupon and capital received ((6% × 20m) + 20m)	(21,200)
At 31.12.20X2	–

3 **Fair value at 31.12.20X1**

	$'000
Interest and capital due on 31.12.20X2 at new market rate (21.2m/1.07)	19,813

Answer 6

D

	$
Issue costs	30,000
Interest $1,000,000 × 5% × 7	350,000
Premium on redemption	260,000
Total finance cost	640,000

Answer 7

The bond is a 'deep discount' bond and is a financial liability of Grumble Co. It is measured at amortised cost as it meets the 'held to collect' test. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

To calculate amortised cost we need to calculate the effective interest rate of the bond:

$$\frac{1{,}000{,}000}{839{,}619} = 1.191 \text{ over three years}$$

To calculate an annual rate, we take the cube root, $(1.191)^{1/3} = 1.06$, so the annual interest rate is 6%.

The charge to the statement of profit or loss and other comprehensive income is $50,377 ($839,619 × 6%).

The balance outstanding at 31 December 20X2 is $889,996 ($839,619 + $50,377).

Answer 8

The equity investment is classified as available-for-sale. It does not meet the criteria to be classified as any other type of financial asset:

- RTC intends to hold it in the long term and so it is not held for trading and therefore is not classified as at fair value through profit or loss.
- Payments are not fixed or determinable (a dividend may be received but this is not guaranteed) and so the investment is neither held-to-maturity nor loans and receivables.

The investment is initially measured at fair value (cost) plus transaction costs:

DEBIT	Available-for-sale financial asset	$13,500,000	
CREDIT	Cash		$13,500,000

To record the acquisition of the equity investment and related transaction costs

Subsequently at the year-end, the investment is re-measured to fair value:

DEBIT	Available-for-sale financial asset	$1,100,000	
CREDIT	Other comprehensive income		$1,100,000

To re-measure the equity investment to fair value.

Answer 9

The financial asset is classified as held-to-maturity since it has fixed payments and fixed maturity and MMC has the positive intention and ability to hold it to maturity. (Note that it cannot be classified as loans and receivables as it is quoted.)

MMC will receive interest of $590,000 (12.5m × 4.72%) each year and $12.5 million when the instrument matures.

MMC must allocate the discount of $2.5 million and the interest receivable over the five-year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years.

Year	Amortised cost at beginning of year	Profit or loss: Interest income for year (@ 10%)	Interest received during year (cash inflow)	Amortised cost at end of year
	$'000	$'000	$'000	$'000
20X1	10,000	1,000	(590)	10,410
20X2	10,410	1,040	(590)	10,860
20X3	10,860	1,090	(590)	11,360
20X4	11,360	1,136	(590)	11,906
20X5	11,906	1,184	(12,500 + 590)	–

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year.

Exam practice

Sonna Inc. 30 minutes

(a) On 1 January 20X1, Sonna Inc. (SC) issued HK$2,000 million of three-year Hong Kong Interbank Borrowing Rate (HIBOR) plus 180 basis points variable rate bond at par value. Interest is payable annually. On the same date, SC entered into an interest rate swap with a bank by paying 2% fixed interest amount and receiving HIBOR plus 180 basis points for three-year and exchange at the dates of interest payment dates. SC measures the bond at amortised cost.

Required:

(i) Explain the difference between the fair value interest rate risk and the cash flow interest rate risk in the context of a bank loan. **(2 marks)**

(ii) Explain what a hedged item and hedging instrument are and discuss how hedge accounting affects the accounting treatment of a hedging instrument in the financial statements under cash flow hedges. **(6 marks)**

(iii) Assuming hedge accounting is not adopted, explain the accounting treatment for the bond and interest rate swap if the market interest rate is increased by 0.5% on 30 September 20X1, the current year end date (no quantification of the effect is required). **(5 marks)**

(b) On 1 August 20X1, SC entered into a non-cancellable purchase order to acquire equipment from Monta Corporation, a Japanese entity, at Yen 300 million. Payment is made upon delivery of the equipment to Hong Kong on 31 December 20X1. On 30 September 20X1, SC entered into a forward contract to exchange Yen 300 million at a pre-determined exchange rate between the Yen and Hong Kong dollar on 31 December 20X1. The functional currency of SC is the Hong Kong dollar.

