Hong Kong Institute of
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香港會計師公會

A Refresher Course on Current

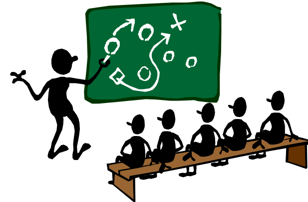
Financial Reporting Standards 2013

Day 1

Time	Topic
09:00 - 11:00	Business combination
11:00 - 11:15	Break
11:15 - 12:45	Statement of cash flow
12:45 - 13:45	Lunch
13:45 - 15:45	Consolidated financial statements
15:45 - 15:30	Break
15:30 - 16:30	Consolidated financial statements (Con't)
16:30 - 17:00	Separate financial statement

A Refresher Course on Current Financial Reporting Standards 2013 (Day 1)

Business Combination



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HKFRS 3
Business Combination

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Agenda

- ❑ Scope of HKFRS 3
- ❑ Business combination vs Asset acquisition
- ❑ Acquisition accounting
- ❑ Measurement and Recognition issues
- ❑ Presentation and Disclosures
- ❑ Recap

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Scope of HKFRS 3

❑ HKFRS 3 applies to a transaction or other event that meets the definition of a business combination **except**

- The formation of a joint venture
- The acquisition of an asset or a group of assets that does not constitute a business
- A combination between entities or businesses under common control

[HKFRS 3.2]

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Identifying a business combination

- **Business Combination: Definition** [HKFRS 3: Appendix A]
  - " A transaction or other event in which an **acquirer** obtains **control** of one or more **business**..."

Do the assets acquired and liabilities assumed constitute a business?

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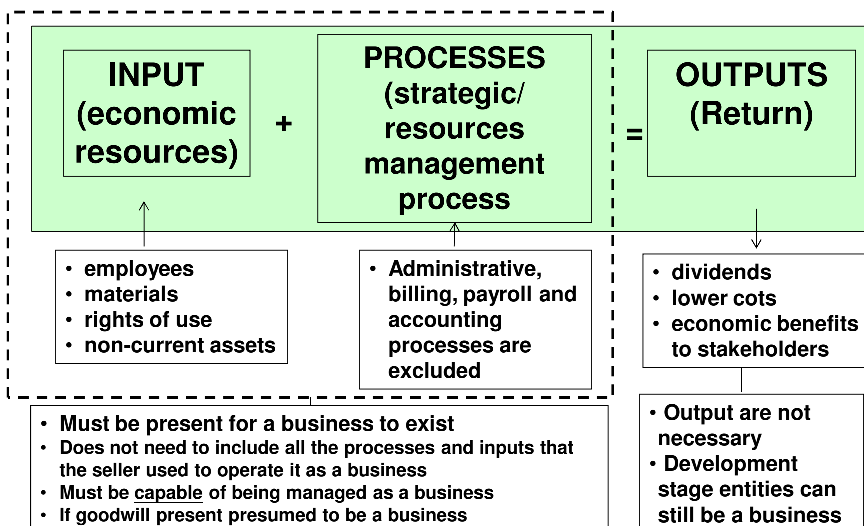
Definition of business [HKFRS 3.B7- B12]



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Acquisition of Asset

- When the acquisition of assets does not constitute a business
  - ⇒ Should NOT be accounted for as a business combination in accordance with HKFRS 3
  - ⇒ No goodwill / gain from bargain purchase arises
- In an acquisition of assets that does not constitute a business, the cost paid by the acquirer should be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.
- Illustration: Annexes 1-3

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Business vs Asset Acquisition

Major differences in accounting treatment

	Business combination	Asset acquisition
Measurement of identifiable assets (including additional intangible assets)	Recorded at fair value	Recorded at costs; cost of acquisition is allocated over the group of assets based on fair values
Goodwill	Recognised	Not recognised
Contingent liabilities	Recognised if represents present obligation that arises from past events and fair value can be reliably measured	Not recognised; subject to HKAS 37
Acquisition-related costs	Expensed as incurred	Capitalised as part of the cost of asset
Deferred tax	Initial recognition exemption not applied - more deferred tax recognised	Initial recognition exemption applies

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Application of Acquisition Method

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Acquisition method

- An entity shall account for each business combination by applying the **acquisition method**
- Applying the acquisition method requires:
  - **Step 1** – Identifying the acquirer
  - **Step 2** – Determining the acquisition date
  - **Step 3** – Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
  - **Step 4** – Recognising and measuring goodwill or a gain from a bargain purchase

[HKAS 3.4,5]

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Step 1:

Identifying An Acquirer

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Who is the Acquirer?

The acquisition method views a business combination from the acquirer's perspective. It assumes that one of the parties to the transaction can be identified as the acquirer. Consequently, HKFRS 3 requires **an acquirer to be identified for all business combinations** [HKFRS 3.6]

Definition of the acquirer: the entity that obtains control over the acquiree

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Has the acquirer obtained control?

- Two-steps approach [HKFRS 3.7]

Step 1 - **Apply the concept of control in HKAS 27 *Consolidated and Separate Financial Statements* to identify the acquirer**

- **Who has the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities? (note: apply HKFRS 10 from 1 January 2013 onwards)**

Step 2 - **If the application of the control concept does not give conclusive answer, should consider additional guidance in HKFRS 3**

Note: **Revised definition of control under HKFRS 10 *Consolidated Financial Statements*, effective I January 2013**:

- An investor controls an investee if and only if the investor has power over the investee, exposure or rights to variable returns from its involvement with the investee and the ability to use its power over the investee to affect the amount of the investor's returns

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Has the acquirer obtained control? (cont'd)

Additional guidance in HKFRS 3.B14-18

The followings are examples ……

Factor	Acquirer is
Consideration is primarily cash	Usually the entity that pays cash
Consideration is primarily equity interests	Usually the entity that issues its equity Interests However, beware of **reverse acquisitions**
Relative size	Usually, the bigger one (with greater assets, revenue and profit)
A new entity is formed to issue equity interests to effect a business combination	One of the combining entities that existed before the business combination shall be identified as the acquirer by applying guidance in HKFRS 3.B13-17

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Step 2

Determining the Acquisition Date

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Acquisition date

- The **date** on which the acquirer **obtains control** of the acquiree [HKFRS 3.8]
- 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**
- The acquirer may obtain control on a date that is either earlier or later than the date on which the transaction is closed or finalised at law. **All pertinent facts and circumstances** surrounding a business combination **should be considered** in assessing when the acquirer has obtained control [HKFRS 3.9]

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Acquisition date – Example

- On 1 Dec 2010, Entity A agreed to pay $20M as a consideration for the acquisition of 100% of the equity interest of Entity B. The agreement states that Entity A obtains the control of Entity B as of the date of the agreement. Entity A paid the consideration of $20M on 1 January 2011

  - Date of acquisition = date the acquirer obtains control of the acquiree
  - Transaction not conditional on the payment of the consideration
  - The agreement specifically states that control passes to Entity A on the date of the agreement
  - Therefore, the date of acquisition for Entity A is 1 Dec 2010

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Acquisition date – Example

- On 1 July 2010, Entity A agreed to pay $20M as a consideration for the acquisition of 100% of the equity interest of Entity B. The agreement states that the acquisition date is 1 Jan 2010. Entity A paid the consideration of $20M on 1 August 2010

  - Date of acquisition = date the acquirer obtains control of the acquiree
  - Despite the agreement states the acquisition date was 1 Jan 2010, Entity A did not have any control before the agreement
  - Control could not be passed back
  - Whether 1 July 2010 or 1 August 2010 is the acquisition date: would depend on when the "actual" control was passed to Entity A
  - Based on all pertinent facts and circumstances

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Acquisition date – Example

- On 1 Jan 2011, Entity A acquired 100% equity interest of Entity B and paid the required consideration. The change of shareholding of Entity B requires approval from the government. The approval was finally obtained on 1 Mar 2011
  - The transaction is conditional subject to the government approval
  - Therefore, the date of acquisition should be the date obtaining the approval from the government
  - Acquisition date = 1 Mar 2011

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Step 3

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

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Recognition principle

- HKFRS 3 contains the following recognition principle:
  - 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** [HKFRS 3.10]

- Some assets and liabilities are recognised as **exceptions to the recognition principle** in accordance with the criteria of particular standards or under other rules. These are:
  - **Contingent liabilities**
  - **Income taxes**
  - **Employee benefits**
  - **Indemnification assets**

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Recognition principle (cont'd)

- **Conditions for recognition**
  - An **asset or liability**, to qualify for recognition, should meet the **definitions contained in the Conceptual Framework** [HKFRS 3.11]

    a) An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity

    b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits [Framework paragraphs 4.44 – 4.46]

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Recognition principle (cont'd)

- **Identifiable**
  - An **asset is identifiable** if it **either**

    a) is **separable,** that is, **capable** of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so, or

    b) arises from **contractual or other legal rights**, regardless of whether those rights are transferrable or separable from the entity or from other rights and obligations

    [HKFRS 3 App A]

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Recognition principle (cont'd)

- **Points to remember on the acquisition date accounting and the recognition principle:**
  - The assets and liabilities should **exist at the acquisition date.** Assets and liabilities that arise after the acquisition date are not recognised [HKFRS 3.11]
    - e.g., future liabilities incurred to carry out restructuring of the acquiree, benefits that the acquirer expects to accrue to its own business as a result of the acquisition
  - The identifiable assets acquired and liabilities assumed are **only those that are part of the acquisition,** i.e. the assets and liabilities acquired in return for the consideration passed between the acquirer and the seller [HKFRS 3.12]
    - e.g., transaction costs are not an asset of the acquired business and are not capitalised into goodwill

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Recognition principle (cont'd)

- Points to remember on the acquisition date accounting and the recognition principle: (cont'd)
  - The assets and liabilities recognised are all of those that meet the definition and the recognition criteria, likely to mean **recognising assets and liabilities that were not recognised by the acquiree in its own balance sheet**

  [HKFRS 3.13]

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Recognition principle (cont'd)

- The acquirer subsumes into goodwill the value of an acquired intangible asset that is **not identifiable** as of the acquisition date [HKFRS 3.B37]

- The acquirer also subsumes into goodwill any value attributed to items that **do not qualify as assets** at the acquisition date [HKFRS 3.B38]

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Measurement principle

- HKFRS 3 contains the following measurement principle:
  - The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their **acquisition-date fair values** [HKFRS 3.18]

- Certain items are not measured in accordance with the measurement principle. They are measured in accordance with another standard or differently. These items are:
  - Income taxes
  - Employee benefits
  - Indemnification assets
  - Reacquired rights
  - Share-based payment awards
  - Assets held for sale

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Measurement principle (cont'd)

- Not permitted to recognise a separate valuation allowance [HKFRS 3.B41]

- Measure the fair value in accordance with its use by **other market participants** instead of 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 [HKFRS 3.B43]

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Classification principle

- The acquirer makes the classifications or designations on the basis of **contractual terms**, **economic conditions**, its **operating or accounting policies**, and other pertinent conditions as they **exist at the acquisition date** [HKFRS 3.15]

- Examples of classifications/designations made at the acquisition date include: [HKFRS 3.16]
  - Classifications of financial assets as at fair value through profit or loss, available-for-sale or held-to-maturity;
  - Classification of financial liabilities as at fair value through profit or loss;
  - Designation of a derivative as a hedging instrument; and
  - Assessment of whether an embedded derivative should be separated from a host contract

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Classification principle (cont'd)

- **Two exceptions** to the principle that classifications or designations are based on the terms of the instruments and conditions at the acquisition date [HKFRS 3.17]:

  - The classification of a **lease contract** as either an operating lease or finance lease in accordance with HKAS 17 *Leases*; and

  - The classification of a contract as **an insurance contract** in accordance with HKFRS 4 *Insurance Contracts*

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Classification principle (cont'd)

- The acquirer classifies such leases and insurance 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 classifications, at the date of that modification, which might be the acquisition date)

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Specific recognition and measurement items

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Intangible assets

- An intangible asset is an identifiable non-monetary asset without physical substance [HKFRS 3 App A]
- An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity [HKAS 38.8]
- An acquirer recognises an acquiree's intangible assets at the acquisition date if they are identifiable [HKFRS 3.B31]
- An intangible is identifiable if either separable or arises from contractual or legal rights

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Examples of intangibles to be recognised in a business combination

- **Marketing-related:** trademarks, internet domain names, newspaper mastheads etc.
- **Customer-related:** customer lists (contractual vs non-contractual), order backlog etc
- **Artistic-related**: plays, operas, books, literary works, musical, films etc
- **Contract-based:** lease agreement, royalty agreement, mining rights, servicing contracts etc
- **Technology-based:** patented technology, software, database, trade secrets (formulas, recipes) etc

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Recognition of intangible assets - example

The net assets acquired in Second acquisition, and the goodwill arising, are as follows:

	Carrying amount before combination RMB'000	Fair value adjustments RMB'000	Fair value RMB'000
Net assets acquired:			
Property, plant and equipment	1,720	—	1,720
Deferred tax assets	11,058	—	11,058
Intangible assets - license	—	190,002	190,002
- trademark	—	61,922	61,922
- backlog orders	—	9,190	9,190
- development cost	3,177		3,177
Inventory	95,326	—	95,326
Trade receivables	79,905	—	79,905
Other receivables and prepayments	14,084	—	14,084
Amounts due from Minority shareholders	2,550	—	2,550
Cash and cash equivalent	96,056	—	96,056
Trade payables	(62,220)	—	(62,220)
Other payables, deposits received and accruals	(93,711)	—	(93,711)
Deferred tax liabilities	—	(39,167)	(39,167)
Income tax payable	(12,664)	—	(12,664)
Deferred income	(62,984)	—	(62,984)
	72,297	221,947	294,244
Preliminary interest held by the Group as an associate			(138,206)
Minority interest			(123,553)
Goodwill arising on acquisition			8,839
Total consideration			41,324

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Intangible Assets – Operating Lease

- **Classification as operating or finance:**
  - **Classification** of a lease contract as either an operating or a finance lease at the acquisition date is **based on factors at the inception of the lease**, which is generally before the acquisition date
  - If the **terms of the contract have been changed** subsequent to the inception of the lease such that the classification of the lease would change, then the classification at the acquisition date is **based on the contractual terms and other factors at the date of that change**

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Intangible Assets – Operating Lease (cont'd)

- **Measurement where acquiree is the lessee:**
  - Where the acquiree is a lessee under an operating lease, an acquirer does not generally recognise an asset for the interest in a leased asset and a liability for the lease payments
  - An acquirer recognises a net asset or liability to the extent that the lease is favourable or unfavourable compared to market terms [HKFRS 3.B28]
  - The acquirer recognises an **intangible asset** if the terms of the lease are **favorable** to market conditions and a **liability** if the terms are **unfavorable at the acquisition date** [HKFRS 3.B29]

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Intangible Assets – Operating Lease (cont'd)

- **Measurement where acquiree is the lessor:**
  - Fair value of the leased asset (e.g. investing property) should take into account the terms of the lease
  - The acquirer should **NOT** recognise the lease agreement as a separate asset or liability [HKFRS 3.B42]

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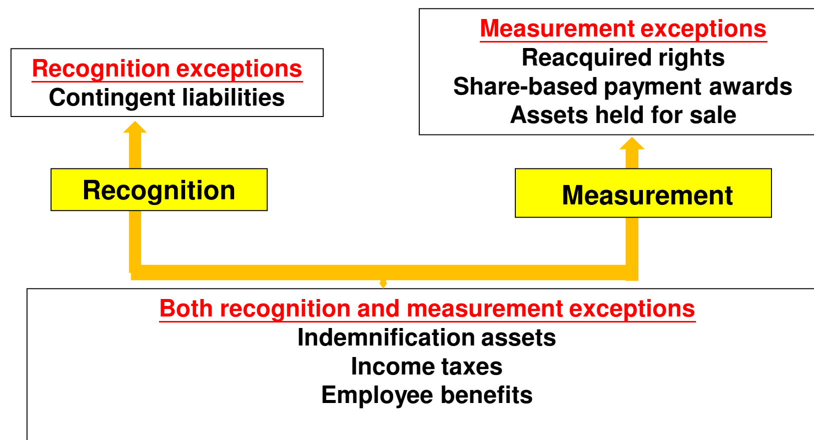
Recognition and measurement exceptions



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Exceptions to the recognition principles

❑ Contingent liabilities

- In a business combination, the requirements of HKAS 37 are not applied in determining which contingent liabilities should be recognised as of the acquisition date
- HKFRS 3 requires that the acquirer should recognise a contingent liability assumed in a business combination as of the acquisition date if: [HKFRS 3.23]
  - it is a present obligation that arises from past events; and
  - its fair value can be measured reliably

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Exceptions to the recognition principles

❑ Contingent liabilities (cont'd)

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

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Exceptions to the recognition principles (cont'd)

❑ Different requirements for contingent liabilities within and outside of a business combination

	HKAS 37 – ongoing preparer	**Business combination**
Possible obligation	Not recognised	Not recognised
Present obligation – not probable that an outflow of economic benefits will occur	Not recognised	Recognised if reliably measurable
Present obligation – probable that an outflow of economic benefits will occur, but cannot be measured reliably	Not recognised	Not recognised

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Exceptions to the recognition principles (cont'd)

❑ Contingent liabilities – subsequent measurement

- After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the **higher** of :
  - the amount that would be recognised in accordance with HKAS 37; and
  - the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with HKAS 18 *Revenue*

[HKFRS 3.56]

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Exceptions to both recognition and measurement Principles

❑ Indemnification assets

- The seller in a business combination may **contractually indemnify the acquirer** for the **outcome of a contingency or uncertainty related to all or part of a specific asset or liability**
  - e.g., the vendor agrees to pay the acquirer the settlement costs of an outstanding court case against the acquiree
  - e.g., the acquired entity is the subject of an uncertain tax position and the vendor agrees to refund the acquiree if any costs are incurred as a result of the investigation, up to a cap

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Exceptions to both recognition and measurement Principles

❑ **Indemnification assets (cont'd)**

The acquirer obtains an indemnification asset as a result of the indemnification [HKFRS 3.27]

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Exceptions to both recognition and measurement Principles (cont'd)

❑ **Indemnification assets (cont'd)**

- Acquirer **recognise an indemnification asset** at the **same time** when the **acquirer recognises the indemnified item**, assuming that there is no uncertainty over the recovery of the indemnification asset

- The **indemnified item** (i.e., contingent liability) is measured at **fair value.** The **indemnification asset** should also be measured at **fair value** using the same assumptions
  - ➢ not necessarily mean that they are recognised at the same amount (e.g. a cap for indemnification)

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Exceptions to both recognition and measurement Principles (cont'd)

Example: Indemnified liability measured at fair value

- Entity E acquires entity F from group G. Entity F manufactures and sells food products. At the time of the acquisition entity F is the defendant in a class action court case whereby a group of entity F's customers have alleged that entity F's products contain harmful levels of artificial colouring that have caused them liver damage
- The claimants are suing entity F for damages of $20m
- Group G has indemnified entity E for the losses up to $10m
- How should entity E account for the contingent liability and the indemnification asset?

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Example: Indemnified liability measured at fair value (cont'd)

- Entity E determines that the fair value of the contingent liability for the court case is $7m. In the business combination $7m is recognised as an identifiable liability of entity F
- Entity E recognises a separate asset of $7m on its consolidated balance sheet (as entity E considers that the $7m will be fully collectible from group G). This has the effect of reducing goodwill by $7m as the indemnification asset is recognised as part of the business combination accounting by reducing the consideration transferred
- The net impact on goodwill from the recognition of the contingent liability and associated indemnification asset is nil

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Example: Indemnified liability measured at fair value (cont'd)

- Entity E does not recognise an asset that is greater than the liability's fair value
- The liability is measured at fair value and the asset is measured on the same basis as no adjustment has been required for collectability or contractual limitations on the indemnified amount

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Exceptions to both recognition and measurement Principles (cont'd)

❑ Indemnification assets – subsequent measurement

- At the end of each subsequent reporting period, the acquirer shall **measure an indemnification asset** that was recognised at the acquisition date on the **same basis** as the **indemnified liability or asset**, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset
- The acquirer shall **derecognise the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it**

  [HKFRS 3.57]

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Exceptions to both recognition and measurement Principles (cont'd)

❑ Income Taxes

- The acquirer shall recognise and measure a deferred asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with HKAS 12 "Income Taxes"
  [HKFRS 3.24]

- 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
  [HKFRS 3.25]

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Exceptions to both recognition and measurement Principles (cont'd)

❑ Recognition of deferred tax assets after initial accounting is complete

- If potential tax benefits (as at acquisition date) subsequently meet the recognition criteria in accordance with HKAS 12 within the measurement period as a result from new information about facts and circumstances that existed at acquisition date, recognise the acquired deferred tax benefit

- Reduce carrying amount of goodwill related to the acquisition. Must not result in the recognition or an increase of "discount" on acquisition (i.e., reduce goodwill up to zero)

- If the carrying amount of the goodwill is zero, any remaining deferred tax benefits shall be recognised in profit or loss [HKAS 12.68(a)]

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Exceptions to both recognition and measurement Principles (cont'd)

Employee Benefits

- The acquirer shall recognise and measure a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with HKAS 19 "Employee Benefits"

  [HKFRS 3.26]

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Exceptions to the measurement principle

Re-acquired rights

- An **acquirer** may **re-acquire a right** that it had **granted** to the **acquiree** to use one or more of the acquirer's recognised or unrecognised assets
  - e.g., right to use the acquirer's trade name under a franchise agreement
  - e.g., right to use the acquirer's technology under a technology licensing agreement

Re-acquired rights generally are **identifiable intangible assets** that the acquirer **separately recognises from goodwill** [HKFRS 3.B35]

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Exceptions to the measurement principle

❑ **Re-acquired rights**

Re-acquired rights are not measured at fair value because the value is determined based only on the right's remaining contractual life without considering renewals

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Exceptions to the measurement principle (cont'd)

❑ **Re-acquired rights – Subsequent measurement**

- A re-acquired right recognised as an intangible asset shall be **amortised over the remaining contractual period** of the contract in which the right was granted
- An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale

[HKFRS 3.55]

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Exceptions to the measurement principle (cont'd)

❑ **Share-based payment awards**

- The acquirer shall **measure a liability or an equity instrument** related to share-based payment transactions of the acquiree **or** the **replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer** in accordance with the method in HKFRS 2 *Share-based Payment* at the acquisition date

[HKFRS 3.30]

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Exceptions to the measurement principle (cont'd)

❑ **Assets held for sale**

- The acquirer shall **measure an acquired non-current asset** (or disposal group) that is classified as held for sale at the acquisition date **in accordance with HKFRS 5** *Non-current Assets Held for Sale and Discontinued Operations* **at fair value less costs to sell**

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Step 4

Recognising & measuring goodwill or a gain from a bargain purchase

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Recognition and measuring goodwill

- The acquirer shall recognise **goodwill** as of the acquisition date measured as the **excess of (a) over (b)** below:[HKFRS 3.32]

  a) The **aggregate** of:

     i. the **consideration transferred** measured in accordance with HKFRS 3, which generally requires acquisition-date fair value

     ii. the **amount of any non-controlling interest** in the acquiree measured in accordance with HKFRS 3; and

     iii. in a business combination achieved in stages, the **acquisition-date fair value of the acquirer's previously held equity interest** in the acquiree

  b) the **net of the acquisition-date amounts** of the **identifiable assets acquired and the liabilities assumed** measured in accordance with HKFRS 3

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Recognising and measuring goodwill (cont'd)

- **Goodwill:** recognise as an asset at date of acquisition
- **Do not amortise**
- **Test for impairment** at least annually, or more frequently when there are indicators of impairment [apply HKAS 36]

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Recognition and measuring a gain from a bargain purchase

- The acquirer will make a **bargain purchase** in which the amount in **(b) exceeds the amount in (a)** below: [HKFRS 3.33]

  a) The **aggregate** of:
     i. the **consideration transferred** measured in accordance with HKFRS 3, which generally requires acquisition-date fair value
     ii. the **amount of any non-controlling interest** in the acquiree measured in accordance with HKFRS 3; and
     iii. in a business combination achieved in stages, the **acquisition-date fair value of the acquirer's previously held equity interest** in the acquiree

  b) the **net of the acquisition-date amounts** of the **identifiable assets acquired and the liabilities assumed** measured in accordance with HKFRS 3

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Recognition and measuring a gain from a bargain Purchase (cont'd)

- Before recognising a gain on a bargain purchase, the acquirer shall **reassess** whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review
- The acquirer shall then **review the procedures** used to measure the amounts required to be recognised at the acquisition date for the identifiable assets acquired and liabilities assumed, the non-controlling interest in the acquiree, for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree, and the consideration transferred

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Recognition and measuring a gain from a bargain Purchase (cont'd)

- Gain on bargain purchase is recognised in profit or loss immediately
- Anomalous transactions, may occur in forced liquidation/distress sale
- Exception of future losses/costs to be incurred is not a valid reason

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❑ Consideration transferred

HKFRS 3 requires the **consideration transferred** in a business combination to be measured **at fair value**, which shall be calculated at the **sum** of: [HKFRS 3.37]

- the acquisition-date fair value of the assets transferred by the acquirer;
- the liabilities incurred by the acquirer to former owners of the acquiree; and
- the equity interests issued by the acquirer to the former owners of the acquiree (except for the measurement of share-based payment awards)

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❑ Consideration transferred (cont'd)

- Acquisition-related costs are costs the acquirer incurs to effect a business combination (including finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities)

- The acquirer shall account for **acquisition-related costs as expenses** in the periods in which the costs are incurred and the services are received, with **one exception**
  - The costs to **issue debt or equity securities** shall be **recognised** in accordance with **HKAS 32 and HKAS 39**

[HKFRS 3.53]

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❑ Cost of business combination

- **Issue equity instruments as consideration**
  - if market price exists - use price at date of exchange (i.e.acquisition date)
  - if market price does not exist/unreliable - use other valuation technique
  - published price at date of exchange – best evidence and shall be used
  - unreliable – only when affected by the thinness of the market

Enter into contract (subject to shareholders approval)	Shareholders' meeting	Acquisition completed
Share price : 0.50	**Share price : 0.60**	**Share price : 0.80**

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❑ Cost of business combination (cont'd)

- **Share-based payment awards**
  - Exchanges of share options or share-based payment awards in conjunction with a business combination are accounted for as **modifications of share-based payment awards in accordance with HKFRS 2**

[HKFRS 3.B56]

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❑ Cost of business combination (cont'd)

▪ Share-based payment awards (cont'd)

- If the **acquirer replaces the acquiree awards**, either all or a portion of the **market-based measure of the acquirer's replacement awards** shall be **included in measuring the consideration transferred** in the business combination [HKFRS 3.B56]
- In situations in which **acquiree awards** would **expire** as a consequence of a business combination and if the **acquirer replaces those awards when it is not obliged to do so**, all of the market-based measure of the replacement awards shall be **recognised as remuneration cost** in the post-combination financial statements in accordance with HKFRS 2 [HKFRS 3.B56]

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❑ Cost of business combination (cont'd)

▪ Provisional fair values

- If the **initial accounting** for a business combination is **incomplete** by the **end of the reporting period** in which the combination occurs, the acquirer shall report in its financial statements **provisional amounts** for the items for which the accounting is incomplete [HKFRS 3.45]
- During the **measurement period**, the acquirer shall **retrospectively adjust the provisional amounts** recognised at the acquisition date to reflect **new information** obtained about facts and circumstances that existed as of the acquisition date and, if known, would have **affected the measurement** of the amounts recognised as of that date [HKFRS 3.45]

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❑ Cost of business combination (cont'd)

▪ Provisional fair values (cont'd)

- During the measurement period, the acquirer shall also **recognise additional assets or liabilities** if **new information** is obtained about facts and circumstances that **existed** as of the acquisition date and, if known, would have resulted in the **recognition of those assets and liabilities** as of that date [HKFRS 3.45]

- The **measurement period ends** as soon as the **acquirer receives the information** it was seeking about facts and circumstances that existed as of the acquisition date **or** learns that **more information is not obtainable**. However, **the measurement period shall not exceed one year from the acquisition date** [HKFRS 3.45]

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❑ Cost of business combination (cont'd)

▪ Provisional fair values (cont'd)

- The acquirer shall consider **all pertinent factors** in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognised or whether that information results from events that occurred after the acquisition date (e.g. information obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later) [HKFRS 3.47]

- The acquirer recognises an **increase (decrease)** in the **provisional amount** recognised for an identifiable asset (liability) by means of a **decrease (increase) in goodwill** [HKFRS 3.48]

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❑ Cost of business combination (cont'd)

▪ Provisional fair values (cont'd)

- During the measurement period, the acquirer shall recognise adjustments to the provisional amounts **as if** the accounting for the business combination had been **completed at the acquisition date**. Thus, the acquirer shall **revise comparative information** for prior periods presented in financial statements as needed, including making any change in depreciation, amortisation or other income effects recognised in completing the initial accounting [HKFRS 3.49]

- **After the measurement periods ends**, the acquirer shall **revise** the accounting for a business combination only to **correct an error** in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* [HKFRS 3.50]

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❑ Cost of business combination (cont'd)

▪ Contingent consideration

- Contingent consideration is usually, **an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree** as part of the exchange for control of the acquiree if specified future events occur or conditions are met [HKFRS 3 App A]

- Contingent consideration can also take the form of **a right of the acquirer to the return of previously transferred assets or equity interests from the sellers** of the acquired business

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❑ Cost of business combination (cont'd)

▪ Contingent consideration (cont'd)

- Contingent consideration should be **measured at fair value at the date of acquisition** [HKFRS 3.39]
- An **acquirer's right to receive contingent consideration** (that is, contingently returnable consideration) is **classified as an asset** [HKFRS 3.40]
- An **acquirer's obligation to pay contingent consideration** is **classified as a liability or equity** based on the definition of an equity instrument and a financial liability in HKAS 32 [HKFRS 3.40]

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❑ Cost of business combination (cont'd)

▪ Contingent Consideration: Subsequent Accounting

- Some **changes in the fair value of contingent consideration** that the acquirer recognises **after the acquisition date** may be the **result of additional information that the acquirer** obtained after that date about facts and circumstances that **existed at the acquisition date**. Such changes are **measurement period adjustments**
- **Changes** resulting from **events after the acquisition date**, such as meeting an earning target, reaching a specified share price or reaching a milestone on a research and development project, are **not measurement period adjustments**

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❑ Cost of business combination (cont'd)

- **Contingent Consideration: Subsequent Accounting (cont'd)**

  - The acquirer shall account for **changes in the fair value** of contingent consideration that are **not measurement period adjustment** as follows:

    - ➢ Contingent consideration classified as **equity** shall **not be remeasured** and its subsequent settlement shall be **accounted for within equity**

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❑ Cost of business combination (cont'd)

- **Contingent Consideration: Subsequent Accounting (cont'd)**

  - ➢ Contingent consideration **classified as an asset or a liability** that:
    - is a **financial instrument** and is within the scope of HAKS 39 shall be **measured at fair value**, with any **resulting gain or loss** recognised either in **profit or loss** or in **other comprehensive income** in accordance with that HKFRS
    - is **not within the scope of HKAS 39** shall be accounted for in accordance with **HKAS 37** or other HKFRSs as appropriate

[HKFRS 3.58]

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❑ Determination what is part of the business combination transaction

- The acquirer and the acquiree may have a **pre-existing relationship** or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination
- The acquirer shall **identify any amounts that are not part** of what the acquirer and the acquiree (or its former owners) **exchanged** in the business combination, i.e., amounts that are not part of the exchange for the acquiree
- The acquirer shall **recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree**

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❑ Determination what is part of the business combination transaction (cont'd)

- A transaction 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, is likely to be a **separate transaction**
- **Examples** of separate transactions that are not included in applying the acquisition method:
  - A transaction that in effect **settles pre-existing relationships** between the acquirer and acquiree;
  - A transaction that **remunerates employees or former owners of the acquiree** for future services; and
  - A transaction that **reimburses the acquiree or its former owners** for paying the acquirer's acquisition-related costs

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❑ Determination what is part of the business combination transaction (cont'd)

- **Pre-existing relationship**

  - The acquirer and acquiree may have a relationship that **existed before** they contemplated the **business combination**, referred to as **"pre-existing relationship"**

  - A pre-existing relationship between the acquirer and acquiree may be **contractual** (e.g. vendor and customer, licensor and licensee) or **non-contractual** (e.g. plaintiff and defendant)

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❑ Determination what is part of the business combination transaction (cont'd)

- **Pre-existing relationship (cont'd)**
  - If the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:
    a) for a **pre-existing non-contractual relationship**, **fair value**
    b) for a **pre-existing contractual relationship**, the **lesser of (i) and (ii)**
      (i) the amount by which the contract is **favorable or unfavorable** from the **perspective** of the **acquirer** when **compared** with terms for **current market transactions** for the same or similar items
      (ii) the amount of any **stated settlement provisions** in the contract available to the counterparty to whom the contract is **unfavourable**

    If **(ii) is less than (i),** the **difference** is **included** as **part of the business combination accounting**

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❑ Determination what is part of the business combination transaction (cont'd)

- **Pre-existing relationship (cont'd)**
  - The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements [HKFRS 3.B52]
  - A pre-existing relationship may be a contract that the acquirer recognises as a **reacquired right**. If the **contract includes terms** that are **favorable or unfavorable** when compared **with pricing for current market transactions** for the same or similar items, the acquirer **recognises**, separately from the business combination, a **gain or loss for the effective settlement of the contract**, measured in accordance with HKFRS 3.B52

  [HKFRS 3.B53]

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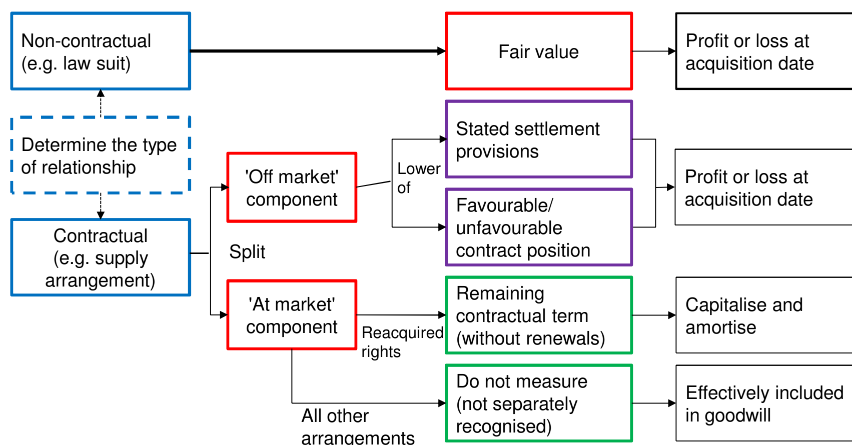
❑ Determination what is part of the business combination transaction (cont'd)

Pre-existing relationship between acquirer and acquiree



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Pre-existing relationship between acquirer and acquiree (cont'd)

Example: Settlement loss on a contractual relationship

- Entity C provides services to entity D under a fixed price contract. Entity C acquires entity D for $100m. Since the inception of the contract, the market price for these services has increased. The terms in the contract are unfavourable compared to current market transactions for entity C in the amount of $10m. The contract contains a provision that would cost either party $6m to terminate the contract at the acquisition date. The fair value (in accordance with HKFRS 3) of entity D's identifiable net assets is $82m, excluding the favourable contract asset

- How much does entity C recognise on settlement of the contract?

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Pre-existing relationship between acquirer and acquiree (cont'd)

Example: Settlement loss on a contractual relationship (cont'd)

- Entity C recognises a settlement loss of $6m, excluding the effect of income taxes

- The amount recognised is the lesser of:
  - the amount the contract terms are either favourable or unfavourable (from the acquirer's perspective) compared to pricing for current market transactions for the same or similar items. This is $10m
  - the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable. This is $6m

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Example: Settlement loss on a contractual relationship (cont'd)

- The $100m in cash paid by entity C is attributed as $6m to settle the services contract and $94m to acquire entity D. The $4m difference between the fair value of the unfavourable contract terms and the contractual settlement provision is included as part of the business combination (and will be part of goodwill). The acquisition of entity D and the effective settlement of the services contract would be recorded as follows (in millions):

		Dr	Cr
Dr	Loss on settlement of services contract with entity	6	
Dr	Goodwill	12	
Dr	Acquired net assets of entity D	82	
	Cr Cash		100

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Example: Settlement loss with a liability previously recorded on a non-contractual relationship

- Entity A is a defendant in litigation relating to a patent infringement claim brought by entity B. Entity A pays $50m to acquire entity B and effectively settles the lawsuit. The fair value of the settlement of the lawsuit is estimated to be $5m
- Entity A had recorded a $3m provision in its financial statements before the acquisition. The fair value (in accordance with HKFRS 3) of entity B's identifiable net assets is $40m, excluding the lawsuit contingent asset
- The fair value of the non-contractual relationship is $5m. After taking account of the provision already recorded on its balance sheet, entity A records a settlement loss related to the litigation of $2m in its income statement, excluding the effect of income taxes

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Example: Settlement loss with a liability previously recorded on a non-contractual relationship (cont'd)

- The acquisition of entity B and the effective settlement of the litigation are recorded as separate transactions (in millions):

		Dr	Cr
Dr	Litigation liability	3	
Dr	Loss on settlement of lawsuit with entity B	2	
Dr	Goodwill	5	
Dr	Acquired net assets of entity B	40	
	Cr Cash		50

- If entity A had previously recorded a liability greater than $5m, a settlement gain would be recognised for the difference between the liability previously recorded and the fair value of the settlement

- $5m of the cash paid has been used to settle the litigation, and $45m has been used to purchase business B

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Example – Re-acquired Rights

- Franchisor P acquires the business of operating Franchisee S for $30,000. In connection with acquisition, P reacquires previously granted franchise rights. The re-acquired franchise right is valued at $3,000 in accordance with the measurement guidance in HKFRS 3
- The terms of the contract covering the rights are unfavourable for P, by $4,000 relative to the terms of current market transactions for similar items. The contract includes a cancellation penalty of $5,000
- The fair value of the identifiable net assets of S, excluding the franchise right, which is measured in accordance with HKFRS 3, is $17,000

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Example – Re-acquired Rights (cont'd)

The cancellation penalty > off-market value of the contract ➔ loss on settlement of the pre-existing relationship is measured based on the value of the off-market component of the contract from P's perspective

	DEBIT	CREDIT
Loss on settlement (profit or loss)	4,000	
Consideration transferred		4,000
To recognise settlement of pre-existing relationship		
Re-acquired rights (intangible asset)	3,000	
Other identifiable net assets of S	17,000	
Goodwill	6,000	
Consideration transferred		26,000
To recognise re-acquired right as part of acquisition accounting		

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❑ Determination what is part of the business combination transaction

- **Contingent payment to employees**
  - The acquirer or vendor may make payments to the employees of the acquiree, which are **contingent on a post-acquisition event** such as a period of continuing service as an employee. In such cases, it is necessary to determine what element of the **payment qualifies as consideration**, and what element is for **post-acquisition services**
  - **Understanding the reasons** why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement

[HKFRS 3.B54]

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Contingent payment to employees (cont'd)

- The acquirer shall consider the following indicators to determine whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or a separate transaction [HKFRS 3.B55]
  - Contingent employment
  - Duration of continuing employment
  - Level of remuneration
  - Incremental payment to employees
  - Number of shares owned
  - Linkage to the valuation
  - Formula for determining consideration
  - Other agreements and issues

Refer to HKFRS 3.B55 for a detailed illustration on each of the above factors

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

A business combination achieved in stages

- An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date

- For example, on 31 December 2012, Entity A holds a 35% non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40% interest in Entity B, which gives it control of Entity B. HKFRS 3 refers to such a transaction as a **business combination achieved in stages or step acquisition**

  [HKFRS 3.41]

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

- **A business combination achieved in stages (cont'd)**
  - In a business combination achieved in stages, the acquirer shall **remeasure its previously held equity interest** in the acquiree at its acquisition-date fair value and **recognise the resulting gain or loss**, if any, in profit or loss

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

- **A business combination achieved in stages (cont'd)**
  - In **prior reporting periods**, the acquirer may have **recognised changes** in the **value** of its **equity interest** in the acquiree in **other comprehensive income** (e.g. investment classified as available for sale). If so, the amount that was recognised in other comprehensive income shall be **recognised** on the **same basis** as would be required if the acquirer had **disposed** directly of the **previously held equity interest**

Previous interests	Effects on step acquisition
At fair value through profit or loss	No additional effects
Available for sale investment	Treat as disposal -> reclassify cumulative G/L from equity to profit or loss
Equity method	Treat as disposal -> reclassify share of associate / JCE's reserve to profit or loss
Proportionate consolidation	Same as above

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

- **A business combination achieved without the transfer of consideration**
  - An acquirer sometimes obtains control of an acquiree without transferring consideration. The acquisition method of accounting for a business combination applies to those combinations
  - Such circumstances include:
    a) The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control

    b) Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights

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Non-controlling Interest (NCI)

- ❑ Non-controlling interest – the equity in a subsidiary not attributable, directly or indirectly, to a parent
- ❑ Under HKAS 27, non-controlling interests can be measured on two bases

  Option 1: by reference to the fair value of the non-controlling interests

  Option 2: by reference to the NCI's share of the identifiable net assets of the acquiree
- ❑ Choice applies for each business combination – not an accounting policy
- ❑ Test for impairment [HKAS 36, Appendix C]: only relevant when Option 2 is applied
- ❑ Allocate to non-controlling interest even when the allocation will result in non-controlling interest having deficit balance

[HKAS 27]

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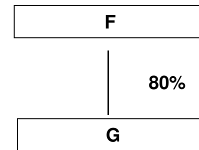
Example – Simple acquisition with NCI



Fact pattern
• Entity F acquires 80% of Entity G for $1,000
• Fair value of net assets of G is $1,000
• Fair value of the NCI is $250

Analysis	NCI based on net assets	NCI based on fair value
Fair value of consideration transferred	1,000	1,000
Amount of non-controlling interest (NCI)	200	250
1,000 (net asset of G) x 20%	**1,200**	**1,250**
Net identifiable assets acquired	1,000	1,000
Goodwill	**200**	**250**

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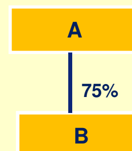
Example – Financial asset under HKAS 39 becomes a subsidiary

Step acquisition with NCIs

Fact pattern
- **Entity A acquires Entity B in a step acquisition**
- **Step 1 (15%) A classifies B as an available-for-sale financial asset**
- **Step 2 (60%) results in A controlling B**
- **Key information is as follows:**



	Step 1	Step 2
Date of acquisition	20X1	20X6
Interest acquired	15%	60%
Total purchase consideration (FV)	10,000	60,000
Fair value of net identifiable assets		80,000
Fair value of original 15% holding	12,000	12,500
Fair value of NCI		20,000

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Example – Financial asset under HKAS 39 becomes a subsidiary (cont'd)

Step acquisition with NCIs

- In 2012, A will include $2,500 in profit or loss, being

Gain on "disposal" of 15% investment ($12,500 - $12,000)	500
Gain previously reported in OCI ($12,000 - $10,000)	2000
Total	2500

- In 2012, A will measure goodwill as follows:

Fair value of consideration given for controlling interest	60,000
Non-controlling interest (25% x $80,000)	20,000
Fair value of previously-held interest	12,500
Sub-total	92,500
Less: fair value of net assets of acquiree	(80,000)
Goodwill	12,500

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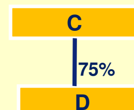
Example – Associate becomes a subsidiary

Step acquisition with NCIs

Fact pattern

- Entity C acquires Entity D in a step acquisition
- Step 1 (40%) C classifies D as an associate (using equity method)
- Step 2 (35%) Additional 35% results in C controlling D
- Key information is as follows:



	Step 1	Step 2
Date of acquisition	20X1	20X6
Interest acquired	40%	35%
Total purchase consideration (FV)	40,000	55,000
Fair value of net identifiable assets		110,000
Fair value of the previously-held 40% interest		50,000
Fair value of NCI		30,000

- C equity accounted for its share of undistributed profits totally $5,000 and included its share of an HKAS 16 revaluation gain of $3,000 in OCI

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Example – Associate becomes a subsidiary (cont'd)

Step acquisition with NCIs

- **In 20x6, C will include $2,000 in profit or loss, being**

Fair value of previously-held interest	**50,000**
Less: carrying amount under HKAS 28	**48,000**
Total	**2,000**

- **In 20X6, C will measure goodwill as follows:**

Fair value of consideration given for controlling interest	**55,000**
Non-controlling interest (fair value)	**30,000**
Fair value of previously-held interest	**50,000**
Sub-total	**135,000**
Less: fair value of net assets of acquiree	**(110,000)**
Goodwill	**25,000**

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Increased shareholding in subsidiary

- An increase in shareholding in an existing subsidiary is treated as a transaction between owners with an adjustment to reserves
- Goodwill is not recalculated
- No gain or loss to profit or loss

	$
Fair value of consideration paid	(X)
Decrease in NCI in net assets at date of transaction	X
Decrease in NCI in goodwill at date of transaction (note)	X
Adjustment to parent's equity	**(X)**
Note: this line is only included where NCI are measured at fair value at the date of acquisition. **Dr. Equity – NCI** **Dr. Equity – controlling interests** **Cr. Cash or other consideration paid**	

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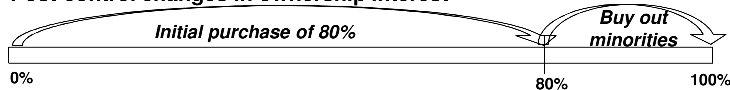
Example – Buy out NCI

Post-control changes in ownership interest



Entity F owned a 80% subsidiary, Entity G, F acquires further 20% interest in G from the NCI for $300. Carrying amount of Entity G's net assets is $1,000 (20% equates to $200). Entity F's other assets are recognized at $2,000.

	Group accounts	
	80% of G	**100% of G**
Net identifiable assets of G	1,000	1,000
Entity F's other assets (including cash)	2,000	1,700
Consolidated net assets of F	**3,000**	**2,700**
Non-controlling interest	200	-
Reserves	-	(100)
Other equity	2,800	2,800
Total equity	**3,000**	**2,700**

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❑ Key Disclosures

- For **EACH business combination effected during the period**, disclose:
  - Name and description of the acquiree
  - Acquisition date
  - Percentage of voting equity interest acquired
  - Primary reasons for business combination and a description of how the acquirer obtained control of the acquiree
  - Cost of business combination and the components of cost (e.g. cash, liabilities incurred, FV and number of equity instrument issued)
  - The amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed
  - The amount of goodwill / discount (a description of factors that contribute to recognition of goodwill / discount)
  - The amount of NCIs recognised and the measurement basis for that amount
  - Revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income

  (Note: The above disclosures are not exhaustive. Please refer to HKFRS 3. B64 – B67 for details and Annex 6 for illustrative disclosures)

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Acquisition of a subsidiary – illustration

[X]. Acquisition of a subsidiary

On 31 March 20X5, the Company acquired 100 per cent of the issued share capital of Entity A for a cash consideration of HKD [X]. The acquisition has been accounted for using the purchase method.

Net assets acquired	Carrying amounts HKD	Fair value adjustments HKD	Fair values HKD
Property, plant and equipment	[X]	[X]	[X]
Trademarks	[X]	[X]	[X]
[Other acquired assets / liabilities…]	[X]	[X]	[X]
	[X]	[X]	[X]
Goodwill			[X]
Total consideration			[X]
Satisfied by cash			[X]
Net cash flow arising on acquisition:			
Cash consideration			[X]
Cash and cash equivalent acquired			[X]
			[X]

Pro Forma Group's Revenue and Results

If the acquisition had been completed on 1 January 20X5, unaudited group's revenue and group's profit attributable to the equity holders of the Company for the year ended 31 December 20X5 would have been HKD [X] and HKD [X] respectively. The pro forma information is presented for illustrative purposes only and is not necessarily an indicative revenue and results of operations of the Group that actually would have been achieved had the acquisition been completed on 1 January 20X5, nor is it intended to be a projection of future results.

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Accounting for Business Combination - An Overview

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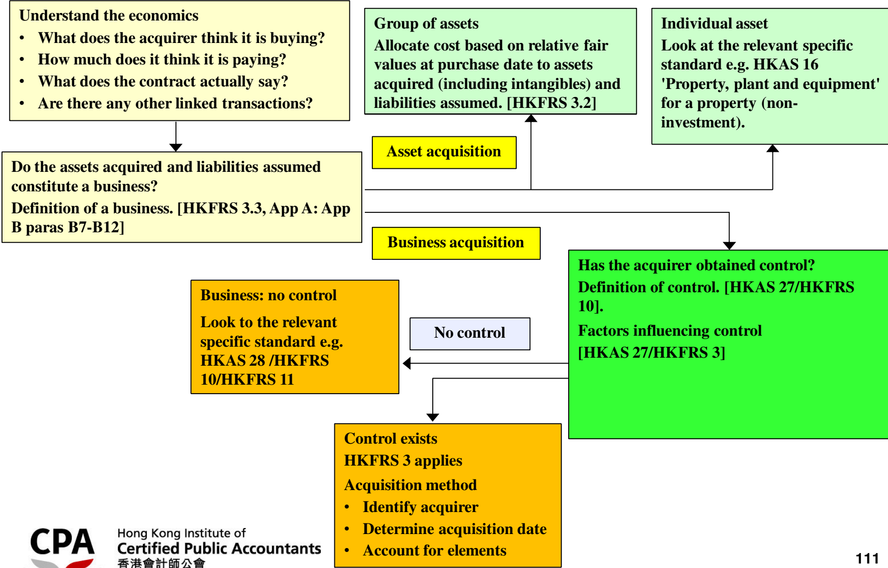
Process for accounting for business combinations (1)



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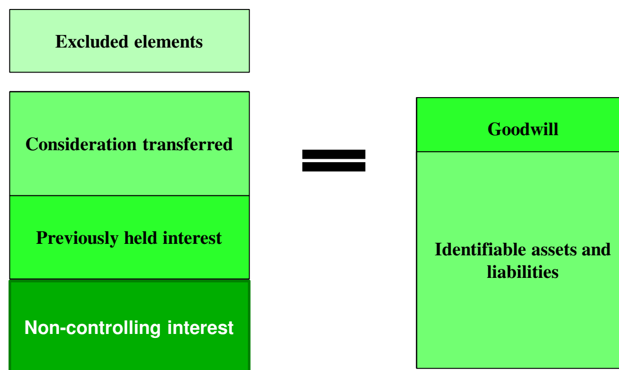
Process for accounting for business combinations (2)



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Process for accounting for business combinations (2)

Consider (a) reasons for the transaction; (b) who initiated the transaction; (c) timing of the transaction [HKFRS 3.B50]

Examples of excluded elements

- Transaction costs [HKFRS 3.53]
- Settlement of pre-existing relationship [HKFRS 3.52]
- Remuneration for future employee services [HKFRS 3.52]
- Reimbursement for paying the acquirer's acquisition costs [HKFRS 3.52]
- Costs to issue debt or equity [HKFRS 3.53]
- Payment for indemnification assets [HKFRS 3.57]

Goodwill

- Goodwill is a residual
- 'Full' or 'partial' goodwill depends on measurement of NCI.

Bargain purchase

- Re-assess fair values [HKFRS 3.36]
- Recognise gain in profit or loss [HKFRS 3.34]

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Process for accounting for business combinations (2)

Components of consideration transferred
[HKFRS 3.37]

- Assets transferred
- Liabilities incurred by acquirer to former owners.
- Equity interests issued by acquirer
- All consideration is recognised and measured at fair value

Forms of consideration transferred (examples)

- Cash, other assets, businesses or subsidiaries of the acquirer
- Contingent consideration [HKFRS 3.39-40]
- Equity instruments, options, warrants [HKFRS 3.37]
- Deferred consideration
- Replacement share awards [HKFRS 3.B56]

Contingent consideration
[HKFRS 3.39, 40, 58]

- Classify as liability or equity
- Equity is not remeasured
- Liability is remeasured through profit or loss

Identifiable assets and liabilities assumed are recognised if:

a) Definition of assets and liabilities is met at the acquisition date; and
b) They are part of what was exchanged in the business combination.
[HKFRS 3.11,12]

Identifiable assets and liabilities assumed are measured at fair value [HKFRS 3.18]

Exceptions to the recognition and/or measurement

- Contingent liabilities [HKFRS 3.22,23]
- Income taxes [HKFRS 3.24, 25]
- Employee benefits [HKFRS 3.26]
- Indemnification assets [HKFRS 3.27,28]
- Reacquired rights [HKFRS 3.29]
- Share-based payment awards [HKFRS 3.30]
- Assets held for sale [HKFRS 3.31]

Areas to watch out for:

- Contracts should be re-assessed except for insurance and leases [HKFRS 3.15-17]
- All identifiable intangibles are recognised [HKFRS 3.B31-40]
- Restructuring provisions are rarely recognised [HKFRS 3.11]
- Measurement period [HKFRS 3.45-50]

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Process for accounting for business combinations (2)

Previously held interest [HKFRS 3.42]

- Remeasure a previously held equity interest at its acquisition-date fair value
- Recognise a gain or loss in profit or loss
- Recycle items of other comprehensive income

Non-controlling interest (NCI)

- Measure NCI either at fair value or at the NCI's proportionate share of the acquiree's identifiable net assets [HKFRS 3.19; App B paras B44, 45]
- Measurement choice for each combination
- NCI measurement determines goodwill

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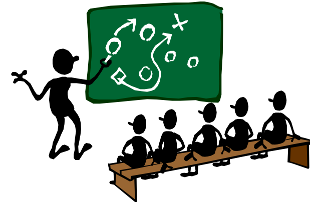
A Refresher Course on Current Financial Reporting Standards 2013 (Day 1)

Statement of cash flows



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HKAS 7
Statement of cash flows

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Agenda

- Objectives and scope of HKAS 7
- Preparation of cash flow statements
- Cash and Cash Equivalents
- Format of cash flow statements
- Classification of cash flows
- Foreign currency cash flows
- Consolidated cash flow statements
- Disclosure requirements

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Agenda

- Objectives and scope of HKAS 7

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Objectives and scope of HKAS 7

- HKAS 7 requires **all entities** to prepare a cash flow statement as an integral part of their financial statements for each period for which financial statements are presented. There are no exemptions from the preparation of a cash flow statement under HKAS 7 [HKAS 7.1]
- HKAS 7 requires the presentation of information about the **historical changes in the cash and cash equivalents** of any entity by means of a statement of cash flows

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Objectives and scope of HKAS 7

- A cash flow statement should **focus on identifying the cash effects of transactions** with parties that are external to the reporting entity and their impact on its cash position
- Only those transactions that involve a cash flow should be reported in the cash flow statement
- Although the title of HKAS 7 is *Statement of Cash Flows,* entities are not required to use that title for the statement itself. Some entities use the title "Cash flow statement"

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Agenda

- Objectives and scope of HKAS 7
- **Preparation of cash flow statements**

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Preparation of cash flow statements

- **Basic requirements:** An entity should prepare and present a statement of cash flows that reports the cash flows of the entity during the period **classified into operating, investing and financing activities**

- **Under HKAS 1** *Presentation of Financial Statements,* comparative information in respect of the previous period should be presented for all amounts reported in the current period's statement of cash flows and the supporting notes

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Preparation of cash flow statements (cont'd)

- **When an entity prepares only individual financial statements,** the statement of cash flows will be for the individual entity
- **When consolidated financial statements are prepared,** a consolidated statement of cash flows will be prepared
- **When an entity produces both separate and consolidated financial statements,** a statement of cash flows will be required for each

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Agenda

- **Objectives and scope of HKAS 7**
- **Preparation of cash flow statements**
- **Cash and Cash Equivalents**

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Cash flows are defined as inflows and outflows of **cash and cash equivalents**

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Cash and cash equivalents

- **Cash** comprises **cash on hand and demand deposits**
- **Demand deposits**
  - not defined in HKFRSs
  - same level of liquidity as cash
  - can be withdrawn without giving notice and without suffering any penalty
  - not restricted to deposits with banks or financial institutions

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Cash and cash equivalents (cont'd)

- **Cash equivalents:**
  - **short-term, highly liquid investments**
    - short-term is not defined, but the standard encourages a cut-off of three months' maturity from the acquisition date
  - **readily convertible** to known amounts of cash
  - subject to an **insignificant risk of changes in value**
  - held for **meeting short-term cash commitments**
  - **not for investment** or other purposes

[HKAS 7.7]

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Cash and cash equivalents (cont'd)

- **Bank overdrafts repayable on demand**
  - included as cash and cash equivalents to the extent that they form an integral part of the entity's cash management
  - netted against cash and cash equivalents for purpose of the statement of cash flows

[HKAS 7.8]

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Cash and cash equivalents (cont'd)

- Disclose reconciliation of cash and cash equivalents in the statement of cash flows or notes to the equivalent amount presented in the statement of financial position

Cash and cash equivalents	20X2 HK$	20X1 HK$
Cash and bank balances	XX	XX
Bank overdrafts	(XX)	(XX)
Cash and cash equivalents in the cash flow statement	XX	XX

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Cash and cash equivalents (cont'd)

Questions:

Are they classified as cash and cash equivalents?

- Certificate of deposits
- Money market funds
- Pledged bank deposits to secure short-term bank borrowings
- Pledged bank deposits to secure long-term bank borrowings
- Gold bullion
- Equity investments

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Agenda

- Objectives and scope of HKAS 7
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Cash flows should be classified by
operating, investing or financing activities
[HKAS 7.10]

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Classification of cash flows

- **Operating activities**
  - principal revenue-producing activities of the entity and other activities that are not investing or financing activities
- **Investing activities**
  - acquisition and disposal of long-term assets and other investments not included in cash equivalents
- **Financing activities**
  - activities that result in changes in the size and composition of the contributed equity and borrowings of the entity

[HKAS 7.6]

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Classification of cash flows

Examples of different types of cash flows

Operating activities	Investing activities	Financing activities
Cash receipts from sale of goods, rendering of services	Cash flows for purchase or sale of property, plant and equipment, intangible and other long-term assets	Cash proceeds from issuing shares, debentures, loans, notes, bonds etc
Cash payments to suppliers for goods and services	Cash flows for purchase / sale of shares or debentures of other entities	Cash payments to owners to acquire or redeem the entity's shares
Cash payments to and on behalf of employees	Cash advances and loans made to other parties	Cash repayments of amounts borrowed
Cash payments/refunds of income taxes unless they can be specifically identified with financing and investing activities	Cash flows in relation to associates/ joint ventures (e.g. dividends received, loan advances)	Cash payments for a finance lease

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Operating activities

- Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. They generally result from the transactions and other events that enter into the determination of profit or loss
- Cash flows from operating activities may be presented either by the **direct method** or **indirect method**
- The Standard encourages the use of the direct method
- In practice, appears that indirect method is usually used

[HKAS 7.13, 18]

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Direct method

	2013	2013
	$'000	$'000
Cash flows from operating activities		
Cash receipts from customers	252,376	
Cash paid to suppliers	(127,045)	
Cash paid to and on behalf of employees	(78,014)	
Other cash payments	(12,038)	
Cash generated from operations	35,279	
Interest paid	(5,933)	
Income taxes paid	(13,447)	
Net cash from operating activities		15,899

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Indirect method

- The indirect method starts with the profit or loss and adjusts it for:
  - **Any non-cash items** included in its calculation (such as depreciation or movements in provisions);
  - **Any cash flows in the period** that were reported in the profit or loss of an earlier period or will be reported in profit or loss of a future period (e.g. operating accruals and prepayments, settlement of a liability for restructuring costs accrued in the prior period); and
  - **Any items of income and expense** that are related to investing or financing cash flows

[HKAS 7.20]

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Indirect method of presenting operating cash flows (alt.1)

	2013	2013
	$'000	$'000
Cash flows from operating activities		
Profit before taxation	19,696	
Adjustments for :		
Depreciation	6,174	
Foreign exchange loss	829	
Interest expense	7,305	
Profit before working capital changes	34,004	
Increase in trade and other receivables	(7,601)	
Increase in trade payables	5,224	
Decrease in inventories	3,652	
Cash generated from operations	**35,279**	
Interest paid	(5,933)	
Income taxes paid	(13,447)	
Net cash from operating activities		15,899

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Indirect method of presenting operating cash flows (Alt. 2)

	2013	2013
	$'000	$'000
Cash flows from operating activities		
Revenue	259,376	
Operating expenses excluding depreciation	(225,372)	
Profit before working capital changes	34,004	
Increase in trade and other receivables	(7,601)	
Increase in trade payables	5,224	
Decrease in inventories	3,652	
Cash generated from operations	35,279	
Interest paid	(5,993)	
Income taxes paid	(13,447)	
Net cash from operating activities		15,839

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Indirect method (cont'd)

- **Confusion about the correct starting point:** should it be profit or loss (i.e. the final figure in the statement of comprehensive income OR can a different figure, such as profit before income tax, be used?
- **The standard itself refers to profit or loss, but the example provided in the appendix to the standard starts with a different figure (i.e. profit before taxation)**

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Agenda

- Objectives and scope of HKAS 7
- Preparation of cash flow statements
- Cash and Cash Equivalents
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- Classification of cash flows

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Interest and dividends

- The cash flows arising from dividends and interest receipts and payments should be classified in the cash flow statement under the activity appropriate to their nature
- Classification should be on a **consistent basis from period to period**. Additionally, these items are required to be **disclosed separately on the face of the cash flow statement**
- The standard requires disclosure on the face of the cash flow statement for **total interest paid regardless of whether the interest has been expensed or capitalised**

[HKAS 7.31,32]

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Interest and dividends (cont'd)

- Cash flows from interest and dividends **paid:**
  - Operating or financing activities
- Cash flows from interest and dividends **received:**
  - Operating or investing activities

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Debt securities issued at a discount or premium

- **Proceeds from debt securities issued at a discount or premium** (e.g. zero coupon debt securities):
  - Classify as a financing cash inflow
- **Excess of amounts repaid** (during the life of the instrument and at maturity) over the amount received when the debt securities were issued:
  - Report as cash outflow, classified in the same way as interest paid

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Debt securities issued at a discount or premium (cont'd)

- **Example:**
  - Proceeds from a zero coupon bond upon issuance: $100,000 on 1 January 2008
  - On 31 December 2012, the company redeems the bond by paying cash of $140,255 to the bondholder
  - Statement of comprehensive income for the five years ended 31 December 2012, classify $40,255 as interest expense
  - Statement of cash flows for the year ended 31 December 2012: $100,000 is classified as a financing cash flow and $40,255 is classified according to the entity's general classification for interest

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Shares classified as liabilities

- When instruments that are legally shares (e.g. certain preference shares) are classified as financial liabilities under HKAS 32, the dividends paid on those shares will be presented as part of the interest expense in the statement of comprehensive income

- In the statement of cash flow, the dividends paid on such shares should similarly be presented as interest paid

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Treasury shares

- The acquisition by an entity of its own equity instruments represents a transaction with owners (who have given up their equity interest) rather than a gain or loss to the entity and, accordingly, any consideration paid is recognised as a deduction in equity
- When consideration paid is in the form of cash, the associated cash flows should be classified as cash flows from financing activities

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Assets held for rental and subsequently held for sale

- Cash flows related to the **acquisition of an asset** recognised in accordance with HKAS 16 *Property Plant and Equipment* are cash flows from **investing activities**
- Cash payments to **manufacture or acquire assets held for rental, which subsequently become held for sale** (i.e. transferred to inventory) are cash flows from **operating activities.** Cash flows from rental payments and subsequent sales of these assets also are classified as operating

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Taxes

- Unless taxes can be specifically identified with financing or investing activities, cash flows arising from taxes on income should be classified as operating cash flows
- Cash flows arising from taxes are required to be **separately disclosed**
- When it is practicable to identify a tax cash flow with an individual transaction that is classified as investing and financing, the tax cash flow will be classified as investing or financing in accordance with the underlying transaction

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Taxes

	$
Tax payable b/f	X
Tax charge (excluding deferred taxation charge)	X
Tax payable c/f	(X)
Tax paid	**X**

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Factored receivables

- No specific guidance on the treatment of factored receivables in the statement of cash flows. However, proceeds from a factoring of receivables may follow the underlying accounting as follows:
  - **Factored receivables without recourse where circumstances qualifying the receivables for derecognition:** the proceeds from the factor will be treated as an operating cash flow
  - **Factored receivables with recourse where the receivables are not derecognised:** the proceeds are recognised as a liability, then the proceeds should be classified as part of financing activities

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Finance lease payments

- Rentals under a finance lease include capital and interest elements. These are split out for the purpose of inclusion in the statement of cash flows and reported as "financing" and "operating" cash flows respectively.
- Example:

Finance leases	**20X2 $'000**	**20X1 $'000**
Amounts payable within one year	10	8
Within 2 – 5 years	100	70
Less finance charges allocated	(15)	(10)
Present value of minimum lease payments	**95**	**68**

Additions to non-current assets acquired under finance leases were $56K. What is the capital element of finance lease rentals paid?

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Offsetting

- Generally, all financing and investing cash flows are reported gross
- Receipts and payments may be netted only when the items concerned (e.g. sale and purchase of investments) turn over quickly, the amounts are large, and the maturities are short; or when they are on behalf of customers and the cash flows reflect the activities of the customers

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Taxes collected on behalf of third parties

- HKAS 7 is **silent** on the classification of cash flows from taxes that are collected on behalf of third parties when the direct method is used to present cash flows from operating activities (e.g. value added tax and goods and services tax)
- Generally, taxes collected on behalf of third parties, when the direct method is used, may be either:
  - Included as separate line items to show the impact on cash flows of such taxes separately; or
  - Included in receipts from customers and payments to suppliers

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Example: Taxes collected on behalf of third parties

Services rendered for cash during 2012 (excluding GST)	100	
GST paid to tax authorities	10	
GST payable to tax authorities (GST collected from customers is 20 of which 10 is paid and 10 remains outstanding to tax authorities)	10	
Statement of financial position	**2012**	**2011**
Share capital	100	100
Retained earnings	100	-
	200	100
Cash	210	100
GST payable	(10)	-
	200	100

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Example: Tax collected on behalf of third parties (cont'd)

	2012
Statement of cash flows extract – direct method option 1	
Receipts from customers (all receivables collected by the end of the reporting period)	100
Indirect taxes collected	20
Indirect taxes paid	(10)
Net cash increase	110
Cash at 1 January 2012	100
Cash at 31 December 2012	210

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Example: Taxes collected on behalf of third parties (cont'd)

	2012
Statement of cash flows extract – direct method option 2	
Receipts from customers (all receivables collected by the end of the reporting period)	120
Payments to tax authorities (all invoices paid by the reporting period)	(10)
Net cash increase	110
Cash at 1 January 2012	100
Cash at 31 December 2012	210

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Example: Taxes collected on behalf of third parties (cont'd)

	2012
Statement of cash flows extract – indirect method	
Net profit	100
Increase in accounts payable	10
Net cash increase	110
Cash at 1 January 2012	100
Cash at 31 December 2012	210

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Other classification issues

- How can we classify the following cash flows by activities?

a. Pledged bank deposits with maturities over 3 months
b. Securities carried at FVTPL
c. Current accounts with group companies
d. Amount due to a shareholder
e. Gain/loss on the changes in fair value of investment property
f. Gain/loss on the disposal of available-for-sale financial assets
g. Investment income from AFS financial assets received

Operating activities

Investing activities

Financing activities

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Agenda

- Objectives and scope of HKAS 7
- Preparation of cash flow statements
- Cash and Cash Equivalents
- Format of cash flow statements
- Classification of cash flows
- **Foreign currency cash flows**

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Foreign currency cash flows

- Cash flows arising from an entity's foreign currency transactions:
  - translated into the entity's functional currency at the **exchange rates at the date of the cash flows**; or when the exchange rates have been relatively stable, an appropriate average can be used

- Presentation currency different from the functional currency:
  - functional currency cash flows are translated into the presentation currency at rates at the dates of the cash flows (or appropriate averages)

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Example 1: Cash held in a foreign currency

	Fx	Rate	Functional currency
Balance of cash held in foreign currency at 1 January 2012	100	1:1	100
Revenue	100	1.5:1	150
Expenses	(50)	1.6:1	(80)
Balance of cash held in foreign currency at 31 December 2012	150		170
Translated cash at the end of the reporting period	150	2:1	300
Gain on cash held in foreign currency			130
Statement of financial position			
	Functional currency 2012		Functional currency 2011
Share capital	100		100
Retained earnings	200	(150-80+130)	0
	300		100
Cash	300		100

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Statement of cash flows extract – direct method

	2012
Statement of cash flows extract – direct method	
Receipts from customers (all receivables collected by the end of the reporting period)	150
Payments to suppliers (all invoices paid by the end of the reporting period)	(80)
Net increase in cash	70
Cash and cash equivalents at 1 January 2012	100
Effect of exchange rate fluctuations on cash held	**130**
Cash and cash equivalents at 31 December 2012	300

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Statement of cash flows extract – indirect method

	2012
Statement of cash flows extract – indirect method	
Net profit	200
Unrealised foreign currency gain	**(130)**
Net increase in cash	70
Cash and cash equivalents at 1 January 2011	100
Effect of exchange rate fluctuations on cash held	**130**
Cash and cash equivalents at 31 December 2011	300

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Example 2: Other foreign currency differences

Assets and liabilities denominated in a foreign currency generally include an element of unrealised exchange differences at the end of the reporting period. When applying the indirect method, the unrealised exchange difference should be presented as a single non-cash item within operating activities, rather than being left embedded in the asset or liability. The following example illustrates this point:

	Fx	Rate	Functional currency
Loan obtained during 2012	250	1.5:1	375
Translate at the end of the reporting period	250	2:1	500

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Example 2 : Other foreign currency differences (cont'd)

Statement of financial position (in AC)			
Share capital	100		100
Retained earnings	75	(200-125)	200
	175		300
Cash	675		300
Loan	(500)		-
	175		300
Statement of cash flows extract – indirect method	**2012**		
Net loss	(125)		
Unrealised foreign currency loss	**125**		
Net cash from operating activities	-		
Loan obtained (financing activities)	375		
Net cash increase	375		
Cash at 1 January 2012	300		
Cash at 31 January 2012	675		
Notes			
Cash on balance at the end of 2012 is held in its own functional currency (FC)			

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Foreign currency cash flows

Assets / liabilities	$
Balance (b/f)	X
Exchange differences	X
Balance (c/f)	(X)
Changes during the period	X

Exchange difference to be adjusted for the profit before tax

Movement of assets and liabilities in the cash flows statement

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Agenda

- Objectives and scope of HKAS 7
- Preparation of cash flow statements
- Cash and Cash Equivalents
- Format of cash flow statements
- Classification of cash flows
- Foreign currency cash flows
- Consolidated cash flow statements

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Consolidated cash flow statements

- The preparation of a consolidated statement of cash flows is the same as a statement of cash flows for a separate financial statements, except that it includes extra line items for cash flows associated with
  - acquisitions and disposals of subsidiaries
  - non-controlling interests
  - associates and joint ventures
- Cash flow that are internal to the group should be eliminated in the preparation of a consolidated statement of cash flows

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Acquisitions and disposals of subsidiaries

- When a subsidiary joins or leaves a group during a financial year, the cash flows of the group should include the cash flows of the subsidiary for the same period.
- The aggregate cash flows arising from **obtaining or losing control** of subsidiaries or other businesses

  → **presented separately and classified as "Cash flows from investing activities"**
- Other disclosures in the notes:
  - total consideration paid or received
  - the portion of the consideration consisting of cash and cash equivalents
  - the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and
  - the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category

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Acquisition of a subsidiary

Consideration transferred	$
Cash	X
Transfer of land and buildings at fair value at date of acquisition	X
Contingent consideration arrangement	X
Total	X

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Acquisition of a subsidiary

Assets acquired and liabilities recognised at the date of acquisition	
Current assets	$
Cash and bank	X
Trade receivable	X
Inventory	X
Non-current assets	
Property, plant and equipment	X
Current liabilities	
Trade payable	X
Accruals	X
Non-current liabilities	
Deferred tax liabilities	X
	X

Goodwill arising on acquisition	
	$
Consideration transferred	X
Non-controlling interests	X
Less: fair value of identifiable net assets acquired	(X)
Goodwill arising on acquisition	X

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Acquisition of a subsidiary

Net cash outflow on acquisition of a subsidiary	$
Consideration paid in cash	X
Less: cash and cash equivalent balances acquired	X
Total	X

Presented as a single line item under investing activities

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Disposal of a subsidiary

Consideration received	$
Cash	X
Deferred sales proceeds	X
Total	X

Analysis of assets and liabilities over which control was lost	
Current assets	$
Cash and bank	X
Trade receivable	X
Non-current assets	
Property, plant and equipment	X
Current liabilities	
Trade payable	X
Accruals	X
Non-current liabilities	
Deferred tax liabilities	X
Net assets disposed of	X

Gain on disposal of subsidiary	
	$
Consideration received	X
Net assets disposed of	(X)
Non-controlling interest	X
Cumulative gain/(loss) on AFS financial assets reclassified from equity	X
Cumulative exchange gain/(loss) in respect of the net assets of the subsidiary reclassified from equity	X
Gain/(loss) on disposal	X/(X)

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Disposal of a subsidiary

Net cash inflow on disposal of a subsidiary	$
Consideration received in cash and cash equivalents	X
Less: cash and cash equivalent balances disposed of	(X)
Total	X

Presented as a single line item under investing activities

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Acquisitions and Disposals of subsidiaries

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- The cash flow effects of losing control are not to be deducted from those of obtaining control. **Each is to be shown separately**
- When preparing the consolidated statement of cash flows, each of the individual assets and liabilities of a subsidiary acquired/disposed of during the period must be excluded when comparing group statements of financial position for cash flow calculations.
- For example,
  - Where subsidiary is **acquired** in the period: the individual assets at the date of acquisition should be subtracted from the movement on the individual items
  - Where a subsidiary is **disposed of** in the period, the individual assets at the date of disposal should be added to the movement on the individual items

Movement of trade receivables	$
Opening balance	X
Trade receivable of subsidiary at the date of acquisition	X
Movement	X/(X)
Closing balance	X

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Acquisitions and Disposals of subsidiaries

- When there has been a change in ownership interests in a subsidiary, but the transaction, event or circumstance has **not resulted in a loss of control**, the associated cash flows are classified as **financing activities**

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Non-controlling interests

- Dividends paid to non-controlling interests should be included under the heading 'cash flows from financing activities' and disclosed separately.
- A typical movement of non-controlling interests can be as follows:

Non-controlling interests	$
Opening balance	X
Share of profit	X
Share of other comprehensive income	X
Dividend paid	(X)
Closing balance	X

Classified as financing activities

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Investments in associates and joint ventures

- When an **interest in an associate or joint venture** is accounted for using the **equity or the cost method**, the investor's statement of cash flows reports only the cash flows between itself and the investee, such as **dividends and advances**
- Assume the investment in associate only represents investment cost and share of profit. Then dividend received can be calculated as follows:

Associate	$
Balance (b/f)	X
Share of profit for the period	X
Balance (c/f)	(X)
Dividend received from associate	X

- When an entity has an interest in a joint venture that is accounted for using proportionate consolidation under HKAS 31 , the consolidated statement of cash flows includes the investor's proportionate share of the cash flows of the joint venture (note: proportionate consolidation is no longer available under HKFRS 11 effective 1 January 2013)

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A typical Consolidated Statement of Cash Flows

	$'000	$'000
Operating activities		
Profit before tax	X	
Adjustments for:		
Depreciation	X	
Allowance for bad debts	X	
Gain on disposal of a subsidiary	(X)	
Finance costs	X	
Exchange loss arising on translating foreign currency bank loans	X	
Share of profits of associate	(X)	
Operating profits before working capital changes	*X*	
Decrease in trade and other receivables	X	
Decrease in trade and other payables	(X)	
Cash generated from operations	X	
Interest paid	(X)	
Tax paid	(X)	
Net cash from operating activities		X

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A typical Consolidated Statement of Cash Flows (cont'd)

	$'000	$'000
Investing activities		
Acquisition of subsidiary, net of cash acquired	(X)	
Increase in certificate of deposit	(X)	
Dividend received from associate	X	
Acquisition of PPE	(X)	
Net cash inflow on disposal of subsidiary	X	
Net cash used in investing activities		(X)
Financing activities		
New bank loans raised	X	
Dividend paid to non-controlling interest	(X)	
Dividend paid	(X)	
Net cash from financing activities		X
Net decrease in cash and cash equivalents		(X)
Cash and cash equivalents at beginning of year/period **Exchange rate effects**		X X
Cash and cash equivalents at end of year/period		X

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Agenda

- Objectives and scope of HKAS 7
- Preparation of cash flow statements
- Cash and Cash Equivalents
- Format of cash flow statements
- Classification of cash flows
- Foreign currency cash flows
- Consolidated cash flow statements
- Disclosure requirements

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Non-cash transactions

- When an entity enters into an investing or financing transaction that does not involve the use of cash or cash equivalents, the transaction is excluded from the statement of cash flows
- Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities
- Examples include:
  - acquisition of assets either by assuming directly the related liabilities or by means of a finance lease
  - acquisition of a subsidiary by means of an equity issue
  - conversion from debt to equity

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Non-cash transactions

Illustrative examples extracted from Deloitte model financial statements 2011

47. Non-cash transactions

During the current year, the Group entered into the following non-cash investing and financing activities which are not reflected in the consolidated statement of cash flows:

- the Group disposed of property, plant and equipment with an aggregate fair value of CU0.4 million to acquire Subseven Limited as indicated in note 44;
- proceeds in respect of the Group's disposal of part of its interest in E Plus Limited and its entire interest in Subzero Limited (CU1.245 million and CU960,000 respectively – see notes 20 and 45) had not been received in cash at the end of the reporting period;
- share issue proceeds of CU8,000 were received in the form of consulting services, as described in note 28.1; and
- the Group acquired CU40,000 of equipment under a finance lease (2010: nil).

