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

MEMBERS' HANDBOOK

Update No. 269

(Issued 29 December 2021)

This Update relates to the following:

(i) Consequential amendments arising from the following Standards are effective for annual reporting periods beginning on or after 1 January 2022 that were previously set out in the Appendices to the respective Standards or in a separate document *Annual Improvements to HKFRSs 2018-2020,* but are now incorporated into the text of the relevant Standards, Basis for Conclusions and Illustrative Examples.

Annual Improvements to HKFRSs 2018-2020

- HKFRS 1 (Revised) *First-time Adoption of International Financial Reporting Standards*
- HKFRS 9 (2014) *Financial Instruments*
- Illustrative Examples accompanying HKFRS 16 *Leases*
- HKAS 41 *Agriculture*

Narrow-scope amendments

- HKFRS 3 (Revised) *Business Combinations*
- HKAS 16 *Property, Plant and Equipment*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

(ii) HKAS 1 (Revised) *Presentation of Financial Statements* and HKFRS Practice Statement 2 *Making Materiality Judgements* are updated for editorial corrections.

(iii) HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives* is withdrawn as it has been superseded by HKFRS 9 (2014) *Financial Instruments* for annual periods beginning on 1 January 2018.

Document Reference and Title	***Instructions***
VOLUME II	
Contents of Volume II	Discard existing pages i-iv & replace with revised pages i-iv.
HONG KONG ACCOUNTING STANDARDS (HKAS)	
HKAS 1 (Revised) *Presentation of Financial Statements*	Replace the cover page and page 49 with revised cover page and revised page 49.

(Continued next page)

Document Reference and Title	***Instructions***
HKAS 16 *Property, Plant and Equipment*	Replace the cover page and pages 2, 4, 10, 17, 18A, 19A, 22, 22B, 25 and 29 with revised cover page and pages 2, 4, 10, 17, 18A, 19A, 22, 22B, 25 and 29. Insert page10A after page 10, page 17A after page 17, pages 25A-25C after page 25, and page 29A after page 29. Discard existing pages 21A-21B and existing pages 43A-43D.
HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	Replace the cover page and pages 2-4, 16-19 and 19A with revised cover page and revised pages 2-4, 16-19 and 19A. Discard existing pages 31-36.
HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (Basis for Conclusions)	Insert the full set of Basis for Conclusions after HKAS 37.
HKAS 41 *Agriculture*	Replace the cover page and pages 2, 3, 8 and 12A with revised cover page and revised pages 2, 3, 8 and 12A.
HKAS 41 *Agriculture* (Basis for Conclusions)	Replace the cover page and pages 2, 2A and 3 with revised cover page and revised pages 2, 2A and 3.

HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)

HKFRS 1 (Revised) *First-time Adoption of Hong Kong Financial Reporting Standards*	Replace the cover page and pages 2, 16, 24, and 27A with revised cover page and revised pages 2, 16, 24, and 27A.
HKFRS 1 (Revised) *First-time Adoption of Hong Kong Financial Reporting Standards* (Basis for Conclusions)	Replace the cover page and pages 13 and 20 with revised cover page and revised pages 13 and 20. Insert page 20A after page 20.
HKFRS 3 (Revised) *Business Combinations*	Replace the cover page and pages 1A, 2-4, 9-11 and 19A with revised cover page and revised pages 1A, 2-4, 9-11 and 19A. Insert page 11A after page 11. Discard existing pages 43-45.
HKFRS 3 (Revised) *Business Combinations* (Basis for Conclusions)	Replace the cover page and pages 3, 5, 28, 28A, 30, 56, 58, 92A and 92B with revised cover page and revised pages 3, 5, 28, 28A, 30, 56, 58, 92A and 92B. Insert page 28B after page 28A, page 56A after page 56 and page 58A after page 58. Discard existing pages 98-101.

(Continued next page)

Document Reference and Title	***Instructions***
HKFRS 9 (2014) *Financial Instruments*	Replace the cover page and pages 2, 36E, 41A and 59 with revised cover page and revised pages 2, 36E, 41A and 59. Insert page 41B after page 41A.
HKFRS 9 (2014) *Financial Instruments* (Basis for Conclusions)	Replace the cover page and pages 2 and 21 with revised cover page and revised pages 2 and 21. Insert page 21A after page 21.
HKFRS 16 *Leases* (Basis for Conclusions)	Replace the cover page and page 41 with revised cover page and page 41. Insert page 41A after page 41.
HKFRS 16 *Leases* (Illustrative Examples)	Replace the cover page and pages 2, 21 and 22 with revised cover page and pages 2, 21 and 22.
Annual Improvements to HKFRSs 2018-2020	Discard the full set of annual improvements.

HONG KONG (IFRIC) INTERPRETATIONS (HK(IFRIC)-Int)

HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives*	Discard the existing HK(IFRIC)-Int 9.

HKFRS PRACTICE STATEMENT

HKFRS Practice Statement 2 *Making Materiality Judgements*	Replace the cover page and page 14 with revised cover page and revised page 14.

Hong Kong Institute of
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香港會計師公會

MEMBERS' HANDBOOK
CONTENTS OF VOLUME II

(Updated to December 2021)

		Issue/(Review date)
	PREFACE AND FRAMEWORK	
PREFACE	Preface to Hong Kong Financial Reporting Standards	10/06(7/21)
CONCEPTUAL FRAMEWORK (Revised)	Conceptual Framework for Financial Reporting 2018.................................	6/18 (8/20)
	HONG KONG ACCOUNTING STANDARDS (HKAS)	
HKAS 1 Revised	Presentation of Financial Statements..	12/07(12/21)
HKAS 2	Inventories	3/04(7/19)
HKAS 7	Statement of Cash Flows	12/04(8/20)
HKAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	9/04(4/21)
HKAS 10	Events after the Reporting Period	3/04(8/20)
HKAS 12	Income Taxes	11/04(6/21)
HKAS 16	Property, Plant and Equipment	11/05(12/21)
HKAS 19 (2011)	Employee Benefits..	7/11(8/20)
HKAS 20	Accounting for Government Grants and Disclosure of Government Assistance	12/04(9/18)
HKAS 21	The Effects of Changes in Foreign Exchange Rates	3/04(8/20)
HKAS 23 Revised	Borrowing Costs...	6/07(7/19)
HKAS 24 Revised	Related Party Disclosures	11/09 (11/16)
HKAS 26	Accounting and Reporting by Retirement Benefit Plans	8/04
HKAS 27 (2011)	Separate Financial Statements	6/11(9/18)
HKAS 28 (2011)	Investments in Associates and Joint Ventures..	6/11(8/20)

		Issue/(Review date)
HKAS 29	Financial Reporting in Hyperinflationary Economies	3/04(4/10)
HKAS 32	Financial Instruments: Presentation	11/04(8/20)
HKAS 33	Earnings per Share	3/04(9/18)
HKAS 34	Interim Financial Reporting	10/04(8/20)
HKAS 36	Impairment of Assets	8/04(7/21)
HKAS 37	Provisions, Contingent Liabilities and Contingent Assets	11/04(12/21)
HKAS 38	Intangible Assets	8/04(8/20)
HKAS 39	Financial Instruments: Recognition and Measurement	1/06(7/21)
HKAS 40	Investment Property	11/05(8/20)
HKAS 41	Agriculture	12/04(12/21)
	HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)	
HKFRS 1 Revised	First-time Adoption of Hong Kong Financial Reporting Standards	12/08(12/21)
HKFRS 2	Share-based Payment	4/04(8/20)
HKFRS 3 Revised	Business Combinations	3/08(12/21)
HKFRS 4	Insurance Contracts	3/06(7/21)
HKFRS 5	Non-current Assets Held for Sale and Discontinued Operations	8/04(8/20)
HKFRS 6	Exploration for and Evaluation of Mineral Resources	2/05(8/20)
HKFRS 7	Financial Instruments: Disclosures	9/05(7/21)
HKFRS 8	Operating Segments	3/07(8/20)
HKFRS 9 (2014)	Financial Instruments	09/14(12/21)
HKFRS 10	Consolidated Financial Statements	6/11(8/20)
HKFRS 11	Joint Arrangements	6/11(7/19)
HKFRS 12	Disclosure of Interests in Other Entities	6/11(8/20)
HKFRS 13	Fair Value Measurement	6/11(7/19)
HKFRS 14	Regulatory Deferral Accounts	2/14(8/20)
HKFRS 15	Revenue from Contracts with Customers	7/14(8/20)
HKFRS 16	Leases	5/16(12/21)
HKFRS 17	Insurance Contracts	1/18 (10/20)

Issue/(Review date)

HONG KONG (IFRIC) INTERPRETATIONS (HK(IFRIC)-Int)

HK(IFRIC)-Int 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities.. 8/04(7/19)

HK(IFRIC)-Int 2 Members' Shares in Co-operative Entities and Similar Instruments............ 2/05(9/18)

HK(IFRIC)-Int 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds .... 2/05(8/20)

HK(IFRIC)-Int 6 Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment.. 9/05

HK(IFRIC)-Int 7 Applying the Restatement Approach under HKAS 29 *Financial Reporting in Hyperinflationary Economies* .... 1/06(7/10)

HK(IFRIC)-Int 10 Interim Financial Reporting and Impairment .... 9/06(9/18)

HK(IFRIC)-Int 12 Service Concession Arrangements... 3/07(8/20)

HK(IFRIC)-Int 14 HKAS 19 —The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction .... 9/07(8/20)

HK(IFRIC)-Int 16 Hedges of a Net Investment in a Foreign Operation.................................... 8/08(9/18)

HK(IFRIC)-Int 17 Distributions of Non-cash Assets to Owners... 12/08(8/20)

HK(IFRIC)-Int 19 Extinguishing Financial Liabilities with Equity Instruments .... 12/09(8/20)

HK(IFRIC)-Int 20 Stripping Costs in the Production Phase of a Surface Mine 11/11 (8/20)

HK(IFRIC)-Int 21 Levies 6/13

HK(IFRIC)-Int 22 Foreign Currency Transactions and Advance Consideration .... 6/17(8/20)

HK(IFRIC)-Int 23 Uncertainty over Income Tax Treatments 7/17

HONG KONG INTERPRETATIONS (HK-Int)*

HK-Int 5 Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause 11/10

HK-Int 5 (2020) Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause 10/20

Note: * *With effect from 24 May 2005, all Interpretations that are developed locally by the Institute are named Hong Kong Interpretations.*

HONG KONG (SIC) INTERPRETATIONS (HK(SIC)-Int)

HK(SIC)-Int 10 Government Assistance – No Specific Relation to Operating Activities ...... 12/04(8/10)

HK(SIC)-Int 25 Income Taxes – Changes in the Tax Status of an Entity or its Shareholders .... 12/04(8/10)

Issue/(Review date)

HK(SIC)-Int 29	Service Concession Arrangements: Disclosures	12/04(8/20)
HK(SIC)-Int 32	Intangible Assets – Web Site Costs	12/04(8/20)
GLOSSARY	Glossary of Terms Relating to Hong Kong Financial Reporting Standards	3/08(12/20)

HONG KONG FINANCIAL REPORTING STANDARD FOR PRIVATE ENTITIES (HKFRS-PE)

HKFRS-PE	HONG KONG FINANCIAL REPORTING STANDARD FOR PRIVATE ENTITIES	4/10(9/15)
HKFRS-PE (Revised)	HONG KONG FINANCIAL REPORTING STANDARD FOR PRIVATE ENTITIES (REVISED)	5/17

SMALL AND MEDIUM-SIZED ENTITY FINANCIAL REPORTING FRAMEWORK AND FINANCIAL REPORTING STANDARD (SME-FRF & SME-FRS)

SME-FRF & SME-FRS (Revised December 2021)	SME-FRF & SME-FRS (Revised December 2021)	12/21

ACCOUNTING GUIDELINES (AG)

AG 1	Preparation and Presentation of Accounts from Incomplete Records	3/84
AG 5	Merger Accounting for Common Control Combinations	11/05 (11/13)
AG 5 (Revised)	Merger Accounting for Common Control Combinations	12/20
AG 7	Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars	3/06

ACCOUNTING BULLETINS (AB)

AB 3 (Revised)	Guidance on Disclosure of Directors' Remuneration	6/19
AB 4	Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance	5/10
AB 5	Guidance for the Preparation and Presentation of a Business Review under the Hong Kong Companies Ordinance Cap. 622	6/19
AB 6	Guidance on the Requirements of Section 436 of the Hong Kong Companies Ordinance Cap. 622	6/19

HKFRS PRACTICE STATEMENT

HKFRS Practice Statement 2	Making Materiality Judgements	3/21(12/21)

HKAS 1 (Revised)
Revised ~~April~~ December 2021

Effective for annual periods
beginning on or after 1 January 2009

Hong Kong Accounting Standard 1 (Revised)

Presentation of Financial Statements

Hong Kong Institute of
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Amendments to HKAS 34 *Interim Financial Reporting*

Paragraph 5 is amended and paragraph 60 is added. New text is underlined and deleted text is struck through.

Content of an interim financial report

5 HKAS 1 defines a complete set of financial statements as including the following components:

…

(e) notes, comprising material ~~significant~~ accounting policy information ~~policies~~ and other explanatory information;

…

Effective date

...

60 *Disclosure of Accounting Policies*, which amends HKAS 1 and HKFRS Practice Statement 2 *Making Materiality Judgements*, and was issued in April 2021, amended paragraph 5. An entity shall apply that amendment for annual reporting periods beginning on or after 1 January 2023. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

HKAS 16

Revised ~~August 2020~~December 2021

Hong Kong Accounting Standard 16

Property, Plant and Equipment

Hong Kong Institute of
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TRANSITIONAL PROVISIONS **80**

EFFECTIVE DATE **81**

WITHDRAWAL OF OTHER PRONOUNCEMENTS **82**

APPENDICES:

A Comparison with International Accounting Standards

B Amendments to other pronouncements

~~**C Amendments to HKAS 16 *Property, Plant and Equipment—Proceeds before Intended Use***~~

BASIS FOR CONCLUSIONS

~~**APPENDIX A**~~
~~**AMENDMENTS TO THE BASIS FOR CONCLUSIONS ON IAS 16 *PROPERTY, PLANT AND EQUIPMENT—PROCEEDS BEFORE INTENDED USE***~~

TABLE OF CONCORDANCE

DISSENTING OPINIONS

Hong Kong Accounting Standard 16 *Property, Plant and Equipment* (HKAS 16) is set out in paragraphs 1-83 and Appendix ~~C~~B. All the paragraphs have equal authority. HKAS 16 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Elements of cost

16 The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

17 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in HKAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly (ie assessing whether the technical and physical performance of the asset is such that it is capable of being used in the production or supply of goods or services, for rental to others, or for administrative purposes)~~, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)~~; and

(f) professional fees.

18 An entity applies HKAS 2 *Inventories* to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period. The obligations for costs accounted for in accordance with HKAS 2 or HKAS 16 are recognised and measured in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

19 Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility;

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(d) administration and other general overhead costs.

20 Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

(b) initial operating losses, such as those incurred while demand for the item's output builds up; and

(c) costs of relocating or reorganising part or all of an entity's operations.

20A Items may be produced while bringing an item of property, plant and equipment to the location and condition necessary for it to be capable of operating in the manner intended by management (such as samples produced when testing whether the asset is functioning properly). An entity recognises the proceeds from selling any such items, and the cost of those items, in profit or loss in accordance with applicable Standards. The entity measures the cost of those items applying the measurement requirements of HKAS 2.

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(ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals;

(iii) acquisitions through business combinations;

(iv) increases or decreases resulting from revaluations under paragraphs 31, 39 and 40 and from impairment losses recognised or reversed in other comprehensive income in accordance with HKAS 36;

(v) impairment losses recognised in profit or loss in accordance with HKAS 36;

(vi) impairment losses reversed in profit or loss in accordance with HKAS 36;

(vii) depreciation;

(viii) the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and

(ix) other changes.

74 The financial statements shall also disclose:

(a) the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

(b) the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction; and

(c) the amount of contractual commitments for the acquisition of property, plant and equipment~~; and~~

~~**(d) if it is not disclosed separately in the statement of comprehensive income, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.**~~

74A If not presented separately in the statement of comprehensive income, the financial statements shall also disclose:

(a) the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss; and

(b) the amounts of proceeds and cost included in profit or loss in accordance with paragraph 20A that relate to items produced that are not an output of the entity's ordinary activities, and which line item(s) in the statement of comprehensive income include(s) such proceeds and cost.

