STANDARD
SETTING

Financial reporting considerations for closing out 2021

MARCH 2022

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

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Foreword

The micro- and macro-economic conditions at the 2021 financial year-end continue to be challenging.

More than two years into the COVID-19 pandemic, different jurisdictions have adopted different strategies in dealing with it. The ensuing global supply chain disruptions, escalating geopolitical uncertainties, ongoing extreme weather phenomena and the global capital market's focus on climate change and sustainable development have taken centre stage in the past year. The resilience of global trade is being tested like never before. Against this backdrop, an entity's suppliers, customers, peers, competitors and distribution channels are all subject to different types and levels of restrictions to their operations.

As uncertainties mount, one thing is clear: corporates, large and small, have had to adapt to the new normal in order to survive with some embracing permanent changes to their business models. For some businesses, the conditions at the 2021 financial year-end and the future outlook at this date may be significantly different from what they were a year ago. Cash flow forecasts developed a year ago may no longer be relevant.

All these have an impact to an entity's financial position, performance and cash flows to a greater or lesser extent. This is true even for a local business given the interconnectedness of global trade. Readers should bear this bigger picture in mind when preparing their 2021 financial statements.

We hope you will find this publication useful.

Cecilia Kwei
Director, Standard Setting
March 2022

Introduction

This educational guidance highlights key financial reporting considerations for entities preparing their December 2021 financial statements but is also relevant for financial years ending after that date.

This guidance is divided into four parts:

I. New and revised HKFRSs mandatorily effective from 1 January 2021
II. Agenda decisions issued by the IFRS Interpretations Committee (IFRS IC) in 2021 that are relevant to Hong Kong entities
III. Key COVID-19-related financial reporting reminders
IV. Topical issue – climate-related reporting

This educational guidance is not intended to be comprehensive nor does it necessarily cover all the potential issues relevant to an entity's 2021 financial statements. Readers should refer to the HKFRSs in the Institute's Members' Handbook for further reference.

Section I – New and revised HKFRSs mandatorily effective from 1 January 2021

Two amendments to HKFRSs are mandatorily effective for entities with a December year-end from 1 January 2021: (i) amendment to HKFRS 16 *Covid-19-Related Rent Concessions* and (ii) phase 2 of the amendments relating to the interest rate benchmark reform.

The amendment to HKFRS 16 *Covid-19-Related Rent Concessions* was issued in 2020 and is mandatorily effective for annual periods beginning on or after 1 June 2020. The discussions below focus on the subsequent extension to this amendment issued in 2021 which, although only mandatorily applicable to annual periods beginning on or after 1 April 2021, will likely be early adopted by entities given the persistent COVID situation.

1. Amendment to HKFRS 16 Covid-19-Related Rent Concessions beyond 30 June 2021

HKFRS 16 *Leases* was amended in June 2020 to provide practical relief to lessees in accounting for qualifying COVID-19-related rent concession[1] (the 2020 Amendments), under which a lessee is not required to assess whether the qualifying COVID-19-related rent concessions are lease modifications, but instead account for them in accordance with other applicable guidance as if they were not lease modifications.

The 2020 Amendments only apply to rent concessions for which any reduction in lease payments affected only payments originally due on or before 30 June 2021 (Eligibility Period). However, due to the continued economic challenges brought by the COVID-19 pandemic, more lessors and lessees renegotiated the rent concessions that extend beyond 30 June 2021. In order to cope with these circumstances, the International Accounting Standards Board (IASB) issued the Amendment to IFRS 16[2] *Covid-19-Related Rent Concessions beyond 30 June 2021* in March 2021, to extend the Eligibility Period for one year, i.e. from 30 June 2021 to 30 June 2022. The Institute approved the equivalent amendments to HKFRS 16 in April 2021 (the 2021 Amendments). A lessee shall apply the 2021 Amendments for annual periods beginning on or after 1 April 2021. Earlier application is permitted, including in financial statements not authorized for issue at the date of issuing the 2021 Amendments (i.e. 9 April 2021).

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[1] The practical expedient is not available to lessors. The conditions required to be fulfilled before the lessee could apply the practical expedient in the 2020 Amendments are set out in HKFRS 16.46B(a) to (c).

[2] HKFRS/HKAS are fully converged with IFRS/IAS.

Under the Amendments, lessees would generally account for the changes in lease payments due to qualifying COVID-19-related rent concessions as "negative variable lease payments" by debiting the lease liability and crediting the same amount in profit or loss, as opposed to accounting for them as a lease modification which would have required adjustments to the lease liability determined at a revised discount rate and the right-of-use asset. The Amendments require retrospective application, with the cumulative effect of their initial application as an adjustment to the opening balance of retained earnings.

We highlight below a few areas which entities should consider when applying the 2021 Amendments.

(i) *Whether the entity (lessee) can choose to apply the 2021 Amendments*

The 2021 Amendments do not provide a new choice to a lessee as to whether to apply the practical expedient. If the lessee has applied the practical expedient in the 2020 Amendments, it must also apply the extended scope of the practical expedient in the 2021 Amendments. This is because an entity shall consistently apply the practical expedient to account for leases (including those newly entered into in 2021) with similar characteristics and in similar circumstances in accordance with its accounting policy (HKFRS 16.2).

Likewise, if the lessee has previously decided not to apply the practical expedient in the 2020 Amendments to account for its qualifying COVID-19-related rent concessions, it cannot apply the extended scope of the practical expedient in the 2021 Amendments. In this case, the 2021 Amendments would have no impact on the lessee.