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Components of cash and cash equivalents

- The components of cash and cash equivalents should be disclosed, and a reconciliation presented between the amounts in the statement of cash flows and the equivalent items reported in the statement of financial position
- As required by HKAS 1, the policy adopted in determining the composition of cash and cash equivalents should also be disclosed

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Balances not available for use by the group

- The amount of significant cash and cash equivalent balances that are not available for use by the group should be disclosed, together with a commentary by management
- Example:
  - a subsidiary operating in a country where exchange controls or other legal restrictions apply and, thus, the cash and cash equivalents in that subsidiary are not available for general use by other members of the group
  - substantial amounts of cash are held in escrow accounts and are only available for use on a particular project

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Additional recommended disclosures

- HKAS 7.50 suggests that disclosure of the following additional information, together with a commentary by management, is encouraged and may include:
  - The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities;
  - The aggregate amounts of cash flows under each classification related to interests in joint ventures that are accounted for using proportionate consolidation;
  - The aggregate amount of cash flows that represent increase in operating capacity separately from those cash flows that are required to maintain operating capacity; and
  - The amount of the cash flows arising from the operating, investing and financing activities of each reportable segment under HKFRS 8 *Operating Segments*

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Thank you for your attention

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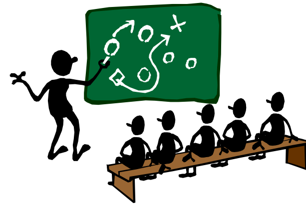
A Refresher Course on Current Financial Reporting Standards 2013 (Day 1)

Consolidated Financial Statements
Separate Financial Statement



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Consolidated Financial Statements

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Agenda

Part 1: Background

Part 2: What is "Control"?

Part 3: Accounting requirements

Part 4: Transitional requirements

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Background

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Background – issuance of IFRS 10, 11 and 12

Why is there a need for issuance?

- The global financial crisis illustrated that the existing consolidation guidance was not fundamentally flawed but could be improved
- Two different consolidation models: perceived inconsistencies between the consolidation guidance in IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities*

  →IAS 27 used control as the basis for consolidation, while SIC-12 focused more on risks and rewards
- The crisis also highlighted the importance of enhancing disclosure requirements, in particular, for special purpose or structured entities

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Background – issuance of IFRS 10, 11 and 12

Why is there a need for issuance?

- IFRS 11 – *Joint arrangements* provides a more realistic reflection of joint arrangements by focusing on the rights and obligations of the arrangement, rather than its legal form (i.e. structure is no longer the only determinant of classification)
- The standard addresses inconsistencies in the reporting of joint arrangements by requiring a single method to account for interests in jointly controlled entities – based on the parties' rights and obligations under the arrangement, with the existence of a separate legal vehicle no longer being the key factor.

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Background – issuance of IFRS 10, 11 and 12

- As a result, the IASB issued a package of five standards:
  - HKAS 27 (2011) *Separate Financial Statements*
  - HKAS 28 (2011) *Investments in Associates and Joint Ventures*
  - HKFRS 10 *Consolidated Financial Statements*
  - HKFRS 11 *Joint Arrangements*
  - HKFRS 12 *Disclosure of Interests in Other Entities*
- Contained in Members' Handbook Update 106 issued in June 2011
- Effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted
- In general, the package of five standards must be applied early at the same time (except for HKFRS 12)

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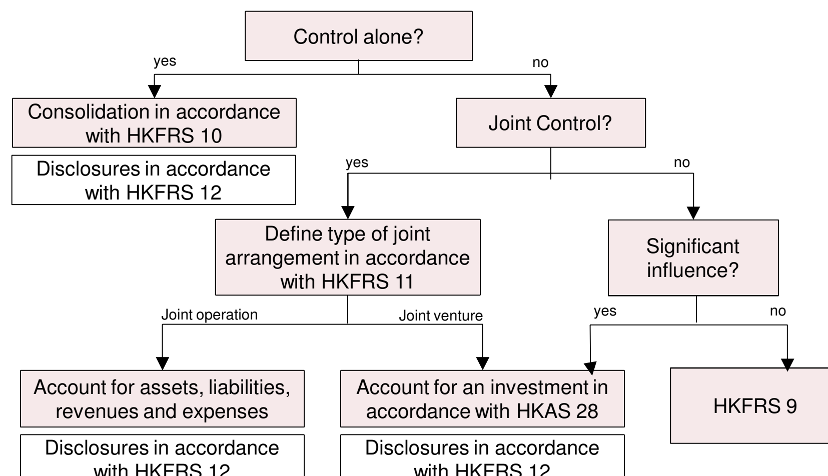
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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What is "Control"?

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Overview of HKFRS 10

- HKFRS 10 identifies the concept of control as the single basis for consolidation for all types of entities
- No separate guidance with a different consolidation model for special purpose entities
- Supersedes HKAS 27 (Revised) *Consolidated and Separate Financial Statements* and HK(SIC) – Int 12 *Consolidation – Special Purpose Entities*
- An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee

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Requirements for subsidiaries	2008 standards	2011 standards
Exemptions from preparing consolidated financial statements	HKAS 27 (2008)	HKFRS 10: requirements similar to those of HKAS 27 (2008)
Determination of entities to be consolidated	• Control model in HKAS 27 (2008) • Risks and rewards model in HK(SIC)-Int 12	HKFRS 10: new single control model applied to all investees
Consolidation procedures	HKAS 27 (2008)	HKFRS 10: requirements substantially the same as those of HKAS 27 (2008)
Separate financial statements	HKAS 27 (2008)	HKAS 27 (2011): requirements substantially the same as those of HKAS 27 (2008)
Disclosures	HKAS 27 (2008)	HKFRS 12: significantly expanded disclosures

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Scope of HKFRS 10

- HKFRS 10 requires that a parent (i.e. an entity that control one or more entities) should present consolidated financial statements.
- HKFRS 10 applies to all entities, except as follows:

a) a parent that is itself a subsidiary of another HKFRS reporter need not prepare consolidated financial statements if it meets certain conditions.

b) Post-employment benefit plans or other long-term employee benefit plans to which HKAS 19 *Employee Benefits* applies

c) Investment entity (amendment to HKFRS 10)

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Investment Entities – consolidation relief

- Issued in December 2012 as amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)
- Qualifying investment entity is required to account for investments in controlled entities as well as investments in associates and joint ventures at FVTPL
- The consolidation exception is mandatory – **not optional**
- The parent of an investment entity (that is not itself an investment entity) is still required to consolidate all subsidiaries
- New disclosures introduced
- Effective for annual periods **beginning on or after 1 Jan 2014** – early application is permitted

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Definition of an investment entity

- To qualify, an entity:

  - obtain funds from one or more investors for the purpose of providing those investor(s) with **investment management services**

  - commits to its investor(s) that its business purpose is to invest funds solely for returns from **capital appreciation and /or investment income**

  - measures and evaluates the performance of substantially all of its investments on a **fair value basis**

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- In addition, an investment entity 'typically' has
  - more than one investment
  - more than one investor
  - investors that are not related parties
  - ownership interests in the form of equity or similar interests
- Absence of any of these characteristics does not necessarily disqualify an entity from being classified as an investment entity
- Additional disclosure – significant judgments and assumptions if still quality for an investment entity

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Exemption from presenting consolidated FS

An entity that has subsidiaries need not present consolidated FS if it meets **ALL** of the following conditions:

1) the entity is itself either (1) a wholly-owned subsidiary or (2) a partially-owned subsidiary of another entity and all its other owners (including those not otherwise entitled to vote) have been informed about, and do not object to, the parent not presenting consolidated FS
2) the entity's debt or equity instruments are not trade in a public market (i.e. a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)
3) the entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
4) the ultimate or any intermediate parent of the entity produces consolidated FS available for public use that comply with HKFRSs or IFRSs

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Statutory requirements

- Under section 124(1) of the Companies Ordinance where, at the end of its financial year, a company has subsidiaries and does not qualify for the exemption set out in section 124(2), it is required to lay group accounts before its members in general meeting
- Section 124 (2) of the Companies Ordinance permits a holding company not to prepare group accounts if the company is a wholly-owned subsidiary of another company at the end of its financial year

Accordingly, a Hong Kong incorporated parent company can only take advantage of the exemption under HKFRS 10 if it also satisfied the exemption allowed under section 124(2) of the Companies Ordinance.

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Statutory requirements

- In addition, Section 124(2) of the *Companies Ordinance* states that a company which publishes group accounts may omit from them any subsidiary, if the company's directors are of the opinion that:
  - inclusion of the subsidiary is impractical, or would be of no real value to members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company; or
  - the result of including the subsidiary would be misleading, or harmful to the business of the company or any of its subsidiaries; or
  - the business of the holding company and the subsidiary are so different that they cannot reasonably be treated as a single undertaking

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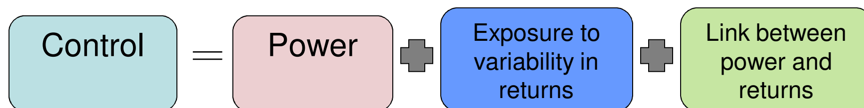
Applying the new control model

HKFRS 10.6 - An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.



An investor, regardless of the nature of its involvement with an investee, is required to determine whether it is a parent by assessing whether it controls the investee.

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Applying the new control model

Points to consider:

•HKFRS 10.8 An investor shall consider all facts and circumstances when assessing whether it controls an investee. The investor shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed above.

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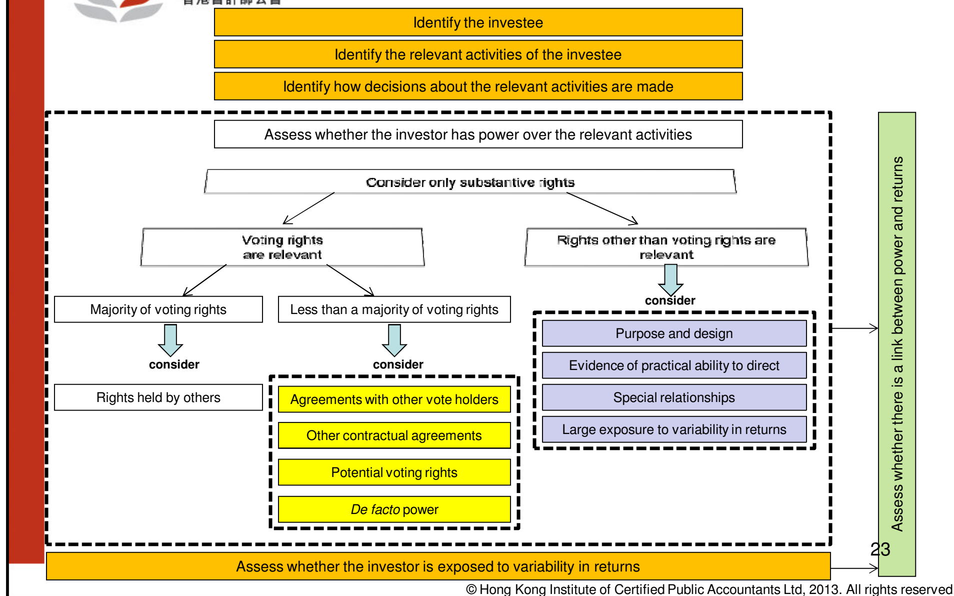

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I. Identify the investee

Investee – not defined in HKFRS 10. It can be a legal entity or a deemed separate entity that is or may be a subsidiary of the investor.

What is a deemed separate entity?

•When an investor has power over only specified assets and liabilities of an entity

•This portion of the entity is referred to as a "Silo"

•When **ALL** of the following conditions are met:

a)the assets, liabilities and equity of the silo are separate from the overall entity such that none of those assets can be used to pay other obligations of the entity and those assets are the only source of payment for specified liabilities of the silo; and

b)Parties other than those with the specified liability, have no rights or obligations related to the specified assets or to residual cash flows from those assets

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I. Identify the investee

When do we need to consolidate this "Silo"?

- When the above two conditions are met, the investor should determine whether it has control of the silo using HKFRS 10's general definition for 'control'
- If an investor controls a silo, the investor should consolidated that silo.
- Other parties should exclude the assets and liabilities of the silo when assessing control and consolidation of the entity.

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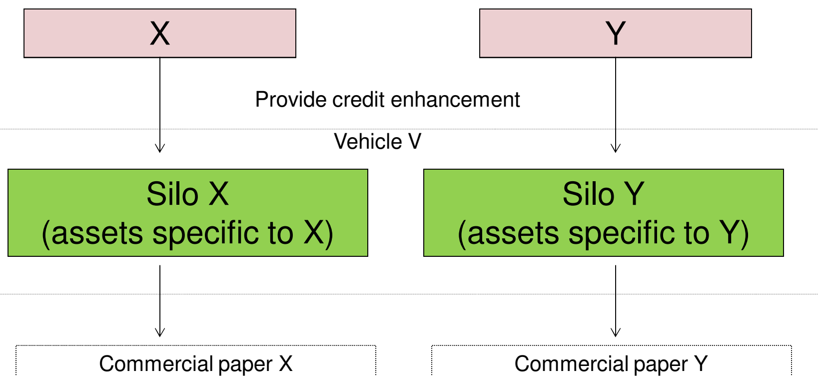
Example: Silo structure

Source: First impressions: consolidated financial statements

These companies, X and Y, transfer trade receivables and credit enhancements to vehicle V, which issues commercial paper, thereby acting as the refinancing vehicle for X and Y. There is no cross-collateralisation of the transferred assets.

Because there is no cross-collateralisation, each originator, X and Y, assesses whether it controls its specific silo, which includes the receivables transferred as financial assets and its specified commercial paper liability.



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II. Identify the relevant activities of the investee

Relevant activities - activities of the investee that significantly affect the investee's returns

A. Range of operating and financing activities

- In many investees, a range of operating and financing activities significantly affect returns. For example:
  - ✓ selling and purchasing of goods or service
  - ✓ managing financial assets during their life
  - ✓ selecting, acquiring and disposing of assets
  - ✓ researching and developing new products or processes
  - ✓ determining of a funding structure or obtaining funding
- It also includes establishing operating and capital decisions, e.g. budgets, and appointing, remunerating and terminating key management personnel or other service providers

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II. Identify the relevant activities of the investee

B. Several investors each direct different relevant activities

- the investor has the current ability to direct the activities that MOST significantly affect the returns of the investee has power
- this principle also applies if different relevant activities occur at different times

- Example

Two investors, A & B, form an investee that is engaged in the development of a medical product and plan to manufacture and market the product after the development. The respective responsibilities to the relevant activities are as follows:

A's responsibility	B's responsibility	
Development	Manufacturing	Marketing

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II. Identify the relevant activities of the investee

- Example (cont'd)

Each investor needs to determine the activity that most significantly affects the investee's returns by considering the following factors:

a) the purpose and design of the investee;
b) the factors that determine the profit margin, revenue and value of the investee as well as the value of the medical product;
c) the effect of each investor's decision-making authority on the investee's returns;
d) the investors' exposure to variability of returns;
e) the uncertainty of, and effort required to obtain, regulatory approval; and
f) which investor controls the medical product once the development phase is successful

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II. Identify the relevant activities of the investee

C. Relevant activities occur only when particular circumstances or events occur

- The investee may be designed so that the direction of its activities and its returns are predetermined unless and until those particular circumstances arise or events occur
- Only the decisions when those events occur can affect the returns significantly and therefore be relevant activities

Example

- The only assets of an investee are receivables
- The only relevant activity is managing the receivables upon default.
- The party that has the ability to manage the defaulting receivables has power over the investee, irrespective of whether any of the borrowers have defaulted.

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III. Identify how decisions about the relevant activities are made

To determine whether:

- voting rights are relevant in assessing whether the investor has power over the investee, ie the investee is controlled by means of voting instruments; or
- voting rights are not relevant in assessing whether the investor has power over the investee, ie the investee is controlled by means of other rights

A. Controlled by means of voting rights

- The assessment of power focuses on which investor, if any, has voting rights sufficient to direct the investee's relevant activities
- In the most straightforward case, the investor that holds a majority of voting rights, in the absence of any other factors, has power (and controls) over the investee

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III. Identify how decisions about the relevant activities are made

B. More complex cases

- Assessing what is determinative in assessing control, i.e. voting or other rights, and identifying the controlling party by analyzing the following:
  - ✓ the purpose and design of the investee
  - ✓ what the relevant activities are
  - ✓ how decisions about those activities are made
  - ✓ whether the investor is exposed, or has rights, to variable returns from its involvement with the investee
  - ✓ whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns

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Power

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IV. Assess whether the investor has power over the relevant activities

HKFRS 10.10 - An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities, ie the activities that significantly affect the investee's returns.*

- Power arises from rights
- Different types of rights, either individually or in combination, can give the investor power, include but not limited to:
  - ✓ rights in the form of voting rights (or potential voting rights)
  - ✓ rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities
  - ✓ rights to appoint or remove another entity that directs the relevant activities
  - ✓ rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor
  - ✓ other rights that give the holder the ability to direct relevant activities

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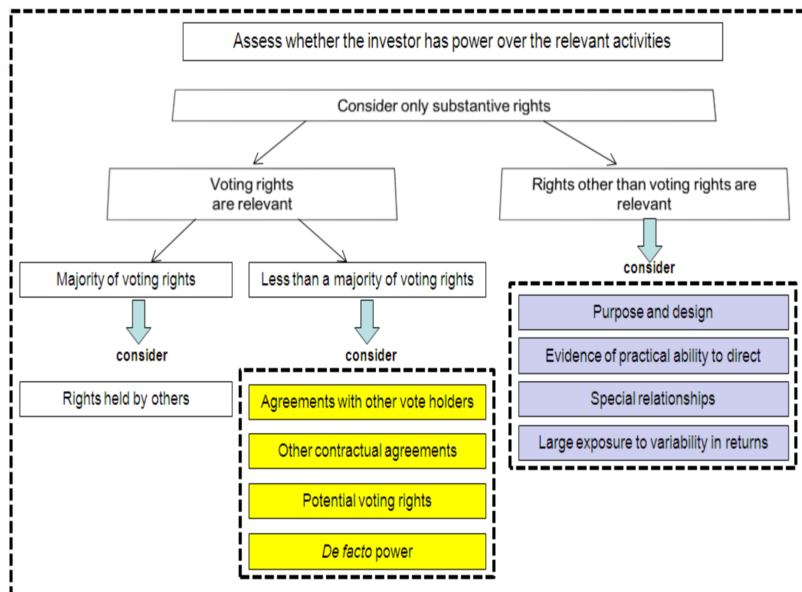

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IV. Assess whether the investor has power over the relevant activities

A. Substantive rights

- For the purpose of assessing power, only substantive rights held by the investor and other parties are considered
- Does NOT arise from protective rights
- To be substantive, rights need to be exercisable when decisions about the direction of the relevant activities need to be made, and the holder needs to have a practical ability to exercise those rights
- Substantive rights exercisable by other parties can prevent an investor from controlling the investee, even if they only give their holders the ability to approve or block decisions that relate to the investee's relevant activities

Determining whether rights are substantive requires judgement, taking into account all facts and circumstances

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Determining whether rights are substantive

Whether there are barriers that prevent the holder from exercising the rights	Whether several parties need to agree for the rights to become exercisable or operational	Whether the party holding the rights would benefit from their exercise of rights
Examples: • financial penalties and incentives • exercise or conversion price that creates a financial barrier • terms and conditions that make it unlikely that rights will be exercised • absence of explicit, reasonable mechanism by which the holder can exercise the rights • Inability of the holder to obtain the information necessary to exercise the rights •Legal or regulatory requirements that prevent the holder from exercise	• the absence of a mechanism that provides the holders with practical ability to exercise their rights collectively is an indicator that the rights may not be substantive • the more parties that are required to agree to exercise the rights, the less likely it is that those rights are substantive • Removal rights exercisable by a board of directors are more likely to be substantive than if the rights were exercisable individually by a large number of investors	Rights are more likely to be substantive when the potential voting rights are in the money or when the investor can realise other benefits (e.g. synergies) with the investee by exercising the potential voting rights

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Example – exercise of voting rights

Fact pattern

- The investee has annual shareholder meetings at which decisions to direct the relevant activities are made
- The next scheduled shareholders' meeting is in 8 months
- However, shareholders that individually or collectively hold at least 5% of the voting rights can call a special meeting to change the existing policies over the relevant activities, but a requirement to give notice to the other shareholders means that such a meeting cannot be held for at least 30 days

Scenario 1 – investor hold a majority of the voting rights

- The investor is able to make decisions about the direction of the relevant activities when they need to be made

→Substantive voting rights

- The fact that it takes 30 days before the investor can exercise its voting rights does not stop the investor from having power

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Scenario 2 – investor hold a forward contract to acquire the majority of shares

- the forward contract settlement date is in 25 days and is deeply in the money
- The existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract will have been settled
- The investor has rights that are essentially equivalent to the majority shareholder as in Scenario 1

→ Substantive rights – the investor has the current ability to direct the relevant activities even before the forward contract is settled

Scenario 3 - investor hold a forward contract to acquire the majority of shares

- the forward contract settlement date is in 6 months
- The investor does not have the current ability to direct the relevant activities because the settlement of the forward contract is in 6 months' time.
- The existing shareholders have the current ability to direct the relevant activities because they can change the existing policies over the relevant activities before the forward contract is settled.

→NO substantive rights

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B. Protective rights

- Protective rights relate to fundamental changes to the activities of an investee or are rights that apply only in exceptional circumstances
- Because protective rights are designed to protect the interests of their holder without giving that party power over the investee to which those rights relate, an investor that holds only protective rights cannot have power or prevent another party from having power over an investee

Protective rights cannot have power
Only substantive rights!

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Examples of protective rights

a) a lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender

b) the right of a party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments

c) the right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions

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C. Franchises

- A franchise agreement for which the investee is the franchisee often gives the franchisor rights that are designed to protect the franchise brand
- Franchise agreements typically give franchisors some decision-making rights with respect to the operations of the franchisee
- HKFRS 10 notes that franchisor rights do not necessarily prevent parties other than the franchisor from having power over the franchisee
- The less the financial support provided by the franchisor and the lower the franchisor's exposure to variability of returns from the franchisee, the more likely it is that the franchisor will have only protective rights

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D. Voting rights

An investor can have power over an investee when the investee's relevant activities are directed through voting rights in the following situations:

- The investor holds the majority of the voting rights; or
- The investor holds less than a majority of the voting rights but:

1) has an agreement with other vote holders;
2) holds rights arising from other contractual arrangements;
3) holds potential voting rights that are exercisable when the decisions about significant activities of the investee will be made
4) holds voting rights sufficient to unilaterally direct the relevant activities of the investee; or
5) holds a combination of the above

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D. Voting rights

Power with a majority of the voting rights

- If the activities of the investee can be directed by a vote of the investor or the majority of the members of the governing body of the investee can be appointed by a vote of the investor, then the investor has power, unless
  - the voting rights are not substantive
  - the voting rights do not provide the investor with the current ability to direct the relevant activities; or
  - another party has existing rights to direct the relevant activities of the investee and that party is not an agent of the investor
- For example, an investor does not control an investee whose relevant activities are directed by a liquidator or regulator

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D. Voting rights

The investor holds less than half of the voting rights but has an agreement with other vote holders

- For example, when an agreement with other vote holders gives the investor the right to exercise voting rights or to direct enough other vote holders on how to vote

Example:
- Company A holds 40% of the voting power of XYZ Co. Ltd and the remaining 60% is held by Company B
- Company B entered into an agreement with Company A such that B defers to the wishes of A in respect of voting because it has no expertise in the area of XYZ's operations
- In accordance with such agreement, A has power over B.

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D. Voting rights

The investor holds less than half of the voting rights but holds rights arising from other contractual agreements

- For example, when the rights within the arrangement in combination with its voting rights give it the current ability to direct some of the processes of an investee that significantly affect the investee's returns
- The processes directed can be, for example, the manufacturing processes or other operating or financing activities of an investee.

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D. Voting rights

The investor holds less than half of the voting rights but holds ***potential voting rights***

- Potential voting rights are considered only if they are substantive
- Consider the purpose and design of the instrument, as well as the purpose and design of any other involvement the investor has with the investee
- Includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions
- If the investor also has voting or other decision-making rights relating to the investee's activities, the investor assesses whether those rights, in combination with potential voting rights, give the investor power

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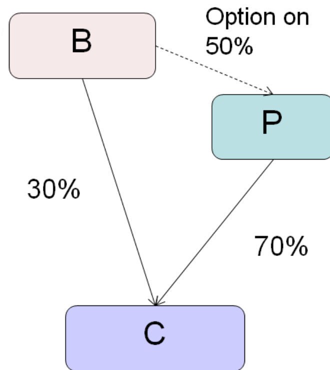
Example 1



- The option is exercisable at any time during the next 2 years at a fixed price that is deeply out of the money (and is expected to remain so for that 2-year period)
- P has been exercising its votes and is actively directing C's activities.

Does B or P has substantive rights?

Under HKFRS 10

- P has power because it has the currently ability to direct the relevant activities.
- The potential voting rights held by B are not considered substantive. However a significant change in the "moneyness" of the options during the 2 years could lead to a conclusion that the options are substantive, which P loses control at that point.

How about under HKAS 27 (2008)?

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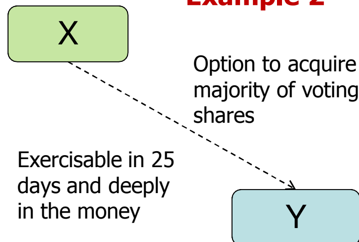
Example 2



- Y has annual shareholder meeting at which decision to direct the relevant activities are made
- The next shareholder meeting is in 8 months' time
- Shareholders can call a special meeting to change the existing policies over relevant activities but a written notice should be made to other shareholders at least 30 days before the meeting.

Does X has substantive rights?

Under HKFRS 10

- X has rights that are essentially equivalent to those of the ordinary shareholders in Y.
- The potential voting rights held by X are substantive and considered when assessing whether X control Y.

How about under HKAS 27 (2008)?

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D. Voting rights

*Power without a majority of the voting rights – **De facto control***

- De facto circumstances are explicitly taken into account when assessing power under HKFRS 10
- An investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally
- When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:

The explicit inclusion of de facto control could introduce changes in practice since HKAS 27 is on basis of legal rather than de facto control.

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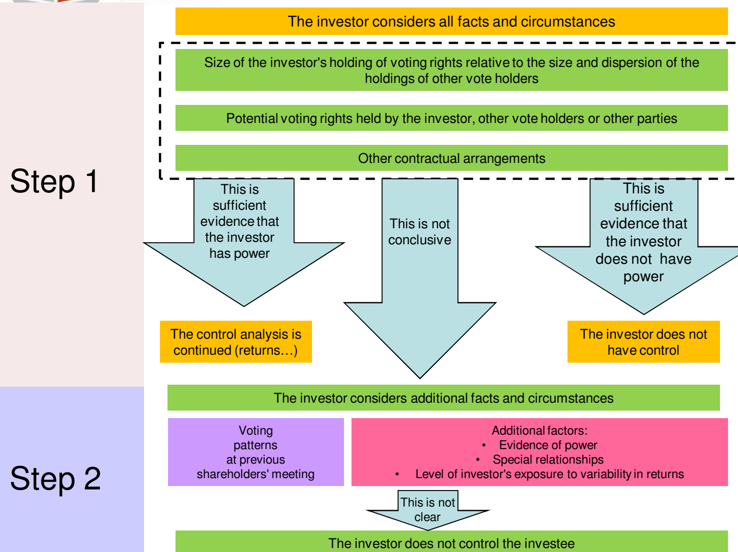

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Examples		Any power?
Scenario 1 A 48% E	• the rest of 52% voting rights are held by thousands of shareholders, none individually hold more than 1% • None of the shareholders has any arrangements to consult each other or make collective decisions. • Coordination between other shareholders would not be easy	Based on the absolute size of A's holding and the relative size of other shareholders, it is likely that A has sufficient dominant voting interest to meet the power criterion.
Scenario 2 A 45% E	• two other shareholders unrelated to A each holder 26% voting rights. • The remaining voting rights are dispersed. • There are no other arrangements that affect decision making	Considering the size of A's voting interest and its relative size to other shareholders, it is likely that A does not have power as only two other investors would need to cooperate to be able to prevent A from controlling E.

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Examples		Any power?
Scenario 3 A 40% E	• Twelve other investors each hold 5% of the voting rights of E • Shareholder agreement grants investor A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities • To change the agreement, a two-thirds majority vote of the shareholders is required	• Not conclusive based on the absolute size of A and the relative size of other shareholders • However, A has contractual right to appoint, remove and set the remuneration of management is sufficient to conclude that it has power over the investee
Scenario 4 A 45% E	• Eleven other shareholders each hold 5% of the voting rights of the investee • None of the shareholders has contractual arrangements to consult any of the others or make collective decisions	• Not conclusive based on the absolute size of A and the relative size of other shareholders • Additional facts and circumstances shall be considered

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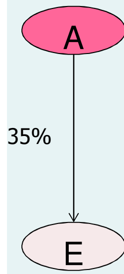
Examples		Any power?
Scenario 5 	• Three other investors each hold 8% voting rights • The remaining 41% is widely dispersed, with no other shareholder holding > 1 %. • No other arrangements that affect decision making • A has been directing the relevant activities of E as a sufficient number of other shareholders voted in the same way as A • Decisions on relevant activities require the approval of a majority of votes cast at shareholders' meetings • At recent shareholders' meetings, 75% of the voting rights have been cast.	• Not conclusive based on the absolute size of A and the relative size of other shareholders • However, the active participation of other shareholders at recent shareholders' meeting indicate that A does not have the practical ability to direct the relevant activities unilaterally (i.e. P holds 47% (35/75) of the active voting rights.

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Exposure to variability in returns

V. Exposure, or rights, to variable returns

- When assessing whether an investor has control of an investee, the investor determines whether it is exposed, or has rights, to variable returns from its involvement with the investee
- Variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee
- Variable returns can be only positive, only negative or both positive and negative
- For example, fixed interest payments from a bond are variable returns because they are subject to default risk and they expose the investor to the credit risk of the issuer
- Fixed performance fees for managing an investee's assets are variable returns because they expose the investor to the performance risk of the investee – the amount of variability depends on the investee's ability to generate sufficient income to pay the fee

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Example of returns

- dividends, other distributions of economic benefits from an investee and changes in the value of the investor's investment in that investee
- remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support
- residual interests in the investee's assets and liabilities on liquidation of that investee
- tax benefits
- access to future liquidity that an investor has from its involvement with an investee
- returns that are not available to other interest holders, such as the investor's ability to use the investee's assets in combination with its own to achieve economies of scale, cost savings or other synergies

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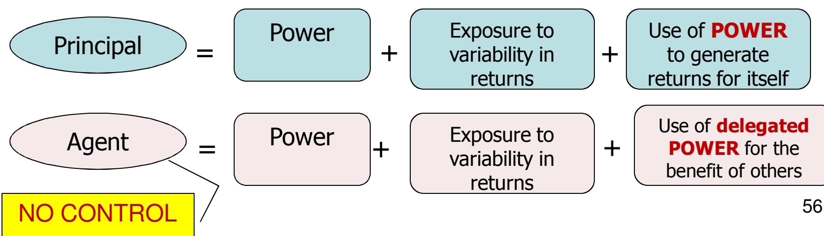
Link between power and returns

VI. Link between power and returns

- An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee
- HKFRS 10 introduces the concept of delegated power
- When an investor with decision-making rights (a decision maker) assesses whether it controls an investee, it shall determine whether it is a principal or an agent



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Principal vs agent

Unless a single party holds substantive rights to remove the decision maker (removal rights) and can remove the decision maker without cause, determining whether a decision maker is an agent requires an evaluation of the following factors:

- Scope of decision-making authority
- Rights held by other parties
- Remuneration
- Other interests held

Scope of decision-making authority
- the activities that are permitted according to the decision-making agreement and specified by law; and
- its level of discretion
- involvement in the design of investee

Rights held by other parties
- Removal rights
- Approval rights

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Principal vs agent

Unless a single party holds substantive rights to remove the decision maker (removal rights) and can remove the decision maker without cause, determining whether a decision maker is an agent requires an evaluation of the following factors:

- Scope of decision-making authority
- Rights held by other parties
- Remuneration
- Other interests held

Remuneration

Agent's remuneration needs to
- Be commensurate with the services provided; and
- Include only term, conditions or amounts customarily present in arrangements for similar services and level of skill negotiated on an arm's length basis.

Other interests held
- Other investments in the investee
- Guarantee provided in respect of performance of investee

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Example:

Fact pattern

- A fund manager, F establishes, markets and manages a fund that provides investment opportunities to a number of investors
- F must make decisions in the best interests of all investors and in accordance with the fund's governing agreements, but it has wide decision-making discretion
- F receives a market-based fee for its services equal to 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved
- The fees are commensurate with the services provided

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	Agent or principal?
Scenario 1 • F has a 2 % investment in the fund • The investor can remove the fund manager by a simple majority vote in the event of breach of contract	• F's 2% investment increases its exposure to variability of returns from the activities of the fund without creating exposure that is of such significance that it indicates that F is a principal • The fund manager's remuneration is at market → F is an agent
Scenario 2 • F has a more substantial pro rata investment in fund • The investor can remove the fund manager by a simple majority vote in the event of breach of contract	• Removal rights are not considered substantive as they are exercisable only in case of breach of contract • The combination of F's investment together with its remuneration could create exposure to variability of returns from the activities of the fund which is significant → F is a principal

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	Agent or principal?
Scenario 3 • F has a 20 % investment in the fund • The fund has a board of directors, all of whose members are independent from F and are appointed by the other investors • The board appoints F annually • The services performed by F could be performed by other fund managers in the industry	• The investors have substantive rights to remove F - board of directors provides a mechanism to ensure that the investors can remove F if they decide to do so → substantive removal rights • The substantive removal rights outweighs the fact that F is exposed to significant exposure to variability of returns due to its combined remuneration and 20% interest in the fund → F is an agent

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Accounting requirements

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Accounting requirements

- Once it has been determined that an investee is a subsidiary, a number of requirements apply in consolidated financial statements. These include:

A. measurement
B. the use of uniform accounting policies
C. the elimination of intragroup transactions
D. the reporting period
E. potential voting rights
F. non-controlling interests (NCI)
G. the loss of control

- These requirements are substantially the same in HKAS 27 (2008) and HKFRS 10
- The guidance on accounting when obtaining control remains in HKFRS 3 when the investee is a business

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A. Measurement

- An entity includes the income and expenses of a subsidiary in the consolidated FS from the date it gains control until the date when the entity ceases to control the subsidiary
- Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated FS at the acquisition date
- For example, depreciation expenses recognised in the consolidated statement of comprehensive income after the acquisition date is based on the fair values of the related depreciable assets recognised in the consolidated FS at the acquisition date

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B. Uniform accounting policies

- If a member of the group uses accounting policies other than those adopted in the consolidated FS for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's FS in preparing the consolidated FS to ensure conformity with the group's accounting policies

C. Intragroup transactions

- Eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group
- Profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory or fixed assets are eliminated in full
- Intragroup losses may indicate an impairment that requires recognition in the consolidated FS

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Source: Insights into IFRS 2011/12

Example – Intra-group transactions (elimination in a "downstream" sale of inventory from parent to an 80% subsidiary)

	Parent	Subsidiary
Cost of inventory	700	1,000
Selling price of inventory	1,000	Not yet sold
Net profit prior to elimination	15,000	8,000
Net assets prior to elimination	125,000	65,000

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Source: Insights into IFRS 2011/12

Example – Intra-group transactions (elimination in a "downstream" sale of inventory from parent to an 80% subsidiary) – cont'd

Elimination entry on consolidation	Debit	Credit
Revenue	1,000	
Cost of sales		700
Inventory		300
To eliminate downstream transaction		
NCI share of profit	1,600 = 8,000 x 20%	

Note: The NCI are calculated without regard to the elimination entry because the unearned profit is in the parent's result. This is notwithstanding the fact that the unearned profit is included in the carrying amount of the inventory in the subsidiary's separate financial statements

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Source: Insights into IFRS 2011/12

Example – Intra-group transactions (elimination in an "upstream" sale of inventory from a 80% subsidiary to the parent)

	Parent	Subsidiary
Cost of inventory	1,000	700
Selling price of inventory	Not yet sold	1,000
Net profit prior to elimination	15,000	8,000
Net assets prior to elimination	125,000	65,000

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Source: Insights into IFRS 2011/12

Example – Intra-group transactions (elimination in an "upstream" sale of inventory from a 80% subsidiary to the parent) – cont'd

Elimination entry on consolidation	Debit	Credit
Revenue	1,000	
Cost of sales		700
Inventory		300
To eliminate downstream transaction		
NCI share of profit	1,540 = (8,000 – 300) x 20%	

Note: The NCI are calculated after eliminating the unearned profit that is included in its results. In addition, the NCI share of net assets also is calculated after the elimination even though the inventory that was overstated from the group's perspective is in the parent's separate statement of financial position.

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D. Reporting period

- The financial statements of the parent and its subsidiaries used in the preparation of the consolidated FS shall have the same reporting date
- When the parent and the subsidiary have different reporting date, the subsidiary prepares additional financial information as of the same date as that of the parent for consolidation purpose
- If this is impracticable to do so, the parent shall use the most recent financial statements of the subsidiary adjusted for the effects of significant transactions or events that occur between the date of the subsidiary's FS and that of the consolidated FS
- In any case, the difference between the date of the subsidiary's FS and that of the consolidated FS shall not be > 3 months.
- The length of the reporting periods and any difference between the dates of the FS shall be the same from period to period.

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Source: Deloitte – iGAAP 2012

Question:

Parent's (P) reporting date: 31 Mar

Subsidiary's (S) reporting date: 31 Dec

For consolidation purpose, P adjusts S's financial statements for the period ended 31 Dec for significant transactions or events that took place between 1 Jan to 31 Mar

In 20X2, S changes its reporting date to align to that of its parent (31 Mar). S will prepare FS for the 12-month ended 31 Mar 20X1 and 20X2. The financial statements for the year ended 31 Mar 20X1 may differ from those used in the consolidated FS for the same year end.

Should the adjustment resulting from S's change in reporting date be recognised in the consolidated FS as a change in accounting policy or as a change in estimate?

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E. Potential voting rights

What is the proportion of profit or loss and changes in equity allocated to the parent and NCI in preparing consolidated FS when potential voting rights, or other derivatives containing potential voting rights exist?

The allocation is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives, unless described below.

- In some circumstances an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest.
- In this case, the proportion allocated to the parent and NCI is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns.

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Source: Deloitte-iGAAP 2012

- The instruments that contain such potential voting rights are not subject to the requirements of HKAS 39 (or when adopted, HKFRS 9).
- In all other cases, instruments containing potential voting rights in a subsidiary are accounted for in accordance with HKAS 39 (or HKFRS 9)

Example 1- potential voting rights

A holds 49% of the ordinary shares of B. The remaining 51% are owned by 3 independent parties (each owns 17%). A also holds a currently exercisable call option that, if exercised, would give A an extra 9% of ordinary shares of B and reduces the interests of the remaining shareholders to 14% each.

The call option is in the money and is expected to remain in the money until the expiry date of the option. If A exercises the call option, it will have control over > 50% of the voting power.

Questions:

1. Does A control B?
2. If A controls B, what are the proportions of profit or loss and OCI allocated to the owners and the NCIs of B?

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Example 1 (cont'd):

1. Does A control B?
   Taking into account A's existing 49% ownership interest and the call option held, A controls B.

2. If A controls B, what are the proportions of profit or loss and OCI allocated to the owners and the NCIs of B?
   - Assume that, prior to exercise, the call option does not give A current access to returns associated with 9% ownership interest.
   - When A prepares its consolidated FS, the proportions of profit or loss and OCI allocated to its owners and the NCIs of B are 49% and 51% respectively.
   - The call option is accounted for as a derivative in accordance with HKAS 39 (or HKFRS 9 when adopted) unless it meets the definition of an equity instrument.

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Source: Deloitte-iGAAP 2012

Example 2- potential voting rights

Same scenario as example 1 except that, instead of having a call option, A has entered into a forward contract with one of the other shareholders to acquire an extra 5% of the ordinary shares of B. The forward contract will be settled in 2 years' time. The contract gives A the right to receive dividends, if any, relating to the 5% ownership interest during the 2-year period. They also oblige the other shareholder to vote in accordance with the instructions of A on that 5% ownership during the 2-year period.

Questions:

1. Does A control B?
2. If A controls B, what are the proportions of profit or loss and OCI allocated to the owners and the NCIs of B?

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Example 2 (con't):

1. Does A control B?
   Taking into account A's existing 49% ownership interest and the forward contract held, A controls B.

2. If A controls B, what are the proportions of profit or loss and OCI allocated to the owners and the NCIs of B?
   - A has rights to dividends, and hence in-substance current access to the returns associated with the 5% shareholding.
   - The proportion of profit or loss and OCI allocated to the owners and the NCIs of B should be 54% and 46% respectively.
   - The forward contract is not subject to the requirements of HKAS 39 (or when adopted HKFRS 9).

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F. Non-controlling interests (NCI)

- HKFRS 10 defines a non-controlling interest as "equity in a subsidiary not attributable, directly or indirectly, to a parent"
- When a subsidiary is not wholly owned, the profit or loss and each component of other comprehensive income of the subsidiary are required to be allocated between the owners of the parent and NCI
- Amount should be attributed to the NCI even if this results in the NCI having a deficit balance.
- HKFRS 10 requires the allocation to be on the basis of existing ownership interests
- If a subsidiary has outstanding cumulative preference shares that are classified as equity and held by NCI, the parent computes its share of profits or losses after adjusting for the dividends on such shares, whether or not the dividends have been declared.

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Presentation of NCI

- NCI should be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent
- The following items should be presented, in addition to the profit or loss and OCI sections, as allocation of profit or loss and OCI for the period:
  - profit or loss for the period attributable to (i) NCI and (ii) owners of the parent; and
  - comprehensive income for the period attributable to (i) NCI and (ii) owners of the parent

  [effective for annual periods beginning on or after 1 Jul 2012]

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Source: Insights into IFRS 2011/12

Example

Group B has an 80% interest in Sub C, which is classified as held for sale and is a discontinued operation. The net profit of the discontinued operation for the year is 200, the related disposal group comprises assets of 1,200, liabilities of 500 and the NCI is measured at 140:

- In the statement of comprehensive income, the result of the discontinued operation is 200. The result is not presented net of NCI of 40 (200 x 20%) because NCI are not an item of income or expense, but instead are presented as an allocation of the entity's profit or loss;
- In the statement of financial position, the assets of the disposal group of 1,200 and liabilities of 500 are presented as a separate line item. The NCI of 140 continue to be presented as a component of equity
- Entities should consider whether the NCI related to a disposal group and/or a discontinued operation should be disclosed separately from NCI related to the continuing operations of the entity

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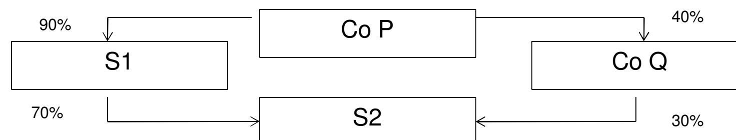
Source: Insights into IFRS 2011/12

Percentage attributable to NCI

- NCI is the equity in a subsidiary not attributable directly or indirectly to the parent. Therefore, the NCI includes any equity interests in a subsidiary that are not held by the parent directly or indirectly through subsidiaries, associates or joint ventures

Example

- Co P prepares consolidated financial statements that include its two subsidiaries, S1 and S2, and the group's interest in an associate, Co Q. Co P's interests in the respective companies are as follows:



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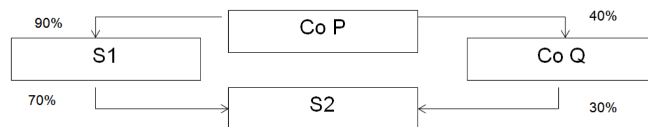

What is the NCI in relation to S1?

- P owns 90% of S1 directly and has no indirect interest in S1. Therefore, the NCI in S1 is 10%. P recognises in its consolidated financial statements 100% of the results of S1, with 10% allocated to NCI

What is the NCI in relation to S2?

- P owns 63% of S2 indirectly through S1 (70% x 90%), and 12% of S2 indirectly through Q (30%x40%). Therefore, P's total interest in S2 is 75% and the NCI is 25%. P recognises in its consolidated financial statements 100% of the results of S2 , with 25% allocated to NCI
- However, when accounting for Q using the equity method, P also would recognise 12% of the results of S2, resulting in double counting which should be eliminated

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- The double counting in respect of P's interest in S2 should be eliminated against the equity-accounted earnings of Q, i.e. the equity-accounted earnings of S2 will be reduced to zero because the consolidated financial statements of the parent already include P's 12% interest in S2 (i.e. 100% of the assets, liabilities, income and expenses of S2 have already been included)

- In some cases, the economic interests of investors will not equal their shareholdings. For example, an entity may control 60% of the voting power in a subsidiary, but own only a 55% economic interest in the profits and net assets. In this case, the NCI is measured based on the economic interest, i.e. 45%.

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Changes in ownership interest while retaining control

- After a parent has obtained control of a subsidiary, it may change its ownership interest in that subsidiary without losing control through the parent buying shares from, or selling shares to, the NCI or through the subsidiary issuing new shares or reacquiring its shares
- Transactions that result in changes in ownership interests while retaining control are equity transactions (i.e. accounted for as transactions with equity holders in their capacity as equity holders). As a result, no gain or loss on such changes is recognised in profit or loss but rather in equity
- Also no change in the carrying amounts of assets (including goodwill) or liabilities is recognised as a result of such transactions

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- The interests of the parent and NCI in the subsidiary are adjusted to reflect the relative change in their interests in the subsidiary's equity
- Any difference between the amount by which NCI is adjusted and the fair value of the consideration paid or received is recognised directly in equity, and attributed it to owners of the parent

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Source: Insights into IFRS 2011/12

Example – Changes in ownership interests while retaining control – issue of new shares

- Co S has 100 ordinary shares outstanding and the carrying amount of its equity (net assets) is 300. Co P owns 90% of S, i.e. 90 shares. S has no other comprehensive income. S issues 20 new ordinary shares to a third party for 120 cash, as a result:
  - S's net assets increase to 420
  - P's ownership interest in S reduces from 90% to 75% (90 shares out of 120 issued); and
  - NCI in S increases from 30 (300 x 10%) to 105 (420 x 25%)

	Debit	Credit
Cash	120	
NCI (equity)		75
Other equity or retained earnings		45

To recognise overall change in equity as a result of partial disposal to NCI

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Source: Insights into IFRS 2011/12

Example – Changes in ownership interests while retaining control – Purchase of equity interests from NCI

- Co P acquired 80% of Co S in a business combination several years ago. P subsequently purchases an additional 10% interest in S
- The contribution of S to P's consolidated financial statements before the purchase of NCI is as follows:

	NCI measured initially at fair value	Interest in NCI measured at proportionate interest in identifiable net assets
Goodwill	100	80
Identifiable net assets	1,000	1,000
Total net assets	1,100	1,080
Equity (parent)	880	880
Equity (NCI)	220	200
Total shareholders' equity	1,100	1,080

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Source: Insights into IFRS 2011/12

- The contribution of S to P's consolidated financial statements after the purchase of the additional 10% interest (exclusive of the consideration paid) is as follows:

	NCI measured initially at fair value	Interest in NCI measured at proportionate interest in identifiable net assets		
		Approach 1	Approach 2	Approach 3
Goodwill	100	80	80	80
Identifiable net assets	1,000	1,000	1,000	1,000
Total net assets	1,100	1,080	1,080	1,080
Equity (parent)	990	988	980	980
Equity (NCI)	110	92	100	100
Total shareholders' equity	1,100	1,080	1080	1080

- The decrease in NCI is calculated as follows:
  (1) 110 = 10% x 1,100 (total net assets including goodwill) when NCI are initially measured at FV
  (2) 108 = 10% x 1080 (total net assets including goodwill) under approach 1
  (3) 100 = (10%/20%) x 200 (NCI) under approach 2
  (4) 100 = 10% x 1000 (total identifiable net assets) under approach 3

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Source: Insights into IFRS 2011/12

Example – Changes in ownership interests while retaining control – Sale of equity interests to NCI

- Co P acquired 80% of Co S in a business combination several years ago. P subsequently sells a 20% interest in S, but retain control of S
- The contribution of S to P's consolidated financial statements before the sale of NCI is as follows:

	NCI measured initially at fair value	Interest in NCI measured at proportionate interest in identifiable net assets
Goodwill	100	80
Identifiable net assets	1,000	1,000
Total net assets	1,100	1,080
Equity (parent)	880	880
Equity (NCI)	220	200
Total shareholders' equity	1,100	1,080

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Source: Insights into IFRS 2011/12

- The contribution of S to P's consolidated financial statements after the sale of equity interest to NCI (exclusive of the consideration received) is as follows:

	NCI measured initially at fair value	Interest in NCI measured at proportionate interest in identifiable net assets		
		Approach 1	Approach 2	Approach 3
Goodwill	100	80	80	80
Identifiable net assets	1,000	1,000	1,000	1,000
Total net assets	1,100	1,080	1,080	1,080
Equity (parent)	660	664	660	680
Equity (NCI)	440	416	420	400
Total shareholders' equity	1,100	1,080	1080	1080

- The increase in NCI is calculated as follows:

(1) 220 = 20% x 1,100 (total net assets including goodwill) when NCI are initially measured at FV
(2) 216 = 20% x 1080 (total net assets including goodwill) under approach 1
(3) 220 = (20%/80%) x 880 (NCI) under approach 2
(4) 200 = 20% x 1000 (total identifiable net assets) under approach 3

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Changes in ownership interest in a subsidiary that has other comprehensive income

- When the relative interests of the parent and NCI change, the balance of other comprehensive income should be reallocated between the parent and NCI in order to reflect the new interests; in respect of any foreign currency translation reserve, such reallocation is required explicitly following a partial disposal

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Source: Insights into IFRS 2011/12

Example – Changes in ownership interests in a subsidiary that has other comprehensive income

- Co P owns 80% of the shares in Co S. On 1 January 2010, P acquires an additional 10% of S for cash of 30. The carrying amount of the cumulative NCI in S before the acquisition is 48, which includes 4 in respect of the NCI's portion of gains recognised in OCI in relation to foreign exchange movements on translation of that subsidiary. In P's consolidated financial statements the decrease in NCI in S is recorded as follows:

	Debit	Credit
NCI (equity)	24	
Other equity (or retained earnings)	6	
Cash		30
To reflect overall change in equity as a result of acquisition of NCI		
Other equity (or retained earnings)	2	
Foreign currency translation reserve (4 x 10/20)		2
To recognise change in attribution of other comprehensive income following acquisition of NCI		

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G. Loss of control

- A parent can lose control of a subsidiary in a variety of ways. The loss of control can occur without a change in absolute or relative ownership levels or in the absence of a transaction.
- Examples of events that may result in a loss of control include:
  - a parent sells all or part of its ownership interest in its subsidiary such that it loses control;
  - a contractual agreement that gave control of the subsidiary to the parent expires;
  - the subsidiary issues shares to third parties, thereby reducing the parent's ownership interest in the subsidiary so that it no longer has control of the subsidiary;
  - substantive participating rights are granted to other parties;
  - the parent distributes its ownership interest in the subsidiary; or
  - the subsidiary becomes subject to the control of a government , court, administrator or regulator

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When a parent loses control of a subsidiary, it shall:

a) Derecognise:

- the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost; and
- the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of OCI attributable to them)

b) Recognise:

- the fair value of the consideration received, if any, from the transaction event or circumstances that resulted in the loss of control;
- if the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and
- any investment retained in the former subsidiary at its fair value at the date when control is lost

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When a parent loses control of a subsidiary, it shall: (cont'd)

c) reclassify to profit or loss, or transfer directly to retained earnings if required by other HKFRSs, the amounts recognised in OCI in relation to the subsidiary on the basis described below.

d) Recognise any resulting difference as a gain or loss in profit or loss attributable to the parent.

The parent shall account for all amounts previously recognised in OCI in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.

As a result, the following amounts are reclassified to profit or loss:

- exchange differences that were recognised in OCI according to HKAS 21;
- changes in the fair value of AFS financial assets recognised previously in OCI in accordance with HKAS 39; and
- the effective portion of gains and losses on hedging instruments in a cash flow hedge recognsied previously in OCI in accordance with HKAS 39.

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- On loss of control of a non-wholly-owned subsidiary, the reserve to be reclassified to profit or loss or to retained earnings, as the case may be, is the net amount, i.e., excluding the amount of reserve allocated to NCI
- The NCI's share of the carrying amount of the net assets of the former subsidiary immediately before control is lost, which includes the share of all profit or loss and other comprehensive income that was attributed to the NCI, is derecognised
- Any retained non-controlling equity investment in the former subsidiary is generally remeasured to its fair value at the date that control is lost. The gain or loss on such remeasurement is included in determining the gain or loss on the loss of control. From the date that control is lost, any remaining investment is accounted for in accordance with HKAS 39, HKAS 28 or HKAS 31, as appropriate

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Source: Insights into IFRS 2011/12

Example – Loss of control

Co P owns 60% of the shares in Co S. On 1 January 2011, P dispose of a 20% interest in S for cash of 400 and loses control over S. The fair value of the remaining 40% investment is determined to be 800. At the date that P disposes of a 20% interest in S, the carrying amount of the net assets of S is 1,750. Other comprehensive income includes the following related to the subsidiary, which are net of amounts that were allocated to NCI:

- foreign currency translation reserve of 60; and
- available-for-sale revaluation of 120

The amount of NCI in the consolidated financial statement of P on 1 January 2011 is 700. The carrying amount of NCI includes the following amounts that were recognised in other comprehensive income before being allocated to NCI:

- foreign currency translation reserve of 40 (60/60% x 40%); and
- available-for-sale revaluation reserve of 80 (120/60% x 40%)

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Source: Insights into IFRS 2011/12

P records the following entry to reflect its loss of control over S at 1 January 2011:

	Debit	Credit
Cash	400	
Equity (NCI)	700	
Foreign currency translation reserve	60	
Available-for-sale revaluation reserve	120	
Investment in S	800	
Net assets of S (including goodwill)		1,750
Profit or loss		330

To recognise loss of control of S

Note:

The 330 recognised in profit or loss represents the increase in the fair value of the retained 40% investment of 100 (800 – (1750 x 40%)), plus the gain on the disposal of the 20% interest of 50 (400-(1750 x 20%), plus the reclassification adjustments of 180 (60+120). Assuming that the remaining interest of 40% represents an associate, the fair value of 800 represents the cost on initial recognition and HKAS 28 applies going forward

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Transitional requirements

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General requirements

- Apply retrospectively with limited exceptions
- In July 2012, Consolidated Financial Statements, Joint Arrangements and Disclosures of Interests in Other Entities: Transition Guidance (Amendments to HKFRS 10, 11, and 12) was issued
  ✓ the amendments clarify the application of the transition guidance in HKFRS 10, 11 and 12
  ✓ Effective date: annual period beginning on or after 1 January 2013

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	Adopting the consolidation standard
Transitional requirements without relief	The entity would be required to restate its entire history as if HKFRS 10 had always been in effect. Relief would be available only to the extent that restatement was impracticable.
Transitional requirements after relief	Easier assessment at the date of transition to HKFRS 10 • For each investee, an entity tests the consolidation conclusion – i.e. whether the investee should be consolidated – at the beginning of the annual period in which HKFRS 10 is applied for the first time. If an entity with a calendar year end has not adopted HKFRS 10 early, then this date is 1 January 2013. • An entity does not change its previous accounting if there is no change in the consolidation conclusion. Restatement limited to one year • If there is a change in the consolidation conclusion and the investee is: – consolidated for the first time, then the mandatory restatement of comparatives is limited to one year; or – deconsolidated, then the mandatory restatement of comparatives is again limited to one year.

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Comparative information

- If an entity presents more than 1 comparative period but not all the comparative periods have been adjusted, the entity should:
  - state the fact
  - clearly identify the information that has not been adjusted, and
  - explain the basis on which it has been prepared.

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	Disclosures about changes in accounting policies
Transitional requirements without relief	As part of its disclosures, the entity would be required to provide information about the effect of the change in accounting policy on each financial statement line item and on earnings per share. This disclosure would be required for both the current period and for all comparative periods presented.
Transitional requirements after relief	***Restatement limited to one year*** • Disclosure of the impact of initial application of standards is required only for the period immediately preceding the date of adoption – i.e. for 2012 for an entity with a calendar year end that does not early adopt the standards. • This means that an entity is not required to keep additional accounting records – e.g. as if an investee had not been consolidated – in the year of adopting the standards in order to collect data to disclose the impact of adopting the standards on the current period.

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General requirements

At the date of initial application of HKFRS 10, is the entity consolidated under:			
HKAS 27/SIC 12	**HKFRS 10**	**Consolidation conclusion**	**Retrospective adjustment**
Yes	Yes	Same	No
No	No		No
No	Yes	Different	Yes
Yes	Yes		Yes
Investee disposed of prior to date of initial application		Same	No

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A) Consolidation upon initial adoption of HKFRS 10

i) The investee is a business

a) Determines the date at which the investor obtained control over the investee according to HKFRS 10; and

b) Measures assets, liabilities and NCI as if HKFRS 3 had been applied at that date.

If (b) is impracticable, then the deemed acquisition date is the beginning of the earliest period for which application of HKFRS 3 is practicable, which could be the current period.

- The investor should adjust retrospectively the annual period immediately preceding the date of initial application.
- If control was obtained earlier than the beginning of the immediately preceding period, the investor shall recognise any difference between (a) the amounts of assets, liabilities and NCI recognised and (b) the previous carrying amount of the investee; as an adjustment to equity at the beginning of the immediately preceding period.

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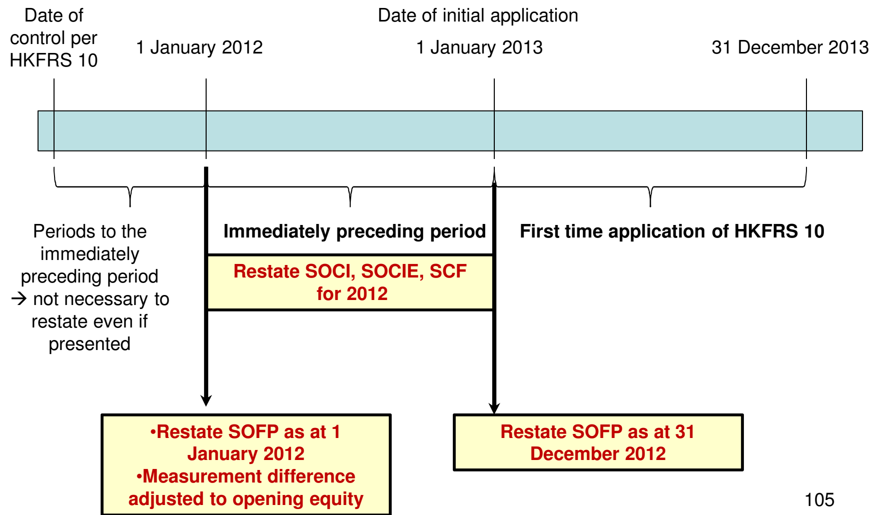

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Control Obtained …	
Before effective date of HKFRS 3 (2008) / HKAS 27 (2008)	After effective date of HKFRS 3 (2008) / HKAS 27 (2008)
• Apply HKFRS 3 (2008) or HKFRS 3 (2004). • If relevant, apply either HKFRS 10 for all periods, or HKAS 27 (2004) up to the effective date of HKAS 27 (2008) and then apply HKFRS 10 from that date.	• Apply HKFRS 3 (2008) • If relevant, apply HKFRS 10.
Notes • HKFRS 3 (2008) was effective for business combinations in annual periods beginning on or after 1 July 2009, or at an earlier date if adopted early. • HKAS 27 (2008) was effective for annual periods beginning on or after 1 July 2009, or at an earlier date if adopted early. • The standards were required to be adopted at the same time.	

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Consolidation upon initial adoption of HKFRS 10

ii) The investee is not a business

a) Determines the date at which the investor obtained control over the investee according to HKFRS 10; and

b) Measures assets, liabilities and NCI as if acquisition accounting had been consolidated from that date, with assets, liabilities and NCI initially measured applying the acquisition method as described in HKFRS 3 but without recognising any goodwill; and

c) Any difference between (b) and the carrying amount of the investor's involvement with the investee in equity.

If (2) is impracticable, then the deemed acquisition date is the beginning of the earliest period for the measurement of assets, liabilities and NCI as described in HKFRS 3 is practicable, which could be the current period.

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B) Deconsolidation upon initial adoption of HKFRS 10

a) Determines the date at which the investor would have stopped consolidating the investee under HKFRS 10; and

b) Measures the retained interest on the date of initial application at the amount at which it would have been measured had HKFRS 10 been effective at that date.

c) Any difference between the previously recognised net assets and NCI, and (b), is accounted for in equity.

If (b) is impracticable, then the investor applies the requirements of HKFRS 10 for a loss of control at the beginning of the earliest period for which it is practicable, which may be the current period.

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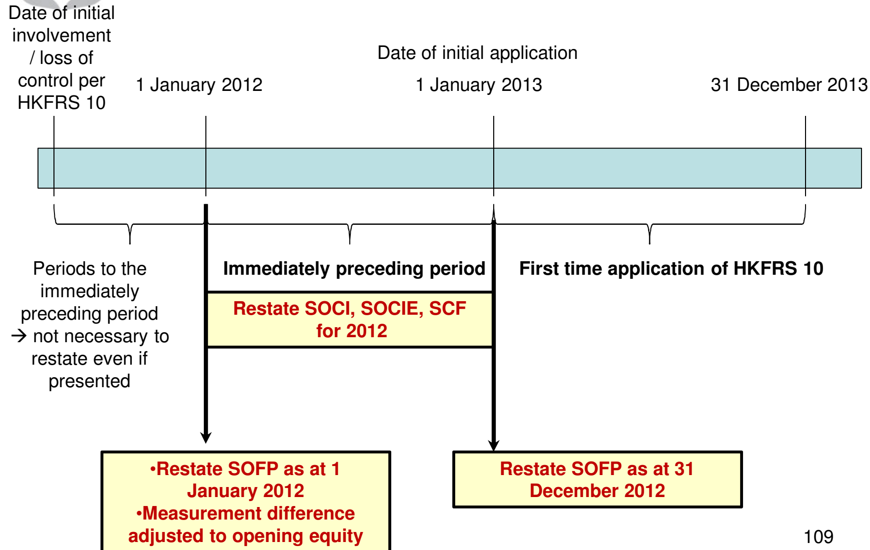

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Source: KPMG - First impressions

Example – No control under HKFRS 10

L acquired a 60% interest in S on 1 Jan 2007 for $40 and determined under HKAS 27 (2008) that S was a subsidiary.

When adopting HKFRS 10, L determines that it does not control S in accordance with HKFRS 10. Had HKFRS 10 been effective in 2007, L would not have controlled S. Instead, S would have been classified as an AFS financial asset measured at fair value according to HKAS 39. No impairment losses would have been recognised between 2007 and 1 Jan 2012 had the investment in S been recorded as an AFS since its acquisition.

At the date of initial application of HKFRS 10, which is 1 Jan 2012, net assets of S are $150 (including goodwill of $25) and NCI are $50. The fair value of 60% of S is estimated to be $115 at that date.

On the date of initial application of HKFRS 10, the entries recorded by L are as follows:

	Dr.	Cr.
AFS financial assets – S	115	
NCI	50	
Equity (retained earnings)	60	
Equity (AFS reserve) (115-40)		75
Net assets		150
To deconsolidate S upon application of HKFRS 10		

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C) Entity disposed of prior to date of initial application

If a reporting entity disposed of its interests in an investee prior to the date of initial application, does the reporting entity need to perform the HKFRS 10 control assessment in the year of initial application?

Example

- X acquired 48% equity interest in Y, a listed company in June 2006.
- X disposed of 48% of its interest in Y in June 2012.
- Assume X applies HKFRS 10 for the first time in its financial year ending 31 December 2013.

Does X need to apply retrospective adjustment?

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Separate financial statements

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Background

- In May 2011, the IASB issued IAS 27 (2011) *Separate Financial Statements* which prescribes the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by local regulations, to present separate financial statements.
- HKAS 27 (2011) replaces the parts of HKAS 27 (2008) *Consolidated and Separate Financial Statements* that previously dealt with separate financial statements
- HKAS 27 (2011) is a part of a suite of Standards issued together, which all adopted at the same time.
- HKAS 27 (2011) is required to be applied for annual periods beginning on or after 1 January 2013.

The requirements of HKAS 27 (2011) are generally consistent with the equivalent requirements previously included in HKAS 27 (2008). But note that separate financial statements may be affected by other changes introduced by the suite of standards, e.g. HKFRS 11 *Joint Arrangements*

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Scope

Accounting for investments in subsidiaries, joint ventures and associates when

- an entity elects; or
- is required by local regulations,

to present separate financial statements

HKAS 27 (2011) does not mandate which entities produce separate financial statements. It applies when an entity prepares separate financial statements that comply with HKFRSs.

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Definition

Separate financial statements are those presented by a parent (ie an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with HKFRS 9 *Financial Instruments.*

- In separate financial statements, investments are accounted for on the basis of the direct equity interest rather than on the basis of the underlying results and net assets of the investees.
- Separate financial statements are those presented in addition to consolidated financial statements or in addition to financial statements in which investments in associates or joint ventures are accounted for using the equity method, other than those being exempted under HKFRS 10 or HKAS 28 (2011).

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Questions

Are these separate financial statements?

a) Financial statements of an entity with associates and joint ventures being equity accounted for

b) Financial statements of an entity that does not have a subsidiary, associate, or joint venture's interest in a joint venture

- Separate financial statements need not be appended to, or accompany, those statements.
- An entity that is exempted in accordance with paragraph 4(a) of HKFRS 10 from consolidation or paragraph 17 of HKAS 28 (2011) from applying the equity method may present separate financial statements as its only financial statements

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Measurement

- When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly ventures and associates either:

  (a) at cost, or

  (b) in accordance with HKFRS 9.

  The entity shall apply the same accounting for each category of investments.
- Investments that accounted for at cost shall be accounted for in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when they are classified as held for sale (or included in a disposal group that is classified as held for sale).
- The measurement of investments accounted for in accordance with HKFRS 9 is not changed in such circumstances.
- Except that, separate financial statements shall be prepared in accordance with all applicable HKFRSs.

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Measurement

- When an entity has chosen to account for its investments in accordance with HKFRS 9, the initial measurement requirements of HKFRS9:5.1.1 should be applied, i.e.
  - for financial assets not classified as at fair value through profit or loss, at fair value plus transaction cost that are directly attributable to the acquisition; and
  - for financial assets classified as at fair value through profit or loss, at fair value
- HKAS 27 (2011) does not define "cost"
- It is appropriate to apply the requirements and guidance in Standards or Interpretations of HKFRSs dealing with similar and related issues according to HKAS8.10-11

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Treatment of dividend income

- An entity shall recognise a dividend from a subsidiary, a joint venture or an associate in profit or loss in its separate financial statements when its right to receive the dividend is established
- The requirements regarding dividends do not make any distinction between distributions paid out of pre- and post-acquisition profits; there is no requirement that dividends paid out of pre-acquisition profits should be recognised a reduction of the cost of the investment
- However, to reduce the risks that the investments may be overstated in the separate financial statements, the requirements in HKAS 36 *Impairment of Assets* should also be observed.

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Treatment of dividend income

Dividend from a subsidiary, jointly controlled entity or associate

HKAS 36.12

(h) for an investment in a subsidiary, joint ventures or associate, the investor recognises a dividend from the investment and evidence is available that:

(i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or

(ii) the dividend exceeds the total comprehensive income of the subsidiary, jointly venture or associate in the period the dividend is declared.

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Disclosures

- An entity shall apply all applicable HKFRSs when providing disclosures in its separate financial statements
- When a parent, in accordance with HKFRS 10.4(a), elects not to prepare consolidated FS and instead prepares separate financial statements, it shall disclose in those separate financial statements:

(a) the fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with HKFRSs or IFRSs have been produced for public use; and the address where those consolidated financial statements are obtainable;

(b) a list of significant investments in subsidiaries, joint ventures and associates, including the name, principal place of business (and country of incorporation, if different), proportion of ownership interest (and proportion of voting rights, if different); and

(c) A description of the method used to account for the investments listed in under (b).

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Disclosures

When a parent (other than a parent covered by the above paragraph) or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, those separate financial statements shall disclose:

(a) the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law;

(b) a list of significant investments in subsidiaries, joint ventures and associates, including the name, principal place of business (and country of incorporation, if different), proportion of ownership interest (and its proportion of the voting rights, if different); and

(c) a description of the method used to account for the investments listed under (b);

and shall identify the financial statements prepared in accordance with HKFRS10 , HKFRS 11 and HKAS 28 (2011) to which they relate.

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Extract from the 2010-11 financial statements of Nanny Holdings Limited

Annex 1

Acquisition of Asset – Example

The acquisition has been accounted for as an acquisition of assets and liabilities. The effect of the acquisition is summarized as follows:

收購事項已列作收購資產及負債。收購事項之影響概述如下：

		HK$'000 千港元
Net assets acquired:	所收購之資產淨值：	
Properties under development for sale	待售發展中物業	1,212,126
Other receivables and prepayments	其他應收款項及預付款項	12,323
Bank balances and cash	銀行結餘及現金	234
Other payables and accrued expenses	其他應付款項及應計開支	(217,583)
Deposits received in advance	預收訂金	(172,983)
Other borrowings	其他借款	(334,249)
Amount due to a non-controlling shareholder	應付一名非控股股東款項	(49,284)
		450,584
Non-controlling interests	非控股權益	(12,727)
Total consideration	總代價	437,857

Extract from the 2010 financial statements of Golden Eagle Retail Group Limited

Annex 2

Acquisition of Asset – Example

In December 2010, the Group acquired 100% equity interests in 徐州金浩投資管理有限公司 (Xuzhou Jinhao Investment Management Co., Ltd.) ("Xuzhou Jinhao"), in which a Director of the Company, Mr. Wang, has beneficial interest, at an aggregation consideration of RMB90,000,000. Details of the transaction are set out in the announcement and circular of the Company dated 10 November 2010 and 6 December 2010 respectively. On the date of acquisition, Xuzhou Jinhao owned a vacant property and has not commenced operations. The property will be used for the Group's department store operation.

In the opinion of the Directors, the above acquisition does not constitute business combination in accordance with HKFRS 3 "Business Combination" and as such, the acquisition has been accounted for as acquisition of asset.

Asset acquired in the transaction is as follows:

	RMB'000
Property, plant and equipment (note)	90,000

Note: The amount includes land use rights, of which the lease payments cannot be allocated reliably between the land and building elements. The entire lease is treated as a finance lease and accounted for as property, plant and equipment.

Acquisition of Asset – Example

Annex 3

Extract from the 2010/11 financial statements of CST Mining Group Limited

(a) Acquisition of assets and liabilities through acquisition of a jointly controlled entity (continued)

The consolidated net assets acquired (including the net assets of the Peruvian mining company which are attributable to Chariot's equity interest of 70% in the jointly controlled entity) was summarised as follows:

	US$'000
Net assets acquired:	
Property, plant and equipment	224,683
Other receivables	13,535
Bank balances and cash	11,278
Other payables	(3,148)
Provision for mine rehabilitation cost	(250)
	246,098
Total consideration satisfied by:	
Cash	235,551
Directly attributable costs	10,547
	246,098
Net cash outflow arising on the acquisition of assets and liabilities through acquisition of a jointly controlled entity:	
Cash consideration paid	235,551
Cash paid for directly attributable costs	10,547
Less: bank balances and cash acquired	(11,278)
	234,820

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A Refresher Course on Current

Financial Reporting Standards 2013

Day 2

Time	Topic
09:00 - 11:00	Associates and joint arrangements
11:00 - 11:15	Break
11:15 - 12:45	Non-current asset held for disposal and discontinued operation
12:45 - 13:45	Lunch
13:45 - 15:15	Related party transactions
15:15 - 15:30	Break
15:30 - 16:15	Borrowing cost
16:15 - 17:00	Provision and contingencies

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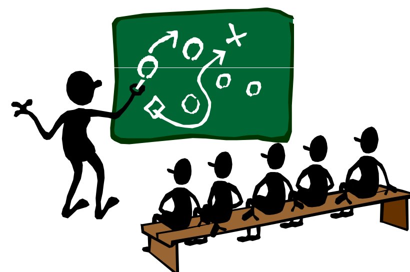
A Refresher Course on Current Financial Reporting Standards 2013 (Day 2)

Associates and joint arrangements



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Associates

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Agenda

Part 1: Background

Part 2: What is "Associate"?

Part 3: Accounting requirements

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Background

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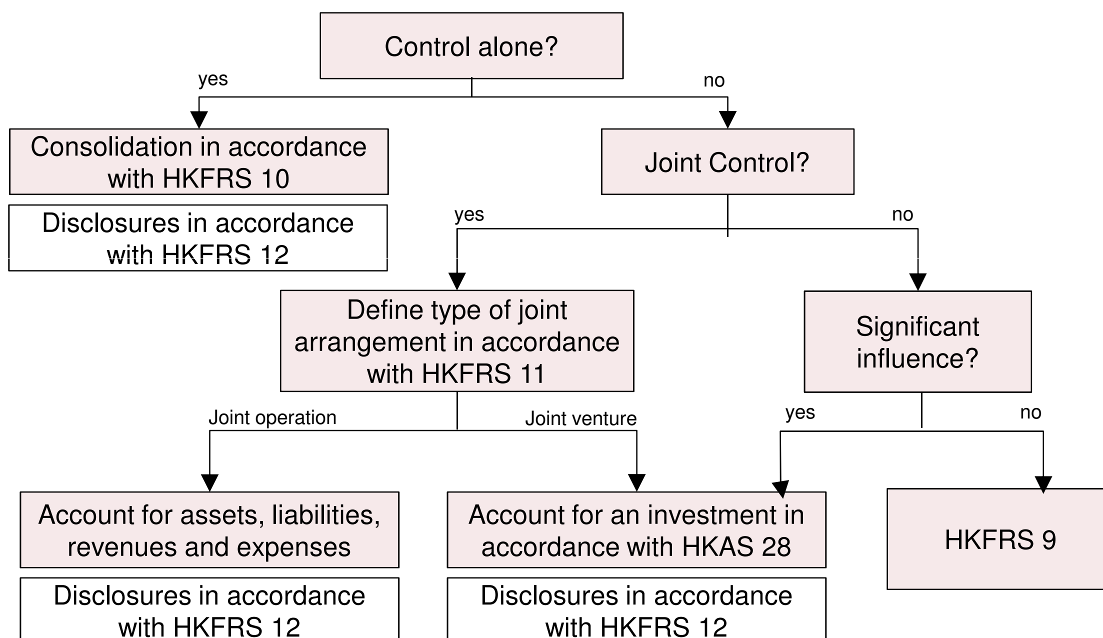
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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Background

- IASB issued *IAS 28 (2011) Investments in Associates and Joint Ventures* in May 2011 which
  - prescribes the accounting for investments in associate; and
  - sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures
- IAS 28 (2011) supersedes the *IAS 28 (2008) Investments in Associates and SIC-13 Jointly Controlled Entities – Non-monetary contributions by venturers*
- IAS 28 (2011) is effective from 1 January 2013. Early application is permitted. But the entity must also apply at the same time IFRS 10, 11, 12, and IAS 27 (2011)

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What is "Associate"?