75 Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information that allows them to review the policies selected by management and enables comparisons to be made with other entities. For similar reasons, it is necessary to disclose:

(a) depreciation, whether recognised in profit or loss or as a part of the cost of other assets, during a period; and

(b) accumulated depreciation at the end of the period.

76 In accordance with HKAS 8 an entity discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:

(a) residual values;

(b) the estimated costs of dismantling, removing or restoring items of property, plant and equipment;

(c) useful lives; and

(d) depreciation methods.

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80AB SSAP 17 Property, Plant and Equipment exempted charitable, government subvented and not-for-profit organisations whose long-term financial objective is other than to achieve operating profits (e.g. trade associations, clubs and retirement schemes) from compliance with its requirements. Those entities that have previously taken advantage of the exemption under SSAP 17 are permitted to deem the carrying amount of an item of property, plant and equipment immediately before applying this Standard on its effective date (or earlier) as the cost of that item. Depreciation on the deemed cost of an item of property, plant and equipment commences from the time at which this Standard is first applied. In the case where a carrying amount is used as a deemed cost for subsequent accounting, this fact and the aggregate of the carrying amounts for each class of property, plant and equipment presented shall be disclosed.

~~81~~80B In the reporting period when *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41) is first applied an entity need not disclose the quantitative information required by paragraph 28(f) of HKAS 8 for the current period. However, an entity shall present the quantitative information required by paragraph 28(f) of HKAS 8 for each prior period presented.

~~81~~80C An entity may elect to measure an item of bearer plants at its fair value at the beginning of the earliest period presented in the financial statements for the reporting period in which the entity first applies Agriculture: Bearer Plants (Amendments to HKAS 16 and HKAS 41) and use that fair value as its deemed cost at that date. Any difference between the previous carrying amount and fair value shall be recognised in opening retained earnings at the beginning of the earliest period presented.

80D *Property, Plant and Equipment—Proceeds before Intended Use*, issued in June 2020, amended paragraphs 17 and 74 and added paragraphs 20A and 74A. An entity shall apply those amendments retrospectively, but only to items of property, plant and equipment that are brought to the location and condition necessary for them to be capable of operating in the manner intended by management on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments. The entity shall recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of that earliest period presented.

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81K *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41), issued in August 2014, amended paragraphs 3, 6 and 37 and added paragraphs 22A and80B-80C. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments retrospectively, in accordance with HKAS 8, except as specified in paragraph80C.

81L HKFRS 16, issued in May 2016, deleted paragraphs 4 and 27 and amended paragraphs 5, 10, 44 and 68–69. An entity shall apply those amendments when it applies HKFRS 16.

81M *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

81N *Property, Plant and Equipment—Proceeds before Intended Use*, issued in June 2020, amended paragraphs 17 and 74, and added paragraphs 20A, 74A and 80D. An entity shall apply those amendments for annual reporting periods beginning on or after 1 January 2022. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

Withdrawal of other pronouncements

82 This Standard supersedes SSAP 17 *Property, Plant and Equipment* (revised in 2001).

83 This Standard supersedes the following Interpretations**:** (a) Interpretation 1 *Costs of Modifying Existing Software* and Interpretation 5 *Property, Plant and Equipment—Compensation for the Impairment or Loss of Items*

CONTENTS

from paragraph

BASIS FOR CONCLUSIONS ON IAS 16 *PROPERTY, PLANT AND EQUIPMENT*

INTRODUCTION	**BC1**
SCOPE	**BC4**
RECOGNITION	**BC5**
Classification of servicing equipment	**BC12A**
MEASUREMENT AT RECOGNITION	**BC13**
Asset dismantlement, removal and restoration costs	**BC13**
Property, Plant and Equipment—Proceeds before Intended Use (2020 amendments)	**BC16A**
Asset exchange transactions	**BC17**
MEASUREMENT AFTER RECOGNITION	**BC25**
Revaluation model	**BC25**
Revaluation method—proportionate restatement of accumulated depreciation when an item of property, plant and equipment is revalued	**BC25A**
Depreciation: unit of measure	**BC26**
Depreciation: depreciable amount	**BC28**
Depreciation: depreciation period	**BC30**
Depreciation: depreciation method	**BC33**
DERECOGNITION	**BC34**
Derecognition date	**BC34**
GAIN CLASSIFICATION	**BC35**
ASSETS HELD FOR RENTAL TO OTHERS	**BC35A**
TRANSITIONAL PROVISIONS	**BC36**
Property, Plant and Equipment—Proceeds before Intended Use (2020 amendments)	**BC36B**
SUMMARY OF CHANGES FROM THE EXPOSURE DRAFT	**BC37**

~~**APPENDIX A**~~
~~**AMENDMENTS TO THE BASIS FOR CONCLUSIONS ON IAS 16**~~
~~***PROPERTY, PLANT AND EQUIPMENT*—PROCEEDS BEFORE INTENDED USE**~~

TABLE OF CONCORDANCE

DISSENTING OPINIONS

Measurement at recognition

Asset dismantlement, removal and restoration costs

BC13 The previous version of IAS 16 provided that in initially measuring an item of property, plant and equipment at its cost, an entity would include the cost of dismantling and removing that item and restoring the site on which it is located to the extent it had recognised an obligation for that cost. As part of its deliberations, the Board evaluated whether it could improve this guidance by addressing associated issues that have arisen in practice.

BC14 The Board concluded that the relatively limited scope of the Improvements project warranted addressing only one matter. That matter was whether the cost of an item of property, plant and equipment should include the initial estimate of the cost of dismantlement, removal and restoration that an entity incurs as a consequence of using the item (instead of as a consequence of acquiring it). Therefore, the Board did not address how an entity should account for (a) changes in the amount of the initial estimate of a recognised obligation, (b) the effects of accretion of, or changes in interest rates on, a recognised obligation or (c) the cost of obligations an entity did not face when it acquired the item, such as an obligation triggered by a law change enacted after the asset was acquired.

BC15 The Board observed that whether the obligation is incurred upon acquisition of the item or while it is being used, its underlying nature and its association with the asset are the same. Therefore, the Board decided that the cost of an item should include the costs of dismantlement, removal or restoration, the obligation for which an entity has incurred as a consequence of having used the item during a particular period other than to produce inventories during that period. An entity applies IAS 2 *Inventories* to the costs of these obligations that are incurred as a consequence of having used the item during a particular period to produce inventories during that period. The Board observed that accounting for these costs initially in accordance with IAS 2 acknowledges their nature. Furthermore, doing so achieves the same result as including these costs as an element of the cost of an item of property, plant and equipment, depreciating them over the production period just completed and identifying the depreciation charge as a cost to produce another asset (inventory), in which case the depreciation charge constitutes part of the cost of that other asset.

BC16 The Board noted that because IAS 16's initial measurement provisions are not affected by an entity's subsequent decision to carry an item under the cost model or the revaluation model, the Board's decision applies to assets that an entity carries under either treatment.

Property, Plant and Equipment—Proceeds before Intended Use (2020 amendments)

Background

BC16A Before the 2020 amendments, paragraph 17(e) specified that directly attributable costs included the costs of testing whether an asset was functioning properly, after deducting the net proceeds from selling items produced while bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The Board received a request asking whether:

(a) the proceeds specified in paragraph 17(e) related only to items produced while testing; and

(b) an entity was required to deduct from the cost of an item of property, plant and equipment any such proceeds that exceeded the costs of testing.

BC16B The Board's research indicated that different entities had applied the requirements in paragraph 17(e) differently. Some entities deducted only proceeds from selling items produced while testing; others deducted the proceeds of all sales until an asset was in the location and condition necessary for it to be capable of operating in the manner intended by management (ie available for use). For some entities, the proceeds deducted from the cost of an item of property, plant and equipment could be significant and could exceed the costs of testing.

Recognising proceeds and related cost in profit or loss

BC16C After considering the findings in paragraph BC16B, the Board decided to amend paragraph 17 to prohibit an entity from deducting from the cost of an item of property, plant and equipment the proceeds from selling items produced before that asset is available for use (proceeds before intended use).

BC16D In the Board's view, the amendments will improve financial reporting. Proceeds before intended use and related cost meet the definition of income and expenses in the *Conceptual Framework for Financial Reporting*. Those items of income and expenses reflect an entity's performance for the period and they should, therefore, be included in the statement of profit or loss.

BC16E The previous requirement to offset proceeds against the cost of an item of property, plant and equipment reduced the usefulness of financial statements to users of financial statements. This is because the previous requirement resulted in an entity including amounts that did not faithfully represent:

(a) its performance. Offsetting proceeds against the cost of an asset understates an entity's revenue (or income) in the period. Moreover, doing so could also have a pervasive and long-term effect on an entity's performance when the asset has a long useful life. Offsetting proceeds decreased the depreciable amount of such an asset and, consequently, reduced the depreciation charge recognised as an expense over the asset's useful life.

(b) the cost of an item of property, plant and equipment. Offsetting proceeds could result in the carrying amount of the asset understating its cost. This, in turn, could reduce the usefulness of financial metrics, such as return on assets, that use the asset's carrying amount.

BC16F The Board considered suggestions that recognising proceeds before intended use and related cost in profit or loss might not provide useful information to users of financial statements. Those holding this view suggested that such sales proceeds—and the related margin—may have little predictive value because:

(a) the sales proceeds are generally non-recurring and are not necessarily an output of an entity's ordinary activities; and

(b) the cost of items produced would not include depreciation of the item of property, plant and equipment—because depreciation of that asset begins when it is available for use.

BC16G In the Board's view, however, the fact that the proceeds may have little predictive value was not a compelling argument for excluding them from profit or loss—the statement of profit or loss includes other items of income or expenses that may have little predictive value but the inclusion of which nonetheless provides useful information to users of financial statements. Recognising proceeds before intended use and related cost in profit or loss will result in entities reporting amounts that more faithfully represent their performance and financial position. It will also have confirmatory value about an entity's performance. The disclosure requirements in paragraph 74A(b) will highlight such proceeds and cost for users of financial statements (see paragraphs BC16L–BC16M).

Measuring the cost of items produced

BC16H When it exposed draft amendments for comment, the Board proposed no requirements on measuring the cost of items produced before an item of property, plant and equipment is available for use. A number of respondents to the Board's draft amendments suggested that the Board develop such requirements. They said measuring the cost of items produced could require extensive judgement, which in turn could result in differences in how entities measure that cost. Respondents' views differed on how prescriptive any requirements should be—some suggested the Board develop only high-level principles while others suggested providing detailed application guidance.

BC16I After considering this feedback, the Board decided to require an entity to apply IAS 2 *Inventories* in measuring the cost of items produced. The Board made this decision because:

(a) IAS 2 sets out a framework for measuring cost without being overly prescriptive; and

(b) an entity would already be required to apply IAS 2 in measuring cost if the entity were to determine that the sale of items produced is an output of its ordinary activities—in this case, the items produced would meet IAS 2's definition of inventories. It would be useful to apply the same requirements to the cost of items produced irrespective of whether the sale of those items is an output of an entity's ordinary activities.

BC16J In addition, the Board concluded that the judgement involved in measuring the cost of items produced is not substantially different from judgements already required when applying IAS 2 and other IFRS Standards in measuring cost, in particular for assets that take a substantial period of time to get ready for their intended use (for example, measuring the cost of abnormal amounts of wasted materials and labour, allocating costs to joint products or measuring the cost of operations incidental to the construction or development of an item of property, plant and equipment).

BC16K The Board acknowledged the amendments might result in implementation costs for some entities. However, the Board concluded that a requirement to measure the cost of items produced applying IAS 2 would not impose costs that outweigh the usefulness of the information provided.

Presentation and disclosure

BC16L The Board developed the requirements in paragraph 74A(b) to provide users of financial statements with information about the sale of items that are not an output of an entity's ordinary activities. Users of financial statements said information that enables them to identify proceeds before intended use, and to understand how those proceeds and related cost affect an entity's performance, would be useful.

BC16M The Board decided not to develop similar requirements for sales of items that are an output of an entity's ordinary activities because the requirements of IFRS 15 *Revenue from Contracts with Customers* and IAS 2 would apply to the proceeds from such sales and related cost.

BC16N Measuring the cost of items produced could necessitate the use of estimates and judgement. However, the Board decided not to add disclosure requirements in this respect because other IFRS Standards such as IAS 1 *Presentation of Financial Statements* already require the disclosure of information about estimates and judgements.

BC16O The Board also decided not to develop specific presentation requirements for proceeds before intended use and related cost because IAS 1 already includes relevant requirements, for example on:

(a) the offsetting of income and expenses; and

(b) the presentation of income and expenses as separate line items in the statement of profit or loss.

Available for use and the meaning of 'testing'

BC16P Paragraph 20 requires an entity to determine when an item of property, plant and equipment is available for use. The Board was informed of differences in how entities make that determination, and considered suggestions to clarify when an asset is available for use. Some of those making this suggestion said the existence of significant proceeds before intended use might indicate that an asset is already available for use before it is determined to be so. In their view, such a clarification would reduce the amount of proceeds being deducted from the cost of an asset than had previously been the case and, thus, would address the matter identified in paragraph BC16B without changing how those proceeds are recognised.

BC16Q The Board decided not to amend IAS 16 to clarify when an asset is available for use. Such an amendment would not be narrow in scope—it might affect the measurement of many items of property, plant and equipment, and additional research would be required to assess potential unintended consequences. Furthermore, the Board had obtained no evidence that differences in how entities determine when an asset is available for use could lead to material differences in the entities' financial statements.

BC16R Nonetheless, the Board decided to clarify the meaning of 'testing' in paragraph 17, noting that such a clarification might help an entity in determining when an asset is available for use. The Board concluded that when testing whether an asset is functioning properly, an entity assesses the technical and physical performance of the asset. The assessment of functioning properly is not an assessment of the financial performance of an asset, such as assessing whether the asset has achieved the level of operating margin initially anticipated by management.

Asset exchange transactions

BC17 Paragraph 22 of the previous version of IAS 16 indicated that if (a) an item of property, plant and equipment is acquired in exchange for a similar asset that has a similar use in the same line of business and has a similar fair value or (b) an item of property, plant and equipment is sold in exchange for an equity interest in a similar asset, then no gain or loss is recognised on the transaction. The cost of the new asset is the carrying amount of the asset given up (rather than the fair value of the purchase consideration given for the new asset).

BC18 This requirement in the previous version of IAS 16 was consistent with views that:

(a) gains should not be recognised on exchanges of assets unless the exchanges represent the culmination of an earning process;

(b) exchanges of assets of a similar nature and value are not a substantive event warranting the recognition of gains; and

(c) requiring or permitting the recognition of gains from such exchanges enables entities to 'manufacture' gains by attributing inflated values to the assets exchanged, if the assets do not have observable market prices in active markets.

BC19 The approach described above raised issues about how to identify whether assets exchanged are similar in nature and value. The Board reviewed this topic, and noted views that:

(a) under the *Framework*, the recognition of income from an exchange of assets does not depend on whether the assets exchanged are dissimilar;

BC35F The Board discussed the comments received in response to its exposure draft of proposed *Improvements to International Financial Reporting Standards* published in 2007 and noted that a few respondents would prefer the issue to be included in one of the Board's major projects such as the revenue recognition project or the financial statement presentation project. However, the Board noted that the proposed amendment would improve financial statement presentation before those projects could be completed and decided to add paragraph 68A as previously exposed. A few respondents raised the concern that the term 'held for sale' in the amendment could be confused with the notion of held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Consequently, the Board clarified in the amendment that IFRS 5 should not be applied in those circumstances.

Transitional provisions

BC36. The Board concluded that it would be impracticable for an entity to determine retrospectively whether a previous transaction involving an exchange of non-monetary assets had commercial substance. This is because it would not be possible for management to avoid using hindsight in making the necessary estimates as of earlier dates. Accordingly, the Board decided that in accordance with the provisions of IAS 8 an entity should consider commercial substance only in evaluating the initial measurement of future transactions involving an exchange of non-monetary assets.

BC36A *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, amended paragraph 35. The Board also decided that the amendment should be required to be applied to all revaluations occurring in annual periods beginning on or after the date of initial application of the amendments and in the immediately preceding annual period. The Board was concerned that the costs of full retrospective application might outweigh the benefits.

Property, Plant and Equipment—Proceeds before Intended Use (2020 amendments)

BC36B The 2020 amendments are expected mainly to affect only a few industries, such as mining and petrochemicals. The Board therefore considered the need, if any, for transition requirements beyond those in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

BC36C The Board concluded that the expected benefits of retrospectively applying the amendments in accordance with IAS 8 might be outweighed by the costs of doing so—in particular, an affected entity might find it difficult and costly to apply the amendments retrospectively to assets made available for use many years ago. In the Board's view, the transition requirements in paragraph 80D promote consistency in application of the amendments for all periods presented, but limit the number of assets an entity is required to reassess on first applying the amendments.