(ii) *Whether a rent concession that was not a qualifying COVID-19-related rent concession in terms of the 2020 Amendments can apply the 2021 Amendments; and if so, how they should transition to the 2021 Amendments*

It depends on why those rent concessions did not qualify for the practical expedient in the 2020 Amendments.

For example, if they were rent concessions which did not meet the relevant criteria only because they resulted in reduced lease payments beyond 30 June 2021, such rent concessions would now meet the practical expedient criteria in the 2021 Amendments as long as the reduction in lease payments do not go beyond 30 June 2022. If the entity has elected to apply the practical expedient in the 2020 Amendments to similar rent concessions, the entity should also apply the practical expedient in the 2021 Amendments to the rent concession under review.

In this situation, the lessee should first reverse the relevant effects of accounting for such rent concessions previously as a lease modification and then account for the rent concessions as variable lease payments in profit or loss by applying the practical expedient in the 2021 Amendments. Entities are also reminded to adjust for the corresponding effect on depreciation of the right-of-use assets given that applying the practical expedient in the 2021 Amendments would result in a higher depreciation expense from the date of the rent concession (assuming there were no adjustments to the right-of-use asset e.g. impairment) as compared to the previous accounting for the rent concessions as a lease modification.

(iii) Impact of when the rent concession is agreed

The timing of when the rent concession is agreed between the lessor and the lessee is not one of the conditions in assessing whether the practical expedient under the 2021 Amendments can be applied. For example, an agreement for rent concession entered into before 30 June 2022 to reduce or defer lease payments originally due after 30 June 2022 would not qualify for the practical expedient. The lessee should instead apply the general requirements of HKFRS 16 to account for the effects of those rent concessions (e.g. accounting for them as lease modifications).

2. *Amendments to HKAS 39 Financial Instruments: Recognition and Measurement, HKFRS 4 Insurance Contracts, HKFRS 7 Financial Instruments: Disclosures, HKFRS 9 Financial Instruments and HKFRS 16 Leases – Interest Rate Benchmark Reform – Phase 2*

The Phase 1 amendments relating to the interest rate benchmark reform (or sometimes called the interbank offered rates (IBOR) reform) (Phase 1 Amendments) took effect in 2020 and were more relevant to entities that apply hedge accounting.

The Phase 2 Amendments became effective from 1 January 2021. The Phase 2 Amendments are expected to have a wider impact on entities of all industries provided that (1) entities have a financial instrument that is indexed to an interest rate benchmark that is subject to the IBOR reform (e.g. a floating loan rate that is linked to the London Inter-Bank Offered Rate, or a fixed-rate debt that is hedged using IBOR-based derivatives); and (2) entities (as lessees) have lease payments that are indexed to an IBOR rate.

The Phase 2 Amendments[3] address issues that might affect financial reporting when an entity replaces the old IBOR benchmark with an alternative benchmark rate (ABR) as a result of the IBOR reform. The following are some key reminders in applying the Phase 2 Amendments:

(i) Changes to contractual cash flows

As a result of the IBOR reform, there might be changes in the basis for determining the contractual cash flows of financial instruments and those changes might have consequential impact on the accounting treatment of affected financial instruments. Under HKFRS 9, such changes to a financial instrument might require recognizing an immediate gain or loss in profit or loss. The Phase 2 Amendments provide a practical expedient in which entities are required to account for such a change by adjusting the effective interest rate on a prospective basis without the need to recognizing an immediate gain or loss. This is the case provided that both conditions set out in HKFRS 9.5.4.7 are met, i.e. 1) the change is necessary as a direct consequence of the interest rate benchmark reform; and 2) the new basis for determining the contractual cash flows is economically equivalent to the basis immediately preceding the change[4].

If there are changes in addition to those required by the IBOR reform, entities should first apply the practical expedient set out in HKFRS 9.5.4.7 to the changes required by the IBOR reform and then apply the other applicable requirements in HKFRS 9 to any additional changes to which the practical expedient does not apply (HKFRS 9.5.4.9). If the additional changes result in the derecognition of the financial instruments, the derecognition requirements in HKFRS 9 apply. Other changes should be accounted for under HKFRS 9.5.4.3 or B5.4.6 as applicable.

A similar practical expedient is available in HKFRS 16 to address the accounting for lease modifications as a result of the IBOR reform. The affected lease liabilities should be remeasured by discounting the revised lease payments using a discount rate that reflects the change in the interest rate, provided the two conditions set out in HKFRS 16.105 are met, i.e. 1) the modification is necessary as a direct consequence of the IBOR reform; and 2) the new basis for determining the lease payments is economically equivalent to the basis preceding the modification. However, if lease modifications are made in addition to those lease modifications required by the IBOR reform, the lessee is required to apply the relevant HKFRS 16 requirements to account for all lease modifications made at the same time, including those required by the IBOR reform (HKFRS 16.106).

[3] The Phase 2 Amendments are to be applied retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, restatement of prior periods is not required if doing so requires the use of hindsight (HKFRS 9.7.2.43 to 7.2.46, HKFRS 16.C20C and C20D). Hedging relationships previously discontinued solely because of changes resulting from the reform will be reinstated if certain conditions are met (HKFRS 9.7.2.44).

[4] HKFRS 9.5.4.8 provides examples of changes that give rise to a new basis for determining the contractual cash flows that is "economically equivalent" to the previous basis.