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Significant influence

Associate – an entity over which the investor has significant influence

Significant influence – the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies

Indicators of significant influence

(a) representation on the board of directors or equivalent governing body of the investee;

(b) participation in policy-making processes, including participation in decisions about dividends or other distributions;

(c) material transactions between the entity and its investee;

(d) interchange of managerial personnel; or

(e) provision of essential technical information.

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Significant influence

- As a general rule, significant influence is presumed to exist when an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee, unless it can be clearly demonstrated that this is not the case
- Conversely, if the entity holds, directly or indirectly, less than 20% of the voting power of the investee, the entity does not have significant influence, unless such influence can be clearly demontrated
- A substantial or majority ownership by another investor does not preclude an investor from having significant influence

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Significant influence

Potential voting rights

- An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of another entity (ie potential voting rights).
- The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence.
- Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

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Significant influence

Potential voting rights

- In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intentions of management and the financial ability to exercise or convert those potential rights.

Example - Potential voting rights

A holds a 15% voting ordinary share interest in B, as well as a call option which can only be exercise at the end of the option period to acquire an additional 10% voting ordinary share interest in B. This option matures in 3 years. A's ownership of the call option which, if converted, would give A's a 25% voting interest in B.

Does A have significant influence over B?

No, because the call option is not currently exercisable.

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Examples	Assume: The ownership interest carries an equivalent percentage of voting rights.
Out-of-the-money options	A has 20% interest in C. A sells one half of its interest to D and buys call options from D that are exercisable at any time at a premium to the market price at issuance. If exercised, these rights would give A its original 20% ownership interest and voting rights. The exercise price has economic substance and is not set deliberately high.
Possibility of exercise or conversion	A has 10% interest in D. A also owns call options that are exercisable at any time at the fair value of the underlying shares and if exercised would give it an additional 15% of the voting rights in D and reduce the other investors' interests. If the option are exercised, A would have an interest that exceeded the 20% presumed threshold for significant influence.

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Significant influence

Ceasing to have significant influence

- Significant influence over an investee is lost when the investor loses the power to participate in the financial and operating policy decisions of that investee.
- The loss of significant influence can occur with or without a change in absolute or relative ownership levels.
- It could occur, for example, when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual arrangement.

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Accounting requirements

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Equity method

(a) Basic principle

Under the equity method of accounting, an equity investment is initially recorded at cost and is subsequently adjusted to reflect the investor's share of the profit or loss of the associate after the date of acquisition. [HKAS 28.10]

- The investor's share of the post-acquisition profits or losses of the investee, which are recognised in the investor's profit or loss;
- Distributions received from the investee, which reduce the carrying amount of the investment; and
- Changes in the investor's proportionate interest in the investee arising from changes in the investee's OCI (such as the impact of property revaluations and some exchange differences). These are recognised in OCI of the investor

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Equity method

(a) Basic principle

Example –Equity method accounting

A acquired 30% interest in C and has significant influence over C. Cost of investment was $250,000. The associate has net assets of $500,000 at the date of acquisition. The fair value of those net assets is $600,000 as the fair value of property is $100,000 higher than its book value. This property has a remaining useful life of 10 years.

After acquisition, C recognised profit after tax of $100,000 and paid a dividend out of these profits of $9,000. C also recognised exchanged losses of $20,000 directly in OCI.

What is the carrying value of A's investment in C at the end of the year?

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Equity method

(b) Proportionate ownership interest

- The investor's share of the associate's profits or losses, or other changes in the associate's equity, is determined normally on the basis of its proportionate ownership interest.

Aggregation of group interests

- Where the investor is a parent, the group's share of the associate is the aggregate of the holdings in that associate by the parent and its subsidiaries. The holdings of the parent's other associates and joint ventures are ignored for this purpose.

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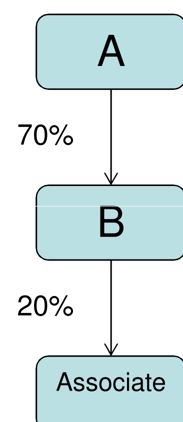
Source: Deloitte iGAAP 2012

Example - aggregation of group interests

- Company A has a 70 per cent interest in Group B. Group B has a 20 per cent investment in an associate.
- Company A's consolidated financial statements fully consolidate the assets and liabilities of Group B, i.e. they include 100 per cent of the assets and liabilities from Group B's consolidated financial statements (which include B's associate on an equity accounting basis).
- Therefore, when determining the appropriate share of the associate's results to include in the consolidated statement of comprehensive income of the A group, it is the full 20 per cent share in the associate that is brought into A's consolidated financial statements, NOT 14 per cent (70 per cent x 20 per cent).



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Source: Deloitte iGAAP 2012

- Suppose the equity of the associate is HK$100m including a net profit for the period of HK$40m.
- Assuming no adjustments are required for the purposes of applying equity accounting, the investment in the associate is shown as HK$20m in the statement of financial position
- The share of the associate's profit is HK$8m (20 per cent x HK$40m), not HK$5.6m (20 per cent x HK$40m x 70 per cent).
- Of that profit of HK$8m, HK$2.4m is attributed to the non-controlling interest and HK$5.6m to the equity holders of the parent.
- The note on investments in associates includes the full share of profit of HK$8m to reconcile the opening carrying amount of the associate to the closing carrying amount.

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Equity method

(c) Potential voting rights

- When potential voting rights or other derivatives containing potential voting rights exist, an entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments.

  → instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with HKFRS 9 / HKAS 39.
- In some circumstances, an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest

  → the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the returns.

  → the instruments are not subject to HKFRS 9 / HKAS 39

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Equity method

(d) Implicit goodwill and fair value adjustments

- On acquisition of the investment in an associate or a joint venture, any difference between the cost of acquisition and the entity's share of the fair values of the net identifiable assets of the associate is accounted for as follows:
  - (a) goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.
  - (b) any excess of the investor's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.
- Appropriate adjustments to the entity's share of the profits or losses after acquisition are made to account for additional depreciation of the depreciable assets based on their fair values at the acquisition date.

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Equity method

(e) Subsequent accounting for goodwill

- No amortisation
- The impairment indicators in HKAS 39 *Financial Instruments: Recognition and Measurement*, apply to investments in associate or joint venture.
- Because goodwill that forms part of the carrying amount of an investment in an associate or a joint venture is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in HKAS 36.
- Instead, the entire carrying amount of the investment is tested for impairment in accordance with HKAS 36 as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever application of the requirements in HKAS 39 indicates that the investment may be impaired
- An impairment loss recognized in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate or joint venture. Accordingly, any reversal of that impairment loss is recognised in accordance with HKAS 36 to the extent that the recoverable amount of the investment subsequently increases

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Equity method

(e) Subsequent accounting for goodwill

Questions:

An entity has a 25% interest in an associate that it acquired some years ago. At that time the associate had a subsidiary (S1) and the associate's consolidated financial statements contained goodwill. In the current financial year, the associate acquired another subsidiary (S2) and goodwill was generated on acquisition.

1. What should be the proper accounting treatment for the goodwill arising from the two acquisition?
2. Assume the S1's consolidated profit for the period is $100 after recognising a goodwill impairment loss of $20, what should be the amount of share of S1's profit for the period?

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Equity method

(f) Reporting periods of associate and joint ventures

- Use the most recent FS of associate or joint venture
- If the end of the reporting period is different, prepare additional FS which correspond to the investor's reporting period
- If impractical, the difference between the end of the reporting period of the associate or joint venture and that of the investor, cannot be more than 3 months
- Length of the reporting periods used and any difference between the ends of the reporting periods should be consistent from period to period
- Adjust for significant events or transactions that occur between the end of the associate or joint venture's reporting period and that of the investor's reporting period

(g) Accounting policies of associate and joint ventures

- If the associate or joint venture uses accounting policies that differ from those of the investor, the associate or joint venture's FS should be adjusted to conform the accounting policies of associates or joint venture investor's to those of the investor

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Equity method

(h) Upstream and downstream transactions

- If an associate is accounted for using the equity method, profits and losses resulting from upstream (associate to investor) and downstream (investor to associate) transactions should be recognised to the extent of unrelated investors' interests in the associate or joint venture.
- The investor's share in the associate's or joint venture's gains or losses is eliminated.

- Examples

Source: PwC manual of accounting 2013

a. Upstream transaction:

An investor has a 20% interest in an associate. The associate sells in inventory costing $300 to the investor for cash of $500. The inventory has not been sold to third parties at the balance sheet date. The associate recorded a profit of $200 on this transaction.

b. Downstream transaction:

An investor has a 20% interest in an associate. The investor sells inventory to the associate for $500. The original cost of the inventory was $300. The inventory has not been sold to a third party at the balance sheet date.

What will be the eliminations for each case?

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Equity method

(h) Upstream and downstream transactions

- Unrealised gain is only eliminated up to the carrying amount of the associate. When it exceeds the carrying amount of the associate, if there is no legal or constructive obligation, a gain is recognised in the income statement. In subsequent years, where the associate reports profits, the investor has an accounting choice.

Questions

Source: PwC manual of accounting 2013

Entity A owns 20% of the shares of associate B. Entity A sells an asset to entity B and record $100 profit. The gain should be reduced at entity A's financial statements by $20.

The carrying amount of A's investment in B is just $5 before the transaction. A has no legal or constructive obligation on behalf of B and has no long-term loans to B.

In 20X6, B earns profit of $60. At year end of 20X6, B still owns the asset it acquired from A.

The asset is sold to a third party in 20X7.

What should be the proper accounting treatment?

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Equity method

(i) Non-monetary contributions by investors

- The contribution of a non-monetary asset to an associate or a joint venture in exchange for an equity interest in the associate or joint venture shall be accounted for in accordance with paragraph 28 (upstream or downstream transactions), except when the contribution lacks commercial substance
- If such a contribution lacks commercial substance, the gain or loss is regarded as unrealised and is not recognised. Such unrealised gains and losses shall be eliminated against the investment accounted for using the equity method and shall not be presented as deferred gains or losses in the entity's consolidated FS or in the entity's FS in which investments are accounted for using the equity method
- If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity recognises in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received.

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Equity method

(j) Losses in excess of investment

- If an investor's share of losses of an associate or joint venture equals or exceeds its "interest in the associate or joint venture", the investor discontinues recognising its share of further losses.
- The "interest in an associate or joint venture" is the carrying amount of the investment in the associate under the equity method together with any long-term interests that, in substance, form part of the investor's net investment in the associate, e.g. preference shares, long-term receivables or loans that is neither planned nor likely to occur in the foreseeable future.
- After the entity's interest is reduced to zero, additional losses are provided for, and a liability is recognised, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture.
- If the associate or joint venture subsequently reports profits, the entity resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

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Source: Deloitte iGAAP 2012

Example - Associate with net asset deficiency

- An investor invests HK$10 million in an associate – HK$5 million to acquire 25 per cent of the equity share capital of the associate and HK$5 million as an unsecured shareholder's loan. The investor has entered into no other guarantees or commitments in respect of the associate.

- **Investment in an associate:**

  25% of share capital: HK$5M
  Shareholder's loan: HK$5M
  Total investment: HK$10M

- The associate is in a start-up situation and expects to make significant losses in the first year, but will generate profits thereafter. The associate has sufficient cash resources to meet its liabilities as they fall due.
- Assuming that the associate makes HK$50 million loss in the first year, share of loss is HK$12.5M (HK$50M x 25%).

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Example - Associate with net asset deficiency (cont'd)

- The investor should recognise a loss of HK$5 million in respect of its equity stake.
- It will recognise a further loss of HK$5 million in respect of the shareholder's loan if, in substance, the loan forms part of the investor's net investment in the associate (as would appear to be the case).
- However, the balance of the investor's share of the net loss (i.e. 25 per cent of HK$50 million - HK$10 million = HK$2.5 million) is not recognised.
- If, in the next year, the associate makes a profit of HK$10 million, the investor recognises no profit since its share of the profit (i.e. HK$2.5 million) equals the amount of the unrecognized loss in the previous period. For any profits made in excess of HK$10 million, the investor recognises its proportionate share.

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Equity method

(k) Others

- **Where the associate is itself a group…**

  the net assets and profits or losses that should be taken into account on equity accounting the associate, should be those in the associate's consolidated financial statements after any adjustment necessary

- **Non-controlling interest (NCI)**

  when an associate has a subsidiary that is party held by a NCI, the NCI is deducted in arriving at the results on which the investor's share is calculated

- **Cumulative preference shares**

  If an associate has outstanding cumulative preference shares that are held by parties other than the entity and are classified as equity, the entity computes its shares of profit or loss after adjusting the dividends on such shares, whether or not the dividends have been declared.

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Equity method

(l) Discontinuing the equity method

An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture as follows:

1. **Associate/joint venture → subsidiary**

   the entity shall account for its investment in accordance with HKFRS 3 *Business Combinations and HKFRS 10.*

2. **Associate/joint venture → financial asset**

   the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKFRS 9. The entity shall recognise in profit or loss any difference between:

   (i) the fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and

   (ii) the carrying amount of the investment at the date the equity method was discontinued.

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Equity method

(l) Discontinuing the equity method (cont'd)

- When an entity discontinues the use of the equity method, the entity shall account for all amounts previously recognised in OCI in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.

  if a gain or loss previously recognised in other comprehensive income by the investee would be reclassified to profit or loss on the disposal of the related assets or liabilities, the entity reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when the equity method is discontinued, e.g. cumulative exchange differences relating to a foreign operation

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Equity method

(m) Change in ownership interest

Associate ⟷ Joint venture

the entity continues to apply the equity method and does not remeasure the retained interest

If an entity's ownership interest in an associate or a joint venture is reduced, but the entity continues to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in OCI relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities.

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Exemption from applying equity method

An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a parent that is exempt from preparing consolidated financial statements by the scope exception in paragraph 4(a) of HKFRS 10 or if **ALL** the following apply:

(a) The entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method.

(b) The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

(c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market.

(d) The ultimate or any intermediate parent of the entity produces consolidated financial statements available for public use that comply with HKFRSs or IFRSs.

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Exemption from applying equity method (cont'd)

- When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with HKFRS 9.

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Classification as held for sale

- When an investment, or a portion of an investment, in an associate or a joint venture meets the criteria to be classified as held for sale:
  - HKFRS 5 should be applied to the investment, or the portion of the investment
  - Any retained portion that has not been classified as held for sale should be accounting for using equity method until the portion that is classified as held for sale is disposed of
  - After the disposal, the retained interest should be accounted for in accordance with HKAS 39 /HKFRS 9 unless significant influence or joint control is retained
  - The retained interest should continue to be accounted for using the equity method

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Joint Arrangements

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Agenda

Part 1: Background

Part 2: Identifying joint arrangements

Part 3: Accounting requirements

Part 4: Transitional requirements

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Background

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Background

- IASB issued *IFRS 11 Joint Arrangements* in May 2011
- IFRS 11 supersedes *IAS 31 Interest in Joint Ventures*
- IFRS 11 establishes principles for the financial reporting by parties to a joint arrangement
- IFRS 11 is effective from 1 January 2013. Early application is permitted.
- Entities applying this standard earlier must also apply HKFRS 10, HKFRS 12, HKAS 27 (2011) and HKAS 28 (2011)

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Background

Weaknesses of HKAS 31	HKFRS 11
• The structure of the arrangement was the only driver for the accounting → May not have always reflected the rights and obligations of the parties arising from the arrangement	• It introduces a principle-based approach that requires a party to a joint arrangement to recognise its rights and obligations arising from the arrangement
• There was an accounting option for jointly controlled entities (equity method or proportionate consolidation)	• No free choice of using equity method or proportionate consolidation for joint ventures (previously jointly controlled entities under HKAS 31)
All these result in inconsistencies in the accounting	

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Identifying Joint Arrangements

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Joint arrangement – is an arrangement over which two or more parties have joint control, being the contractually agreed sharing of control, i.e. unanimous consent is required for decisions about the relevant activities.

A. Assessing joint control

Step 1

- An entity shall assess whether all the parties, or a group of the parties, control the arrangement collectively

Step 2

- An entity shall assess whether it has joint control of the arrangement
- Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that collectively control the arrangement
- Unanimous consent means that any party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions about the relevant activities without its consent

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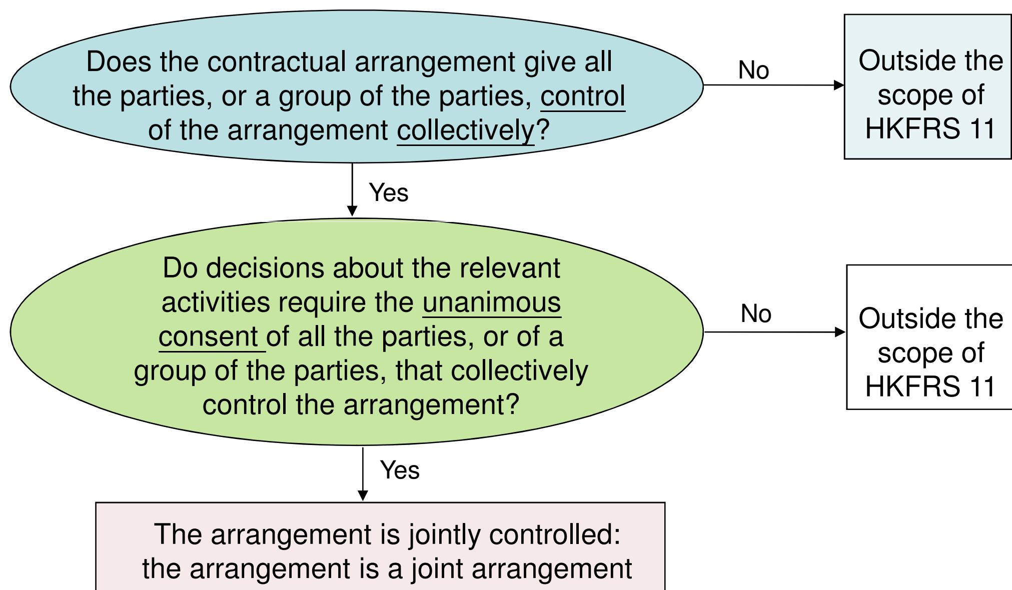
Assessing joint control



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Is the control joint?

- An enforceable contractual arrangement can be evidenced in several ways, but is often in writing and usually in the form of a contract or documented discussions between the parties.
- The contractual arrangement sets out the terms on which the parties participate in the activity that is the subject of the joint arrangement and generally deals with matters such as
  - the purpose, activity and duration of the joint arrangement;
  - the governing body's members' appointment process;
  - the decision-making process;
  - the capital or other contributions required of the parties; and
  - the sharing of assets, liabilities, revenues, expenses and profits or losses arising from the joint arrangement

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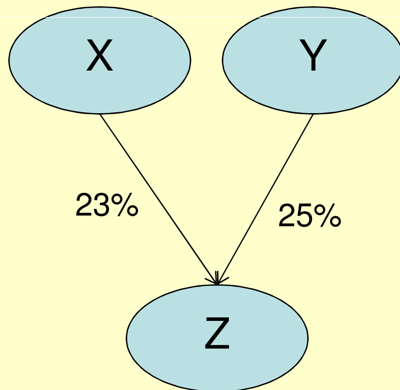
Source: First impressions: joint arrangements

Questions:

1. If the parties can demonstrate past experience of voting together in the absence of a contractual agreement, can this satisfy the requirements of "joint control"?
2. Can the control in a joint arrangement be based on de facto circumstances when that joint control has contractually established?



- The remaining voting rights are held by thousands of shareholders, with individual shareholders each hold <1%.
- X and Y have contractually agreed that on decisions about the relevant activities of Z, the casting of their combined 48% voting power requires their unanimous consent.
- None of the other shareholders has any arrangements to consult each other to make collective decisions.

Does joint control exist for X and Y?

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75% of the votes are required to make decisions about the relevant activities of the arrangement

Scenario	Arrangements	Step 1 – collective control?	Step 2 – joint control?	Joint arrangements?
1	A – 50% B – 30% C – 20%	Yes - A and B must act together to direct the relevant activities	Yes - decisions about the relevant activities of the arrangement cannot be made without both A and B agreeing	Yes
2	A – 50% B – 25% C – 25%	Yes – A and B or A and C have to act together to direct the relevant activities	No - there is more than one combination of parties that can agree to reach 75% of the voting rights (i.e. either A & B/A & C)	No

Unless a contractual arrangement specifies which combination of parties is required to make unanimous decisions about the relevant activities, this arrangement is not a joint arrangement.

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Is the control joint?

- Any party with joint control can prevent any of the other parties from making unilateral decisions without its consent.
- However, not all parties to the arrangement need to share control over the arrangement for it to be considered a joint arrangement.

The assessment of joint control require judgement and consideration of all facts and circumstances. A change in the facts and circumstances will require re-assessment of whether joint control still exists. (HKFRS11.12 (BC23))

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B. Classification of a joint arrangement

Joint operation

- The parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement
- Those parties are called joint operators

Joint venture

- The parties that have joint control of the arrangement have rights to the net assets of the arrangement
- Those parties are called joint venturers

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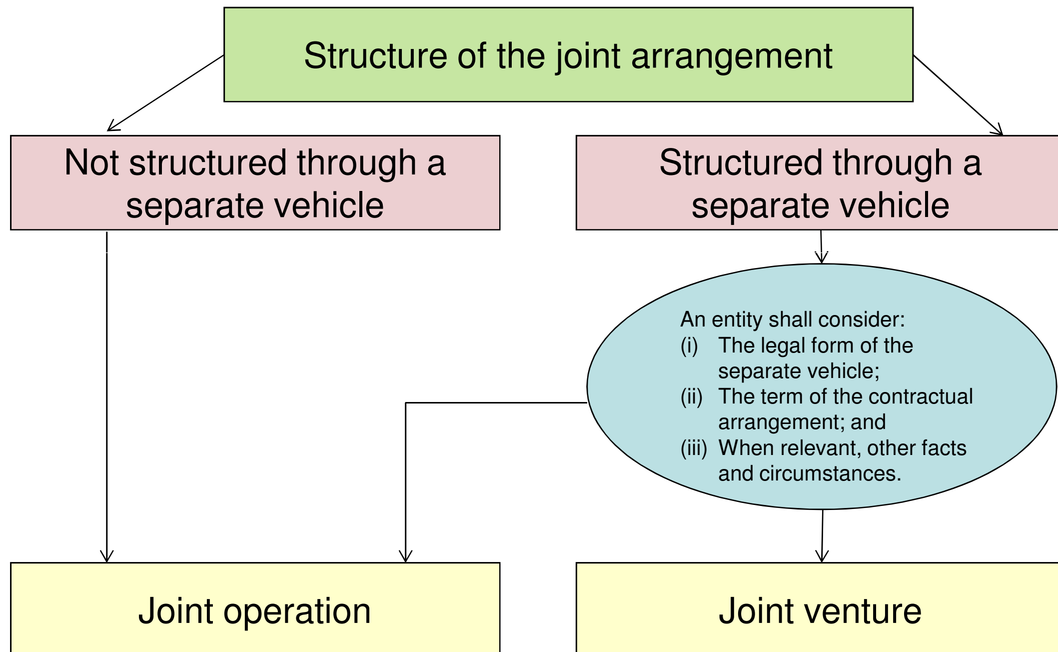
B. Classification of a joint arrangement



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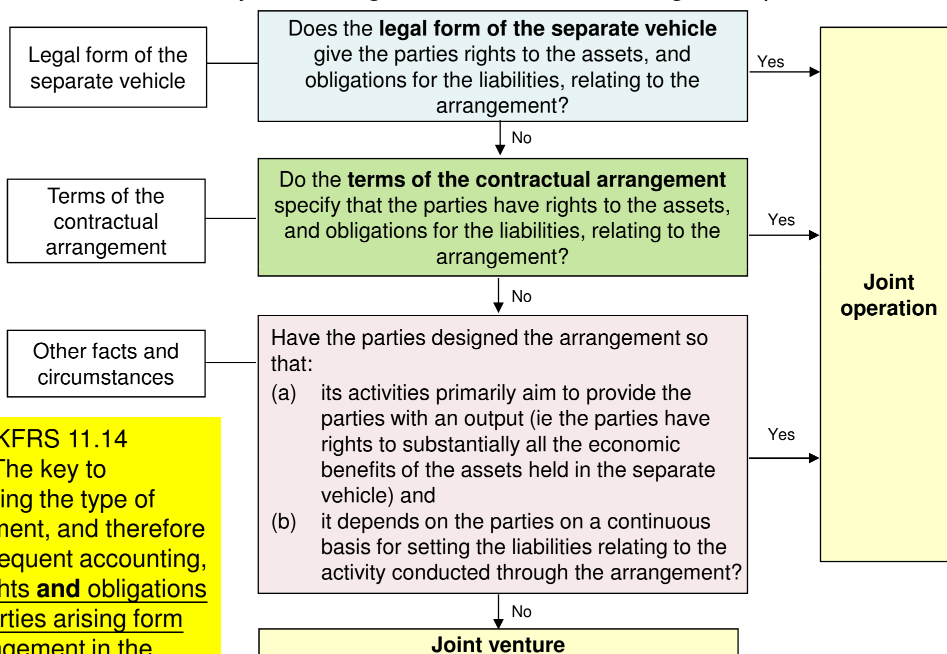
Classification of a joint arrangement structured through a separate vehicle



Note: HKFRS 11.14 (B14) – The key to determining the type of arrangement, and therefore the subsequent accounting, is the rights **and** obligations of the parties arising form the arrangement in the normal course of business.

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I. Structure of joint arrangements

- A separate vehicle is a separately identifiable financial structure, including separate legal entities or entities recognised by statue, regardless of whether those entities have a legal personality.
- A joint arrangement not structured through a separate vehicle can be classified as a joint operation.
- A joint arrangement structured through a separate vehicle can either be a joint venture or a joint operation.
- If there is a separate vehicle, the remaining tests apply.

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II. Legal form of the arrangement

- If the legal form of the separate vehicle does not confer separation between the parties and the separate vehicle, i.e. the assets and liabilities placed in the separate vehicle are the parties' assets and liabilities, then the joint arrangement is a joint operation.

Example – Assessing the legal form

- A & B set up a separate vehicle (entity Z)
- The contractual arrangement between the parties establishes the parties' rights to the assets, responsibility for all operational or financial obligations and the sharing of profit or loss
- The main feature of the its legal form is that the parties (and not the entity) have rights to the assets and obligations for the liabilities of the entity

Is it a joint operation or joint venture?

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II. Legal form of the arrangement

Example – Assessing the legal form (cont'd)

Is it a joint operation or joint venture?

- The arrangement is structured through a separate entity-> consider other factors
- The legal form of the separate vehicle does not confer separation between the parties and the vehicle, the joint arrangement is a joint operation

Please note that

- As the legal form of the separate vehicle is sufficient to conclude that the joint arrangement is a joint operation, there is no requirement to consider the terms of the contractual arrangement, though they are consistent with the legal form of the arrangement
- The fact that the parties have agreed to share the profit or loss arising from the arrangement would not prevent the arrangement from being a joint operation as the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.

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III. The contractual arrangement

- In many cases, the rights and obligations agreed to by the parties in their contractual arrangements are consistent, or do not conflict, with the rights and obligations conferred on the parties by the legal form of the separate vehicle in which the arrangement has been structured
- But in other cases, the parties use the contractual arrangement to reverse or modify the rights and obligations conferred by the legal form of the separate vehicle in which the arrangement has been structured

Example

Two parties structure a joint arrangement in an incorporated entity. Each party has a 50% ownership interest. The incorporation enables the separation of the entity from its owners (i.e. the assets and liabilities held in the entity are the assets and liabilities of the incorporated entity).

- By the legal form of the separate vehicle → the parties has rights to the net assets of the arrangement → joint venture

The parties then modify the features of the corporation through their contractual arrangement so that each has an interest in the assets and each is liable for the liabilities of the incorporated entity in a specified proportion → Joint operation.

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III. The contractual arrangement

- Please refer to Appendix 1 for examples of the contractual terms
- A guarantee to third parties provided by the parties to the arrangement, e.g. for service provided by or financing provided to the arrangement, does not in itself determine that the joint arrangement is a joint operation, as it does not provide the parties with rights to assets and obligations for liabilities
- An obligation for unpaid or additional capital does not result in joint operation classification
- When the contractual arrangement specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, they are parties to a joint operation and do not need to consider other facts and circumstances for the purposes of classifying the joint arrangement.

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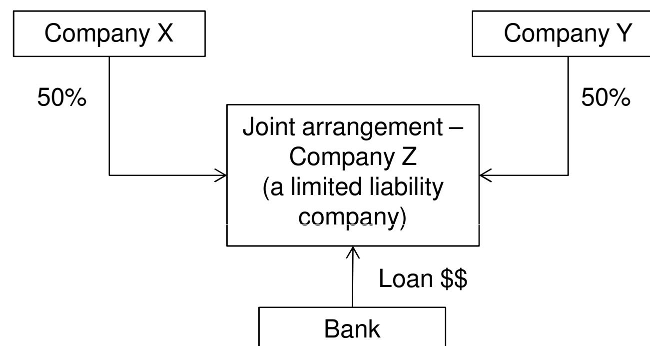
Example 1



- Company Z develops residential properties and then sells them to third parties.
- To finance the project, Company Z obtains financing from a bank.
- The agreement says that the proceeds from sale of properties will be used to repay the loan and any surplus will be distributed to X and Y in proportion to X's and Y's ownership interests in Z.
- Z will then be wound up.

What is the classification of the joint arrangement Z?

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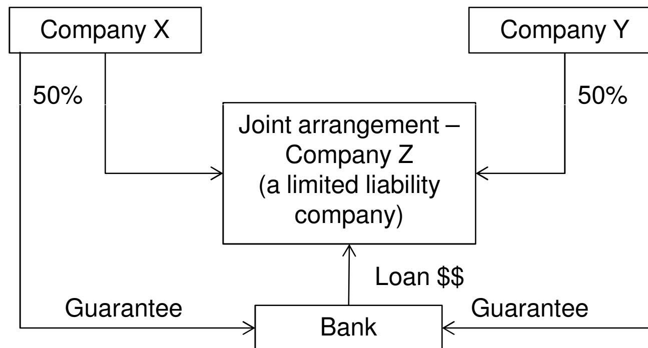
Example 2

- **Same facts as Example 1**
- X and Y now provide guarantees to the Bank with regard to the bank loan.



Would you change the conclusion?

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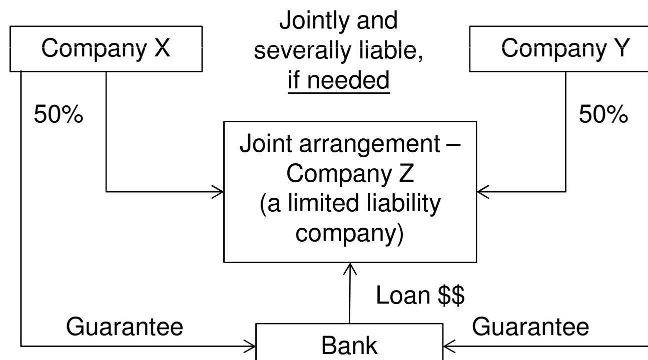
Example 3

- **Same facts as Example 1 and 2**
- In addition, there is an irrevocable agreement between X, Y and Z such that X and Y agree to provide the necessary funds in equal amount, if required, to ensure that Z is able to pay its obligations and comply with the applicable legislation and regulation.



Would you change the conclusion?

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IV. Other facts and circumstances

- When the terms of the contractual arrangement do not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, the parties shall consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture.

- Points to consider:

a) The parties have rights to substantially all of the economic benefits relating to the arrangement

→when the activities of an arrangement are designed to provide output to the parties and the arrangement is limited in its ability to sell to third parties

b) The arrangement depends on the parties on a continuous basis for settling its liabilities

→ the liabilities incurred by the arrangement are, in substance, satisfied only by the cash flows received from the parties through their purchase of the output, i.e. the parties are substantially the only source of cash flows contributing to the arrangement's operations.

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Example 3(a) – Other facts and circumstances

Background

- Two parties have set up a strategic and operating agreement in which they have agreed the terms under which they will conduct the manufacturing and distribution of product P in different markets
- The parties have agreed the following in respect of the manufacturing arrangement
  - the manufacturing arrangement will produce product P to meet the demand required by the parties
  - the parties have committed themselves to purchasing its whole production in accordance with their ownership interests at a price that covers all production costs incurred
  - any cash shortage are financed by the parties in accordance with their ownership interest
- The parties have agreed the following in respect of the distribution arrangement
  - the parties will sell the finished output, purchased from the manufacturing arrangement, to the distribution arrangement at a price to be fixed by the parties; and
  - the distribution arrangement will subsequently sell the output to the market

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Example 3(a) – Other facts and circumstances (cont'd)

Analysis

- Separate vehicle → joint operation or joint venture
- Legal form of the separate vehicle

  →legal form confers separation between the parties and the separate vehicle → An initial indication that the arrangements are joint ventures
- Contractual terms → no indicators
- Other facts and circumstances

  a) manufacturing arrangement is a joint operation:

  – the parties have committed themselves to purchasing all of the production manufactured and therefore have rights to substantially all the economic benefits of the assets; and

  – the parties have an obligation for the manufacturing arrangement's liabilities, as there is exclusive dependence on the parties for the generation of cash flows and to cover any cash shortages

  b) distribution arrangement is a joint venture:

  – there are no other facts and circumstances that would indicate that the arrangement is a joint operation.

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Example 3(b) – Other facts and circumstances

Background

- Assume that the manufacturing vehicle also distributes the products itself to third-party customers
- The parties also agree to set up a distribution arrangement to distribute product P exclusively to assist in widening the distribution of product P in additional specific markets
- However, no fixed proportion of the production is committed to be purchased by, or reserved for, the distribution vehicle

Analysis

- The manufacturing vehicle becomes a self-financed arrangement that has a trade of its own, distributing product P to third-party customers, and consequently assuming demand, inventory and credit risks
- The manufacturing arrangement is not dependent on the parties – a joint venture
- No change in conclusion for distribution vehicle

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Considerations

Some or all of the following characteristics might indicate that a joint arrangement in a legal entity should be classified as a joint operation:

1. The joint arrangement may be prohibited from selling any of its output to third parties
2. The parties have uninterrupted access to the output
3. There is likely to be a binding obligation on the parties to purchase substantially all of the output
4. The demand, inventory and credit risks relating to the activities of the arrangement are passed on to the parties and do not rest with the arrangement
5. The output or services are priced to cover the costs of the arrangement and not expected to generate significant net income
6. The arrangement is unlikely to have any third party borrowings without guarantees or take-or-pay arrangements with the parties

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Accounting requirements

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Financial statements of parties to a joint arrangement

	Consolidated financial statements	Separate financial statements
Joint venturers	Equity method in accordance with HKAS 28 (2011)	Choice between cost or in accordance with HKFRS 9/ HKAS 39
Joint operators	Recognises its own assets, liabilities and transactions, including its share of those incurred jointly	

Proportionate consolidation is no longer permitted for joint ventures

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A. Joint operators

- In both its consolidated and separate FS, a joint operator recognises its assets, liabilities and transactions, including its share of those incurred jointly. These assets, liabilities and transactions are accounted for in accordance with the relevant HKFRSs.

Example 1 – shared rights to assets/revenue and shared obligations for liabilities/expenses

- The parties share and operate assets together.
- The agreement establishes the rights to the assets that are operated jointly and how output or revenues from the assets and operating costs are shared among the parties.
- Each party accounts for its share of assets, liabilities, output or revenues and expenses in accordance with the terms of the arrangement

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A. Joint operators

Example 2 – unshared rights to assets and unshared obligations for liabilities, and shared rights to revenues and obligations for expenses

- The parties agree to manufacture a product together, but each party is responsible for a specific task using its own assets and incurring its own liabilities
- The arrangement also specifies how the common revenues and expenses will be shared among the parties.
- In its FS, each party recognises its assets and liabilities used for the specific task, and revenues and expenses in accordance with the terms of the arrangement

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A. Joint operators - Upstream and downstream transactions

Accounting for sales or contributions of assets to a joint operation

- When an entity enters into a transaction with a joint operation in which it is a joint operator, such as a sale or contribution of assets, it is conducting the transaction with the other parties to the joint operation and, as such, the joint operator shall recognise gains and losses resulting from such a transaction only to the extent of the other parties' interests in the joint operation.
- When such transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed to the joint operation, or of an impairment loss of those assets, those losses shall be recognised fully by the joint operator.

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A. Joint operators - Upstream and downstream transactions

Accounting for purchases of assets from a joint operation

- When an entity enters into a transaction with a joint operation in which it is a joint operator, such as a purchase of assets, it shall not recognise its share of the gains and losses until it resells those assets to a third party.
- When such transactions provide evidence of a reduction in the net realisable value of the assets to be purchased or of an impairment loss of those assets, a joint operator shall recognise its share of those losses.

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Financial statements of other parties to a joint arrangement

	Consolidated financial statements	Separate financial statements
Other parties to a joint venture	If significant influence exists, then equity method in accordance with HKAS 28 (2011) or in accordance with HKFRS 9 / HKAS 39	If significant influence exists, then choice between cost or in accordance with HKFRS 9 or HKAS 39, otherwise, in accordance with HKFRS 9 / HKAS 39
Other parties to a joint operation	Recognises its own assets, liabilities and transactions, including its share of those incurred jointly, if it has rights to the assets and obligations for the liabilities. Otherwise, it accounts for its interest in accordance with the HKFRS applicable to that interest, e.g. HKAS 28 (2011) or HKFRS 9/ HKAS 39	

If the interest in the joint venture is accounted for in accordance with HKFRS 9 / HKAS 39 in the consolidated FS, the same accounting is adopted for the separate FS.

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Transitional requirements

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Effective date and transitional requirements

- HKFRS 11 and HKAS 28 (2011) are effective for annual periods beginning on or after 1 January 2013
- Early adoption is permitted
- An entity early adopting HKFRS 11 is also required to adopt HKFRS 10, HKFRS12, HKAS 27 (2011) and HKAS 28 (2011) at the same time and to disclose that fact

- Amendments to HKFRS 11 was issued in June 2012 to provide transitional relief

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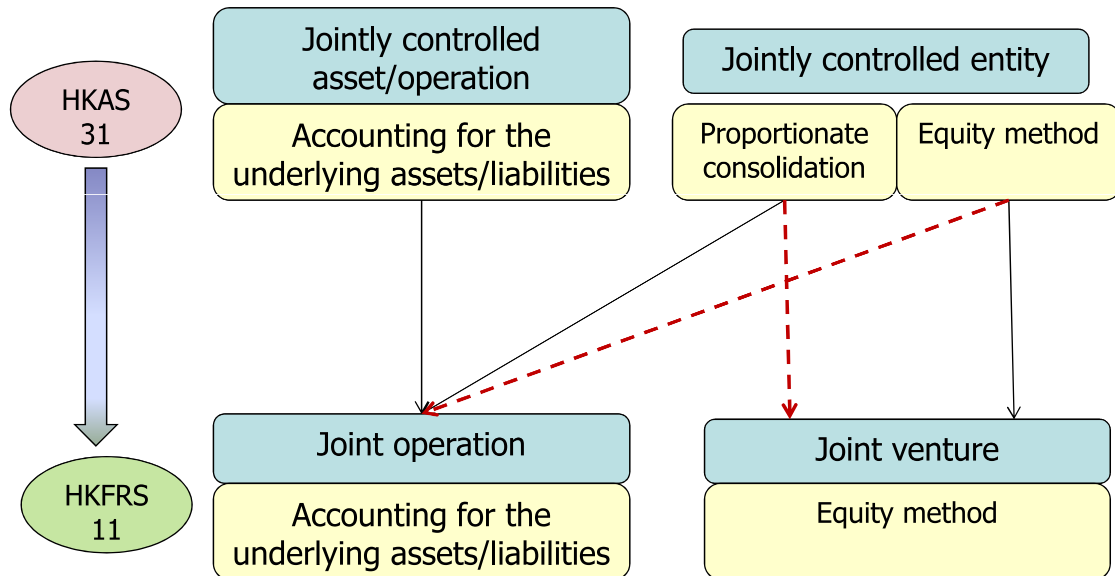
How could this affect you?

Consolidated financial statements



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I. Transition from proportionate consolidation to the equity method

At the beginning of the immediately preceding period presented, an entity:

- Derecognise assets (including goodwill if any) and liabilities
- Aggregates the carrying amounts of the individual assets and liabilities previously proportionately consolidated, including any goodwill, into a single amount (the investment's deemed cost)
- Applies HKAS 28 (2011) to assess the investment for indications of impairment, recognising any impairment in accordance with HKAS 36, as an adjustment to opening retained earnings; and
- Discloses a breakdown of the assets and liabilities that comprise the investment, in aggregate for all joint ventures for which this disclosure is provided

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I. Transition from proportionate consolidation to the equity method

Impact on profit (loss) for the year of the application of IFRS 11

Decrease in revenue	(2,124)	(2,005)
Decrease in cost of sales	1,350	1,300
Decrease in distribution expenses	55	50
Decrease in marketing expenses	55	50
Decrease in administration expenses	276	323
Decrease in finance costs	18	16
Decrease in income tax expenses	33	24
Increase in share of profits of a joint venture	337	242
Increase (decrease) in profit for the year	–	–

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	As at 01/01/10 as previously reported	IFRS 10 adjustments	IFRS 11 adjustments	As at 01/01/10 as restated
	CU'000	CU'000	CU'000	CU'000
Property, plant and equipment	161,058	2,908	(6,754)	157,212
Goodwill	23,920	200	–	24,120
Investments in associates	5,706	(1,300)	–	4,406
Investments in a joint venture	–	–	3,420	3,420
Inventories	29,688	240	(1,000)	28,928
Trade and other receivables	13,550	350	(1,192)	12,708
Cash and bank balances	9,082	300	–	9,382
Borrowings – non-current	(25,785)	(500)	4,213	(22,072)
Deferred tax liabilities	(4,436)	(209)	200	(4,445)
Trade and other payables	(52,750)	(300)	1,093	(51,957)
Current tax liabilities	(4,910)	(100)	20	(4,990)
Impact on net assets	155,123	1,589	–	156,712
Non-controlling interests	(17,242)	(1,589)	–	(18,831)
Others (please specify)	–	–	–	–
Impact on equity	(17,242)	(1,589)	–	(18,831)

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I. Transition from proportionate consolidation to the equity method

1. What if the goodwill was previously allocated to a larger CGU or a group of CGU?

   The goodwill, in such case, is then allocated to the investment in proportion to the relative carrying amounts of the joint venture and relevant CGUs.

2. What if the aggregation of the individual assets and liabilities previously proportionately consolidated results in negative net assets?

   The entity recognises the corresponding liability only if it has a legal or constructive obligation related to the negative net assets.

   If no liability is recognised, then an adjustment is made to retained earnings at the beginning of the earliest period presented. The entity discloses that fact and the unrecognised share of losses.

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II. Transition from equity method to accounting for assets and liabilities

At the beginning of the earliest period presented, an entity:

- Derecognises the investment previously accounted for using the equity method, including any amounts forming part of the net investment (A)
- Measures the initial carrying amount of the assets and liabilities based on their carrying amounts used in applying the equity method
- Recognises its share of each of the assets and the liabilities in the joint operation, including any goodwill that formed part of the investment, based on its rights and obligations in a specified proportion in accordance with the contractual arrangement (B)

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II. Transition from equity method to accounting for assets and liabilities

- Recognises any difference between the net investment accounted for using the equity method and the net assets recognised as follows:
  - if B > A (i.e. net assets recognised > investment derecognised), the difference is recognised first against any goodwill related to the investment, with any remaining balance recognised as an adjustment to the opening retained earning; or
  - if A > B (i.e. investment derecognised >net assets recognised), the difference is recognised as an adjustment to opening retained earnings
- Provides a reconciliation between the investment accounted for using the equity method and the net assets recognised

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Example – from equity method to assets and liabilities

M accounted for a 50% interest in a JCE using the equity method. On transition to HKFRS 11, M determines that it actually has the rights to the assets and obligations for the liabilities of the joint arrangement, i.e. it is a joint operation. Underlying M's equity accounted investment were the following balances, at the 50% interest level, at the beginning of the earliest period presented:

Property, plant and equipment	500
Loans receivable	250
Goodwill	175
Trade payables	(125)
Bank borrowings	(150)
	650
Previously recognised unallocated impairment loss	(100)
Equity-accounted investment	550

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Example – from equity method to assets and liabilities (cont'd)

On transition to HKFRS 11, M recognises the following entry:

	Dr	Cr
Property, plant and equipment	500	
Loans receivable	250	
Goodwill (175-100)	75	
Trade payables		125
Bank borrowings		150
Equity-accounted investment		550

If the previously unallocated impairment loss was greater than the carrying amount of goodwill, then any remaining balance would be recognised as an adjustment to retained earnings.

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III. No transitional requirements

- From accounting for the underlying assets and liabilities under HKAS 31 to accounting for the underlying assets and liabilities under HKFRS 11
- From equity method under HKAS 31 and HKAS 28 (2008) to equity method under HKFRS 11 and HKAS 28 (2011)
- From proportionate consolidation to accounting for assets and liabilities

  There may be some arrangements in which the rights to some assets and liabilities are not the same as the participation interest held and used for the purposes of proportionate consolidation → transitional adjustments may be required

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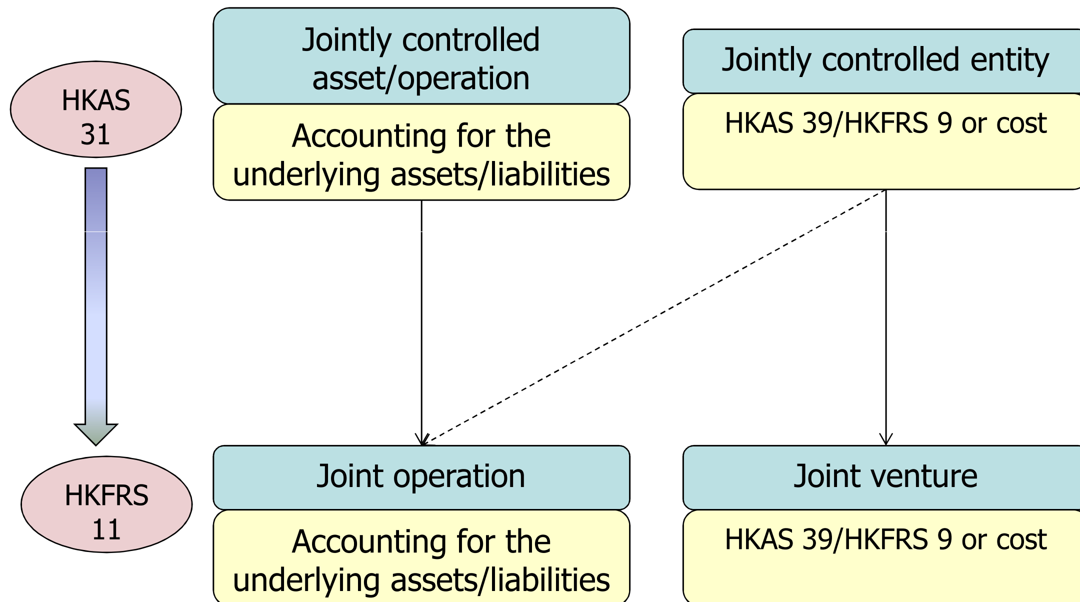
Separate financial statements



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I. From HKFRS 9/HKAS 39 or cost to accounting for assets and liabilities

At the beginning of the earliest period presented, an entity:

- Derecognises the investment held at cost or in accordance with HKFRS 9 or HKAS 39
- Recognises its interest in the underlying assets and liabilities, based on its rights and obligations in a specified proportion in accordance with the contractual arrangement
- Recognises any difference between the net asset recognised and the investment derecognised as an adjustment to the retained earnings
- Provide a reconciliation between the investment and the net assets recognised

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Transitional relief

	Adopting the joint arrangements standard
Transitional requirements without relief	The entity would be required to restate its entire history as if HKFRS 11 had always been in effect. Relief would be available only to the extent that restatement was impracticable.
Transitional requirements after relief	***Restatement limited to one year*** • If the entity is required to change the accounting for a joint venture (under HKFRS 11) *to the equity method, then the mandatory restatement of comparatives is limited to one year.* • If the entity is required to change the accounting for a joint operation (under HKFRS 11) *from the equity method, then the mandatory restatement of comparatives is again limited to one year.* • This means that entities that provide comparatives for more than one period have the option of leaving additional comparative periods unchanged.

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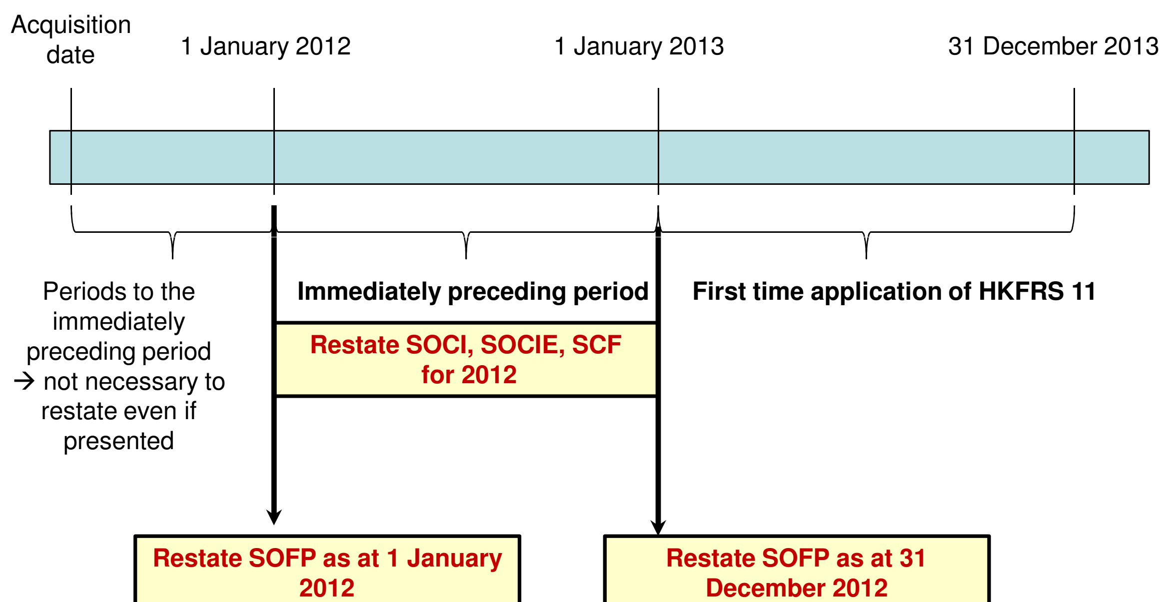
Transitional relief



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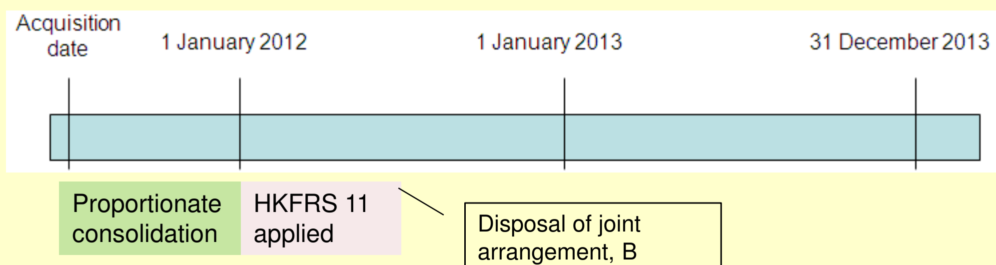
Question

A acquired a 50% interest in a JCE, B on its formation on 1 July 2009. A elected to account for B using proportionate consolidation under HKAS 31. A disposed of its interest in B on 1 June 2012.

A's year end is 31 December and the date on which it assesses its joint arrangements is 1 January 2012. Is there any transitional relief for such situation?

Answer

Unlike under HKFRS 10, there is no relief under HKFRS 11 from the date on which an entity assesses whether a joint arrangement is a joint venture or a joint operation.



Proportionate consolidation | HKFRS 11 applied | Disposal of joint arrangement, B

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Summary – HKFRS 11

- HKFRS 11 classifies joint arrangements as either joint operations (combining the existing concepts of jointly controlled assets and jointly controlled operations) or joint ventures (equivalent to a jointly controlled entity)
- HKFRS 11 requires the use of equity method of accounting for interests in joint ventures, thus eliminating the proportionate consolidation method
- The existence of a separate legal vehicle is no longer the key factor in the determination as to whether a joint arrangement is a joint operation or a joint venture – but based on parties' rights and obligations
- Effective on 1 January 2013
- For more illustrative examples, please refer to Appendix 2

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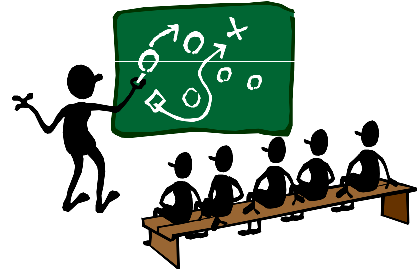
A Refresher Course on Current Financial Reporting Standards 2013 (Day 2)

HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*



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HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

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Agenda

A. Scope of HKFRS 5

B. Measurement of assets held for sale

C. Presentation & disclosures

D. Held for sale criteria no longer met

E. Discontinued operations

F. Presentation & disclosures

G. Distributions of non-cash assets to owners

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A. Scope of HKFRS 5

- ❑ Non-current assets are assets that do not meet the definition of current assets

- ❑ Criteria for classification as current assets:

- It is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
- It is held primarily for the purpose of being traded;
- It is expected to be realised within twelve months after the reporting period;
- It is cash or a cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period

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"Scoped-out" non-current assets

"Scoped-out" non-current assets under HKFRS 5 RE: Measurement requirements	
	▪ Deferred tax assets (HKAS 12)
	▪ Assets arising from employee benefits (HKAS 19)
	▪ Financial assets within the scope of HKAS 39
	▪ Non-current assets that are accounted for in accordance with the fair value model in HKAS 40
	▪ Non-current assets that are measured at fair value less costs to sell in accordance with HKAS 41
	▪ Contractual rights under insurance contracts as defined in HKFRS 4

*The non-current assets listed above are excluded from the measurement requirements of HKFRS 5 when they are held for sale either as individual assets or when they form part of a disposal group. The exclusion relate only to the measurement requirements of HKFRS 5 – the classification and presentation requirements of HKFRS 5 apply to all non-current assets

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Disposal Group

- A disposal group is defined as follows: [HKFRS 5 App A]

  "a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash generating unit to which goodwill has been allocated in accordance with the requirements of HKAS 36.80-87 or if it is an operation within such a cash-generating unit."

- A disposal group may include current assets. It can also include current and non-current liabilities. However, only liabilities that will be transferred as part of the transaction are classified as part of the disposal group

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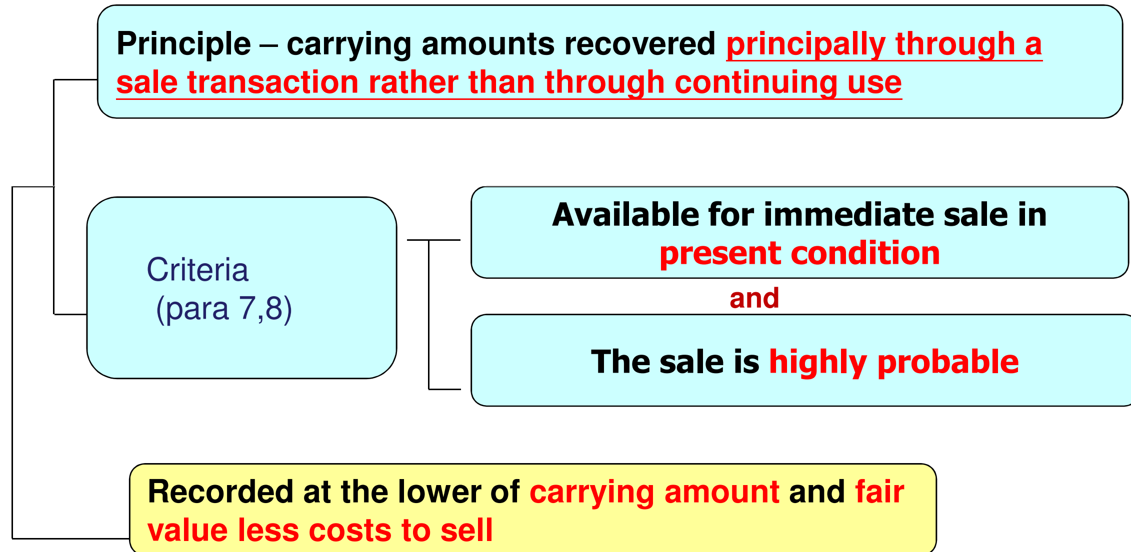
Classifications as non-current assets held for sale



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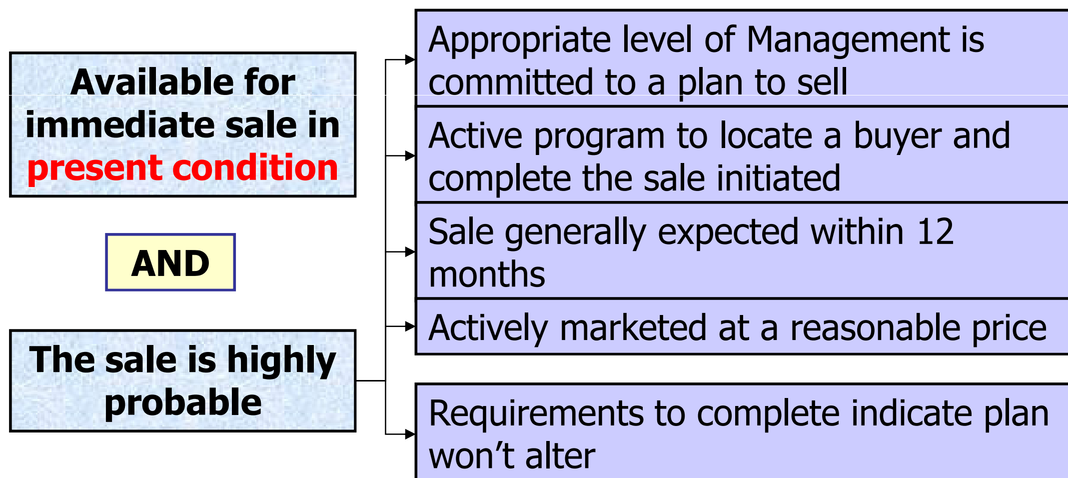
Held for Sale Classification Criteria

Principle – carrying amounts recovered principally through a sale transaction rather than through continuing use

Criteria (*para 7, 8*)



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Held for Sale Classification Criteria

Available for sale – Example 1:

An entity is committed to a plan to sell its headquarters building and has initiated actions to locate a buyer.

(a) The entity intends to transfer the building to a buyer after it vacates the building. The time necessary to vacate the building is usual and customary for sales of such assets.

(b) The entity will continue to use the building until construction of a new headquarters building is completed. The entity will only transfer the existing headquarters to a buyer until after the construction of the new building is completed.

Do they meet the criteria of available for sale?

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Held for Sale Classification Criteria

Available for sale – Example 2:

An entity is committed to a plan to sell a manufacturing facility and has initiated actions to locate a buyer. At the plan commitment date, there is a backlog of uncompleted customer orders.

(a) The entity intends to sell the manufacturing facility with its operation. Any uncompleted customer orders at the sale date will be transferred to the buyer. The transfer of uncompleted customer orders at the sale date will not affect the timing of facility's transfer.

(b) The entity intends to sell the manufacturing facility, but without its operations. The entity does not intend to transfer the facility to a buyer until after it ceases all operations of the facility and eliminates the backlog of uncompleted customer orders.

Do they meet the criteria of available for sale?

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Held for Sale Classification Criteria

Available for sale – Example 3:

An entity acquires a property comprising land and buildings that it intends to sell. It does not intend to transfer the property to a buyer until after it completes renovations to increase the property's sales value.

After the renovations are completed, the entity becomes aware of environmental damage requiring remediation. The entity still intends to sell the property.

Does it meet the criteria of available for sale?

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Held for Sale Classification Criteria

Highly probable

- Defined in Appendix A of HKFRS 5 as "significantly more likely than probable"
- "Probable" is defined as "more likely than not"
- Issues noted in Quality Assurance annual report 2010:

  some companies disclosed an "intention" to dispose of the assets without commitment to a plan for sale or they expected to complete the sale after one year.

  →Does Not fulfill the requirements of para 8 of HKFRS 5

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Held for Sale Classification Criteria

Extension of the one year period condition

- Events or circumstances may extend the period to complete the sale beyond one year. An extension of the period required to complete a sale does not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group).
- Refer to Appendix 3 for the list of situations where exception to the one-year requirement apply.
- The standard is silent on how long the one-year period may be extended.

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Held for Sale Classification Criteria

Exceptions to the criterion in para 8:

Events are expected to delay the sale at the date of initial classification

An entity in the power generating industry is committed to a plan to sell a disposal group that represents a significant portion of its regulated operations. The sale requires regulatory approval, which could extent the period required to complete the sale beyond one year. Actions necessary to obtain that approval cannot be initiated until after a buyer is known and a firm purchase commitment is obtained. However, a firm purchase commitment is highly probable within one year.

Does it meet the exceptions to the criterion?

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Held for Sale Classification Criteria

Exceptions to the criterion in para 8:

Events are unexpectedly imposed when a firm purchase commitment is entered into

An entity is committed to a plan to sell a manufacturing facility in its present condition and classifies the facility as held-for-sale at that date. After a firm purchase commitment is obtained, the buyer's inspection of the property identified environmental damage not previously known to exist. The entity is required by the buyer to make good the damage, which will extend the period required to complete sale beyond one year. The entity has initiated actions to make good the damage and the damage's satisfactory rectification is highly probable.

Does it meet the exceptions to the criterion?

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Held for Sale Classification Criteria

Exceptions to the criterion in para 8:

Events arise during the one year period following classification as held-for-sale

An entity is committed to a plan to sell a non-current asset and classifies the asset as held-for-sale at that date.

During the initial one year period, the market conditions that existed at the date the asset was initially classified as held-for-sale deteriorate and, as a result, the asset is not sold by the end of the period. During that period, the entity actively marketed, but did not receive any reasonable offers to purchase the asset and in response reduced the price. The asset continues to be actively marketed at a price that is reasonable given the change in market conditions.

Does it meet the exceptions to the criterion?

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Held for Sale Classification Criteria

Newly acquired assets or disposal groups

- When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, it shall classify the non-current asset (or disposal group) as held for sale at the acquisition date only if the one-year requirement in paragraph 8 is met (except as permitted by paragraph 9) and it is highly probable that any other criteria in paragraphs 7 and 8 that are not met at that date will be met within a short period following the acquisition (usually within three months).

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Non-current asset/disposal group to be abandoned

- ❑ An entity shall not classify as held for sale a non-current asset that is to be abandoned (used to the end of their economic life and to be closed rather than sold) and account for a non-current asset that has been temporarily taken out of use as if it has been abandoned

- ❑ HKFRS 5 requires that an entity shall not classify a disposal group that is to be abandoned as a disposal group held for sale. However, if the disposal group to be abandoned meets the criteria for classification as a discontinued operation, the entity shall present the results and cash flows of the disposal group as discontinued operations at the date on which it ceases to be used

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Disposal and partial disposal

- Where an entity is committed to sale plan involving loss of control of a subsidiary, all of the assets and liabilities of that subsidiary are classified as held for sale, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale [HKFRS 5.8A]

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Disposals and partial disposals (cont'd)

Type of Transaction	Held for Sale?	Reason
Subsidiary to subsidiary	No	Control remains
Subsidiary to jointly controlled entity (JCE)	Yes	Control lost
Subsidiary to associate	Yes	Control lost
Subsidiary to investment	Yes	Control lost
JCE to JCE	No	Joint control still remains
JCE to Investment	Yes	Joint control lost
JCE to associate	Yes	Joint control lost
Associate to associate	No	Significant influence remains
Associate to investment	Yes	Significant influence lost

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Disposal and partial disposal

- However, one should also consider if the carrying amount is recovered principally through sale or through use.
- Under this policy, the investment is considered to be one unit of account when analyzing if the held-for-sale criteria of HKFRS 5 have been met
- E.g. a reduction in a 21% associate to a 19% available-for-sale investment may imply that the carrying amount is not covered principally through sale, and hence not qualify as held-for-sale

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Disposal and partial disposal

- For associate and joint ventures, HKAS 28 (2011) effective for annual period beginning 1 Jan 2013
- The unit of account at which the held-for-sale criteria are considered is at the level of the portion of the investment being disposed of
- An entity applies HKFRS 5 to an investment or portion of an investment in an associate or joint venture that meets the criteria to be classified as held-for-sale
- Any retained portion of the investment that has not been classified as held-for-sale continues to be accounted for using equity method until disposal of the portion that is classified as held-for-sale takes place
- E.g. Group disposes 30% out of 35% interest in an associate. The remaining 5% is accounted for as an available-for –sale financial asset. Only 30% to be disposed of is classified as held-for-sale

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The definition of fair value follows that of HKFRS 13 upon the adoption of HKFRS 13

B. Measurement of assets held for sale

Initial Measurement

- **Recorded at the lower of carrying amount and fair value less costs to sell:**
  - On initial classification
  - At every reporting date
- **Initial measurement of disposal group**
  - Carrying amounts of all assets & liabilities measured under applicable HKFRSs immediately before its initial classification .
  - If fair value less costs to sell of disposal group is below aggregate carrying amounts, difference is recognised as impairment loss in profit or loss
- **Costs to sell** - measured at their present value when the sale is expected to occur beyond one year

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Subsequent Measurement

- Remeasured in accordance with applicable HKFRSs:

  For disposal group,
  - scoped out non-current assets
  - all current assets and all liabilities

- No depreciation or amortisation for "*scoped in non-current assets*".

Further impairment loss is written off for excess of updated carrying amount exceeding fair value less costs to sell

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Increases and Decreases in Fair Value Less Costs to Sell

- **Impairment loss (subsequent reversal) recognised (reversed) for a disposal group shall be allocated**:
  - only between the "*scoped in non-current assets*"
  - in the order set out in HKAS 36.104(a)&(b) and HKAS 36.122

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Increases and Decreases in Fair Value Less Costs to Sell

36.104 The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

(a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and

(b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

36.122 A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised in accordance with paragraph 119.

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Increases and Decreases in Fair Value Less Costs to Sell (cont'd)

❑ Subsequent increase in fair value less costs to sell

A gain is recognised

- to the extent that it has not been recognised for measurement of exempted assets and liabilities
- not in excess of cumulative impairment loss (HKAS 36 & HKFRS 5)

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Extracted from PwC Manual of Accounting 2013

Example

- Entity A has a business that it has owned for a number of years, which was stated at the following amounts in its consolidated financial statements as follows:

	Carrying value at 31 December 20x3	Carrying value at 15 June 20x4
Goodwill	200	200
Intangible assets	950	930
Available for sale financial asset	300	360
Property, plant and equipment	1,100	1,020
Deferred tax asset	250	250
Current assets - inventory, receivable and cash	600	520
Current liabilities	(850)	(870)
Non-current liabilities - provisions	(300)	(250)
	2,250	2,160

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Extracted from PwC Manual of Accounting 2013

Example

- Entity A decides to sell the business and puts it on the market on 14 June 20x4. Assuming that
  - ✓The disposal group meets all the condition to be classified as held for sale at 15 June 20x4.
  - ✓The disposal group does not meet the conditions in paragraph 32 of HKFRS 5 to be classified as discontinued operation.
- Entity A is marketing the disposal group at 1.9 million. It estimates that the costs to sell will be 70,000, which includes professional fee paid to external lawyers and accountants.

Question 1: How should entity A allocate the impairment to the carrying values of the disposal group?

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Extracted from PwC Manual of Accounting 2013

Example

- The disposal group should be measured at 1.83 million and the impairment write down of 330k (2.16 million – 1.83 million) should be recorded within profit from continuing operations.

	Carrying value at 15 June 20x4	Impairment	Carrying value under HKFRS 5
Goodwill	200	(200)	-
Intangible assets	930	(62)	868
Available for sale financial asset	360	-	360
Property, plant and equipment	1,020	(68)	952
Deferred tax asset	250	-	250
Current assets - inventory, receivable and cash	520	-	520
Current liabilities	(870)	-	(870)
Non-current liabilities - provisions	(250)	-	(250)
	2,160	(330)	1,830

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Extracted from PwC Manual of Accounting 2013

Example

Update measurement at period end

- The disposal group has not been sold by the year end 20x4. There has been no change to the plan to sell the disposal group and entity A still expects to sell it within one year of initial classification.
- All of the assets and liabilities outside HKFRS 5's measurement scope are re-measured in accordance with the relevant standards.

	Carrying value at 15 June 20x4	re-measurement 31 December 20x4	HKFRS 5 impairment	Carrying value 31 December 20x4
Goodwill	-	-	-	-
Intangible assets	868	-	(29)	839
Available for sale financial asset	360	50	-	410
Property, plant and equipment	952	-	(31)	921
Deferred tax asset	250	(20)	-	230
Current assets - inventory, receivable and cash	520	(120)	-	400
Current liabilities	(870)	(30)	-	(900)
Non-current liabilities - provisions	(250)	-	-	(250)
	1,830	(120)	(60)	1,650

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Extracted from PwC Manual of Accounting 2013

Example

Presentation

- Since the disposal group is not classified as discontinued operation, it has to be consolidated as normal (i.e. transactions are recorded within individual line items).
- The fall in its net assets value of 120K under the re-measurement will be recorded in the individual income statement line items.
- There will then be an impairment recorded in profit or loss of 60,000.

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Extracted from PwC Manual of Accounting 2013

Example

Subsequent increase in fair value less costs to sell

- At 31 March 20x5, the disposal group as a whole has a fair value less costs to sell of 1.95 million, a 300k (1.95 -1.65 million) subsequent increase. Out of these increase, 100K gain arises from the re-measurement of individual assets and liabilities outside HKFRS 5's measurement scope.

Question: How to account for the subsequent increase?

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Example

Subsequent increase in fair value less costs to sell

- Such subsequent increase has not been recognised for exempted assets and liabilities. In fact, there has been a loss of 120k recognised at 31 Dec 20x4.
- Total impairment loss of 390K (330 + 60K) was recognised under HKFRS 5 and HKAS 36. Out of which 200K related to goodwill impairment which cannot be reversed. Therefore the maximum amount that can be reversed is 190K.
- Therefore the carrying amount of the disposal group is increased to 1.94 million (1.65 million + 100k + 190k).

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C. Presentation & Disclosure

	Summary
HKFRS 5 requires that an entity:	▪ shall present a non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the statement of financial position ▪ Shall present the liabilities of a disposal group classified as held for sale separately from other liabilities in the statement of financial position ▪ Shall not offset these assets and liabilities and shall not present them as a single amount ▪ Shall separately disclose either in the statement of financial position or in the notes the major classes of assets and liabilities classified as held for sale, except that such disclosures are not required for a disposal group if it is newly acquired subsidiary ▪ Shall not reclassify or re-present amounts presented for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the statements of financial position for prior periods to reflect the classification in the statement of financial position for the latest period presented

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C. Presentation & Disclosure (cont'd)

	Summary
HKFRS 5 requires that an entity:	▪ shall present separately any cumulative income or expense recognised in other comprehensive income relating to a non-current asset or disposal group classified as held for sale; and ▪ Any gain or loss on the remeasurement of a non-current asset or disposal group classified as held for sale that does not meet the definition of a discontinued operation shall be included in profit or loss from continuing operations
HKFRS 5 requires that an entity shall disclose in the notes:	• description of the non-current asset or disposal group • description of facts and circumstances of the sale (disposal) and the expected timing • impairment losses and reversals, if any, and where in the statement of comprehensive income they are recognised • if applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with HKFRS 8 *Operating Segments*

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C. Presentation & Disclosure (cont'd)

	Summary
HKFRS 5 requires that an entity shall disclose in the notes:	•an entity shall disclose, in the period of the decision to change the plan to sell the non-current asset (or disposal group), a description of the facts and circumstances leading to the decision and the effect of the decision on the results of operations for the period and any prior periods presented

Please refer to the standard for the full list of disclosures

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D. Held for Sale Criteria No Longer Met

- **Cease to classify asset (or disposal group) as held for sale.**

  Example:

  In Oct, an entity with a Dec year end decides to sell one of its subsidiaries. The board begins to actively market the subsidiary and negotiate with potential buyers. At the year end, management considers it highly probable that the sale will be completed within 12 months. However, in Feb, negotiations fall though and the entity decides to wind up the subsidiary instead of selling it.

  Question: How should the entity account for the subsidiary as at the year end in the financial statement?

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D. Held for Sale Criteria No Longer Met

Measurement on de-classification as held for sale

- **measure at the lower of**

  - carrying amount before classification as held for sale, adjusted for any depreciation, amortisation or revaluations that would have otherwise been recognised.

  and

  - recoverable amount at date of subsequent decision not to sell.

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D. Held for Sale Criteria No Longer Met

Presentation of adjustments to carrying amount on de-classification

- include any required adjustment to the carrying amount of a non-current asset that ceases to be classified as held for sale in income from continuing operations in the period in which the criteria in paragraphs 7-9 are no longer met.
- Present that adjustment in the same caption in the statement of comprehensive income used to present a gain or loss, if any, recognised in on re-measurement of a non-current asset (or disposal group) classified as held for sale

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D. Held for Sale Criteria No Longer Met

Question:

Does the comparative figures need to be re-presented to move the assets / disposal group from the HKFRS 5 caption of held for sale?