BC36D The Board decided not to provide transition requirements for first-time adopters of IFRS Standards because:

(a) IFRS 1 *First-time Adoption of International Financial Reporting Standards* provides deemed cost exemptions for items of property, plant and equipment. These exemptions allow a first-time adopter to measure such assets without reference to IAS 16.

(b) if a first-time adopter does not apply those deemed cost exemptions, it would apply all the requirements in IAS 16 retrospectively. The Board concluded that there would be little benefit in providing first-time adopters with an exception or exemption relating to only one aspect of the requirements in IAS 16.

Summary of changes from the Exposure Draft

BC37. The main changes from the ED proposals to the revised Standard are as follows.

(a) The ED contained two recognition principles, one applying to subsequent expenditures on existing items of property, plant and equipment. The Standard contains a single recognition principle that applies to costs incurred initially to acquire an item and costs incurred subsequently to add to, replace part of or service an item. An entity applies the recognition principle to the latter costs at the time it incurs them.

(b) Under the approach proposed in the ED, an entity measured an item of property, plant and equipment acquired in exchange for a non-monetary asset at fair value irrespective of whether the exchange transaction in which it was acquired had commercial substance. Under the Standard, a lack of commercial substance is cause for an entity to measure the acquired asset at the carrying amount of the asset given up.

(c) Compared with the Standard, the ED did not as clearly set out the principle that an entity separately depreciates at least the parts of an item of property, plant and equipment that are of significant cost.

(d) Under the approach proposed in the ED, an entity derecognised the carrying amount of a replaced part of an item of property, plant and equipment if it recognised in the carrying amount of the asset the cost of the replacement under the general recognition principle. In the Standard, an entity also applies this approach to a replacement of a part of an item that is not depreciated separately.

(e) In finalising the Standard, the Board identified further necessary consequential amendments to IFRS 1, IAS 14, IAS 34, IAS 36, IAS 37, IAS 38, IAS 40, SIC-13, SIC-21, SIC-22 and SIC-32.

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HKAS 37
Revised ~~August 2020~~December 2021

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 37

Provisions, Contingent Liabilities and Contingent Assets

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

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Contents

	from paragraph
INTRODUCTION	**IN1**

HONG KONG ACCOUNTING STANDARD 37
PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

OBJECTIVE	
SCOPE	**1**
DEFINITIONS	**10**
Provisions and other liabilities	**11**
Relationship between provisions and contingent liabilities	**12**
RECOGNITION	**14**
Provisions	**14**
Present obligation	15
Past event	17
Probable outflow of resources embodying economic benefits	23
Reliable estimate of the obligation	25
Contingent liabilities	**27**
Contingent assets	**31**
MEASUREMENT	**36**
Best estimate	**36**
Risk and uncertainties	**42**
Present value	**45**
Future events	**48**
Expected disposals of assets	**51**
REIMBURSEMENTS	**53**
CHANGES IN PROVISIONS	**59**
USE OF PROVISIONS	**61**
APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES	**63**
Future operating losses	**63**
Onerous contracts	**66**
Restructuring	**70**
DISCLOSURE	**84**
TRANSITIONAL PROVISIONS	**94A**
EFFECTIVE DATE	**95**

APPENDICES

A. **Tables – Provisions, contingent liabilities, contingent assets and reimbursements**

B. **Decision tree**

C. **Examples: recognition**

D. **Examples: disclosure**

E. **Comparison with International Accounting Standards**

~~**F.** **Onerous Contracts – Cost of Fulfilling a Contract (Amendments to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)**~~

~~**G.** **Addition of a Basis for Conclusions**~~

BASIS FOR CONCLUSIONS

Hong Kong Accounting Standard 37 *Provisions, Contingent Liabilities and Contingent Assets* (HKAS 37) is set out in paragraphs 1-~~102~~105. All the paragraphs have equal authority. HKAS 37 should be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Changes in provisions

59 **Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.**

60 Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Use of provisions

61 **A provision shall be used only for expenditures for which the provision was originally recognised.**

62 Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the recognition and measurement rules

Future operating losses

63 **Provisions shall not be recognised for future operating losses.**

64 Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

65 An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity tests these assets for impairment under HKAS 36 *Impairment of Assets*.

Onerous contracts

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

67 Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

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

68A The cost of fulfilling a contract comprises the costs that relate directly to the contract. Costs that relate directly to a contract consist of both:

(a) the incremental costs of fulfilling that contract—for example, direct labour and materials; and

(b) an allocation of other costs that relate directly to fulfilling contracts—for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others.

69 Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets ~~dedicated to that~~ used in fulfilling the contract (see HKAS 36).

Restructuring

70 The following are examples of events that may fall under the definition of restructuring:

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

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

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

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

71 A provision for restructuring costs is recognised only when the general recognition criteria for provisions set out in paragraph 14 are met. Paragraphs 72-83 set out how the general recognition criteria apply to restructurings.

72 A constructive obligation to restructure arises only when an entity:

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

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

(ii) the principal locations affected;

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

(iv) the expenditures that will be undertaken; and

(v) when the plan will be implemented; and

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

73 Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (ie setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

74 For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

75 A management or board decision to restructure taken before the end of the reporting period does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period:

(a) started to implement the restructuring plan; or

(b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

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If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting period, disclosure is required under HKAS 10 *Events after the Reporting Period*, if the restructuring is material and non-disclosure could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

76 Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of paragraph 72 are met.

77 In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (e.g. employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.

78 No obligation arises for the sale of an operation until the entity is committed to the sale, ie there is a binding sale agreement.

79 Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under HKAS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

80 A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

(**a**) **necessarily entailed by the restructuring; and**

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

81 A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

82 Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract as defined in paragraph 10.

83 As required by paragraph 51, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

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Disclosure

84 For each class of provision, an entity shall disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (ie incurred and charged against the provision) during the period;

(d) unused amounts reversed during the period; and

(e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required.

85 An entity shall disclose the following for each class of provision:

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

(b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and

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

86 Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 36-52;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

87 In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs 85(a) and (b) and 86(a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

88 Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by paragraphs 84-86 in a way that shows the link between the provision and the contingent liability.

89 Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-52.

90 It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.

91 Where any of the information required by paragraphs 86 and 89 is not disclosed because it is not practicable to do so, that fact shall be stated.

92 **In extremely rare cases, disclosure of some or all of the information required by paragraphs 84-89 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.**

Transitional provisions

93 [Not used]

94 [Not used]

94A *Onerous Contracts—Cost of Fulfilling a Contract*, issued in June 2020, added paragraph 68A and amended paragraph 69. An entity shall apply those amendments to contracts for which it has not yet fulfilled all its obligations at the beginning of the annual reporting period in which it first applies the amendments (the date of initial application). The entity shall not restate comparative information. Instead, the entity shall recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings or other component of equity, as appropriate, at the date of initial application.

Effective date

95 **This Standard becomes operative for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.**

96 This Standard supersedes SSAP 28 *Provisions, Contingent Liabilities and Contingent Assets (*issued in January 2001).

97 [Not used]

98 [Not used]

99 *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraph 5 as a consequential amendment derived from the amendment to HKFRS 3. An entity shall apply that amendment prospectively to business combinations to which the amendment to HKFRS 3 applies.

100 HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 5 and deleted paragraph 6. An entity shall apply those amendments when it applies HKFRS 15.

101 HKFRS 9, as issued in September 2014, amended paragraph 2 and deleted paragraphs 97 and 98. An entity shall apply those amendments when it applies HKFRS 9.

102 HKFRS 16, issued in May 2016, amended paragraph 5. An entity shall apply that amendment when it applies HKFRS 16.

103 *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

104 *Definition of Material* (Amendments to HKAS 1 and HKAS 8), issued in January 2019, amended paragraph 75. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments when it applies the amendments to the definition of material in paragraph 7 of HKAS 1 and paragraphs 5 and 6 of HKAS 8.

105 *Onerous Contracts—Cost of Fulfilling a Contract*, issued in June 2020, added paragraphs 68A and 94A and amended paragraph 69. An entity shall apply those amendments for annual reporting periods beginning on or after 1 January 2022. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

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HKAS 37 BC
Issued December 2021

Basis for Conclusions on
Hong Kong Accounting Standard 37

Provisions, Contingent Liabilities and Contingent Assets

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

BASIS FOR CONCLUSIONS ON IAS 37 *PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS*

Onerous Contracts – Cost of Fulfilling a Contract (Amendments to HKAS 37) is based on *Onerous Contracts – Cost of Fulfilling a Contract* (Amendments to IAS 37). In approving Amendments to HKAS 37, the Financial Reporting Standard Committee of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on Amendments to IAS 37. Accordingly, there are no significant differences between the Amendments to HKAS 37 and the Amendments to IAS 37. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 37 referred to below generally correspond with those in HKAS 37.

CONTENTS

from paragraph

BASIS FOR CONCLUSIONS ON IAS 37 *PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS*

ONEROUS CONTRACTS—COST OF FULFILLING A CONTRACT (PARAGRAPH 68A) **BC1**

The cost of fulfilling a contract **BC2**

Examples **BC14**

Interaction with requirements for impaired assets **BC17**

Scope **BC18**

Transitional provisions **BC20**

Basis for Conclusions on
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

This Basis for Conclusions accompanies, but is not part of, IAS 37. IAS 37 was issued by the International Accounting Standards Committee in 1998 and was not accompanied by a Basis for Conclusions. This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (Board) in developing amendments to IAS 37. Individual Board members gave greater weight to some factors than to others.

Onerous Contracts—Cost of Fulfilling a Contract (paragraph 68A)

BC1 In May 2020 the Board added paragraph 68A to IAS 37. Paragraph 68A specifies which costs an entity includes in determining the cost of fulfilling a contract for the purpose of assessing whether the contract is onerous. The Board added this clarification in response to a recommendation from the IFRS Interpretations Committee, whose research indicated that:

(a) differing views on which costs to include could lead to material differences in the financial statements of entities that enter into some types of contracts.

(b) the need for clarification was urgent. Following the withdrawal of IAS 11 *Construction Contracts*, entities are required to apply IAS 37 instead of IAS 11 to assess whether construction contracts are onerous. IAS 11 specified which costs to include, but IAS 37 did not.

The cost of fulfilling a contract

BC2 Views differed on what an entity should include in the cost of fulfilling a contract when assessing whether the contract is onerous—whether to include:

(a) only the incremental costs of fulfilling the contract—for example, the cost of materials and labour required to construct a building; or

(b) all costs that relate directly to the contract—both the incremental costs and an allocation of other costs that relate directly to fulfilling contracts—for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling the contract among others, or an allocation of the costs of management and supervision of contracts.

BC3 The Board decided to require an entity to include all costs that relate directly to a contract. The Board concluded that:

(a) including all such costs provides more useful information to users of the entity's financial statements (paragraphs BC4–BC7);

(b) the benefits of providing that information are likely to outweigh the costs (paragraphs BC8–BC9); and

(c) a requirement to include all costs that relate directly to a contract is consistent with other requirements in IAS 37 and requirements in other IFRS Standards (paragraphs BC10–BC13).

Useful information

BC4 An entity may obtain the resources it needs to fulfil a contract in different ways. For example, if an entity needs equipment to fulfil a contract to manufacture goods or provide services, it may either hire the equipment for use only on that contract, or buy the equipment and use it on several contracts. The Board concluded that to provide a faithful representation of the effect of a contract on an entity's financial position, the entity should identify the resources needed to fulfil the contract and include the cost of those resources, regardless of how it expects to obtain them. Including only incremental costs in that assessment—for example, the costs of hiring equipment but not an allocation of the depreciation of purchased equipment—would fail to recognise the costs of resources shared with other contracts.

BC5 The Board considered contracts an entity will fulfil using existing assets with idle capacity. If the income from such a contract will exceed the incremental cost of fulfilling it, the contract will improve the entity's financial position and performance. But, unless the income will fully cover the cost of the capacity used, including that cost in assessing whether the contract is onerous might suggest otherwise because the entity will recognise an onerous contract provision and a loss when it incurs a present obligation by entering into the contract. If that capacity were not used to fulfil the contract, such a loss would not be recognised.

BC6 The Board concluded that, even for a contract that will be fulfilled using existing idle capacity, including all costs that relate directly to the contract (that is, including the cost of the capacity used) provides useful information. By entering into a contract at a price that does not fully cover the cost of the capacity used, the entity has committed itself to using that capacity to provide goods or services at a price that would not be sustainable if all contracts were similarly priced. The entity has effectively committed itself to making a loss on that capacity for the life of the contract. In the Board's view, including the cost of the capacity used in assessing whether a contract is onerous provides information that is relevant to users of financial statements and faithfully represents the effect of the contract on the entity's financial position and performance. The Board noted that an entity would disclose additional information about the contract if such information is relevant to an understanding of the entity's financial statements.

BC7 The Board also considered requirements in other IFRS Standards. Several IFRS Standards—such as IAS 2 *Inventories*—specify the costs to include in measuring a non-monetary asset. Although their detailed requirements differ, they all require an entity to include both the incremental costs of purchasing or constructing the asset, and an allocation of other directly related or directly attributable costs, such as production overheads. The Board concluded that, in assessing whether a contract to deliver goods is onerous, the way an entity determines the cost of fulfilling the contract should be broadly consistent with the way it measures the cost of the goods when it holds them. Such consistency leads to more useful information.

Cost of applying the requirements

BC8 The Board discussed suggestions that it might be costly for a manufacturing entity to estimate and allocate all the costs that relate directly to a contract if the entity has not yet manufactured the goods it will deliver under the contract.

BC9 The Board noted that IAS 2 requires an entity to measure the cost of manufactured inventories at an amount that includes both the incremental costs of production and an allocation of production overheads. Further, a manufacturing entity that enters into contracts to supply inventory is likely to need information about these costs to make pricing decisions. Therefore, the entity is likely to have already the information it needs to estimate and allocate the costs that will relate directly to contracts into which it has entered. The Board therefore concluded that a requirement to estimate and allocate costs that relate directly to a contract would not impose costs that outweigh the usefulness of the information provided.

Consistency with other requirements in IAS 37 and requirements in other IFRS Standards

BC10 IAS 37 defines an onerous contract as ‘a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it’. The Board concluded that the unavoidable costs of fulfilling a contract are the costs an entity cannot avoid because it *has* the contract (as opposed to the costs the entity could avoid if it *did not have* the contract). The costs an entity cannot avoid because it has a contract include both the incremental costs of that contract and an allocation of other costs that relate directly to fulfilling contracts, including that contract.

BC11 The Board discussed whether including costs other than the incremental costs of fulfilling a contract would be inconsistent with other requirements in IAS 37. Those holding this view suggested that, because an entity will incur those other costs regardless of whether it fulfils the contract under consideration, the costs are not costs of ‘fulfilling the contract’—they are costs of operating the business. Paragraph 18 of IAS 37 specifies that no provision is recognised for costs that need to be incurred to operate in the future, and paragraph 63 prohibits recognition of future operating losses.

BC12 However, the Board concluded that a requirement to include all costs that relate directly to a contract in assessing whether the contract is onerous is consistent with other requirements in IAS 37. It concluded that:

(a) in recognising an onerous contract provision, an entity would not be recognising a provision for the costs themselves—that is, it would not be identifying those costs as present obligations in their own right. Instead, the entity would be recognising its present obligation to deliver goods or provide services in exchange for other economic benefits, measuring that obligation at an amount that includes the cost of all the resources to be used to fulfil the obligation.

(b) paragraph 63 of IAS 37 prohibits an entity from recognising future operating losses because such losses are not liabilities; in other words, the entity does not have a present obligation to incur those losses. In contrast, in assessing whether a contract is onerous, an entity determines the cost of fulfilling its present obligation under an existing contract. Therefore, including all costs that relate directly to a contract in assessing whether the contract is onerous does not result in an entity recognising future operating losses.

BC13 The Board noted that a requirement to include all costs that relate directly to a contract is consistent with IFRS 17 *Insurance Contracts*. IFRS 17 requires insurers to include all costs that relate directly to the fulfilment of a contract in assessing whether an insurance contract is onerous. These costs include an allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts.

Examples

BC14 When it exposed draft amendments for comment, the Board proposed to include a list of examples of costs that do and do not relate directly to a contract. These examples were based on paragraphs 97–98 of IFRS 15 *Revenue from Contracts with Customers*.