Given different IBORs (in terms of currency and tenure) will be replaced by their respective ABRs in phases, entities should continue to actively manage their IBOR transition process, including taking stock of contracts (including lease contracts) to identify those which will or may be affected by the IBOR reform and those which do not have fallback provisions so as to renegotiate with the respective counterparties (e.g. banks) ahead of time. Entities may also consider setting up a coordination team consisting of representatives from the affected departments (e.g. legal, accounting, tax and information technology) to ensure a smooth transition process.

(ii) Hedge accounting

The Phase 2 Amendments provide specific relief from discontinuing hedging relationships. For example, an entity is not required to discontinue existing hedging relationships when changes to the hedged risks, hedged items or hedging instruments arise as a result of changes required by the IBOR reform.

Entities that have applied hedge accounting should identify any hedging relationships (i.e. cash flow or fair value hedges of interest rate risk) that would fall within the scope of the Phase 2 Amendments. In particular, entities should assess whether there are any changes to the hedged risks, hedged items and hedging instruments for which the hedge documentation needs to be updated in order to avoid a discontinuation of the existing hedging relationship.

(iii) Disclosures

Entities need to provide specific disclosures to enable users of financial statements to understand the effect of the IBOR reform on their financial instruments and risk management strategy. HKFRS 7.24I and 24J set out the relevant qualitative and quantitative disclosure requirements.

Section II – Agenda decisions issued by the IFRS IC in 2021[5] that are relevant to Hong Kong entities

The appendix to this educational guidance provides a full list of agenda decisions issued by the IFRS IC in 2021. This section highlights those agenda decisions that are more widely relevant to companies reporting in Hong Kong. Given HKFRSs are fully converged with IFRSs, entities are advised to consider if any of the agenda decisions have an impact on their current accounting policies; and if so, implement any necessary accounting policy changes on a timely basis[6].

1. Costs necessary to sell inventories

HKAS 2 *Inventories* requires an entity to measure its inventories at the lower of cost and net realizable value (NRV). HKAS 2.6 defines NRV as *"the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated costs necessary to make the sale"*. However, HKAS 2 does not provide further guidance on how to determine the "estimated costs necessary to make the sale". Therefore, questions arise as to whether an entity should include all costs necessary to make the sale or only those that are incremental to the sale when determining the NRV of inventories.

The agenda decision issued in June 2021 clarifies that the costs necessary to make the sale are not limited to only incremental costs. Entities should apply judgement to determine which costs are necessary to make the sale taking into account their own circumstances. This could include the nature of inventories, industry and sales environment in which the entity operates. Any significant judgements made in applying the accounting policy should be disclosed if material.

2. Software-as-a-Service (SaaS) arrangements or cloud computing arrangements

In cloud computing arrangements, customers can access and use the underlying software on an as-needed basis rather than have control or possession over the underlying software. The IFRS IC published two agenda decisions in 2019 and 2021 respectively, clarifying the accounting by customers for a specific aspect of cloud

[5] Agenda decisions (including any explanatory material contained therein) cannot add or change requirements in IFRSs. Instead, explanatory material explains how the applicable principles and requirements of IFRSs apply to the fact pattern described in the agenda decision. Explanatory material derives its authority from IFRSs themselves and accordingly, an entity is required to apply the applicable IFRSs reflecting the explanatory material in an agenda decision, subject to its having sufficient time to implement that accounting (Paragraphs 8.4 and 8.5 to the IASB Due Process Handbook).

[6] See Sue Lloyd's March 2019 article Agenda decisions – time is of the essence.

technology – SaaS arrangement. The agenda decisions do not address the accounting for other aspects of cloud technology.

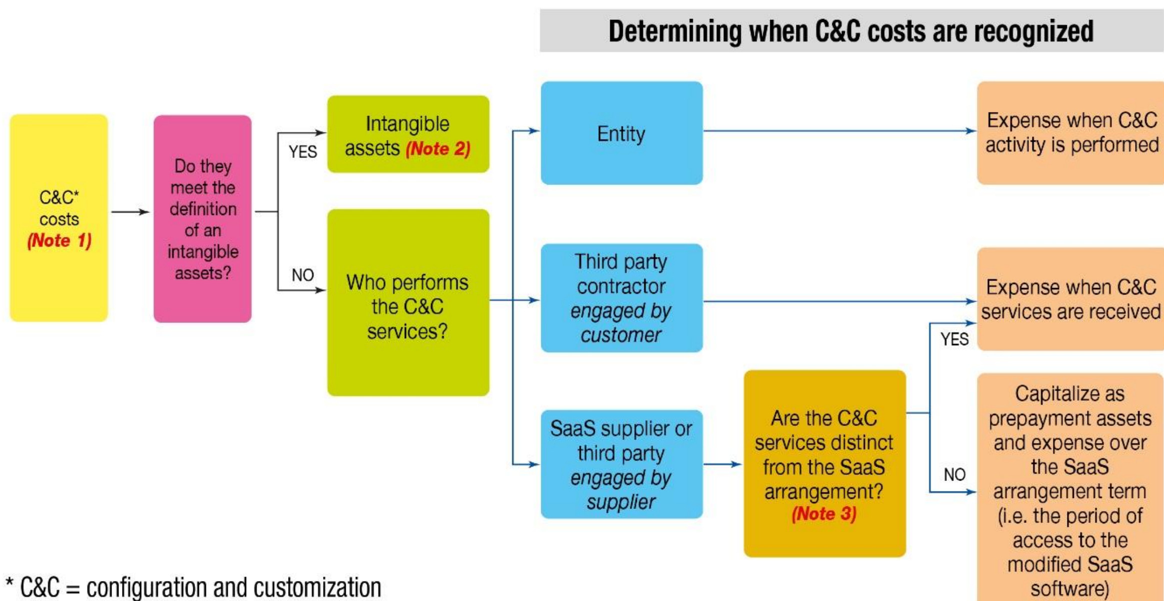
In the 2019 agenda decision, the IFRS IC concluded that a contract that conveys to the customer only the right to access to the supplier's application software in the future is a service contract, instead of a lease of the software or a software intangible asset.