Answer:

HKFRS 5 para 40 "An entity shall not reclassify or re-present amounts presented for non-current assets or for the assets and liabilities of disposal groups classified as held for sale in the statement of financial position for prior periods to reflect the classification in the statement of financial position for the latest period presented. "

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Further thoughts

- **Restructuring of operations often occurs before the disposal of a business. Provision for restructuring are accounted for under the rules of HKAS 37**
- **Contingent liability in disposal group leading to an impairment loss**
- **Intercompany balances that are eliminated on consolidation**

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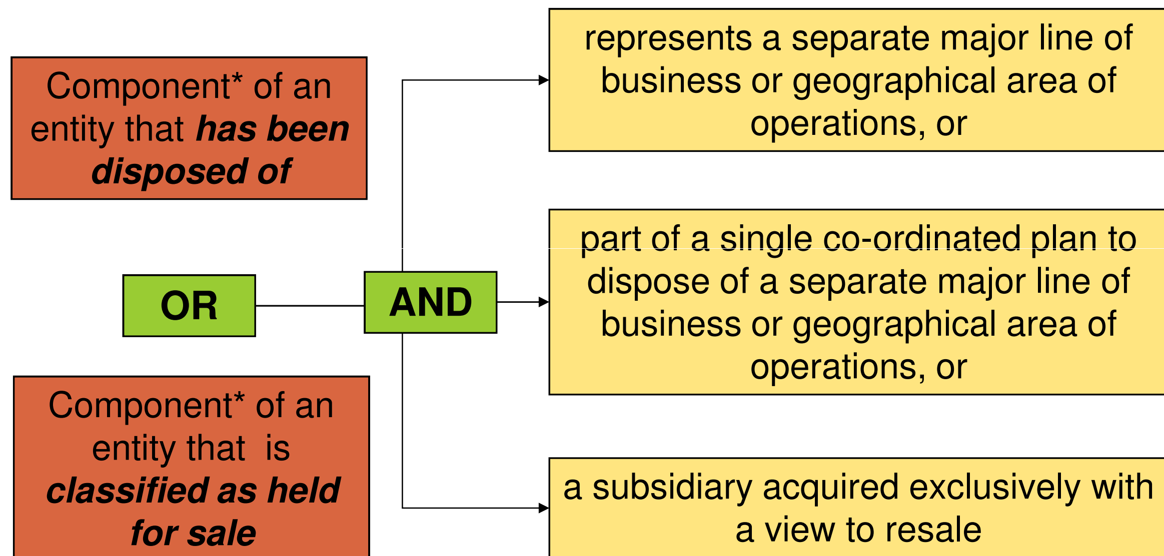
E. Discontinued Operations



*A component of an entity comprises operations & cash flows that can be clearly distinguished operationally and for financial reporting purposes from the rest of the entity.

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E. Discontinued Operations (Con't)

Do they satisfy the definition of discontinued operations?

- Gradual phasing out of a product line or class of service
- Discontinuing several products within an ongoing line of business
- Shifting some production activities for a particular line of business from one location to another
- Closing a facility to achieve productivity improvements or other cost savings

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E. Discontinued Operations (Con't)

Timing of discontinued operations

- For operation that are to be terminated or closed down rather than sold → not qualify as discontinued when the entity makes a decision to close them.
- They will qualify to be presented as discontinued once they actually are closed.

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Timing of discontinued operations – examples

1. A company carried out a pharmaceutical wholesaling business that it operated from several leasehold premises throughout the country. The business has been closed, all stocks have been disposed of and employees made redundant before the end of three months into the next financial year. At that time some debtors remain to be collected and costs will continue to be incurred in respect of the vacated premises until the leases are disposed of .

2. A group has announced it is closing an engineering contracting segment. Although no new contracts are being undertaken, all existing contracts will be completed and the business will be run down accordingly.

3. A group is closing its lending operation. It will make no new loans, but will continue to collect the principal and interest on the outstanding loans until the end of the original term.

When should the operation be classified as discontinued?

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E. Discontinued Operations (Con't)

Measuring discontinued operations

- Discontinued operations held for sale are measured in the same way as other disposal groups, i.e. lower of
  - ✓ carrying amount; and
  - ✓ fair value less costs to sell
- When a discontinued operation has been disposed of, there will be no balance sheet items to re-present.

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F. Presentation & disclosures

- **Statement of comprehensive income**

  A single amount comprises of:

  ✓ The sum of the post-tax profit or loss of the discontinued operation; and

  ✓ the post-tax gain or loss recognised on the measurement to fair value less cost to sell or fair value adjustments on the disposal of the assets (or disposal group)

  If the entity presents profit or loss in a separate income statement, a section identified as relating to discontinued operations is presented in that separate statement. [HKFRS 5.33-33A].

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F. Presentation & disclosures

- an analysis of the single amount into:

  (i) the revenue, expenses and pre-tax profit or loss of discontinued operations;

  (ii) the related income tax expense as required by paragraph 81(h) of HKAS 12;

  (iii) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and

  (iv) the related income tax expense as required by paragraph 81(h) of HKAS 12.

The analysis may be presented in the notes or in the statement of comprehensive income.

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F. Presentation & disclosures

- **Balance sheet presentation.** A discontinued operation held for sale is presented in the same way as other disposal group that are held for sale.
- **Cash flow statement presentation.** The net cash flows attributable to the operating, investing, and financing activities of a discontinued operation shall be separately presented on the face of the cash flow statement or disclosed in the notes. [HKFRS 5.33]
- **Comparative information.** Balance sheet information is neither restated nor re-measured for discontinued operations. For statement of comprehensive income, the comparative information does have to be restated.

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F. Presentation & disclosures

- **No retroactive classification.** HKFRS 5 prohibits the retroactive classification as a discontinued operation, when the discontinued criteria are met after the balance sheet date. [HKFRS 5.12]

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F. Presentation & disclosures

In addition to the presentations noted above, the following disclosures are required:

- adjustments made in the current period to amounts disclosed as a discontinued operation in prior periods must be separately disclosed. [HKFRS 5.35]
- if an entity ceases to classify a component as held for sale, the results of that component previously presented in discontinued operations must be reclassified and included in income from continuing operations for all periods presented. [HKFRS 5.36]

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F. Presentation & Disclosures

- Para 5B of HKFRS 5 states that the required disclosures for non-current assets (or disposal groups) classified as held for sale or discontinued operations are specified in HKFRS 5

- The disclosure requirements of other HKFRSs are applicable to those assets (or disposal groups) only if they specifically require disclosures in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations, or they relate to items not within the measurement scope of HKFRS 5

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G. Distributions of non-cash assets to owners

- Non-cash assets held for distribution to owners are now specifically scoped into HKFRS 5 and should be treated in accordance with HKFRS 5's classification, presentation and measurement

- Whether or not a non-cash asset is classified as 'held for distribution to owners' is determined using HKFRS 5's general principles regarding whether the transaction is highly probable

- When the non-cash asset is classified as held for distribution to owners, it is re-measured at the lower of its carrying amount and fair value less costs to distribute, with any adjustment to carrying amount recognised in accordance with the general principles of HKFRS 5

- Where the fair value less costs to distribute of an asset accounted for using the cost model is less than its carrying amount, an impairment loss should be recognised in profit or loss. Where the fair value less costs to distribute is higher than the carrying amount, no adjustment is made until the distribution is made

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Thank you for your attention

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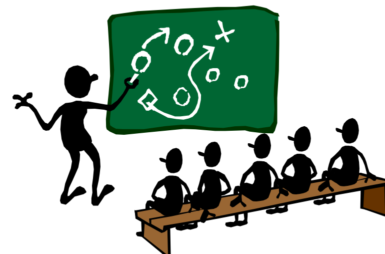
A Refresher Course on Current Financial Reporting Standards 2013 (Day 2)

Associates and joint arrangements



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Agenda

- Scope of HKAS 24
- Related Party Relationships - Definition
- Related Party Relationships – Examples
- Related Party Transactions
- Disclosure Requirements
- Overall recap

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Agenda

- Scope of HKAS 24

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Scope of HKAS 24

- HKAS 24 is a disclosure standard
- It sets out **how** related party relationships, transactions and balances, including commitments, should be identified and **what** disclosures should be made and **when**

  [HKAS 24.2]

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Scope of HKAS 24 (cont'd)

- HKAS 24 requires disclosure of **related party transactions and balances**, **including commitments**, in the **separate financial statements of parent companies and subsidiaries**, i.e. intra-group transactions between such entities are disclosed
- **Intra-group transactions** would be eliminated and would, therefore, **not be disclosed** in the **consolidated financial statements**
- HKAS 24 also requires disclosure of related party **transactions and balances, including commitments**, between a venturer or investor in a joint venture or an associate ('**investor**') and its joint venture or associate ('**investee**') to be **disclosed** in the **separate financial statements of both the investor and investee**. Transactions and balances that are not eliminated on consolidation would be disclosed in any consolidated financial statements produced by the investor

  [HKAS 24.3,4]

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Scope of HKAS 24 (cont'd)

- **No 'confidentiality' exemption** even in the situation where an entity has a duty of confidentiality imposed by law

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Agenda

- Scope of HKAS 24
- **Related Party Relationships - Definition**

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Related parties

❑ **Related party definition**

- A related party can be a **person**, an **entity**, or an **unincorporated business**

- **Definition** of related party is in two parts
  - the first part of the definition identifies **general criteria** that result in a **person,** or a **close member** of that **person's family**, being a related party of the reporting entity

  - the second part of the definition specifically identifies **conditions** that result in an **entity** being related to the reporting entity

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Related parties

❑ **Relationships with persons – general criteria**

- The general criteria state that a **person**, or a **close member** of that **person's family**, is **a related party** of the reporting entity if that **person**:

  - Has **control** or **joint control** over the reporting entity

  - Has **significant influence** over the reporting entity

  - Is a **member of the key management personnel** of the reporting entity or of a parent of the reporting entity

[HKAS 24.9(a)]

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Related parties

❑ Relationships with persons – general criteria

- **"Key management personnel"** is defined in HKAS 24 as "*those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity*"

[HKAS 24.9]

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Related parties

- A close family member of key management personnel of the entity or of a parent of the entity or of any person that controls, or has joint control or significant influence over the entity is a related party of the entity [HKAS 24.9(a)]
- What is a close family member?

❑ **"Close family members of a person** are defined as those **family members who may be expected to influence**, or **be influenced by**, that person in their dealings with the entity, including

- The person's children and spouse or domestic partner
- Children of the person's spouse or domestic partner
- Dependants of the person or the person's spouse or domestic partner

[HKAS 24.9]

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Related parties

❑ Relationships with other entities – specific criteria

- HKAS 24 specifically identifies certain parties are always treated as related parties, including….

- **members of the same group** (i.e., parents, subsidiaries and fellow subsidiaries) are all related to each other

  ❑ **This means ultimate and intermediate parents, subsidiaries and fellow subsidiaries of the reporting entity are related parties [HKAS 24.9(b)(i)]**

  ❑ **All entities in a group, whether unincorporated (e.g. partnership) or incorporated, are related parties**

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Related parties

❑ Relationships with other entities – specific criteria

- HKAS 24 specifically identifies certain parties are always treated as related parties, including…

❑ **Investors and their associates are related parties**

❑ **Venturers and their joint ventures are related parties**

❑ **This extends to an associate or joint venture of a member of a group of which the reporting entity is a member**

❑ **Where an entity has a joint venture, the joint venture's subsidiaries will be related parties of the entity**

❑ **Where an entity has an associate, the associate's subsidiaries will be related parties of the entity**

[HKAS 24.9(b)(ii)], [HKAS 24.12]

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Related parties

❑ Relationships with other entities – specific criteria

- HKAS 24 specifically identifies certain parties are always treated as related parties, including….

❑ Two joint ventures of the same third party

❑ A joint venture of a third entity and an associate of that third entity

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Related parties

❑ Relationships with other entities – specific criteria

- HKAS 24 specifically identifies certain parties are always treated as related parties, including…

Where a person (or close member of that person's family):

❑ controls or jointly controls an entity;

❑ has significant influence over the entity; or

❑ is a member of that entity's (or the entity's parent's) key management personnel

that entity is a related party of another entity controlled or jointly controlled by the same person (or close member of that person's family)

[HKAS 24.9(b)(vi), (vii)]

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Related parties

❑ **Relationships with other entities – specific criteria**

- HKAS 24 specifically identifies certain parties are always treated as related parties, including…

❑ **An entity and a post-employment benefit plan (such as a pension scheme) for the benefit of that entity's employees or employees of any other entity related to the entity**

❑ **If the reporting entity is itself such a plan, the sponsoring employers are also related parties of that entity**

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Substance of the relationship

❑ In consideration each possible related party relationship, attention is directed to the **substance** of the relationship and **not merely the legal form**

[HKAS 24.10]

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Agenda

- Scope of HKAS 24
- Related Parties - Definition
- Related Parties Relationships - Examples

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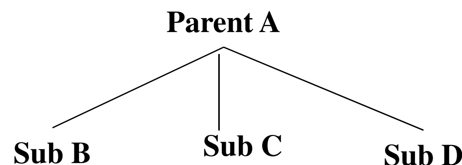
Related parties

- Example – Directors of subsidiaries as key management personnel of a group



- Parent A has three subsidiaries. Parent's main activity is to coordinate its subsidiaries operations.
- How should management disclose the remuneration of subsidiaries' directors in its consolidated financial statements?

A director of a subsidiary is not automatically a related party of the group. The director is a related party of the group if he is determined to be a member of the group's key management personnel

Under HKAS 24, the remuneration of any subsidiaries' directors who are identified as key management personnel of the group should be disclosed with the remuneration of the parent's directors in the consolidated financial statements

Separate disclosure of the remuneration of the individual directors is not required under HKAS 24 unless required by local legislative requirements

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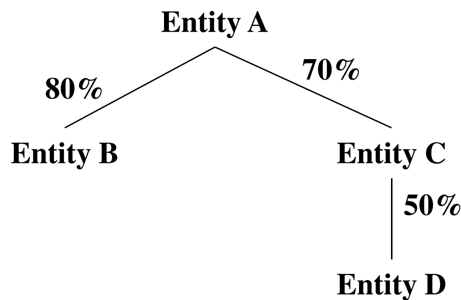
Related parties

❑ **Example – Joint venture of group member**



- Entities A, B and C are members of the same group and, hence, are related parties of one another. [HKAS 24.9(b)(i)]
- As a joint venture of entity C, entity D is a related party of that entity
- Entity D is also a related party of the other members of the group in which entity C sits, that is, entity D is a related party of both entity A and entity B. [HKAS 24.9(b)(ii)]
- If entity D was an associate of entity C, it would, similarly, be a related party of entities A, B and C

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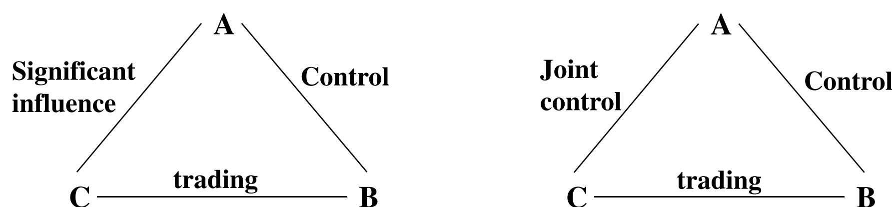
Related parties

❑ **Example – Control, significant influence or joint control from the same source**



- Entities A and B are related parties [HKAS 24.9(b)(i)]
- Entities A and C are related parties [HKAS 24. 9(b)(ii)]

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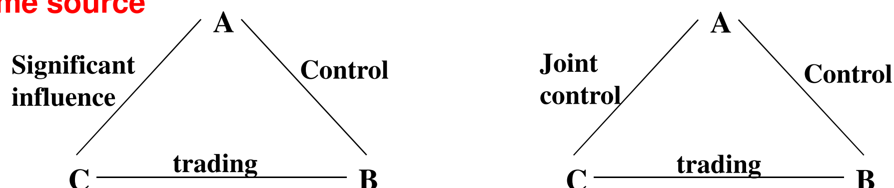
Related parties

❑ Example – Control, significant influence or joint control from the same source



- Entities B and C are related parties. Entity B should disclose details of any transactions with entity C that have been entered into (together with any resulting balances). Similarly, entity C should include details of any transactions with entity B that have been entered into (together with any resulting balances) [HKAS 24.9(b)(ii)]
- Disclosure of transactions between entities B and C will be required in entity A's consolidated financial statements (even if the transactions were at arm's length) because these are related party transactions between an associate (or joint venture) and the entity A group (of which the entity controlled by entity A is a member) and the transactions are not eliminated on consolidation

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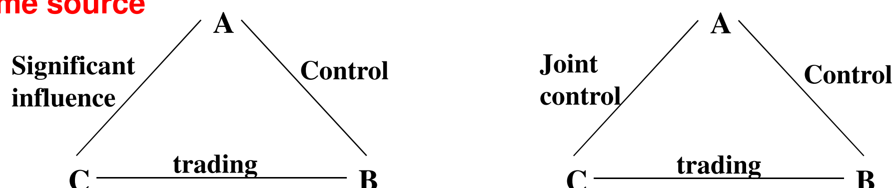
Related parties

❑ Example – Control, significant influence or joint control from the same source



- Entity A is not required to disclose the transactions between entity B and entity C as related party transactions in entity A's separate financial statements
- HKAS 24 defines a related party transaction as *"a transfer of resources, services or obligations between a reporting entity and a related party …"*. [HKAS 24.9]. For its separate financial statements, entity A is the reporting entity and so transactions between entity B and entity C are not transactions with the reporting entity and are not, therefore, related party transactions

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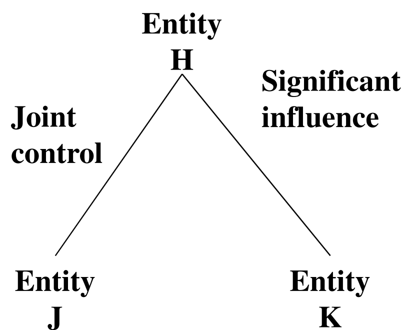
Related parties

❑ Example – Entity with joint control and significant influence



- Both entities J and K are entity H's related parties [HKAS 24.9(b)(ii)].
- In entity J's financial statements, entities H and K are entity J's related parties [HKAS 24.9(b)(ii), (iv)]
- In entity K's financial statements, entities H and J are entity K's related parties [HKAS 24.9(b)(ii), (iv)]
- If entity H has joint control, as opposed to significant influence, over entity K, similar principles would apply and each entity within the structure shown would be related [HKAS 24.9(b)(ii), (iii)]

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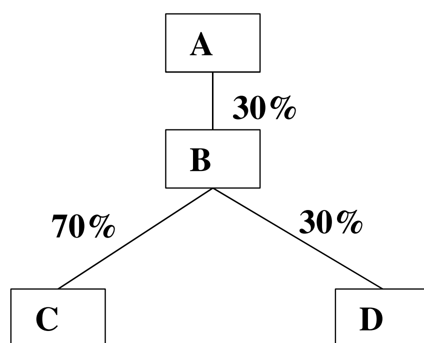
Related parties

❑ Example – Transactions with related parties of an associate and joint venture



Entity A transacts with entities C and D. Should entity A disclose these transactions as related party transactions?

- Entity A should disclose entity A's transactions with entity C in entity A's separate financial statements. Entity C is a related party of entity A, because entity C is the subsidiary of entity A's associate, entity B [HKAS 24.12]. Entity A, therefore, has significant influence over entities B and C
- Entity A is not required to disclose entity A's transactions with entity D in its financial statements. Entity D is not a related party of entity A, because entity A has no ability to exercise control or significant influence over entity D
- Entity C is required to disclose its transactions with entity A in its financial statements, because entity A is a related party. Entity D is not required to disclose transactions with entity A, because they are not related parties

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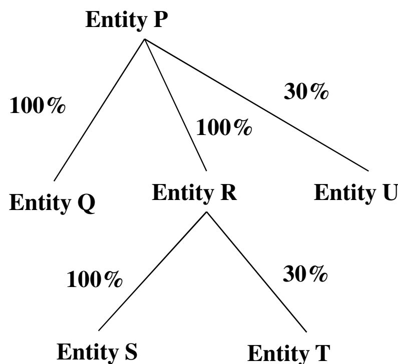
Related parties

❑ **Example – Group holdings – subsidiaries and associates**



P's consolidated and separate financial statements

- Entities Q, R, S, T and U are all related parties of entity P in P's separate financial statements [HKAS 24.9(b)(i), (ii)]
- Entities T and U are related to entity P in P's consolidated financial statements (while transactions between entity P and each of entities Q, R and S will be eliminated on consolidation and hence no related party disclosures would be required) [HKAS 24.9b(i), (ii), 4]

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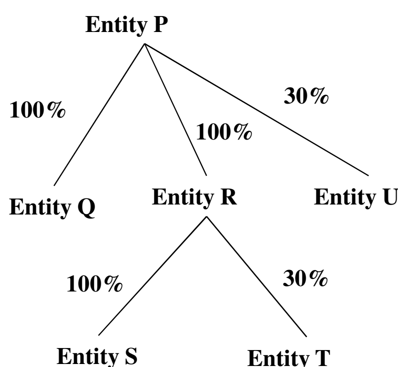
Related parties

❑ **Example – Group holdings – subsidiaries and associates**



Financial statements of entities Q, R and S statements

- All entities shown within the structure are related to one another for the purposes of each of subsidiary entities Q, R and S's separate financial statements. For example, entities P, R, S, T and U are all related parties of entity Q. [HKAS 24.9b(i), (ii)]

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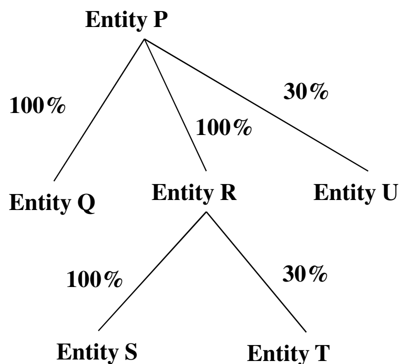
Related parties

❑ Example – Group holdings – subsidiaries and associates



Entity T's financial statement

- Entity R is a related party of entity T and, therefore, the other entities (entities P, R and S) within entity R's group are also related parties of entity T [HKAS 24 para 9 (b)(ii)].
- However, entity U is not a related party of entity T because two associates of the same investor are not related parties simply by virtue of their common investor

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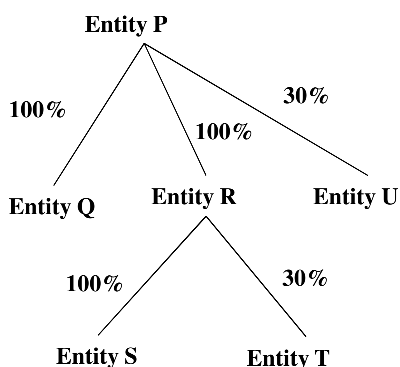
Related parties

❑ Example – Group holdings – subsidiaries and associates



Entity U's financial statement

- Entity P is a related party of entity U and, therefore, the other entities (entities Q, R and S) within entity P's group are also related parties of entity U. [HKAS 24.9(b)(ii)]
- However, entity T is not a related party of entity U.

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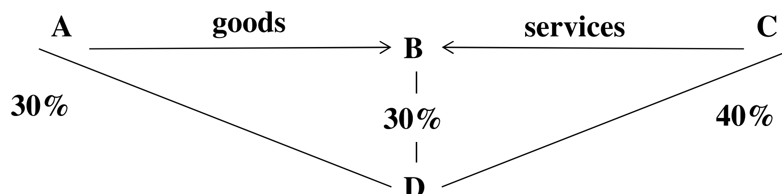
Related parties

❑ **Example – Transactions between different investors in an associate**



- Entities A, B and C are related parties of entity D, but not necessarily related parties of each other. Consequently, unless there is some other relationship between entities A, B and C (other than the fact that they are all investees in entity D) that would make them related parties, the transaction entities A and B and between entities C and B would not be disclosable in any of the financial statements of entities A, B, C or D

[HKAS 24.9(b)(i), 11(b)]

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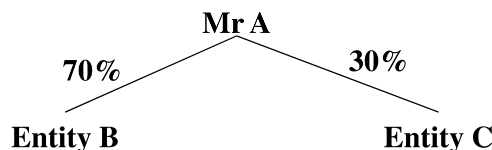
Related parties

❑ **Example – Investor controls one entity and has significant influence over another**



- Mr A controls entity B and, therefore, is a related party of that entity [HKAS 24.9(a)(i)]
- Mr A has significant influence over entity C and, therefore, is a related party of that entity [HKAS 24.9(a)(ii)]
- Because Mr A has control over entity B and significant influence over entity C, entity B and entity C are related parties. [HKAS 24.9(b)(vii)] Therefore, entity B's financial statements should include details of transactions with Mr A and entity C. Entity C's financial statements should include details of transactions with Mr A and entity B
- The position would be the same where Mr A had joint control, as opposed to control, over entity B. Mr A would be a related party of entity B and entity C while entities B and C would be related parties of one another

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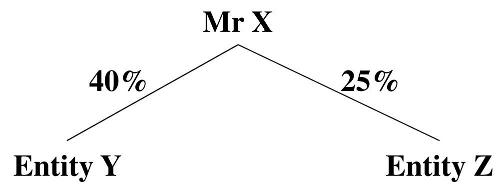
Related parties

❑ Example – Investor has significant influence over two entities



- Mr X has significant influence over entity Y and, therefore, is a related party of that entity [HKAS 24.9(a)(ii)]
- Mr X has significant influence over entity Z and, therefore, is a related party of that entity [HKAS 24.9(a)(ii)]
- Entity Y and entity Z are not related to each other. Investees are not related just because they are subject to significant influence from the same investor [HKAS 24.BC25]

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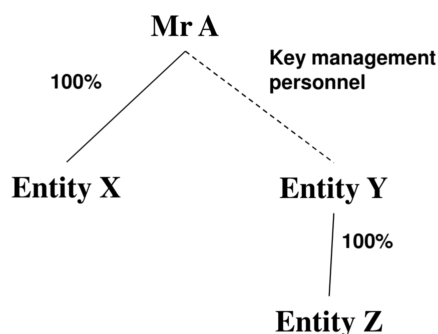
Related parties

❑ Example – Key management personnel



Entity X's financial statements

- Entity Y is a related party of entity X because Mr A is a member of key management personnel of entity Y and he also controls entity X [HKAS 24.9(b)(vii).]
- Entity Z is also a related party of entity X, given that Mr A is a member of key management personnel of its parent, entity Y [HKAS 24.9(b)(vii)]

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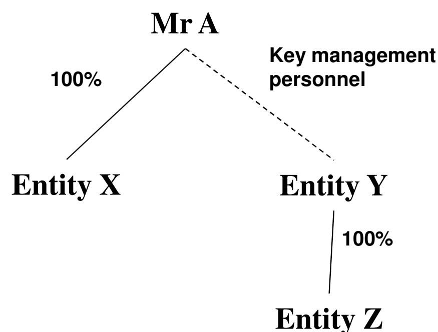
Related parties

❑ Example – Key management personnel



Entity Y's separate and consolidated financial statements

- Entities X and Z are related parties of entity Y, given that Mr A, a member of entity Y's key management personnel, controls entity X and entity Y controls entity Z [HKAS 24.9(b)(vi), 9(b)(i)]
- In entity Y's consolidated financial statements, entity X is a related party

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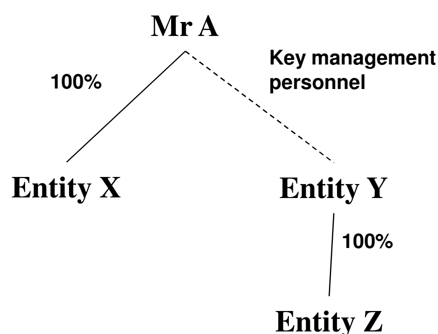
Related parties

❑ Example – Key management personnel



Entity Z's financial statements

- Entity X is a related party of entity Z because Mr A controls entity X and he is also a member of entity Z' s parent's key management personnel [HKAS 24.9(b)(vi)]

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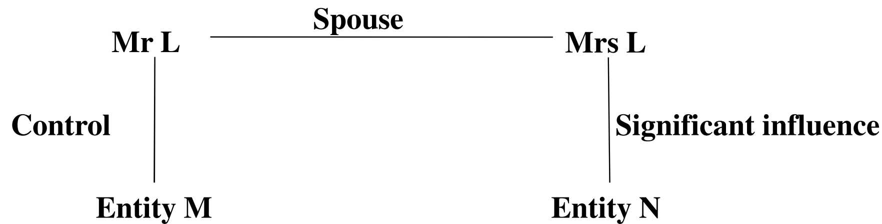
Related parties

❑ Example – Close family members



- ❑ Mr L control entity M and Mrs L has significant influence over entity N, in entity M's financial statements, entity N is a related party [HKAS 24.9(b)(vii)]
- ❑ Similarly, in entity N's financial statements, entity M is a related party [HKAS 24.9(b)(vi)]

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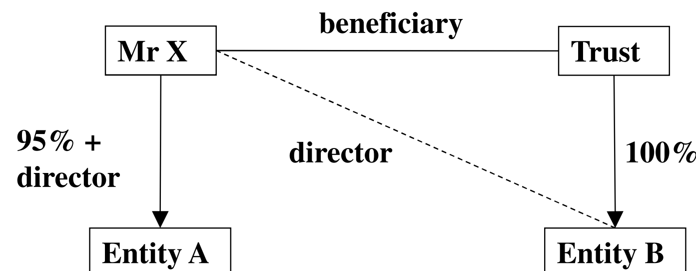
Related parties

❑ Example – Director's relationship with a trust



- ❑ Entity A and B are related parties because the director controls entity A and is a member of the key management personnel of entity B [HKAS 24.9(b)(vii), (vi)]

What if Mr X transferred his 95% of entity A to the trust, but remained a director of entity A?

- ❑ Mr X controls the trust, the two entities will be related [HKAS 24.9(b)(vi), (vii)]

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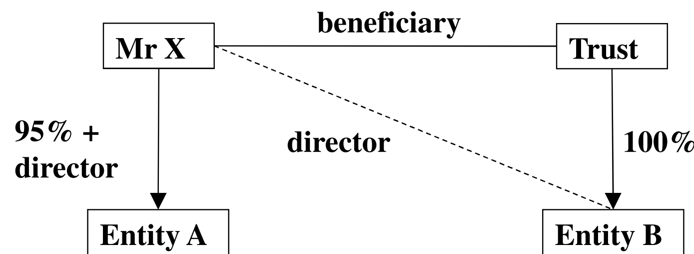
Related parties

❑ **Example – Director's relationship with a trust**



What if Mr X resigned as a director of entity A, but retained his 95% holding?

- Whilst not (nominally) a director of entity A, Mr X continues to control entity A through his 95% holding. If Mr X controls the trust, entities A and B are related because Mr X controls entity A and also, through the trust, controls entity B. Entity A and B are controlled by the same person and so are related parties [HKAS 24.9(b)(vi)]

- In addition, although not nominally a director of entity A, Mr X may still be 'key management personnel' even if he resigned as a director of entity A [HKAS 24 para 9(b)(vii)]

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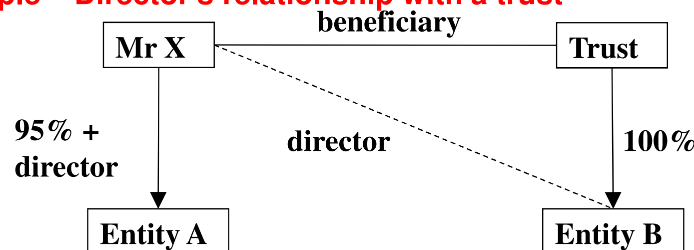
Related parties

❑ **Example – Director's relationship with a trust**



What if Mr X resigned as a director of entities A and B and transferred the 95% holding in entity A to the trust?

- If the director controls the trust, he controls entities A and B through the trust and they will, therefore, be related parties [HKAS 24.9(b)(vi)]
- If Mr X continues to direct the operating and financial policies of the two entities he should be regarded for the purpose of HKAS 24 as being key management personnel.
- HKAS 24.10 states that "***in considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form***"

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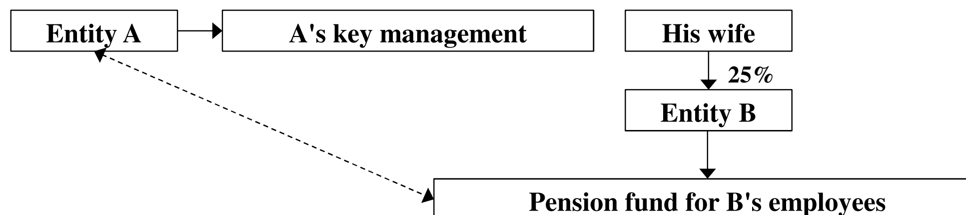
Related parties

- **Example – Post employment plans of a related party outside the group**



Entity A transacts with the pension fund set up for the benefits of all employees of entity B. Should entity A disclose these transactions?

- The pension fund is set up for the benefit of the employees of entity B and is, therefore, a related party of entity B [HKAS 24.9(b)(v)]
- Entity A is not a related party of entity B. Two entities are not related parties simply because a member of key management personnel of one entity has significant influence over the other entity [HKAS 24.11(a)]. Therefore, the pension fund is not related party of entity A and the transactions between entity A and the pension fund do not need to be disclosed

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Parties that are not necessarily related

- Two entities simply because they have a **director or other member of key management personnel in common**, or because a member of key management personnel of one entity has significant influence over the other entity
- Two venturers simply because they **share joint control over a joint venture**
- **Departments and agencies of a government that does not control, jointly or significantly influence the reporting entity**, providers of finance, trade unions and public utilities, simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process)
- A customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting **economic dependence**

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Related parties for only part of the year

- Disclosure is only required in respect of transactions during the period for which the entities are related
- A party that is unrelated at the time of the transaction is not a related party transaction

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Agenda

- Scope of HKAS 24
- Related Party Relationships - Definition
- Related Party Relationships – Examples
- Related Party Transactions

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Related party transactions

- A 'related party transaction' is defined as:

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

  [HKAS 24.9]

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Related party transactions (cont'd)

- Types of related party transactions that require disclosure in the period in which they occur:
  - Purchases or sales of goods (finished or unfinished)
  - Purchases or sales of property and other assets
  - Rendering or receiving of services
  - Leases
  - Transfers or research of services
  - License agreements
  - Provision of finance (including loans and equity contributions in cash or in kind)
  - Guarantees and the provision of collateral security

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Related party transactions (cont'd)

- Types of related party transactions that require disclosure in the period in which they occur: (cont'd)
  - Commitments to do something if a particular event occurs or does not occur in the future, including recognised and unrecognised executory contracts
  - Settlement of liabilities on behalf of the entity or by the entity on behalf of that related party
  - Participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities

[HKAS 24.21,22]

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Agenda

- Scope of HKAS 24
- Related Party Relationships - Definition
- Related Party Relationships – Examples
- Related Party Transactions
- Disclosure Requirements

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Disclosure requirements

❑ Disclosure of control – Parents and subsidiaries

- HKAS 24 requires disclosure of **relationships between a parent and its subsidiaries, irrespective of whether there have been transactions between them**

  [HKAS 24.13]

- This disclosure is in addition to the requirements of HKAS 27, which requires disclosures, in a parent's separate financial statements, of:
  - A list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and , if different, proportion of voting power held
  - A description of the method used to account for such investments

  [HKAS 27.42]

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Disclosure requirements

❑ Disclosure of control – Parent and ultimate controlling party

- An entity must **disclose the name of its parent and, if different, the name of the ultimate controlling party**

- **If neither the parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent** that does so must also be disclosed. This will be the first parent in the group above the immediate parent that produces consolidated financial statements available for public use.

- In addition, HKAS 1 requires disclosure of the ultimate parent entity

  [HKAS 24.13,16; HKAS 1.138(c)]

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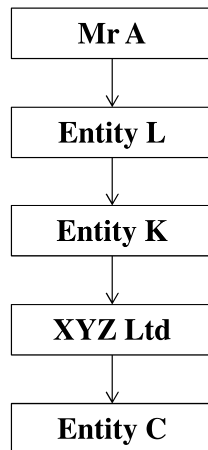
Disclosure requirements

- Example – Disclosure where ultimate controlling party is not an entity



- Entity XYZ Limited directly owns 100% of the shares of entity C and the ultimate controlling party of entity C is Mr A
- Entity XYZ Limited does not publish financial statements available for public use
- Entity K is the immediate parent of XYZ Limited. Entity L is the immediate parent of entity K. Both entities K and L produce consolidated financial statements filed with the local stock exchange

Which controlling parties need to be disclosed by entity C?

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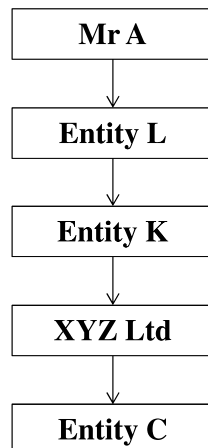
Disclosure requirements

- Example – Disclosure where ultimate controlling party is not an entity



- Entity C must disclose the name of XYZ Limited as the direct parent and Mr A as the ultimate controlling party, irrespective of whether there were transactions between them during the year [HKAS 24.13]
- Entity K is also disclosed as the next most senior parent that produces consolidated financial statements available for public use. The next most senior parent is the first parent in the group above the immediate parent that produces consolidated financial statements available for public use [HKAS 24.16]
- Entity L must be disclosed as the ultimate parent entity of entity C, if this information is not disclosed elsewhere in the information published with financial statements [HKAS 1.138(c)]

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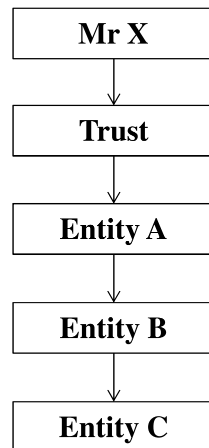
Disclosure requirements

- Example – Disclosure of controlling party that does not prepare financial statements



- Entity B directly owns 100% shares of entity C
- Entity C's ultimate parent is entity A
- Mr X controls entity A through a trust based in the British Virgin Islands
- Neither entity B nor entity A nor the trust publishes financial statements. During the year, there have been no transactions between them and entity C

Should entity C's management disclose the name of its parent and the ultimate controlling party if neither produces financial statements available for public use?

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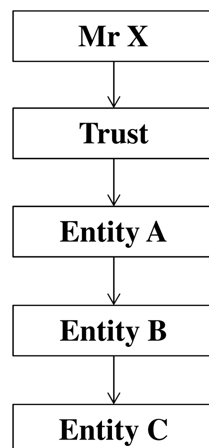
Disclosure requirements

- Example – Disclosure of controlling party that does not prepare financial statements



- Yes. Entity C is obliged to disclose the name of entity B as the direct parent and Mr X as the ultimate controlling party, even if neither produces financial statements available for public use [HKAS 24.13]
- The disclosure should be made irrespective of whether there were transactions between them during the year
- Entity C would also be required to disclose entity A as the ultimate parent entity [HKAS 24.138(c)]

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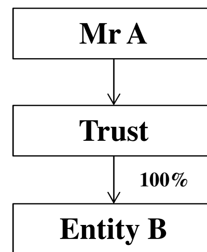
Disclosure requirements

❑ Example – A trust as the ultimate controlling party



- ❑ Entity B is controlled by trust T
- ❑ Mr. A has a direct interest in 100% of trust T and controls the trust
- ❑ Trust T has signed an agreement with Mr. A that prevents the trust from disclosing publicly the particulars of its controlling party, Mr. A

Who should entity B disclose as its controlling party, given trust T has signed an agreement prohibiting it from disclosing its relationship with Mr. A?

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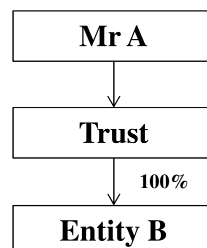
Disclosure requirements

❑ Example – A trust as the ultimate controlling party



- ❑ Entity B's management should disclose Mr. A as the controlling party of entity A irrespective of whether there were transactions between them during the year [HKAS 24.13]
- ❑ A legal agreement does not negate the requirement to disclose the controlling party

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Disclosure requirements

- **Key management personnel compensation**
  - An entity shall disclose **key management personnel compensation in total** and for **each** of the following categories:
    - Short-term employee benefits
    - Post-employment benefits
    - Other long-term benefits
    - Termination benefits; and
    - Share-based payment

[HKAS 24.17]

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Disclosure requirements

- **Key management personnel compensation – Example 1**
  - A director of a parent entity is also a director of one of its subsidiaries
  - The subsidiary bears cost for services received and pays the director directly in respect of services as a director of the subsidiary
  - The parent entity compensating the director for his/her services to the parent

- **The parent entity will disclose in its separate financial statements the amount paid to the director in respect of services to the parent entity**
- **The subsidiary will disclose the amount paid to the director by the subsidiary earned by the director in respect of services to the subsidiary**

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Disclosure requirements

- **Key management personnel compensation – Example 2**
  - A director of a parent entity is also a director of one of its subsidiaries
  - The subsidiary bears cost indirectly via a management charge for services received from the director
  - The parent entity pays the director for his/her services as a director to both the subsidiary and the parent and recharges the subsidiary for the services as a director of the subsidiary

- **The parent entity will disclose in its separate financial statements the amount paid to the director in respect of services to the parent entity**
- **The subsidiary will disclose the amount receivable by the director for services to the subsidiary, i.e., the amount recharged by the parent in respect of the director's services**

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Disclosure requirements

- **Key management personnel compensation – Example 3**
  - A director of a parent entity is also a director of one of its subsidiaries
  - The subsidiary bears no cost for services received
  - The parent entity pays the director for his/her services as a director to both the subsidiary, but no recharge is made to the subsidiary

- **The parent entity will disclose in its separate financial statements the amount paid to the director in respect of services to the parent entity**
- **The subsidiary will disclose details of the compensation paid by the parent entity in respect of the director's services to the subsidiary and explained the effect that the charge for director's compensation has been borne by the parent may be useful, although not required**

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Disclosure requirements

- **Disclosure of transactions and balances**
  - If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the **nature of the related party relationship** as well as **information about those transactions and outstanding balances**, **including commitments**, necessary for the users to understand the potential effect of the relationship on the financial statements. These disclosure requirements are in addition to those in HKAS 24.17
  - At a minimum, disclosures shall include:
    - the **amount of the transactions**
    - the **amount of outstanding balances**, including commitments and their **terms and conditions**, including whether they are secured, and the nature of the consideration to be provided in settlement and details of any guarantees given or received;
    - **provisions for doubtful debts** related to the amount of outstanding balances; and
    - the **expense recognised** during the period **in respect of bad or doubtful debts** due from related parties

[HKAS 24.18]

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Disclosure requirements

- **Categories of disclosure**
  - The disclosures referred in HKAS 24.18 should be made separately in respect of each of the following:
    - The parent
    - Entities that have joint control or significant influence over the entity
    - Subsidiaries
    - Associates
    - Joint ventures
    - Key management personnel of the entity or of its parent
    - Other related parties

[HKAS 24.19]

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Disclosure requirements

❑ Arm's length transactions

- Disclosures that related party transactions were made on terms equivalent to those that prevail in **arm's length transactions** are made **only if** such terms can be **substantiated**

[HKAS 24.23]

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Disclosure requirements

❑ Aggregation - general

- Items of a **similar nature may be disclosed in aggregate** except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity

[HKAS 24.24]

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Disclosure requirements

❑ **Comparatives**

- HKAS 24 is silent on comparatives
- HKAS 1 states that, except when a standard provides otherwise (which HKAS 24 does not do), comparative information must be given for all amounts reported in the financial statements
- Comparative information should be included for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements

[HKAS 1.38]

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Disclosure requirements

❑ **Subsidiaries acquired and disposed of in the year**

- **Consolidated financial statements**
  - Where a group has acquired a subsidiary, transactions between the members of the acquiring group and the acquired subsidiary prior to the date of acquisition are not disclosable in the consolidated financial statements
  - Where a group has disposed of a subsidiary during the year, post-disposal transactions between the members of the group and the subsidiary disposed of are not disclosable in the consolidated financial statements as the related party relationship ceases on disposal. As pre-disposal transactions are eliminated on consolidation, no disclosure is required

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Disclosure requirements

- Subsidiaries acquired and disposed of in the year
  - **Parent's separate financial statements**
    - Where an entity acquires a subsidiary, only transactions between the parent and the subsidiary after the date of acquisition are disclosable in the entity's separate financial statements
    - Where an entity disposes of a subsidiary, only transactions between the parent and the subsidiary up to the date of disposal are disclosable in the entity's separate financial statements

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Disclosure requirements

- Subsidiaries acquired and disposed of in the year
  - **Subsidiary's financial statements**
    - Where an entity is acquired in the period, only transactions after the date of acquisition are disclosable in its financial statements because this is the period during which the related party relationship exists
    - Where a subsidiary is disposed of during the period, only transactions up to the date of disposal are disclosable in its financial statements because this is the period during which the related party relationship exists

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Disclosure requirements

- **Exemption from disclosure**
  - Transactions eliminated on consolidation
  - Parties that are not necessarily related
  - Government-related entities

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Disclosure requirements

- **Government-related entities**
  - HKAS 24 includes an **exemption** from the disclosure requirements of HKAS 24.18 in relation to related party transactions and outstanding balances, including commitments, with:
    - **a government that has control, joint control or significant influence over the reporting entity**; and
    - **another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity**

[HKAS 24.25]

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Disclosure requirements

❑ Government-related entities (cont'd)

- Government is defined as "government, government agencies and similar bodies whether local, national or international"

- Government-related entities are those that are "controlled, jointly controlled or significantly influenced by a government"

[HKAS 24.9]

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Disclosure requirements

❑ Government-related entities (cont'd)

- If the reporting entity applies the exemption, it must disclose:
  - The **name** of the government and the **nature of the its relationship** with the reporting entity (that is, control, joint control or significant influence); and
  - The following information in sufficient detail to enable users to understand the effect of related party transactions on the entity's financial statements:
    - The **nature and amount of each individually significant transaction**; and
    - The **qualitative or quantitative extent of any collectively but not individually, significant transactions**

  - Other factors relevant in establishing the level of significance of the transaction include whether it is significant in terms of size, carried out on non-market terms, outside normal day-to-day business operations, disclosed to regulatory or supervisory authorities, reported to senior management, subject to shareholder approval

[HKAS 24.26, 27]

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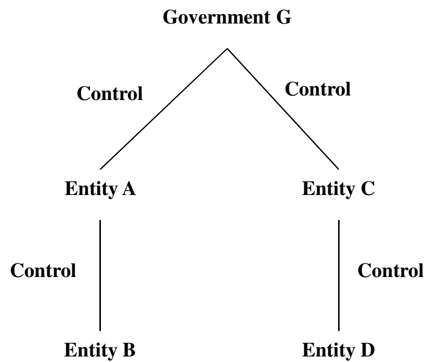
Disclosure requirements

❑ Example – Government control



- ❑ Entities A, B, C and D may take the exemption from disclosure for government-related entities [HKAS 24.15]
- ❑ Entity A is not required to disclose details of its transactions with government G or with entities B, C and D [HKAS 24.25]
- ❑ Entities A, B, C and D are exempt from the requirement to disclose transactions with government G, because they are transactions with a government that has control [HKAS 24.25(a)]
- ❑ Entities A and B are exempt from the requirement to disclose transactions with entities C and D, and vice versa. This is because they are transactions with another entity that is a related party because the same government has control [HKAS 24.25(b)]

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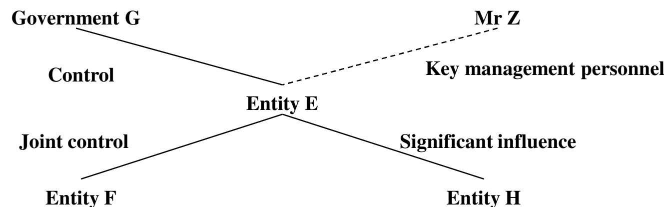
Disclosure requirements

❑ Example – Government control and member of key management personnel



- ❑ Entities E, F and H may take the exemption from disclosure for government-related entities because government G has direct or indirect control, joint control or significant influence over each of them
- ❑ For example, entity H is not required to disclose details of its transactions with government G and entities E and F [HKAS 24.25]
- ❑ The exemption does not apply to transactions between entity E and Mr Z. Mr Z is not a related party of entities F and H since entity E is not a parent of either entity

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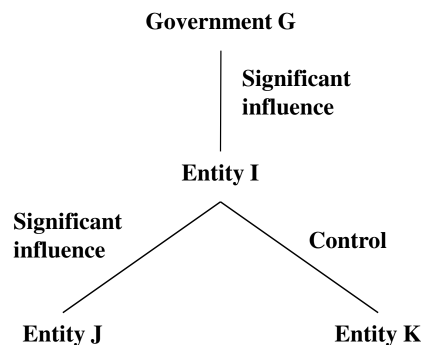
Disclosure requirements

❑ **Example – Government holding significant influence**



- ❑ Entities I and K may take the exemption from disclosure for government-related entities because government G has significant influence over entity I and entity K (as entity I controls entity K) [HKAS 24.25]
- ❑ The exemption does not extend to any transactions with entity J, because while, government G has significant influence over entity I, entity I's significant influence over entity J is not sufficient to assert that government G also has significant influence over entity J
- ❑ Transactions between entity J and entity I and between entity J and entity K are subject to the full disclosure requirements of HKAS 24 [HKAS 24.9(b)(ii)]

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Non-disclosure and the position of the auditor

- If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:
  - Discuss the non-disclosure with those charged with governance;
  - Describe in the basis for modification paragraph the nature of the omitted information; and
  - Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information

[HKAS 705.19]

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Non-disclosure and the position of the auditor

- Circumstances where it would not be practicable to disclose the omitted information:
  - The disclosures have not been prepared by management or the disclosures are otherwise not readily available to the auditor; or
  - In the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report

[HKAS 705.A19]

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Agenda

- Scope of HKAS 24
- Related Party Relationships - Definition
- Related Party Relationships – Examples
- Related Party Transactions
- Disclosure Requirements
- Overall recap

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HKAS 24 *Related Party*

- **Some principles to remember for related party relationships….**
- **Direct/indirect relationships:**
  - Related party relationships under HKAS 24 are symmetrical
  - All direct relationships involving control, joint control or significant influence are related party relationships
  - Significant influence and key management personnel relationships are treated as the same level of "closeness". These relationships are not as close as a relationship of control or joint control

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HKAS 24 *Related Party*

- **Some key principles to remember….**
- **Direct/indirect relationships:**
  - Relationship between a reporting entity and a corporate investor and between a reporting entity and an individual investor are treated in the same manner
  - An individual and close members of that individual's family are treated as one party in analysing related party relationships
  - Members of the same group (i.e., parent and all subsidiaries) are treated as one party in respect of the reporting entity in analysing related party relationships

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HKAS 24 *Related Party*

- **Some key principles to remember….**
- **Direct/indirect relationships:**
  - A post-employment benefit plan for employees of the reporting entity or any entity that is a related party of the reporting entity is considered to be a related party of the reporting entity

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HKAS 24 *Related Party*

- **Some key principles to remember….**
- **Others:**
- No recognition or measurement requirements for related party transactions
- Disclosure of related party relationships between a parent and its subsidiaries is required, even if there have been no transactions between them
- No disclosure is required in the consolidated financial statements of intra-group transactions eliminated in preparing those statements

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HKAS 24 *Related Party*

- **Some key principles to remember….**
- **Others:**
  - Comprehensive disclosures of related party transactions are required for each category of related party relationship
  - Key management personnel compensation is disclosed in total and is analysed by component
  - In certain circumstances, government-related entities are allowed to provide less detailed disclosures on related party transactions

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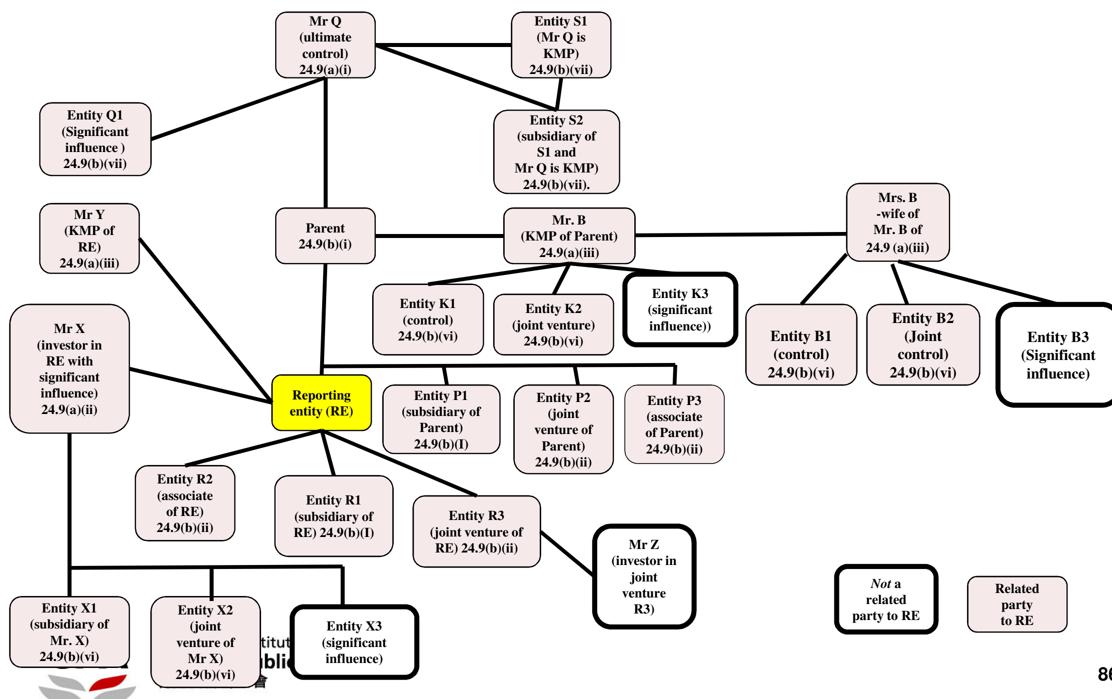
Summary of related party relationship



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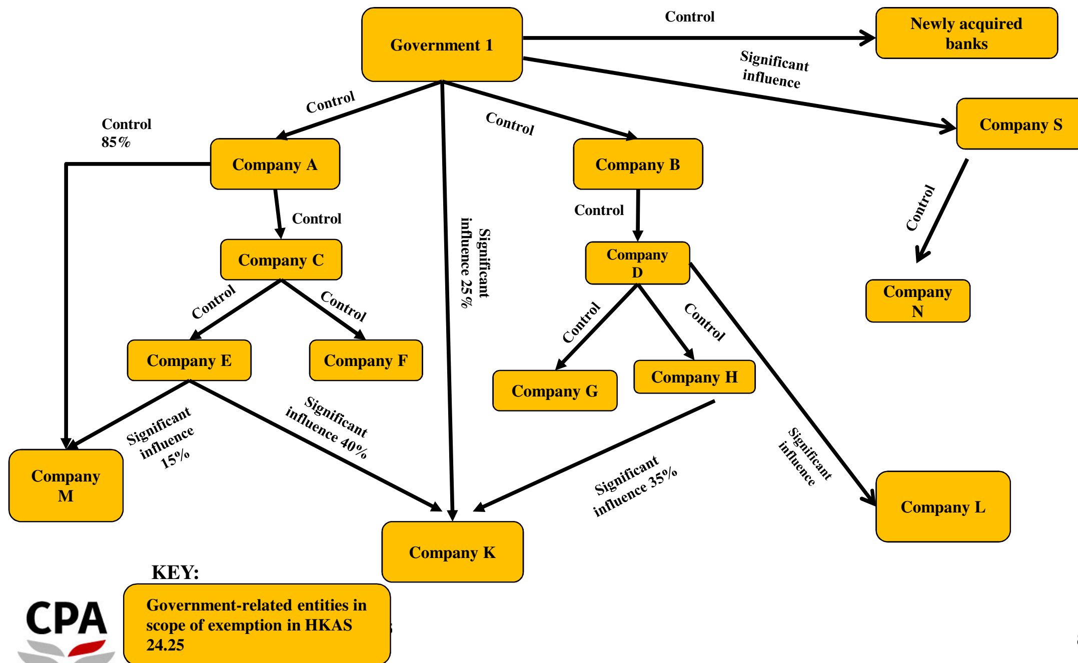
Government-related entities in scope exemption



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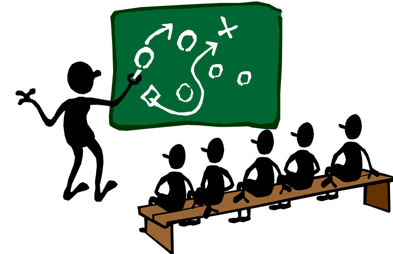
A Refresher Course on Current Financial Reporting Standards 2013 (Day 2)

Associates and joint arrangements



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HKAS 23
Borrowing Costs

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Agenda

- Core principle of HKAS 23
- Borrowing costs
- Qualifying assets
- Costs eligible for capitalisation
- Period of capitalisation of directly attributable costs and borrowing costs
- Disclosures

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Agenda

- Core principle of HKAS 23

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HKAS 23 – Core principle

- **Capitalise borrowing costs** that are directly attributable to the acquisition, construction, or production of a **qualifying asset**

  Exceptions: (i) qualifying assets measured at fair value
  (ii) inventories that are manufactured or produced in large quantities on a repetitive basis

- Other borrowing costs are recognised as an expense

- Borrowing costs are **reduced by interest income** from the **temporary investment of borrowings**

[HKAS 23.4,8]

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HKAS 23 – Core principle

Questions:

- Has the entity incurred borrowing costs?
- Does the entity have a qualifying asset ?
- Has the entity incurred expenditure on the qualifying asset?
- Are activities undertaken that are necessary to prepare the asset for its intended use or sale?

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Agenda

- Core principle of HKAS 23
- Borrowing costs

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Borrowing costs

- Borrowing costs are defined in HKAS 23 as "**Interest and other costs that an entity incurs in connection with the borrowing of funds**"

- Borrowing costs may include:
  - Interest expense calculated using the effective interest method
  - Finance charges in respect of finance leases recognised in accordance with HKAS 17
  - Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs

  [HKAS 23.5,6]

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Agenda

- Core principle of HKAS 23
- Borrowing costs
- Qualifying assets

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Qualifying asset

- A qualifying asset is defined as "**an asset that necessarily takes a substantial period of time to get ready for its intended use or sale**"
- There is **no specific guidance** on how long a **"substantial period of time"** is. Judgment required.
- The term **"necessarily"** is included in the definition of a qualifying asset to indicate that the nature of the asset should be such that it takes a long time to get it ready for its intended use or sale. Therefore, an asset that takes a long time to prepare for use or sale only because of inefficiencies in the development process is not a qualifying asset

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Qualifying asset (cont'd)

- Qualifying assets are not limited to property, plant and equipment, but also include assets such as **inventories that require a 'substantial period of time' to bring them to a saleable condition** (e.g. Whisky or property held for sale)

- **Assets that are ready for their intended use or sale when acquired are not qualifying assets**, even if expenditure subsequently is incurred on the asset

[HKAS 23.5,7]

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Examples of qualifying assets

Assets that may be qualifying assets	Non-qualifying assets
➢ inventories;	➢ assets that are ready for their intended use or sale when acquired;
➢ intangible assets;	
➢ investment properties;	➢ financial assets; and
➢ manufacturing plants; and	➢ inventories that are manufactured, or otherwise produced, over a short period of time
➢ power generation facilities	

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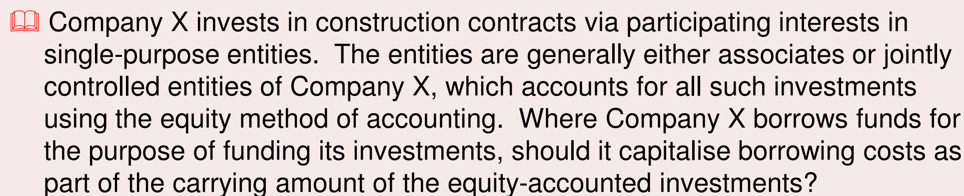
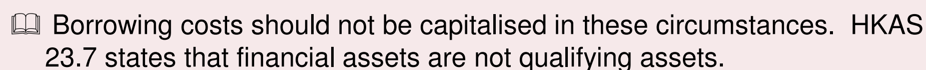
Example: whether an equity-accounted investment can be a qualifying asset

Background



- Company X invests in construction contracts via participating interests in single-purpose entities. The entities are generally either associates or jointly controlled entities of Company X, which accounts for all such investments using the equity method of accounting. Where Company X borrows funds for the purpose of funding its investments, should it capitalise borrowing costs as part of the carrying amount of the equity-accounted investments?

Answer



- Borrowing costs should not be capitalised in these circumstances. HKAS 23.7 states that financial assets are not qualifying assets.

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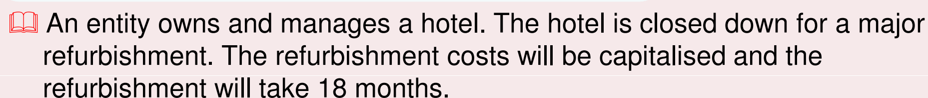
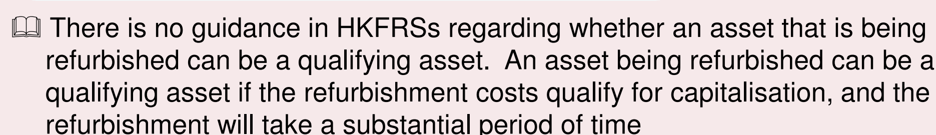
Example: Whether an asset being refurbished can be a qualifying asset?

Background



- An entity owns and manages a hotel. The hotel is closed down for a major refurbishment. The refurbishment costs will be capitalised and the refurbishment will take 18 months.

Answer



- There is no guidance in HKFRSs regarding whether an asset that is being refurbished can be a qualifying asset. An asset being refurbished can be a qualifying asset if the refurbishment costs qualify for capitalisation, and the refurbishment will take a substantial period of time

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Agenda

- Core principle of HKAS 23
- Borrowing costs
- Qualifying assets
- Costs eligible for capitalisation

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Borrowing costs eligible for capitalisation

- Borrowing costs eligible for capitalisation may include:
  - **Interest expense** calculated using the effective interest method, include:
    - Interest on specific borrowings to obtain the qualifying asset
    - Interest on general borrowings
  - **Finance charges** in respect of finance leases

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Costs eligible for capitalisation

- Directly attributable borrowing costs should be capitalised
- Directly attributable means that those borrowing costs that would have been avoided if there had been no expenditure on the asset
- Specific borrowings versus general borrowings
- The amount of borrowing costs to be capitalised is **calculated on a pre-tax basis**. Borrowing costs that are capitalised may give rise to deferred tax

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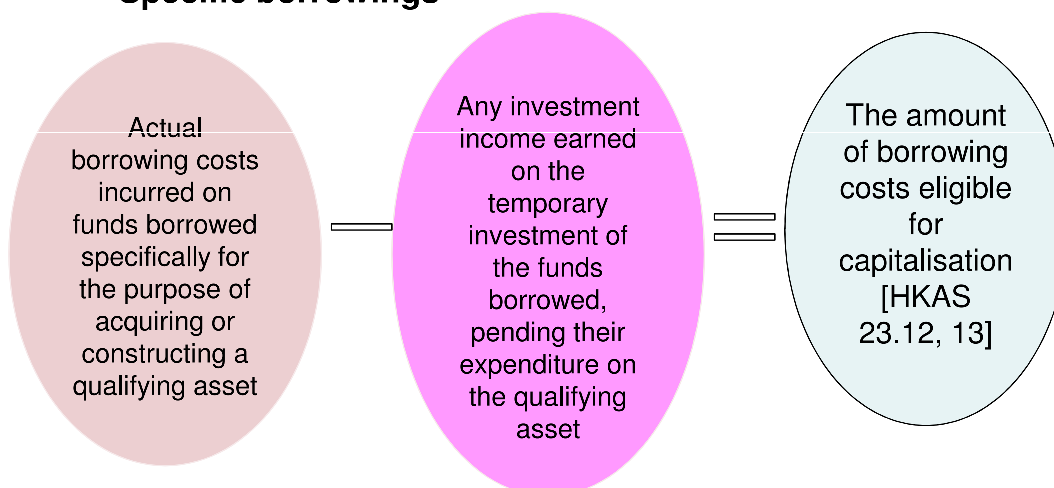
Amount of borrowing costs to be capitalised

- **Specific borrowings**



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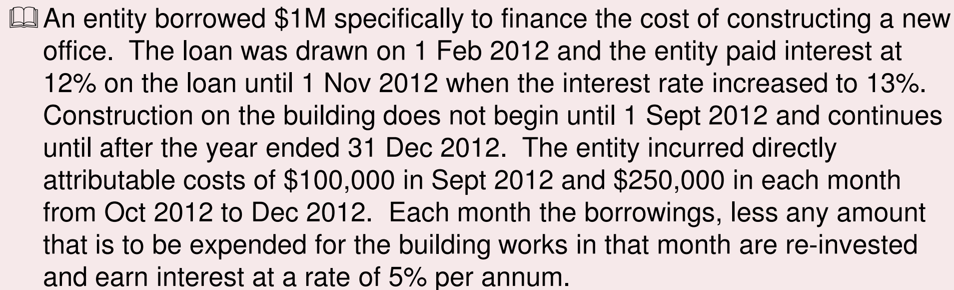
Example: Qualifying asset funded by specific borrowings

Background


An entity borrowed $1M specifically to finance the cost of constructing a new office. The loan was drawn on 1 Feb 2012 and the entity paid interest at 12% on the loan until 1 Nov 2012 when the interest rate increased to 13%. Construction on the building does not begin until 1 Sept 2012 and continues until after the year ended 31 Dec 2012. The entity incurred directly attributable costs of $100,000 in Sept 2012 and $250,000 in each month from Oct 2012 to Dec 2012. Each month the borrowings, less any amount that is to be expended for the building works in that month are re-invested and earn interest at a rate of 5% per annum.

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Example: Qualifying asset funded by specific borrowings (cont'd)

Interest capitalised:

The interest paid and received during the period of construction:

Balance outstanding	Interest
Interest payable for Sept 2012 at 12%	10,000
Interest payable for Oct 2012 at 12%	10,000
Interest payable for Nov 2012 at 13%	10,833
Interest payable for Dec 2012 at 13%	10,834
Total interest payable during period of construction to Dec 2012	41,667
Interest receivable on re-invested funds of $900,000 in Sept 2012	3,750
Interest receivable on re-invested funds of $650,000 in Oct 2012	2,708
Interest receivable on re-invested funds of $400,000 in Nov 2012	1,667
Interest receivable on re-invested funds of $150,000 in Dec 2012	625
Total interest receivable to end Dec 2012	8,750
Net interest cost capitalised	32,917

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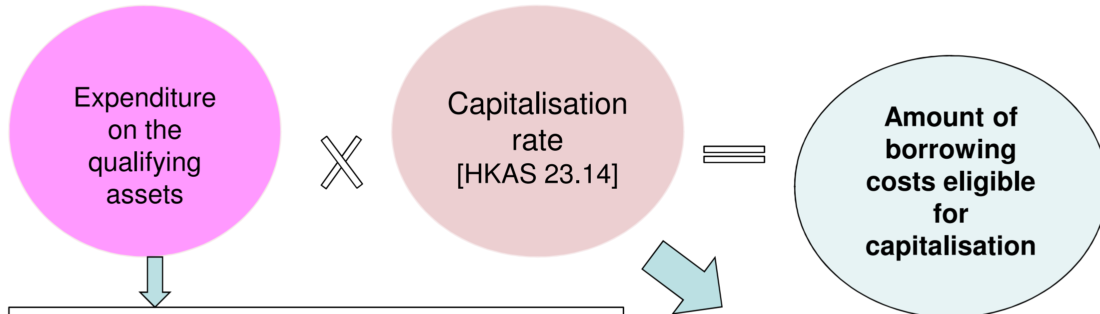
Amount of borrowing costs to be capitalised

- **General borrowing costs**



- should be reduced by any pre-sale deposits, progress payments or grants received in connection with the qualifying asset
- The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period

- Total general borrowing cost for the period (i.e. other than specific borrowings relating to qualifying assets) ÷ Weighted average total general borrowings (i.e. other than those specific borrowings)

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Example: Qualifying asset funded from a general borrowing pool

Background

- An entity centrally co-ordinates its financing activities through a treasury function, with borrowings being raised to finance general requirements, including the acquisition and development of qualifying assets
- During the year ended 31 December 2012, the entity commenced a property development project and incurred the following expenditure:

	HK$' 000
June 1	5,000
October 1	10,000
November 1	10,000

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Example: Qualifying asset funded from a general borrowing pool (cont'd)

Background (cont'd)

- The entity had total borrowings outstanding during the period, and incurred interest on those borrowings, as follows:

		Balance outstanding	Interest
Long term loans		HK$'000	HK$'000
	10 years at 10%	35,000	3,500
	5 years at 8%	10,000	800
Short-term loans*		12,000	1,600
Bank overdraft*		5,000	500
		62,000	6,400

* The amounts disclosed for short-term loans and the bank overdraft represent the average amounts outstanding during the period and the interest incurred at variable rates

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Example: Qualifying asset funded from a general borrowing pool (cont'd)

Question

- How much should Entity A capitalise its borrowing cost?

Answer

- Capitalisation rate:

Total borrowing costs for the period	=	**6,400**	= **10.32%**
Weighted average total borrowings		**62,000**	

- Interest capitalised is therefore calculated as follows:

	HK$'000
HK$5M x 7/12 x 10.32%	**301**
HK$10M x 3/12 x 10.32%	**258**
HK$10M x 2/12 x 10.32%	**172**
Interest capitalised for the period	**731**

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Limits on borrowing costs capitalised

The capitalisation of general borrowing costs calculated using the capitalisation rate is subject to the condition that the amount of borrowing costs capitalised should not exceed the actual borrowing costs incurred during that same period [HKAS 23.14]

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Limits on borrowing costs capitalised

- During 2012, CEF Ltd incurred general borrowings on 1 January for a general loan of $50,000 at 4% per annum. It also issued a debenture of $200,000 on 1 April 2012 at 5% per annum. CEF Ltd. Is constructing numerous qualifying assets and had capitalised $9,000 borrowing costs on other qualifying assets, excluding the qualifying asset A, for the year ended 31 December 2012. Expenses incurred as from 1 May 2012 on this qualifying asset A was $45,000.

- What are capitalised borrowing rate?
- How much costs should be capitalised?

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Limits on borrowing costs capitalised

- During 2012, CEF Ltd incurred general borrowings on 1 January for a general loan of $50,000 at 4% per annum. It also issued a debenture of $200,000 on 1 April 2012 at 5% per annum. CEF Ltd. Is constructing numerous qualifying assets and had capitalised $9,000 borrowing costs on other qualifying assets, excluding the qualifying asset A, for the year ended 31 December 2012. Expenses incurred as from 1 May 2012 on this qualifying asset A was $45,000.

- Capitalisation rate: 4.75%
  - Interest expense: $9,500
  - weighted average loan amount: [(50,000) + (200,000 x 9/12)] = $200,000
- Interest on qualifying asset: ($45,000 x 4.75%) x 8/12 = $1,425
- Borrowing costs to the amount of $500 would be capitalised on the qualifying asset A
- The balance of $925 would not be capitalised, since total borrowing costs capitalised would then exceed total borrowing cost incurred

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Calculation in the consolidated financial statements

- **No specific guidance** in HKFRSs related to the calculation in consolidated financial statements. Judgment is required.

- Where the treasury function is managed within the group - may include all borrowings of a parent and its subsidiaries when calculating the weighted average borrowing costs

- Where each subsidiary is responsible for managing its own treasury, may be appropriate for each subsidiary to calculate the weighted average applicable to its own borrowings

- **Only external borrowings should be considered in calculating a weighted average group borrowing rate**

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Example: Borrowing cost capitalised

Background

- A group consists of the parent and two subsidiaries. Sub 1 is engaged in the construction of a power plant that is wholly financed by fellow subsidiary 2, which obtains the necessary funds through bank borrowings. No intra group interest is charged by Subsidiary 2 to subsidiary 1

Question

- Can interest be capitalised?

Answer

- No interest should be capitalised in either of the individual financial statements of subsidiary 1 and subsidiary 2 under these circumstances. Subsidiary 1 has incurred no borrowing costs, and subsidiary 2 has no qualifying asset
- Interest will be capitalised in the consolidated financial statements of the parent, provided that the amount capitalised fairly reflect the interest cost to the group of borrowings from third parties which could have been avoided if the expenditure on the qualifying asset had not been made

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Example: Exchange differences to be included in borrowing costs

- An entity which prepares its financial statements in **Thai Baht** (the entity's **functional currency**) enters into a borrowing arrangement, with the following terms and conditions:

Drawdown amount (in the foreign currency)	**US $100M**
Drawdown date	1 January 2012
Exchange rate at drawdown	Baht 25: US$1
Interest rate on foreign borrowings (fixed)	6% per annum
Interest rate on similar borrowing in Thailand as at the drawdown date (fixed)	12% per annum
Average exchange rate for 2012	Baht 36: US$1
Closing exchange rate for 2012	Baht 47: US$1

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Example: Exchange differences to be included in borrowing costs (cont'd)

- The following interest payments were made in 2012:

Interest payments (6% X US$100M)	US$6M
Translated at average rate	**Baht 216 million**

- The borrowing costs that would have been incurred in the 2012 reporting period if the funds had been borrowed in Baht:

Baht equivalent of US$100M at 1 January 20X1	Baht 2,500 million
Annual interest expense based on Thai interest rates (12%)	**Baht 300 million**

- **Baht 84 million is the limit on the amount to be classified as borrowing costs.**

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Example: Exchange differences to be included in borrowing costs (cont'd)

- The foreign exchange loss incurred on the retranslation of the principal amount of the US$100 million borrowings during 2012 is calculated as follows:

Baht equivalent at opening rate of Baht 25: US$1	Baht 2,500 million
Baht equivalent at closing rate of Baht 47: US$1	Baht 4.700 million
Foreign exchange loss	**Baht 2,200 million**

- **The amount of borrowing costs included in the cost of assets under construction for 2012 = Baht 300 million** (the Baht equivalent of the US$ interest paid of Baht 216 million plus Baht 84 million of the exchange loss arising on the principal amount). This is equal to the interest expense that would have been incurred if the funds had been borrowed in Thailand based on commercial interest rate at that time
- The remaining exchange loss on the principal **(Baht 2,116 million) is recognised in profit or loss in the year**

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Agenda

- Core principle of HKAS 23
- Borrowing costs
- Qualifying assets
- Costs eligible for capitalisation
- Period of capitalisation of directly attributable costs and borrowing costs

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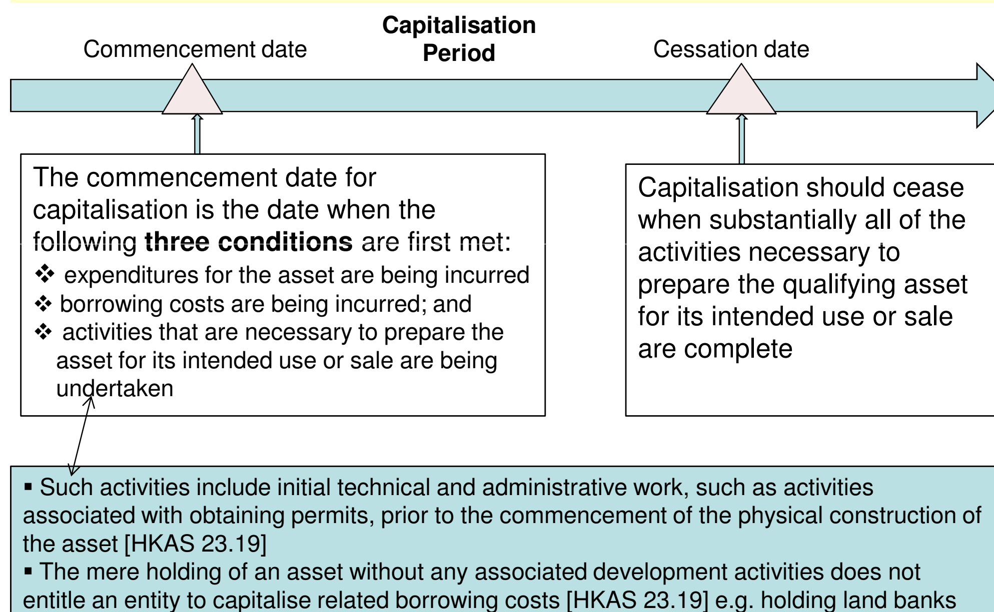
Period of capitalisation [HKAS 23.17,19]



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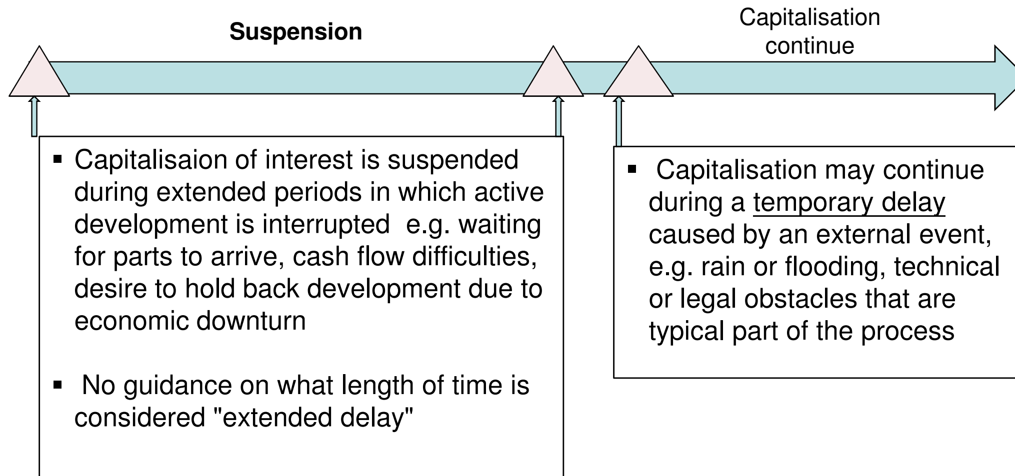
Suspension of capitalisation



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Qualifying assets – construction in stages

A qualifying asset is constructed in stages, and each stage or part can be used or sold individually while construction of the remaining development continues

- Capitalisation of the borrowing costs related to that part should cease when substantially all of the activities necessary to prepare that part for its intended use or sale are completed [HKAS 23.24]
- e.g. a development comprising several buildings or units, each of which can be used or sold individually

- Borrowing costs should be capitalised until all of the activities necessary to prepare the entire asset for its intended use or sale are substantially complete
- E.g. a manufacturing facility involving a sequence of processes, where production cannot begin until all the processes are in place

- **Capitalisation ceases when the activities necessary to prepare the asset for its intended use or sale are substantially complete**

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Recognition of an impairment loss or write-down

- When the carrying amount or the expected ultimate cost of the qualifying asset **exceeds** its recoverable amount or net realisable value, the carrying amount is **written down or written off** in accordance with the requirements of other HKFRSs. [HKAS 23.16]

  - **Capitalised the interest cost** as part of the gross carrying amount of the asset, and then **recognise an impairment loss** for any excess over the estimated recoverable amount or net realisable value in accordance with the requirements of HKAS 36 "Impairment of Assets" or HKAS 2 "Inventories", as appropriate

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Agenda

- ❑ **Core principle of HKAS 23**
- ❑ **Borrowing costs**
- ❑ **Qualifying assets**
- ❑ **Costs eligible for capitalisation**
- ❑ **Period of capitalisation of directly attributable costs and borrowing costs**
- ❑ **Disclosures**

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Disclosures

- Entities are required to disclose: [HKAS 23.26]
  - the **amount of borrowing costs capitalised** during the period; and
  - the **capitalisation rate** used to determine the amount of borrowing costs eligible for capitalisation

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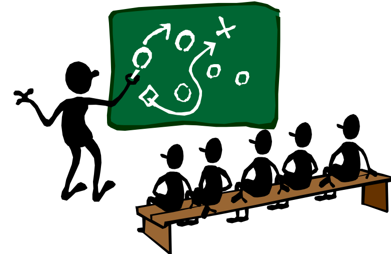
A Refresher Course on Current Financial Reporting Standards 2013 (Day 2)

HKAS 37

Provisions, Contingent Liabilities and Contingent Assets



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HKAS 37

Provisions, Contingent Liabilities and Contingent Assets

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Agenda

- Objectives and scope of HKAS 37
- Provisions vs Other liabilities
- Recognising provision under HKAS 37
- Contingent liability/asset
- Measurement
- Restructuring costs
- Onerous contract

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Agenda

- Objectives and scope of HKAS 37

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Introduction

- **What is a liability?**
  - HKAS 37 defines a liability as a "**present obligation** of the entity arising from **past events**, the settlement of which is expected to result in an **outflow from the entity of resources** embodying economic benefits" [HKAS 37.10]

- **What is a provision?**
  - A provision is defined in HKAS 37 as **"a liability of uncertain timing or amount"** [HKAS 37.10]

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Objective of HKAS 37

The objective of HKAS 37 is to ensure (i) that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and (ii) that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount

- The recognition and disclosure requirements are designed to prohibit:
  - The creation of provisions where there is no liability
  - The use of old provisions created for one purpose to meet new expenditure for a different purpose; and
  - The undisclosed release of provisions into profit or loss

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Scope of HKAS 37

- The requirements of HKAS 37 apply to all provisions, contingent liabilities and contingent assets other than those:
  - Resulting from **executory contracts**, **except where the contract is onerous** [HKAS 37.1(a)]; and
  - **Financial instruments (including guarantees)** that are within the scope of HKAS 39 [HKAS 37.2]
  - **Covered by another Standard** dealing with a more specific type of provision, contingent liability or contingent asset, such as the acquirer's treatment of contingent liabilities assumed in a business combination under HKFRS 3, construction contracts under HKAS 11 etc. [HKAS 37.1(c)]

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What is an executory contract?