BC15 Some respondents to the Board's draft amendments noted differences between the examples proposed and those in other IFRS Standards that specify which costs to include in measuring the cost of non-monetary assets. Those respondents asked the Board to clarify whether some costs mentioned in those other IFRS Standards would be regarded as costs that relate directly to the contract by an entity applying IAS 37. Respondents also asked the Board to provide examples of costs that relate directly to contracts other than contracts to deliver goods or provide services.

BC16 In response to this feedback, the Board decided to replace the list of examples with a more general description of the types of costs that relate directly to a contract—that is, the incremental costs of fulfilling the contract and an allocation of other costs that relate directly to fulfilling contracts. The Board concluded that the more general description:

(a) can be applied to all types of contract, rather than only to contracts to deliver goods or provide services;

(b) avoids unintended consequences of slight differences in the wording of examples in different IFRS Standards; and

(c) provides a framework within which an entity can judge whether a particular cost relates directly to a contract.

Interaction with requirements for impaired assets

BC17 Paragraph 69 of IAS 37 requires that, before an entity establishes a provision for an onerous contract, the entity recognises any impairment loss that has occurred on assets 'used in fulfilling the contract'. Paragraph 69 originally referred to assets 'dedicated to that contract'. However, the term 'dedicated' could be read to apply only to assets used solely on that contract, and not used on other contracts. The Board amended the terminology in paragraph 69 to clarify that the requirement to recognise any impairment loss before establishing an onerous contract provision applies to all assets whose cost would be considered in assessing whether the contract is onerous.

Scope

BC18 Some respondents to the Board's draft amendments asked the Board to expand the scope of the project to clarify other aspects of the onerous contract requirements in IAS 37, such as:

(a) measuring onerous contracts—whether an entity would consider the same costs in measuring a provision for an onerous contract as it would consider in assessing whether that contract is onerous.

(b) selecting a unit of account—whether, and if so when, an entity should combine groups of similar contracts or segment contracts into components when applying the onerous contract requirements.

BC19 The Board decided not to consider other aspects of the onerous contract requirements in IAS 37 because doing so would have prolonged the project, delaying the issue of amendments regarded as urgent (see paragraph BC1(b)). The amendments therefore do not change the requirements in IAS 37 beyond clarifying the costs an entity is required to include in assessing whether a contract is onerous.

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Transitional provisions

BC20 On transition entities are required to apply the amendments only to contracts for which the entity has not fulfilled all its obligations at the date of initial application, without restating comparative amounts. The Board concluded that it may be difficult and costly for an entity to obtain the information needed to restate comparative amounts, and the information provided by doing so was unlikely to be sufficiently useful to justify the costs that the entity might incur.

BC21 The Board decided not to provide entities with an option to restate comparative amounts—that is, not to provide the option of retrospective application, as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Board concluded that the benefits of providing that option would be limited, and would be outweighed by the complexity and possible loss of comparability between the financial statements of entities applying the amendments at their effective date.

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HKAS 41
Revised ~~July 2019~~December 2021

Hong Kong Accounting Standard 41

Agriculture

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CONTENTS

	from paragraph
INTRODUCTION	**IN1**
HONG KONG ACCOUNTING STANDARD 41	
AGRICULTURE	
OBJECTIVE	
SCOPE	**1**
DEFINITIONS	**5**
Agriculture-related definitions	**5**
General definitions	**8**
RECOGNITION AND MEASUREMENT	**10**
Gains and losses	**26**
Inability to measure fair value reliably	**30**
GOVERNMENT GRANTS	**34**
DISCLOSURE	**40**
General	**40**
Additional disclosures for biological assets where fair value cannot be measured reliably	**54**
Government grants	**57**
EFFECTIVE DATE AND TRANSITION	**58**
APPENDIX – Illustrative examples	
APPENDIX – COMPARISON WITH INTERNATIONAL ACCOUNTING STANDARDS	
BASIS FOR CONCLUSIONS	
BASIS FOR IASC'S CONCLUSIONS	

Hong Kong Accounting Standard 41 *Agriculture* (HKAS 41) is set out in paragraphs 1-645. All the paragraphs have equal authority. HKAS 41 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

22 An entity does not include any cash flows for financing the assets~~, taxation,~~ or re-establishing biological assets after harvest (for example, the cost of replanting trees in a plantation forest after harvest).

23 [Deleted]

24 Cost may sometimes approximate fair value, particularly when

(a) little biological transformation has taken place since initial cost incurrence (for example, for seedlings planted immediately prior to the end of a reporting period or newly acquired livestock); or

(b) the impact of the biological transformation on price is not expected to be material (for example, for the initial growth in a 30-year pine plantation production cycle).

25 Biological assets are often physically attached to land (for example, trees in a plantation forest). There may be no separate market for biological assets that are attached to the land but an active market may exist for the combined assets, that is, for the biological assets, raw land, and land improvements, as a package. An entity may use information regarding the combined assets to measure the fair value of the biological assets. For example, the fair value of raw land and land improvements may be deducted from the fair value of the combined assets to arrive at the fair value of biological assets.

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62 *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41), issued in August 2014, amended paragraphs 1–5, 8, 24 and 44 and added paragraphs 5A–5C and 63. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments retrospectively in accordance with HKAS 8.

63 In the reporting period when *Agriculture: Bearer Plants* (Amendments to HKAS 16 and HKAS 41) is first applied an entity need not disclose the quantitative information required by paragraph 28(f) of HKAS 8 for the current period. However, an entity shall present the quantitative information required by paragraph 28(f) of HKAS 8 for each prior period presented.

64 HKFRS 16, issued in May 2016, amended paragraph 2. An entity shall apply that amendment when it applies HKFRS 16.

65 *Annual Improvements to HKFRS Standards 2018–2020*, issued in June 2020, amended paragraph 22. An entity shall apply that amendment to fair value measurements on or after the beginning of the first annual reporting period beginning on or after 1 January 2022. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

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HKAS 41 BC
Revised ~~August 2020~~December 2021

Basis for Conclusions
Hong Kong Accounting Standard 41

Agriculture

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Basis for Conclusions on
IAS 41 *Agriculture*

This Basis for Conclusions accompanies, but is not part of, IAS 41.

HKAS 41 is based on IAS 41 Agriculture. In approving HKAS 41, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 41. Accordingly, there are no significant differences between HKAS 41 and IAS 41. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 41 referred to below generally correspond with those in HKAS 41.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on amending IAS 41 *Agriculture*, including by issuing ~~*Improvements to IFRSs* in May 2008 and by~~ *Agriculture: Bearer Plants* (Amendments to IAS 16 and IAS 41)[*] in June 2014. Individual Board members gave greater weight to some factors than to others.

BC2 Because the Board's intention was not to reconsider the fundamental approach to the accounting for agriculture established by IAS 41, this Basis for Conclusions does not discuss requirements in IAS 41 that the Board has not reconsidered. The IASC Basis for Conclusions on IAS 41 follows this Basis.

Scope（2008 and 2014 amendments）

Costs to sell (paragraph 5) – 2008 amendments

BC3 Before the *Improvements to IFRSs* issued in May 2008, IAS 41 used the term 'point-of-sale costs'. This term was not used elsewhere in IFRSs. The term 'costs to sell' is used in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 36 *Impairment of Assets*. The Board decided that 'point-of-sale costs' and 'costs to sell' meant the same thing in the context of IAS 41. The word 'incremental' in the definition of 'costs to sell' excludes costs that are included in the fair value measurement of a biological asset, such as transport costs. It includes costs that are necessary for a sale to occur but that would not otherwise arise, such as commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. Both terms relate to transaction costs arising at the point of sale.

BC4 Therefore, the Board decided to replace the terms 'point-of-sale costs' and 'estimated point-of-sale costs' with 'costs to sell' to make IAS 41 consistent with IFRS 5 and IAS 36.

Produce growing on bearer plants – 2014 amendments

BC4A Before *Agriculture: Bearer Plants* (Amendments to IAS 16 and IAS 41) was issued in June 2014, IAS 41 required all biological assets related to agricultural activity to be measured at fair value less costs to sell. However, the Board observed that there is a class of biological assets, bearer plants, that are held by an entity solely to grow produce over their productive life. The Board's principal decision underlying the 2014 amendments is that bearer plants should be treated as property, plant and equipment. Accordingly, the Board decided to account for bearer plants as property, plant and equipment in accordance with the requirements in IAS 16 *Property, Plant and Equipment*.

[*] *Agriculture: Bearer Plants* (Amendments to IAS 16 and IAS 41), issued in June 2014, introduced a definition of a bearer plant. The amendments require biological assets meeting the definition of a bearer plant to be accounted for as property, plant and equipment in accordance with IAS 16 *Property, Plant and Equipment* and as such the amendments are more comprehensively discussed in paragraphs BC38–BC117 of IAS 16. The produce growing on the bearer plants is within the scope of IAS 41. A summary of the specific changes to IAS 41 are discussed in paragraphs BC4A–BC4E of this Standard.

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BC4B Nevertheless the Board noted that the same argument is not true for the produce growing on the bearer plants that is undergoing biological transformation until it is harvested (for example, grapes growing on a grape vine). The Board observed that the produce is a consumable biological asset growing on the bearer plant and the growth of the produce directly increases the expected revenue from the sale of the produce. Consequently, fair value measurement of the growing produce provides useful information to users of financial statements about future cash flows that an entity is expected to realise. In contrast the bearer plants themselves are not sold and the changes in the fair value of the bearer plants do not directly influence the entity's future cash flows. The Board also observed that produce will ultimately be detached from the bearer plants and is normally sold separately, meaning it has a market value on its own. This is in contrast to many bearer plants that are unlikely to have an observable market value on their own because they can only be sold while attached to the land.

BC4C The Board acknowledged that measuring produce growing on bearer plants at fair value less costs to sell sometimes might be difficult to apply in practice. However, it was noted that similar difficulties are encountered when measuring the fair value less costs to sell of the produce growing in the ground. Consequently, the Board decided that it would be inconsistent to provide additional relief from fair value measurement for produce growing on a bearer plant and not also for other biological assets within the scope of IAS 41. The Board observed that if preparers encounter significant practical difficulties on initial measurement of produce, they should consider whether they meet the requirements of the exemptions in paragraphs 10(c) and 30 of IAS 41.

BC4D Consequently, the Board decided to reaffirm that produce is a biological asset within the scope of IAS 41 and should be measured at fair value less costs to sell with changes recognised in profit and loss as the produce grows. This would maintain consistency of accounting for produce growing in the ground and produce growing on a bearer plant. Consequently, the Board decided to keep the produce within the scope of IAS 41.

BC4E The Board noted that most of the areas for which respondents asked for additional guidance were specific to a particular type of bearer plant or produce. The Board decided that because of the specialised nature and diversity of bearer plants and produce it would be too difficult for the Board to develop additional guidance on measuring the fair value of produce.

Recognition and measurement ~~– 2008 amendments~~

Discount rate (paragraph 20) – 2008 amendments

BC5 As part of the annual improvements project begun in 2007, the Board reconsidered whether it is appropriate to require a pre-tax discount rate in paragraph 20 when measuring fair value.[*] The Board noted that a fair value measurement should take into account the attributes, including tax attributes, that a market participant would consider when pricing an asset or liability.

BC6 The Board noted that a willing buyer would factor into the amount that it would be willing to pay the seller to acquire an asset (or would receive to assume a liability) all incremental cash flows that would benefit that buyer. Those incremental cash flows would be reduced by expected income tax payments using appropriate tax rates (ie the tax rate of a market participant buyer). Accordingly, fair value takes into account future income taxes that a market participant purchasing the asset (or assuming the liability) would be expected to pay (or to receive), without regard to an entity's specific tax situation.[#]

[*] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

[#] IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

BC7 Therefore, the Board decided to keep the requirement to use a current market-based discount rate but in *Improvements to IFRSs* issued in May 2008 removed the reference to a pre-tax discount rate in paragraph 20.

Additional biological transformation (paragraph 21) – 2008 amendments

BC8 Sometimes the fair value of an asset in its current location and condition is estimated using discounted cash flows. Paragraph 21 could be read to exclude from such calculations increases in cash flows arising from 'additional biological transformation'. Diversity in practice had developed from different interpretations of this requirement. The Board decided that not including these cash flows resulted in a carrying amount that is not representative of the asset's fair value. The Board noted that an entity should consider the risks associated with cash flows from 'additional biological transformation' in determining the expected cash flows, the discount rate, or some combination of the two. Therefore, the Board decided to amend IAS 41 to remove the prohibition on an entity taking into account the cash flows resulting from 'additional biological transformation' when estimating the fair value of a biological asset.*

BC9 In its exposure draft of proposed *Improvements to International Financial Reporting Standards* published in 2007, the Board proposed changing the definition of biological transformation to include harvest. This was because the Board wished to make clear that harvest altered the condition of a biological asset. Some commentators objected to this change on the basis that harvest is a human activity rather than a biological transformation. The Board agreed with this argument and decided not to include the harvest in the definition of biological transformation. Instead, the Board amended the Standard to refer to biological transformation or harvest when applicable to make clear that harvest changes the condition of an asset.

BC10 Because applying the changes discussed in paragraphs BC8 and BC9 retrospectively might require some entities to remeasure the fair value of biological assets at a past date, the Board decided that these amendments should be applied prospectively.

Taxation in Fair Value Measurements – 2020 amendment

BC11 The 2008 amendments removed the requirement for entities to use a pre-tax discount rate to discount cash flows when measuring fair value (see paragraphs BC5–BC7). At that time the Board did not amend paragraph 22 of IAS 41 to delete the reference to cash flows for taxation. Consequently, before *Annual Improvements to IFRS Standards 2018–2020*, IAS 41 had required an entity to use pre-tax cash flows when measuring fair value but did not require the use of a pre-tax discount rate to discount those cash flows.

BC12 In 2020, the Board amended paragraph 22 to remove the requirement to exclude cash flows for taxation when measuring fair value because:

(a) doing so aligns the requirements in IAS 41 on fair value measurement with those in IFRS 13 *Fair Value Measurement*. When measuring fair value, IFRS 13 neither prescribes the use of a single present value technique nor limits the use of present value techniques to only those discussed in that Standard. However, when using a present value technique, paragraph B14 of IFRS 13 requires assumptions about cash flows and discount rates to be internally consistent. Depending on the particular facts and circumstances, an entity applying a present value technique might measure fair value by discounting after-tax cash flows using an after-tax discount rate or pre-tax cash flows at a rate consistent with those cash flows.

(b) it would appear the Board's intention in amending IAS 41 in 2008 was to permit entities to include tax cash flows in measuring fair value (see paragraph BC6). Removing 'taxation' from paragraph 22 is consistent with that intent.

* IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence, paragraph 21 of IAS 41 has been deleted.

HKFRS 1 (Revised)
Revised ~~August 2020~~December 2021

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standards 1 (Revised)

First-time Adoption of Hong Kong Financial Reporting Standards

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39AC HK(IFRIC)-Int 22 *Foreign Currency Transactions and Advance Consideration* added paragraph D36 and amended paragraph D1. An entity shall apply that amendment when it applies HK(IFRIC)-Int 22.

39AD *Annual Improvements to HKFRS Standards 2014–2016 Cycle*, issued in February 2017, amended paragraphs 39L and 39T and deleted paragraphs 39D, 39F, 39AA and E3–E7. An entity shall apply those amendments for annual periods beginning on or after 1 January 2018.

39AE *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

39AF HK(IFRIC)-Int 23 *Uncertainty over Income Tax Treatments* added paragraph E8. An entity shall apply that amendment when it applies HK(IFRIC)-Int 23.

39AG *Annual Improvements to HKFRS Standards 2018–2020*, issued in June 2020, amended paragraph D1(f) and added paragraph D13A. An entity shall apply that amendment for annual reporting periods beginning on or after 1 January 2022. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

Withdrawal of HKFRS 1 (issued 2003)

40 This HKFRS supersedes HKFRS 1 (issued in 2003 and amended at December 2008).

Appendix D
Exemptions from other HKFRSs

This appendix is an integral part of the HKFRS.