The 2021 agenda decision goes further to address a specific issue on how a customer should account for the costs of configuring or customizing a supplier's application software in a SaaS arrangement that is determined to be a service contract. The agenda decision explains whether those costs should be recognized as (1) a prepayment asset; (2) an intangible asset; or (3) an expense when incurred.

A **prepayment asset** will arise if the entity (customer) pays the supplier *before* receiving the configuration and customization services and the expenditure does not give rise to an intangible asset.

In terms of an **intangible asset,** the IFRS IC observed that an entity would often *not* recognize the configuration and customization costs in a SaaS arrangement as such because (i) the entity does not control the software being configured or customized; and (ii) the configuration or customization activities do not create a resource controlled by the entity that is separate from the software. However, entities should be mindful of whether additional resources (e.g. programming codes) may be created from the SaaS arrangement and assess whether they meet the definition and recognition criteria as intangible assets.

If the configuration and customization costs do not give rise to an intangible asset, the entity needs to apply HKAS 38.68 to HKAS 38.70 to account for such costs as an **expense** when it receives the related services. It is important to note that an entity receives the services when the supplier performs them, and not when the entity uses those services (HKAS 38.69A). HKAS 38, however, does not contain any guidance on the identification of the services the entity (customer) receives. In this respect, the agenda decision notes that IFRS 15 *Revenue from Contracts with Customers* contains requirements that deal with similar and related issues from the supplier's perspective. Those requirements should be considered by the entity (customer) in determining whether the supplier performs a configuration or customization service that is distinct from the right to access to the supplier's application software, and consequently, when the entity should recognize the related costs. See diagram below.



Notes:

1) It is assumed that the SaaS arrangement does not contain a lease and therefore HKFRS 16 *Leases* does not apply.

2) Capitalize as intangible asset and amortize over its useful life under HKAS 38. If the configuration and customization activities are carried out by the entity itself, the related costs can only be capitalized if the criteria in HKAS 38.57 are met.

3) The agenda decision notes that IFRS 15 contains requirements that help an entity determine whether C&C services are distinct from the SaaS arrangement. According to HKFRS 15.27, a good or service is distinct from other goods or services within the contract if both of the following criteria are met:
   a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (ie the good or service is capable of being distinct); and
   b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (ie the promise to transfer the good or service is distinct within the context of the contract).

   HKFRS 15.29 also includes examples of factors that may indicate that two or more promises within a contract would not be distinct.

As can be seen from the above, judgement must be applied in determining whether and when configuration and customization costs in a SaaS arrangement should be capitalized or expensed. Collaboration between various departments within an entity may be needed to obtain a sufficient understanding of the details of each SaaS arrangement in determining the appropriate accounting treatment. Entities should reassess whether their current accounting policy is appropriate in light of the agenda decision.

4) Supply chain financing arrangements – Reverse factoring

Alert Issue 37 discusses the IFRS IC agenda decision issued in December 2020 on supply chain financing arrangements or reverse factoring arrangements (collectively referred to as supply chain financing arrangements). As the agenda decision was issued in December 2020 which was near the end of the 2020 reporting period, there might not have been sufficient time for some entities to reflect the agenda decision in their December 2020 financial statements. Such entities should consider the agenda decision in their December 2021 financial statements.

As a recap, under a typical supply chain financing arrangement, a financial institution agrees to pay amounts an entity owes to its suppliers and the entity agrees to pay the financial institution at the same time as (or on a date later than) when suppliers are paid. The agenda decision explains how an entity presents liabilities that are part of the supply chain financing arrangement on the statement of financial position under such an arrangement. The major points are summarized below:

(i) The presentation of the liabilities as trade payables, borrowings or other separate line items is not a free choice.

Entities making extensive use of supply chain financing arrangements should consider each major arrangement to assess the nature and function of the liabilities subject to reverse factoring. This will help determine whether the liabilities should continue to be presented within trade payables or whether a separate presentation (e.g. as part of other financial liabilities or as an additional line item) would be relevant to an understanding of the entity's financial position in accordance with paragraphs 55, 57 and 58 of HKAS 1 *Presentation of Financial Statements*.

Applying paragraph 11(a) of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 1.70, the IFRS IC concluded that an entity presents a financial liability as a trade payable only when it:

a) represents a liability to pay for goods or services;
b) is invoiced or formally agreed with the supplier; and
c) is part of the working capital used in the entity's normal operating cycle.

In making the above assessment, entities should consider the nature and extent of the changes to the rights and obligations between the entity (purchaser) and the supplier/bank as a result of the supply chain financing arrangement. It is also important to understand the purpose of entering into a supply chain financing arrangement and for the presentation of the related liability to reflect the function of the arrangement within the entity. For example, if the arrangement was entered

into in order for the entity to obtain extended funding that differs materially from the terms of other trade payables, and the entity provides additional security that would not be provided without the arrangement, these may indicate that the related liability may need to be presented separately from a trade payable.