- Executory contracts are contracts under which neither party has performed any of its obligations, or both parties have partially performed their obligations to an equal extent [HKAS 37.3]

Executory contracts do not fall within the scope of HKAS 37, unless they are onerous

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Illustration of executory contract

- On 1 January 2012, Entity A entered into a contract with Entity B for the manufacture and delivery of 100 units of component Q at five different dates in the future, i.e. 500 units are to be delivered in total. Payment is due on delivery of the units
- On **1 January 2012**, the **contract** between Entity A and Entity B is **executory because neither party has performed any of its obligations**: Entity B has neither manufactured nor delivered any of the units, nor has Entity A paid for any of them
- By **1 March 2012**, Entity B has produced and delivered 200 of the units and Entity A has paid in full for those 200 units. At this date, the contract between Entity A and Entity B continues to be **executory because both parties have partially performed their obligations to an equal extent**
- By **1 June 2012**, Entity B has produced and delivered the full 500 units, but Entity A has only paid for 400 units in total. The contract between Entity A and Entity B no longer meets the definition of an executory contract because the two parties have not performed under the terms of the contract to an equal extent. Entity A is required to **recognise a liability** for the final 100 units of component Q for which it has not yet paid

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Agenda

- ❑ **Objectives and scope of HKAS 37**
- ❑ **Provisions vs Other liabilities**

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Use of the term provision [HKAS 37.7]

- The use of the term "provision" is restricted to liabilities of uncertain timing or amount
- It does not cover adjustments to the carrying amounts of assets (such as depreciation, impairment and allowances for doubtful debts) for which the term "provision" is used in some jurisdiction

Allowance for bad debts instead of provision for bad debts

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Provisions versus other liabilities

- Provisions can be distinguished from other types of liability, including those that involve uncertain amounts, by considering the events that give rise to the obligation and also the **degree of uncertainty** about the **amount of the payment** or the **timing of the payment**

Examples	Classifications	Degree of uncertainty
Goods & services that have been received or supplied and have been invoiced or formally agreed with the supplier	Trade payables	None
Goods & services that have been received but have not been invoiced or formally agreed with the supplier	Accrued expenses	Some (the degree of uncertainty is generally much less than the uncertainty of provisions)
Legal claim from supplier for breach of exclusive supply agreement	Provision (if conditions met)	Significant

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Further examples: Provisions versus Other liabilities

Nature of the obligation	Provision	Other liabilities	Comments
Warranties given for goods or services sold	✔		
Refunds given for goods sold	✔		
Payments for damages connected with legal cases that are probable	✔		
Holiday pay earned by employees		✔	Accrual – short-term compensated absences are recognised in accordance with HKAS 19
Interest payments/property rentals		✔	Accrual – the service has been received and amount of payment is known
Ordinary dividend declared and authorised and approved before the period end		✔	Recognise as a current financial liability

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Provisions versus Other liabilities

- ***Accruals are often presented as part of trade and other payables, whereas provisions are reported separately*** **[HKAS 37.11]**
- ***Provisions are subject to disclosure requirements that do not apply to other payables***
  - ***For each class of provision an entity should provide a reconciliation of the carrying amount of the provision at the beginning and end of the period showing***

    (a) Additional provisions made in the period, including increases to existing provisions
    (b) Amounts used, i.e. incurred and charged against the provision, during the period
    (c) Unused amounts reversed during the period; and
    (d) 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***

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Agenda

- Objectives and scope of HKAS 37
- Provisions vs Other liabilities
- **Recognising provision under HKAS 37**

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Recognising provision under HKAS 37

- A provision is a liability of uncertain timing or amount. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits [HKAS 37.10]

- Following from the definition of a provision, the standard requires that a provision should only be recognised where **all** of the following conditions are met:
  - an entity has a **present obligation** (legal or constructive) as a result of a **past event**;
  - it is **probable that an outflow of resources** embodying economic benefits will be required to settle the obligation; and
  - a **reliable estimate** can be made of the amount of the obligation

If these conditions are not met, no provision shall be recognised

[HKAS 37.14]

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Present obligation and past events

- A present obligation can stem from a legal agreement (a "**legal obligation**") or may be constructive in nature (a "**constructive obligation**")

- **Legal obligation**
  - Can derive from a contract (e.g. a manufacturer gives warranties at the time of sale to purchasers of its products), legislation (e.g. clean-up cost), or other operation of law

- **Constructive obligation**
  - An obligation that **derives from an entity's actions** by an established pattern of past practice or published policies which has created a valid expectation on the part of those other parties that it will discharge those responsibilities (e.g. a retail store has a policy of refunding any return by dissatisfied customers within 7 days, even though no legal obligation to do so, its policy of making refunds is generally known)

[HKAS 37.10)

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Present obligation and past events

- In order for there to be a liability and a need to make a provision, it is necessary for something to have happened in the past (a "past event') to trigger a present obligation ("obligating event")

- For an event to be an obligating event, it is necessary that the entity has **no realistic alternative** to settling the obligation created by the event. This is case only:
  - where the settlement of the obligation can be enforced by law; or
  - in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation

- Example:
  - the obligating event giving rise to the need to make a warranty provision is the original sale of goods under warranty

[HKAS 37.17]

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Present obligation and past events

- Financial statement deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, **no provision is recognised for costs that need to be incurred to operate in the future**. The only liabilities recognised in an entity's statement of financial position are those that exist at the end of the reporting period

- Only those **obligations arising from past events existing independently of an entity's future actions** (ie, future conduct of its business) that are **recognised as provisions**

[HKAS 37.18, 19]

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Uncertainty about whether an obligation exists

- In rare circumstances where there has been a past event it may not be clear whether there is a present obligation (particularly in the case of a legal claim, an entity may dispute whether there is an obligation even if it is clear that there is a past event)

- In these cases, a past event is deemed to give rise to a present obligation if it is **more likely than not** that a present obligation exists at the reporting date

[HKAS 37.15]

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Uncertainty about whether an obligation exists

- An entity determines whether a present obligation exists at the end of the reporting period by **taking account of all available evidence, including, the opinion of experts**. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence:
  - Where it s **more likely than not** that a present obligation exists at the end of the reporting period, the entity **recognises a provision** (if the recognition criteria are met); and
  - Where it is **more likely that no present obligation exists** at the end of the reporting period, the entity **discloses a contingent liability**, **unless the possibility of an outflow of resources embodying economic benefits is remote**

[HKAS 37.16]

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Example: Obligating events – regulatory notification

- Entity A received a notice from the environment agency that investigations will be made on claims of pollution caused by the entity because neighbours living near entity A's factory claim that its operations have caused ground water contamination
- The investigation will only consider whether entity A has caused contamination and, if so, what penalties and fines should be levied on it
- Manufacturing operations have been conducted at the site for 150 years, but entity A acquired the factory only 50 years ago
- Entity A has used toxins at the plant, but only to an extent that is unlikely to cause pollution according to available records. However, management is not sure whether it has all the information about the entire 50 years. Therefore, neither management nor external experts are able to assess entity A's responsibility until the investigation is completed

Should management recognise a provision in this situation?

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Example: Obligating events – regulatory notification

- Analysis:
  - Management considers all available evidence on whether or not a present obligation exists
  - The available evidence does not support a conclusion that a present obligation exists
  - Disclose the contingent liability for potential penalties and fines that may be imposed if past contamination is proved, but not recognise a liability for the potential penalties and fine at the balance sheet date
  - If, and to the extent that, the entity is obligated at the balance sheet to meet any costs of the investigation, irrespective of the outcome of the investigation, the entity recognises a liability for such costs at the balance sheet date

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Probable outflow of economic benefits and reliable estimate

- The standard emphasises that, in nearly all cases, an entity will be able to determine a range of possible outcomes and will generally be competent to make an estimate of an obligation that will be sufficiently reliable to use in recognising a provision [HKAS 37.25]

- In **extreme rare cases**, there will be situations where it will not be possible for even an expert to make a reliable estimate of the obligation such that a provision can be made. In this type of circumstance, because of the uncertainty in the measurement of the obligation, the liability is disclosed as a contingent liability [HKAS 37.26]

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Counterparty

- An obligation always involves another party to whom the obligation is owed. However, an entity is not required to be able to identify the counterparty to the obligation before a provision is recognised

[HKAS 37.20]

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Illustration of the recognition criteria

Situation	Provision?	Action
Past event has occurred, resulting in a **possible obligation** for which a transfer of benefits is possible but **not probable**	X	**Unless** the possibility of a transfer of benefits is **remote**, **disclose a contingent liability**
Past event has occurred, resulting in a **present obligation** for which there may **possibly be a transfer of benefits**, but for which there **probably will not**	X	**Unless** the possibility of a transfer of benefits is **remote**, **disclose a contingent liability**
Past event has occurred, resulting in a **present obligation** for which it is likely there will be a transfer of benefits, but a **reliably estimate cannot be made** of the amount of the obligation	X	**Disclose a contingent liability** (note: this situation is likely to be very rare)

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Illustration of the recognition criteria (cont'd)

Situation	Provision?	Action
Past event has occurred, resulting in a **present obligation** for which it is **likely** there will be a **transfer of benefits**, a **reliable estimate** can be made of the amount of the obligation	✔	**Recognise provision** and make necessary disclosure
An **obligating event has not taken place by the end of the reporting period, but it takes place after the reporting period**, resulting in an obligation for which it is likely there will be a transfer of benefits; a reliable estimate can be made of the amount of the obligation	X	Consider whether the requirements of **HKAS 10 *Events after the Reporting Period*** require the disclosure of the non-adjusting event that has arisen

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Agenda

- ❑ Objectives and scope of HKAS 37
- ❑ Provisions vs Other liabilities
- ❑ Recognising provision under HKAS 37
- ❑ Contingent liability/asset

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Contingent liability

- A contingent liability can arise in the following three situations where there is a:
  - **Present obligation as a result of a past event**
    - That probably requires an outflow of resources embodying economic benefits, but where the **obligation cannot be measured reliably**
    - That may, but **will probably not, require an outflow of resources** embodying economic benefits
  - **Possible obligation as a result of a past event**, that may, but will **probably not, require an outflow of resources** embodying economic benefits

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Contingent liability (cont'd)

- A contingent liability should **not** be **recognised**, but **should be disclosed** unless the possibility of an outflow of resources embodying economic benefits is remote [HKAS 37.27, 28]
- **Contingent liabilities are reviewed continuously to assess whether an outflow of resources has become probable**. If the recognition criteria are met, then a liability is recognised in the statement of financial position in which the change in probability occurs [HKAS 37.30]
- Contingent liabilities are **not recognised** in the statement of financial position **unless they were assumed in a business combination**

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Joint and several liability

- Where an entity is jointly and severally liable for an obligation, the entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable
- The remainder, expected to be paid by other parties, is a contingent liability

[HKAS 37.29]

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Contingent asset

- Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity (e.g., a claim that an entity is pursuing through legal processes, where the outcome is uncertain)
- **Contingent assets are not recognised in the statement of financial position** because this may result in the recognition of income that may never be realised. When the **realisation of income is virtually certain**, then the related asset is not a contingent asset and its **recognition is appropriate**
- A contingent asset is **disclosed** where **an inflow of economic benefits is probable**

An entity should not recognise a contingent asset

[HKAS 37.31-34]

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- Objectives and scope of HKAS 37
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- Measurement

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Measurement

- The amount recognised as a provision shall be the **best estimate of the expenditure** required to settle the present obligation at the end of the reporting period

[HKAS 37.36]

HKAS 37.26 concludes that the circumstances in which the entity will not be possible to reach a reliable estimate will be extremely rare. That liability will instead be disclosed as a contingent liability

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Measurement (cont'd)

- Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur (e.g. An entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology)

- Gain from the expected disposal of assets shall not be taken into account in measuring a provision

[HKAS 37.48, 51]

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Estimation techniques

- If the provision is being made for a large population of items, then the provision is measured at its **expected value**

- Examples: product warranties

Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used

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Examples: Estimation techniques – large population

- Scenario:
  - An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent with the first six months after purchase
  - If minor defects were detected in all products sold, repair costs of $1M would result
  - If major defects were detected in all products sold, repair costs of $4M would result
  - The entity's past experience and future expectations indicate that, for the last six month's sales, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects
  - The entity assesses the probability of an outflow for the warranty obligations as a whole

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Examples: Estimation techniques – large population

- Analysis:
  - The expected value of the cost of repairs is:

    (75% x $nil) + (20% x $1M) + (5% of $4M) = $400,000

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Estimation techniques – Single obligations

- If the provision is for a single item, **the most likely outcome usually is the best estimate**

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Examples: Estimation techniques – Single obligations

- Scenario:
  - An entity faces a single legal claim, with a 40% likelihood of success with no cost and a 60% likelihood of failure with a cost of HK$1M
- Analysis:
  - Expected value is not valid
  - It is more likely that the cost of HK$1M will result
  - Therefore, a provision for HK$1M will be recognised

Where the provision relates to a single event, or a smaller number of events, expected value is not a valid technique

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Examples: Estimation techniques – Single obligations

- Scenario:
  - An entity is required to replace a major component in an asset under warranty
  - Each replacement costs HK$1M
  - From experience, there is a 30% chance of a single failure, a 50% chance of two failures, and a 20% chance of three failures
- Analysis:
  - The most likely outcomes is two failures, costing HK$2M
  - The expected value is HK$1.9M ((30% x HK$1M) + (50% x HK$2M) + (20% x HK$3m))
  - The expected value supports the provision for the most likely outcome of HK$2M

Where the most likely outcome is close to the expected value, it will be appropriate to provide for the most likely outcome, since expected value provides evidence of the probable outflow of benefits

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Examples: Estimation techniques – Single obligations

- Scenario:
  - An entity is required to replace a major component in an asset under a warranty
  - Each replacement costs HK$1M
  - From experience, there is 40% chance of a single failure, a 30% chance of two failures, and a 30% chance of three failures
- Analysis:
  - The most likely outcome is a single failure, costing HK$1M
  - The expected value is HK$1.9M ((40% x HK$1M) + (30% x HK$2M) + (30% x HK$3M)
  - The most likely outcomes of HK$1M has only a 40% probability
  - There is a 60% probability that the cost will be higher
  - The outcome closest to expected value is HK$2M, i.e. two failures

Where the most likely outcome and the expected value are not close together, it will often be appropriate to provide for whichever possible outcome is nearest to the expected value

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Estimation techniques – Single obligations

Irrespective of the method applied, in relation to very material items, entities may wish to consider whether it would be appropriate to provide any further information, e.g. the range of possible outcomes

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Discounting

- HKAS 37 requires that where **the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation**
- For the majority of provisions that will reverse in the short-term, the effects of discounting may be immaterial and are not then required to be made

[HKAS 37.45]

In practice the standard makes it clear that it only requires cash flows to be discounted where it has a material effect

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Choice of discount rate

- The discount rate selected should:
  - be pre-tax;
  - reflect current market assessments of the time value of money; and
  - reflect risks specific to the liability

Under HKAS 37, it is acceptable to reflect risk either in the estimation of cash flows or by adjusting the discount rate

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Discount rate

- An entity sells a vacuum cleaner, model A, on which it provides a standard warranty of a 3-year guarantee for parts and labour
- At the beginning of the year, the entity manufactures a new range of vacuum cleaner, model B. Model B is a high-end vacuum cleaner and uses the latest technology. The entity also provides a standard warranty of a 3-year guarantee for parts and labour
- It is presumed that the standard warranty represents an insignificant part of the sales transaction and is not a separate element

How should the discount rate be determined for warranty provisions?

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Discount rate (cont'd)

- Analysis:
  - Should not use the same rate in discounting the warranty provision for model A and model B
  - The provisions are for different products that display different kinds of risk and, therefore, unless otherwise reflected in the gross cash flow estimates, different discount rates should be used
  - The entity may take into account the discount rate of model A, adjust it to reflect specific risks of model B and to exclude specific risks of model A

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Continued recognition and reversal

- Provisions should be reviewed at each balance sheet date and adjusted to reflect current best estimates
- 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
- **A provision shall be used for the expenditures for which it was originally set up and should be reversed when it is no longer required**

[HKAS 37.59, 61]

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Continue recognition and reversal (cont'd)

- Adjustments to provisions arise from three sources:
  - revisions to estimated cash flows (both amount and likelihood)
  - changes to present value due to the passage of time; and
  - revisions of discount rates to reflect prevailing current market conditions

- 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

- The effect of revising estimates of cash flows is not part of this unwinding and should be dealt with as part of any adjustment to the previous provision

[HKAS 37.60]

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Unwinding the discount

- Entity A has litigation pending. Legal advise is that entity A will lose the case and costs of $1,200 in two years' time are estimated. The liability is recognised on a discounted basis. The discount rate at which the liability has been discounted is the nominal risk free rate which is 4.5%. Assume the discount rate does not change

	Discount at 4.5%	NPV	Cash flows	Borrowing costs
	0.9157	1,099		
Year 1	0.9569	1,148		49
Year 2	1.0000	1,200	1,200	52

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Reimbursements

- An entity with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party via:
  - an insurance contract arranged to cover a risk;
  - an indemnity clause in a contract; or
  - a warranty provided by a supplier

- Reimbursements are **recognsied as a separate asset when recovery is virtually certain**. The amount recognised is **limited to the amount of the related provision**

The expectation that an outflow related to an obligation will be reimbursed does not affect the assessment of the probability of an outflow for the obligation

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Reimbursements (cont'd)

- The appropriate presentation of a reimbursement is:
  - in the statement of financial position, a separate asset is recognised (which must not exceed the amount of the provision)
  - in the statement of comprehensive income, a net amount may be presented, being the anticipated cost of the obligation less the reimbursement

[HKAS 37.53, 54]

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Example: Reimbursement

- Scenario:
  - A customer sue Entity A for $300 for a defective products purchased from entity A
  - Entity A can recover the cost of the defect and a penalty of 12% from the supplier
  - The supplier has confirmed that it will pay $336 ($300 + (300 x 12%)) to entity A as soon as entity A paid the customer
- Analysis:
  - Entity A should recognise a provision for the claim of $300
  - Recognise the reimbursement of $300 as a separate asset
  - The expense and the reimbursement may be netted in the statement of comprehensive income
  - The asset and the provision are not netted in the statement of financial position and presented gross
  - Entity A discloses the unrecognised reimbursement of $36 in the notes to the financial statements

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Agenda

- **Objectives and scope of HKAS 37**
- **Provisions vs Other liabilities**
- **Recognising provision under HKAS 37**
- **Contingent liability/asset**
- **Measurement**
- **Restructuring costs**
- **Onerous contract**

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Restructuring

- A restructuring is a programme planned and controlled by management that materially changes the scope of the business or the manner in which it is conducted

- **A constructive obligation for a restructuring arises only when**:
  - there is **a formal plan for the restructuring** specifying
    - the business or part of a business concerned
    - the principal locations affected
    - the location, function and approximate number of employees whose services will be terminated
    - the expenditure to be incurred; and
    - when the plan will be implemented
  - **and the entity has raised a valid expectation in those affected that it will carry out the plan** by either
    - starting to implement the plan; or
    - announcing its main features to those affected by it

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Examples: Restructuring

- Scenario:
  - In a monthly meeting held on 12 December 2012 the board of an entity resolved to close down a division
  - The board also decided not to communicate this resolution to any of those affected before 13 January 2013
  - No other steps were taken to implement the decision until that date
  - The current financial year of the entity ends at 31 December 2012
  - Should a provision be made?

- Analysis:
  - There has been no obligating event occurred before the year end
  - So there is no obligation
  - No provision is required at 31 December 2012

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Examples: Restructuring

- Scenario:
  - In a monthly meeting held on 12 December 2012 the board of an entity resolved to close down a division
  - In a special meeting on 20 December 2012 a detailed plan for closing down the division prepared by the General Manager was endorsed by the board
  - Immediately after the special meeting, letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division
  - The current financial year of the entity ends at 31 December 2012
  - Should a provision be made?
- Analysis:
  - The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed
  - A provision is recognised at 31 December 2012 for the best estimate of the costs of closing the division

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Restructuring (cont'd)

- An obligation related to the **sale of an operation** arises only when there is a **binding sale agreement**. Even though the decision to sell an operation has been announced, no provision is recognised for obligations arising as a result of the sale until there is a binding sale agreement

- There is no specific requirements for the contents of the announcement. However, the announcement should be **sufficiently explicit to create a valid expectation in those affected that the plan will be implemented.**

- **An entity is not required to know the identity of the counterparty to the obligation before a provision is recognised**. Therefore, it is not necessary to notify individual counterparties (e.g. each employee or vendor) before a provision is recognised.

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Restructuring (cont'd)

- For a plan to create a constructive obligation, implementation should begin as soon as possible and it should be completed in a timeframe that would not allow for significant changes to the plan

- Restructuring provisions **include only incremental costs associated directly with the restructuring.** Amounts to be recognised in a restructuring provision include:
  - employee termination benefits that relate directly to the restructuring
  - contract termination costs e.g. lease termination penalties
  - onerous contract provisions
  - consulting fee that relate directly to the restructuring
  - expected costs from when operations cease until final disposal

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Restructuring (cont'd)

- The Standard prohibits recognition of provision for costs associated with ongoing activities. Therefore restructuring provisions are not recognised for:
  - costs of retaining or relocating continuing staff
  - marketing and administrative costs
  - investment in new systems and distribution networks
  - loyalty bonuses or amounts paid to staff as an incentive to stay

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Future operating costs

- HKAS 37 seeks to stop artificial "smoothing" of results
- Entities will no longer be able to provide on an annual basis for items such as future repairs, so as to produce a reasonably level charge each year
- Such costs will instead generally be charged to profit or loss when they are actually incurred, i.e. when the work is done

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Determining whether a contract is onerous

- An onerous contract is one in which the unavoidable cost of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract
- In assessing whether a contract is onerous, it is necessary to consider:
  - the unavoidable costs of meeting the contractual obligations, which is the lower of the net costs fulfilling the contract and cost of terminating it; and
  - the economic benefits expected to be received.

HKAS 37 requires that if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision

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Examples: Onerous contracts

- Scenario 1:
  - An entity operates profitably in a factory that it has leased under an operating lease
  - During the year ended 31 December 2012 the entity relocates its operations to a new factory
  - The lease on the old factory continues for the next four years
  - It cannot be cancelled and it is unlikely that the entity can sub-let the factory to another user

- Scenario 2:
  - Same facts as above except that the factory can be let to the Cultural Development Department as an exhibition centre for artists, generating a low level of income

Should provision be made?

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Examples: Onerous contracts

- Analysis:

Scenario 1:

- The obligating event is the signing of the lease contract which gives rise to a legal obligation
- The lease becomes onerous since it is almost certain that the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it
- A provision is recognised for the best estimate of the unavoidable lease payments

Scenario 2:

- Similar to Scenario 1 that the lease becomes onerous
- A provision is recognised for the best estimate of the net amount of the unavoidable lease costs
- i.e. the gross unavoidable lease costs less the probable net revenue expected from the sub-letting

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Examples: Onerous contracts

- Example: Determination of costs for an onerous contract

  - Company F leases office space for an annual rental of $20. The remaining lease term is 5 years, although after 2 years, F has an option to cancel the lease and pay a penalty of $25.
  - The cost of fulfilling the contract is $75 (the present value of $20 X 5).
  - The cost of terminating the contract is $60 (the present value of ($20 x 2 + $25).
  - The cost used to determine whether the contract is onerous should be $60.

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Financial Guarantee Contract

- Financial guarantee contract are within the scope of HKAS 39 unless the issuer of the contract has previously asserted explicitly that it regards such contracts as insurance contracts. **Generally, when a financial guarantee recgonised under HKAS 39 or HKFRS 4 becomes probable of being exercised, the provision is measured in accordance with HKAS 37** [HKAS 39.2(e), 47(c)]

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Presentation and Disclosure

Reminders:

- ***Provisions are disclosed as a separate line item in the statement of position***
- ***Movements in each class of provisions during the reporting period are disclosed***
- ***Comparative period information is not required***
- ***Provisions that will be utilised within one year are classified as current liabilities***

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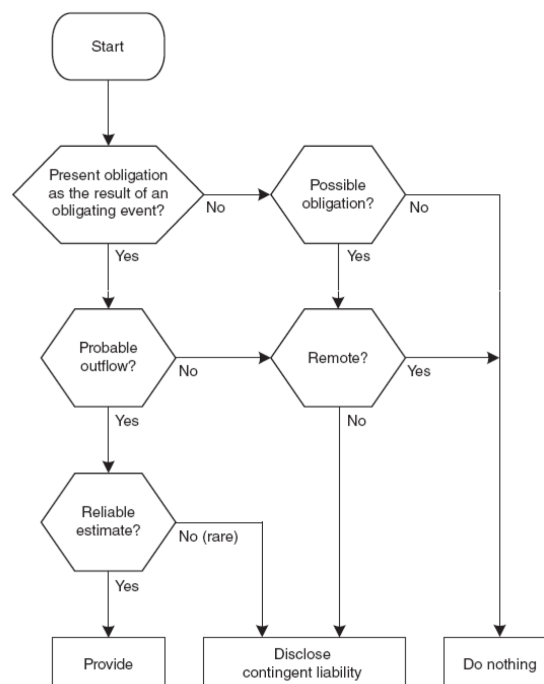
Final Recap



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Thank you for your attention

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Assessing the terms of the contractual arrangement		
	Joint operation	**Joint venture**
The terms of the contractual arrangement	The contractual arrangement provides the parties to the joint arrangement with rights to the assets, and obligations for the liabilities, relating to the arrangement.	The contractual arrangement provides the parties to the joint arrangement with rights to the net assets of the arrangement (ie it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities, relating to the arrangement).
Rights to assets	The contractual arrangement establishes that the parties to the joint arrangement share all interests (eg rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The contractual arrangement establishes that the assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie no rights, title or ownership) in the assets of the arrangement.
Obligations for liabilities	The contractual arrangement establishes that the parties to the joint arrangement share all liabilities, obligations, costs and expenses in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The contractual arrangement establishes that the joint arrangement is liable for the debts and obligations of the arrangement.
		The contractual arrangement establishes that the parties to the joint arrangement are liable to the arrangement only to the extent of their respective investments in the arrangement or to their respective obligations to contribute any unpaid or additional capital to the arrangement, or both.

Assessing the terms of the contractual arrangement		
	Joint operation	**Joint venture**
	The contractual arrangement establishes that the parties to the joint arrangement are liable for claims raised by third parties.	The contractual arrangement states that creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.
Revenues, expenses, profit or loss	The contractual arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly, which could differ from their ownership interest in the joint arrangement. In other instances, the parties might have agreed to share the profit or loss relating to the arrangement on the basis of a specified proportion such as the parties' ownership interest in the arrangement. This would not prevent the arrangement from being a joint operation if the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.
Guarantees	The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation. The feature that determines whether the joint arrangement is a joint operation or a joint venture is whether the parties have obligations for the liabilities relating to the arrangement (for some of which the parties might or might not have provided a guarantee).	

Appendix 2

HKFRS 11 IE
Issued June 2011

Illustrative Examples
Hong Kong Financial Reporting Standard 11

Joint Arrangements

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Illustrative examples

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Illustrative examples
IFRS 11 *Joint Arrangements*

These examples accompany, but are not part of, IFRS 11. They illustrate aspects of IFRS 11 but are not intended to provide interpretative guidance.

IE1 These examples portray hypothetical situations illustrating the judgements that might be used when applying IFRS 11 in different situations. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying IFRS 11.

Example 1 – Construction services

IE2 A and B (the parties) are two companies whose businesses are the provision of many types of public and private construction services. They set up a contractual arrangement to work together for the purpose of fulfilling a contract with a government for the design and construction of a road between two cities. The contractual arrangement determines the participation shares of A and B and establishes joint control of the arrangement, the subject matter of which is the delivery of the road.

IE3 The parties set up a separate vehicle (entity Z) through which to conduct the arrangement. Entity Z, on behalf of A and B, enters into the contract with the government. In addition, the assets and liabilities relating to the arrangement are held in entity Z. The main feature of entity Z's legal form is that the parties, not entity Z, have rights to the assets, and obligations for the liabilities, of the entity.

IE4 The contractual arrangement between A and B additionally establishes that:

(a) the rights to all the assets needed to undertake the activities of the arrangement are shared by the parties on the basis of their participation shares in the arrangement;

(b) the parties have several and joint responsibility for all operating and financial obligations relating to the activities of the arrangement on the basis of their participation shares in the arrangement; and

(c) the profit or loss resulting from the activities of the arrangement is shared by A and B on the basis of their participation shares in the arrangement.

IE5 For the purposes of co-ordinating and overseeing the activities, A and B appoint an operator, who will be an employee of one of the parties. After a specified time, the role of the operator will rotate to an employee of the other party. A and B agree that the activities will be executed by the operator's employees on a 'no gain or loss' basis.

IE6 In accordance with the terms specified in the contract with the government, entity Z invoices the construction services to the government on behalf of the parties.

Analysis

IE7 The joint arrangement is carried out through a separate vehicle whose legal form does not confer separation between the parties and the separate vehicle (ie the assets and liabilities held in entity Z are the parties' assets and liabilities). This is reinforced by the terms agreed by the parties in their contractual arrangement, which state that A and B have rights to the assets, and obligations for the liabilities, relating to the arrangement that is conducted through entity Z. The joint arrangement is a joint operation.

IE8 A and B each recognise in their financial statements their share of the assets (eg property, plant and equipment, accounts receivable) and their share of any liabilities resulting from the arrangement (eg accounts payable to third parties) on the basis of their agreed participation share. Each also recognises its share of the revenue and expenses resulting from the construction services provided to the government through entity Z.

Example 2 – Shopping centre operated jointly

IE9 Two real estate companies (the parties) set up a separate vehicle (entity X) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in entity X. The main feature of entity X's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

IE10 The terms of the contractual arrangement are such that:

(a) entity X owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.

(b) the parties are not liable in respect of the debts, liabilities or obligations of entity X. If entity X is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.

(c) the parties have the right to sell or pledge their interests in entity X.

(d) each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in entity X.

Analysis

IE11 The joint arrangement is carried out through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). In addition, the terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, relating to the arrangement. Instead, the terms of the contractual arrangement establish that the parties have rights to the net assets of entity X.

IE12 On the basis of the description above, there are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to the arrangement, and that the parties have an obligation for the liabilities relating to the arrangement. The joint arrangement is a joint venture.

IE13 The parties recognise their rights to the net assets of entity X as investments and account for them using the equity method.

Example 3 – Joint manufacturing and distribution of a product

IE14 Companies A and B (the parties) have set up a strategic and operating agreement (the framework agreement) in which they have agreed the terms according to which they will conduct the manufacturing and distribution of a product (product P) in different markets.

IE15 The parties have agreed to conduct manufacturing and distribution activities by establishing joint arrangements, as described below:

(a) Manufacturing activity: the parties have agreed to undertake the manufacturing activity through a joint arrangement (the manufacturing arrangement). The manufacturing arrangement is structured in a separate vehicle (entity M) whose legal form causes it to be considered in its own right (ie the assets and liabilities held in entity M are the assets and liabilities of entity M and not the assets and liabilities of the parties). In accordance with the framework agreement, the parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement in accordance with their ownership interests in entity M. The parties subsequently sell product P to another arrangement, jointly controlled by the two parties themselves, that has been established exclusively for the distribution of product P as described below. Neither the framework agreement nor the contractual arrangement between A and B dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity.

(b) Distribution activity: the parties have agreed to undertake the distribution activity through a joint arrangement (the distribution arrangement). The parties have structured the distribution arrangement in a separate vehicle (entity D) whose legal form causes it to be considered in its own right (ie the assets and liabilities held in entity D are the assets and liabilities of entity D and not the assets and liabilities of the parties). In accordance with the framework agreement, the distribution arrangement orders its requirements for product P from the parties according to the needs of the different markets where the distribution arrangement sells the product. Neither the framework agreement nor the contractual arrangement between A and B dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.

IE16 In addition, the framework agreement establishes:

(a) that the manufacturing arrangement will produce product P to meet the requirements for product P that the distribution arrangement places on the parties;

(b) the commercial terms relating to the sale of product P by the manufacturing arrangement to the parties. The manufacturing arrangement will sell product P to the parties at a price agreed by A and B that covers all production costs incurred. Subsequently, the parties sell the product to the distribution arrangement at a price agreed by A and B.

(c) that any cash shortages that the manufacturing arrangement may incur will be financed by the parties in accordance with their ownership interests in entity M.

Analysis

IE17 The framework agreement sets up the terms under which parties A and B conduct the manufacturing and distribution of product P. These activities are undertaken through joint arrangements whose purpose is either the manufacturing or the distribution of product P.

IE18 The parties carry out the manufacturing arrangement through entity M whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the contractual arrangement dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, when considering the following facts and circumstances the parties have concluded that the manufacturing arrangement is a joint operation:

(a) The parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement. Consequently, A and B have rights to substantially all the economic benefits of the assets of the manufacturing arrangement.

(b) The manufacturing arrangement manufactures product P to meet the quantity and quality needs of the parties so that they can fulfil the demand for product P of the distribution arrangement. The exclusive dependence of the manufacturing arrangement upon the parties for the generation of cash flows and the parties' commitments to provide funds when the manufacturing arrangement incurs any cash shortages indicate that the parties have an obligation for the liabilities of the manufacturing arrangement, because those liabilities will be settled through the parties' purchases of product P or by the parties' direct provision of funds.

IE19 The parties carry out the distribution activities through entity D, whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the contractual arrangement dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.

IE20 There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to the distribution arrangement or that the parties have an obligation for the liabilities relating to that arrangement. The distribution arrangement is a joint venture.

IE21 A and B each recognise in their financial statements their share of the assets (eg property, plant and equipment, cash) and their share of any liabilities resulting from the manufacturing arrangement (eg accounts payable to third parties) on the basis of their ownership interest in entity M. Each party also recognises its share of the expenses resulting from the manufacture of product P incurred by the manufacturing arrangement and its share of the revenues relating to the sales of product P to the distribution arrangement.

IE22 The parties recognise their rights to the net assets of the distribution arrangement as investments and account for them using the equity method.

Variation

IE23 Assume that the parties agree that the manufacturing arrangement described above is responsible not only for manufacturing product P, but also for its distribution to third-party customers.

IE24 The parties also agree to set up a distribution arrangement like the one described above to distribute product P exclusively to assist in widening the distribution of product P in additional specific markets.

IE25 The manufacturing arrangement also sells product P directly to the distribution arrangement. No fixed proportion of the production of the manufacturing arrangement is committed to be purchased by, or to be reserved to, the distribution arrangement.

Analysis

IE26 The variation has affected neither the legal form of the separate vehicle in which the manufacturing activity is conducted nor the contractual terms relating to the parties' rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, it causes the manufacturing arrangement to be a self-financed arrangement because it is able to undertake trade on its own behalf, distributing product P to third-party customers and, consequently, assuming demand, inventory and credit risks. Even though the manufacturing arrangement might also sell product P to the distribution arrangement, in this scenario the manufacturing arrangement is not dependent on the parties to be able to carry out its activities on a continuous basis. In this case, the manufacturing arrangement is a joint venture.

IE27 The variation has no effect on the classification of the distribution arrangement as a joint venture.

IE28 The parties recognise their rights to the net assets of the manufacturing arrangement and their rights to the net assets of the distribution arrangement as investments and account for them using the equity method.

Example 4 – Bank operated jointly

IE29 Banks A and B (the parties) agreed to combine their corporate, investment banking, asset management and services activities by establishing a separate vehicle (bank C). Both parties expect the arrangement to benefit them in different ways. Bank A believes that the arrangement could enable it to achieve its strategic plans to increase its size, offering an opportunity to exploit its full potential for organic growth through an enlarged offering of products and services. Bank B expects the arrangement to reinforce its offering in financial savings and market products.

IE30 The main feature of bank C's legal form is that it causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). Banks A and B each have a 40 per cent ownership interest in bank C, with the remaining 20 per cent being listed and widely held. The shareholders' agreement between bank A and bank B establishes joint control of the activities of bank C.

IE31 In addition, bank A and bank B entered into an irrevocable agreement under which, even in the event of a dispute, both banks agree to provide the necessary funds in equal amount and, if required, jointly and severally, to ensure that bank C complies with the applicable legislation and banking regulations, and honours any commitments made to the banking authorities. This commitment represents the assumption by each party of 50 per cent of any funds needed to ensure that bank C complies with legislation and banking regulations.

Analysis

IE32 The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of bank C, but it establishes that the parties have rights to the net assets of bank C. The commitment by the parties to provide support if bank C is not able to comply with the applicable legislation and banking regulations is not by itself a determinant that the parties have an obligation for the liabilities of bank C. There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of bank C and that the parties have an obligation for the liabilities of bank C. The joint arrangement is a joint venture.

IE33 Both banks A and B recognise their rights to the net assets of bank C as investments and account for them using the equity method.

Example 5 – Oil and gas exploration, development and production activities

IE34 Companies A and B (the parties) set up a separate vehicle (entity H) and a Joint Operating Agreement (JOA) to undertake oil and gas exploration, development and production activities in country O. The main feature of entity H's legal form is that it causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).

IE35 Country O has granted entity H permits for the oil and gas exploration, development and production activities to be undertaken in a specific assigned block of land (fields).

IE36 The shareholders' agreement and JOA agreed by the parties establish their rights and obligations relating to those activities. The main terms of those agreements are summarised below.

Shareholders' agreement

IE37 The board of entity H consists of a director from each party. Each party has a 50 per cent shareholding in entity H. The unanimous consent of the directors is required for any resolution to be passed.

Joint Operating Agreement (JOA)

IE38 The JOA establishes an Operating Committee. This Committee consists of one representative from each party. Each party has a 50 per cent participating interest in the Operating Committee.

IE39 The Operating Committee approves the budgets and work programmes relating to the activities, which also require the unanimous consent of the representatives of each party. One of the parties is appointed as operator and is responsible for managing and conducting the approved work programmes.

IE40 The JOA specifies that the rights and obligations arising from the exploration, development and production activities shall be shared among the parties in proportion to each party's shareholding in entity H. In particular, the JOA establishes that the parties share:

(a) the rights and the obligations arising from the exploration and development permits granted to entity H (eg the permits, rehabilitation liabilities, any royalties and taxes payable);

(b) the production obtained; and

(c) all costs associated with all work programmes.

IE41 The costs incurred in relation to all the work programmes are covered by cash calls on the parties. If either party fails to satisfy its monetary obligations, the other is required to contribute to entity H the amount in default. The amount in default is regarded as a debt owed by the defaulting party to the other party.

Analysis

IE42 The parties carry out the joint arrangement through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The parties have been able to reverse the initial assessment of their rights and obligations arising from the legal form of the separate vehicle in which the arrangement is conducted. They have done this by agreeing terms in the JOA that entitle them to rights to the assets (eg exploration and development permits, production, and any other assets arising from the activities) and obligations for the liabilities (eg all costs and obligations arising from the work programmes) that are held in entity H. The joint arrangement is a joint operation.

IE43 Both company A and company B recognise in their financial statements their own share of the assets and of any liabilities resulting from the arrangement on the basis of their agreed participating interest. On that basis, each party also recognises its share of the revenue (from the sale of their share of the production) and its share of the expenses.

Example 6 – Liquefied natural gas arrangement

IE44 Company A owns an undeveloped gas field that contains substantial gas resources. Company A determines that the gas field will be economically viable only if the gas is sold to customers in overseas markets. To do so, a liquefied natural gas (LNG) facility must be built to liquefy the gas so that it can be transported by ship to the overseas markets.

IE45 Company A enters into a joint arrangement with company B in order to develop and operate the gas field and the LNG facility. Under that arrangement, companies A and B (the parties) agree to contribute the gas field and cash, respectively, to a new separate vehicle, entity C. In exchange for those contributions, the parties each take a 50 per cent ownership interest in entity C. The main feature of entity C's legal form is that it causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).

IE46 The contractual arrangement between the parties specifies that:

(a) companies A and B must each appoint two members to the board of entity C. The board of directors must unanimously agree the strategy and investments made by entity C.

(b) day-to-day management of the gas field and LNG facility, including development and construction activities, will be undertaken by the staff of company B in accordance with the directions jointly agreed by the parties. Entity C will reimburse B for the costs it incurs in managing the gas field and LNG facility.

(c) entity C is liable for taxes and royalties on the production and sale of LNG as well as for other liabilities incurred in the ordinary course of business, such as accounts payable, site restoration and decommissioning liabilities.

(d) companies A and B have equal shares in the profit from the activities carried out in the arrangement and, as such, are entitled to equal shares of any dividends distributed by entity C.

IE47 The contractual arrangement does not specify that either party has rights to the assets, or obligations for the liabilities, of entity C.

IE48 The board of entity C decides to enter into a financing arrangement with a syndicate of lenders to help fund the development of the gas field and construction of the LNG facility. The estimated total cost of the development and construction is CU1,000 million.*

IE49 The lending syndicate provides entity C with a CU700 million loan. The arrangement specifies that the syndicate has recourse to companies A and B only if entity C defaults on the loan arrangement during the development of the field and construction of the LNG facility. The lending syndicate agrees that it will not have recourse to companies A and B once the LNG facility is in production because it has assessed that the cash inflows that entity C should generate from LNG sales will be sufficient to meet the loan repayments. Although at this time the lenders have no recourse to companies A and B, the syndicate maintains protection against default by entity C by taking a lien on the LNG facility.

* In this example monetary amounts are denominated in 'currency units (CU)'.

Analysis

IE50 The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of entity C, but they establish that the parties have rights to the net assets of entity C. The recourse nature of the financing arrangement during the development of the gas field and construction of the LNG facility (ie companies A and B providing separate guarantees during this phase) does not, by itself, impose on the parties an obligation for the liabilities of entity C (ie the loan is a liability of entity C). Companies A and B have separate liabilities, which are their guarantees to repay that loan if entity C defaults during the development and construction phase.

IE51 There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of entity C and that the parties have an obligation for the liabilities of entity C. The joint arrangement is a joint venture.

IE52 The parties recognise their rights to the net assets of entity C as investments and account for them using the equity method.

Appendix B
Application supplement

This appendix is an integral part of the HKFRS.

Extension of the period required to complete a sale

B1 As noted in paragraph 9, an extension of the period required to complete a sale does not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group). An exception to the one-year requirement in paragraph 8 shall therefore apply in the following situations in which such events or circumstances arise:

(a) at the date an entity commits itself to a plan to sell a non-current asset (or disposal group) it reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (or disposal group) that will extend the period required to complete the sale, and:

(i) actions necessary to respond to those conditions cannot be initiated until after a *firm purchase commitment* is obtained, and

(ii) a firm purchase commitment is highly probable within one year.

(b) an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a non-current asset (or disposal group) previously classified as held for sale that will extend the period required to complete the sale, and:

(i) timely actions necessary to respond to the conditions have been taken, and

(ii) a favourable resolution of the delaying factors is expected.

(c) during the initial one-year period, circumstances arise that were previously considered unlikely and, as a result, a non-current asset (or disposal group) previously classified as held for sale is not sold by the end of that period, and:

(i) during the initial one-year period the entity took action necessary to respond to the change in circumstances,

(ii) the non-current asset (or disposal group) is being actively marketed at a price that is reasonable, given the change in circumstances, and

(iii) the criteria in paragraphs 7 and 8 are met.

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Source	Hong Kong GAAP Limited			
HKAS 1.10(b), 81(a), 51(b),(c)	**Consolidated statement of comprehensive income for the year ended 31 December 2012**			**[Alt 1]**
HKAS 1.38, 113		Notes	Year ended 31/12/12	Year ended 31/12/11
HKAS 1.51(d),(e)			HK$'000	HK$'000 (restated)
	Continuing operations			
HKAS 1.82(a)	Revenue	5	140,918	151,840
HKAS 1.85, 99	Cost of sales		(87,897)	(91,840)
HKAS 1.85	Gross profit		53,021	60,000
HKAS 1.85	Investment and other income	7	3,608	2,351
HKAS 1.85	Other gains and losses	8	(1,128)	(173)
HKAS 1.99	Distribution and selling expenses		(11,520)	(10,055)
HKAS 1.99	Administrative expenses		(9,380)	(13,570)
HKAS 1.82(b)	Finance costs	9	(4,178)	(6,313)
HKAS 1.99	Other expenses		(1,280)	(1,711)
HKAS 1.82(c)	Share of profits of associates	24	1,186	1,589
HKAS 1.85	Gain recognised on disposal of an associate	24	581	-
HKAS 1.85	Profit before tax		30,910	32,118
HKAS 1.82(d)	Income tax expense	10	(11,642)	(11,836)
HKAS 1.85	Profit for the year from continuing operations	13	19,268	20,282
	Discontinued operations			
HKAS 1.82(e)	Profit for the year from discontinued operations	11	8,310	9,995
HKAS 1.82(f)	**Profit for the year**		27,578	30,277
	Other comprehensive income, net of income tax	45		
HKAS 1.82(g)	Exchange differences on translating foreign operations		(191)	177
HKAS 1.82(g)	Net (loss)/gain on available-for-sale financial assets		(300)	57
HKAS 1.82(g)	Net gain on hedging instruments in cash flow hedges		36	36
HKAS 1.82(h)	Share of other comprehensive income of associates		-	-
HKAS 1.85	Other comprehensive income for the year, net of income tax		(455)	270
HKAS 1.82(i)	**Total comprehensive income for the year**		27,123	30,547
	Profit for the year attributable to:			
HKAS 1.83(a)(ii)	Owners of the Company		23,578	27,514
HKAS 1.83(a)(i)	Non-controlling interests		4,000	2,763
			27,578	30,277
	Total comprehensive income for the year attributable to:			
HKAS 1.83(b)(ii)	Owners of the Company		23,123	27,784
HKAS 1.83(b)(i)	Non-controlling interests		4,000	2,763
			27,123	30,547

Note: The format outlined above aggregates expenses according to their function.
See next page for discussion of the format of the statement of comprehensive income.

Source	Hong Kong GAAP Limited			
	Consolidated statement of comprehensive income for the year ended 31 December 2012 – continued			**[Alt 1] continued**
		Note	Year ended 31/12/12	Year ended 31/12/11 (restated)
App 16.4(1)(g) GR 18.50B(1)(m)	**Earnings per share**	17		
	From continuing and discontinued operations			
HKAS 33.66	Basic (HK cents per share)		104.8	119.6
HKAS 33.66	Diluted (HK cents per share)		99.2	118.8
	From continuing operations			
HKAS 33.66	Basic (HK cents per share)		67.9	76.2
HKAS 33.66	Diluted (HK cents per share)		64.3	75.5

HKAS 1.90&94

Note: ***One statement vs. two statements***

Alt 1 above illustrates the presentation of profit and loss items, and other comprehensive income items, in one statement. Alt 2 (see next pages) illustrates the presentation of profit and loss items, and other comprehensive income items, in two separate statements.

The presentation does not affect whether the items should be recognised in profit or loss or in other comprehensive income. The only difference between the one-statement and the two-statement approaches is that, for the latter, a total is struck in the separate income statement at 'profit for the year' (this is the same amount as is presented as a sub-total under the one-statement approach). This 'profit for the year' is then the starting point for the statement of comprehensive income, which is required to be presented immediately following the income statement. Under the two-statement approach, the analysis of 'profit for the year' between the amount attributable to the owners of the parent and the amount attributable to non-controlling interests is presented as part of the separate income statement.

Presentation options for reclassification adjustments

In addition, in accordance with HKAS 1.94, an entity may present reclassification adjustments in the statement of comprehensive income or in the notes. In Alt 1 above, the entity has elected to present reclassification adjustments in the notes. Alt 2 (see next pages) illustrates the presentation of reclassification adjustments in the statement of comprehensive income.

Presentation options for income tax relating to items of other comprehensive income

Furthermore, for the components of other comprehensive income, additional presentation options are available as follows: the individual components of other comprehensive income may be presented net of tax in the statement of comprehensive income (as illustrated on the previous page), or they may be presented gross with a single line deduction for tax (see Alt 2). Whichever option is selected, the income tax relating to each component of other comprehensive income must be disclosed, either in the statement of comprehensive income or in the notes (see note 45).

Source	Hong Kong GAAP Limited			
HKAS 1.10(b), 81(b), 51(b),(c)	**Consolidated income statement for the year ended 31 December 2012**			**[Alt 2]**
HKAS 1.38, 113		Notes	Year ended 31/12/12	Year ended 31/12/11
HKAS 1.51(d),(e)			HK$'000	HK$'000 (restated)
	Continuing operations			
HKAS 1.82(a)	Revenue	5	140,918	151,840
HKAS 1.85	Investment and other income	7	3,608	2,351
HKAS 1.85	Other gains and losses	8	(1,128)	(173)
HKAS 1.99	Changes in inventories of finished goods and work in progress		(7,134)	2,118
HKAS 1.99	Raw materials and consumables used		(67,625)	(84,037)
HKAS 1.99	Depreciation and amortisation expenses	13	(12,412)	(13,878)
HKAS 1.99	Employee benefits expense	13	(9,869)	(11,563)
HKAS 1.82(b)	Finance costs	9	(4,178)	(6,313)
HKAS 1.99	Other expenses		(13,037)	(9,816)
HKAS 1.82(c)	Share of profits of associates	24	1,186	1,589
HKAS 1.85	Gain recognised on disposal of an associate	24	581	-
HKAS 1.85	Profit before tax		30,910	32,118
HKAS 1.82(d)	Income tax expense	10	(11,642)	(11,836)
HKAS 1.85	Profit for the year from continuing operations	13	19,268	20,282
	Discontinued operations			
HKAS 1.82(e)	Profit for the year from discontinued operations	11	8,310	9,995
HKAS 1.82(f)	**Profit for the year**		27,578	30,277
	Attributable to:			
HKAS 1.83(a)(ii)	Owners of the Company		23,578	27,514
HKAS 1.83(a)(i)	Non-controlling interests		4,000	2,763
			27,578	30,277
App 16.4(1)(g) GR18.50B(1)(m)	**Earnings per share**	17		
	From continuing and discontinued operations			
HKAS 33.66, 67A	Basic (cents per share)		104.8	119.6
HKAS 33.66, 67A	Diluted (cents per share)		99.2	118.8
	From continuing operations			
HKAS 33.66, 67A	Basic (cents per share)		67.9	76.2
HKAS 33.66, 67A	Diluted (cents per share)		64.3	75.5

Note: The format outlined above aggregates expenses according to their nature.

See the previous page for a discussion of the format of the statement of comprehensive income. Note that where the two-statement approach is adopted (above and on the next page), as required by HKAS 1.12, the income statement must be displayed immediately before the statement of comprehensive income.

Source	Hong Kong GAAP Limited			
HKAS 1.10(b), 81(b), 51(b),(c)	**Consolidated statement of comprehensive income for the year ended 31 December 2012**			**[Alt 2] continued**
HKAS 1.38, 113		Note	Year ended 31/12/12	Year ended 31/12/11
HKAS 1.51(d),(e)			HK$'000	HK$'000 (restated)
HKAS 1.82(f)	**Profit for the year**		27,578	30,277
	Other comprehensive income	45		
HKAS 1.82(g)	Exchange differences on translating foreign operations			
	Exchange differences arising during the year		(71)	177
	Reclassification adjustments relating to foreign operations disposed of during the year		(120)	-
			(191)	177
HKAS 1.82(g)	Available-for-sale financial assets			
	Net (loss)/gain arising on revaluation of available-for-sale financial assets during the year		(400)	76
	Reclassification upon impairment		-	-
	Reclassification adjustments relating to available-for-sale financial assets disposed of during the year		-	-
			(400)	76
HKAS 1.82(g)	Cash flow hedges			
	Gains arising during the year		406	316
	Reclassification adjustments for amounts recognised in profit or loss		(355)	(287)
			51	29
HKAS 1.82(h)	Share of other comprehensive income of associates		-	-
	Income tax relating to components of other comprehensive income		85	(12)
HKAS 1.82(i)	**Total comprehensive income for the year**		27,123	30,547
	Attributable to:			
HKAS 1.83(b)(ii)	Owners of the Company		23,123	27,784
HKAS 1.83(b)(i)	Non-controlling interests		4,000	2,763
			27,123	30,547

Source	Hong Kong GAAP Limited				
HKAS 1.10(a), 81(b), 51(b),(c)	**Consolidated statement of financial position at 31 December 2012**				
HKAS 1.38, 113		Notes	31/12/12	31/12/11	01/01/11
HKAS 1.51(d),(e)			HK$'000	HK$'000 (restated)	HK$'000 (restated)
HKAS 1.60	**Non-current assets**				
HKAS 1.54(a)	Property, plant and equipment	18	111,583	137,211	164,503
HKAS 1.55	Prepaid lease payments	19	2,300	2,400	2,500
HKAS 1.54(b)	Investment properties	20	2,086	1,942	1,670
HKAS 1.55	Goodwill	21	20,285	24,060	23,920
HKAS 1.54(c)	Other intangible assets	23	9,739	11,325	12,523
HKAS 1.54(e)	Interests in associates	24	7,319	7,270	5,706
HKAS 1.54(d), 55	Held-to-maturity investments	26	2,059	1,658	1,212
HKAS 1.54(d), 55	Available-for-sale investments	27	5,600	4,857	3,403
HKAS 1.54(o), 56	Deferred tax assets	42	1,714	1,023	1,726
HKAS 1.55	Finance lease receivables	28	830	717	739
HKAS 1.54(d)	Other financial assets	41	212	140	135
			163,727	192,603	218,037
HKAS 1.60	**Current assets**				
HKAS 1.54(g)	Inventories	29	19,554	20,938	25,112
HKAS 1.54(h)	Trade and other receivables	30	20,995	14,792	12,357
HKAS 1.55	Finance lease receivables	28	198	188	182
HKAS 1.55	Amounts due from directors	32	656	107	82
HKAS 1.55	Amounts due from customers for contract work	31	240	230	220
HKAS 1.54(d), 55	Held-to-maturity investments	26	4,804	3,604	2,200
HKAS 1.54(d), 55	Held-for-trading investments	33	12,480	8,448	6,201
HKAS 1.55	Pledged bank deposits	34	2,000	2,000	2,000
HKAS 1.54(d)	Other financial assets	41	316	257	201
HKAS 1.54(n)	Current tax assets		125	60	81
HKAS 1.54(i)	Cash and bank balances	34	20,836	22,388	7,582
			82,204	73,012	56,218
HKAS 1.54(j)	Assets classified as held for sale	12	22,336	-	-
			104,540	73,012	56,218
HKAS 1.60	**Current liabilities**				
HKAS 1.54(k)	Trade and other payables	35	12,087	20,488	53,162
HKAS 1.55	Amounts due to customers for contract work	31	36	15	12
HKAS 1.54(m),55	Borrowings	36	22,446	25,600	33,618
HKAS 1.54(m),55	Loan from government	37	2,798	-	-
HKAS 1.54(m)	Other financial liabilities	41	116	18	-
HKAS 1.54(n)	Current tax liabilities		5,270	5,868	4,910
HKAS 1.54(l)	Provisions	40	3,356	3,195	2,235
HKAS 1.55	Deferred revenue	43	355	240	63
HKAS 1.55	Obligations under finance leases	39	9	54	72
HKAS 1.54(m),55	Bank overdrafts	34	538	378	312
			47,011	55,856	94,384
HKAS 1.54(p)	Liabilities directly associated with assets classified as held for sale	12	3,684	-	-
			50,695	55,856	94,384
App 16.4(2)(d) GR 18.50B(2)(d)	**Net current assets/(liabilities)**		53,845	17,156	(38,166)
App 16.4(2)(e) GR 18.50B(2)(e)	**Total assets less current liabilities**		217,572	209,759	179,871

Source	Hong Kong GAAP Limited

Consolidated statement of financial position at 31 December 2012

Source		Notes	31/12/12 HK$'000	31/12/11 HK$'000 (restated)	01/01/11 HK$'000 (restated)
	Capital and reserves				
HKAS 1.55	Share capital	44	17,819	23,005	23,005
HKAS 1.55	Share premium and reserves	45	128,524	122,806	101,163
HKAS 1.54(r)	Equity attributable to owners of the Company		146,343	145,811	124,168
HKAS 1.54(q)	Non-controlling interests	45	25,511	21,200	18,437
	Total equity		171,854	167,011	142,605
HKAS 1.60	**Non-current liabilities**				
HKAS 1.54(m),55	Borrowings	36	31,178	31,713	28,014
HKAS 1.54(m),55	Loan from government	37	-	2,610	-
HKAS 1.54(m),55	Convertible notes	38	4,144	-	-
HKAS 1.55	Retirement benefit obligations	46	1,695	1,195	739
HKAS 1.54(o)	Deferred tax liabilities	42	6,303	4,667	4,319
HKAS 1.54(l)	Provisions	40	2,294	2,231	4,102
HKAS 1.55	Deferred revenue	43	24	297	41
HKAS 1.55	Obligations under finance leases	39	5	35	51
HKAS 1.54(m)	Other financial liabilities	41	75	-	-
			45,718	42,748	37,266
			217,572	209,759	179,871

HKAS 10.17
s129B(1)

The consolidated financial statements on pages 33 to 153 were approved and authorised for issue by the Board of Directors on 10 February 2013 and are signed on its behalf by:

Gary D.K.Wong	Daniel D.D. Lee
(Chairman and Managing Director)	(Director)

Note: HKAS 1.10(f) requires that an entity presents a statement of financial position as at the beginning of the preceding period when it applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

As part of the Annual Improvements to HKFRSs 2009-2011 Cycle, *HKAS 1* Presentation of Financial Statements *has been revised to provide guidance on when a statement of financial position as at the beginning of the preceding period (third statement of financial position) and the related notes should be presented in the financial statements. Based on the amendments, an entity is required to present a third statement of financial position if:*

(a) it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and

(b) the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the third statement of financial position.

Other than disclosures of certain specified information as required by HKAS 1.41-44 and HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, *the related notes to the third statement of financial position are not required to be disclosed.*

In this model, it is assumed that the application of the amendments to HKAS 12 Deferred Tax: Recovery of Underlying Assets *has resulted in a material retrospective restatement of certain items in the financial statements (see note 2). As such, a third statement of financial position has been presented.*

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2012 – continued

HKAS 12.81(ab)

Income tax recognised in other comprehensive income

	Year ended 31/12/12	Year ended 31/12/11
	HK$'000	HK$'000
Current tax		
[Please describe]	-	-
Deferred tax		
Arising on income and expenses recognised in other comprehensive income:		
Revaluations of available-for-sale financial assets	(100)	19
Revaluations of effective hedging instruments in cash flow hedges	101	79
Others [please describe]	-	-
	1	98
Arising on reclassification of cumulative gain of effective hedging instruments in cash flow hedges from equity to profit or loss	(86)	(86)
Total income tax recognised in other comprehensive income	(85)	12

11. Discontinued operations

Disposal of toy manufacturing operations

HKFRS 5.30
HKFRS 5.41

On 28 September 2012, the Company entered into a sale agreement to dispose of Subzero Limited, which carried out all of the Group's toy manufacturing operations. The disposal of the toy manufacturing operations is consistent with the Group's long-term policy to focus its activities on the electronic equipment and other leisure goods markets. The disposal was completed on 30 November 2012, on which date control of the toy manufacturing operations passed to the acquirer. Details of the assets and liabilities disposed of, and the calculation of the profit or loss on disposal, are disclosed in note 51.

Plan to dispose of the bicycle business

HKFRS 5.30
HKFRS 5.41

On 30 November 2012, the Directors announced a plan to dispose of the Group's bicycle business. The disposal is consistent with the Group's long-term policy to focus its activities on the electronic equipment and other leisure goods markets. The Group is actively seeking a buyer for its bicycle business and expects to complete the sale by 31 July 2013. The net proceeds of sale are expected to exceed the carrying amount of the related net assets and, accordingly, no impairment losses were recognised, neither when the operation was reclassified as held for sale nor at the end of the reporting period.

Analysis of profit for the year from discontinued operations

The combined results of the discontinued operations (i.e. toy and bicycle businesses) included in the profit for the year are set out below. The comparative profit and cash flows from discontinued operations have been re-presented to include those operations classified as discontinued in the current year.

Source	Hong Kong GAAP Limited		
	Notes to the consolidated financial statements for the year ended 31 December 2012 – continued		
		Year ended 31/12/12	Year ended 31/12/11
		HK$'000	HK$'000
HKFRS 5.33(b)	*Profit for the year from discontinued operations*		
	Revenue	64,435	77,892
	Other gains	30	49
	Distribution and selling expenses	(23,118)	(32,009)
	Administrative expenses	(31,817)	(32,939)
	Profit before tax	9,530	12,993
HKAS 12.81(h)	Attributable income tax expense	(2,524)	(2,998)
		7,006	9,995
	Loss on remeasurement to fair value less costs to sell	-	-
	Gain on disposal of operation (including HK$0.12 million reclassification of foreign currency translation reserve from equity to profit or loss on disposal of the operation (see note 51)	1,789	-
HKAS 12.81(h)	Attributable income tax expense	(485)	-
		1,304	-
HKFRS 5.33(d)	Profit for the year from discontinued operations (attributable to owners of the Company)	8,310	9,995
	Profit for the year from discontinued operations include the following:		
Sch 10:13(1)(a)	Depreciation and amortisation	1,767	3,472
Sch 10:15	Auditor's remuneration	150	130
HKFRS 5.33(c)	*Cash flows from discontinued operations*		
	Net cash inflows from operating activities	6,381	7,078
	Net cash inflows from investing activities	2,767	-
	Net cash outflows from financing activities	(5,000)	-
	Net cash inflows	4,148	7,078

The bicycle business has been classified and accounted for at 31 December 2012 as a disposal group held for sale (see note 12).

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2012 – continued

12. Assets classified as held for sale

	31/12/12 HK$'000	31/12/11 HK$'000
Leasehold land (Note 1)	1,120	-
Assets related to bicycle business (Note 2)	21,216	-
	22,336	-
Liabilities directly associated with assets classified as held for sale (Note 2)	3,684	-

Notes:

HKFRS 5.41

1) The Group intends to dispose of a parcel of leasehold land which it no longer uses in the next 12 months. The property located on the leasehold land was previously used in the Group's toy manufacturing operations and has been fully depreciated. A search is underway for a buyer. No impairment loss was recognised on reclassification of the land as held for sale nor at 31 December 2012.

HKFRS 5.41
HKFRS 5.38

2) As described in note 11, the Group is seeking to dispose of its bicycle business and anticipates that the disposal will be completed by 31 July 2013. The major classes of assets and liabilities of the bicycle business at the end of the reporting period are as follows:

Source		31/12/12 HK$'000
	Goodwill	1,147
	Property, plant and equipment	17,084
HKAS 2.36(c)	Inventories	830
	Trade receivables	1,980
	Cash and bank balances	175
	Assets of bicycle business classified as held for sale	21,216
	Trade payables	(3,254)
	Current tax liabilities	-
	Deferred tax liabilities	(430)
	Liabilities of bicycle business associated with assets classified as held for sale	(3,684)
	Net assets of bicycle business classified as held for sale	17,532

13. Profit for the year from continuing operations

HKFRS 5.33(d)

Profit for the year from continuing operations is attributable to:

	Year ended 31/12/12 HK$'000	Year ended 31/12/11 HK$'000
Owners of the Company	15,268	17,519
Non-controlling interests	4,000	2,763
	19,268	20,282

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A Refresher Course on Current

Financial Reporting Standards 2013

Day 3

Time	Topic
09:00 - 11:00	Accounting for properties
11:00 - 11:15	Break
11:15 - 12:45	Foreign currencies translation

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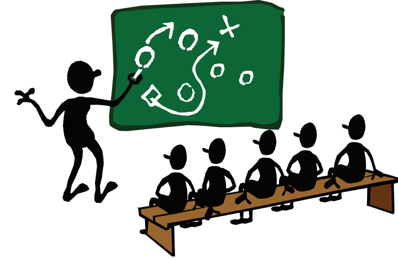
A Refresher Course on Current Financial Reporting Standards 2013 (Day 3)

Accounting for properties



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Accounting for properties

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Different types of properties

How to account for a property under applicable HKFRS?

- Depends on the purpose and management's intention of holding the property
- Normally, all self-owned properties will be classified as follows:
  - Own use property
  - Property held to earn rental or capital appreciation
  - Property held for sale
  - Hotel property

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Different types of properties

How to account for a property under applicable HKFRS?

- Depending on the types of properties, the appropriate accounting standards that apply are as follows:

Types of properties	Accounting standards
Own use property	HKAS 16 PPE
Property held to earn rental or capital appreciation	HKAS 40 Investment property
Property held for sale	HKAS 2 Inventories
Hotel property	Depends

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Part 1 : Own use properties

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HKAS 16 - Scope

In-scope	Out of scope
• are held for use in production or supply of goods or services, or for administrative purposes; and • are expected to be used during more than one period	• Assets held under leases (HKAS 17 "Leases") • Property, plant and equipment classified as held for sale (HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations") • Biological assets related to agricultural activity (HKAS 41 "Agriculture") • Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources • property being constructed or developed for future use as investment property

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General Recognition Criteria

The recognition criteria are:

- ❒ **Derived from the general principles for asset recognition established by the "Framework for the Preparation and Presentation of Financial Statements"**
- ❒ **An item of property, plant and equipment is to be recognised as an asset if, and only if:**

It is probable that future economic benefits associated with the asset will flow to the entity

The cost of the asset to the entity can be measured reliably

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Measurement at recognition

An item of property, plant and equipment should initially be recorded at cost

Cost is defined as the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction

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Elements of cost

In the case of an acquired asset, cost comprises:

- The purchase price, including import duties and non-refundable purchase taxes after deducting trade discounts and rebates;
- Any directly attributable costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, and
- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located (this element will be included only when, and to the extent that, the entity has an obligation to dismantle and remove the asset, and has therefore set a provision in accordance with HKAS 37 *Provisions, Contingent liabilities and Contingent Assets*)

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Recognition – Subsequent costs

➢ **General recognition criteria (i.e., inflow of future economic benefits probable and cost of entity measured reliably**)
If the recognition criteria are met ➔the expenditure will be added to the carrying amount of the PPE
If the recognition criteria are not met ➔ the expenditure will be expensed when incurred

Questions:

- Repair and maintenances, e.g. repair of heating and electrical system?
- Replacement parts, e.g. replacement of elevators or water system?
- Major inspection ?

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Measurement of cost – Payments deferred beyond normal credit terms

- When payment for an item of property, plant and equipment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payments: [HKAS 16.23]
  - → Recognised as an interest expense over the period of credit, unless it can be capitalised in accordance with HKAS 23 "Borrowing Costs"

- **Normal credit terms:**

  The "normal credit terms" provision is intended to recognise that settlement of cash purchases often takes a few days, weeks, or even months (depending on the industry and national laws), and imputation of interest is not required in those circumstances

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Measurement of cost – Exchange of assets

- Where an item of property, plant and equipment is acquired in exchange for a non-monetary asset, or a combination of monetary and non-monetary assets, the cost of that item is measured at fair value (even if the entity cannot immediately derecognise the asset given up) unless

  [HKAS 16.24]
  - the exchange transaction lacks commercial substance; or
  - the fair value of neither the asset received nor the asset given up is reliably measurable
- If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up

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Measurement of cost – Exchange of assets

Question:

A ship charterer owns land and buildings which are carried in its statement of financial position at an aggregate carrying amount of $10 million, but which have a fair value of $15 million. It exchanges the land and buildings for a ship, which has a fair value of $15 million, and pays an additional $3 million cash.

Provided that the transaction has commercial substance, what will be the required journal entry for this transaction?

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Measurement of cost - Others

Government grant

- The carrying amount of an item of property, plant and equipment may be reduced by government grants, in accordance with HKAS 20 "Accounting for Government Grants and Disclosure of Government Assistance" [HKAS 16.28]

Assets held under finance lease

- The cost of assets held under finance leases is determined using the principles set out in HKAS 17 "Leases"

Assets acquired as part of a business combination

- HKFRS 3 "Business Combinations" requires that property, plant and equipment of a subsidiary acquired as part of a business combination be measured initially at fair value for the purpose of inclusion in the consolidated financial statements.

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Measurement after recognition

Accounting Policy Choice:

- Permits cost model or a revaluation model
- Whichever accounting policy is selected, it is required to be applied to entire classes of property, plant and equipment [HKAS 16.29]

Cost Model:

- After recognition as an asset, an item of property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses [HKAS 16.30]

Revaluation Model:

- After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and any subsequent accumulated impairment losses [HKAS 16.31]

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The Revaluation Model

- **Initial adoption of revaluation basis:**
  - ➢ Represents a change in accounting policy, but HKAS 8.17 specifies that it should be dealt with as a revaluation rather than as a prior period adjustment
    - Valuation increase: recognised as other comprehensive income
    - Valuation decrease: recognised as profit or loss for the year
- **Determination of fair value:**
  - ➢ Definition: the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction [HKAS 16.6]
  - ➢ Fair value of land and building: market-based evidence by appraisal that is normally undertaken by professional qualified valuers [HKAS 16.32]

Upon adoption of HKFRS 13,
- Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date
- Paragraph 32 is deleted

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Frequency of revaluations

- Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet
- Where items of property, plant and equipment have only insignificant changes in fair value, the Standard indicates that it may be necessary to revalue them only every three or five years [HKAS 16.34]

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Question：Accumulated depreciation at the date of revaluation

- A property has a carrying amount of HK$10M, represented by cost of HK$12M and accumulated depreciation of HK$2M. It is revalued to its fair value of HK$13M.
  - ➢ How would you adjust the cost and the accumulated depreciation of the property?

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Accumulated depreciation at the date of revaluation

HKAS 16.35 allows that any depreciation accumulated on an asset at the date of revaluation can be dealt with in one of two ways, i.e. either:

- **Method A (often used when an asset is revalued to its depreciated replacement cost by means of an index)**
  — restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. The carrying amount is increased to the revalued amount by restating the cost and depreciation proportionately
- **Method B (often used for buildings, and most commonly used in practice)**
  —eliminated against the gross carrying amount of the asset and the resulting net amount restated to the revalued amount of the asset. The accumulated depreciation is eliminated, and any remaining surplus is used to increase cost

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Example：Accumulated depreciation at the date of revaluation

A property has a carrying amount of HK$10M, represented by cost of HK$12M and accumulated depreciation of HK$2M. It is revalued to its fair value of HK$13M.