D1 An entity may elect to use one or more of the following exemptions:

(a) share-based payment transactions (paragraphs D2 and D3);

(b) insurance contracts (paragraph D4);

(c) deemed cost (paragraphs D5–D8B);

(d) leases (paragraphs D9 andD9B–D9E);

(e) [deleted]

(f) cumulative translation differences (paragraphs D12–D13A ~~and D13~~);

(g) investments in subsidiaries, joint ventures and associates (paragraphs D14 and D15A);

(h) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs D16 and D17);

(i) compound financial instruments (paragraph D18);

(j) designation of previously recognised financial instruments (paragraph D19-D19C);

(k) fair value measurement of financial assets or financial liabilities at initial recognition (paragraph D20);

(l) decommissioning liabilities included in the cost of property, plant and equipment (paragraphs D21 and D21A);

(m) financial assets or intangible assets accounted for in accordance with HK(IFRIC)-Int 12 *Service Concession Arrangements* (paragraph D22);

(n) borrowing costs (paragraph D23);

(o) [deleted];

(p) extinguishing financial liabilities with equity instruments (paragraph D25);

(q) severe hyperinflation (paragraphs D26–D30);

(r) joint arrangements (paragraph D31);

(s) stripping costs in the production phase of a surface mine (paragraph D32);

(t) designation of contracts to buy or sell a non-financial item (paragraph D33).

(u) revenue (paragraphs D34 and D35); and

(v) foreign currency transactions and advance consideration (paragraph D36).

An entity shall not apply these exemptions by analogy to other items.

D10-D11 [Deleted]

Cumulative translation differences

D12 HKAS 21 requires an entity:

(a) to recognise some translation differences in other comprehensive income and accumulate these in a separate component of equity; and

(b) on disposal of a foreign operation, to reclassify the cumulative translation difference for that foreign operation (including, if applicable, gains and losses on related hedges) from equity to profit or loss as part of the gain or loss on disposal.

D13 However, a first-time adopter need not comply with these requirements for cumulative translation differences that existed at the date of transition to HKFRSs. If a first-time adopter uses this exemption:

(a) the cumulative translation differences for all foreign operations are deemed to be zero at the date of transition to HKFRSs; and

(b) the gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of transition to HKFRSs and shall include later translation differences.

D13A Instead of applying paragraph D12 or paragraph D13, a subsidiary that uses the exemption in paragraph D16(a) may elect, in its financial statements, to measure cumulative translation differences for all foreign operations at the carrying amount that would be included in the parent's consolidated financial statements, based on the parent's date of transition to HKFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary. A similar election is available to an associate or joint venture that uses the exemption in paragraph D16(a).

Investments in subsidiaries, joint ventures and associates

D14 When an entity prepares separate financial statements, HKAS 27 requires it to account for its investments in subsidiaries, joint ventures and associates either:

(a) at cost;

(b) in accordance with HKFRS 9; or

(c) using the equity method as described in HKAS 28.

D15 If a first-time adopter measures such an investment at cost in accordance with HKAS 27, it shall measure that investment at one of the following amounts in its separate opening HKFRS statement of financial position:

(a) cost determined in accordance with HKAS 27; or

(b) deemed cost. The deemed cost of such an investment shall be its:

(i) fair value at the entity's date of transition to HKFRSs in its separate financial statements; or

(ii) previous GAAP carrying amount at that date.

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Basis for Conclusions on
Hong Kong Financial Reporting Standards 1 (Revised)

First-time Adoption of Hong Kong Financial Reporting Standards

Hong Kong Institute of
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(c) Some of the exemptions proposed in ED 1 were implicit options because they relied on the entity's own judgement of undue cost or effort and some others were explicit options. Only a few exemptions were really mandatory.

(d) Unlike the other exceptions to retrospective application, the requirement to apply hedge accounting prospectively was not intended as a pragmatic concession on cost benefit grounds. Retrospective application in an area that relies on designation by management would not be acceptable, even if an entity applied all other aspects of IFRSs retrospectively.

BC29 The Board found these comments persuasive. In finalising the IFRS, the Board grouped the exceptions to retrospective application into two categories:

(a) Some exceptions consist of optional exemptions (paragraphs BC30–BC63E).

(b) The other exceptions prohibit full retrospective application of IFRSs to some aspects of derecognition (paragraphs BC20–BC23), hedge accounting (paragraphs BC75–BC80), and estimates (paragraph BC84).

Exemptions from other IFRSs

BC30 An entity may elect to use one or more of the following exemptions:

(a) business combinations (paragraphs BC31–BC40);

(b) deemed cost (paragraphs BC41–BC47E);

(c) employee benefits (paragraphs BC48–BC52);

(d) cumulative translation differences (paragraphs BC53–BC55C~~BC55~~);

(e) compound financial instruments (paragraphs BC56–BC58);

(f) investments in subsidiaries, jointly controlled entities[*] and associates (paragraphs BC58A–BC58M);

(g) assets and liabilities of subsidiaries, associates and joint ventures (paragraphs BC59–BC63);

(h) designation of previously recognised financial instruments (paragraph BC63A);

(i) share-based payment transactions (paragraph BC63B);

(j) changes in existing decommissioning, restoration and similar liabilities included in the cost of property, plant and equipment (paragraphs BC63C and BC63CA);

(k) leases (paragraphs BC63D–BC63DB);

(l) borrowing costs (paragraph BC63E);

(m) severe hyperinflation (paragraphs BC63F–BC63J); and

(n) joint arrangements (paragraphs BC63K and BC63L).

[*] 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31 and changed the terminology.

(a) An entity might know the aggregate CTDs, but might not know the amount for each subsidiary. If so, it could not transfer that amount to the income statement on disposal of that subsidiary. This would defeat the objective of identifying CTDs as a separate component of equity.

(b) The amount of CTDs in accordance with previous GAAP might be inappropriate as it might be affected by adjustments made on transition to IFRSs to assets and liabilities of foreign entities.

BC55 The Board found these arguments persuasive. Therefore, a first-time adopter need not identify the CTDs at the date of transition to IFRSs (paragraphs D12 and D13 of the IFRS). The first-time adopter need not show that identifying the CTDs would involve undue cost or effort.

Subsidiary as a First-time Adopter (Annual Improvements to IFRS Standards 2018–2020)

BC55A Paragraph D16(a) provides a subsidiary that becomes a first-time adopter later than its parent with an exemption relating to the measurement of its assets and liabilities. Paragraphs BC59–BC60 explain that the Board provided this exemption so that a subsidiary would not have to keep two parallel sets of accounting records based on different dates of transition to IFRSs.

BC55B The exemption in paragraph D16(a) does not apply to components of equity. Accordingly, before the amendment that added paragraph D13A, a subsidiary that became a first-time adopter later than its parent might have been required to keep two parallel sets of accounting records for cumulative translation differences based on different dates of transition to IFRSs. Following the rationale in paragraphs BC59–BC60, the Board decided to extend the exemption in paragraph D16(a) to cumulative translation differences to reduce costs for first-time adopters. The Board noted that IFRS 1 already provides an exemption relating to cumulative translation differences. Extending the exemption in paragraph D16(a) would therefore not diminish the relevance of information reported by a subsidiary that becomes a first-time adopter later than its parent.

BC55C Entities that apply paragraph D16(a) could in some situations find it burdensome to measure cumulative translation differences using the amount reported by the parent. The Board therefore decided to permit, but not require, a subsidiary applying paragraph D16(a) to use that exemption for cumulative translation differences. The amendment also applies to an associate or joint venture that uses the exemption in paragraph D16(a).

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Compound financial instruments

BC56 IAS 32 requires an entity to split a compound financial instrument at inception into separate liability and equity components. Even if the liability component is no longer outstanding, retrospective application of IAS 32 would involve separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component of the instrument.

BC57 Some respondents to ED 1 argued that separating these two portions would be costly if the liability component of the compound instrument is no longer outstanding at the date of transition to IFRSs. The Board agreed with those comments. Therefore, if the liability component is no longer outstanding at the date of transition to IFRSs, a first-time adopter need not separate the cumulative interest on the liability component from the equity component (paragraph D18 of the IFRS).

BC58 Some respondents requested an exemption for compound instruments even if still outstanding at the date of transition to IFRSs. One possible approach would be to use the fair value of the components at the date of transition to IFRSs as deemed cost. However, as the IFRS does not include any exemptions for financial liabilities, the Board concluded that it would be inconsistent to create such an exemption for the liability component of a compound instrument.

Investments in subsidiaries, jointly controlled entities* and associates

BC58A IAS 27 *Consolidated and Separate Financial Statements* requires an entity, in its separate financial statements, to account for investments in subsidiaries, jointly controlled entities* and associates either at cost or in accordance with IAS 39.[#∀] For those investments that are measured at cost, the previous version of IAS 27 (before *Cost of an Investment* in a *Subsidiary, Jointly Controlled Entity or Associate* was issued in May 2008) required an entity to recognise income from the investment only to the extent the entity received distributions from post-acquisition retained earnings (the 'cost method'). Distributions received in excess of such profits were regarded as a recovery of investment and were recognised as a reduction in the cost of the investment.

BC58B For some jurisdictions, these aspects of IAS 27 led to practical difficulties on transition to IFRSs. In order to apply IAS 27 retrospectively, it would be necessary:

(a) to measure the fair value of the consideration given at the date of acquisition; and

(b) to determine whether any dividends received from a subsidiary after its acquisition were paid out of pre-acquisition retained earnings, which would reduce the carrying

* 'Jointly controlled entities' were defined in IAS 31 *Interests in Joint Ventures*. IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31 and changed the terminology.

The consolidation guidance was removed from IAS 27 and the Standard was renamed *Separate Financial Statements* by IFRS 10 *Consolidated Financial Statements* issued in May 2011. The accounting requirements for separate financial statements were not changed.

∀ IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

HKFRS 3 (Revised)
Revised ~~August 2020~~December 2021

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

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CONTENTS

from paragraph

INTRODUCTION **IN1**

HONG KONG FINANCIAL REPORTING STANDARD 3
BUSINESS COMBINATIONS

OBJECTIVE **1**

SCOPE **2**

IDENTIFYING A BUSINESS COMBINATION **3**

THE ACQUISITION METHOD **4**

Identifying the acquirer **6**

Determining the acquisition date **8**

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree **10**

Recognition principle 10

Recognition conditions 11

Classifying or designating identifiable assets acquired and liabilities assumed in a business combination 15

Measurement principle 18

Exceptions to the recognition or measurement principles 21

Exceptions to the recognition principle 22

Exceptions to both the recognition and measurement principles 24

Exceptions to the measurement principle 29

Recognising and measuring goodwill or a gain from a bargain purchase **32**

Bargain purchases 34

Consideration transferred 37

Contingent consideration 39

Additional guidance for applying the acquisition method to particular types of business combinations **41**

A business combination achieved in stages 41

A business combination achieved without the transfer of consideration 43

Measurement period **45**

Determining what is part of the business combination transaction **51**

Acquisition-related costs 53

SUBSEQUENT MEASUREMENT AND ACCOUNTING	**54**
Reacquired rights	**55**
Contingent liabilities	**56**
Indemnification assets	**57**
Contingent consideration	**58**
DISCLOSURES	**59**
EFFECTIVE DATE AND TRANSITION	**64**
Effective date	**64**
Transition	**65**
Income taxes	67
REFERENCE TO HKFRS 9	**67A**
WITHDRAWAL OF HKFRS 3 (issued 2004)	**68**

APPENDICES

A **Defined terms**

B **Application guidance**

C **Amendments to other HKFRSs**

D **Comparison with International Accounting Standards**

~~**E** **Reference to the Conceptual Framework (Amendments to HKFRS 3 *Business Combinations*)**~~

BASIS FOR CONCLUSIONS

ILLUSTRATIVE EXAMPLES

Hong Kong Financial Reporting Standard 3 *Business Combinations* (HKFRS 3) is set out in paragraphs 1 – 68 and Appendices A – C~~ and E~~. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. HKFRS 3 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

This revised Standard was issued in March 2008. It supersedes HKFRS 3 issued in 2004, as amended in 2005 and 2007.

and any non-controlling interest in the acquiree; and

(d) recognising and measuring goodwill or a gain from a bargain purchase.

Identifying the acquirer

6 For each business combination, one of the combining entities shall be identified as the acquirer.

7 The guidance in HKFRS 10 shall be used to identify the acquirer—the entity that obtains *control* of another entity, i.e. the acquiree. If a business combination has occurred but applying the guidance in HKFRS 10 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 shall be considered in making that determination.

Determining the acquisition date

8 The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

9 The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Recognition principle

10 As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.

Recognition conditions

11 To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the ~~*Framework for the Preparation and Presentation of Financial Statements*~~~~*~~ *Conceptual Framework for Financial Reporting* at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post-combination financial statements in accordance with other HKFRSs.

12 In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former *owners*) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 51–53 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable HKFRSs.

~~* For this Standard, acquirers are required to apply the definitions of an asset and a liability and supporting guidance in the *Framework for the Preparation and Presentation of Financial Statements* rather than the *Conceptual Framework for Financial Reporting* issued in 2018.~~

13 The acquirer's application of the recognition principle and conditions may result in recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements. For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

14 Paragraphs B31–B40 provide guidance on recognising intangible assets. Paragraphs ~~22~~21A–28B specify the types of identifiable assets and liabilities that include items for which this HKFRS provides limited exceptions to the recognition principle and conditions.

Classifying or designating identifiable assets acquired and liabilities assumed in a business combination

15 At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other HKFRSs subsequently. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date.

16 In some situations, HKFRSs provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:

(a) classification of particular financial assets and liabilities as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income in accordance with HKFRS 9 *Financial Instruments*;

(b) designation of a derivative instrument as a hedging instrument in accordance with HKFRS 9; and

(c) assessment of whether an embedded derivative should be separated from a host contract in accordance with HKFRS 9 (which is a matter of 'classification' as this HKFRS uses that term).

17 This HKFRS provides two exceptions to the principle in paragraph 15:

(a) classification of a lease contract in which the acquiree is the lessor as either an operating lease or a finance lease in accordance with HKFRS 16 *Leases*; and

(b) classification of a contract as an insurance contract in accordance with HKFRS 4 *Insurance Contracts*.

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

Measurement principle

18 The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

19 For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

(a) fair value; or

(b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by HKFRSs.

20 Paragraphs 24 – 31 specify the types of identifiable assets and liabilities that include items for which this HKFRS provides limited exceptions to the measurement principle.

Exceptions to the recognition or measurement principles

21 This HKFRS provides limited exceptions to its recognition and measurement principles. Paragraphs ~~22~~21A-31 specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs ~~22~~21A-31, which will result in some items being:

(a) recognised either by applying recognition conditions in addition to those in paragraphs 11 and 12 or by applying the requirements of other HKFRSs, with results that differ from applying the recognition principle and conditions.

(b) measured at an amount other than their acquisition-date fair values.

~~Exception~~ Exceptions to the recognition principle

Liabilities and contingent liabilities within the scope of HKAS 37 or HK(IFRIC)-Int 21

21A Paragraph 21B applies to liabilities and contingent liabilities that would be within the scope of HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or HK(IFRIC)-Int 21 *Levies* if they were incurred separately rather than assumed in a business combination.

21B The *Conceptual Framework for Financial Reporting* defines a liability as 'a present obligation of the entity to transfer an economic resource as a result of past events'. For a provision or contingent liability that would be within the scope of HKAS 37, the acquirer shall apply paragraphs 15–22 of HKAS 37 to determine whether at the acquisition date a present obligation exists as a result of past events. For a levy that would be within the scope of HK(IFRIC)-Int 21, the acquirer shall apply HK(IFRIC)-Int 21 to determine whether the obligating event that gives rise to a liability to pay the levy has occurred by the acquisition date.

21C A present obligation identified in accordance with paragraph 21B might meet the definition of a contingent liability set out in paragraph 22(b). If so, paragraph 23 applies to that contingent liability.

Contingent liabilities and contingent assets

22 HKAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ defines a contingent liability as:

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

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

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

23 ~~The requirements in HKAS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the~~ The acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to paragraphs 14(b), 23, 27, 29 and 30 of HKAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Paragraph 56 of this HKFRS provides guidance on the subsequent accounting for contingent liabilities.

23A HKAS 37 defines a contingent asset as 'a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity'. The acquirer shall not recognise a contingent asset at the acquisition date.

Exceptions to both the recognition and measurement principles

Income taxes

24 The acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with HKAS 12 *Income Taxes*.

25 The acquirer shall account for the potential tax effects of temporary differences and carryforwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with HKAS 12.

64H [Deleted]

64I *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraphs 40 and 58 and added paragraph 67A and its related heading. An entity shall apply that amendment prospectively to business combinations for which the acquisition date is on or after 1 July 2014. Earlier application is permitted. An entity may apply the amendment earlier provided that HKFRS 9 and HKAS 37 (both as amended by *Annual Improvements to HKFRSs 2010–2012 Cycle*) have also been applied. If an entity applies that amendment earlier it shall disclose that fact.