(ii) An entity assesses whether and when to derecognize a liability that is (or becomes) part of a supply chain financing arrangement by applying the derecognition requirements in HKFRS 9. An entity that derecognizes a trade payable to a supplier and recognizes a new financial liability to a financial institution applies HKAS 1 in determining how to present that new liability in its statement of financial position (see point (i) above).

(iii) The assessment of the nature of the liabilities in (i) above may help in determining the classification of the related cash flows in the statement of cash flows. For example, if the entity considers the related liability to be a trade payable that is part of its working capital, the entity presents any related cash outflows as an operating activity. Any material non-cash transactions should be disclosed accordingly in the notes to the financial statements.

(iv) Any significant judgements applied in determining the presentation of the liabilities and cash flows related to the arrangement should be disclosed[7].

[7] The IASB published an exposure draft in November 2021 proposing amendments to IAS 7 and IFRS 7 to (1) require entities to provide information in the notes that enables users of financial statements to assess the effects of supply chain financing arrangements on their liabilities and cash flows; and (2) specify the qualitative and qualitative disclosure requirements. The comment period for the exposure draft is due on 28 March 2022.

Section III – Key COVID-19-related financial reporting reminders

COVID-19 continues to have a wide-ranging impact on many entities. While this guidance re-emphasizes some of the key COVID-19-related accounting considerations as discussed in Alert Issue 33 and Alert Issue 37, it also highlights other considerations that warrant specific attention for the December 2021 financial statements.

1. Going concern assessments and disclosures

HKAS 1 requires management to assess an entity's ability to continue as a going concern when preparing financial statements. Given the significant drop in revenue and profitability experienced by many entities under the COVID-19 environment, the IASB published an educational material in January 2021 which provides a helpful reminder on the application of IAS 1 on the going concern assessment and related disclosures. The educational material sets out four scenarios as follows:

(i) No significant doubts about going concern.
(ii) Significant doubts about going concern but mitigating actions judged sufficient to make going concern appropriate. No material uncertainties remain.
(iii) Significant doubts about going concern but mitigating actions judged sufficient to make going concern appropriate. Material uncertainties about going concern remain after considering mitigating actions.
(iv) Intends to liquidate or to cease trading, or no realistic alternative but to do so.

The second and the third scenarios require more judgement to assess (1) the significance of the doubts about going concern; and (2) the sufficiency of mitigating actions to address the going concern. It is crucial for entities to provide entity-specific disclosures to explain and support the judgement management has made, in addition to the disclosures about material uncertainties relating to going concern. Entities are reminded that HKAS 1 requires management to look at a period of at least 12 months from the end of the reporting period when making the going concern assessment. The educational material also states that, considering time periods longer than 12 months is not inconsistent with the requirements in IAS 1, which establishes a minimum period, not a cap. However, if before the financial statements are authorized for issue, circumstances were to deteriorate so that management no longer has any realistic alternative but to cease trading, the financial statements must not be prepared on a going concern basis as required by HKAS 10 *Events after the Reporting Period*.

2. *Judgements and key sources of estimation uncertainties*

Many areas discussed in this guidance may require significant judgements and estimations. While the specific disclosure requirements of judgements and estimates are provided in the respective HKFRSs, HKAS 1.122 and 125 set out the overarching principles that require an entity to disclose:

(i) the judgements, apart from those involving estimations, that management have made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements; and

(ii) information about the assumptions an entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Consistent with prior years, significant judgements and estimation uncertainties are expected in the following areas: material uncertainty related to going concern (HKAS 1), asset impairments (HKAS 36 *Impairment of Assets*), determination of useful lives of assets (HKAS 16 *Property, Plant and Equipment* and HKAS 38), expected credit losses on financial assets (HKFRS 7 and HKFRS 9), write-down of inventories (HKAS 2), fair value measurements (HKFRS 13) and estimation of provisions (HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) amongst others.

On this note, regulators have consistently observed generic disclosures in their review of financial statements and have consistently requested entities to improve on this front[8]. Entities are reminded that meaningful, transparent and specific disclosures of judgements and estimates should be made based on the entity's own facts and circumstances. Providing such information will help users of the financial statements understand more about the entity and assist them in making investment decisions.

3. *Impairment considerations and disclosures*

(i) Non-financial assets

Impairment review continues to be an important topic. Non-financial assets, typically property, plant and equipment, intangible assets and goodwill, might be impaired because of the impact brought by the COVID-19 pandemic, the ensuing

[8] See, for example, "Review of Issuers' Annual Reports 2021" published by Hong Kong Stock Exchange.

worldwide supply chain disruptions as well as ongoing geopolitical uncertainties. It is therefore particularly important for entities to ensure that the requirements of HKAS 36 are properly followed when performing an impairment review of relevant assets. We discussed the application of HKAS 36 in the educational material issued in June 2020 and Alert Issue 37 with specific considerations given to the impact of COVID-19. In view of their continued relevance, entities are encouraged to read this guidance, together with the aforesaid materials when preparing the December 2021 financial statements.