	Method A	Method B
	'000	'000
Cost or valuation		
Before revaluation	12,000	12,000
Revaluation adjustment	3,600*	1,000
After revaluation	15,600	13,000
Depreciation		
Before revaluation	2,000	2,000
Revaluation adjustment	600*	(2,000)
After revaluation	2,600	0
Revalued amount	13,000	13,000

*allocated in the ratio 12:2

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Revaluation to be made for entire class of assets

- When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belong is required to be revalued [HKAS 16.36]

  Reasons:

  1. to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and valuations at different dates [HKAS 16.38]
  2. to prevent the distortions caused by the selective use of revaluation (i.e., cherry-picking), so as to take credit for gains without acknowledging falls in the value of similar assets

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Revaluation Model – Surplus or Deficit arising from revaluation

Surplus [HKAS 16.39]

- When an asset's carrying amount is increased as a result of a revaluation, the increase (being the difference between the fair value at the date of revaluation and the carrying amount at that date) should generally be recognised in OCI and accumulated in equity under the heading of revaluation surplus [HKAS 16.39]
- A revaluation increase should be recognised as income, to the extent that it reverses a revaluation decrease of the same asset previously recognised as an expense [HKAS 16.39]
- When a revaluation surplus is recognised, no amendment is made to profit or loss to reverse depreciation previously charged

Deficit [HKAS 16.40]

- When an asset's carrying amount is decreased as a result of a revaluation, the decrease should generally be recognised as an expense [HKAS 16.40]
- A revaluation decrease should be recognised in OCI, to the extent of any credit balance existing in the revaluation surplus in respect of that same asset [HKAS 16.40]

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Example：
Treatment of revaluation movement

- An entity purchased a property on 1 July 20X1 for HK$140M. At 31 December 20X1, the property was valued at HK$125M. At 31 December 20X2, the fair value of the property had increased to HK$150M
  - ➢ **How should the entity account for these changes?**

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Example：
Treatment of revaluation movement

- An entity purchased a property on 1 July 20X1 for HK$60M. At 31 December 20X1, the property was valued at HK$70M. At 31 December 20X2, the fair value of the property had decreased to HK$55M
  - ➢ **How should the entity account for these changes?**

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Utilisation of revaluation reserve

- The entity had a choice of utilisation of revaluation reserve
  - Opt to utilise ➔directly transferred to retained earnings (should not made through the profit or loss):
    - When the asset is derecognised (on retirement or disposal); OR
    - Transferred over the period for which the asset is used by the entity (the amount of the reserve transferred is the difference between the depreciation charge based on the revalued carrying amount of the asset and the depreciation charged based on the asset's original cost)
  - Opt not to utilise ➔ the revaluation surplus may be left in equity under the heading revaluation surplus

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Depreciation

- The depreciation charge for each period should be recognised in profit or loss, unless it qualifies to be capitalised in the carrying amount of another asset [HKAS 16.48]
- In order to comply with HKAS 16 relating to depreciation, it is necessary to identify:
  - the parts (components) of each item of PPE that are depreciated separately;
  - the cost or valuation of each separately depreciable component;
  - the estimated residual value of each separately depreciable component;
  - the length of time during which the component will be commercially useful to the entity; and
  - the most appropriate depreciation method for each separately depreciable component

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Each significant component to be depreciated separately

- **Significant components/parts:** an item of PPE or those separately identifiable components of the item with a cost that is significant to the total cost of the item should be depreciated separately [HKAS 16.43-44]

  What can be the significant components/parts of a property?
  - ✓ Structural design
  - ✓ Membrane
  - ✓ Exterior doors and windows
  - ✓ Interior walls, doors, windows
  - ✓ Heating and other technical systems
  - ✓ Sanitary facilities etc.

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Each significant component to be depreciated separately

- **Group of components:** There may be a number of significant parts which, although separately identifiable, have the same useful life and which are appropriately depreciated using the same depreciation method. Such items will generally be grouped together for the purposes of calculating the depreciation charge [HKAS 16.45]

- **Insignificant components:** The Standard allows the individually insignificant parts can be depreciated as a group, provided that the depreciation rate and method selected result in a faithful representation of the pattern of consumption of benefits [HKAS 16.46]

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Residual Value

Definitions:

The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life **[HKAS 16.6]**

- The residual value of an asset is required to be reviewed at least at each financial year end [HKAS 16.51]
- The revised estimate should be based on market conditions current at the financial reporting date
- Where the revised estimate differs significantly from previous estimates of residual value, the effect is accounted for prospectively as a change in estimate
- The depreciation charge over the remaining useful life of the asset is adjusted to take account of the revised estimate of residual value
- Where the revised estimate of residual value is equal to or greater than the asset's carrying amount (whether due to inflation or otherwise), then the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount [HKAS 16.54]

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Depreciation - Others

Estimates of useful lives

- The useful life of an asset is defined as: [HKAS 16.6]
  - the period over which an asset is expected to be available for use by an entity; or
  - the number of production or similar units expected to be obtained from the asset by an entity

- Factors impacting the useful life of an asset:
  - the expected usage of the asset
  - the expected wear and tear
  - technical or commercial obsolescence
  - legal or similar limits on the use of the asset

- Estimate of the useful life of an item of property, plan and equipment should be reviewed at each financial year-end
  - If expectations differ from previous estimates, the change is accounted for as a change in accounting estimates [HKAS 16.51]
  - A significant reduction in the estimated useful life of an asset may indicate that the asset has been impaired

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Depreciation - Others

Commencement of depreciation

- Depreciation of an asset commences when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management [HKAS 16.55]
- This is the same point in time at which the entity is required to cease capitalising costs within the carrying amount of the asset

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Depreciation - Others

Cessation of depreciation

- Depreciation of an asset ceases at the earlier of:
  - the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations"; and
  - the date that the asset is derecognised
- Unless the asset is fully depreciated, depreciation of an asset does not cease when an asset becomes idle or is retired from active use
  - where the depreciation charge is calculated by reference to the usage of the asset, while there is no production ➔ depreciation charge may be zero [HKAS 16.55]
  - when an asset becomes idle, or is retired from active use, this may trigger an impairment loss which may reduce the carrying amount to estimated recoverable amount

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Method of depreciation

Principal:
The depreciation method used should be that which reflects most closely the pattern in which the asset's economic benefits are expected to be consumed by the entity [HKAS 16.60]

- **Method:**
  - most commonly used: straight-line method & the reducing balance method
  - more accurately matches costs with revenue: unit of production method (commonly used in the oil, gas and other extractive industries)
- The depreciation method applied to an item of property, plant and equipment should be reviewed at least at each financial year-end
  - Except where there is a change in the expected of consumption of economic benefits embodied in the asset, the depreciation method adopted should be applied consistently from period to period
  - If there has been a significant change in the expected pattern of consumption of benefits, the depreciation method is changed to reflect the changed pattern
- A change of depreciation method constitutes a change in accounting estimate
  - the carrying amount of the asset is written off using the new method over the remaining useful life, commencing with the period in which the change takes place
  - Separate disclosure of the impact of the change will be required if the change has a material effect in the current period or is expected to have a material effect in subsequent periods

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Depreciation of particular classes of asset

Freehold Land

- Freehold land that is not subject to depletion (e.g. by the extraction of minerals) does not have a limited useful life and, therefore, should not be depreciated
- Where freehold land is purchased, it is necessary to allocate the purchase consideration between the value of the land and the building
- Any revaluations of freehold property should distinguish between land and building

- Where the cost of site dismantlement, removal and restoration is included in the cost of land, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs
- In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it [HKAS 16.59]

- Where the value of freehold land is adversely affected by long-term environmental factors, an impairment loss should be recognised to reflect any decline in its estimated recoverable amount below its carrying amount

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Depreciation of particular classes of asset (cont'd)

- The estimated useful lives are usually significantly longer than other items of PPE
- Depreciation method: generally using straight-line method
- HKAS 16 emphasises that an increase in the value of the land on which a building stands does not affect the determination of the useful life of the building [HKAS 16.58]

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Derecognition

- The carrying amount of an item of PPE should be derecognised:
  - On disposal; or
  - When no future economic benefits are expected from its use or disposal
- The gain or loss arising on the derecognition of an item of PPE must be included in profit or loss when the amount is derecognised (prohibits classification as revenue)
  - The standard requires the date of disposal of an item of PPE be determined using the criteria for recognising revenue from the sale of goods, as set out in HKAS 18 "Revenue"
  - Except for sales and leaseback where HKAS 17 would apply
- Where a revalued asset is disposed of, any credit balance on the revaluation reserve attributable to that asset may be transferred directly to retained earnings (such transfer is not mandatory), but must not be reflected in profit or loss

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Disclosures

For each class of PPE, should disclose

- Measurement bases (i.e. cost or valuation) to determine the gross carrying amount;
- Depreciation methods used;
- Useful lives or the depreciation rate used
- Gross carrying amount and the accumulated depreciation at the beginning and end of the period; and
- Reconciliation of the carrying amount at the beginning and end of the period
- Existence and amounts of restrictions on title & PPE pledged as security for liabilities;
- Amount of expenditures recognised in the carrying amount of an item of PPE in the course of construction;
- Amount of contractual commitments for acquisition of PPE; and
- If not disclosed separately in the statement of comprehensive income, the amount of compensation from third parties for items of PPE that were impaired, lost or given up that is included in profit or loss

Reconciliation

- Additions;
- Assets classified as held for sale or included as a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals'
- Acquisitions through business combinations;
- Increases or decreases resulting from revaluations and from impairment losses recognised or reversed in other comprehensive income;
- Impairment losses recognised/reversed in P/L during the period
- Depreciation;
- Net exchange differences arising on the translation of the F/S 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
- Other changes

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Deleted and refer to HKFRS 13 upon the adoption of HKFRS 13

Disclosure (cont'd)

- For items of PPE stated at revalued amounts, the entity is required to disclose [HKAS 16.77]
  - The effective date of the revaluation;
  - Whether an independent valuer was involved
  - The methods and significant assumptions applied in estimating the items' fair values;
  - The extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques;
  - For each revalued class of PPE, the carrying amount that would have been recognised had the assets been carried under the cost model; and
  - The revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders

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Additional recommended disclosures

- HKAS 16.79 also encourages but does not require the disclosure of the following information:
  - the carrying amount of temporarily idle property, plant and equipment;
  - the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;
  - the carrying amount of property, plant and equipment retired from active use and not classified as held for sale in accordance with HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations"; and
  - when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount

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Annual improvements project 2011

Amendment to HKAS 16

- The amendment clarifies that spare parts and servicing equipment are classified as PPE rather than inventory when they meet the definition of PPE
- Practical implications:

  The previous wording of HKAS 16 indicated that servicing equipment should be classified as inventory, even if it was used for more than one period. Following the amendment, this equipment used for more than one period is classified as PPE
- Applies retrospectively for annual periods beginning on or after 1 January 2013. Early adoption is permitted

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Part 2: Investment Property

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Definition of Investment Property

- Investment property is property (land or a building or part of a building or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both. [HKAS 40.5]

Examples of investment property: [HKAS 40.8]

- land held for long-term capital appreciation
- land held for undetermined future use
- building owned by the entity and leased out under one or more operating leases
- vacant building held to be leased out under an operating lease
- property that is being constructed or developed for future use as investment property

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Definition of Investment Property

- The following are not investment property and, therefore, are outside the scope of HKAS 40: [HKAS 40.5 and 40.9]
  - property held for use in the production or supply of goods or services or for administrative purposes
  - property held for sale in the ordinary course of business or in the process of construction of development for such sale (HKAS 2 *Inventories*)
  - property being constructed or developed on behalf of third parties (HKAS 11 *Construction Contracts*)
  - owner-occupied property (HKAS 16 *Property, Plant and Equipment*), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees and owner-occupied property awaiting disposal
  - property leased to another entity under a finance lease

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Other Classification Issues

Questions:

How should we classify the following properties?

1. Part of the property unit is for own use as office and part of the property unit is leased out to a third party.

2. The property is leased to a fellow subsidiary of the group.

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Other Classification Issues

- **Partial own use.** If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. Therefore the part that is rented out is investment property. If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant. [HAS 40.10]

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Other Classification Issues

- **Intracompany rentals.** Property rented to a parent, subsidiary, or fellow subsidiary is not investment property in consolidated financial statements that include both the lessor and the lessee, because the property is owner-occupied from the perspective of the group. However, such property could qualify as investment property in the separate financial statements of the lessor, if the definition of investment property is otherwise met. [HKAS 40.15]

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Recognition

- Investment property should be recognised as an asset when it is probable that the future economic benefits that are associated with the property will flow to the entity, and the cost of the property can be reliably measured. [HKAS 40.16]

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Initial measurement

- Investment property is initially measured at cost, including transaction costs. Such cost should not include start-up costs, abnormal waste, or initial operating losses incurred before the investment property achieves the planned level of occupancy. [HKAS 40.20 and 40.23]

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Measurement subsequent to initial recognition

- HKAS 40 permits entities to choose between: [HKAS 40.30]
  - a fair value model, and
  - a cost model

- One method must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation.

HKAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model

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HKFRS 13 – Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair value model

- Investment property is remeasured at fair value, which is the amount for which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. [HKAS 40.5]
- Gains or losses arising from changes in the fair value of investment property must be included in profit or loss for the period in which it arises. [HKAS 40.35]

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Refer to the definition of fair value under HKFRS 13 upon the adoption of HKFRS 13

Fair value model

Determination of fair value

- Fair value should reflect the market conditions at the end of the reporting period.
- The best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts
- In the absence of such information, the entity may consider current prices for properties of a different nature or subject to different conditions, recent prices on less active markets with adjustments to reflect changes in economic conditions, and discounted cash flow projections based on reliable estimates of future cash flows.

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Fair value model

- There is a **rebuttable presumption** that the entity will be able to determine the fair value of an investment property reliably on **a continuing basis**. However:
  - If an entity determines that the fair value of an investment property under construction is not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, it measures that investment property under construction at cost until either its fair value becomes reliably determinable or construction is completed, whichever is earlier.

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Fair value model

- If an entity determines that the fair value of an investment property (other than an investment property under construction) is not reliably determinable on a continuing basis, the entity shall measure that investment property using the cost model in HKAS 16. The residual value of the investment property shall be assumed to be zero. The entity shall apply HKAS 16 until disposal of the investment property.

- Where a property has previously been measured at fair value, it should continue to be measured at fair value until disposal, even if comparable market transactions become less frequent or market prices become less readily available. [HKAS 40.55]

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Cost Model

- After initial recognition, investment property is accounted for in accordance with the cost model as set out in HKAS 16 *Property, Plant and Equipment* – cost less accumulated depreciation and less accumulated impairment losses. [HKAS 40.56]

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Transfers to or from Investment Property Classification

- Transfers to, or from, investment property should only be made **when there is a change in use**, evidenced by one or more of the following: [HKAS 40.57]
  - commencement of owner-occupation (transfer from investment property to owner-occupied property)
  - commencement of development with a view to sale (transfer from investment property to inventories)
  - end of owner-occupation (transfer from owner-occupied property to investment property)
  - commencement of an operating lease to another party (transfer from inventories to investment property)

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Transfers to or from Investment Property Classification

- When an entity decides to sell an investment property without development, it continues to treat the property as an investment property until it is derecognised and does not treat it as inventory [HKAS 40.58]

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Transfer	Change in use	Treatment
IP (fair value) to PPE	commencement of owner-occupation	the fair value at the date of change in use is the 'cost' of the property under its new classification [HKAS 40.60]
IP (fair value) to inventory	commencement of development with a view to sale	
PPE to IP (fair value)	end of owner-occupation	HKAS 16 should be applied up to the date of reclassification. Any difference arising between the carrying amount under HKAS 16 at that date and the fair value is dealt with as a revaluation under HKAS 16 [HKAS 40.61]
Inventory to IP (fair value)	commencement of an operating lease to another party	any difference between the fair value at the date of transfer and it previous carrying amount should be recognised in profit or loss [HKAS 40.63]
PUD to IP (fair value)	Complete construction/development	any difference between the fair value at the date of transfer and the previous carrying amount should be recognised in profit or loss. [HKAS 40.65]

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Transfers to or from Investment Property Classification

- When an entity uses the cost model for investment property, transfers between categories do not change the carrying amount of the property transferred, and they do not change the cost of the property for measurement or disclosure purposes. [HKAS 40.59]

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Disposal

- An investment property should be derecognised on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal. The gain or loss on disposal should be calculated as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the profit or loss. [HKAS 40.66 and 40.69]
- Compensation from third parties is recognised when it becomes receivable. [HKAS 40.72]

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Disclosure

Both Fair Value Model and Cost Model [HKAS 40.75]

- whether the fair value or the cost model is used
- if the fair value model is used, whether property interests held under operating leases are classified and accounted for as investment property
- if classification is difficult, the criteria to distinguish investment property from owner-occupied property and from property held for sale
- the methods and significant assumptions applied in determining the fair value of investment property

Deleted and refer to HKFRS 13 upon the adoption of HKFRS 13

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Disclosure

- the extent to which the fair value of investment property is based on a valuation by a qualified independent valuer; if there has been no such valuation, that fact must be disclosed
- the amounts recognised in profit or loss for:
  - rental income from investment property
  - direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period
  - direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income during the period
  - the cumulative change in fair value recognised in profit or loss on a sale from a pool of assets in which the cost model is used into a pool in which the fair value model is used

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Disclosure

- restrictions on the realisability of investment property or the remittance of income and proceeds of disposal
- contractual obligations to purchase, construct, or develop investment property or for repairs, maintenance or enhancements

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Additional Disclosures for the Fair Value Model [HKAS 40.76]

- a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing additions, disposals, fair value adjustments, net foreign exchange differences, transfers to and from inventories and owner-occupied property, and other changes [HKAS 40.76]
- significant adjustments to an outside valuation (if any) [HKAS 40.77]
- if an entity that otherwise uses the fair value model measures an item of investment property using the cost model, certain additional disclosures are required [HKAS 40.78]

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Additional Disclosures for the Cost Model [HKAS 40.79]

- the depreciation methods used
- the useful lives or the depreciation rates used
- the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period
- a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing additions, disposals, depreciation, impairment recognised or reversed, foreign exchange differences, transfers to and from inventories and owner-occupied property, and other changes
- the fair value of investment property. If the fair value of an item of investment property cannot be measured reliably, additional disclosures are required, including, if possible, the range of estimates within which fair value is highly likely to lie

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Part 3: Properties held for sale

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Agenda

- Definition of inventories
- Initial measurement
- Cost formula
- Subsequent measurement
- Recognition as an expense
- Disclosure

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Definition of Inventories

- HKAS 2 defines inventories as assets: [HKAS 2.6]
  - held for sale in the ordinary course of business (finished goods)
  - in the production process for sale in the ordinary course of business (work in progress); and
  - materials and supplies that are consumed in production (raw materials)

Properties held / developed with a view for sale in the ordinary course of business

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Initial measurement

- Measure at cost
- The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Type	Descriptions	Example
Cost of purchase	comprise the purchase price, import duties and other taxes and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted	Land costs, Stamp duty etc

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Question: Entity A is granted a 10% settlement discount by the property developer for all purchases of properties settled within 30 days of purchase. How should entity A account for this settlement discount?

Analysis:

- HKAS 2.11: measurement of cost should take into account rebates and discounts
- Entity A should estimate the expected discount to be received and deduct the prompt settlement discount from the cost of the inventory
- Consistent with HKAS 18.10 "…a transaction should be measured at fair value of the consideration received or receivable taken into account of any trade discounts and volume discounts…"

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Initial measurement

Type	Descriptions	Example
Cost of conversion	costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods	Construction costs,
Other costs	only to the extent that they are incurred in bringing the inventories to their present location and condition.	Design cost for specific customers
Borrowing costs	Apply the principles of HKAS 23 (revised) - directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.	Finance costs in relation to a borrowing for the land acquisition

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Initial measurement

- Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

  (a) abnormal amounts of wasted materials, labour or other production costs;

  (b) storage costs, unless those costs are necessary in the production process before a further production stage;

  (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

  (d) selling costs.

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Initial measurement

- An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

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Cost formula

- The cost of inventories shall be assigned by using the **first-in, first-out (FIFO) or weighted average cost formula or specific identification**. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

No Last-in, first out (LIFO)

- Inventories used in one operating segment may have a use to the entity different from the same type of inventories used in another operating segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

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HKFRS 13
Fair value – the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Subsequent measurement

- Inventories shall be measured at the lower of cost and net realisable value.
- Net realisable value (NRV) vs fair value

NRV	Fair value
the estimated selling price in the **ordinary course of business** less the estimated costs of completion and the estimated costs necessary to make the sale.	amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction
Entity specific	Not entity specific

NRV may NOT = fair value less costs to sell

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Subsequent measurement

Consideration of NRV

- the most reliable evidence available at the time the estimates are made, of the amount the inventories are **expected to realise**.
- These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period
- Consider if there are any sales contracts that have been entered into

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Question: For write-down to net realisable value, how should "the costs necessary to make the sale" be determined to arrive at the net realisable value of the inventories?

Analysis:

- Should determine in a manner consistent with the definition of "costs of disposal" in HKAS 36 *Impairment of Assets* which states that these costs are "incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense"
- An incremental cost is one which would not be incurred if the activity was not undertaken
- General overheads may not be allocated for the purposes of determining costs to sell, but direct transaction costs must be allocated

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Subsequent measurement

When the cost of properties held for sale may not be recoverable?

- ❖ Damaged
- ❖ Wholly or partially obsolete
- ❖ Selling prices have declined
- ❖ estimated costs of completion or the estimated costs to be incurred to make the sale have increased

→ write inventories down below cost to net realisable value

How to assess the recoverability of properties under development?

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Question: A property held for sale which cost \$10M has a sale price of \$11M, but subsequently were sold at \$8M. Assume the cost to make the sale is immaterial, what is the accounting treatment?

Analysis:

- Sale at the lower price will generally provide evidence of the net realisable value of the inventory at the end of the reporting period and the closing inventories will therefore be carried at \$8M less any cost to sell
- However, if on further investigation, it indicates that the cause of the loss in value did not reflect conditions existing at the end of the reporting period, such loss should not be accounted for until the next period

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Subsequent measurement

- Inventories are usually written down to net realisable value item by item.
- In some circumstances, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line.

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Comparison basis (example)

Type of products	Cost	Net realisable value	Lower of cost & NRV: Individual items	Lower of cost & NRV: Classified items
Classification A: 1	$800	$980	$800	
2	1,500	1,000	1,000	
3	900	1,100	900	
Subtotal	3,200	3,080		3,080
Classification B: 4	$3,000	$4,800	3,000	
5	4,500	5,000	4,500	
6	2,000	1,750	1,750	
Subtotal	9,500	11,550		9,500
Total	$12,700	$14,630	$11,950	$12,580

	Comparison basis	NRV	Loss
Prohibited		14,630	0
May allowed	Grouped by similar nature	12,580	120
Mandatory	Individual items	11,950	750

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Subsequent measurement

- ❖ A new assessment is made of net realisable value in each subsequent period

Subsequent increase in NRV

- ❖ The amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realisable value.
- ❖ This occurs, for example, when an item of inventory that is carried at net realisable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

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Recognition as an expense

The following items are recognised in the profit or loss in relation to properties held for sale:

- ❖ Properties are sold (match with the period when revenue is recognised)

Be careful with the cost allocation among different inventories

- ❖ Write-down of inventories to NRV
- ❖ Reversal of write-down of inventories (recognise as a reduction of cost of inventories)
- ❖ Expenses incurred that cannot be capitalised

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Disclosure

Required disclosures: [HKAS 2.36]

- accounting policy
- the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity
- carrying amount of any inventories carried at net realisable value
- amount of any write-down of inventories recognised as an expense in the period
- amount of any reversal of a write-down to NRV and the circumstances that led to such reversal
- carrying amount of inventories pledged as security for liabilities

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Disclosure (Con't)

- cost of inventories recognised as expense (cost of goods sold).

HKAS 2 acknowledges that some enterprises classify income statement expenses by nature (materials, labour, and so on) rather than by function (cost of goods sold, selling expense, and so on). Accordingly, as an alternative to disclosing cost of goods sold, HKAS 2 allows an entity to disclose operating costs recognised during the period by nature of the cost (construction costs, labour costs, other operating costs) and the amount of the net change in inventories for the period). [HKAS 2.39] This is consistent with HKAS 1 *Presentation of Financial Statements*, which allows presentation of expenses by function or nature.

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Part 4: Hotel property

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Hotel Property

- Classifications may vary depending on the arrangement that may exist

- The owner of a hotel property may transfer some responsibilities to third parties under a management contract. Terms of such contracts may vary widely. The owner's role may be restricted to that of a passive investor, in which case the property would be more likely to qualify as investment property
- For example, if the owner's primary source of income from the property comes from longer-term leases, the hotel is likely to be an investment property and hence HKAS 40 applies.

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Hotel Property

- At the other extreme, the contract may simply result in the outsourcing of some day-to-day responsibilities, while the owner retains significant exposure to variations in the cash flows generated by the operation of the hotel.
- For example, if the property owner's primary source of income from the property depends on day-to-day or week-by-week occupancy of hotel rooms and usage of restaurants and other facilities, and the property owner is providing services directly to hotel guests and diners, the hotel is likely to be property held by the entity for use in the production of services.
- In this case, the contract has little effect on the substance of the owner's interest and property is likely to be classified as owner-managed and hence HKAS 16 applies

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HKAS 17 Amendment – Leases

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Previous issues

Previous HKAS 17.14 *"… a characteristic of land…. if title is not expected to pass to the lessee…. the lessee normally does not receive substantially all of the risks and rewards…… the lease of land will be an operating lease."*

Therefore…

- land element of a leasehold property, no matter the lease term is 10 years or 999 years → operating lease
- This is based on the notion that the life of land is infinite and therefore the lessee could not possibly enjoy the majority of risks and rewards during a finite lease term

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Amendment - overview

- HKAS 17 Para 15A

  "When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7–13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life."
- Lease classified as finance lease if it transfers all the risk and rewards incidental to ownership
- Even when there is no transfer of title at the end of lease

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Amendment - overview

Example

999 – year lease of land	Reason
• Lease of land with no title transfer at end of lease	• Significant risks and rewards have been transferred to lessee even no transfer title • Economically similar to entity purchased the land and buildings • Present value of the residual value of property in lease of several decades was negligible. • Account for land element as finance lease consistent with economic position of lessee **Classified as: Finance Lease**

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Amendment - overview

- Effective for annual periods beginning on or after 1 January 2010
- Apply retrospectively based on the information that existed at the inception of the lease
- If impractical, assess the land element of the property leases using information available at the time of applying the amendment

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Application

Land interest in an own-use property

- ✓ Apply HKAS 16 Property, plant and equipment
- ✓ Account for land interest using either cost model or revaluation model, depending on the lessee's accounting policy
- ✓ Depreciate the land interest over the period of expected use on a systematic basis that is consistent with the depreciation policy adopted for the building owned
- ✓ Reclassify the unexpired leasehold land to PPE

Properties under development

- No amortisation of leasehold land until ready for use
- Follow existing asset treatment

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Application

Land interest in an investment property

- ✓ Apply HKAS 40 Investment property
- ✓ Account for land interest using either fair value model or cost model, depending on the lessee's accounting policy
- ✓ For most entities selecting the fair value model, they need to periodically re-measure the property (including the land) to fair value
- ✓ Record changes in fair value in the profit or loss

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Application

Land interest in an inventory

Previous accounting treatment

- Leasehold land classified as prepaid operating lease or leasehold land and land use rights
- Amortised on a straight line basis over the period of the lease.
- Amortisation capitalized during the construction stage but charged to profit or loss following completion of development.

Accounting treatment under amendment

✓ Apply HKAS 2 Inventories
✓ No amortisation on leasehold land
✓ Measured at the lower of cost and net realisable value
✓ Classification into "Current" / "non-current" based on the normal operating cycle for property inventories

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Considerations

✓ Classification of lease depend on the judgement to decide whether the lease transfers the significant risks and rewards of ownership of the land
✓ Land leases with a term as short as "several decades" might be regarded as finance leases if the lessee is economically in the same position as a purchaser
✓ For property market where the reversionary interest is small or that the lease term specified in the land lease will be capable of extension for a nominal amount, this may imply land interest as finance lease

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Disclosures

✓ Apply HKAS 8 “Accounting policies, change in accounting estimates and errors” for change in accounting policy

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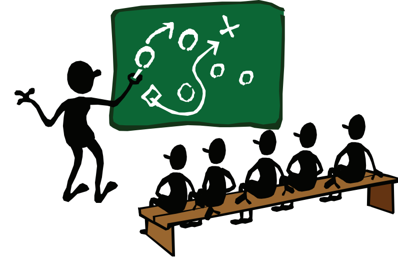
A Refresher Course on Current Financial Reporting Standards 2013 (Day 3)

Foreign currencies translation



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HKAS 21 – The effects of changes in foreign exchange rates

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Agenda

- Scope
- Definitions
- Functional currency
- Net investment in a foreign operation
- Reporting foreign currency transactions in the functional currency
- Change in functional currency
- Presentation currency
- Translation of a foreign operation
- Disposal or partial disposal of a foreign operation
- Tax effects of all exchange differences
- Disclosures

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No more proportionate consolidation under HKFRS 11

Scope

✓ accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement;*

✓ translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and

✓ translating an entity's results and financial position into a presentation currency.

X hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation.

X presentation in a statement of cash flows of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation

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Scope

Example: Hedging in a net investment in a foreign operation

Background

X, a HK entity with HK$ as functional currency, has a foreign subsidiary with a different functional currency. X's investment in the subsidiary is US$ 2 million. X has a third party long-term debt agreement of US$ 4 million. X designates US$ 2 million of the debt at the beginning of the year as a hedge of its net investment in the foreign subsidiary.

Analysis

- US$ 2 million debt qualifying as a hedging instrument is outside the scope of HKAS 21 and is dealt with by HKAS 39.
- Remaining US$ 2 million not designated in the hedging relationship is still within the scope of HKAS 21.

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Definitions

Terms	Definitions
Foreign operation	A subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity
Functional currency	Currency of the primary economic environment in which the entity operates
Presentation currency	Currency in which the financial statements are presented
Net investment in a foreign operation	Amount of the reporting entity's interest in the net assets of that operation
Monetary items	Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency

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Definitions

Monetary items	Non-monetary items
Cash	Property, plant and equipment
Bank balances and loans	Intangible assets
Deposits	Goodwill
Accrued expenses	Shareholders' equity
Trade receivable/ payable	Investments in associates / JVs
Tax refund / payable	Inventories
Debt securities	Equity securities
Allowance for doubtful debts	Allowance for stock obsolescence
Deferred tax assets/liabilities	Deferred income

** For prepayments – if it is refundable, it is more akin to a deposit and hence, is a monetary items. Conversely, where it is not refundable, it is non-monetary.

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Functional currency

- Each entity is required to determine its functional currency in accordance with HKAS 21
- This applies whether the entity is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch)
- There is NO concept of a "group functional currency" in HKFRSs
- Judgment is required in assessing the functional currency
- Function currency will change ONLY if there is a change in the primary economic environment in which the entity operates

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Primary indicators of a functional currency

- the currency that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and the currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
- the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Further indicators:

- currency in which funds from financing activities are generated; and
- currency in which receipts from operating activities are usually retained.

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Functional currency of a foreign operation

Whether the functional currency of the foreign operation is the same as that of a reporting entity to which it is related?

- Whether the activities of a foreign operation are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;
- Whether the transactions with that reporting entity are a high or low proportion of the foreign operation's activities;
- Whether cash flows from the activities of the foreign operation directly affect the cash flows of that reporting entity and are readily available for remittance to it; and
- Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by that reporting entity.

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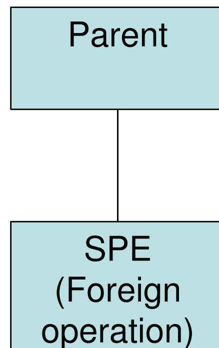
Functional currency of a foreign operation

Example 1:



- The special purpose entity (SPE) is set up to conduct on behalf of the parent entity (e.g. leasing vehicles) and the SPE is an extension of the reporting entity.
- What is the functional currency of the SPE?

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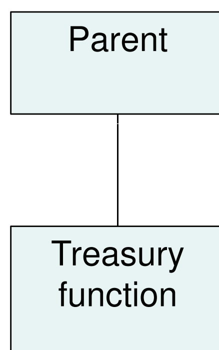
Functional currency of a foreign operation

Example 2:



- What is the functional currency of the entity that carries out treasury function?
  - ✓ If it exists to serve the funding and cash management needs of the group as a whole (i.e. constitute an extension of the parent), the functional currency is the same as that of the parent.
  - ✓ If it exist solely to service a specific sub-group, the functional currency may be different from that of the parent.

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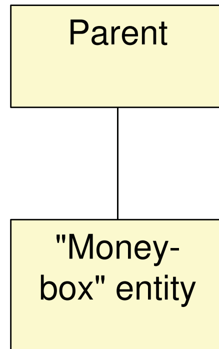
Functional currency of a foreign operation

Example 3:



- A "money-box" entity is an entity that holds cash for the group only.
- What is the functional currency of the "money-box" entity?
  - ✓ The currency of the cash will not be the determining factor.
  - ✓ Consider whose benefit the "money-box" entity exists, which will determine its functional currency.

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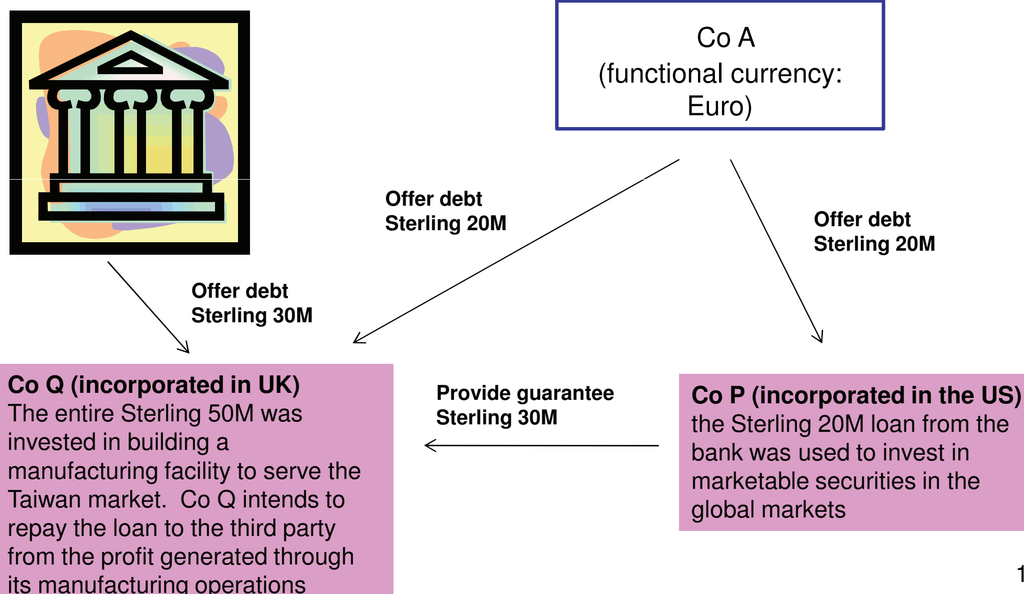
Example 4: What are the functional currencies of Co P and Co Q ?



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Example 4:

Accounting Treatment:

- **Co Q:** Possible functional currency can be Sterling or Taiwan Dollars because that is the currency that influence the sale prices and costs of its goods, as well as the regulations and competitive forces under which it operates

- **Co P:** even though Co P is domiciled in the US, its activities are carried out as an extension of Co A which those activities could have been carried out directly in the parent's books. Therefore, Co P should identify the Euro as its functional currency

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Functional currency – investment holding co

- For an investment holding entity that does not undertake any material operating activities of its own, the consideration (para HKAS 21.9) of the currency that mainly influences sales and costs of sales is not directly relevant.
- Current IAS 21 does not provide direct guidance on how to determine the functional currency of such holding entities

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Current practice

- For most of the listed companies' financial statements in Hong Kong, there are mainly two distinct approaches in determining the functional currency of investment holding companies which have some common facts as below:
  - The investment holding company (i.e. the listed company) is incorporated in Hong Kong or elsewhere (e.g. the Cayman Islands and Bermuda) with its shares listed on the Hong Kong Stock Exchange;
  - The ordinary share capital and the borrowings of the investment holding company are all denominated in Hong Kong dollars (HKD);
  - The investment holding company incurs some administrative and local expenses, comprising mainly directors' emoluments, limited staff costs and office rental payments, which are settled in HKD;

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- The principal assets of the holding company are its investments in subsidiaries. All of the operating subsidiaries of the holding company operate in Mainland China and their functional currency is Renminbi (RMB). Any dividend income received from the subsidiaries is either received in HKD or converted into HKD on receipt as the holding company does not have any RMB liabilities and, due to currency restrictions over the RMB, has very limited ability to hold RMB cash deposits

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View 1

- One view would be that the functional currency of the holding companies is to be determined as HKD
- The proponents of this view note that there is no scope within paragraphs 9 to 14 of IAS 21 for an investment holding company to be viewed as an extension of its subsidiary (i.e. the attribution of a functional currency from one group entity to another in accordance with paragraph 11 only applies in a downwards direction i.e. from parent to subsidiary (or other investee) and not vice versa)
- HKD is the currency in which all its operating expenses (small though they may be) are denominated and the currency of its sources of financing. The currency of Mainland China, the RMB, is not considered to be the functional currency of the investment holding company as it does not itself operate in Mainland China and carries its investments in the operating subsidiaries at cost

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- the operating subsidiaries are regarded as foreign operations of the investment holding company as these subsidiaries accumulate cash and other monetary items, incur expenses, generate income and arrange borrowings all substantially in their own local currency of the RMB with a significant degree of autonomy
- The supporters of this approach also note that such investment holding companies frequently exist to hold investments within jurisdictions with restricted currencies, such as the RMB
- In their view it would seem inappropriate to identify a restricted currency, such as the RMB, as the functional currency of an entity, when that entity is itself legally unable to hold the currency and would incur operational costs if settling transactions denominated in that currency due to the need to enter into foreign exchange trades

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View 2

- An alternate view would be that the RMB is a more appropriate functional currency for such an investment holding company given that its primary source of income (being dividend income from its operating subsidiaries) is from Mainland China and its ability to service debts and make distributions to its owners are heavily dependent on the economy of Mainland China
- This approach is considered by its supporters to be consistent with the provision in paragraph 12 which states that the entity needs to consider the primary factors stated in paragraph 9 of IAS 21, before going down to the indicators stated in other paragraphs of IAS 21. In the context of an investment holding company the assessment of income, as required by paragraph 9(a), would be the dividend income to be received from its operating subsidiaries

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- Furthermore, the currency in which dividends from subsidiaries are denominated of itself is not a conclusive factor in determining the functional currency of an investment holding company
- Paragraph IN7 in the introduction to IAS 21 makes clear that the Standard gives greater emphasis to the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated
- Investment holding companies control their subsidiaries and thus may ask for dividends to be paid in whatever currency they like. The currency in which dividend income is denominated is therefore not relevant in determining the functional currency of an investment holding company, as the amount of the dividend income is determined by the currency of the income of subsidiaries (eg the RMB) and retranslated into the settlement currency
- Likewise, management should not determine the functional currency of an investment holding company solely based on the currency in which funds are invested in the subsidiaries

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Functional currency – investment holding co

- IAS 21 paragraphs 9—11 provide factors to be considered in determining the functional currency of an entity. Paragraph 12 states that when the 'indicators are mixed and the functional currency is not obvious, management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions'
- In addition, paragraph 17 of IAS 21 requires that an entity determine its functional currency in accordance with paragraphs 9—14 of the standard. Therefore, paragraph 9 should not be considered in isolation when determining the functional currency of an entity

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Example: Functional currency

- **HSBC Holdings:**
  Annual report for ye 31 December 2012:
- Foreign currencies:

HSBC's consolidated financial statements are presented in US dollars which is also HSBC Holdings' functional currency. HSBC Holdings' functional currency is the US dollar because the US dollar and currencies linked to it are the most significant currencies relevant to the underlying transactions, events and conditions of its subsidiaries, as well as representing a significant proportion of its funds generated from financing activities. HSBC uses the US dollar as its presentation currency in its consolidated financial statements because the US dollar and currencies linked to it form the major currency bloc in which HSBC transacts and funds its business.

- **Agile Property Holdings Limited:**
  Annual report for ye 31 December 2012:
- Functional and presentation currency

Items included in the financial statements of each of the group companies are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The consolidated financial statements are presented in Renminbi ("RMB"), which is the Company's functional and the Group's presentation currency.

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Monetary item that forms part of a net investment in a foreign operation

- Receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation.
- Such monetary items may include long-term receivables or loans. They do NOT include trade receivables or trade payables.
- HKSA 21 does not specify a time period that might qualify as the "foreseeable future".
- The entity that has a monetary item receivable from or payable to the foreign operation may be the parent or any subsidiary in the group, including another foreign operation.
- For example, an entity has two subsidiaries, A and B. B is a foreign operation. A grants a loan to B. A's loan receivable from B would be part of the entity's net investment in B if settlement of the loan is neither planned nor likely to occur in the foreseeable future.

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Monetary item that forms part of a net investment in a foreign operation

- Can the following monetary items form part of the net investment in a foreign operation?
  - Rolling balance intragroup accounts
  - Parent guarantee of foreign subsidiary's debt
  - Foreign-currency denominated intragroup payables arising in the normal course of business with no fixed repayment terms
  - Short-term intragroup debt with parent's representation each year that it will not demand repayment in that year
- A monetary item that meets the requirements for accounting as "net investment in a foreign operation" can be denominated in a currency other than the functional currency of either the reporting entity or the foreign operation.

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Reporting foreign currency transactions in the functional currency

Initial recognition: recorded, in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction

Subsequent reporting periods

- **Monetary items**: translated using the closing rate
- **Non-monetary items at historical costs**: translated using the exchange rate at the date of the transaction
- **Non-monetary items at fair value**: translated using the exchange rates at the date when the fair value was determined

***For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, e.g. an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

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Reporting foreign currency transactions in the functional currency

Questions: How about those non-monetary items with carrying amounts that is determined by comparing two or more amounts, for example:

- the lower of cost and net realisable value for inventory (HKAS 2)
- the lower of an asset's previous carrying amount and its recoverable amount to determine the amount of an impairment loss (HKAS 36)?

HKAS 21.25

the carrying amount is determined by comparing:

(a) the cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e. the rate at the date of the transaction for an item measured in terms of historical cost), and

(b) the net realisable value or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (e.g. the closing rate at the end of the reporting period).

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency, or vice versa.

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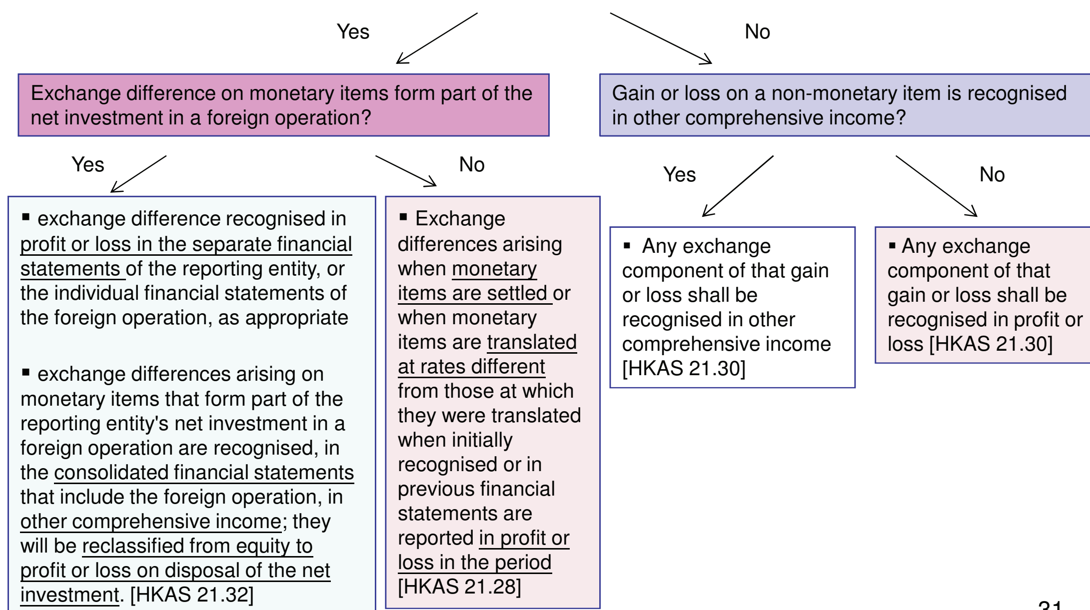
Reporting foreign currency transactions in the functional currency



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Exchange differences on non-monetary items

Example: Non-monetary items measured at fair value in a foreign currency:

Company A (US$ functional currency)

1 Nov 20X1: Purchased a building for SGD 50 million with full payment made (SGD 1.68:US$1)

31 Dec 20X1: Building is not depreciated as it is not yet available for use. Fair value is SGD 60 million. (SGD 1.71: US$1)

<u>1 Nov 20X1:</u>

Dr. Property, plant and equipment	US$29,761,905
Cr. Cash	US$29,761,905

(Measured the historical cost at the exchange rate of SGD 1.68:US$1)

<u>31 Dec 20X1:</u>

Dr. Property, plant and equipment	US$5,325,814
Cr. Revaluation gain (via OCI)	US$5,325,814

(The building is a non-monetary item and held at fair value. It is retranslated at the rate of SGD 1.71: US$1.)

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Exchange rates – other considerations

- Several exchange rates available

  the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. [HKAS 21.26]
- Lack of exchangeability between two currencies

  If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made. [HKAS 21.26]
- Exchange rate movements after the end of the reporting period

  If there is significant volatility in exchange rates, the effect on foreign currency monetary items of a change in exchange rates after the year end should be disclosed if the change is of significance to the users of financial statements
- Accounting records in a currency other than the functional currency

  At the time the entity prepares its financial statements, all amounts are translated into the functional currency in accordance with paragraphs 20-26. This produces the same amounts in the functional currency as would have occurred had the items been recorded initially in the functional currency. [HKAS 21.36]

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Change in functional currency

- Reason for the change in functional currency:

  Once determined, the functional currency can be changed ONLY if there is a change to those underlying transactions, events and conditions.

  For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in en entity's functional currency.
- Accounting treatment:
  - ✓ The entity applies the translation procedures applicable to the new functional currency prospectively from the date of the change.
  - ✓ In other words, an entity translates all items into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost.
  - ✓ Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation.
- Disclosure:

  The fact that there has been a change in functional currency and the reasons for the change

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Presentation currency

The presentation currency is defined as the currency in which the financial statements are presented.

- It can be any currency of choice
- Presenting the financial statements in a currency other than the functional currency does not change the way in which the underlying items are measured.
- For example:
  - ✓ When a group contains entities with different functional currencies, the results and financial position of each entity must be expressed in a common currency in order to produce the consolidated accounts. Such presentation currency is often, but not always, the functional currency of the parent.
  - ✓ Entities may also choose to present their accounts in a currency other than their functional currency in order to:
    - provide information to overseas shareholders; or
    - comply with the regulation in certain jurisdictions where entities are required to present the accounts in local currency.

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Presentation currency

Translation to the presentation currency

(a) assets and liabilities for each statement of financial position presented (ie including comparatives) shall be translated at the closing rate at the date of that statement of financial position;

(b) income and expenses for each statement of comprehensive income or separate income statement presented (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences shall be recognised in other comprehensive income.

How about translation of share capital or other equity reserves?

- The 'foreign currency translation reserve' should not include any amounts for the retranslation of share capital or other equity reserves.
- It is, therefore, appropriate to translate share capital and other components of equity using the historical rates.
- There may be circumstances where more than one historical rate will apply when share capital is issued at different times.

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Presentation currency

Notes:

- Cash flows are translated on a basis similar to that required for income and expenses, i.e. using the exchange rates at the transaction dates.
- Equity transactions (e.g. contributions to equity share capital, distributions to owners of equity) are also translated at the exchange rates at the transaction dates.
- A rate approximates the exchange rates at the dates of the transactions is often used to translate income and expenses. If the exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

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Translation of a foreign operation

- Generally follow that of the principles of translating the functional currency to the presentation currency
- Other factors to considers:
  - ✓ Not wholly-owned foreign operations
  - ✓ Exchange differences on intragroup transactions
  - ✓ Financial statements of foreign operations prepared to a different date
  - ✓ Goodwill and fair value adjustments

(I) Not wholly-owned foreign operations

- The cumulative amount of the exchange differences is presented in a separate component of equity until disposal of the foreign operation.
- When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognised as part of, non-controlling interests in the consolidated statement of financial position

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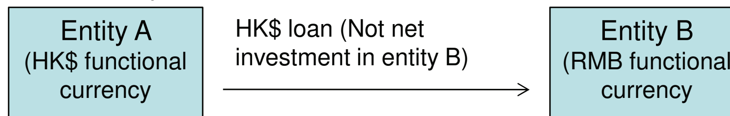
Translation of a foreign operation

(II) Exchange differences on intragroup transactions

- An intragroup monetary asset or liability, whether short-term or loan-term, cannot be eliminated against the corresponding intragroup liability or asset without showing exchange differences in the consolidated financial statements.
- In the consolidated financial statements of the reporting entity, such an exchange difference is recognised in profit or loss unless it is a monetary item that forms part of the reporting entity's net investment in the foreign operation.
- For example:



  - Exchange difference arises on retranslation into functional currency of RMB in entity's B individual financial statements.
  - On consolidation, although the intercompany loan will be eliminated, the related exchange gain or loss recognised in entity's B accounts will also be recognised in the consolidated profit or loss.

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Translation of a foreign operation

(III) Financial statements of a foreign operation prepared to a different date

- HKAS 27 / HKFRS 10 allows an operation prepares financial statements to a date different from that of the reporting entity and included in the consolidated accounts, provided that the difference is no greater than three months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates.
- For example, significant movements may arise between the two dates if the functional currency of the foreign operation devalues significantly against that of the reporting entity.
- The same approach is used in applying the equity method to associates and jointly controlled entities and in applying proportionate consolidation to jointly controlled entities. [joint ventures under HKFRS 11]

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Translation of a foreign operation

(IV) Goodwill and fair value adjustments

- Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be:
  - treated as assets and liabilities of the foreign operation, and therefore expressed in the functional currency of the foreign operation; and
  - translated at the closing rate

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Disposal or partial disposal of a foreign operation

Disposals

- On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognised in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised.
- The following events, transactions or changes in circumstances are accounted for as disposals:
  - ✓ Disposal of entire interest in a foreign operation
  - ✓ Loss of control of a subsidiary that includes a foreign operation
  - ✓ Loss of significant influence over an associate that includes a foreign operation
  - ✓ Loss of joint control over a jointly controlled entity that includes a foreign operation [joint arrangement under HKFRS 11]

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Disposal or partial disposal of a foreign operation

Differences attributable to non-controlling interests

- On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be derecognised, but shall not be reclassified to profit or loss.
- For example:
  - ✓ P has held an 80% interest in a foreign operation, S. Exchange differences of HK$2.5 million relating to S have been recognised in other comprehensive income. 80% of the exchange differences (i.e. HK$ 2 million) have been accumulated in P's foreign currency translation reserve in equity and the remainder have been attributed to non-controlling interests.
  - ✓ On loss of control, the HK$2 million in P's reserve are reclassified from reserve to profit or loss and included in the calculation of profit or loss on disposal.
  - ✓ HK$0.5 million were already reflected as part of the non-controlling interest in the consolidated accounts and are derecognised upon loss of control.

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Disposal or partial disposal of a foreign operation

Partial disposals

- A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except those reductions in paragraph 48A that are accounted for as disposals.
- Partial disposal of a subsidiary that includes a foreign operation:
  - Re-attribute the proportionate share of the cumulative amount of the exchange differences in other comprehensive income to the non-controlling interest in the foreign operation.
  - Such transfer will be recognised in equity.
  - For example, P held 100% interest in a foreign subsidiary S. Exchange differences of HK$2.5 million recognised in OCI and accumulated in a separate component of equity.

P disposes of 20% interests in S but retains control of S. 20% of the cumulative exchange differences (i.e. HK$0.5 million) are transferred within equity from the foreign currency translation reserve to non-controlling interests.

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Disposal or partial disposal of a foreign operation

Partial disposals

- Other partial disposal of a foreign operation:
  - Reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.
  - For example, I held a 40% interest in an associate, A. Exchange differences of HK$8 million relating to A have been recognised in OCI and accumulated in a separate component of equity.
    I disposes of 15% interest in A, but retains significant influence. The proportionate share of accumulated exchange differences (i.e. 3 million) is derecognised and is recognised in profit or loss as a reclassification adjustment.

Write-downs

- A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

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Tax effects of all exchange differences

- Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. HKAS 12 *Income Taxes applies to these tax effects.*

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Disclosure

- The amount of exchange differences recognised in profit or loss (excluding differences arising on financial instruments measured at fair value through profit or loss in accordance with HKAS 39) [HKAS 21.52(a)]
- Net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period [HKAS 21.52(b)]
- When the presentation currency is different from the functional currency, disclose that fact together with the functional currency and the reason for using a different presentation currency [HKAS 21.53]

  Refer to Annex 2 for an extract of annual report for disclosures.
- A change in the functional currency of either the reporting entity or a significant foreign operation and the reason. [HKAS 21.54]
- When an entity presents its financial statements in a currency that is different from its functional currency, it may describe those financial statements as complying with HKFRS only if they comply with all the requirements of each applicable Standard (including HKAS 21) and each applicable Interpretation. [HKAS 21.55]

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Consolidated Balance Sheet

As at 31 December 2012

	Note	As at 31 December 2012 RMB'000	2011 RMB'000
ASSETS			
Non-current assets			
Property and equipment	6	**9,702,631**	8,325,789
Investment properties	7	**26,248,098**	20,566,979
Land use rights	8	**4,717,336**	2,475,068
Intangible assets	9	**2,139,925**	2,264,027
Associated companies	11	**1,490,441**	1,308,281
Jointly controlled entities	12	**5,547,675**	4,307,877
Available-for-sale financial assets	13	**369,833**	267,362
Deferred income tax assets	24	**1,248,390**	1,313,909
Other non-current assets	14	**757,250**	3,205,665
		52,221,579	44,034,957
Current assets			
Properties under development	15	**37,608,942**	37,324,085
Completed properties held for sale	16	**7,103,351**	7,382,116
Trade and other receivables and prepayments	17	**6,638,544**	4,472,085
Prepayment for acquisition of land use rights	18	**6,676,235**	7,634,561
Prepaid income taxes		**1,165,244**	949,184
Amounts due from related companies	19	**1,316,027**	1,451,591
Restricted cash	20	**2,204,028**	1,681,222
Cash and cash equivalents	20	**15,893,845**	12,312,740
		78,606,216	73,207,584
Total assets		**130,827,795**	117,242,541
EQUITY			
Equity attributable to the equity holders of the Company			
Share capital	21	**356,275**	355,737
Reserves			
– Proposed final dividend	22	**1,548,559**	505,772
– Others	22	**34,002,316**	29,730,171
		35,907,150	30,591,680
Non-controlling interests		**5,020,082**	4,426,397
Total equity		**40,927,232**	35,018,077

Consolidated Balance Sheet

As at 31 December 2012

	Note	As at 31 December 2012 RMB'000	2011 RMB'000
LIABILITIES			
Non-current liabilities			
Borrowings	23	**28,613,297**	27,577,834
Deferred income tax liabilities	24	**3,775,578**	3,172,815
		32,388,875	30,750,649
Current liabilities			
Trade and other payables	25	**14,316,430**	17,317,407
Advanced proceeds received from customers		**20,578,024**	11,828,902
Income tax payable		**7,259,690**	7,159,326
Borrowings	23	**12,380,644**	14,983,419
Derivative financial instruments	26	**42,572**	52,115
Amounts due to related parties	27	**2,897,713**	30,831
Deferred income		**36,615**	101,815
		57,511,688	51,473,815
Total liabilities		**89,900,563**	82,224,464
Total equity and liabilities		**130,827,795**	117,242,541
Net current assets		**21,094,528**	21,733,769
Total assets less current liabilities		**73,316,107**	65,768,726

Hui Wing Mau
Director

Hui Sai Tan, Jason
Director

The notes on pages 71 to 164 are an integral part of these consolidated financial statements.

Consolidated Statement of Comprehensive Income

For the year ended 31 December 2012

	Note	Year ended 31 December 2012 RMB'000	2011 RMB'000
Revenue	5	**28,652,243**	26,031,426
Cost of sales	29	**(19,046,444)**	(16,031,376)
Gross profit		**9,605,799**	10,000,050
Fair value gains on investment properties	7	**2,362,880**	2,527,013
Other income/other gains – net	28	**1,196,104**	794,320
Selling and marketing costs	29	**(1,046,841)**	(769,889)
Administrative expenses	29	**(1,815,871)**	(1,349,272)
Other operating expenses	29	**(266,706)**	(192,173)
Operating profit		**10,035,365**	11,010,049
Finance income		**146,055**	100,074
Finance costs		**(168,170)**	(480,420)
Finance costs – net	30	**(22,115)**	(380,346)
Share of results of			
– Associated companies	11	**(210,938)**	97,653
– Jointly controlled entities	12	**363,125**	24,213
		152,187	121,866
Profit before income tax		**10,165,437**	10,751,569
Income tax expense	32	**(3,580,949)**	(4,302,640)
Profit for the year		**6,584,488**	6,448,929
Other comprehensive income:			
Fair value gains/(losses) on available-for-sale financial assets, net of tax		**76,853**	(60,346)
Total comprehensive income for the year		**6,661,341**	6,388,583

Consolidated Statement of Comprehensive Income

For the year ended 31 December 2012

	Note	Year ended 31 December 2012 RMB'000	2011 RMB'000
Profit for the year attributable to:			
Equity holders of the Company		**5,764,632**	5,722,775
Non-controlling interests		**819,856**	726,154
		6,584,488	6,448,929
Total comprehensive income for the year attributable to:			
Equity holders of the Company		**5,813,987**	5,684,021
Non-controlling interests		**847,354**	704,562
		6,661,341	6,388,583
Earnings per share for profit attributable to the equity holders of the Company			
– Basic (RMB cents)	33	**166.3**	162.2
– Diluted (RMB cents)	33	**166.2**	162.1

The notes on pages 71 to 164 are an integral part of these consolidated financial statements.

	Note	Year ended 31 December 2012 RMB'000	2011 RMB'000
Dividends	34	**1,548,559**	1,145,545

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.5 Foreign currency translation *(continued)*

(c) Group companies

The results and financial position of all the group entities (none of which has the currency of a hyper-inflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- Assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;

- Income and expenses for each income statement are translated at average exchange rates; and

- all resulting exchange differences are recognised in other comprehensive income.

2.6 Property and equipment

Property and equipment are stated at historical cost less accumulated depreciation and accumulated impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items. Buildings comprise hotel buildings and self-use buildings.

Assets under construction are stated at historical cost less impairment losses. Historical cost includes expenditure that is directly attributable to the development of the assets which comprises construction costs, borrowing costs and professional fees incurred during the development period. On completion, the assets are transferred to buildings within property and equipment.

No depreciation is provided for assets under construction. The carrying amount of an asset under construction is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognised. All other repairs and maintenance costs are charged to the income statement during the financial period in which they are incurred.

Depreciation on property and equipment is calculated using the straight-line method to allocate their costs less their residual values and impairment loss over their estimated useful lives, as follows:

Buildings	50 years or the remaining lease period of the land use rights, whichever is shorter
Building improvements	10 to 20 years
Furniture and equipment	5 years
Jet plane and motor vehicles	10 to 20 years

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.6 Property and equipment *(continued)*

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount (Note 2.9).

Gains and losses on disposals are determined by comparing proceeds with the carrying amount and are recognised within "Other income/other gains – net" in the income statement.

2.7 Investment property

Investment property, principally comprising leasehold land and buildings, is held for long-term rental yields or for capital appreciation or both, and that is not occupied by the Group. It also includes properties that are being constructed or developed for future use as investment properties. Land held under operating leases are accounted for as investment properties when the rest of the definition of an investment property is met. In such cases, the operating leases concerned are accounted for as if they were finance leases. Investment property is initially measured at cost, including related transaction costs and where applicable borrowing costs. After initial recognition, investment properties are carried at fair value, representing open market value determined at each reporting date by external valuers. Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific asset. If the information is not available, the Group uses alternative valuation methods such as recent prices on less active markets or discounted cash flow projections. Changes in fair values are recorded in the income statement as 'fair value gains/losses on investment properties'.

If an entity determines that the fair value of an investment property under construction is not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, it shall measure that investment property under construction at cost until either its fair value becomes reliably determinable or construction is completed (whichever is earlier).

If an investment property becomes owner-occupied or commences development with a view to sale, it is reclassified as property and equipment or as properties under development or completed properties held for sale, and the property's deemed cost for subsequent accounting is its fair value at the date of change in use.

If an item of property and equipment becomes an investment property because its use has changed, any difference resulting between the carrying amount and the fair value of this item at the date of transfer is recognised as a revaluation of property and equipment in equity under HKAS 16. If a property commences an operating lease to another party, it is transferred from properties under development or completed properties held for sale to investment property, and any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.12 Properties under development

Properties under development are stated at the lower of cost and net realisable value. Net realisable value takes into account the price ultimately expected to be realised, less applicable variable selling expenses and the anticipated costs to completion.

Development cost of properties comprises cost of land use rights, construction costs, borrowing costs and professional fees incurred during the development period. On completion, the properties are transferred to completed properties held for sale.

Properties under development are classified as current assets unless the construction period of the relevant property development project is expected to complete beyond normal operating cycle.

2.13 Completed properties held for sale

Completed properties held for sale are stated at the lower of cost and net realisable value.

Cost comprises development costs attributable to the unsold properties.

Net realisable value is determined by reference to the sale proceeds of properties sold in the ordinary course of business, less applicable variable selling expenses, or by management estimates based on prevailing marketing conditions.

2.14 Trade and other receivables

Trade receivables are amounts due from customers for properties sold or services performed in the ordinary course of business. If collection of trade and other receivables is expected in one year or less (or in the normal operating cycle of the business if longer), they are classified as current assets. If not, they are presented as non-current assets.

Trade and other receivables are recognized initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment.

2.15 Cash and cash equivalents

Cash and cash equivalents include cash in hand, call deposits with original maturities of three months or less that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.23 Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sales of properties and services in the ordinary course of the Group's activities. Revenue is shown, net of discounts and after eliminating sales with the Group companies. Revenue is recognised as follows:

(i) Sales of properties

Revenue from sales of properties is recognised when the risks and rewards of the properties are transferred to the purchasers, which is when the construction of relevant properties has been completed and the properties have been delivered to the purchasers pursuant to the sales agreement and collectibility of related receivables is reasonably assured. Deposits and instalments received on properties sold prior to the date of revenue recognition are included in the consolidated balance sheet under current liabilities.

(ii) Property management services

Revenue arising from property management services is recognised in the accounting period in which the services are rendered.

(iii) Interest income

Interest income is recognised on a time-proportion basis using the effective interest method.

(iv) Rental income

Rental income from properties letting under operating leases is recognised on a straight line basis over the lease terms.

(v) Hotel operation income

Hotel operation income which includes rooms rental, food and beverage sales and other ancillary services is recognised when the services are rendered.

(vi) Sales of goods

The Group operates certain retail department stores. Sales of goods are recognized when the Group sells goods to the customers.

(vii) Dividend income

Dividend income is recognised when the right to receive payment is established.

4 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS *(CONTINUED)*

4.1 Critical accounting estimates and assumptions *(continued)*

(d) Fair value of investment properties

The best evidence of fair value is current prices in an active market for the properties with similar lease and other contracts. In the absence of such information, the Group determines the amount within a range of reasonable fair value estimates. In making its judgement, the Group considers information from a variety of sources including:

(i) current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;

(ii) recent prices of similar properties in less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and

(iii) discounted cash flow projections based on reliable estimates of future cash flows, derived from the terms of any existing lease and other contracts and (where possible) from external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

The Group assesses the fair value of its investment properties based on valuations determined by independent professional qualified valuers.

(e) Provision for properties under development and completed properties held for sale

The Group assesses the carrying amounts of properties under development and completed properties held for sale according to their net realisable value based on the realisability of these properties, taking into account costs to completion based on past experience and net sales value based on prevailing market conditions. Provision is made when events or changes in circumstances indicate that the carrying amounts may not be realised. The assessment requires the use of judgement and estimates.

(f) Fair value of derivatives financial instruments

The Group's derivative financial instruments are interest rate swap contracts entered into with commercial bank, the fair value of which is determined using valuation models for which not all inputs are market observable prices or rates.

(g) Impairment of trade receivable

When there is objective evidence of impairment loss, the Group takes into consideration the estimation of future cash flows to determine impairment loss. The amount of the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective increase rate (i.e. the effective interest rate computed at initial recognition). Where the actual future cash flows are less than expected, an impairment loss may arise.

4 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS *(CONTINUED)*

4.2 Critical judgements in applying the Group's accounting policy

Classification between investment properties and owner-occupied properties

The Group determines whether a property qualifies as an investment property, and has developed criteria in making that judgement.

Investment property is a property held to earn rentals or for capital appreciation or both. Therefore, the Group considers whether a property generates cash flows largely independently of the other assets held by the Group. Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), the Group accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

5 SEGMENT INFORMATION

The CODM has been identified as the management committee. The CODM reviews the Group's internal reporting in order to assess performance and allocate resources. The CODM has determined the operating segments based on these reports.

As majority of the Group's consolidated revenue and results are attributable to the market in the PRC and most of the Group's consolidated assets are located in the PRC, therefore no geographical information is presented.

The CODM assesses the performance of the operating segments based on a measure of revenue and profit before tax. The information provided to the CODM is measured in a manner consistent with that in the financial statements.

(a) Revenue

Turnover of the Group consists of the following revenue recognised during the year:

	Year ended 31 December	
	2012	2011
	RMB'000	RMB'000
Sales of properties	**26,607,120**	24,589,476
Hotel operation income	**999,134**	892,012
Rental income from investment properties	**507,415**	440,559
Others	**538,574**	109,379
	28,652,243	26,031,426

6 PROPERTY AND EQUIPMENT – GROUP

	Assets under construction RMB'000	Hotel buildings and improvements RMB'000	Furniture and equipment RMB'000	Jet plane and motor vehicles RMB'000	Self-use buildings RMB'000	Total RMB'000
Cost						
At 1 January 2012	3,064,683	5,395,075	234,294	459,495	411,792	9,565,339
Additions	1,546,742	22,589	70,604	3,994	180,794	1,824,723
Amortisation of land use rights	20,268	–	–	–	–	20,268
Disposals	–	–	(10,383)	(6,679)	–	(17,062)
Transfer to properties under development and completed properties held for sale	(53,743)	–	–	–	(85,101)	(138,844)
At 31 December 2012	4,577,950	5,417,664	294,515	456,810	507,485	11,254,424
Accumulated depreciation						
At 1 January 2012	–	1,064,100	66,380	60,454	48,616	1,239,550
Charge for the year	–	262,314	40,537	32,785	11,395	347,031
Disposals	–	–	(8,386)	(5,315)	–	(13,701)
Transfer to properties under development and completed properties held for sale	–	–	–	–	(21,087)	(21,087)
At 31 December 2012	–	1,326,414	98,531	87,924	38,924	1,551,793
Net book value						
At 31 December 2012	4,577,950	4,091,250	195,984	368,886	468,561	9,702,631

6 PROPERTY AND EQUIPMENT – GROUP *(CONTINUED)*

	Assets under construction RMB'000	Hotel buildings and improvements RMB'000	Furniture and equipment RMB'000	Jet plane and motor vehicles RMB'000	Self-use buildings RMB'000	Total RMB'000
Cost						
At 1 January 2011	2,069,136	4,488,086	114,488	446,901	404,873	7,523,484
Additions	1,870,311	29,815	103,396	25,914	19,665	2,049,101
Amortisation of land use rights	31,977	–	–	–	–	31,977
Disposals	–	(3,804)	(9,353)	(13,320)	(12,746)	(39,223)
Transfer upon completion	(906,741)	880,978	25,763	–	–	–
At 31 December 2011	3,064,683	5,395,075	234,294	459,495	411,792	9,565,339
Accumulated depreciation						
At 1 January 2011	–	835,250	47,208	39,692	47,706	969,856
Charge for the year	–	230,192	26,398	30,415	11,009	298,014
Disposals	–	(1,342)	(7,226)	(9,653)	(10,099)	(28,320)
At 31 December 2011	–	1,064,100	66,380	60,454	48,616	1,239,550
Net book value						
At 31 December 2011	3,064,683	4,330,975	167,914	399,041	363,176	8,325,789

Depreciation charge of RMB347,031,000 for the year ended 31 December 2012 (2011: RMB298,014,000) has been recorded in cost of sales and administrative expenses in the consolidated income statement (Note 29).

As at 31 December 2012, assets under construction and buildings of the Group with a total carrying amount of RMB5,747,018,000 (2011: RMB6,955,413,000) were pledged as collateral for certain bank borrowings of the Group (Note 23).

As at 31 December 2012, interest capitalised in assets under construction amounted to RMB131,231,000 (2011: RMB169,950,000).

The capitalisation rate of borrowings was 7.48% for the year ended 31 December 2012 (2011: 7.89%).

7 INVESTMENT PROPERTIES – GROUP

	Year ended 31 December	
	2012	2011
	RMB'000	RMB'000
Opening balance	**20,566,979**	11,854,995
Additions		
– Transfer from properties under development	**242,937**	3,477,519
– Additions-construction cost and others	**3,075,302**	2,707,452
Fair value gains	**2,362,880**	2,527,013
Ending balance	**26,248,098**	20,566,979

(a) Amounts recognised in profit and loss for investment properties

	Year ended 31 December	
	2012	2011
Rental income	**507,415**	440,559
Direct operating expenses from properties that generated rental income	**33,119**	31,789
Direct operating expenses from properties that did not generate rental income	**5,415**	4,914

(b) Valuation basis

The fair values of the Group's investment properties were assessed as at 31 December 2012 by Vigers Appraisal & Consulting Limited ("Vigers") and Shanghai Zhonghua Asserts Appraisal Co., Ltd. ("Shanghai Zhonghua"), two independent professional qualified valuers. Valuations were performed using either: (i) income capitalisation approach based on existing and current market rents for similar properties, using capitalisation rates that reflect current market assessments of the uncertainty in the market; or (ii) direct comparison approach assuming sales of these properties in its existing state by making reference to comparable sales transactions as available in the relevant market. Shanghai Zhonghua assessed the fair values of investment properties held by Shanghai Shimao, a subsidiary of the Group listed in Shanghai Stock Exchange. The management has evaluated the standards and assumptions used, as well as the results got by Shanghai Zhonghua, and concluded the valuations are acceptable for preparation of these consolidation financial statements.

(c) Pledge

As at 31 December 2012, the Group's investment properties were held in the PRC on leases of between 10 to 50 years. Investment properties with a carrying amount of RMB15,261,100,000 (2011: RMB14,423,730,000) were pledged as collateral for the Group's borrowings (Note 23).

7 INVESTMENT PROPERTIES – GROUP *(CONTINUED)*

(d) Leasing arrangements

Some of the investment properties are leased to tenants under long term operating leases with rentals receivable monthly. Minimum lease rental receivable under non cancellable operating leases of investment properties not recognised in the financial statements are as follows:

	As at 31 December	
	2012	2011
	RMB'000	RMB'000
Within 1 year	**325,370**	451,152
Later than 1 year but no later than 5 years	**863,981**	1,067,904
Later than 5 years	**707,087**	831,485
	1,896,438	2,350,541

(e) Investment properties under construction

As at 31 December 2012, RMB10,470,979,000 of the investment properties are under construction (2011: RMB6,680,698,000).

8 LAND USE RIGHTS – GROUP

	Year ended 31 December	
	2012	2011
	RMB'000	RMB'000
Land use rights relating to property and equipment under non-current assets		
Opening balance	**2,475,068**	2,572,389
Additions	**2,422,593**	148,117
Amortisation		
– Capitalised in property and equipment (Note 6)	**(20,268)**	(31,977)
– Recognised as expenses (Note 29)	**(42,368)**	(40,058)
Transfer to properties under development and completed properties held for sale	**(117,689)**	(173,403)
Ending balance	**4,717,336**	2,475,068
Outside Hong Kong, held on leases of:		
Over 50 years	**79,103**	79,098
Between 10 to 50 years	**4,638,233**	2,395,970
	4,717,336	2,475,068

8 LAND USE RIGHTS – GROUP *(CONTINUED)*

Land use rights comprise cost of acquiring rights to use certain land, which are all located in the PRC, for assets under construction, hotel buildings and self-use buildings over fixed periods.

As at 31 December 2012, land use rights of RMB1,877,321,000 (2011: of RMB1,892,220,000) were pledged as collateral for the Group's bank borrowings (Note 23).

9 INTANGIBLE ASSETS – GROUP

Intangible assets comprise goodwill arising from acquisitions:

	Year ended 31 December	
	2012	2011
	RMB'000	RMB'000
Opening balance	**2,264,027**	2,280,462
Write-off of goodwill recognised as expenses (Note 29)	**(124,102)**	(16,435)
Ending balance	**2,139,925**	2,264,027

Impairment tests for goodwill

Goodwill is allocated to the Group's cash-generating units (CGUs) identified according to business segment. A segment level summary of the goodwill is presented below:

	As at 31 December	
	2012	2011
	RMB'000	RMB'000
Property development and investment – Shanghai Shimao	**1,709,730**	1,709,730
Property development and investment – Others	**299,267**	423,369
Hotel operation	**130,928**	130,928
	2,139,925	2,264,027

The recoverable amounts of CGUs are determined based on their fair values (less cost to sell). The fair value of CGU – Property development and investment – Shanghai Shimao is determined according to the quoted price of Shanghai Shimao's equity shares in the PRC share capital market with adjustment of control premium. The fair values of other CGUs are determined according to the value of the underlying properties and decrease along with the sales of underlying properties, and the attributable goodwill is impaired accordingly.

The goodwill impairment was included in other operating expenses in the consolidated income statement.

14 OTHER NON-CURRENT ASSETS – GROUP

As at 31 December 2012, the Group has made prepayments of RMB757,250,000 (2011: RMB2,875,665,000) for certain land use rights for the purpose to develop hotel buildings, self-used buildings and investment properties, the ownership certificates of which have not been obtained.

As at 31 December 2011, the Group made prepayments of RMB330,000,000 for acquisition of additional 5% interests in a subsidiary. In June 2012, this acquisition was completed.

15 PROPERTIES UNDER DEVELOPMENT – GROUP

	As at 31 December	
	2012	2011
	RMB'000	RMB'000
Properties under development comprise:		
Land use rights	**21,881,174**	20,424,315
Construction costs and capitalised expenditures	**12,384,879**	14,702,487
Interests capitalised	**3,342,889**	2,197,283
	37,608,942	37,324,085

	As at 31 December	
	2012	2011
	RMB'000	RMB'000
Land use rights		
Outside Hong Kong, held on leases of:		
Over 50 years	**17,729,216**	14,772,368
Between 10 to 50 years	**4,151,958**	5,651,947
	21,881,174	20,424,315

The properties under development are all located in the PRC. The relevant land use rights are on leases of 40 to 70 years.

15 PROPERTIES UNDER DEVELOPMENT – GROUP *(CONTINUED)*

As at 31 December 2012, properties under development of approximately RMB15,341,479,000 (2011: RMB17,502,613,000) were pledged as collateral for the Group's bank borrowings (Note 23).

The capitalisation rate of borrowings was 7.48% for the year ended 31 December 2012 (2011: 7.89%).

	As at 31 December	
	2012	2011
	RMB'000	RMB'000
Properties under development:		
Expected to be completed and available for sale after more than 12 months	**15,793,008**	18,233,372
Expected to be completed and available for sale within 12 months	**21,815,934**	19,090,713
	37,608,942	37,324,085

16 COMPLETED PROPERTIES HELD FOR SALE – GROUP

All completed properties held for sale are located in the PRC. Included in completed properties held for sale, there are land use rights as follows:

	As at 31 December	
	2012	2011
	RMB'000	RMB'000
Outside Hong Kong, held on leases of:		
Over 50 years	**1,020,287**	1,125,561
Between 10 to 50 years	**133,839**	247,374
	1,154,126	1,372,935

As at 31 December 2012, completed properties held for sale of RMB1,159,357,000 (2011: RMB1,049,536,000) were pledged as collateral for the Group's bank borrowings (Note 23).

For the year ended 31 December 2012, no impairment losses (2011: RMB15,398,000) was recognized by the group on completed properties held for sale.

(x) Foreign currencies

(i) *Functional and presentation currency*

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The Company's functional currency is Renminbi. The consolidated financial statements are presented in Hong Kong dollars to facilitate analysis of financial information by the holding company.

(ii) *Transactions and balances*

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies at the exchange rates ruling at the end of the reporting period are recognised in the income statement.

Translation differences on financial assets held at fair value through profit or loss is reported as part of the fair value gain or loss. Translation differences on non-monetary available-for-sale financial assets are included in equity.