Required

Discuss the accounting implications for the purchase contract and forward contract if fair value hedge accounting is adopted. **(4 marks)**

Total = 17 marks

HKICPA June 2012 (amended)

Good product limited 29 minutes

Good Product Limited (GPL), a Bermuda company listed on the Hong Kong Stock Exchange, has issued a Hong Kong Dollar convertible bond (CB) with a principal amount of HK$500 million on 1 July 20X3. GPL adopts 31 December as its financial year-end. The coupon interest is 3% per annum and payable annually in arrears. The maturity of the CB is 30 June 20X9. The holders are entitled to redeem at par together with any accrued interest upon maturity. The CB holders are entitled to convert the CB into 100 million ordinary shares of HK$1 each of GPL on or before maturity.

On 1 October 20X3, certain holders exercised their options to convert into shares in GPL for a principal amount of HK$50 million.

The prevailing market interest rate of a similar type of instrument without a conversion option is 6.3%. The functional currency and presentation currency of GPL is renminbi (RMB) and HK dollar (HK$) respectively.

On 1 July 20X3, the fair value of the conversion option was HK$80 million and the fair value of the liability component was HK$420 million. On 1 October 20X3, the fair value of the conversion option was HK$70 million and the fair value of the liability component was HK$430 million. On 31 December 20X3, the fair value of the conversion option was HK$100 million and the fair value of the liability component was HK$420 million.

For a compound instrument issued by GPL, GPL adopts an accounting policy to account for the debt component at amortised cost and the conversion option, being an equity component is not remeasured. For a hybrid instrument issued by GPL, GPL adopts an accounting policy to account for the debt component at amortised cost and the conversion/early redemptions option, being a derivative component, at fair value through profit or loss.

Required

(a) Discuss the accounting implications and prepare the journal entries with detailed calculations for the issue of CB on 1 July 20X3. **(5 marks)**

(b) Prepare the journal entries with detailed calculations for the partial conversion of CB on 1 October 20X3. **(5 marks)**

(c) Assume there had not been any conversion in part (b), prepare the journal entries with detailed calculations for the CB as at 31 December 20X3 and discuss the classification of current/non-current of the CB in the statement of financial position. **(6 marks)**

(**Note.** Ignore any tax effect)

Total = 16 marks

HKICPA December 2014

Chapter 18 Financial instruments

Question 1

(a) (i) A fixed rate bank loan exposes the borrower to fair value interest rate risk, i.e. the change in market interest rate will affect the fair value of the bank loan.

A variable rate bank loan exposes the borrower to cash flow interest rate risk, i.e. the change in market interest rate will affect the cash flow of the bank loan with an increase or decrease in payment of loan interest.

(ii) A hedging instrument is a designated derivative or a designated non-derivative financial asset or non-derivative financial liability measured at fair value through profit or loss whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

A hedged item is a recognised asset, liability, unrecognised firm commitment, highly probable forecast transaction or net investment in a foreign operation that exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged.

Hedge accounting recognises the offsetting effect on profit or loss of changes in the fair values of the hedging instrument and the hedged item. The objective is to ensure that the gain or loss on the hedging instrument is recognised in profit or loss (or in the case of certain equity investments in OCI) in the same period when the item that is being hedged affects profit or loss (or OCI).

Without adopting hedge accounting, the hedging instrument, if it is a derivative, will normally be measured at fair value through profit or loss. The hedged item may adopt a different accounting treatment under HKFRS which results in a mis-match of the effects of changes in the fair value.

If a cash flow hedge meets the conditions for hedge accounting during the period, it shall be accounted for as follows:

- The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income and accumulated in a cash flow hedge reserve, and
- The ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss

If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, the amount that had been recognised in other comprehensive income shall be included in the initial cost or other carrying amount of the asset or liability.

(iii) The variable rate bond of SC has a cash flow exposure to changes in the market rate of interest.

An increase in the market interest rate, assuming other variables affecting the valuation of the bond are unchanged, theoretically means that the fair value of a variable rate bond will not change while a fixed rate bond will decrease.

Since SC measures the bond at amortised cost, the increase in the market interest rate of 0.5% will not result in any adjustment to the carrying amount of the bond.