HKAS 36 requires an entity to assess and identify any impairment indicators at each reporting date. In order to cope with the challenges brought by COVID-19, some businesses might have changed their business models allowing their operations to return to pre-pandemic levels or even achieve growth. In such cases, the impairment indicator(s) noted in previous years may no longer exist or their impact might have softened this year. Entities should make sure that the assumptions and estimates used in the calculation of the recoverable amount of previously impaired assets are updated to reflect the recent changes in their business model, economic environment and conditions at the end of the current reporting period. In particular, those entities which are able to resume business growth should assess whether there is any indication that an impairment loss recognized in prior periods for an asset other than goodwill should be reversed. The remaining useful life, the depreciation (amortization) method and/or the residual value may also need to be reviewed and adjusted in accordance with the applicable HKFRS, even if no impairment loss is reversed for the asset.

Adequate disclosures of key assumptions and other information required by HKAS 36 shall be made when (1) an impairment loss has been recognized or reversed for an individual asset or a cash-generating unit (CGU); and (2) when a CGU contains goodwill or intangible assets with indefinite useful lives the amount of which is significant in proportion to the respective total carrying amount of these items, even when no impairment loss is recognized for these items.

(ii) Financial assets

The matters discussed on HKFRS 9 in our educational material issued in June 2020 and Alert Issue 37 issued in last year continue to be applicable. One of the most critical and challenging areas among them is the assessment of whether there has been a significant increase in credit risk for a financial asset which may involve significant judgements. An overall evaluation of all available facts and circumstances in the credit risk assessment is essential. For example, entities may enter into short-term loan arrangements in terms of which the loans are contractually due within 12 months but in practice the loans are renewed year on year, especially for related party loans. Management should take due care when considering whether there has been a significant increase in credit risk in these loans and whether they are credit impaired. Any significant assumptions, bases for

estimations and relevant HKFRS 7 disclosures should be clearly disclosed in the financial statements.

The HKFRS 7 disclosures including but not limited to key assumptions and estimation techniques used in the estimation of ECL and credit risk assessment need to be provided in order to assist users of financial statements in understanding how COVID-19 affects the estimations and credit risk assessments.

4. Debt restructurings

Some entities may negotiate with their lenders to restructure their existing debt obligations in order to maintain or improve their cash flows and financial situation. We highlight below some of the challenging areas surrounding debt restructurings and other complex issues under HKFRS 9.

(i) Whether the restructuring results in a substantial modification to the debt instrument

Under HKFRS 9, an exchange between an existing debtor and lender of debt instruments with substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

A modification to a financial liability is substantial if the net present value (NPV) of the cash flows under the modified terms (including fees) is at least 10% different from the NPV of the remaining cash flows under the original terms, calculated using the original effective interest rate (EIR). This is commonly known as the 10% test. A substantial modification of a financial liability is accounted for as a derecognition of the original financial liability and a recognition of a new financial liability.

(ii) Non-substantial debt modifications

Non-substantial modifications of a financial liability do not result in the derecognition of the financial liability. Instead, financial liabilities measured at amortised cost are remeasured by discounting the modified contractual cash flows at the financial liability's original EIR and a gain or loss on modification is recognized in profit or loss at the date of modification or exchange (HKFRS 9.B5.4.6).

(iii) Treatment of fees and costs incurred as a result of debt restructuring[9]

The treatment depends on whether the exchange of debt instruments or modification of terms is accounted for as a derecognition event (HKFRS 9.B3.3.6A). If so, any costs or fees incurred are recognized as part of the gain or loss on derecognition. If not, any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.

As can be seen above, it is important for entities to assess properly whether the debt modification is substantial under HKFRS 9 as it results in different accounting treatments.

(iv) Other notable areas

- Entities may obtain funds through issuing bonds. If the entity (bond issuer) repurchases its bonds, they are extinguished (i.e. derecognized) even if the entity is a market maker of the bonds or intends to resell them in the near term (HKFRS 9.B3.3.2).

- As part of a debt restructuring, an entity may transfer financial assets (other than cash) to settle debts owed to creditors. This may lead to complex questions as to whether, when and the extent to which the financial asset should be derecognized. HKFRS 9.3.2.1 to 3.2.23 provides detailed requirements of derecognition of a financial asset.

- Some debts may be restructured such that the whole or a part of the debt is settled by issuing the entity's own equity instruments to the creditor, commonly known as debt to equity swaps. Entities should refer to HK(IFRIC) Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments* to see if it applies in those cases.

- Entities within a group should conduct a careful assessment of all facts and circumstances to understand the substance of an intragroup debt restructuring arrangement. For example, whether the restructuring transaction is in substance a capital contribution or distribution if the lender is acting in its capacity as a shareholder in the transaction.

5. Recognition of deferred tax assets

Under HKAS 12 *Income Taxes*, a deferred tax asset is recognized for all deductible temporary differences and unused tax losses (tax credits) carried forward (with certain

[9] Amendments to HKFRS 9 issued in June 2020 as part of the Annual Improvements to HKFRS 2018-2020 clarify which fees should be included in the "10% Test" for derecognition of financial liabilities. The Amendments are effective for annual periods beginning on or after 1 January 2022.

exceptions), to the extent that it is probable that future taxable profits will be available against which the deductible temporary differences can be utilized. The sufficiency of estimated future taxable profits therefore has a direct impact on the recognition of deferred tax asset.

As discussed in the "Going concern assessments and disclosures" and "Impairment considerations and disclosures" sections, many entities suffered from worsening financial performance and cash flows under the COVID-19 pandemic, the ensuing global supply chain crunch and other geopolitical uncertainties. These will have negative impacts on management's estimation of future cash flows and profitability which will in turn affect the extent to which deferred tax assets may be recognized.