64J *Annual Improvements Cycle 2011–2013* issued in January 2014 amended paragraph 2(a). An entity shall apply that amendment prospectively for annual periods beginning on or after 1 July 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

64K HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 56. An entity shall apply that amendment when it applies HKFRS 15.

64L HKFRS 9, as issued in September 2014, amended paragraphs 16, 42, 53, 56, 58 and B41 and deleted paragraphs 64A, 64D and 64H. An entity shall apply those amendments when it applies HKFRS 9.

64M HKFRS 16, issued in May 2016, amended paragraphs 14, 17, B32 and B42, deleted paragraphs B28–B30 and their related heading and added paragraphs 28A–28B and their related heading. An entity shall apply those amendments when it applies HKFRS 16.

64N *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

64O *Annual Improvements to HKFRS Standards 2015–2017 Cycle*, issued in February 2018, added paragraph 42A. An entity shall apply those amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies those amendments earlier, it shall disclose that fact.

64P *Definition of a Business*, issued in January 2019, added paragraphs B7A–B7C, B8A and B12A–B12D, amended the definition of the term 'business' in Appendix A, amended paragraphs 3, B7–B9, B11 and B12 and deleted paragraph B10. An entity shall apply these amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period. Earlier application of these amendments is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

64Q Reference *to the Conceptual Framework*, issued in June 2020, amended paragraphs 11, 14, 21, 22 and 23 and added paragraphs 21A, 21B, 21C and 23A. An entity shall apply those amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2022. Earlier application is permitted if at the same time or earlier an entity also applies all the amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*, issued in June 2018.

Transition

65 Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of this HKFRS shall not be adjusted upon application of this HKFRS.

65A Contingent consideration balances arising from business combinations whose acquisition dates preceded the date when an entity first applied this HKFRS as issued in 2008 shall not be adjusted upon first application of this HKFRS. Paragraphs 65B–65E shall be applied in the subsequent accounting for those balances. Paragraphs 65B–65E shall not apply to the accounting for contingent consideration balances arising from business combinations with acquisition dates on or after the date when the entity first applied this HKFRS as issued in 2008. In paragraphs 65B–65E business combination refers exclusively to business combinations whose acquisition date preceded the application of this HKFRS as issued in 2008.

Basis for Conclusions on

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

Hong Kong Institute of
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Identifying the acquirer **BC82**

Developing the guidance in SFAS 141 BC84

Developing the guidance in IFRS 3 BC93

Identifying an acquirer in a business combination effected through an exchange of equity interests BC94

Identifying an acquirer if a new entity is formed to effect a business combination BC98

Convergence and clarification of SFAS 141's and IFRS 3's guidance for identifying the acquirer BC102

Identifying the acquirer in business combinations involving only mutual entities BC104

Determining the acquisition date **BC106**

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree **BC111**

Recognition BC111

Conditions for recognition BC112

Recognising particular identifiable assets acquired and liabilities assumed BC131

Classifying and designating assets acquired and liabilities assumed BC185

Recognition, classification and measurement guidance for insurance and reinsurance contracts BC189

Measurement BC197

Why establish fair value as the measurement principle? BC198

Definition of fair value BC246

Measuring the acquisition-date fair values of particular assets acquired BC252

Exceptions to the recognition or measurement principle BC263

Exceptions to the recognition principle BC265

Exceptions to both the recognition and measurement principles BC279

Exceptions to the measurement principle BC304

Un-replaced and voluntarily replaced share-based payment transactions BC311A

Disclosure requirements of IFRS 3	**BC411**
Disclosure requirements of the revised standards	**BC419**
Disclosure of information about post-combination revenue and profit or loss of the acquiree	**BC423**
EFFECTIVE DATE AND TRANSITION	**BC429**
Effective date and transition for combinations of mutual entities or by contract alone	**BC433**
Transition requirements for contingent consideration from a business combination that occurred before the effective date of IFRS 3 (as revised in 2008)	**BC434A**
Effective date and transition for clarifications of the accounting for contingent consideration that arises from business combinations	**BC434D**
Scope exceptions for joint ventures	**BC434E**
Previously held interest in a joint operation (amendments issued in December 2017)	**BC434F**
Amendments issued in May 2020	**BC434G**
BENEFITS AND COSTS	**BC435**
DISSENTING OPINIONS ON IFRS 3	

APPENDIX~~CES~~

A **Amendments to the Basis for Conclusions on other IFRSs**

~~**B** **Reference to the Conceptual Framework (Amendments to the Basis for Conclusions on IFRS 3 *Business Combinations*)**~~

An asset or a liability at the acquisition date

BC113 In determining whether an item should be recognised at the acquisition date as part of the business combination, the boards decided that the appropriate first step is to apply the definitions of assets and liabilities in the IASB's *Framework* or FASB Concepts Statement No. 6 *Elements of Financial Statements*, respectively.

BC114 The boards observed that in accordance with both IFRS 3 and SFAS 141, and their predecessors and the related interpretative guidance, particular items were recognised **as if** they were assets acquired or liabilities assumed at the acquisition date even though they did not meet the definition of an asset or a liability. That practice was related to the previous emphasis on measuring the cost of (or investment in) the acquiree rather than the acquisition-date fair values of the assets acquired and liabilities assumed. For example, as discussed in paragraphs BC365–BC370, some expenses for services received in connection with a business combination were capitalised as part of the cost of the acquiree (and recognised as part of goodwill) **as if** they were an asset at the acquisition date. In addition, some future costs that an acquirer expected to incur often were viewed as a cost of the acquiree and recognised **as if** they were a liability at the acquisition date–expected restructuring costs were an example. The boards concluded that the representational faithfulness, consistency and understandability of financial reporting would be improved by eliminating such practices.

BC114A Paragraph 11 of IFRS 3 ~~contains references~~ referred to the definitions of an asset and a liability in the *Framework for the Preparation and Presentation of Financial Statements* (*Framework*). It ~~requires~~ required those definitions to be used when deciding whether to recognise assets and liabilities as part of a business combination. In developing the revised *Conceptual Framework for Financial Reporting*, issued in 2018 (2018 *Conceptual Framework*), the IASB considered whether it should replace ~~those references~~ that reference with ~~references~~ a reference to the revised definitions in the 2018 *Conceptual Framework*. In some cases, applying the revised definitions could change which assets and liabilities qualify for recognition in a business combination. In some such cases, the post-acquisition accounting required by other IFRS Standards could then lead to immediate derecognition of assets or liabilities recognised in a business combination, resulting in so-called *Day 2 gains or losses* that do not depict an economic gain or loss.

BC114B Although the IASB intended to replace all references to the *Framework* with references to the 2018 *Conceptual Framework*, the IASB did not intend to make significant changes to the requirements of IFRS Standards containing those references. Consequently, the IASB decided to retain the reference to the *Framework* in paragraph 11 of IFRS 3 until it ~~completes~~had completed an analysis of the possible consequences of referring in that paragraph to the revised definitions of an asset and a liability. ~~Once that analysis is complete, the IASB intends to amend IFRS 3 to replace the reference to the *Framework* in a way that avoids unintended consequences, such as *Day 2 gains or losses*.~~

BC114C The IASB's analysis led it to conclude that the problem of *Day 2 gains or losses* would be significant in practice only for liabilities that an acquirer accounts for after the acquisition date by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IFRIC 21 *Levies*. To avoid the problem, the IASB decided to add a further exception to the recognition principle in IFRS 3. The reasons for making this exception are explained in paragraphs BC264A–BC264E. The IASB noted that adding this exception to the recognition principle would not only avoid *Day 2 gains or losses*; it would also avoid any changes to the assets and liabilities recognised in a business combination ahead of any future amendments to align IAS 37 and IFRIC 21 with the 2018 *Conceptual Framework*.

BC114D The IASB replaced the reference to the *Framework* and added the exception to its recognition principle in May 2020. At the same time, the IASB made two other amendments to clarify aspects of IFRS 3 that it concluded would not be affected by replacing the reference to the *Framework*:

(a) the IASB added paragraph 23A to IFRS 3 to clarify the requirements for contingent assets—that is, possible assets whose existence is uncertain. IFRS 3 prohibits the recognition of contingent assets acquired in a business combination. This prohibition can be inferred from the recognition principle and is confirmed in paragraph BC276 of this Basis for Conclusions. However, the prohibition was not stated explicitly in IFRS 3 itself, and questions arose as to how it would be affected by replacing the reference to the *Framework*. The IASB concluded it would be unaffected—the 2018 *Conceptual Framework* specifies criteria for recognising assets and liabilities, and paragraph 5.14 says that these criteria might not be met if it is uncertain whether an asset exists. The IASB added paragraph 23A to IFRS 3 to make its requirements for contingent assets explicit and clarify that replacing the reference to the *Framework* does not change them.

(b) the IASB deleted paragraph BC125 from this Basis for Conclusions. In applying any IFRS Standard, an entity should apply only the recognition criteria specified in that Standard. However, paragraph BC125 referred to the *Framework* in a way that could be read to mean that, in applying IFRS 3, an acquirer of a business should apply both the recognition criteria specified in IFRS 3 and other recognition criteria discussed in the *Framework*. The IASB deleted paragraph BC125 because of its potential to cause misunderstanding. The IASB does not usually amend the basis for its previous conclusions, but decided that, in this instance, the importance of reducing the risk of misunderstanding warranted the deletion.

Part of the business combination

BC115 The second condition for recognising an asset acquired or a liability assumed or incurred in a business combination is that the asset or liability must be part of the business combination transaction rather than an asset or a liability resulting from a separate transaction. Making that distinction requires an acquirer to identify the components of a transaction in which it obtains control over an acquiree. The objective of the condition and the guidance on identifying the components of a business combination is to ensure that each component is accounted for in accordance with its economic substance.

BC116 The boards decided to provide application guidance to help address concerns about the difficulty of determining whether a part of the consideration transferred is for the acquiree or is for another purpose. The boards observed that parties directly involved in the negotiations of an impending business combination may take on the characteristics of related parties. Therefore, they may be willing to enter into other agreements or include as part of the business combination agreement some arrangements that are designed primarily for the benefit of the acquirer or the combined entity, for example, to achieve more favourable financial reporting outcomes after the business combination. Because of those concerns the boards decided to develop a principle for determining whether a particular transaction or arrangement entered into by the parties to the combination is part of what the acquirer and acquiree exchange in the business combination or is a separate transaction.

BC117 The boards concluded that a transaction that is designed primarily for the economic benefit of the acquirer or the combined entity (rather than the acquiree or its former owners before the business combination) is not part of the exchange for the acquiree. Those transactions should be accounted for separately from the business combination. The boards acknowledge that judgement may be required to determine whether part of the consideration paid or the assets acquired and liabilities assumed stems from a separate transaction. Accordingly, the 2005 Exposure Draft included both a general principle and implementation guidance for applying that principle, including several examples.

BC118 Respondents' comments on the proposed guidance on identifying the components of a business combination transaction were mixed. For example, some respondents said that the general principle was clear and provided adequate guidance; others said that the proposed principle was not clear. Several respondents said that the focus on determining whether a transaction benefits the acquiree or the acquirer was not clear because a transaction or event that benefits the acquiree would also benefit the combined entity because the acquiree is part of the combined entity.

BC119 The boards agreed with respondents that the proposed principle for distinguishing between components of a business combination needed improvement. Accordingly, they revised the principle to focus on whether a transaction is entered into by or on behalf of the acquirer or **primarily** for the benefit of the acquirer or the combined entity, rather than **primarily** for the benefit of the acquiree or its former owners **before the combination** (paragraph 52 of the revised IFRS 3).

BC124 To provide additional help in identifying the components of a business combination, paragraph B50 of the revised IFRS 3 includes three factors to be considered in assessing a business combination transaction: (a) the reason for the transaction, (b) who initiated the transaction and (c) the timing of the transaction. Although those factors are neither mutually exclusive nor individually conclusive, the boards decided that the factors could help in considering whether a transaction or event is arranged primarily for the economic benefit of the acquirer or the combined entity or primarily for the benefit of the acquiree and its former owners before the business combination.

~~IFRS 3's criterion on reliability of measurement~~

BC125 ~~IFRS 3 included another recognition criterion for assets acquired or liabilities assumed in a business combination. That criterion required an asset or liability to be recognised separately from goodwill only if it could be reliably measured. In its deliberations leading to the revised IFRS 3, the IASB decided to eliminate reliability of measurement as an overall criterion, which it observed is unnecessary because reliability of measurement is a part of the overall recognition criteria in the *Framework*.~~[Deleted][#]

IFRS 3's criterion on probability of an inflow or outflow of benefits

BC126 IFRS 3 provided that an acquirer should recognise the acquiree's identifiable assets (other than intangible assets) and liabilities (other than contingent liabilities) only if it is probable that the asset or liability will result in an inflow or outflow of economic benefits. The revised IFRS 3 does not contain that probability recognition criterion and thus it requires the acquirer to recognise identifiable assets acquired and liabilities assumed regardless of the degree of probability of an inflow or outflow of economic benefits.

BC127 The recognition criteria in the *Framework* include the concept of probability to refer to the degree of uncertainty that the future economic benefits associated with an asset or liability will flow to or from the entity.

BC128 During the development of the revised IFRS 3, the IASB reconsidered items described in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as contingent assets and contingent liabilities. Analysing the rights or obligations in such items to determine which are conditional and which are unconditional clarifies the question of whether the entity has an asset or a liability at the acquisition date.[*] As a result, the IASB concluded that many items previously described as contingent assets or contingent liabilities meet the definition of an asset or a liability in the *Framework* because they contain unconditional rights or obligations as well as conditional rights or obligations. Once the unconditional right in an asset (the unconditional obligation in a liability) is identified, the question to be addressed becomes what is the inflow (outflow) of economic benefits relating to that unconditional right (unconditional obligation).

BC129 The IASB noted that the *Framework* articulates the probability recognition criterion in terms of a flow of economic benefits rather than just direct cash flows. If an entity has an unconditional obligation, it is certain that an outflow of economic benefits from the entity is required, even if there is uncertainty about the timing and the amount of the outflow of benefits associated with a related conditional obligation. Hence, the IASB concluded that the liability (the unconditional obligation) satisfies the *Framework's* probability recognition criterion. That conclusion applies equally to unconditional rights. Thus, if an entity has an unconditional right, it is certain that it has the right to an inflow of economic benefits, and the probability recognition criterion is satisfied.

[#] See paragraph BC114D(b).

[*] Paragraphs BC11–BC17 and BC22–BC26 of the Basis for Conclusions on the draft amendments to IAS 37, published for comment in June 2005, discuss this issue in more detail.

Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them

BC261 While the revised standards were being developed, the FASB received enquiries about inconsistencies in practice in accordance with SFAS 141 related to measuring particular intangible assets that an acquirer intends not to use or intends to use in a way different from the way other market participants would use them. For example, if the acquirer did not intend to use a brand name acquired in a business combination, some entities assigned no value to the asset and other entities measured it at the amount at which market participants could be expected to exchange the asset, ie at its fair value.

BC262 To avoid such inconsistencies in practice, the boards decided to clarify the measurement of assets that an acquirer intends not to use (paragraph B43 of the revised IFRS 3). The intention of both IFRS 3 and SFAS 141 was that assets, both tangible and intangible, should be measured at their fair values regardless of how or whether the acquirer intends to use them. The FASB observed that measuring such assets in accordance with their highest and best use is consistent with SFAS 157. Paragraph A12 of SFAS 157 illustrates determining the fair value of an in-process research and development project acquired in a business combination that the acquirer does not intend to complete. The IASB understands from its consultation with preparers, valuation experts and auditors that IFRS 3 was applied in the way the revised standards require.*

Exceptions to the recognition or measurement principle

BC263 As indicated in paragraphs 14 and 20 of the revised IFRS 3, the revised standards include limited exceptions to its recognition and measurement principles. Paragraphs BC265–BC311 discuss the types of identifiable assets and liabilities for which exceptions are provided and the reasons for those exceptions.