The interest rate swap, as a derivative, is measured at fair value through profit or loss, if hedge accounting is not adopted.

An increase in the market interest rate of 0.5% will result in SC receiving more under the variable rate interest amount in exchange for paying 2% fixed interest amount.

Theoretically, the fair value of the interest rate swap should be increased and a gain will be recognised in profit or loss.

(b) If SC designates the hedge as a fair value hedge, the non-cancellable purchase order in Yen is considered as a firm commitment to be hedged (hedged item) in connection with the spot foreign currency risk.

The Yen forward contract is considered to be as the hedging instrument.

As a financial derivative, the Yen forward contract will have been reported at fair value on each reporting date, with gains or losses reported in profit or loss.

Under a fair value hedge, the change in fair value of the firm commitment related to the hedged risk will also be recognised in profit or loss and adjusts the carrying amount of the hedged item. This applies if the hedged item is otherwise measured at cost. For SC's hedged item which is an unrecognised firm commitment, its cumulative change in the fair value attributable to the hedged risk is recognised as an asset or liability.

Question 2

(a) As the functional currency of GPL is RMB while the settlement of the CB is HK$, it does not fulfil the definition of equity instrument, that is, to be settled by exchanging a fixed amount of cash for a fixed number of its own equity instruments. Accordingly, under GPL's accounting policies, the debt component of the CB is carried at amortised cost and the conversion option is accounted for as a derivative at fair value through profit or loss.

In accordance with HKFRS 9 B4.3.3, when the CB is a hybrid instrument, that is, the embedded conversion option classified as a derivative and the host instrument, the initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

Journal entries for the issue of CB on 1 July 20X3:

DEBIT	Cash/Bank	HK$500 million	
CREDIT	Convertible Bond – liability		HK$420 million
CREDIT	Derivative – conversion option		HK$80 million

(b) Carrying amount of the debt component of the CB to be converted at 1 October 20X3:

HK$(420 million) × [1 + (6.3% × 3/12)] × HK$(50/500) million = HK$42.66 million

Carrying amount of derivative component of the CB to be converted at 1 October 20X3:

HK$70(500 – 430) million × HK$(50/500) million = HK$7 million

Journal entries for the conversion of CB into shares on 1 October 20X3:

DEBIT	Convertible Bond – liability	HK$42.66 million	
DEBIT	Derivative – conversion option	HK$7 million	
CREDIT	Equity		HK$49.66 million

(c) Effective interest expense of the debt component of the CB for the year ended 31 December 20X3:

HK$420 million × (6.3%*6/12) = HK$13.23 million

Fair value change of derivative component of the CB for the year ended 31 December 20X3:

Initial fair value (HK$80 million) – year-end fair value (HK$100 million) = fair value loss of HK$20 million

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Journal entries for the year ended 31 December 20X3:

Finance cost – effective interest	HK$13.23 million	
Fair value change – profit or loss	HK$20 million	
CREDIT Convertible Bond – liability		HK$13.23 million
CREDIT Derivative – conversion option		HK$20 million

The CB should be classified as non-current at the statement of financial position. With the maturity on 30 June 20X9, the issuer has an unconditional right to defer settlement of the liability for at least 12 months after the reporting period. Under HKAS 1.69(d), it mentions the terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments that do not affect its classification.

Chapter 14 revision cards.qxp 9/12/2016 3:14 PM Page 1

14: Revenue

Topic List

HKFRS 15

Application of HKFRS 15

You should be able to explain and apply the HKFRS 15 five-step approach to revenue recognition.

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Five-step approach

Step 1: Identify the contract(s) with a customer

Step 2: Identify separate performance obligations

Step 3: Determine the transaction price

Step 4: Allocate transaction price to performance obligations

Step 5: Recognise revenue as or when each performance obligation is satisfied

Step 1: Identify the contract(s) with a customer

- Must be approved by parties to contract
- Must have commercial substance
- Parties' rights/payment terms must be identified
- Probable seller will collect consideration

Combine contracts if:

- Entered into at/near same time with same customer or related party of customer, and
- One or more of following criteria met:
  - Contracts negotiated as package with single objective
  - Consideration in one contract depends on the other contract
  - Goods/services promised are single performance obligation