Entities should ensure that the estimation of future taxable profits for the purposes of recognizing deferred tax assets is revised at every reporting date to reflect the conditions at that date and that the assumptions used are consistent with those applied in other areas of financial reporting, e.g. asset impairment assessments and fair value measurements.

As required by HKAS 12.82(b), an entity should disclose the amount of deferred tax asset and the nature of evidence supporting its recognition when it has suffered a loss in either the current or preceding period.

6. Provisions and contingent liabilities

(i) Recognition and measurement

Here are some key reminders when applying HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in terms of recognizing a provision.

- Estimated future operating losses cannot be recognized as a provision. A provision can only be recognized when all of the following criteria are met: (1) an entity has a *present obligation* (legal or constructive) as a result of a past event; (2) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (3) a reliable estimate can be made of the amount of the obligation (HKAS 37.14).

- HKAS 37 does not apply to provisions or instruments covered by other HKFRSs (HKAS 37.5), e.g. penalties resulting from a failure to perform under a revenue contract should be accounted for under HKFRS 15 and not under HKAS 37. However, a provision under HKAS 37 should be recognized if the contract becomes onerous as a result of the penalty. Regarding leases, HKAS 37 applies to a lease that becomes onerous *before* the commencement date of the lease. However, a lease that becomes onerous

after the commencement date should be accounted for under HKFRS 16 (HKFRS 16.BC72).

Given the current macro-economic conditions, it may be that the unavoidable costs of meeting the obligations under a contract may exceed the economic benefits expected to be received under the contract, resulting in an onerous contract under HKAS 37. The unavoidable costs reflect the least net cost of exiting from the contract, which is the lower of cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Any impairment loss on the associated assets should be recognized before a separate provision for an onerous contract is recognized.

Another provision that has become increasingly common under the current economic environment is a restructuring provision. Some entities may need to undergo restructuring e.g. sale or termination of a line of business, closure of a business location or relocation of business activities and changes in management structure. HKAS 37.14, 72 to 83 provide specific guidance on the nature of obligations and the types of costs that are eligible for inclusion in the restructuring provisions. An important point to note is that a public announcement of a plan to restructure does not automatically constitute a constructive obligation. A constructive obligation is created only if the announcement is made in such a way and in sufficient detail that it gives rise to valid expectations in other parties that the restructuring will take place.

If the main features of a restructuring are announced after the reporting date, no provision is recognized at the reporting date. The details of the restructuring should instead be disclosed as a non-adjusting event in accordance with HKAS 10 if they are material.

Other provisions such as those for reinstatement of leased premises, closure of a division and self-insurance may also be recognized under the current economic environment. Relevant illustrative examples are provided in Appendix C to HKAS 37.

(ii) Disclosures

Entities should provide entity-specific disclosures regarding provisions that reflect the entities' own facts and circumstances. Potential obligations that did not exist before the outbreak of COVID-19 and other geopolitical uncertainties may now have to be disclosed as contingent liabilities in accordance with HKAS 37. Where practicable, information such as an estimate of the financial effect and an indication of the uncertainties relating to the amount and timing of any cash outflows should be disclosed. Furthermore, contingent liabilities need to be assessed continually to determine whether an outflow of resources embodying economic benefits has become probable in which case a provision may be needed.

Section IV – Topical issue – climate-related reporting

Climate change has attracted increasing attention from investors and other stakeholders in recent years. Many jurisdictions have announced pledges and implemented policies with an aim to limiting the rise in global temperature to less than 1.5°C above pre-industrial levels by the end of this century. Such pledges and policies include achieving net-zero carbon emissions sometime within this century. The road to net-zero will in turn have an impact to entities especially those that have a high carbon footprint and those that are prone to climate risks (e.g. transportation, building materials, agriculture, mining and energy etc.). Any change to an entity's strategy to achieve net zero, to adapt to or mitigate climate risks will have a consequential impact on the entity's financial performance, position and cash flows.

Even if an entity were to continue business as usual, it is likely that it will still be affected by climate change, e.g. more frequent and extreme typhoons in Hong Kong requiring closure of businesses and leading to damage to physical assets; or wild fires and monsoons hitting manufacturing facilities in other parts of the world from where the entity sources raw materials. Government and regulators may also impose rules on how an entity operates in order to achieve the government's own goal of achieving net zero.

All in all, climate risks will affect an entity to a greater or lesser extent in the coming years. As such, regardless of whether the entity is actively managing climate risks, management should assess how climate risks will impact its financial statements.

Although HKFRSs do not explicitly address climate-related matters, the principles of identifying risks and assessing the extent to which they affect the entity's financial position, performance and cash flows are already embedded in HKFRSs. Climate risks are no different from other risks faced by an entity in this regard. Entities should carry out a robust and continual assessment of the impact of climate change on their operations, e.g. from the determination of the useful lives, residual values and fair value of polluting assets, changing consumer preferences on the NRV of inventories, the fair value of financial assets in high climate risk industries v. green investments, to more drastic actions such as restructuring the entity's operations. Any significant judgements made in applying accounting policies and significant estimation uncertainties should be disclosed in accordance with HKAS 1.122 and 125.

In order to address the financial reporting impacts of climate-related matters, we recommend entities refer to the two educational materials published by the IASB in November 2020 and November 2019 as a starting point. The 2020 publication supplements the 2019 one to provide further discussions on the effect of climate-related matters on financial reporting.