BC264 It is important to note that not every item that falls into a particular type of asset or liability is an exception to either the recognition or the measurement principle (or both). For example, contingent liabilities are identified as an exception to the recognition principle because the revised IFRS 3 includes a recognition condition for them in addition to the recognition conditions in paragraphs 11 and 12. Although applying that additional condition will result in not recognising some contingent liabilities, those that meet the additional condition will be recognised in accordance with the recognition principle. Another example is employee benefits, which are identified as a type of asset or liability for which exceptions to both the recognition and the measurement principles are provided. As discussed further in paragraphs BC296–BC300, the acquirer is required to recognise and measure liabilities and any related assets resulting from the acquiree's employee benefit arrangements in accordance with IAS 19 *Employee Benefits* rather than by applying the recognition and measurement principles in the revised IFRS 3. Applying the requirements of IAS 19 will result in recognising many, if not most, types of employee benefit liabilities in the same way as would result from applying the recognition principle (see paragraph BC297). However, others, for example withdrawal liabilities from multi-employer plans for entities applying US GAAP, are not necessarily consistent with the recognition principle. In addition, applying the requirements of IAS 19 generally will result in measuring liabilities for employee benefits (and any related assets) on a basis other than their acquisition-date fair values. However, applying the requirements of SFAS 146 to one-off termination benefits results in measuring liabilities for those benefits at their acquisition-date fair values.

* IFRS 13, issued in May 2011, describes the concept of highest and best use and provides examples of its application in a business combination.

~~Exception~~ Exceptions to the recognition principle

Liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21 (paragraphs 21A–21C)

BC264A Paragraph 11 of IFRS 3 specifies that, to qualify for recognition at the acquisition date, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the 2018 *Conceptual Framework*. Paragraph 54 of IFRS 3 specifies that after the acquisition date, an entity generally accounts for those assets and liabilities in accordance with other applicable IFRS Standards for those items.

BC264B As a result of applying the definition of a liability in the 2018 *Conceptual Framework*, an acquirer might recognise at the acquisition date a liability to pay a levy that it would not recognise subsequently when applying IFRIC 21 *Levies*. This difference arises because an entity might recognise a liability earlier applying the 2018 *Conceptual Framework*. Applying IFRIC 21, an entity recognises a liability to pay a levy only when it conducts the activity that triggers the payment of the levy, whereas applying the 2018 *Conceptual Framework*, an entity recognises a liability when it conducts an earlier activity if:

(a) conducting that earlier activity means the entity may have to pay a levy it would not otherwise have had to pay; and

(b) the entity has no practical ability to avoid the later activity that will trigger payment of the levy.

BC264C If an acquirer recognised a liability to pay a levy at the acquisition date when applying the 2018 *Conceptual Framework* and derecognised the liability immediately afterwards when applying IFRIC 21, it would recognise a so-called *Day 2 gain*. This recognised gain would not depict an economic gain, so would not faithfully represent any aspect of the entity's financial performance.

BC264D The IASB noted that IFRIC 21 is an interpretation of IAS 37, and so concluded that the problem of *Day 2 gains* could arise not only for levies within the scope of IFRIC 21 but also for other obligations within the scope of IAS 37. To avoid this problem, the IASB added paragraph 21B to IFRS 3. This paragraph makes an exception from the requirements of paragraph 11 for liabilities and contingent liabilities that would be within the scope of IAS 37 or IFRIC 21 if incurred separately, rather than assumed in a business combination. The exception requires an entity to apply criteria in IAS 37 or IFRIC 21 respectively to determine whether a present obligation exists at the acquisition date. The exception refers to IFRIC 21 as well as IAS 37 because, although IFRIC 21 is an interpretation of IAS 37, it also applies to levies whose timing and amount are certain and so are outside the scope of IAS 37.

BC264E A present obligation identified applying the exception in paragraph 21B of IFRS 3 might meet the definition of a contingent liability. This will be the case if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or if the amount of the obligation cannot be measured with sufficient reliability. The IASB added paragraph 21C to IFRS 3 to clarify that, if the present obligation identified applying paragraph 21B meets the definition of a contingent liability, paragraph 23 of IFRS 3 also applies to that contingent liability.

Assets and liabilities arising from contingencies (paragraphs 22–23A)

BC265 Both the FASB's conclusions on recognising assets and liabilities arising from contingencies and the IASB's conclusions on recognising contingent liabilities resulted in exceptions to the recognition principle in the revised standards because both will result in some items being unrecognised at the acquisition date. However, the details of the

transaction or other event. For a liability, the more-likely-than-not criterion focuses on whether the acquirer has a present obligation to sacrifice future economic benefits as a result of a past transaction or other event. If that criterion is met at the acquisition date, the acquirer recognises the asset or liability, measured at its acquisition-date fair value, as part of the accounting for the business combination. If that criterion is not met at the acquisition date, the acquirer accounts for the non-contractual contingency in accordance with other US GAAP, including SFAS 5, as appropriate. The FASB concluded that adding the more-likely-than-not criterion would permit acquirers to focus their efforts on the more readily identifiable contingencies of acquirees, thereby avoiding spending disproportionate amounts of time searching for contingencies that, even if identified, would have less significant effects.

The IASB's conclusions on contingent liabilities and contingent assets

BC272 In developing the 2005 Exposure Draft, the IASB concluded that an asset or a liability should be recognised separately from goodwill if it satisfies the definitions in the *Framework*. In some cases, the amount of the future economic benefits embodied in the asset or required to settle the liability is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. That uncertainty is reflected in measurement. The FASB reached a consistent conclusion.

BC273 At the same time as it published the 2005 Exposure Draft, the IASB also published for comment a separate exposure draft containing similar proposals on the accounting for contingent assets and contingent liabilities within the scope of IAS 37. At that time, the IASB expected that the effective date of the revised IAS 37 would be the same as the effective date of the revised IFRS 3. However, the IASB now expects to issue a revised IAS 37 at a later date. Accordingly, except for clarifying that an acquirer should not recognise a so-called contingent liability that is not an obligation at the acquisition date, the IASB decided to carry forward the related requirements in the original IFRS 3. The IASB expects to reconsider and, if necessary, amend the requirements in the revised IFRS 3 when it issues the revised IAS 37.

BC274 The IASB concluded that an acquirer should recognise a contingent liability assumed in a business combination only if it satisfies the definition of a liability in the *Framework*. This is consistent with the overall objective of the second phase of the project on business combinations in which an acquirer recognises the assets acquired and liabilities assumed at the date control is obtained.

BC275 However, the IASB observed that the definition of a contingent liability in IAS 37 includes both (a) 'possible obligations' and (b) present obligations for which either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured reliably. The IASB concluded that a contingent liability assumed in a business combination should be recognised only if it is a present obligation. Therefore, unlike the previous version of IFRS 3, the revised IFRS 3 does not permit the recognition of 'possible obligations'.

BC276 Like its decision on the recognition of contingent liabilities assumed in a business combination, the IASB concluded that an acquirer should recognise a contingent asset acquired in a business combination only if it satisfies the definition of an asset in the *Framework*. However, the IASB observed that the definition of a contingent asset in IAS 37 includes only 'possible assets'. A contingent asset arises when it is uncertain whether an entity has an asset at the end of the reporting period, but it is expected that some future event will confirm whether the entity has an asset. Accordingly, the IASB concluded that contingent assets should not be recognised, even if it is virtually certain that they will become unconditional or non-contingent. If an entity determines that an asset exists at the acquisition date (ie that it has an unconditional right at the acquisition date), that asset is not a contingent asset and should be accounted for in accordance with the appropriate IFRS.

BC276A In May 2020 the IASB added paragraph 23A to IFRS 3 to clarify the requirements for contingent assets. This amendment is explained further in paragraph BC114D(a).

BC276B The requirements for recognising contingent liabilities and contingent assets include both applications of and exceptions to the recognition principle. The IASB located all these requirements in the section headed 'exceptions to the recognition principle' because it concluded the requirements are clearest if they are all located together.

Effective date and transition for clarifications of the accounting for contingent consideration that arises from business combinations

BC434D *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, clarifies the accounting for contingent consideration that arises from business combinations. The IASB considered whether the transition provisions of paragraph 19 in IAS 8 should apply, which require retrospective application. The IASB considered that the amendments required fair value measurement, and that some entities might not have previously applied fair value measurement for the subsequent measurement of contingent consideration. Retrospective application might therefore require the determination of fair value for contingent consideration, which might not have been previously measured at fair value following initial recognition. It may be impracticable for an entity to determine the fair value of such contingent consideration without using hindsight. Consequently, the IASB decided to require prospective application to avoid the risk of hindsight being applied. The IASB also decided on a 1 July 2014 mandatory effective date for the amendments to IFRS 3 and the consequential amendments to IAS 37 as well as to IFRS 9 and IAS 39, depending on the financial instruments Standard that is applied by the entity at the time that this amendment becomes effective.

Scope exceptions for joint ventures

BC434E *Annual Improvements Cycle 2011–2013* issued in December 2013 amended paragraph 2(a) and added paragraph 64J to clarify the scope exception in paragraph 2(a) of IFRS 3. It took into consideration the transition provisions and effective date of the amendment to IFRS 3. In order to be consistent with the prospective initial application of IFRS 3, the IASB decided that an entity shall apply the amendment to IFRS 3 prospectively for annual periods beginning on or after 1 July 2014.

Previously held interest in a joint operation (amendments issued in December 2017)

BC434F The IASB decided that an entity applies paragraph 42A to business combinations occurring on or after the date it first applies the amendments. Applying the amendments to business combinations occurring before that date may have required the use of hindsight to remeasure the entity's previously held interest.

Amendments issued in May 2020

BC434G *Reference to the Conceptual Framework*, issued in May 2020, updated paragraph 11 of IFRS 3, replacing a reference to the *Framework* with a reference to the 2018 *Conceptual Framework*. It made further amendments to avoid unintended consequences of updating the reference.

BC434H Paragraph 64Q of IFRS 3 requires an entity to apply these amendments prospectively. It also permits an entity to apply the amendments before their effective date, without disclosing that it has done so. The IASB concluded that no significant benefits would be gained from requiring either retrospective application or disclosure of early application. The IASB reached this conclusion because it did not expect the amendments to change significantly the population of assets and liabilities recognised in a business combination.

Benefits and costs

BC435 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is substantially a judgemental process. Furthermore, the costs do not necessarily fall on those who enjoy the benefits. For these reasons, it is difficult to apply a cost-benefit test in any particular case. In making its judgement, the IASB considers:

(a) the costs incurred by preparers of financial statements;

(b) the costs incurred by users of financial statements when information is not available;

(c) the comparative advantage that preparers have in developing information, when compared with the costs that users would incur to develop surrogate information; and

(d) the benefit of better economic decision-making as a result of improved financial reporting.

In the second phase of the business combinations project the IASB also considered the costs and benefits of the revised IFRS 3 relative to IFRS 3.

BC436 The IASB concluded that the revised IFRS 3 benefits both preparers and users of financial statements by converging to common high quality, understandable and enforceable accounting standards for business combinations in IFRSs and US GAAP. This improves the comparability of financial information around the world and it also simplifies and reduces the costs of accounting for entities that issue financial statements in accordance with both IFRSs and US GAAP.

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Hong Kong Financial Reporting Standard 9 (2014)

Financial Instruments

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7.1.3 *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraphs 4.2.1 and 5.7.5 as a consequential amendment derived from the amendment to HKFRS 3. An entity shall apply that amendment prospectively to business combinations to which the amendment to HKFRS 3 applies.

7.1.4 HKFRS 15, issued in July 2014, amended paragraphs 3.1.1, 4.2.1, 5.1.1, 5.2.1, 5.7.6, B3.2.13, B5.7.1, C5 and C42 and deleted paragraph C16 and its related heading. Paragraphs 5.1.3 and 5.7.1A, and a definition to Appendix A, were added. An entity shall apply those amendments when it applies HKFRS 15.

7.1.5 HKFRS 16, issued in May 2016, amended paragraphs 2.1, 5.5.15, B4.3.8, B5.5.34 and B5.5.46. An entity shall apply those amendments when it applies HKFRS 16.

7.1.6 [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]

7.1.7 *Prepayment Features with Negative Compensation* (Amendments to HKFRS 9), issued in November 2017, added paragraphs 7.2.29–7.2.34 and B4.1.12A and amended paragraphs B4.1.11(b) and B4.1.12(b). An entity shall apply these amendments for annual periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

7.1.8 *Interest Rate Benchmark Reform*, which amended HKFRS 9, HKAS 39 and HKFRS 7, issued in November 2019, added Section 6.8 and amended paragraph 7.2.26. An entity shall apply these amendments for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

7.1.9 ~~*[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*~~*Annual Improvements to HKFRS Standards 2018–2020*, issued in June 2020, added paragraphs 7.2.35 and B3.3.6A and amended paragraph B3.3.6. An entity shall apply that amendment for annual reporting periods beginning on or after 1 January 2022. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

7.1.10 *Interest Rate Benchmark Reform—Phase 2*, which amended HKFRS 9, HKAS 39, HKFRS 7, HKFRS 4 and HKFRS 16, issued in October 2020, added paragraphs 5.4.5–5.4.9, 6.8.13, Section 6.9 and paragraphs 7.2.43–7.2.46. An entity shall apply these amendments for annual periods beginning on or after 1 January 2021. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

7.2 Transition

7.2.1 An entity shall apply this Standard retrospectively, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 7.2.4–7.2.26 and 7.2.28. This Standard shall not be applied to items that have already been derecognised at the date of initial application.

7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1, 7.2.3–7.2.28 and 7.3.2, the date of initial application is the date when an entity first applies those requirements of this Standard and must be the beginning of a reporting period after the issue of this Standard. Depending on the entity's chosen approach to applying HKFRS 9, the transition can involve one or more than one date of initial application for different requirements.

Transition for classification and measurement (Chapters 4 and 5)

7.2.3 At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraphs 4.1.2(a) or 4.1.2A(a) on the basis of the facts and circumstances that exist at that date. The resulting classification shall be applied retrospectively irrespective of the entity's business model in prior reporting periods.

7.2.34 In the reporting period that includes the date of initial application of these amendments, the entity shall disclose the following information as at that date of initial application for each class of financial assets and financial liabilities that were affected by these amendments:

(a) the previous measurement category and carrying amount determined immediately before applying these amendments;

(b) the new measurement category and carrying amount determined after applying these amendments;

(c) the carrying amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated; and

(d) the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.

Transition for Annual Improvements to HKFRS Standards

7.2.35 An entity shall apply *Annual Improvements to HKFRS Standards 2018–2020* to financial liabilities that are modified or exchanged on or after the beginning of the annual reporting period in which the entity first applies the amendment.

7.2.3~~5~~6- 7.2.42 *[These paragraphs refer to amendments that are not yet effective, and are therefore not included in this edition.]*

Transition for *Interest Rate Benchmark Reform—Phase 2*

7.2.43 An entity shall apply *Interest Rate Benchmark Reform—Phase 2* retrospectively in accordance with HKAS 8, except as specified in paragraphs 7.2.44–7.2.46.

7.2.44 An entity shall designate a new hedging relationship (for example, as described in paragraph 6.9.13) only prospectively (ie an entity is prohibited from designating a new hedge accounting relationship in prior periods). However, an entity shall reinstate a discontinued hedging relationship if, and only if, these conditions are met:

(a) the entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging relationship if these amendments had been applied at that time; and

(b) at the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (after taking into account these amendments).

7.2.45 If, in applying paragraph 7.2.44, an entity reinstates a discontinued hedging relationship, the entity shall read references in paragraphs 6.9.11 and 6.9.12 to the date the alternative benchmark rate is designated as a non-contractually specified risk component for the first time as referring to the date of initial application of these amendments (ie the 24-month period for that alternative benchmark rate designated as a non-contractually specified risk component begins from the date of initial application of these amendments).

7.2.46 An entity is not required to restate prior periods to reflect the application of these amendments. The entity may restate prior periods if, and only if, it is possible without the use of hindsight. If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application of these amendments in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.

7.3 Withdrawal of HK(IFRIC) - Int 9, HKFRS 9 (2009), HKFRS 9 (2010) and HKFRS 9 (2013)

7.3.1 This Standard supersedes HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives*. The requirements added to HKFRS 9 in November 2010 incorporated the requirements previously set out in paragraphs 5 and 7 of HK(IFRIC)-Int 9. As a consequential amendment, HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* incorporated the requirements previously set out in paragraph 8 of HK(IFRIC)-Int 9.

7.3.2 This Standard supersedes HKFRS 9 (2009), HKFRS 9 (2010) and HKFRS 9 (2013). However, for annual periods beginning before 1 January 2018, an entity may elect to apply those earlier versions of HKFRS 9 instead of applying this Standard if, and only if, the entity's relevant date of initial application is before 1 February 2015.

B3.3.4 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.

B3.3.5 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 3.2.1–3.2.23 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.

B3.3.6 For the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. In determining those fees paid net of fees received, a borrower includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf.