(iii) *Group companies*

The results and financial position of all the Group's entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

(1) assets and liabilities for each statement of financial position presented are translated at the closing rate at the date of the end of that reporting period;

(2) income and expenses for each income statement are translated at average exchange rates;

(3) all resulting exchange differences are recognised as a separate component of equity; and

(4) on the disposal of the Group's entire interest in a foreign operation, or a disposal involving loss of control over a subsidiary that includes a foreign operation, all of the exchange differences accumulated in equity in respect of that operation attributable to the equity holders of the Company are reclassified to profit or loss.

During the preparation of consolidated financial statements, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings, are taken to shareholders' equity. In the case of a partial disposal that does not result in the Group losing control over a subsidiary that includes a foreign operation, the proportionate share of accumulated exchange differences are reattributed to non-controlling interests and are not recognised in profit or loss. For all other partial disposals (that is, reductions in the Group's ownership interest in associated companies or jointly controlled entities that do not result in the Group losing significant influence or joint control) the proportionate share of the accumulated exchange difference is reclassified to profit or loss.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the exchange rate ruling at the end of reporting period.

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A Refresher Course on Current

Financial Reporting Standards 2013

Day 4

Time	Topic
09:00 - 11:00	Financial instruments: measurement and recognition
11:00 - 11:15	Break
11:15 - 12:15	Financial instruments: presentation and disclosures
12:15 - 13:00	Revenue recognition, customer loyalty programme
13:00 - 14:00	Lunch
14:00 - 15:15	Impairment
15:15 - 16:00	Revision question

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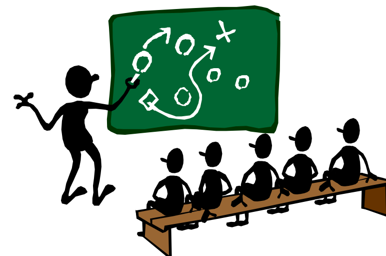
A Refresher Course on Current Financial Reporting Standards 2013 (Day 4)

Financial Instruments



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Financial Instruments

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Hong Kong Financial Reporting Standards

❖ HKFRS - Our focus in this session

Financial Instruments

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

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HKAS 32

Financial Instruments: Presentation

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Agenda – HKAS 32

- Definitions
- Principles of liability/equity classification
- Compound financial instruments

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❖ Definition of a financial instrument and applicability of HKAS 32

- A financial instrument is any contract that gives rise to a financial asset of an entity and a financial liability or equity instrument of another entity
- HKAS 32 applies to all financial instruments except for:
  - interests in subsidiaries, associates and joint ventures
  - employers' rights and obligations under employee benefit plans
  - rights and obligations arising under insurance contracts
  - financial instruments, contracts and obligations under share-based payment arrangements
- HKAS 39 also scopes out these instruments, but has some additional scope exemptions

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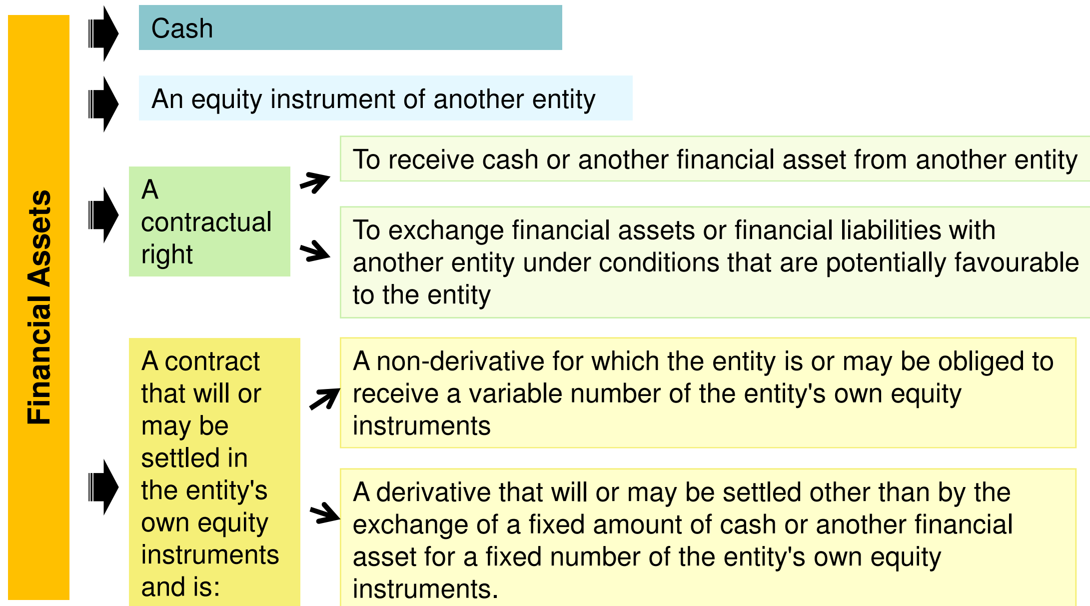
Definition of a financial asset [HKAS 32.11]



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Question:

Financial assets

❖ **Are gold bullion, prepaid expenses and tax receivables financial assets and measured under HKAS 39?**

i. **Gold bullion** is not a financial instrument. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in the bullion. It is a commodity

ii. **Prepaid expense** is not a financial asset. The anticipated future economic benefit of the prepaid expense is the receipt of goods or services

iii. **Tax receivables** are not financial assets. They arise from statutory requirements

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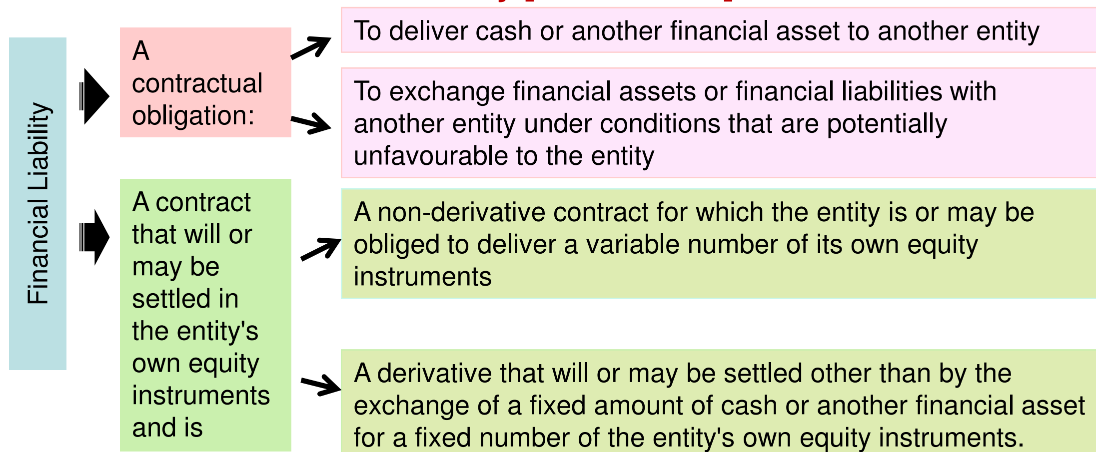
Definition of a financial liability [HKAS 32.11]



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Exemptions from liability classification

- The following two categories of financial instruments issued by an entity are exempt from liability classification even if they contain an obligation for the entity to deliver cash or another financial asset:
  - puttable financial instruments that meets certain conditions; and
  - an instrument, or a component of an instrument, that contains an obligation for the issuing entity to deliver to the holder a pro rata share of the net assets of the issuing entity only on its liquidation
  - refer to HKAS 32.16, 16A-16D

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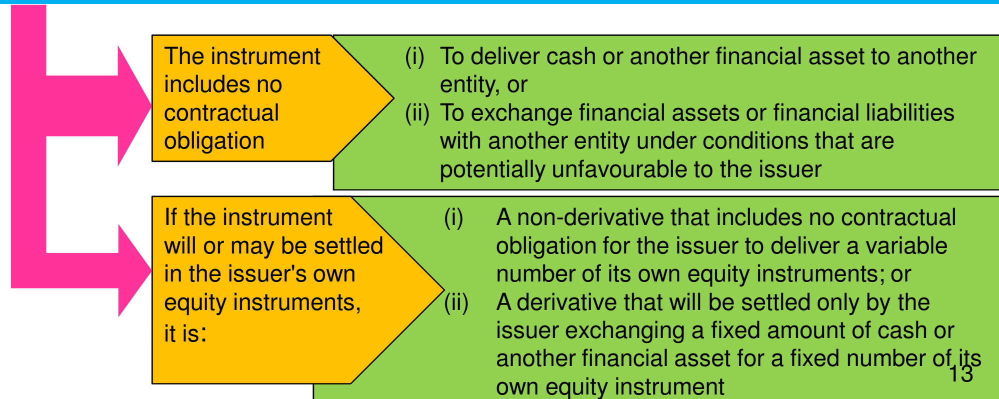
Equity Instrument [HKAS 32.11 & 16]

- An equity instrument is any contract that evidence a residual interest in the assets of the entity after deducting all of its liabilities
- In classifying a financial instrument as liability or equity, equity classification is appropriate only if the instrument fails the definition of a financial liability
- To determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions as follows are met



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Principles of liability/equity classification

a. Contractual obligation to settle in cash or another financial asset

b. Fixed for fixed requirement

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Principles of liability/equity classification

Contractual obligation to settle in cash or another financial asset

- ❑ Classification of a financial instrument at initial recognition should be:
  - according to the substance of the contractual arrangement, not its legal form, and
  - the definitions of a financial asset, financial liability and an equity instrument
- ❑ Key features to determine whether a financial instrument is a liability:
  - existence of a contractual obligation of one party (the issuer) to deliver cash or another financial asset to another party (the holder), or
  - to exchange financial assets or liabilities under conditions that are potentially unfavourable

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Principles of liability/equity classification

Fixed for fixed requirement

- ❑ A **contract** is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments
- ❑ Classification of contracts that may/will be settled in the entity's own equity instruments is dependent on:
  - whether there is variability in either the number of own equity delivered and/or variability in the amount of cash or other financial assets received, or whether both are fixed
- ❑ A contract that will be settled by the **entity receiving (or delivering) a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument** ('fixed for fixed' requirement)

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Principles of liability/equity classification

Fixed for fixed requirement (cont'd)

- **Questions?**
  - A contract to deliver as many of the entity's own equity instruments as are equal in value of $100.
  - A contract to deliver as many of the entity's own equity instruments as are equal in value of the value of 100 ounces of gold.

Are these contracts an equity or a financial liability?

- Such a contract is **a financial liability** even though the entity must or can settle it by delivering its own equity instruments.
- It is **not an equity instrument** because the entity uses a variable number of its own equity instrument as a means to settle the contract.
- The contract **does not evidence a residual interest** in the entity's assets after deducting all of its liabilities.

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Principles of liability/equity classification

Classification of Rights Issues

- A financial instrument that gives the holder the right to acquire a fixed number of the entity's own equity instruments for a fixed amount of **any currency** is an equity instrument if, and only if, the entity offers the financial instrument pro rata to all of its existing owners of the same class of its own non-derivative equity instruments, **such rights issues are classified as equity regardless of the currency in which the exercise price is denominated**

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Principles of liability/equity classification
Compound financial instruments

- The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and equity component

- Such components shall be classified separately as financial liabilities, financial assets or equity instruments

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Principles of liability/equity classification
Compound financial instruments (cont'd)

- **Example:** Bonds with conversion features which comprises two components:
  - financial liability (a contractual arrangement to deliver cash or another financial asset), and
  - an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity)

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Separating the liability and equity components

- Separation of the instrument into its liability and equity components is made upon **initial recognition** and is **not subsequently revised**

- **Method** for separating a convertible bond:
  - (a) The fair value of the liability component is calculated, and this fair value establishes the initial carrying amount of the liability component; and
  - (b) The fair value of the liability component is deducted from the fair value of the instrument as a whole, with the residual amount being the equity component.

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Example – Separation of a convertible bond (HKAS 32 IE34 – IE36)

An entity issues 2,000 convertible bonds at the start of year 1:

(a) 3-year term

(b) Issued at par

(c) Face value of HK$1,000 per bond (Total proceeds of HK$2,000,000)

(d) Interest payable annually in arrears at a nominal interest rate of 6%

(e) Convertible at any time into 250 ordinary shares for each bond

(f) Market interest rate for similar debt without conversion option of 9%

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Example – Separation of a convertible bond (HKAS 32 IE34 – IE36) - Cont'd

	HK$
Present value of the principal – HK$2,000,000 payable at the end of three years $\frac{2,000,000}{(1.09)^3}$	1,544,367
Present value of the interest – HK$120,000 payable annually in arrears for three years $\frac{120,000}{1.09} + \frac{120,000}{(1.09)^2} + \frac{120,000}{(1.09)^3}$	303,755
Total liability component	1,848,122
Equity component (by deduction)	151,878
Proceeds of the bond issue	2,000,000

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Financial Instrument: Measurement and Recognition

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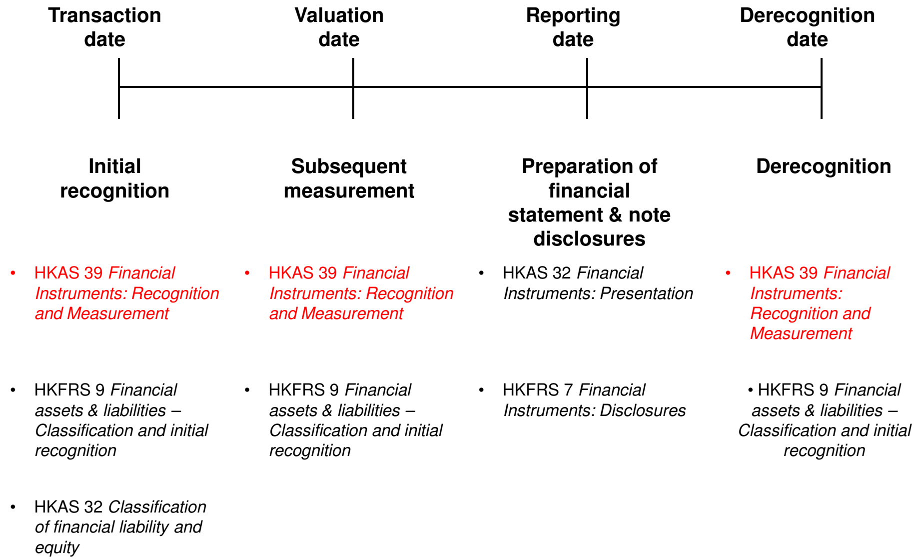
HKFRSs that deal with the accounting for financial instruments



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HKAS 39

"Financial Instruments: Recognition and Measurement"

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Types of Financial Instruments

- **Non-derivative financial instruments**
- **Derivative instruments**
- **Embedded derivatives**

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Classification of financial assets

- **At fair value through profit or loss (FVTPL)**
  - **Held for trading**
  - **Designated as at FVTPL**
- **Held-to-maturity**
- **Loans and receivables**
- **Available-for-sale**

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Classification of financial liabilities

- **At fair value through profit or loss (FVTPL)**
  - **Held for trading**
  - **Designated as at FVTPL**

- Others (measured at amortised cost)

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Financial assets/liabilities at fair value through profit or loss (FVTPL)

Held for trading financial assets/liabilities

- Acquired or incurred principally for the purpose of sale or settled in the near term OR
- On initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking OR
- It is a derivative (except for a derivative that is a designated and effective hedging instrument)

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Financial assets/liabilities at fair value through profit or loss (FVTPL)

Fair Value Option (FVO)

- A financial asset or a financial liability may upon initial recognition be designated as at FVTPL only if it meets one of the following conditions:
  - it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (commonly referred to as an "accounting mismatch")
  - a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel

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Financial assets/liabilities at fair value through profit or loss (FVTPL)

Fair Value Option (FVO)

- In the case of a hybrid contract containing one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability as FVTPL unless:
  - the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
  - it is clear that separation of the embedded derivative is prohibited

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Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than those the entity intends to sell immediately or in the short-term, and those that the entity on initial recognition designates as either FVTPL or available-for-sale

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Held-to-maturity investments (HTM)

- HTM investments are non-derivative financial instruments with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity, other than those that the entity, upon initial recognition, elects to designate as at FVTPL or available-for-sale or that meet the definition of loans and receivables
- Example:
  - Preference shares with fixed or determinable payments and a fixed maturity (e.g. mandatorily redeemable preference shares) determined to be financial liabilities under HKAS 32 for the issuer can be classified as HTM by the holders
  - A variable interest debt instrument (e.g. a five-year debt instrument which pays LIBOR plus 150 basis points, with interest payments receivable semi-annually in arrears)

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Available-for-sale financial assets (AFS)

AFS financial assets are those non-derivative financial assets that are designated as AFS, or are not classified as loans and receivables or HTM investments, are not held for trading and are not designated as at FVTPL on initial recognition

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Derivatives

- A derivative is a financial instrument or other contract within the scope of HKAS 39 with all three of the following characteristics:
  - Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying')
  - Its requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
  - It is settled at a future date

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Derivatives

- Stand-alone derivatives
  - Held for trading
  - Hedge accounting
    - a fair value hedge
    - a cash flow hedge; and
    - a hedge of a net investment in a foreign operation ("net investment hedge")
- Embedded derivatives

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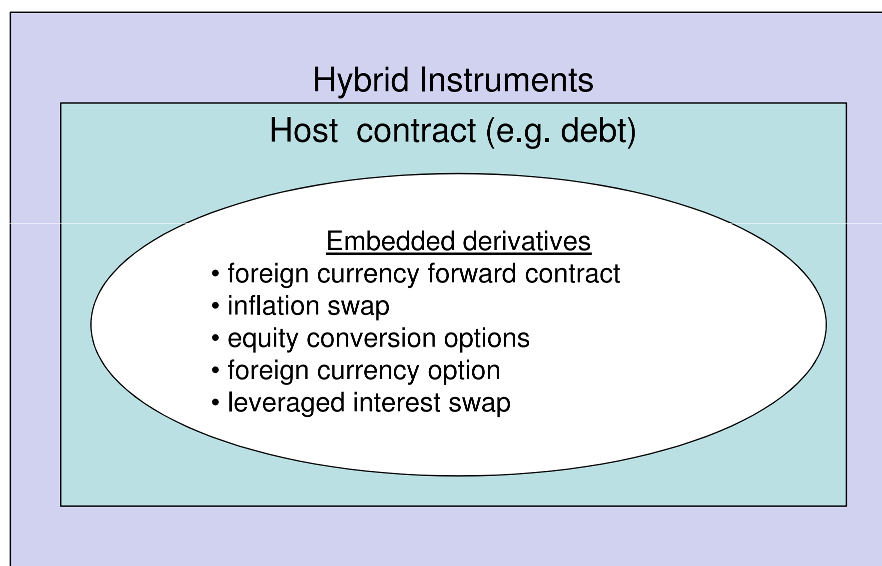
Embedded derivative



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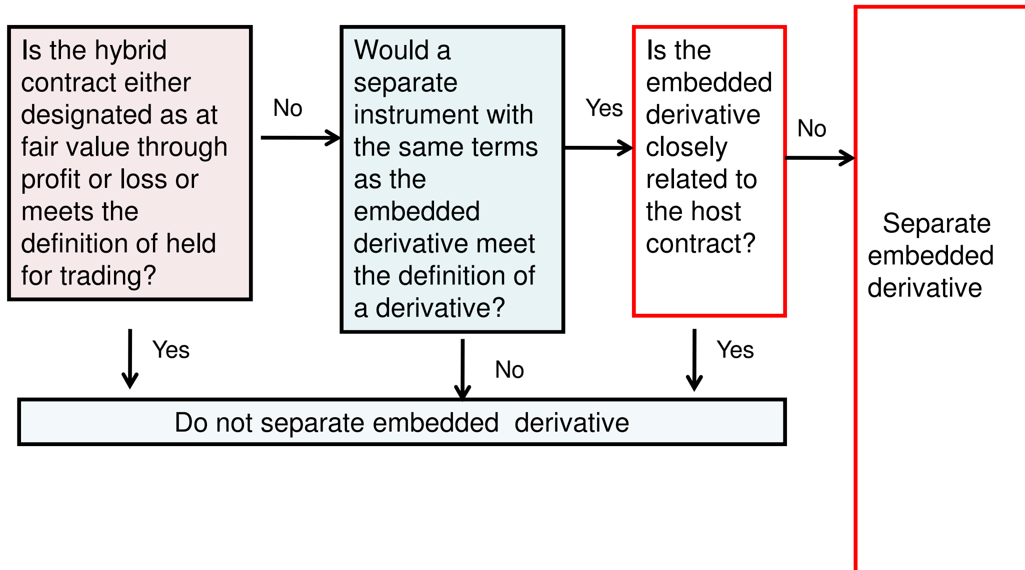
Separation Conditions



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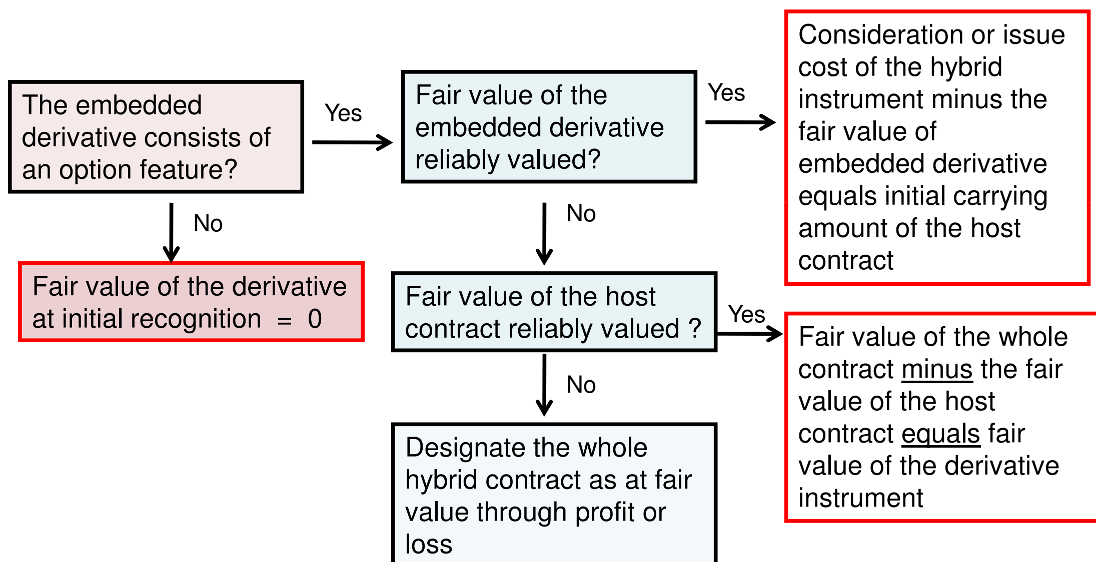
Price allocation between embedded derivative and host contract



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Initial recognition and subsequent measurements

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Initial measurement of financial assets and liabilities

- HKAS 39 requires that financial assets and liabilities are measured initially at "fair value"
- For a financial asset or liability that is not classified as "at fair value through profit or loss" (FVTPL), transaction costs that are directly attributable to the acquisition or issue of the asset or liability should be added to or deducted from the fair value on initial recognition

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Subsequent measurement of financial instruments

Classifications	Measurement basis	Fair value changes
Financial assets/liabilities at fair value through profit or loss (FVTPL)	Fair Value	Recognised in profit or loss
Held-to-maturity investments	Amortised cost	-
Loans and receivables	Amortised cost	-
Available-for-sale financial assets	Fair value	Recognised in OCI
Financial assets carried at cost	Cost (*note)*	

(note) Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured, are measured at cost.

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Subsequent measurement of financial liabilities

After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, **except for**:

- Financial liabilities at fair value through profit or loss. Such liabilities , including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost
- Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies
- Financial guarantee contracts

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Financial guarantee contracts

Definition

- Contracts that require the issuer to make specified payments to reimburse the holder for **a loss** it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument

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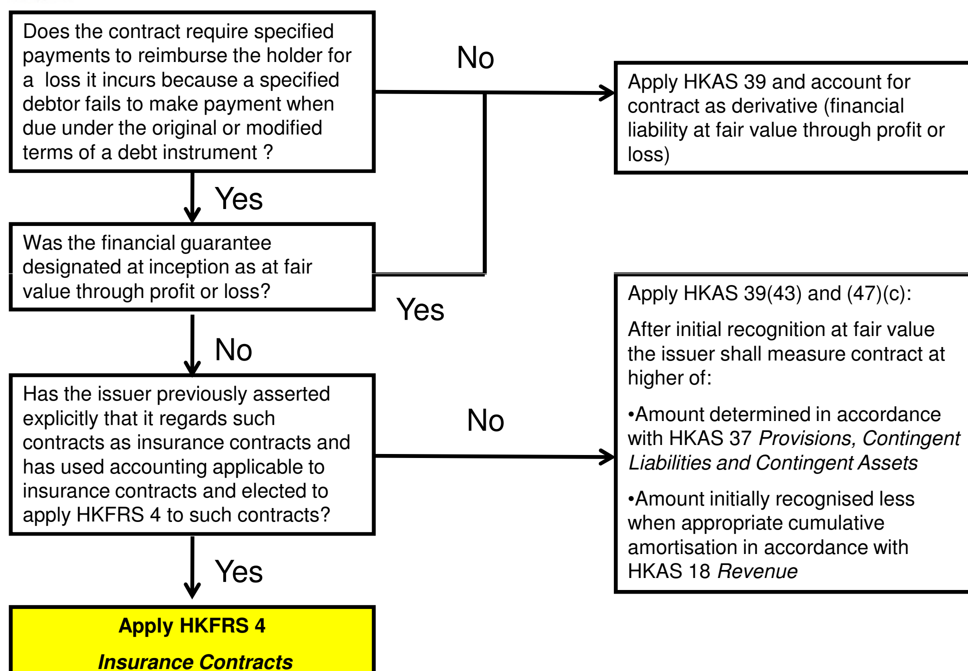
Decision tree: The treatment of issued financial guarantees



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Monetary financial assets/liabilities

- Monetary items are defined in HKAS 21 *The Effects of Changes in Foreign Exchange Rates* as units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency
- Where a financial asset or financial liability is a monetary item under HKAS 21, foreign exchange gains and losses should be recognised in profit or loss in accordance with HKAS 21
- For AFS financial assets that are not monetary items under HKAS 21 (e.g. equity instruments), the gain or loss that is recognised in OCI includes any related foreign currency component

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Summary of how foreign currency is treated for the various financial assets/liabilities classifications:

Classifications	Monetary or non-monetary item	Foreign currency gains and losses from re-measurement (prior to its disposal)*
Available-for-sale	Monetary item (e.g. debt security)	Profit or loss
Available-for-sale	Non-monetary item (e.g. equity security)	Equity
Loans and receivables	Always a monetary item	Profit or loss
Held-to-maturity	Always a monetary item	Profit or loss
Fair value through profit or loss	Not applicable	Profit or loss
Liability carried at amortised cost	Always a monetary item	Profit or loss

** Assumes that the item is not being hedged for foreign currency, or is not a hedging instrument in a foreign currency hedge*

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Derivatives

Classifications	Measurement basis	Fair value changes
Non-hedging	Fair value	Profit and loss
Hedging		
▪ Fair value hedge	Fair value	Profit and loss
▪ Cash flow hedge	Fair value	- **Effective portion:** Recognised in other comprehensive income - Subsequently reclassified from equity to profit or loss in the same periods which the hedged item affects profit or loss **- Ineffective portion:** Recognised immediately in profit or loss
▪ Net investment hedge	Fair value	- **Effective portion:** Recognised in other comprehensive income - Reclassified from equity to profit or loss when the net investment affect profit or loss - **Ineffective portion:** Recognised immediately in profit or loss

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Question:

Presentation of disposal of financial assets

❖ **Regarding the presentation of the disposal of financial assets in the ordinary course of business in the statement of comprehensive income, it is noted that some preparers show sales proceeds from the sale of financial assets as revenue (gross), while others present the gains and losses on disposal net. What guidance is available in this respect?**

i. Revenue arising from disposal of financial assets and financial liabilities is scoped out from HKAS 18 *Revenue*

ii. Disposals of financial assets are addressed in HKAS 39 *Financial Instruments: Recognition and Measurement* and HKFRS 7 *Financial Instruments: Disclosures*

iii. Gains and losses arising from disposal of financial assets should be presented net

iv. However, the entity is not precluded from disclosing additional information in the financial statements related to gross sales proceeds provided that they are not described as 'revenue'

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Summary of reclassifications:

Out of	Into	Criteria	Example
Fair Value Through Profit and Loss	Loans and Receivables	▪ Debt instrument meets the definition of loans and receivable ▪ The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset for the foreseeable future	▪ A trade receivable that at initial recognition was intended to be sold when that intent no longer applies

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Summary of reclassifications:

Out of	Into	Criteria	Example
Fair Value Through Profit and Loss	Held to maturity	▪ Debt instrument does not meet the definition of loans and receivables (if the instrument met the definition of loans and receivables it could not be reclassified to held to maturity because the held to maturity definition specifically excludes loans and receivables) ▪ The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset for the foreseeable future and circumstances are rare	▪ A debt security that at initial recognition was intended to be sold in the near term and is a security that is traded in an active market (e.g. corporate debt, government bond) and where the entity now considers it has the intent and ability to hold to maturity ▪ the circumstances for the reclassification are deemed rare

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Summary of reclassifications:

Out of	Into	Criteria	Example
Fair Value Through Profit and Loss	Available for sale	▪ Debt instrument meets the definition of loans and receivable ▪ The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset for the foreseeable future	▪ A trade receivable that at initial recognition was intended to be sold when that intent no longer applies

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Summary of reclassifications:

Out of	Into	Criteria	Example
Fair Value Through Profit and Loss	Available for sale	▪ Equity instrument or debt instrument does not meet the definition of loans and receivable ▪ The asset is no longer held for the purpose of selling in the near term and the circumstances are rare	▪ A debt security that at initial recognition was intended to be sold and is a security that is traded in an active market (e.g. corporate debt, government bond) ▪ The circumstances for the reclassification are deemed rare

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Summary of reclassifications:

Out of	Into	Criteria	Example
Available for Sale	Loans and receivables	▪ Debt instrument meets the definition of loans and receivables ▪ The entity has the intention and ability to hold the financial asset for the foreseeable future	▪ A trade receivable that at initial recognition was designated as available for sale investments

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Summary of reclassifications:

Out of	Into	Criteria	Example
Available for Sale	Held to maturity	▪ Debt instrument does not meet the definition of loans and receivables ▪ The asset is held with the intention and ability to hold to maturity	▪ A debt security that at initial recognition was intended to be sold prior to maturity and is security that is traded in an active market (e.g. corporate debt, government bond) and where the entity now considers it has the intent and ability to hold to maturity

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Summary of reclassifications:

Out of	Into	Criteria	Example
Held to maturity	Available for sale	▪ Debt instrument is no longer held with the intent and ability to hold to maturity ▪ If there are more than insignificant amount of sales or reclassifications of held to maturity assets the held to maturity portfolio is "tainted" and the whole portfolio must be reclassified to available for sale	▪ A debt security that at initial recognition was considered traded in an active market (e.g. corporate debt, government bond) and the entity had the intent and ability to hold to maturity but the intent or ability no longer applies

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Summary of reclassifications:

Out of	Into	Criteria	Example
Available for sale	Fair value through profit and loss	▪ Not permitted	▪ Not permitted
Held to maturity	Loans and receivables	▪ Not permitted	▪ Not permitted
Held to maturity	Fair value through profit and loss	▪ Not permitted	▪ Not permitted
Loans and receivables	Held to maturity	▪ Not permitted	▪ Not permitted
Loans and receivables	Available for sale	▪ Not specifically covered in HKAS 39	
Loans and receivables	Fair value through profit and loss	▪ Not permitted	▪ Not permitted

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Reclassification - Summary

The reclassification requirements for financial assets can be summarised in the following table:

	To category				
From category	**Held-for-trading**	**Designated at fair value**	**Loans and receivables**	**Held-to-maturity**	**Available-for-sale**
Held-for-trading		No	Yes	Yes	Yes
Designated at fair value	No		No	No	No
Loans and receivables	No	No		No	Not specifically covered in HKAS 39
Held-to-maturity	No	No	No		Yes
Available-for-sale	No	No	Yes	Yes	

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Question:

Reclassification

❖ **What are the new "amortised cost" and the "effective interest rate" when a financial asset is reclassified from AFS to loans and receivables?**

i. The fair value at the date of reclassification becomes the amortised cost. This new "amortised cost" is used as the basis for assessing impairment in the future

ii. The effective interest rate is recalculated using the fair value at the date of reclassification. This new effective interest rate will be used to calculate interest income in future periods and considered as the original effective interest rate when measuring impairment

iii. Any previous gain or loss on that asset that has been recognised directly in other comprehensive income is amortised to profit and loss over the investment's remaining life using the effective interest method

iv. Any difference between the new amortised cost and the amount payable on maturity is also amortised in a similar manner, akin to the amortisation of a premium or a discount.

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Question:

Reclassification

i. On 1 Jan 2011, an entity reclassifies a $9M bond from AFS to loans and receivables. On the date of reclassification, the bond's amortised cost is $9,198,571 and the original effective interest rate is 8.75%. The bond's fair value is $9,488,165, which becomes its new amortised cost.

ii. The excess of the new carrying amount over the amount receivable at maturity on 31 Dec 2012 (i.e. $488,165) is amortised to profit or loss over the remaining term to give a new effective rate of 7%.

iii. The cumulative gain of $289,594 in other comprehensive income as at 31 Dec 2010 (i.e. $9,488,165 - $9,198,571) is also amortised to profit or loss during the remaining two years to maturity.

($)	Cash received	Interest income @7%	New amortised cost
1 Jan 2011	-	-	9,488,165
31 Dec 2011	900,000	664,172	9,252,337
31 Dec 2012	9,900,000	647,663	-
		1,311,835	
Amortisation of gain in OCI in 2011 and 2012		289,594	
Total amount recognised in profit or loss		1,601,429	

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Question:

The tainting rules

❖ **An entity's held-to-maturity ("HTM") portfolio consists of a mixture of sterling corporate bonds, treasury bonds and eurodollar bonds. The entity prepares its financial statements to 31 Dec 2012. During September 2012, the entity sold a certain eurodollar bond (not considered insignificant in relation to the total HTM portfolio) to realise a large gain. Can the entity reclassify only the eurodollar bonds to available-for-sale ("AFS") category?**

i. An entity shall not classify any financial assets as HTM if the entity, has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of HTM before maturity

ii. The standard does not define what an insignificant amount means, except that it should be measured by reference to the total amount of HTM investments

iii. Furthermore, all the entity's HTM investment, not just investment s of a similar type, should be reclassified into AFS category and measured at fair value

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Question:

The tainting rules

iv. The reclassification is recorded in the reporting period in which the sales occurred (i.e. 31 Dec 2012). The HTM are re-measured to fair value, with any difference recognised in other comprehensive income

v. As tainting occurs in the year 31 Dec 2012, the HTM classification for the comparative period to 31 Dec 2011 is not affected

vi. Any fixed interest securities acquired during 2013 and 2014, which could qualify for HTM classification, cannot be classified as such in those years

Tainting occurs	HTM classification prohibited	HTM classification prohibited	HTM classification permitted
31 Dec 2012	31 Dec 2013	31 Dec 2014	31 Dec 2015

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HKAS 39 Financial Instruments: Recognition and Measurement

The tainting rules

vii. A sale or reclassification would not taint the rest of the portfolio if it was:

- so close to maturity or the financial asset's call date that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- made after the entity has collected substantially all of the financial asset's original principal through scheduled payments or pre-payments; or
- due to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

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Question:

The tainting rules

- **Can an entity apply the tainting rules separately to HTM held by different entities in the consolidated financial statements, for example, if the group entities are in different countries with different legal or economic environments?**

i. No. If an entity has sold or reclassified more than an insignificant amount of investments classified as HTM in the consolidated financial statements, it cannot classify any financial assets as HTM in the consolidated financial statements unless the exception conditions are met

ii. Sales between group entities generally would not taint the HTM classification at the group level, but may do so at the individual entity level

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Impairment

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Impairment assessment

Financial asset	Assessment required?
➢ **Investment in debt instruments**	
❑ Loans & receivables	✔
❑ Held-to-maturity investments	✔
❑ Available-for-sale financial assets	✔
❑ Fair value through profit or loss	✕
➢ **Investment in equity instruments**	
❑ Fair value through profit or loss	✕
❑ Available-for-sale financial assets	✔
❑ Unquoted equity instruments measured at cost	✔
➢ **Derivative instruments (including separated embedded derivatives)**	
❑ Fair value through profit or loss	✕
❑ Derivatives that result in physical delivery of unquoted equity investments measured at cost	✔

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Impairment of financial assets

- HKAS 39 requires an assessment, at the end of each reporting period, of whether there is any objective evidence that a financial asset or group of financial assets is impaired. An asset is impaired, and an impairment loss recognised, if and only if, such evidence exists

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Impairment of financial assets

- The two most notable characteristics of the HKAS 39 impairment model are:

  i. Impairment loss should be recognised when they are incurred, rather than as expected;

  ii. An impairment loss should be regarded as incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after initial recognition (a 'lost event')

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Examples of loss events

- Significant financial difficulty of the issuer or obligor
- A breach of contract, such as default or delinquency in interest or principal payments
- The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider
- It becoming probable that the borrower will enter bankruptcy or other financial reorganisation
- The disappearance of an active market for that financial asset because of financial difficulties
- Adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amounts

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Impairment of equity investments

- **Information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates may constitute objective evidence of an impairment**
- **A significant or prolonged decline in fair value (below cost) is objective evidence of impairment**
- **The determination of what constitutes a 'significant or prolonged' decline in fair value requires application of judgement**

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Impairment of equity investments – significant or prolonged decline in fair value

- Either a significant or a prolonged decline is sufficient to require the recognition of an impairment loss
- A 'significant or prolonged' decline in the fair value of an instrument is not just an indicator of possible impairment, and the IFRS Interpretations Committee concluded that when such a decline exists, recognition of an impairment loss is required
- The fact that the decline in the value of an investment is in line with the overall level of decline in the relevant market does not mean that an entity can conclude the investment is not impaired

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Impairment of equity investments – significant or prolonged decline in fair value (continued)

- The existence of a significant or prolonged decline cannot be overcome by forecasts of an expected recovery of market values, regardless of their expected timing (that is, an anticipated market recovery is not relevant to the assessment of 'significant or prolonged')
- The assessment of whether a decline is 'significant or prolonged' must be made in the functional currency of the entity holding the instrument

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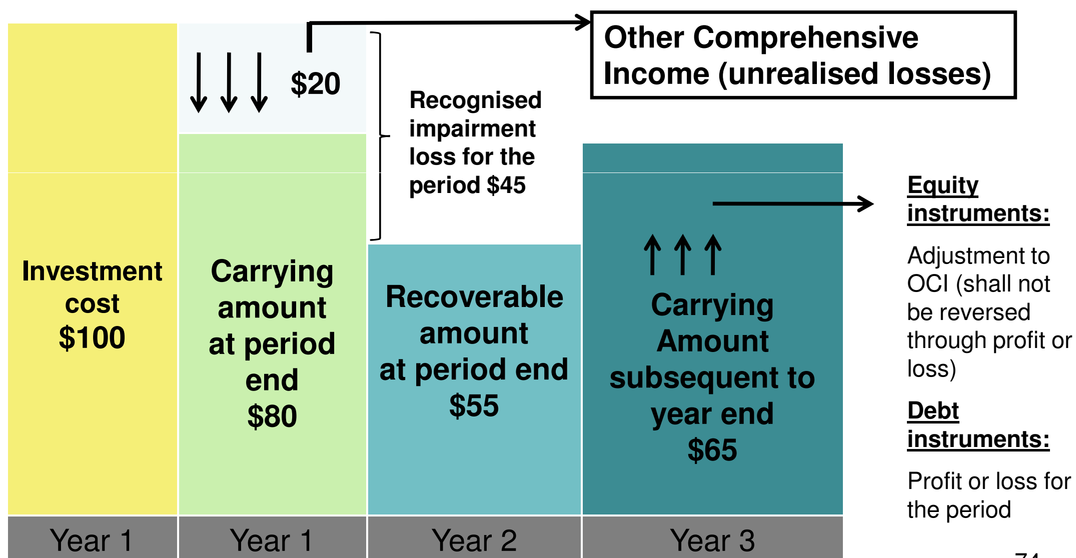
Impairment loss/reversals: available-for-sale financial assets



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Impairment of financial assets carried at amortised cost – debt instrument

i. **Once an impairment loss has been identified, impairment of a financial asset carried at amortised cost is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate (i.e. the effective interest rate computed at initial recognition)**

ii. **The carrying amount of the asset is reduced, either directly or through use of an allowance account. The amount of loss is recognised in profit or loss**

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Impairment of financial assets carried at amortised cost – debt instrument

Situations where the original discount rate is not used:

Financial assets	Appropriate discount rate
Variable rate loans / HTM investments	Current variable rate determined under the contract
Financial assets reclassified out of held for trade or AFS	New effective interest rate calculated using the fair value at the date of reclassification

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Impairment of financial assets at amortised cost - Example

31 Dec 2011	• Fixed rate loan's amortised carrying value: $583,435 • Original effective rate: 6.7322%	
	• Impairment indicators noted • Loan is restructured with revised payment schedule • New effective rate: 6.3071% • Present value of revised payment schedule discounted at the original effective rate of 6.7322% amounts to $432,402	• Impairment loss of $151,033 ($583,435 – 432,402) is recognised in the profit or loss
31 Dec 2012	• Interest income is recognised at the rate of discount used to measure the impairment	• Interest income of $29,110 ($432,402 x 6.7322%) is recognised

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Reversals of impairment loss of assets carried at amortised cost – debt instrument

- If the amount of a past impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, then the impairment is reversed through profit or loss
- However, the carrying amount should not be increased to an amount that exceeds what the amortised cost would have been (at the date of the reversal) had the impairment not been recognised
- The reversal is recognised in profit or loss

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Hedge Accounting

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Objective of Hedge Accounting

- Ensure that the gain or loss on the hedging instrument is recognised in profit or loss in the same period when the item that is being hedged affects profit or loss
- Hedge accounting allows entities to:
  - Override the normal accounting treatment for derivative (cash flow hedge); or
  - Adjust the carrying value of assets and liabilities, including firm commitments (fair value hedge)

HKAS 39 does not mandate the use of hedge accounting. Hedge accounting is voluntary

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Conditions for hedge accounting

- Formal documentation (hedging relationship and risk management objectives and strategy)
- Hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to hedge risk
- Effectiveness of the hedge can be measured and is assessed on an ongoing basis
- Hedged forecasted transactions must be highly probable and must present an exposure to variations in cash flows that ultimately affect reported net profit or loss

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Hedge accounting – documentation requirements

- The hedging documentation dealing with hedges against particular risks should be formal and include the following elements:
  - nature of hedging relationship
  - risk management objective and strategy for undertaking hedge
  - identification of the hedging instrument
  - identification of the related hedged item or transaction
  - the nature of the risk being hedged (particular risk)
  - description of how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or the hedged transaction's cash flows that is attributable to the hedged risk

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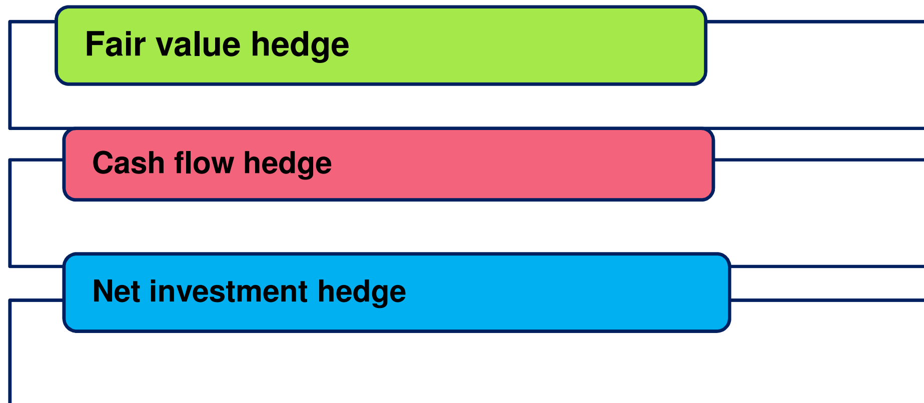
Hedge Accounting: Types of Hedging



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Hedge Accounting: Types of Hedging Relationships

1. Fair value hedge - hedge of the variability of changes in fair value of a recognised asset or liability or a firm commitment
2. Cash flow hedge - hedge of exposure to variability in cash flows on a recognised asset or liability, or a forecasted transaction
3. Hedge of a net investment in foreign operations

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Hedging relationships - Examples

Cash flow hedges

Examples:
- Variable rate liabilities (e.g. loans)
- Variable rate assets (e.g. investments in bonds)
- Highly probable future issuance of debts
- Highly probable forecast sales and purchases
- Foreign currency risks

Fair value hedges

Examples:
- Fixed rate liabilities (e.g. loans)
- Fixed rate assets (e.g. investments in bonds)
- Investment in equity securities
- Non-financial items (e.g. inventories price risk)
- Foreign currency risks (excluding hedges on highly probable transactions and net investments)

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Hedging relationships - Examples

Net investment hedge

Examples:
- A forward foreign currency contract that hedges the foreign exchange risk of an investment in a foreign subsidiary

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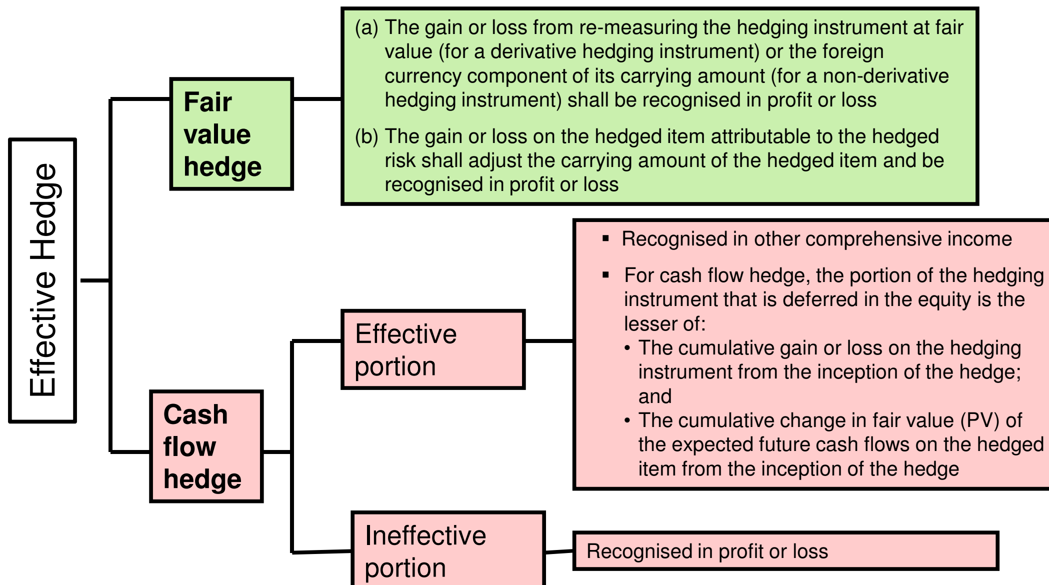
Hedge accounting (HKAS 39.89,95,102)



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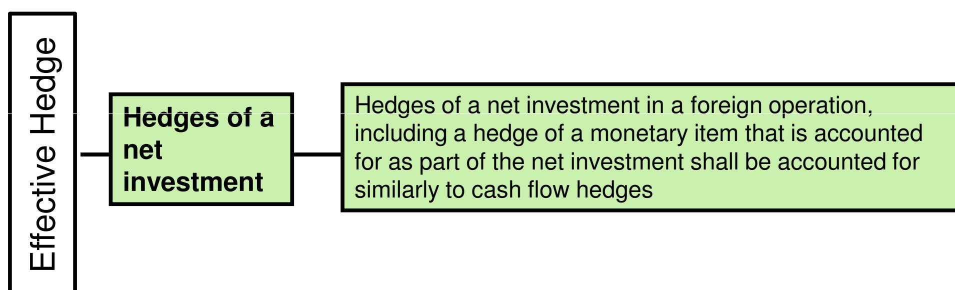
Hedge accounting (HKAS 39.89,95,102) (continued)



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Cash Flow Hedge: Basis Adjustment

- If a cash flow hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or liability
  - Choice of accounting policy regarding the gains and losses deferred in equity:
    - Reclassify the associated gains/losses from equity into profit and loss in the same period or periods during which the asset acquired or liability assumed affects profit and loss; OR
    - Remove the associated gains or losses deferred in equity and include them in the initial cost or carrying amount of the asset or liability

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Hedge Accounting: Assessing Hedge Effectiveness

- Hedge effectiveness is the degree to which offsetting changes in fair value or cash flows attributable to a hedged risk are achieved by the hedging instrument
- A hedge is regarded as highly effective only if:
  - At inception and subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in cash flow or fair value (prospective test)
  - Actual offsetting within a range of 80% to 125% is acceptable (retrospective test)

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Hedge Accounting: Assessing Hedge Effectiveness

- When actual results are within a range of 80-125, but not 100% exactly, any deviation from a 100% means the hedge relationship is partly ineffective
- Any ineffectiveness must be recognised in the profit and loss
- Method of assessing hedge effectiveness depends on the documented risk management strategy and objective
- No single method for assessing hedge effectiveness is prescribed, but time value of money should be considered

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Hedge Accounting: Assessing Hedge Effectiveness

Actual effectiveness	Example	Qualified for hedge accounting?	Impact
Within 80%-125%	Hedged item: 100 Hedging instrument: (100)	Effective (perfect hedge)	Nil
Within 80%-125%	Hedged item: 100 Hedging instrument: (80)	Effective	Ineffective portion to P/L
Outside 80%-125%	Hedged item: 100 Hedging instrument: (75)	Ineffective	Fail hedge accounting – changes in FV of hedging instrument to P/L

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Example: Fair Value Hedge

Example:

- Hedge item is a $ 1,000 fixed rate loan receivable measured at amortised cost
- Hedging benchmark interest rate using an interest rate swap (pay fixed receive floating)
- Interest rate increase (i.e. fair value of the fixed rate loan decrease)

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Example: Fair Value Hedge

	Debit/(Credit)		
	Loan	Derivative	Net
Beginning balance	1,000		
Hedge accounting	(100)	102	(2)
Ending balance	900	102	(2)

Ineffective portion

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Example: Fair Value Hedge

Dr. Derivative assets	102	
Cr. Profit or loss		102
Dr. Profit or loss	100	
Cr. Loan receivable		100

Note: Excludes potential deferred tax effects, if any

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Example: Cash Flow Hedge with Basis Adjustment

- Airline whose functional currency is HK$ orders Airbus for €100 million, when, delivery and payment in 2 years
- Airline hedges FX risk by buying 2-year €/HK$ forward at HK$10=€1
- End of year 1, 1 year forward rate => HK$11=€1
- End of year 2, spot rate => HK$11=€1

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Example: Cash Flow Hedge with Basis Adjustment

Entry at end of Year 1

	Debit	Credit
Derivative asset	HK$100m	
Equity (Hedge)		HK$100m

Note: Excludes potential deferred tax effects, if any

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Example: Cash Flow Hedge with Basis Adjustment

Entries at end of Year 2 – With Basis adjustment*

	Debit	Credit
Airplane	HK$1,100m	
Cash		HK$1,100m
Cash	HK$100m	
Derivative asset		HK$100m
*Equity (Hedge)	HK$100m	
Airplane		HK$100m

Note: Excludes potential deferred tax effects, if any

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Example: Cash Flow Hedge with Basis Adjustment

Depreciation of Airplane

With basis adjustment:

- Depreciate airplane HK$1,000 million over its useful life

With no basis adjustment:

- Depreciate airplane HK$1,100 million over its useful life
- The HK$100m remaining in equity is amortised over the life of airplane

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Discontinue Hedge Accounting

Hedge accounting must be prospectively discontinued when:

- The hedging instrument expires or is sold, terminated or exercised.
  - Planned rollover is not expiration
  - Gain/loss remains in equity until forecast transaction occurs
- The hedge no longer meets the criteria for hedge accounting
  - Gain/loss remains in equity until forecast transaction occurs
- The entity de-designates the hedging relationship
  - Gain/loss remains in equity until forecast transaction occurs
- The forecast transaction is no longer expected to occur
  - Gain/loss in equity is recognised in profit or loss.

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HKFRS 9
"Financial Instruments"

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Background

- A phased project which aims to replace the existing standard on financial instruments, IAS 39 *Financial Instruments: Recognition and Measurement*
- The objectives of the project is to simplify the classifications and measurement requirements for financial instruments
- Split into 3 phases:
  - Classification and Measurement
  - Impairment methodology; and
  - Hedge accounting

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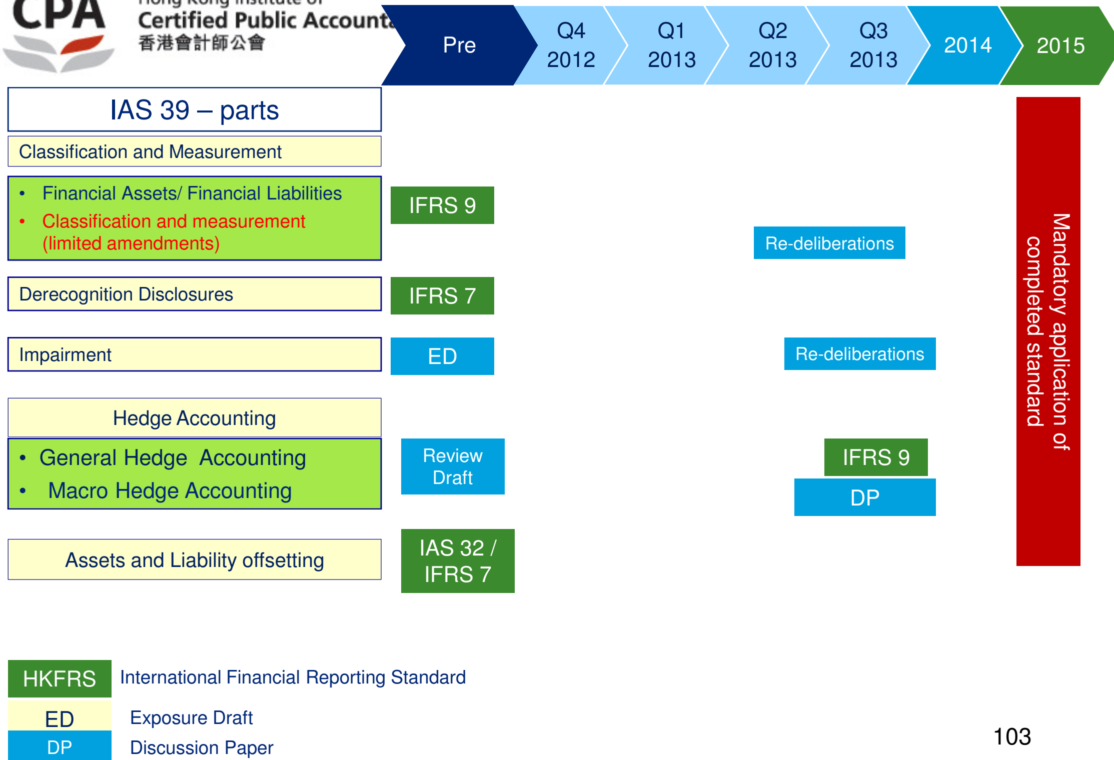
IASB's timetable on financial instrument projects



HKFRS International Financial Reporting Standard

ED Exposure Draft

DP Discussion Paper

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Structure of HKFRS 9

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Structure of HKFRS 9

Chapters

1 Objective
2 Scope
3 Recognition and Derecognition
4 Classification
5 Measurement
6 Hedge Accounting *(not used yet)*
7 Effective Date and Transition

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Chapter 1 Objective and Chapter 2 Scope

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Chapters 1 and 2

Objective

- The objective of HKFRS 9 is to establish principles for the financial reporting of *financial assets* and *financial liabilities* that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows

Scope

- An entity shall apply HKFRS 9 to *all items* within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement*

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Chapter 3
Recognition & Derecognition

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Chapter 3

Recognition and Derecognition

- **When?** An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument

- **Initial recognition of financial assets:** at fair value, plus, in the case of a financial asset that is not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset (consistent with HKAS 39)

- **Initial recognition of financial liabilities:** at fair value, minus, in the case of a financial liability that is not at fair value through profit or loss, transaction costs that are directly attributable to issuing the financial liability (consistent with HKAS 39)

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Chapter 3

Recognition and Derecognition (cont'd)

- **Derecognition of financial instruments** – same as HKAS 39
  (but with increased disclosure for transactions involving transfers of financial assets – contained in amendments to HKFRS 7)

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Chapters 4 & 5
Classification and Measurement

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Classification Guidance – Financial assets

- **Types:**
  - Under HKFRS 9, a financial asset is classified into a measurement category at inception. Two primary measurement categories:
    - **amortised cost**; and
    - **fair value**
  - The existing categories under HKAS 39 of "held-to maturity", "loans and receivables" and "available-for-sale" are eliminated
  - HKFRS 9 eliminates the previous exception under HKAS 39 to measure certain investments in unquoted equity instruments at cost if fair value cannot be measured reliably (but provides guidance on when cost may be an appropriate estimate of fair value)
  - Similarly, the exemption for derivative assets that are linked to and settled by delivery of such unquoted equity instruments was eliminated

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Classification Guidance (cont'd)

- **How?**
  - Classification under HKFRS 9 is driven by the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets
  - A financial asset is measured at **amortised cost** if two criteria are met:
    - The objective of the business model is to hold the financial asset for the collection of the contractual cash flows ('Business Model' test)
    - The contractual asset's cash flows solely represent payments of principal and interest ('Characteristics of the financial asset' test)
  - If a financial asset does not meet both of these conditions, then it is measured at fair value

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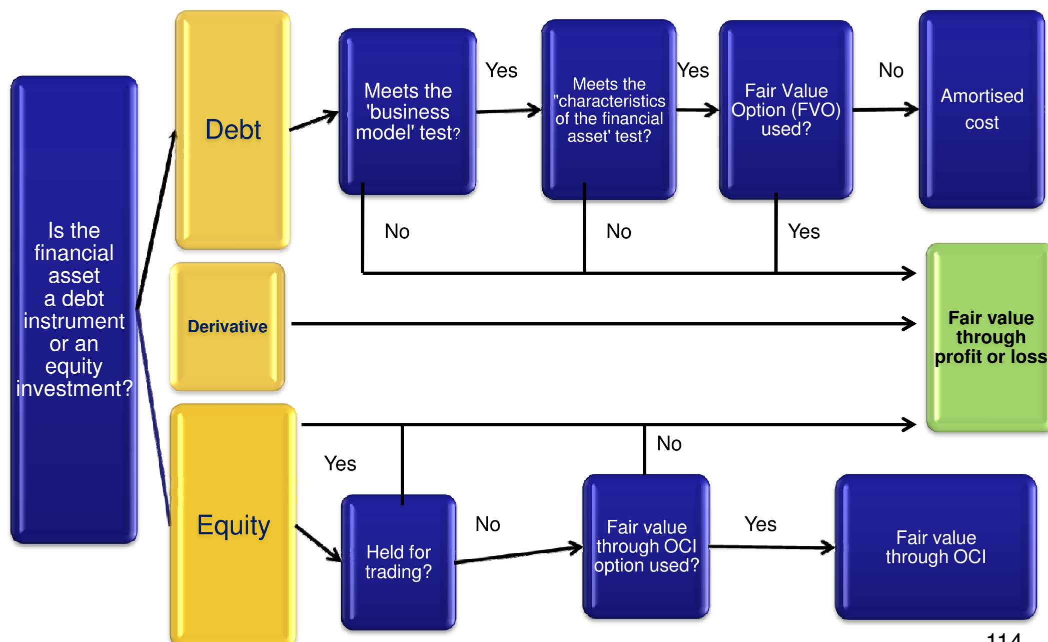
Classification and measurement of financial assets



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Business Model

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"Business Model" test

- Financial assets are subsequently measured at amortised cost or fair value based on the entity's business model as determined by the entity's key management personnel
- The objective of the entity's business model is to hold instruments to collect contractual cash flows rather than to sell instruments prior to contractual maturity to realise fair value changes
- Management will need to apply judgement to determine at what level the business model condition is applied
  - provide a faithful representation of how business activities are actually managed
  - not made at the level of an individual asset
  - the entity's business model is not a choice
  - it is a matter of fact and does not depend on management intent for individual instruments

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"Business Model" test

- **Question:** Can a single entity have more than one business model for managing its financial instruments?
  - Apply judgment to determine at what level the business model condition is applied
  - An entity may hold a portfolio of investments that 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
  - **A single entity may have more than one business model for managing its financial instruments**
  - **Classification need not be determined at the reporting entity level**

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"Business Model" test

Example 1

- An entity holds investments to collect contractual cash flows but would sell an investment in particular circumstances, e.g.
  - a financial asset no longer meets the entity's investment policy (e.g., the credit rating of the asset declines below that required by the investment policy)
  - an insurer adjusts its investment portfolio to reflect a change in expected duration (i.e., the expected timing of payouts); or
  - an entity needs to fund capital expenditures

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"Business Model" test

Example 1 (cont'd)

Analysis:

- Although the entity may consider the financial assets' fair value from a liquidity perspective, the entity's objective is to hold the financial assets and collect contractual cash flows
- Some sales would not contradict that objective
- If more than an infrequent number of sales are made out of the portfolio, the entity needs to assess whether and how those sales are consistent with the collecting contractual cash flows objective

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"Business Model" test

Example 2

- An entity's business model is to purchase portfolios of financial assets such as loans. Those portfolios may or may not include financial assets with incurred credit losses
- If payment on the loans is not made on a timely basis, the entity attempts to extract the contractual cash flows through various means, e.g. by making contact with the debtor by mail, telephone or other methods
- In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate

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"Business Model" test
Example 2 (cont'd)

Analysis:

- The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows
- The entity does not purchase the portfolio to make a profit by selling them
- The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (e.g., some of the financial assets have incurred credit losses)
- The fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model
- If the portfolio is not managed on a fair value basis, the objective of the business model could be to hold the assets to collect the contractual cash flows

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"Business Model" test
Example 3

- An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle (SPV). The SPV issues instruments to investors
- The originating entity controls the securitisation vehicle and thus consolidates it
- The SPV collects the contractual cash flows from the loans and passes them on to its investors
- Assume the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the SPV

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Business Model" test

Example 3 (cont'd)

Analysis:

- On the sale of the loans to the vehicle, the loans continue to be recognised in the consolidated financial statements, but are derecognised in the separate financial statements of the originating entity
- The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows
- The originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle. For the purpose of its separate financial statements, it would not be considered to be managing this portfolio in order to collect the contractual cash flows

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"Business Model" test

Example 4

- **Factoring:** An entity has a past practice of factoring its receivables

Analysis:

- If significant risks and rewards have transferred from the entity, resulting in the original receivable being derecognised from the balance sheet, the entity is not holding these receivables to collect its cash flows, but intends to sell them. Hence, classify such receivable as fair value through profit or loss
- If the significant risks and rewards are not transferred from the entity, and the receivables do not, qualify for derecognition, the client's business objective may still be to hold the assets in order to collect the contractual cash flows

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"Business Model" test

Example 5

- An entity actively manages a portfolio of assets in order to realise fair value changes arising from changes in credit spreads and yield curves
- The entity's objective results in active buying and selling

Analysis:

- The entity is managing its portfolio to realise fair value gains rather than to collect contractual cash flows

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Cash Flow Characteristics

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"Characteristics of the financial asset" test

- To qualify for amortised cost measurement, the cash flows from a financial asset should represent, on specified dates, **solely payments of principal and interest on the principal amount outstanding**

- Interest is defined as "consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time"

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"Characteristics of the financial asset" test

- **Leverage is not consistent with the sole payment of principal and interest criterion**

- Leverage which increases the variability of the contractual cash flows such that they do not have the economic characteristics of interest

- The standard lists stand-alone option, forward and swap contracts as instruments that include leverage

- An instrument that is subordinated to other instruments (e.g., to general creditors) may still have contractual cash flows that are principal and interest

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"Characteristics of the financial asset" test

- A financial asset with contractual terms that permit the issuer (i.e., the debtor) to **prepay before maturity** or the holder (i.e., the creditor) **to put the financial asset back** to the issuer before maturity or either party **to extend the term** of a financial asset may meet the sole payment of principal and interest criterion only if:
  - the provision is not contingent on future events, other than terms that protect:
    - i. the holder against credit deterioration of the issuer (e.g. defaults, credit downgrades, loan covenant violations), or
    - ii. the holder or issuer against changes in relevant taxation or law; and
  - in the case of prepayment, the prepayment amount substantially represents unpaid principal and interest, but may include reasonable additional compensation for early termination; or
  - in the case of an extension option, the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding

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"Characteristics of the financial asset" test

Examples:

Instruments that **will qualify**	Analysis
• **A bond with a stated maturity**. Payments of principal and interest are linked to an unleveraged inflation index	• This linkage resets the time value of money to the current level. In other words, the interest rate on the instruments reflects 'real' interest. The interest amounts are consideration for the time value of money on the principal amount outstanding

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"Characteristics of the financial asset" test

Examples:	
Instruments that **will qualify**	Analysis
• **An instrument with a stated maturity and variable interest** for which the borrower can choose a market interest rate that corresponds to the reset period on an ongoing basis (e.g. at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term	• The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money and for the credit risk associated with the instrument • The fact that the interest rate is reset during the life of the instrument does not disqualify the instrument from meeting the solely payment of principal and interest criterion

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"Characteristics of the financial asset" test

Examples:	
Instruments that **will qualify**	Analysis
• A bond with a stated maturity date and pays a **variable interest rate which is capped**	• This is like a combination of a fixed and floating rate bond, as the cap reduces the variability of cash flows
• A **full recourse loan** secured by collateral	• The fact that a full recourse loan is secured by collateral does not affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding

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"Characteristics of the financial asset" test

Examples:

Instruments that **will not qualify**	Analysis
• A **convertible bond** that is convertible into equity instruments of the issuer	• The criterion is not met as the return on the bond is not just consideration for the time value of money and credit risk but also reflects the value of the issuer's equity
• A loan that pays **an inverse floating rate**, i.e., the interest rate has an inverse relationship to the market interest rate	• The criterion is not met as interest has an inverse relationship to market rates and so does not represent consideration for the time value of money and credit risk

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"Characteristics of the financial asset" test

Examples:

Instruments that **will not qualify**	Analysis
• A loan with **interest payments indexed to the debtor's performance** (e.g. debtor's net income) or an equity index	• The criterion is not met as a return linked to performance or an equity index is not consideration for the time value of money and credit risk
• A **perpetual instrument that is callable at any time by the issuer at par plus accrued interest**, but for which interest is only payable if the issuer remains solvent after payment and **any deferred interest does not accrue additional interest**	• The criterion is not met as the issuer may defer payments and additional interest does not accrue on the amounts deferred. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding

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Option to Designate Financial Assets at Fair Value Through Profit or Loss

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Fair value option (FVO) for financial assets

Fair value option available, if…

- Accounting mismatch
- ~~Manage on fair value basis~~ → Not managed to collect contractual cash flows → FV
- ~~Embedded derivative(s)~~ → Hybrid contracts with financial host classified in entirety

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Embedded Derivatives

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Embedded Derivatives

- Embedded derivatives that would have been separately accounted for under HKAS 39 because they were not closely related to the financial asset host **will no longer be separated**

- The contractual cash flows of the financial asset are assessed in their entirely and the asset as a whole is measured at fair value through profit and loss if any of its cash flows do not represent payments of principal and interest

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Embedded Derivatives

Example:

- An entity has an investment in a conventional convertible bond
- Under the terms of the bond, the holder has the option to convert it into fixed number of equity shares of the issuer
- Under current HKAS 39, unless the bond is held for trading or designated as FVTPL, the bond is bifurcated into the conversion option (an embedded derivative) and the host debt instrument because the economic characteristics and risks of the conversion option (primarily equity price risk) are not closely related to those of the host debt instrument
- The conversion option is separately accounted for at FVTPL while the host debt instrument may be classified as a loan and receivable or as available-for-sale
- **Under HKFRS 9, the convertible bond is analysed for classification in its entirely**
- The presence of the conversion option causes the instrument to fail the test on solely payment of principal and interest. **The convertible bond in its entirety would be accounted for at FVTPL**

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Investments in equity instruments

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Equity Instruments

- All equity investments held must be **measured at fair value** under HKFRS 9
- **No cost exemption** for unquoted equity instruments
- In limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if **insufficient more recent information is available to determine fair value**, or if there is a **wide range of possible fair value measurements** and cost represents the best estimate of fair value within that range
- The standard also gives examples of when cost will not be representative of fair value

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Equity Instruments

- Examples of indicators of the circumstances in which cost **may not** be the best estimate of fair value:
  - a significant change in the performance of the investee compared with budgets, plans or milestones;
  - changes in expectation that the investee's technical product milestones will be achieved
  - a significant change in the market for the investee's equity or its products or potential products
  - a significant change in the global economy or the economic environment in which the investee operates
  - a significant change in the performance of comparable entities, or in the valuations implied by the overall market
  - internal matters of the investee such as fraud, commercial disputes, litigation, changes in management

Given the indicators, it is not expected that cost will be representative of fair value for an extended period of time

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Equity Instruments

- **Gains and losses** arising on equity investments are **recognised in profit or loss** unless the entity irrevocably designates at initial recognition that they should be recognised in other comprehensive income

- Presentation of fair value changes in other comprehensive income:
  - **Available for all equity instruments that are not held for trading**
  - **Can be made on an instrument-by-instrument basis**
  - **Irrevocable for that holding, i.e. no reclassification**

- Dividends income is recognised in profit or loss in accordance with HKAS 18 *Revenue*

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Equity Instruments

- **No** amount recognised in OCI is ever **reclassified to profit or loss** at a later date

- **No impairment testing** is required

- Additional disclosures

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Classification Guidance – Financial liabilities

- **Requirements** contained in HKAS 39 regarding the classification and measurement of financial liabilities have been **retained**

- Continue to be **two measurement categories** for financial liabilities:
  a. fair value through profit or loss
  b. amortised cost

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Classification Guidance – Financial liabilities

- Financial liabilities generally are measured subsequently at amortised cost **except** for the following instruments:

  a. financial liabilities that are held for trading (including derivatives)

  b. financial liabilities that upon initial recognition are designated as at fair value through profit or loss;

  c. financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies

  d. financial guarantee contracts; and

  e. commitments to provide a loan at a below-market interest rate

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Classification Guidance – Financial liabilities

- **Retains the eligibility conditions in HKAS 39 for irrevocably designating**, at initial recognition, a financial liability as measured at fair value through profit or loss (the fair value option)
- **Still required to separate derivatives embedded** in financial liabilities where they are not closely related to the host contract (that is, separated embedded derivative continues to be measured at FVTPL, and the residual debt host continues to be measured at amortised cost)
- **No reclassification**: An entity shall not reclassify any financial liability

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New Measurement Guidance – Financial liabilities

- An entity shall present a gain or loss on a financial liability designated as at fair value through profit or loss as follows:
  - The amount of change in the fair value of the financial liability that is attributable to **changes in the credit risk of that liability shall be presented in OCI**; and
  - The remaining amount of change in the fair value of the liability shall be presented in profit or loss

  unless presentation of the fair value change in respect of the liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss

- The determination of whether there will be a mismatch is **made at initial recognition and is not reassessed**

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New Measurement Guidance – Financial liabilities

- Amounts presented in OCI shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity

- **The only other substantive change from HKAS 39 is to eliminate the exception from fair value measurement contained in HKAS 39 for derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured. Under HKAS 39, such derivatives are measured at cost**

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HKFRS 9 Classification and measurement
Financial Liabilities – FVO and own credit

- **What is 'own credit''?**
  - Fair value changes in liability arising from changes in the issuer's credit quality
- **How is it measured?**
  - Often measured as change in margin over a benchmark interest rate
- **What is the concern?**
  - Gain when credit quality deteriorates, loss when credit quality improves
  - Reporting such gains and losses is not useful

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HKFRS 9 Classification and measurement
Financial Liabilities – FVO and own credit

To address 'own credit risk':

- Retain HKAS 39 measurement requirements for financial liabilities:
  - held for trading => fair value through P & L
  - hybrid liabilities => bifurcation requirements in HKAS 39
  - 'vanilla' liabilities => amortised cost
  - maintain FVO (with current eligibility conditions)

BUT

- Separate out 'own credit risk' for FVO
- 'Own credit risk' portion would be separated in a manner similar to that previously used in HKFRS 7 for disclosure (HKFRS 7 B4)

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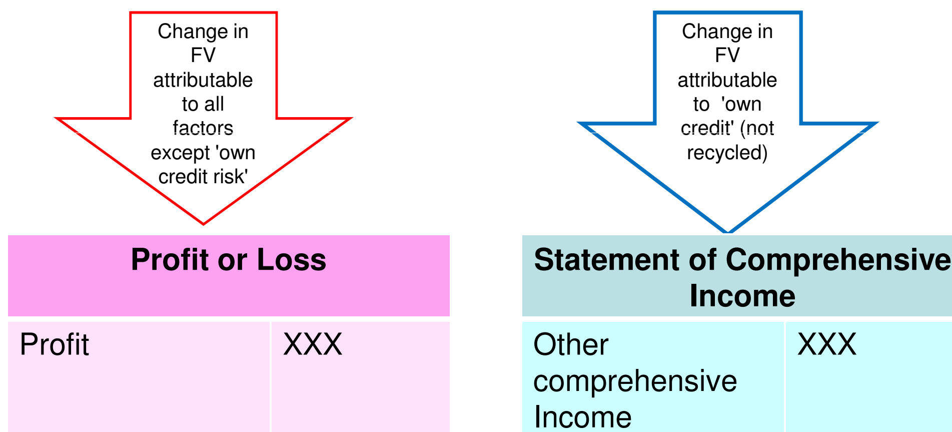
Financial liability at FVO
on statement of financial position at (full) fair value



Mandatory for all liabilities at FVO unless this would create or enlarge an accounting mis-match

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Impact of HKFRS 9

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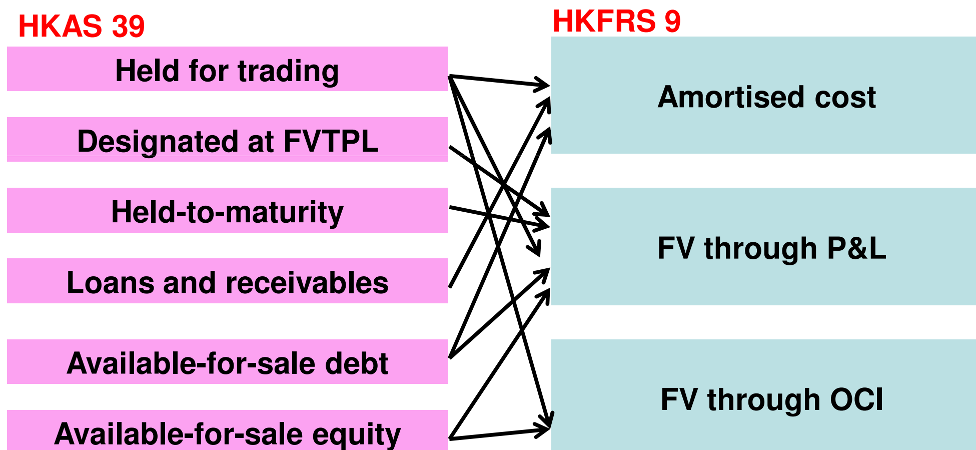
Classification & Measurement – Financial Assets



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Classification & Measurement – Financial Liabilities

HKAS 39		HKFRS 9
Amortised cost	→	Amortised cost
Trading	→	FV through P&L
Designated at FVTPL	→	FV through P&L but changes in 'own credit risk' recognised in OCI

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Impact of HKFRS 9

Changes in the requirement to test financial assets for impairment

Financial Asset	HKAS 39 Classification	Impairment testing required?	HKFRS 9 Classification	Impairment testing required?
Debt instruments	Available for sale	Yes	Amortised cost	Yes
	Loan and receivable	Yes	FVTPL	No
	Held to maturity	Yes		
	FVTPL	No		
Equity investments	Available for sale	Yes	FVTOCI	No
	Cost less impairment	Yes	FVTPL	No
	FVTPL	No		

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Impairment – Equity instrument and AFS instrument

- Although HKFRS 9 currently does not address accounting for impairment directly, the changes in classification and measurement requirements for financial assets will impact whether and how impairment is measured for many assets. In particular, impairment of AFS assets is measured currently by reference to the fair value of the investment
- As HKFRS 9 eliminates AFS category, it also eliminates the AFS impairment rules
- The requirement contained in HKAS 39 'A significant or prolonged decline in the fair value of an investment in equity instrument below its cost is also objective evidence of impairment' is **not carried forward to HKFRS 9**

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Reclassifications

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Reclassifications

- Classification of financial instruments is determined on initial recognition. Subsequent reclassification between categories generally is prohibited
- When an entity **changes its business model** for managing financial assets that is significant to its operations, a reassessment is required
- The standard states that **changes to the business models are expected to be very infrequent, significant and demonstrable** to external parties

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Reclassifications

- Reclassification is to be accounted for **prospectively** from the reclassification date, which is the first day of the first reporting period following the change in business model
  - **reclassification from amortised cost to fair value:** measure instrument at fair value on that date; recognise difference between previous carrying amount and fair value in profit or loss
  - **reclassification from fair value to amortised cost:** fair value of the instrument on the date of reclassification becomes its new carrying amount

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Reclassifications

- Previously recognised gains, losses or interest are **not** restated
- Financial liability shall not be reclassified
- Reclassification triggers **disclosure** requirements
- Examples provided in application guidance

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Effective Date, Comparative Information and Transition

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Effective date, comparative information and transition

- Mandatory effective date of **1 January 2015**, early adoption permitted
- If an entity applies HKFRS 9 in its financial statements for a period before 1 January 2015, it shall disclose that fact
- Entities that early adopt for reporting periods prior to 1 January 2012 are not required to restate comparatives
- Entities that early adopt for reporting periods ended 31 December 2012, restate prior periods or provide modified disclosures
- Entities that adopt HKFRS 9 after 31 December 2012, provide modified disclosures
- Modified disclosures:
  - Changes in the classifications of financial assets and financial liabilities
  - Where financial assets and financial liabilities measured at amortised cost are reclassified, their fair value changes and related interest that would have been recognised if not reclassified

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IFRS 9 - Work-in-progress

Impairment

Hedging

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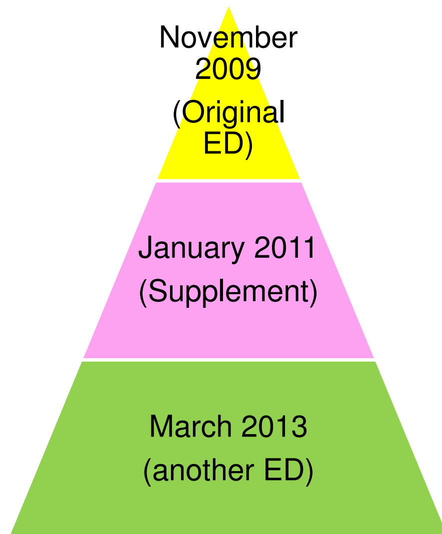
IMPAIRMENT



- **second stage of the 3-phase project to replace IAS 39**
- ED issued on 5 November 2009 (ED/2009/12 Financial Instruments" Amortised Cost and Impairment)
- Use an 'expected cash flow' model to replace the IAS 39's 'incurred loss' model
- ED was not well received
- Supplement to ED issued in January 2012
- The IASB issued the Exposure Draft *Financial Instruments: Expected Credit Losses* on 07 March 2013. The ED is open for comment until 05 July 2013.