Under the overarching requirements of HKAS 1.31, entities should consider providing additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users of the financial statements to understand the impact of climate-related matters on their financial position and performance.

Appendix – New and revised Hong Kong Financial Reporting Standards, and Agenda Decisions issued by the IFRS IC

The following amendments to HKFRS became effective as of 1 January 2021:

Standards	Description
Amendments to HKAS 39 *Financial Instruments: Recognition and Measurement*, HKFRS 4 *Insurance Contracts*, HKFRS 7 *Financial Instruments: Disclosures*, HKFRS 9 *Financial Instruments* and HKFRS 16 *Leases – Interest Rate Benchmark Reform – Phase 2*	The amendments addresses issues that might affect financial reporting when a company replaces the old interest rate benchmark with an alternative benchmark rate as a result of the interest rate benchmark reform (Phase 2).
Amendment to HKFRS 16 *Leases – Covid-19-Related Rent Concessions*[10]	The amendment exempts lessees from having to consider individual lease contracts to determine whether rent concessions occurring as a direct consequence of the COVID-19 pandemic are lease modifications and allows lessees to account for such rent concessions as if they were not lease modifications. It applies to COVID-19-related rent concessions that reduce lease payments due on or before 30 June 2021. The amendment does not affect lessors.

The following new and amended standards, interpretation, practice statement and accounting guideline have been issued but are not yet effective. They are available for early adoption.

Effective from annual periods beginning on or after:	New and Amended Standards, Interpretation, Practice Statement and Accounting Guideline
New Standard	
1 January 2023	HKFRS 17 *Insurance Contracts*
1 January 2023	Amendments to HKFRS 17 *Insurance Contracts*

[10] Effective for accounting periods beginning on or after 1 June 2020. Earlier application is permitted, including in financial statements – interim or annual – not authorized for issue at 4 June 2020.

Effective from annual periods beginning on or after:	**New and Amended Standards, Interpretation, Practice Statement and Accounting Guideline**
Amended Standards, Interpretation, Practice Statement and Accounting Guideline	
1 April 2021	Amendment to HKFRS 16 *Covid-19-Related Rent Concessions beyond 30 June 2021*
1 January 2022	Amendments to HKFRS 3 *Business Combinations – Reference to the Conceptual Framework*
1 January 2022	Amendments to HKAS 16 *Property, Plant and Equipment – Property, Plant and Equipment – Proceeds before Intended Use*
1 January 2022	Amendments to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets – Onerous Contracts – Cost of Fulfilling a Contract*
1 January 2022	*Annual Improvements to HKFRSs 2018-2020*: • Amendment to HKFRS 1 *First-time Adoption of International Financial Reporting Standards* • Amendment to HKFRS 9 *Financial Instruments* • Amendment to Illustrative Examples accompanying HKFRS 16 *Leases* • Amendment to HKAS 41 *Agriculture*
Common control combinations that occur on or after the beginning of the first annual reporting period beginning on or after 1 January 2022	Revised Accounting Guideline 5 *Merger Accounting for Common Control Combinations*
1 January 2023	Amendments to HKAS 1 *Presentation of Financial Statements – Classification of Liabilities as Current or Non-current* [11]

[11] In June 2021, the IASB decided to propose further amendments to IAS 1 (which was subsequently issued in November 2021 with a comment deadline of 21 March 2022) and to defer the effective date of such amendments to no earlier than 1 January 2024.

Effective from annual periods beginning on or after:	**New and Amended Standards, Interpretation, Practice Statement and Accounting Guideline**
Should only be applied when an entity applies the Amendments to HKAS 1 as referred to in Page 23	Hong Kong Interpretation 5 (2020) *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*
1 January 2023	Amendments to HKAS 1 *Presentation of Financial Statements* and HKFRS Practice Statement 2 *Making Materiality Judgements – Disclosure of Accounting Policies*
1 January 2023	Amendments to HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors – Definition of Accounting Estimates*
1 January 2023	Amendments to HKAS 12 *Income Taxes – Deferred Tax related to Assets and Liabilities arising from a Single Transaction*
Effective date to be determined by the IASB but early adoption is permitted	Amendments to HKFRS 10 *Consolidated Financial Statements* and HKAS 28 *Investments in Associates and Joint Ventures – Sale or Contribution of Assets between an Investor and its Associate or Joint Venture*

The following agenda decisions were published by the IFRS IC in 2021:

IFRS IC Update	**Agenda decisions**
April 2021	• Configuration or Customization Costs in a Cloud Computing Arrangement (IAS 38 *Intangible Assets*)
May 2021	• Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9 *Financial Instruments*) • Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)
June 2021	• Preparation of Financial Statements when an Entity is No Longer a Going Concern (IAS 10 *Events after the Reporting Period*) • Costs Necessary to Sell Inventories (IAS 2 *Inventories*)

IFRS IC Update	Agenda decisions
October 2021	• Non-refundable Value Added Tax on Lease Payments (IFRS 16 *Leases*) • Accounting for Warrants that are Classified as Financial Liabilities on Initial Recognition (IAS 32 *Financial Instruments: Presentation*)
December 2021	• Economic Benefits from Use of a Windfarm (IFRS 16 *Leases*)

About the Standard Setting Department

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing and ethics for professional accountants in Hong Kong. The due process documents of the Standard Setting Department (SSD) explain the processes and procedures for developing local standards and adopting international standards.

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