Step 2: Identify separate performance obligations

Separate performance obligations if:

- Promised good or service is **distinct**
- Series of goods/services are substantially same and have same pattern of transfer to customer

Distinct:

- Good/service could be used alone or with other resources available to customer and
- Promise to transfer good/service is separately identifiable from other promises in contract

Step 3: Determine the transaction price

- Include variable consideration if highly probable it won't be reversed
- Adjust transaction price for significant financing benefit to seller or customer
- Include non-cash consideration at fair value
- Recognise refund liability rather than revenue for expected returns
- Consideration paid to customer that is not in exchange for good/service is reduction in transaction price

Step 4: Allocate transaction price to performance obligations

Allocate based on standalone selling price of performance obligations in contract.

Step 5: Recognise revenue as or when each performance obligation is satisfied

At single point in time when customer obtains control of asset.

Over a period of time with progress based on input or output method. When outcome of performance obligation can't be reliably measured (early in contract), revenue = costs incurred.

HKFRS 15

Modifications:

New additional contract accounted for if:

- Additional distinct goods/services promised as part of modification, and
- Increase in selling price reflects standalone selling price of these goods/services

Otherwise original contract terminated and replaced by new contract if remaining goods/services distinct from those promised before modification.

Change in transaction price:

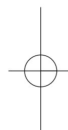
Allocate to performance obligations on same basis as original allocation of transaction price.

In SOFP:

- Contract asset
- Receivable
- Contract liability

Contract costs:

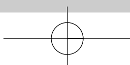
- Incremental costs of obtaining new contract capitalised if costs expected to be recovered.
- Costs of fulfilling contract are accounted for in accordance with relevant standard. If not within scope of another standard, capitalise if directly relate to contract, will be used to satisfy future performance obligations and are expected to be recoverable.

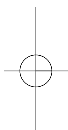


Disclosure

Contract costs:

- Quantitative details of contracts with customers (revenue, receivables, impairment losses) and qualitative details (description of performance obligations)
- Significant judgments
- Assets recognised





Sales with right of return	Recognise revenue to extent seller expects to be entitled to it and recognise refund liability for the consideration received that seller doesn't expect to be entitled to. Recognise asset for right to recover assets/adjust cost of sales.
Extended warranties	Apply HKAS 37 to standard warranty providing assurance that product will function as intended. Extended purchased warranty or warranty for additional services accounted for as separate performance obligation and allocated revenue.
Transactions involving an agent	For a principal, revenue is the gross amount of consideration from a customer. For an agent, revenue is the fee or commission that the seller expects to receive for providing goods/services to customer.

Licensing	If promise to grant licence not distinct from promised goods or services, treat as single performance obligation. If promise to grant licence is distinct it is a separate performance obligation; revenue is recognised at one point in time if licence allows access to intellectual property as it exists at a single point in time; revenue is recognised over time if licence allows access to intellectual property as it exists at any given time in the licence period (i.e. customer benefits from updates and improvements).
Royalties	Royalty measured by reference to sales or usage recognised as revenue at later of: ▪ Subsequent sale or usage ▪ Satisfaction of performance obligation that some or all of royalty is allocated to

Repurchase agreements	Seller can or must repurchase – account for as financing arrangement if repurchase price exceeds selling price or transaction part of sale and leaseback. Otherwise apply HKAS 17 *Leases*. Customer can enforce repurchase – if no significant economic incentive to force repurchase account for as sale with right of return; if significant economic incentive to force repurchase exists and contract not part of a sale and leaseback, apply HKAS 17 *Leases*; if significant economic incentive to force repurchase exists and contract is part of a sale and leaseback, account for as financing arrangement.
Consignment arrangements	Revenue is recognised when sale made to third party.
Bill and hold arrangements	If bill and hold criteria met, control has passed and revenue is recognised. Some revenue may need to be allocated to provision of storage service by seller.

Options for additional goods/services, e.g. loyalty scheme	If option for additional goods/services is a material right that the customer wouldn't receive otherwise, transaction price is allocated to the right to obtain additional goods/services.
Non-refundable upfront fees	If upfront fee is prepayment for goods/services provided over length of contract, recognise over contract period.