B3.3.6A If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

B3.3.7 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and

(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Classification (Chapter 4)

Classification of financial assets (Section 4.1)

The entity's business model for managing financial assets

B4.1.1 Paragraph 4.1.1(a) requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets, unless paragraph 4.1.5 applies. An entity assesses whether its financial assets meet the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a) on the basis of the business model as determined by the entity's key management personnel (as defined in HKAS 24 *Related Party Disclosures*).

B4.1.2 An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes. Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into subportfolios in order to reflect the level at which an entity manages those financial assets. For example, that may be the case if an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them.

HKFRS 9 BC
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Basis for Conclusions on
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not related to the entire asset, but is limited in amount. The IASB noted that precluding derecognition to the extent of the continuing involvement is useful to users of financial statements in such cases, because it reflects the entity's retained exposure to the risks and rewards of the financial asset better than full derecognition.

BCZ3.28 When the entity transfers some significant risks and rewards and retains others and derecognition is precluded because the entity retains control of the transferred asset, the entity no longer retains all the upside and downside exposure to gains and losses resulting from the transferred asset. Consequently, the revised IAS 39 required (and IFRS 9 now requires) the asset and the associated liability to be measured in a way that ensures that any changes in value of the transferred asset that are not attributed to the entity are not recognised by the entity.

BCZ3.29 For example, special measurement and income recognition issues arise if derecognition is precluded because the transferor has retained a call option or written a put option and the asset is measured at fair value. In those situations, in the absence of additional guidance, application of the general measurement and income recognition requirements for financial assets and financial liabilities may result in accounting that does not represent the transferor's rights and obligations related to the transfer.

Improved disclosure requirements issued in October 2010

BC3.30 In March 2009 the IASB published an Exposure Draft *Derecognition* (Proposed amendments to IAS 39 and IFRS 7) (the '2009 Derecognition Exposure Draft'). In June 2009 the IASB held public round tables in North America, Asia and Europe to discuss the proposals in the 2009 Derecognition Exposure Draft. In addition to the round tables, the IASB undertook an extensive outreach programme with users, preparers, regulators, auditors, trade associations and others.

BC3.31 However, in June 2010 the IASB revised its strategy and work plan. The IASB and the US Financial Accounting Standards Board (FASB) decided that their near-term priority should be to increase the transparency and comparability of their standards by improving and aligning US GAAP and IFRS disclosure requirements for financial assets transferred to another entity. The boards also decided to conduct additional research and analysis, including a post-implementation review of the FASB's recently amended requirements, as a basis for assessing the nature and direction of any further efforts to improve or align IFRS and US GAAP. As a result, the IASB finalised the disclosure requirements that were included in the 2009 Derecognition Exposure Draft with a view to aligning the disclosure requirements in IFRS with US GAAP requirements for transfers of financial assets. Those disclosure requirements were issued in October 2010 as an amendment to IFRS 7. In October 2010 the requirements in IAS 39 for derecognition of financial assets and financial liabilities were carried forward unchanged to IFRS 9.

BC3.32 *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

Fees in the '10 per cent' Test for Derecognition of Financial Liabilities (*Annual Improvements to IFRS Standards 2018–2020*)

BC3.33 Paragraph 3.3.2 requires an entity to derecognise the original financial liability and recognise a new financial liability when there is:

(a) an exchange between an existing borrower and lender of debt instruments with substantially different terms; or

(b) a substantial modification of the terms of an existing financial liability or a part of it.

Paragraph B3.3.6 specifies that the terms are substantially different if the discounted present value of the cash flows under the new terms using the original effective interest rate is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability (10 per cent test). Paragraph B3.3.6 requires an entity to include 'any fees paid net of any fees received' in the 10 per cent test.

BC3.34 The Board decided to amend paragraph B3.3.6 in response to a request to clarify which fees an entity includes in the 10 per cent test. The clarification aligns with the objective of the test, which is to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows between the borrower and lender.

BC3.35 The transition requirements in paragraph 7.2.35 reflect the Board's view that the expected benefit from retrospective application of the amendment would not outweigh the cost of requiring entities to reassess all previous modifications and exchanges. In particular, retrospective application would be unlikely to provide users of financial statements with trend information because financial liabilities are generally modified or exchanged on an ad hoc basis.

BC3.36 Paragraph AG62 of IAS 39 includes the same requirements as those in paragraph B3.3.6 of IFRS 9. An entity that has not previously applied any version of IFRS 9 and whose activities are predominantly connected with insurance is permitted to apply IAS 39 for a limited period of time. In providing the temporary exemption from applying IFRS 9, the Board had not contemplated maintaining IAS 39 (other than for hedge accounting) given the temporary and limited nature of the exemption. Therefore, the Board did not amend paragraph AG62 of IAS 39.

Classification (Chapter 4)

Classification of financial assets

BC4.1 In IFRS 9 as issued in 2009 the IASB aimed to help users to understand the financial reporting of financial assets by:

(a) reducing the number of classification categories and providing a clearer rationale for measuring financial assets in a particular way that replaces the numerous categories in IAS 39, each of which has specific rules dictating how an asset can or must be classified;

(b) applying a single impairment method to all financial assets not measured at fair value, which replaces the many different impairment methods that are associated with the numerous classification categories in IAS 39; and

HKFRS 16 BC

Revised ~~July~~ December 2021

Basis for Conclusions on
Hong Kong Financial Reporting Standard 16

Leases

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variable lease payments linked to future performance or use meet the definition of a liability for the lessee until the performance or use occurs. They regarded those payments to be avoidable by the lessee and, accordingly, concluded that the lessee does not have a present obligation to make those payments at the commencement date. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future economic benefits to be derived from use of the asset.

Residual value guarantees (paragraph 27(c))

BC170 The IASB decided that a lessee should account for a residual value guarantee that it provides to the lessor as part of the lease liability (and as part of the cost of the right-of-use asset). In reaching this decision, the IASB noted that payments resulting from a residual value guarantee cannot be avoided by the lessee—the lessee has an unconditional obligation to pay the lessor if the value of the underlying asset moves in a particular way. Accordingly, any uncertainty relating to the payment of a residual value guarantee does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary in response to movements in the value of the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee.

BC171 Therefore, the IASB decided that a lessee should estimate the amount expected to be payable to the lessor under residual value guarantees and include that amount in the measurement of the lease liability. In the IASB's view, the measurement of a residual value guarantee should reflect an entity's reasonable expectation of the amount that will be paid.

BC172 The IASB considered whether a lessee should recognise and measure residual value guarantees as separate components of a lease, because such guarantees are linked to the value of the underlying asset and may meet the definition of a derivative. However, the IASB noted that residual value guarantees are often interlinked with other terms and conditions in a lease so that accounting for the guarantees as separate components could diminish the relevance and faithful representation of the information provided. Recognising such guarantees separately could also be costly to apply.

Options to purchase the underlying asset (paragraph 27(d))

BC173 The IASB decided that purchase options should be included in the measurement of the lease liability in the same way as options to extend the term of a lease (ie the exercise price of a purchase option would be included in the measurement of a lease liability if the lessee is reasonably certain to exercise that option). This is because the IASB views a purchase option as effectively the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the IASB concluded that, for the same reasons underlying the decision to include extension options, including the exercise price within the measurement of a lease liability if the lessee is reasonably certain to exercise the option provides the most useful information to users of financial statements.

Lease Incentives (Annual Improvements to IFRS Standards 2018–2020)

BC173A The Board was informed about the potential for confusion in applying IFRS 16 because of the way Illustrative Example 13 accompanying IFRS 16 had illustrated the requirements for lease incentives. Before the amendment, Illustrative Example 13 had included as part of the fact pattern a reimbursement relating to leasehold improvements; the example had not explained clearly enough the conclusion as to whether the reimbursement would meet the definition of a lease incentive in IFRS 16.

BC173B The Board decided to remove the potential for confusion by deleting from Illustrative Example 13 the reimbursement relating to leasehold improvements. The Board concluded that little would be lost by deleting it.

Subsequent measurement of the right-of-use asset (paragraphs 29–35)

BC174 The IASB decided that, after the commencement date, a lessee should measure the right-of-use asset at cost less accumulated depreciation and accumulated impairment losses, adjusted for remeasurements of the lease liability (see paragraph BC192). Paragraphs BC41–BC56 include a detailed discussion of the feedback received on the lessee accounting model and the basis for the IASB's decisions regarding the subsequent measurement of a lessee's right-of-use asset.

BC175 The IASB did not adopt an alternative approach whereby a lessee would be required to measure the right-of-use asset at fair value after initial measurement, because this approach would be:

(a) inconsistent with the subsequent measurement of many other non-financial assets; and

(b) more complex and costly for entities to apply than a cost-based approach, because it requires the use of both current expected cash flows and current interest rates.

HKFRS 16 IE
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Illustrative Examples

Hong Kong Financial Reporting Standard 16

Leases

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continued…

Example 12—Lessee allocation of consideration to lease and non-lease components of a contract

Lessee allocates all of the variable consideration to the maintenance of the long-reach excavator, and, thus, to the non-lease components of the contract. Lessee then accounts for each lease component applying the guidance in IFRS 16, treating the allocated consideration as the lease payments for each lease component.

(a) In these Illustrative Examples, currency amounts are denominated in ‘currency units’ (CU).

Lessee measurement (paragraphs 18–41 and B34–B41)

IE5 The following example illustrates how a lessee measures right-of-use assets and lease liabilities. It also illustrates how a lessee accounts for a change in the lease term.

Example 13—Measurement by a lessee and accounting for a change in the lease term

Part 1—Initial measurement of the right-of-use asset and the lease liability

Lessee enters into a 10-year lease of a floor of a building, with an option to extend for five years. Lease payments are CU50,000 per year during the initial term and CU55,000 per year during the optional period, all payable at the beginning of each year. To obtain the lease, Lessee incurs initial direct costs of CU20,000, of which CU15,000 relates to a payment to a former tenant occupying that floor of the building and CU5,000 relates to a commission paid to the real estate agent that arranged the lease. As an incentive to Lessee for entering into the lease, Lessor agrees to reimburse to Lessee the real estate commission of CU5,000~~ and Lessee’s leasehold improvements of CU7,000~~.

At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines that the lease term is 10 years.

The interest rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, receives the lease incentive ~~incentives~~ from Lessor and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

Lessee initially recognises assets and liabilities in relation to the lease as follows.

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000
Right-of-use asset	CU20,000	
Cash (initial direct costs)		CU20,000

continued…

continued…

Example 13—Measurement by a lessee and accounting for a change in the lease term

Cash (lease incentive)	CU5,000	
Right-of-use asset		CU5,000

~~Lessee accounts for the reimbursement of leasehold improvements from Lessor applying other relevant Standards and not as a lease incentive applying IFRS 16. This is because costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset.~~

Part 2—Subsequent measurement and accounting for a change in the lease term

In the sixth year of the lease, Lessee acquires Entity A. Entity A has been leasing a floor in another building. The lease entered into by Entity A contains a termination option that is exercisable by Entity A. Following the acquisition of Entity A, Lessee needs two floors in a building suitable for the increased workforce. To minimise costs, Lessee (a) enters into a separate eight-year lease of another floor in the building leased that will be available for use at the end of Year 7 and (b) terminates early the lease entered into by Entity A with effect from the beginning of Year 8.

Moving Entity A's staff to the same building occupied by Lessee creates an economic incentive for Lessee to extend its original lease at the end of the non-cancellable period of 10 years. The acquisition of Entity A and the relocation of Entity A's staff is a significant event that is within the control of Lessee and affects whether Lessee is reasonably certain to exercise the extension option not previously included in its determination of the lease term. This is because the original floor has greater utility (and thus provides greater benefits) to Lessee than alternative assets that could be leased for a similar amount to the lease payments for the optional period—Lessee would incur additional costs if it were to lease a similar floor in a different building because the workforce would be located in different buildings. Consequently, at the end of Year 6, Lessee concludes that it is now reasonably certain to exercise the option to extend its original lease as a result of its acquisition and planned relocation of Entity A.

Lessee's incremental borrowing rate at the end of Year 6 is 6 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a nine-year term, and with similar collateral. Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

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HKFRS Practice Statement 2
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Hong Kong Financial Reporting Standards Practice Statement 2

Making Materiality Judgements

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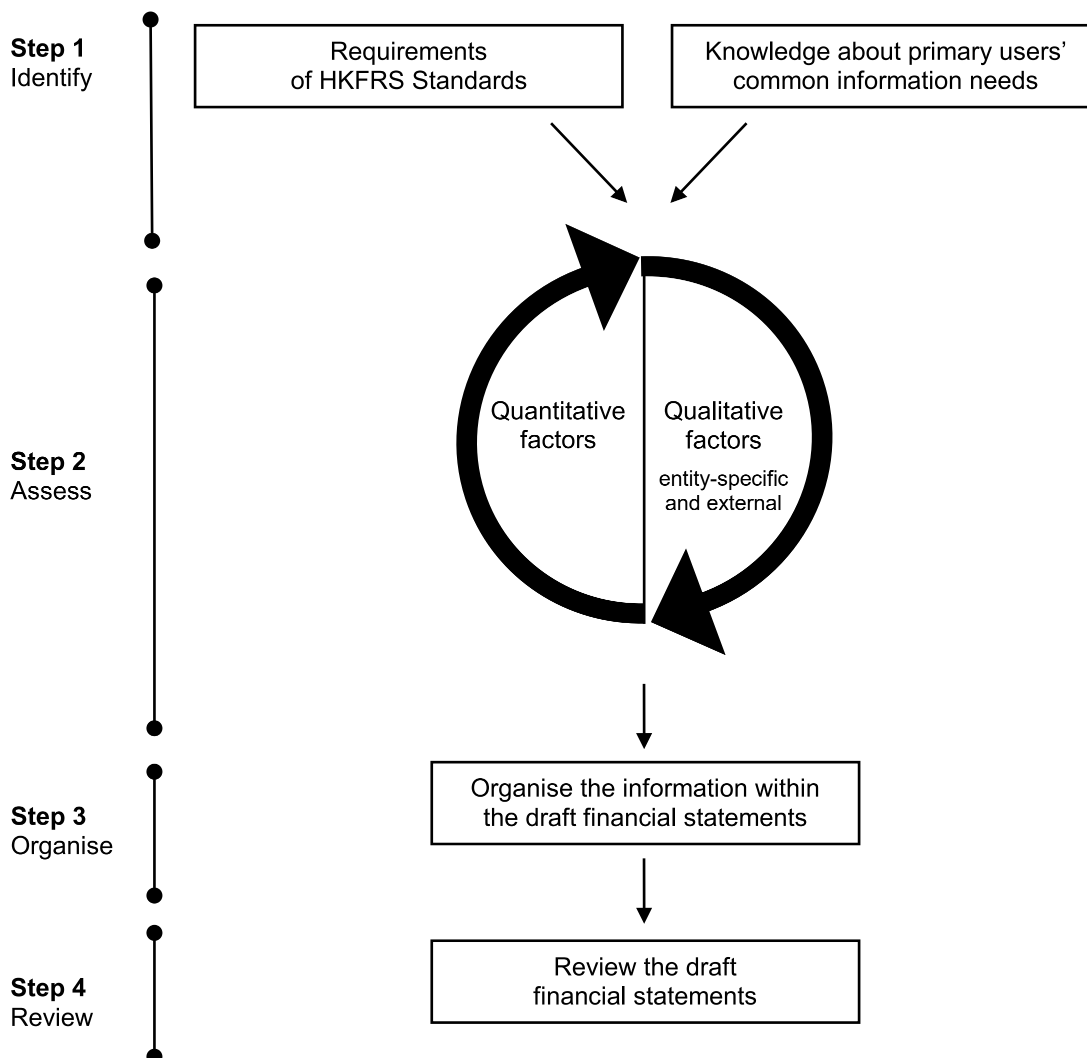
Diagram 1—the four-step materiality process



Step 1—identify

35 An entity identifies information about its transactions, other events and conditions that primary users might need to understand to make decisions about providing resources to the entity.

36 In identifying this information, an entity considers, as a starting point, the requirements of the HKFRS Standards applicable to its transactions, other events and conditions. This is the starting point because, when developing a Standard, the HKICPA identifies the information it expects will meet the needs of a broad range of primary users for a wide variety of entities in a range of circumstances.[19]

37 When the HKICPA develops a Standard, it also considers the balance between the benefits of providing information and the costs of complying with the requirements in that Standard. However, the cost of applying the requirements in the Standards is not a factor for an entity to consider when making materiality judgements—the entity should not consider the cost of complying with requirements in HKFRS Standards, unless there is explicit permission in the Standards.

[19] See paragraph 1.8 of the *Conceptual Framework*.