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Impairment – Expected credit losses (based on reasonably available information)

❖ **Three-bucket approach – focuses on credit deterioration**

Bucket 1	Bucket 2	Bucket 3
Assets not affected by observable events (no identified credit deterioration)	**Assets affected by observable events**	**Individual assets expected to default**
Allowance	**Allowance**	**Allowance**
• Financial assets in this bucket would have a credit allowance measured as shortfalls in cash flows expected to materialise in the next 12 months	• Financial assets in this bucket would have a credit allowance measured as the **lifetime expected losses** • Would evaluated for credit deterioration at a **portfolio level**	• Full lifetime expected credit losses calculated at an individual asset level because asset-specific default information is available

Deterioration of credit quality →

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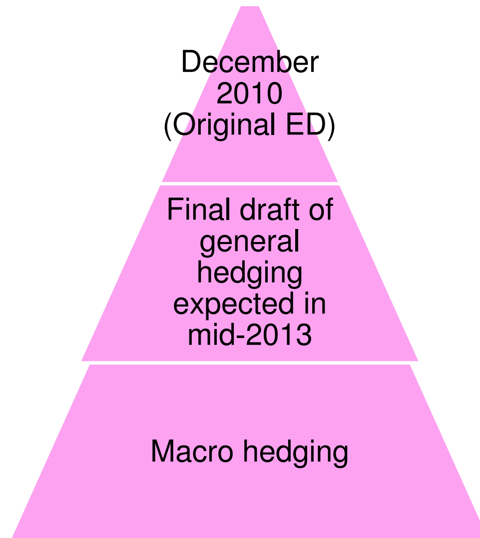
HEDGING



- **third stage of the 3-phase project to replace IAS 39**
- ED published 9 December 2010
- The IASB finalised its deliberations on the forthcoming hedge accounting requirements in April 2013. Draft of the new version of IFRS 9, incorporating the final version of Chapter 6 Hedge Accounting is expect to publish in mid-2013
- Separate ED or DP on portfolio (macro) hedging expected in the third or fourth quarter of 2012

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Proposed key changes based on the draft of forthcoming HKFRS on general hedge accounting

- The new hedge accounting model is more closely with an entity's risk management.
- All financial instruments measured at FVTPL could be eligible hedging instruments
- Accounting for time value of options and forward points
- Designation of risk components is also applicable for non-financial hedged items, provided such risk components are separately identifiable and reliably measurable
- Hedge of net positions is allowed under specific circumstances
- "80%-125% rule" for retrospective assessment is no longer necessary
- Hedge relationships must be rebalanced (i.e., adjustment of the hedge ratio) if they fail to meet the objective of hedge effectiveness while the risk management objective remains the same
- Hedge accounting could not be revoked voluntarily, discontinue only when the hedge relationship ceases to meet the qualifying criteria

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Financial instruments: Classification and Measurement (limited amendments)

- Contractual terms of financial assets that change the timing or amount of payments of principal and interest would not preclude the amortised cost measurement
- Introduction of a FVTOCI category for debt investments with effective interest income and impairment recognised in profit or loss, with certain qualifying criteria
- Whether reclassification between categories are allowed and how reclassifications should be accounted for
- Bifurcation:
  - financial assets that contain cash flows that are not solely principal and interest would not be eligible for bifurcation (must be FVTPL)
  - Financial liabilities would be bifurcated using the existing requirements in HKFRS 9

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IFRS/HKFRS 9

What do you need to think about when applying the new rules?

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IFRS/HKFRS 9: Financial Assets

Process and Systems

- Complete reassessment of all financial assets
- Assessing business models and contractual terms
- Fair value methodologies

↓

Financial statements/key financial ratios

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IFRS/HKFRS 9: Financial Liabilities

Fair value change of 'own credit risk' in OCI. Reduce volatility in profit or loss

- All changes in fair value presented in profit or loss if accounting mismatch
- Disclosure of 'own credit' for liabilities designated at fair value through profit or loss

↓

Consider carefully on the planned timing of adoption. Cannot revoke or designate FVO for liabilities on transition.

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HKFRS 7

Financial Instruments: Disclosures

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HKFRS 7 *Financial Instruments: Disclosures*

❖ Background

- HKFRS 7 was originally issued in 2005
- Significant amendments subsequently include:
  - *Improving Disclosures about Financial Instruments (2009)* amended the required disclosures for fair value measurement and liquidity risk
  - *Improvements to HKFRS (2010)* clarified and refined certain disclosure requirements
  - *Transfer of Financial Assets* issued in October 2010 (effective for annual accounting periods beginning on or after 1 July 2011) amended the required disclosure for transfers of financial assets that resulted in continued recognition or derecognition

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Background**

- Significant amendments subsequently include (cont'd):
  - *HKFRS 13 Fair Value Measurement* issued in May 2011 (effective for annual periods beginning on or after 1 January 2013) removed the fair value disclosures from HKFRS 7 and included them, with limited amendment, in HKFRS 13

❖ **All of the amendments listed, if not currently effective, permit application in advance of their effective dates**

❖ **Required to disclose that fact if early applied**

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Scope**

- Applicable to **all entities** and to **all risks** arising from **all financial instruments,** whether recognised or unrecognised
- Recognised financial instruments: financial assets and financial liabilities that are within the scope of HKAS 39
- Unrecognised financial instruments: financial instruments, that although outside the scope of HKAS 39, are within the scope of HKFRS 7

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HKFRS 7 *Financial Instruments: Disclosures*

Scope application

❖Are leases within the scope of HKFRS 7?

- HKFRS includes within its scope any lease which meets the definition of a financial instrument
- Finance leases are financial instruments, whereas operating leases are not

Financial Instrument	Within scope of HKAS 32?	Within scope of HKFRS 7?	Within scope of HKAS 39?
Finance lease receivables of a lessor	Yes	Yes	No (i)
Finance lease obligations of a lessee	Yes	Yes	No (ii)

(i) Except for the requirements on derecognition, impairment and embedded derivatives
(ii) Except for the requirements on derecognition and embedded derivatives

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HKFRS 7 *Financial Instruments: Disclosures*

Scope application

❖Does HKFRS 7 applies to financial statements of subsidiaries?

- There is no exemption even if full disclosures are provided in the consolidated financial statements in which the subsidiary is included
- When an entity prepares any financial statements in accordance with HKFRSs, users of those financial statements should receive information of the same quality as users of general purpose financial statements prepared in accordance with HKFRSs

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HKFRS 7 *Financial Instruments: Disclosures*

Scope application

❖ **Are all financial instruments of subsidiaries in the consolidated financial statements within the scope of HKFRS 7?**

- Consolidated financial statements include all financial instruments of subsidiaries except those intragroup financial instruments that are fully eliminated on consolidation
- Only if the financial instrument is fully eliminated on consolidation is it excluded from the scope of HKFRS 7 in the consolidated financial statements

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Disclosures relating to the statement of financial position**

- Carrying amounts of each of the following categories:

  a. Financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39
  b. Held-to-maturity investments
  c. Loans and receivables
  d. Available-for-sale financial assets
  e. Financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39
  f. Financial liabilities measured at amortised cost

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HKFRS 7 *Financial Instruments: Disclosures*

Financial assets at fair value through profit and loss (FVTPL)

❖ What are the minimum disclosures if a entity designates a loan or receivable as at FVTPL?

- HKFRS 7 requires disclosures of :
  a. the maximum exposure to *credit risk* of the loan or receivable at the end of the reporting period

  b. the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk

  c. the amount of change, during the period and cumulatively, in the fair value of the loan or receivable that is attributable to changes in the credit risk (not market risk) of the financial asset

  d. the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated

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HKFRS 7 *Financial Instruments: Disclosures*

Financial assets at fair value through profit and loss (FVTPL)

❖ What is the maximum exposure to credit risk for loans and receivables? Cash loss or carrying amount?

- Credit risk is defined as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation" [HKFRS 7: Appendix A]

- If the fair value of the debt is $70. The amount of the debt is $100

- Two views:
  i. the maximum exposure to credit risk is viewed as a cash loss, then the amount to be disclosed would be the amount owed
  ii. the maximum exposure to credit risk is viewed as a loss that will be recognised in the statement of comprehensive income, then the fair value would be disclosed

❖ Either approach is supportable. Must apply a consistent policy.

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖How about financial liabilities designated as at FVTPL? Any minimum disclosure requirements? Why?

- HKFRS 7 requires disclosures of :

  a. the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability

  b. the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation

  c. The methods used to comply with the requirements

  d. To alleviate concerns that users may misinterpret the profit or loss effects of changes in issuer's credit risk

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ How do we determine the amount of changes in the fair value of the financial liability that is attributable to changes in the liability's credit risk?

- Determine the amount of change as the change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ What exactly does it mean? A working example?

- An entity issued a 5-year bond which trades on a recognised bond exchange.
- Maturity date: 31 December 20X5
- Nominal value: $500M
- Coupon: 9%, payable annually on 31 December in arrears
- Issue price (1 Jan 20X1): $450M
- Fair value (31 Dec 20X1): $400M
- 5-year LIBOR (1 Jan 20X1): 10.5%
- 4-year LIBOR (31 Dec 20X1): 12.75%

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ Step 1: Determine the liability's internal rate of return (IRR) using the observed market price of the liability and the liability's contractual cash flows at the beginning of the period

- Issue price: 450,000,000
- Coupon: 9%, payable annually on 31 December in arrears
- Nominal value: $500M

Year 0	(450,000,000)
Year 1	45,000,000
Year 2	45,000,000
Year 3	45,000,000
Year 4	45,000,000
Year 5	545,000,000

Date of issue: IRR = effective interest rate = 11.76%

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ Step 2: Deduct the observed/benchmark interest rate at the beginning of the period from the IRR to arrive at the instrument-specific component of the IRR

- IRR: 11.76%
- 5-year LIBOR: 10.5%

11.76% - 10.5% = 1.26%	Instrument specific component of the IRR

The portion of the effective interest rate relating to credit risk of the bond: 1.26%

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ Step 3: Compute the present value of the cash flows of the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of the observed benchmark interest rate at the end of the period and the instrument-specific component of the IRR

- 4- year LIBOR (31 December 20X1): 12.75%
- Instrument specific component of IRR: 1.26%

Remaining cash flow discounted at IRR of 14.01%	
Year 2	45,000,000
Year 3	45,000,000
Year 4	45,000,000
Year 5	545,000,000

PV = $427,059,828 at end of the reporting period

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ **Step 4: Compute the change in the fair value of the liability not attributable to changes in the observed (benchmark) interest rate**

- Observed market price: $400,000,000
- PV of remaining contractual cash flows using the benchmark interest plus the instrument-specific component of IRR: $427,059,828

Changes in fair value due to changes in credit risk of the bond:	$427,059,828 - $400,000,000 = $27,059,828

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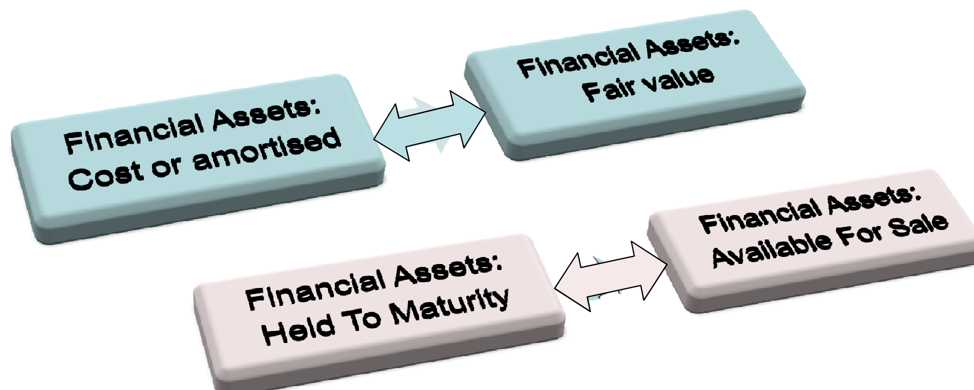
HKFRS 7 *Financial Instruments: Disclosures*

❖ **Reclassifications**



❖ **Disclose the amount that has been reclassified into and out of each category**

❖ **Disclose the reason for the reclassifications**

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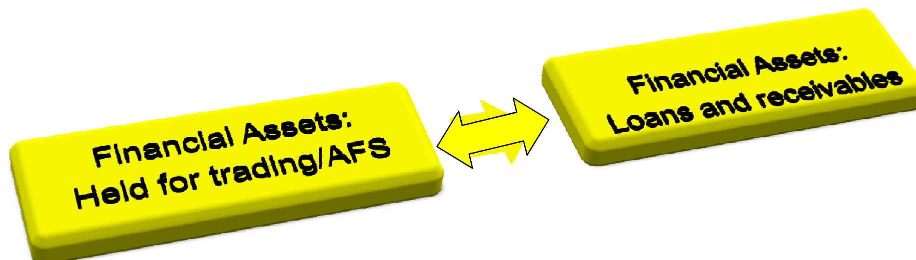
HKFRS 7 *Financial Instruments: Disclosures*

❖Reclassifications



- ❖ **Significant effects**
- ❖ **Extensive disclosures for reclassification out of FVTPL and out of AFS to loans and receivables**

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HKFRS 7 *Financial Instruments: Disclosures*

Reclassifications of financial instruments

❖What are the required disclosures for reclassifications out of FVTPL or AFS to loans and receivables?

a. the amount reclassified into and out of each category
b. for each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods
c. if a financial asset was reclassified under rare situation, the facts and circumstances indicating that the situation was rare
d. for the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognised in profit or loss or other comprehensive income (OCI) in that reporting period and in the previous reporting period
e. for the reporting period following the reclassification, the fair gain or loss that would have been recognised in profit or loss or OCI if the financial asset had not been reclassified
f. the effective interest rate and the estimated amounts of cash flows the entity expected to recover, as at the date of reclassification of the financial asset

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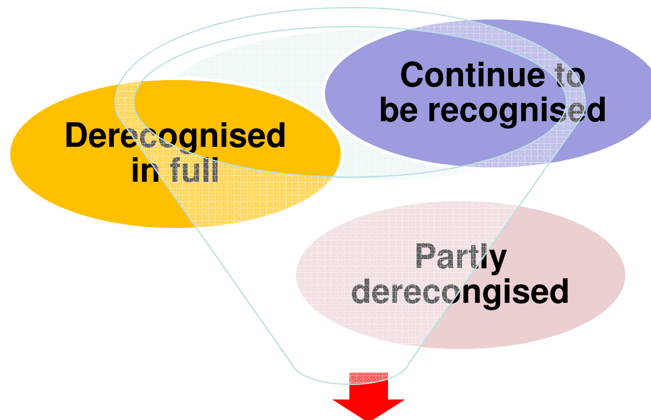
HKFRS 7 *Financial Instruments: Disclosures*

❖ Transfers of financial assets



Significant? Risks retained? Nature of risks and rewards the entity continues to be exposed? Extent of its continuing involvement with the transferred asset?

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Disclosures – Transfers of Financial Assets

Disclosures for financial assets that are not derecognised in their entirety (HKFRS 7.42D)

- The entity should disclose at each reporting date for each class of transferred financial assets that are **not derecognised in their entirety**:
  - The nature of the transferred assets
  - The nature of risks and rewards of ownership to which the entity is exposed
  - Description of nature and relationship between the transferred assets and associated liabilities, including restrictions arising from the transfer on the reporting entity's use of the transferred assets
  - When the counterparty (counterparties) to the associated liabilities has (have) recourse only to the transferred assets, a schedule that sets out the fair value of the transferred assets, the fair value of the associated liabilities and the net position (the difference between the fair value of the transferred assets and the associated liabilities)

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Disclosures – Transfers of Financial Assets

Disclosures for financial assets that are not derecognised in their entirety (HKFRS 7.42D) – cont'd

- When the entity continues to recognise all of the transferred assets, the carrying amounts of the transferred assets and the associated liabilities
- When the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities

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Continuing involvement:
• retains any contractual rights or obligations in the transferred financial asset or obtains new contractual rights or obligations relating to the transferred financial asset

Disclosures – Transfers of Financial Assets

Disclosures for financial assets that are derecognised in their entirety but the entity has continuing involvement (HKFRS 7.42E)

- The entity should disclose as a minimum for each type of continuing involvement at each reporting date:
  - The carrying amounts of the assets and liabilities that represent the entity's continuing involvement and the line items;
  - The fair value of the assets and liabilities that represent the entity's continuing involvement;
  - The amount that best represents the entity's maximum exposure to loss;
  - The undiscounted cash outflows that would or may be required to repurchase the derecognised financial assets, or other amounts payable to transferee;
  - A maturity analysis of the undiscounted cash outflows; and
  - Qualitative information that explains and supports the above quantitative disclosures.

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Disclosures – Transfers of Financial Assets

Disclosures for financial assets that are derecognised in their entirety but the entity has continuing involvement (HKFRS 7.42G)

- The entity should disclose for each type of continuing involvement:
  - The gain or loss recognised at the date of transfer of the assets
  - Income and expense recognised, both in the reporting period and cumulatively, from the entity's continuing involvement in the derecognised financial assets
  - If the total amount of proceeds from transfer activity in a reporting period is not evenly distributed throughout the reporting period, (i) when the greatest transfer activity took place; (ii) the amount recognised from the transfer activity in that part of the reporting period; and (iii) the total amount of proceeds from the transfer activity in that part of the reporting period.
- An entity should provide this information for each period for which a statement of comprehensive income is presented

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HKFRS 7 *Financial Instruments: Disclosures*

❖ Collaterals

- An entity is required to disclose (i) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities and (ii) the terms and conditions relating to the pledge
- When the entity holds collateral (both financial and non-financial assets) as security for financial assets loaned to another entity and the entity is permitted to sell or repledge in the absence of default by the owner of the collateral, the entity is required to disclose (i) the fair value of the collateral held; (ii) the fair value of any such collateral that has been sold or repledged and whether the entity has an obligation to return it; and (iii) the terms and conditions associated with its use of the collateral

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HKFRS 7 *Financial Instruments: Disclosures*

Collaterals

❖ **If the entity does not have the right to sell or pledge the collateral in the absence of default by the borrower, are there any specific disclosure requirement then?**

a) Included in the credit risk disclosures note

b) Generally, a description of collateral held as security and their financial effect to which the collateral mitigate the credit risk

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Allowance account for credit losses**

- When financial assets are impaired by credit losses, and the entity recognises the impairment in a separate allowance account rather than by directly reducing the carrying amount of the assets, the entity is required to present a reconciliation of changes in that allowance account during the period
- This disclosure is required by class of financial asset

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HKFRS 7 *Financial Instruments: Disclosures*

Allowance account for credit losses

❖ **Which components of the reconciliation are required to be separately presented?**

a) HKFRS 7 does not specify the components of reconciliation to be separately presented

For Illustration:	**$**
Opening balance	XX
Plus: impairment losses recognised	XX
Less: reversals of impairment losses	XX
Less: amounts written off during the year	XX
Plus/less: exchange gains and losses on foreign denominated items	XX
Less: unwind of discount	XX
Closing balance	XX

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Defaults and breaches**

- For loans payable recognised at the end of the reporting period, required to disclose any defaults during the period of principal, interest, sinking fund, or redemption terms
- Disclose the carrying amount of any such loans that are in default at the end of the reporting period and whether the default was remedied or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue

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HKFRS 7 *Financial Instruments: Disclosures*

Defaults and breaches

❖ **If the defaults were rectified by the end of the reporting period, are the disclosures regarding defaults during the period still required?**

a) Disclosure regarding defaults is required even when those defaults were rectified by the end of the reporting period

b) To provide the users with relevant information about the entity's creditworthiness and its prospects for obtaining future loans

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Disclosures relating to the statement of comprehensive income**

- HKFRS 7 requires disclosure of specified income, expense, gains or loss items either in the statement of comprehensive income or in the notes to the financial statements

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HKFRS 7 *Financial Instruments: Disclosures*

Net gains or net losses

❖ **Can the entity disclose net gains or losses for all financial assets or financial liabilities in one lump sum? If not, what are the required disclosed components?**

a) The entity is required to disclose the net gains or net losses for each class of financial assets and financial liabilities

b) To assist user understand the extent to which accounting policies affect the performance of the entity and the nature of the gains and losses

c) To allow users to appraise management in how the financial instruments are classified and, ultimately, its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities

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HKFRS 7 *Financial Instruments: Disclosures*

Interest income and interest expense

❖ **Can the entity only disclose the net of interest income and interest expense for financial assets and financial liabilities in the statement of comprehensive income or in the notes?**

a) Disclose total interest income and total interest expense, determined using the effective interest method, for financial assets or financial liabilities that are not classified as at FVTPL

b) Total interest expense is a component of the finance costs that are required to be disclosed as a line item

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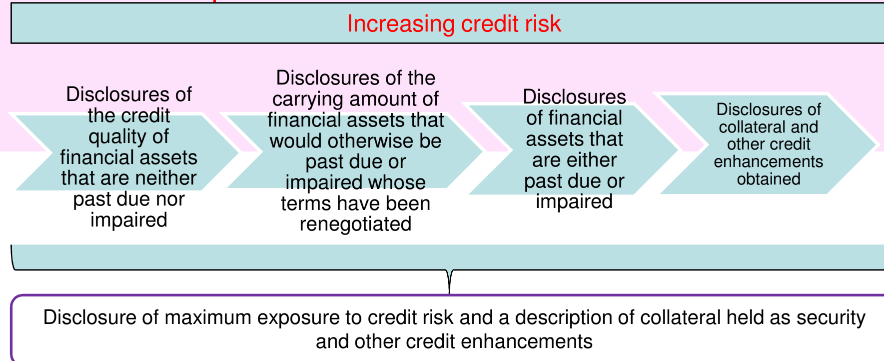
HKFRS 7 *Financial Instruments: Disclosures*

❖Risk from financial instrument: Credit risk

- Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation
- Disclosure requirements:



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HKFRS 7 *Financial Instruments: Disclosures*

Maximum exposure to credit risk: loan commitment

❖ **If Bank A issues a loan commitment to entity B for $100M. (i) What will be disclosed in Bank A's financial statements with respect to the loan commitment? (ii) If entity C issues a financial guarantee to Bank A relating to Bank A's loan commitment to entity B. Will the disclosed amount be different?**

i. The maximum exposure to credit risk to be disclosed in Bank A's financial statements with respect to the loan commitment equals the full amount of the loan that has been offered , i.e. $100

ii. The maximum exposure to credit risk for Bank A is $100M, being the maximum potential loss under the loan ignoring the guarantee it has acquired to reduce the potential loss

iii. The maximum exposure to credit risk for entity C is also $100M because this is the maximum amount entity C could have to pay to Bank A if the guarantee is called upon

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HKFRS 7 *Financial Instruments: Disclosures*

Maximum exposure to credit risk: receivables

❖ **Customers purchase goods from entity A under the entity standard credit terms. Entity A also purchases goods from some of its major customers. Outstanding amounts at end of year are as follows:**

Gross trade receivables	$ 365,000
Impairment loss	(14,000)
Net carrying amount	$ 351,000
Amounts owed to customers	(75,000)

What is the maximum exposure to credit risk at the end of the reporting period for entity A?

i. The maximum exposure to credit risk at the end of each reporting period is the gross amount due from its customers less the allowances recognised for impairment losses

ii. The payables are excluded from the analysis because they are not offset in the statement of financial position

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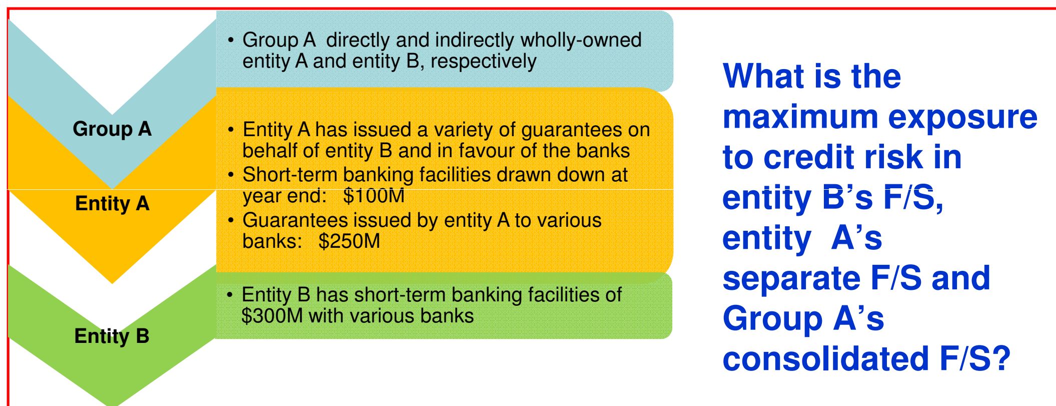
HKFRS 7 *Financial Instruments: Disclosures*

Maximum exposure to credit risk: financial guarantee contracts



What is the maximum exposure to credit risk in entity B's F/S, entity A's separate F/S and Group A's consolidated F/S?

i. **Entity B: Nil**. Entity B is the borrower, it does not have an exposure to credit risk

ii. **Entity A**: **$250M**. The full amount of the guarantee that would be required to be paid if the guarantee is called upon

iii. **Group A: Nil.** From the group's perspective , the group is the borrower. It does not have exposure to credit risk. The amount repayable is the same irrespective of whether entity B repays the debt or entity A repays the debt on entity B's behalf

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosure of collateral held as security and other credit enhancement

❖ **If an entity holds collateral as security against its financial assets, what are the requirements in terms of disclosures that best represents the maximum exposure to credit risk of the entity?**

i. Provide a description of collateral held e.g. types
ii. The policies and processes for valuing and managing collaterals
iii. The main types of counterparties to collateral and their credit worthiness
iv. Information about risk concentrations within the collateral

20X1	Personal customers	Commercial customers	Financial customers	Governments	Total
Credit exposure	870	880	441	162	2353
Collateral value	(707)	(472)	(392)	(42)	(1613)
Total unsecured credit exposure	163	408	49	120	740
Real property	200	130	170	10	510
Bank accounts	180	272	142	20	614
Guarantees	327	70	80	12	489
Total	707	472	392	42	1613

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosure of collateral and other credit enhancements obtained

❖ **A bank lends $100K to a homeowner with property specified as collateral for the loan. During the period, the homeowner defaults under the loan and the property meets the criteria for recognition in the statement of financial position before being disposed of. Is the bank required to disclose the collaterals foreclosed?**

i. When an entity obtains financial or non-financial assets by taking possession of collateral or calling on other credit enhancements (e.g. financial guarantee contracts) at foreclosure, and such assets are required to be recognised at the reporting date in accordance with HKAS 39 or other Standards, disclose nature and carrying amounts of those assets

ii. Disclose the entity's policies for disposing of the assets or using them in the operations when the assets are not readily convertible into cash

These disclosures provide information about the frequency of such events and the entity's ability to obtain and realise the value of the collaterals

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosure regarding financial assets that are either past due or impaired

Receivables, past due and not impaired	Gross amt at 31.12.2011	Receivables past due, impaired	Receivables not impaired, past due by:				
			Up to 30 days	31 to 60 days	61 to 90 days	91 to 120 days	Over 120 days
Financial receivables	4065	53	-	-	-	-	5
Trade receivables	9829	1160	785	94	53	39	120
Other receivables and other assets	9731	5	-	-	-	1	3
	23.625	1.218	785	94	53	40	128

What are the specific requirements under HKFRS 7 for 'past due' or 'impaired' financial assets?

i. Past due versus Impaired: Subtle distinction
ii. Past due or impaired information should be provided by **class of financial assets**
iii. An analysis of the age of the financial assets that are past due but not impaired at the end of the reporting period
iv. Use judgment to determine an appropriate number of time bands, generally based on internal reporting to management

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HKFRS 7 *Financial Instruments: Disclosures*

❖**Risk from financial instrument: Liquidity risk**

- Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset

Quantitative liquidity risk disclosures

- A maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities
- A maturity analysis for derivative financial liabilities, including the remaining contractual maturities for understanding of the timing of cash flows
- A description of how the entity manages the liquidity risk

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis

❖ **If the entity recognised a financial liability which is exclusively settled in the issuer's own equity instruments, would that financial liability be included in the maturity analysis?**

i. If a financial liability is exclusively settled in the issuer's own equity instruments (e.g. a variable number of equity shares equal to a fixed monetary amount) , the financial liability will not be included in the liquidity risk disclosures

ii. If the issuer has the right to deliver its own equity instruments instead of cash or another financial asset, the financial liability is deemed not to have liquidity risk

iii. If the issuer cannot avoid settlement in cash or other financial asset, the financial asset, even if there is an equity-settled alternative, the financial liability must be included in the liquidity risk disclosures

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: amount to include in the time band

❖ **Are interest charges computed for the disclosure of contractual maturities of financial liabilities such as bank loans? If interest charges of bank loans within the contractual period are computed for the disclosure of contractual maturities, how about the future rental payments of the contractual leased period of a tenancy agreement? Should that be included for the disclosure of contractual maturities of financial liabilities?**

i. Present contractual, undiscounted cash flows

ii. Amounts differ from the amounts disclosed in the statement of financial position for financial liabilities, which are typically discounted amounts

iii. Operating leases are primarily uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. A finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: amount to include in the time band

❖ How do we compute the interest charges for the disclosure of contractual maturities of financial liabilities for foreign currency denominated fixed- or floating-rate debt instruments?

i. Foreign currency denominated fixed- or floating-rate debt instruments: Disclose principal and interest in the appropriate time bands based on the interest rates curves in the foreign currency interest rate environment

ii. May be disclosed in the foreign currency

iii. May disclose in the functional currency when preparing entity-only financial statements

iv. May disclose in the group presentation currency when preparing consolidated financial statements

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: amount to include in the time band

❖ When the amount payable is not fixed, as is the case for issued debt that has a variable interest rate, how should the interest charges for the disclosure of contractual maturities of financial liabilities be determined?

i. The amount disclosed should be determined by reference to the conditions existing at the end of the reporting period

ii. "Conditions existing at the end of the reporting period" refer to:
(a) absolute level of the index at the end of the reporting period (e.g. LIBOR rate at the end of the reporting period , i.e., five interest payments of the same amount ?, OR

(b) future LIBOR that exist at the end of the reporting period (e.g. for a five-year LIBOR-based debt having five interest payments based on the prevailing forward curve at the end of the reporting period, i.e., based on expectation of future LIBOR)?

The latter appears more appropriate. It recognises the conditions at the period end relating to the entity's expected payments of cash or another financial asset

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: determining which time band

❖ **Which time band should a demand deposit be disclosed under the maturity analysis? How about the American-style written option or the European-style option?**

Disclose the liability in the time band on the basis of the earliest date on which the entity can be required to pay when the counterparty has a choice regarding when an amount is required to be paid

Demand deposits: included in the earliest time band because the deposit holder can require repayment on demand

American-style written option: disclose in the earliest time band in which the holder can exercise because the holder can exercise anytime

European-style option: included in the time period equivalent to its maturity because it is only exercisable by the holder at maturity

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: determining which time band

❖ **What about if the entity is committed to make amounts available in instalments? What about undrawn loan facilities? What about if a entity has written a financial guarantee contracts?**

i. **Commitment to make amounts available in instalments:** disclose each instalment amount to the earliest period in which the entity can be required to pay

ii. **Undrawn loan commitment:** included in the time band containing the earliest date it can be drawn down. If the holder can drawn down the loan at any time, included in the earliest time period

iii. **Financial guarantee contracts:** the maximum amount that the writer could be required to pay to the holder of the guarantee included in the time band that reflects the earliest period in which the guarantee could be called

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: determining which time band

❖ **Does the entity have to disclose the maturity analysis of the financial assets in all cases as HKAS 1.65 states that HKFRS 7 requires disclosure of the maturity dates of financial assets and financial liabilities?**

i. HKFRS 7 requires disclosure of a liquidity analysis for all financial liabilities

ii. An entity is not required to disclose a maturity analysis for financial assets in all cases

iii. Minimum required disclosure is for a maturity analysis for financial liabilities only

iv. A maturity analysis should be disclosed for financial assets if the entity holds financial assets for managing liquidity risk and that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Risk from financial instrument: Market risk**

- Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices

Currency Risk	Interest Rate Risk	Other Price Risk
• Risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates • Arises on financial instruments that are denominated in a different currency to the entity's functional currency	• Risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates • Arises on interest-bearing financial instruments that are recognised in the statement of financial position and some financial instruments that are not recognised in the statement of financial position	• Risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk

❖ What are the requirements under HKFRS 7 on disclosures of market risks?

i. Market risk sensitivity analysis is required for each type of market risk to which the entity is exposed at the end of the reporting period

ii. Show how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at the end of the reporting period

iii. Disclose methods and assumptions used in preparing the sensitivity analysis

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

❖ How should we disclose the sensitivity analysis for currency risk?

i. Identify the functional currency of the entity

ii. Identify those financial instruments denominated in foreign currencies held as at the end of the reporting date

iii. Determine the reasonably possible change in foreign currency rates. Expected change in foreign currency rates may be different for each foreign currency.

iv. According to HKFRS 7, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

For example:

i. The entity's functional currency is RMB

ii. The carrying amount of the entity's foreign currency denominated monetary assets and liabilities are as follows:

	2012 RMB'000	2011 RMB'000
Assets		
USD	70	1,000
HKD	280	2,100
Liabilities		
USD	1,600	800

iii. 5% is the sensitivity rate used when reporting foreign currency risk internally to key management personnel and represents management's assessment of the reasonably possible change in foreign exchange rates. A positive /(negative) number indicates an increase/(decrease) in profit for the year where RMB strengthens against the relevant currencies.

	2012 RMB'000	2011 RMB'000
USD	77	(10)
HKD	(14)	(105)

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

Other considerations:

i. How should we prepare the sensitivity analysis for consolidated financial statements with foreign subsidiaries?

- Prepare the maturity analysis of each foreign subsidiary and then aggregate them all at group level? (i.e. consider the functional currency of each foreign subsidiary)
- Prepare the maturity analysis altogether at the group level by referring only to the functional currency of the holding entity?

ii. How to present the results of the analysis if the presentation currency is different from the functional currency?

- Using the average rate to translate?
- Using the rate as at the reporting date to translate?

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

❖ **HKFRS 7 states that sensitivity analysis is prepared to show the risk to which the entity is exposed at the end of the reporting period. What does it mean by at the end of the reporting period? If I hold an overnight time deposit / demand deposit, would it be appropriate if I calculate the impact on the P&L for 1 day to represent "the end of the reporting period"?**

i. HKFRS 7 paragraph 40(b) states that unless the entity complies with paragraph 41 (that is, the entity should disclose the methods and assumptions used in preparing the sensitivity analysis unless it prepares a sensitivity analysis that reflects interdependencies between risk variables and uses it to manage financial risks), it shall disclose the methods and assumptions used in preparing the sensitivity analysis.

ii. For example, as extracted from Deloitte illustrative financial statements "the analysis is prepared assuming the amount of the liability outstanding at the end of the reporting period was outstanding for the whole year".

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

iii. As extracted from KPMG's illustrated financial statements, "the impact on the group's profit after tax (and retained profits) and other components of consolidated equity is estimated as an annualized impact on interest expense or income of such a change in interest rates"

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HKFRS 7 *Financial Instruments: Disclosures*

Important:

For detailed disclosures requirements under HKFRS 7, refer to the following link:

http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/hkfrs9.pdf

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Hong Kong Financial Reporting Standards

❖Financial Instruments: Way forward

- **Financial Instruments**
  - **HKAS 39 will be replaced by a new Standard: HKFRS 9 *Financial Instruments***
  - **HKFRS 7 will be consequentially amended to reflect the requirements of HKFRS 9; and**
  - **HKAS 32 will be unchanged except for some amendments to the offset requirements**

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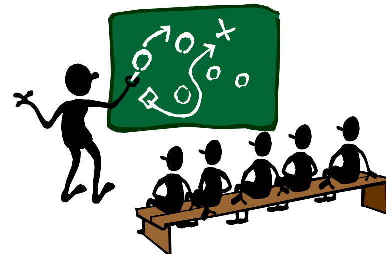
A Refresher Course on Current Financial Reporting Standards 2013 (Day 4)

HKAS 18 Revenue



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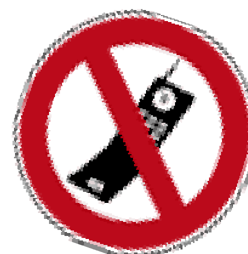

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HKAS 18 Revenue

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Introduction

- **Revenue may be generated by:**
  - **sale of goods**, including goods produced or purchased by the entity for resale
  - **construction contracts**, which are specifically negotiated contracts for the construction of an asset or a combination of assets if those assets are closely interrelated or interdependent in terms of their design, technology and function or ultimate purpose or use
  - **Rendering of services**, typically involving the performance of a contractually agreed task; and
  - Use of an entity's assets that generates fees such as **royalties, dividends and interest**

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Scope of HKAS 18

Revenue from sale of goods	• Including goods produced for sale and goods purchased for sale, such as merchandise purchased by a retailer or land and other property held for resale
Revenue from services rendered	• Including rendering of services in accordance with contract terms
Revenue from use by others of assets belonging to the entity	• Including interest, dividend and royalties

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Exclusion from HKAS 18

HKAS 18 excludes from its scope revenue arising from:

- X Lease agreement (dealt with by HKAS 17 "Leases"
- X Dividends from equity-accounted investments (dealt with by HKAS 28 "Investments in associate"
- X Insurance contracts within the scope of HKFRS 4 "Insurance contracts"
- X Changes in the fair value of financial assets and liabilities or their disposal (dealt with by HKAS 39 "Financial Instruments: Recognition and measurement)
- X Changes in the fair value of other current assets
- X Initial recognition and changes in the fair value of biological assets related to agricultural activity (dealt with by HKAS 41 "Agriculture")
- X Initial recognition of agricultural produce (also dealt with by HKAS 41)
- X The extraction of mineral ores

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Definition of revenue

- **General definition**
- Gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows results in increases in equity, other than increases relating to contributions from equity

- **Items not within definition of revenue**
- Contributions from equity participants
- Amounts collected on behalf of the principal and which do not result in increases in equity for the equity

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Gross or net presentation

- Revenue includes only **gross inflows** of economic benefits that are received or receivable by the entity **on its own account**
- Amounts **collected on behalf of third parties** (e.g. sales taxes collected on behalf of custom authority) are not economic benefits which flow to the entity and do not result in increases in equity
- The amount of revenue recognised for a transaction is **net of any trade discounts or volume rebates given,** since these discounts and rebates are not received as consideration by the seller

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Agency relationship

- Gross amounts collected by the agent on behalf of the principal are not benefits that flow to the agent and therefore, they are not revenue. **The agent's revenue is the amount of commission**
- The **principal** in an agency relationship recognises the **gross amount** charged to the ultimate customer as revenue. Commission paid to the agent is accounted for as an expense by the principal.
- Determining whether an entity is acting as an agent or principal is based on an **evaluation of the risks and responsibilities** taken by the entity, including inventory risk and responsibility for the delivery of goods or services.
- Judgment is required and all relevant facts and circumstances must be considered

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Agency relationship (cont'd)

- **Example:** A travel agents sell airline tickets to the public generally at a price determined by reference to the market rate, but often pay the airline a discounted amount. The travel agent does not bear any general inventory risk because it does not carry tickets in inventory and only purchases tickets when it receives orders or bookings from customers.
- In this case, the travel agent does not bear any inventory risk nor is it responsible for carrying out the services related to the ticket itself, as this is the responsibility of the airlines.
- The travel agent's revenue should reflect only the fee and not the gross amount billed to the customer

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Measurement of revenue

- Revenue is measured at the **fair value** of the consideration received or receivable.
- The nominal amount of the consideration received or receivable will not vary materially from its fair value because most trade receivables are due within a relatively short time-frame
- When consideration is to be received outside such a short time-frame, the fair value of the consideration to be received will not be the same as the nominal amount of the consideration due to the time value of money. Such an arrangement effectively includes a **financing transaction**. Therefore, to calculate the fair value of the consideration receivable, **future receipts are discounted using an imputed interest rate**

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Measurement of revenue (cont'd)

- To calculate the fair value of the consideration receivable, future receipts are discounted using an imputed interest rate which is the more clearly determinable of :
  - the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
  - a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services*

* where the second approach is taken, the resulting interest rate should be assessed for reasonableness. If the rate appears unrealistically low, this may indicate that the current cash sales price that would be appropriate for this particular customer has not been correctly identified

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Example: Deferred consideration

- An entity sells an item of equipment for $100,000 under a financing agreement which has no stated interest rate
- Annual instalments of $20,000 are due each year for five years from the date of purchase
  - **Scenario 1:** The seller believes that the buyer would be able to obtain financing from other sources at an interest rate of 10%
  - **Scenario 2:** If the buyer had paid cash for the equipment, the sales price would have been $80,000

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Example: Deferred consideration: discounting based on interest rate (scenario 1)

Analysis:

- Assuming no down payment, five annual instalments of $20,000, and an interest rate of 10%, the fair value of the stream of payments forming the considerations is $75,816
- The amount of interest earned each year as follows:

	{A}	{A x 10%=B}	{C-B}	{C}
1st year end	75,816	7,581	12,419	20,000
2nd year end	63,397	6,340	13,660	20,000
3rd year end	49,737	4,974	15,026	20,000
4th year end	34,711	3,471	16,529	20,000
5th year end	18,182	1,818	18,182	20,000
Total		24,184	75,816	100,000

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Example: Deferred consideration: discounting based on interest rate (scenario 1) – cont'd

Initial recognition at date of sale:

	DR	CR
Trade receivables	75,816	
Sales revenue		75,816

Yearly income

	Year end	1st	2nd	3rd	4th	5th
DR	Cash	20,000	20,000	20,000	20,000	20,000
CR	Trade receivables	12,419	13,660	15,026	16,529	18,182
CR	Interest income	7,581	6,340	4,974	3,471	1,818

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Example: Deferred consideration: discounting to current cash sales price (scenario 2)

Analysis:

- Since the cash price offered is $80,000, it is necessary to determine the interest rate which discount $100,000 to $80,000 over a five year period, assuming no down payment and five annual instalments of $20,000. This interest rate is 7.93%
- The amount of interest earned each year as follows:

	{A}	{A x 7.93%=B}	{C-B}	{C}
1st year end	80,000	6,345	13,655	20,000
2nd year end	66,345	5,262	14,738	20,000
3rd year end	51,607	4,093	15,907	20,000
4th year end	35,700	2,931	17,169	20,000
5th year end	18,531	1,469	18,531	20,000
Total		20,000	80,000	100,000

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Example: Deferred consideration: discounting based on interest rate (scenario 2) – cont'd

Initial recognition at date of sale:

	DR	CR
Trade receivable	80,000	
Sales revenue		80,000

Yearly income

	Year end	1st	2nd	3rd	4th	5th
DR	Cash	20,000	20,000	20,000	20,000	20,000
CR	Trade receivables	13,655	14,738	15,907	17,169	18,531
CR	Interest income	6,345	5,267	4,093	2,931	1,469

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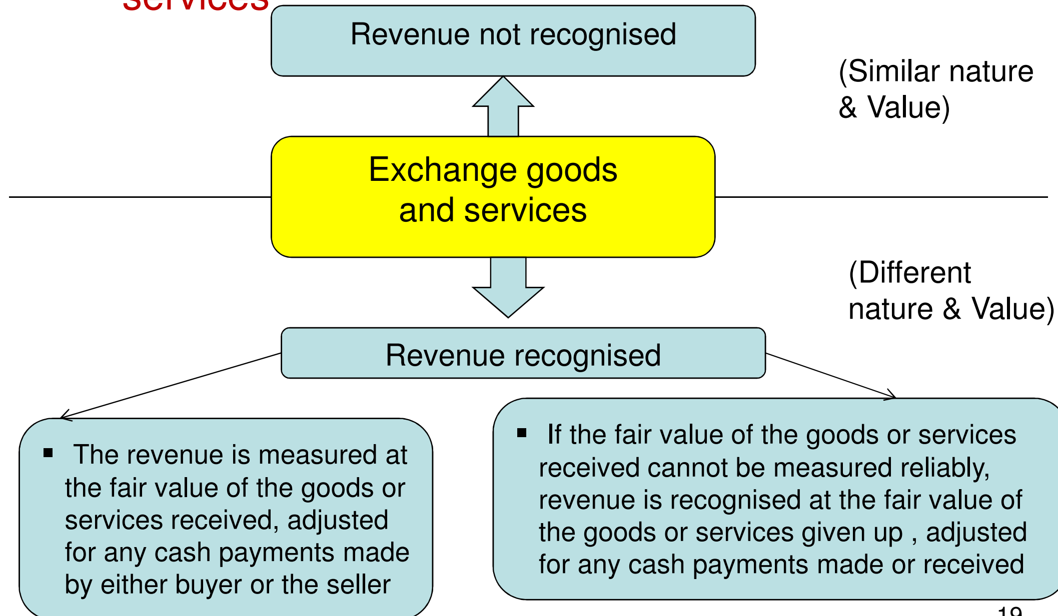
Measurement of revenue: Exchange of goods or services



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Example: Transfer of inventories for an entity's own shares

- Entity A has produced inventory at a cost of $80 that is normally sold to unrelated third parties at a price of $100
- Entity A enters into a transaction to buy $100 of its ordinary shares from a shareholder in return for $100 of its inventory
- How should Entity A account for this transaction?

Analysis:

- Entity A should record revenue for the sale of its inventory for $100 and treasury shares for $100. The form of consideration should not have an impact on whether revenue is recognised
- Entity A would then recognise cost of sales and reduce inventories by $80

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Recognition – Identifying components

- The first step in recognising revenue is to determine whether a single arrangement **comprises separately identifiable components.** In an arrangement that comprises more than one activity, it may be appropriate to identify the separable components within the contract and **allocate revenue to each separately identified component.**
- If no separable components are identified, then it may not be appropriate to recognise any revenue until completion of the final deliverables if the transaction is accounted for under HKAS 18
- In some cases, a contract may identify separate components, but it may be appropriate to account for them as a single transaction

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Recognition – identifying components (cont'd)

- **Example:** a contract to sell software may include an element related to after-sales servicing over a period of time. In such circumstances, it is appropriate to split the transaction into two components, a sale element and a servicing element, and to apply the revenue recognition criteria to each component individually
- **Example:** a seller may enter into a contract to sell goods but agree in a separate contract to repurchase the goods at a later date. In such circumstances, the revenue recognition criteria are applied to both transactions together to determine if revenue is recognised

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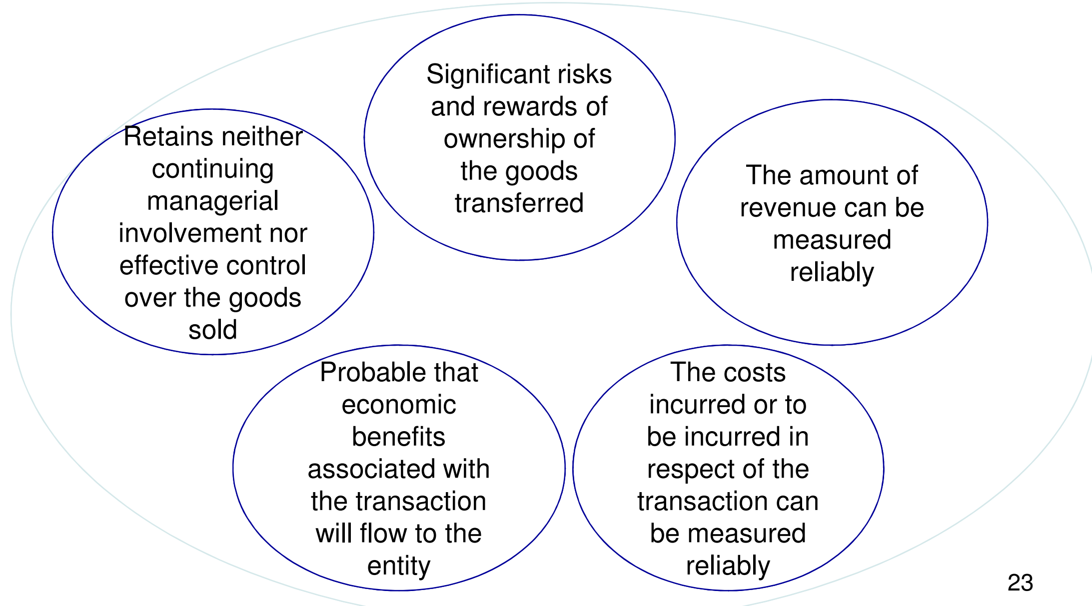
Recognition criteria: sales of goods

All of the following criteria have to be met [HKAS 18.14]



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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(a) : Risks and rewards of ownership

- The circumstances of the transaction must be examined to assess when a seller has transferred the significant risks and rewards of ownership to the buyer

- Generally, the transfer of the risks and rewards of ownership **coincides** with the transfer of the legal title or the passing of possession to the buyer

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(a) : Risks and rewards of ownership

If significant risks of ownership are retained by the seller, the transaction is not a sale and revenue is not recognised

Examples:

▪ when the seller retains an obligation for unsatisfactory performance not covered by normal warranty provisions	▪ when receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods	▪ when goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity	▪ when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the seller is uncertain about the probability of return

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(a) : Risks and rewards of ownership

If only an insignificant risk of ownership is retained by the seller, the transaction is a sale and revenue is recognised

Examples:

▪ A seller may retain the legal title to goods solely to protect the collectibility of the amount due	▪ an insignificant risk of ownership may be retained by the seller in a retail sale when a refund is offered if the customer is not satisfied. ▪ Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability and corresponding reduction for returns based on previous experience and other relevant factors

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Example: Warranty

- An entity manufactures an item of customised machinery and gives a three-month warranty covering the cost of any adjustments or repair subsequent to delivery
- The product is likely to have some serious problems that will need to be remedied after the delivery, due to the need to suit the particular customer's environment
- It is not possible to estimate with reliability the cost to the seller of carrying out any such adjustments or repair
- Under the terms of the sales contract, title passes on delivery
- **Can the seller recognise revenue immediately**?

Analysis:

The risks and rewards of ownership do not pass until the three-month period has expired, since it is not possible to estimate, and therefore accrue, any costs of repairs or adjustments, which could be material

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Example: Equipment sold subject to right of return

- A heavy equipment manufacturer sells an item of machinery to a customer who is anticipating being awarded a particular road-building contract from the Government
- In the sales contract, the seller gives the customer the right to return the machinery if the customer does not win the contract
- There is no way to estimate reliably whether the customer will return the machinery

Analysis:

The risks and rewards of ownership do not pass until the customer has been granted the road-building contract from the Government

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Example: Retail guarantee

- A retail shop offers a lifetime guarantee on its products
- A customer may return any item for any reason at any time and have its money refunded
- Based on reliable, historical data, .95 per cent of sales are returned under this policy

Analysis:

Based on historical data (.95%), the shop retains only insignificant risks and rewards of ownership by offering this guarantee. Provided that the other revenue recognition criteria are met, revenue should be recognised at the time of sale and a corresponding provision of 0.95% of the amount of the sale should be recognised to cover the cost of expected sales returns

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Example: Retention of title

- As a matter of policy, a manufacturer writes its sales contracts in such a way that legal title does not pass on delivery but when consideration for the goods is received
- A sale is made and related goods are delivered to a customer who is not a particular credit risk policy

Analysis:

- The risks and rewards of ownership have passed even though title has not
- Transfer of title may be an indicator that the risks and rewards of ownership have passed to the buyer, but it is not a required condition
- Therefore, provided that the other revenue recognition criteria are met, revenue can be recognised if the only rights that a seller retains with the title are those enabling recovery of the goods in the event of customer default on payment

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Example: Sale of products with a time restriction on resale or use

- Co A, a manufacturer of designer clothing, ships clothing for the spring season to customers (clothing retailers) in Dec 2009
- While the customers take title to the goods when they receive them, the terms of the sales prohibit the customers from displaying or selling the clothing until Feb 2010
- The terms of the arrangement are such that payment generally is not due until the restriction is lifted.
- When is revenue recognised - when the goods are delivered (2009) or when the restriction on resale expires 2010?

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Example: Sale of products with a time restriction on resale or use (cont'd)

Analysis:

- The limitation on when the product can be sold would not, of itself, preclude revenue recognition in 2009.
- HKAS 18.14(a) prohibits revenue recognition when goods are sold, until the seller has transferred to the buyer the significant risks and rewards of ownership of the goods
- In the above situation , the timing is short compared to the life cycle of the inventory and the timing of the restriction does not affect the value of the inventory to be sold
- If the timing was longer, however, for example until the summer season, a review of whether the significant rewards of ownership had been transferred should be performed

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(b) :
Continuing managerial involvement and effective control

- This criterion generally goes hand-in-hand with the risks and rewards of ownership. It would be unusual for an entity to retain effective control over goods without retaining the risks and rewards of ownership
- Each situation should be considered individually

Examples:

- a software consultancy firm may install a software system for a client and then oversee and manage the computer department that uses the software
- This outsourcing of managerial control over the computer department does not necessarily prohibit revenue recognition for the provision of the software
- It will be necessary to consider the terms of the agreement to determine whether the risk and rewards stemming from the software have been transferred to the client

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(c) :
Reliable measurement of revenue

- Until the amount of revenue to be received can be measured reliably, revenue cannot be recognised
- This does not imply that the consideration must have been received in all cases for revenue to be recognised
- Generally, consideration will be agreed in advance and the revenue from a sale will be recognised when all of the other recognition criteria are met

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(d) : Probability of receipt of economic benefits

- Revenue cannot be recognised unless it is probable that the economic benefits or consideration associated with the transaction will flow to the entity
- If revenue has been recognised and it later emerges that the related consideration will not be collectible, an expense for bad debts is reconised rather than reversing the related revenue (HKAS 18.18)

Example:

- When it is not probable that consideration will be received from a particular customer due to exchange controls in the country in which the customer operates which limit the amount of currency that can be remitted from that country, revenue is not recognised until the consideration is received

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(e) : Measurement of costs incurred related to the transaction

When the costs incurred or to be incurred in a transaction cannot be measured reliably, revenue is not recognised

- This criterion flows from the matching principle. Under this principle, when revenue is recognised, the related expenses are also recognised
- If such costs cannot be estimated reliably, revenue is deferred until the amount of such expenses can be more reliably estimated or have been incurred
- In these circumstances, any consideration already received from the sale of goods is recognised as a liability

Example:

- Warranty costs

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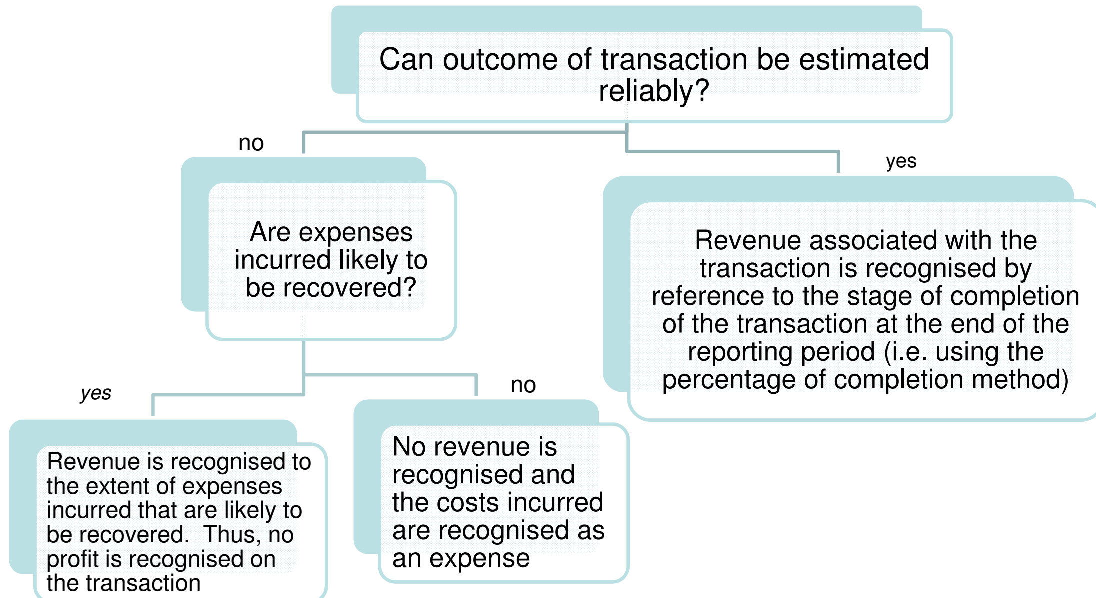
Recognition criteria – rendering of services



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Recognition criteria: rendering of services

Conditions for the outcome of a transaction to be estimated reliably (HKAS 18.20)

- Amount of revenue can be measured reliably
- Probable that the economic benefits associated with the transaction will flow to the entity
- Stage of completion can be measured reliably
- The cost incurred and to complete can be measured reliably

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Recognition criteria – rendering of services

HKAS 18.20 (a): Amount of revenue can be measured reliably

- An entity is usually able to make reliable estimate after it has agreed the following with the other parties to the transaction:
  - each party's enforceable rights regarding the service to be provided and received by the parties
  - the consideration to be exchanged; and
  - the manner and terms of settlement

Examples:

- membership fees
- performance-based fee part way through the performance period

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Example: Performance-based fee part way through the performance period

- Co A, an investment manager, will earn a bonus $1 million if a managed fund's performance exceeds the performance of the S&P 500 by 20% for the calendar year 2009
- Co A's financial year ends 30 June 2009. At that time, the fund is outperforming the S&P 500 by 25%
- Should the investment manager recognise revenue (bonus) at 30 June 2009 and if so, $500,000 (one-half year's worth) or $1M (the expected total hours)?

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Example: Performance-based fee part way through the performance period (cont'd)

Analysis:

- HKAS 18.20 states that revenue can be recognised when the amount of revenue can be measured reliably and it is probable that the economic benefits will flow to the entity
- The investment manager has not earned the bonus until the annual return exceeds the performance of the S&P 500 by 20%.As the markets are very volatile, the annual performance of the S&P 500 cannot be estimated reliably before the end of the year
- Consequently no amount of the bonus can be determined reliably before the bonus measurement date
- The fund manager should not recognise any of the bonus at 30 June 2009

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Recognition criteria – rendering of services

HKAS 18.20 (c): Stage of completion of the transaction at the end of the reporting period can be measured reliably

- The stage of completion of a transaction at the end of the reporting period can be determined in a number of ways
- Progress payments and advances received from customers are generally not reliable indicators of the stage of completion
- Depending on the nature of the transaction, methods for determining the stage of completion may include:
  - surveys of work performed
  - services performed to date as a percentage of total services to be performed; or
  - the proportion that costs incurred to date bear to the estimated total costs of the transaction

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Recognition criteria: Interest revenue

Interest revenue should be recognised using the effective interest method when:

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

and

The amount of the revenue can be measured reliably

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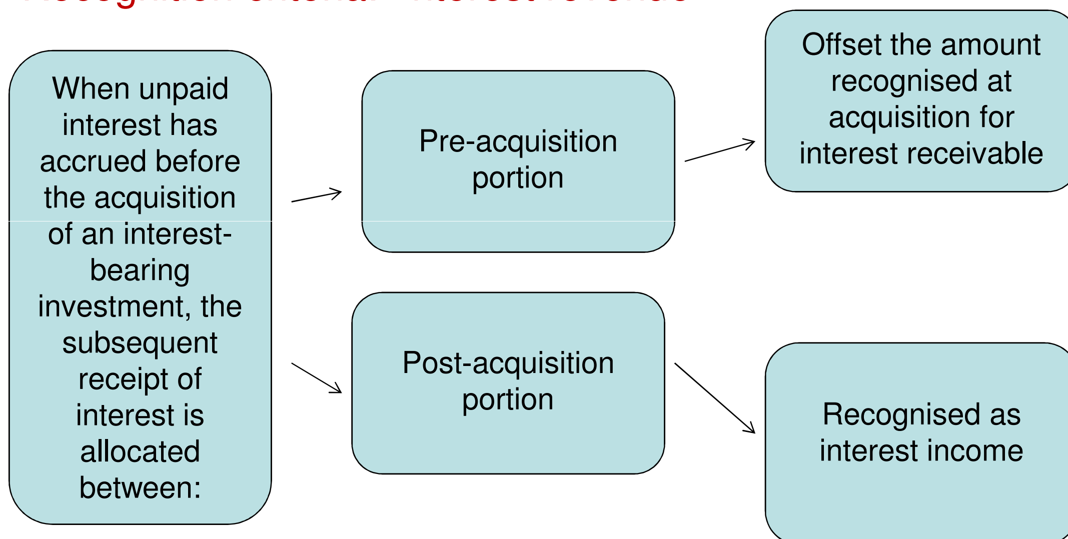
Recognition criteria: Interest revenue



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Example: Interest revenue

- An entity purchases $1M face value bonds for $1.03M on 1 April 2009. The bonds pay interest at 12% per annum on 31 December and 30 June each year
- The investor will receive $60,000 as interest for the period from 1 January 2009 to 30 June 2009, but only $30,000 of this is to be treated as interest revenue
- The entries to record the acquisition of the bond and the receipt of interest on 30 June 2009 will be as follows:

On acquisition				
DR	Investment		1000000	
DR	Interest receivable		30000	
CR		Cash		1030000

Interest payment date				
DR	Cash		60000	
CR		Interest		30000
CR		Interest receivable		30000

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Recognition criteria: Royalty income

Royalty revenue should be recognised on an accrual basis in accordance with the substance of the relevant agreement when (HKAS 18.29 & 30(b)):

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

and

The amount of the revenue can be measured reliably

Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regards to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis (HKAS 18.33)

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Example: Recognition of royalty income

- Purpose of most royalty agreements is to sell a right to use an entity's assets, such as trademarks, patents, and software, for a certain period of time
- Under royalty agreements, should revenue recognition be up front upon signing the agreement or should it be deferred and spread over the duration of the agreement?

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Example: Recognition of royalty income (cont'd)

Analysis:

- Appendix to HKAS 18 states that recognition of revenue under royalty agreements should be recognised in accordance with the substance of the arrangements
- It further clarifies that the overriding factor in determining the accounting treatment for such arrangement should be whether the licensor has any remaining obligation to perform
- The outcome of each arrangement depends on the circumstances
- **Typical examples: License to use a trademark**
  - revenue recognition should be deferred and spread over the license term by the seller if required the seller continue to ensure the quality of the trademark (ie, imposes a genuine performance obligation). Otherwise, revenue shall be recognised immediately

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Example: Recognition of royalty income (cont'd)

Analysis:

- **Typical examples: Software licensing arrangement**
  - Software licensing arrangements allow the licensee (customer) to use intellectual property
  - In the absence of any requirement that the licensor provide technical support, software upgrades or enhancements, a sale has occurred and revenue from the sale can be fully recognised upon delivery of the software license
  - If the licensor sells technical support or software upgrades together with the license, the arrangement should be analysed if it is a multiple-element arrangement. Revenue shall be recognised separately for each of the identified components

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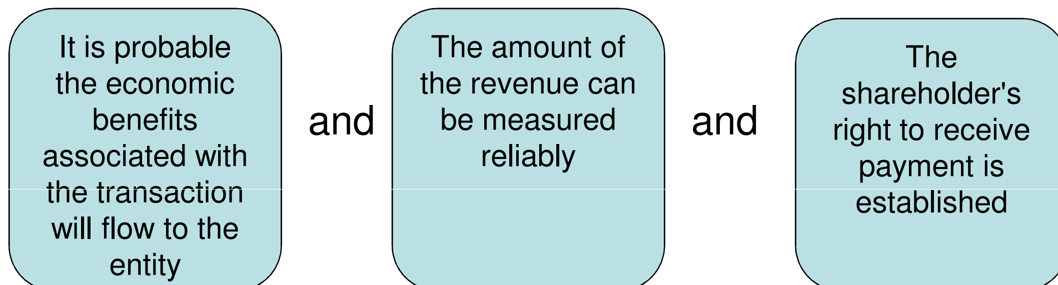
Recognition criteria: Dividend revenue

Revenue should be recognised when:



In May 2008, the IASB issued amendments to HKFRS 1 *First-time Adoption of Hong Hong Financial Reporting Standards* and HKAS 27 *Consolidated and Separate Financial Statements* in respect of the cost of an investment in a subsidiary, jointly controlled entity or associate. For annual periods beginning on or after 1 January 2009, dividend revenue is recognised in profit or loss irrespective of whether it is declared from pre- or post-acquisition profits and separately, in some cases, it is necessary to consider whether the equity investment may be impaired

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Hong Kong Financial Reporting Standards

❖Revenue recognition: Way forward

- **Revenue from contracts with customers**

__Objective:__

A joint MOU project conducted by IASB and FASB to develop a common, comprehensive, principles-based revenue standard that can be applied consistently to complex transactions across a wide range of industries and all types of revenue-generating transactions (would replace IAS 11 and IAS 18)

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Revenue recognition project – timeline

Objective: A joint MOU project conducted by IASB and FASB

- **2002 Deliberations began**
- **2008 Discussion paper issued**
- **2010 First exposure draft issued**
- **2011 November 2011 – 2nd exposure draft**
- **2012 Roundtables/outreach/redeliberations**
- **2013 Q3 - Final standard planned**
- **2015 Effective date?**

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Revenue from Contracts with Customers – Re-exposure draft ED/2011/6

Core principle: 'An entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services"

- **Five steps to recognise revenue:**
  - Step 1: Identify the contract with the customer
  - Step 2: Identify the separate performance obligations
  - Step 3: Determine the transaction price
  - Step 4: Allocate the transaction price
  - Step 5: Recognise revenue when or as a performance obligation is satisfied

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Revenue from Contracts with Customers – Re-exposure draft ED/2011/6

Key proposals:

- Specific criteria in determining whether a contract exists, e.g. whether the contract has commercial substance, whether the parties to the contract have approved the contract and are committed to perform their respective obligations; whether the entity can identify each party's rights regarding the goods or services to be transferred; whether the entity can identify the payment terms for the goods or services to be transferred
- Evaluate which goods or services promised in a contract are 'distinct' and to be accounted for as a separate performance obligation
- Define transaction price as 'the amount of consideration that an entity expects to receive from a customer in exchange for transferring goods and services excluding amounts collected on behalf of third parties'
- Present recognised estimates of expected credit losses as a separate line item next to gross revenue

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Revenue from Contracts with Customers – Re-exposure draft ED/2011/6

Key proposals (cont'd):

- Allocate transaction price to separate performance obligations based on relative standalone selling price of the goods or service underlying each of those performance obligation
- Revenue recognised as control transfers – overtime or point in time
- For transfer of control over a period, the performance obligation has to be satisfied continuously and the entity has to apply a method to measure the progress towards completion
- Assess onerous performance obligations satisfied over time and recognise a liability as appropriate

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- **PWC Dataline A look at current financial reporting – revenue from contracts with customers**
  http://www.pwc.com/en_US/us/cfodirect/assets/pdf/dataline/dataline-2013-04-revenue-from-contracts-with-customers.pdf

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TechWatch

- A monthly publication with the objective of updating members on the latest technical developments in auditing, code of ethics, financial reporting and business
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Financial reporting and auditing alerts

- Alert to draw members' attention to topical financial reporting and auditing issues that should be given particular attention
  http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/financial-and-auditing-alert

Staff summary of newly issued financial reporting standards

- Provide members with an overview of requirements in relation to new Hong Kong Financial Reporting Standards issued by the Institute
  http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/staff-summary

Technical enquiry system

- Members can submit technical queries by email on standards issued by the Institute and where appropriate, examples will also be provided to assist members' understanding on issues related to auditing, code of ethics or financial reporting
  https://app1.hkicpa.org.hk/professionaltechnical/policy/content.php

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- Specially created to assist members and other stakeholders to have an easy access to information in relation to the HKFRS for Private Entities
  http://www.hkicpa.org.hk/en/standards-and-regulations/standards/hkfrs-pe-info-centre

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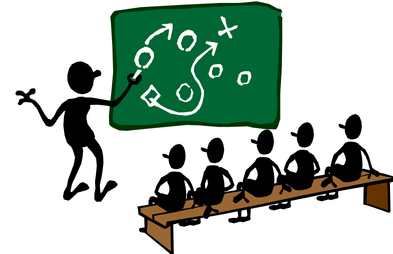
A Refresher Course on Current Financial Reporting Standards 2013 (Day 4)

Impairment of assets



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Agenda

A. Scope
B. Key definition
C. Indications of impairment
D. Determining recoverable amount
E. Recognition of impairment loss
F. Cash generating unit
G. Impairment of goodwill
H. Reversal of impairment loss
I. Disclosures

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Objective

- To ensure that assets are carried at no more than their recoverable amount, and to define how recoverable amount is determined.

carrying amount > recoverable amount??

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A. Scope

HKAS 36 applies to all assets except: [HKAS 36.2]

- inventories (see HKAS 2)
- assets arising from construction contracts (see HKAS 11)
- deferred tax assets (see HKAS 12)
- assets arising from employee benefits (see HKAS 19)
- financial assets (see HKAS 39)
- investment property carried at fair value (see HKAS 40)
- agricultural assets carried at fair value less costs to sell (see HKAS 41)
- insurance contract assets (see HKFRS 4)
- non-current assets held for sale (see HKFRS 5)

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A. Scope

Therefore, IAS 36 applies to (among other assets):

- land
- buildings
- machinery and equipment
- investment property carried at cost
- Biological assets carried at cost
- intangible assets
- goodwill
- investments in subsidiaries, associates, and joint ventures carried at cost
- assets carried at revalued amounts under HKAS 16 and HKAS 38

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B. Key Definitions

- Impairment loss: the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.
- Carrying amount: the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses
- Recoverable amount: the higher of an asset's fair value less costs to sell and its value in use
- Fair value less costs to sell: the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
- Value in use: the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

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C. Identifying an asset that may be impaired

Timing of assessment – general requirements

- At the end of each reporting period, review all assets to look for any indication that an asset may be impaired
- HKAS 36 para 12 – 14 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, an entity is required to make a formal estimate of recoverable amount. [HKAS 36.9]
- The standard does not require an entity to make a formal estimate of recoverable amount if no indication of an impairment loss is present.

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C. Identifying an asset that may be impaired (Con't)

Timing of assessment - exception

- The recoverable amounts of the following types of **intangible assets** should be **tested for impairment annually** whether or not there is any indication that it may be impaired [HKAS 36.10]
  - an intangible asset with an indefinite useful
  - an intangible asset not yet available for use
  - goodwill acquired in a business combination
- For goodwill / intangible assets with an indefinite life **newly acquired during the current period**, impairment test must be carried out **before the end of the current annual period**

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D. Indications of Impairment [HKAS 36.12]

External sources:

- Asset's value declines
- negative changes in technology, markets, economy, or laws
- increases in market interest rates
- company stock price is below book value

Internal sources:

- obsolescence or physical damage
- asset is part of a restructuring or held for disposal
- worse economic performance of the asset than expected
  - Higher operating and maintaining cost than budgeted
  - Actual net cash flows/operating profit worse than budgeted
  - Operating losses or net cash outflows result when aggregating current period figures and budgeted figures for the future

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D. Indications of Impairment [HKAS 36.12]

Dividend from a subsidiary, JCE/JV or associate

Dividend is recognised when:

- Carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated FS of the investee's net assets, including associated goodwill; or
- Dividend exceeds the total comprehensive income of the subsidiary, JCE/JV or associate in the period the dividend is declared.

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D. Indications of Impairment [HKAS 36.12]

These lists are not intended to be exhaustive. [HKAS 36.13] Further, an indication that an asset may be impaired may indicate that the asset's useful life, depreciation method, or residual value may need to be reviewed and adjusted. [HKAS 36.17]

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E. Determining Recoverable Amount

Recoverable amount→ higher of fair value less costs to sell and value in use (VIU)

Fair value less costs to sell or VIU?

- If either fair value less costs to sell or value in use is more than carrying amount, it is not necessary to calculate the other amount. The asset is not impaired.
- If fair value less costs to sell cannot be determined, then recoverable amount is value in use.
- For assets to be disposed of, recoverable amount is fair value less costs to sell.

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HKFRS 13
Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair Value Less Costs to Sell

Level 1
- If there is a **binding sale agreement** in an arm's length transaction, use the price under that agreement less costs of disposal.

Level 2
- If there is an **active market** for that type of asset, use market price less costs of disposal.

Level 3
- If there is no active market, use the **best estimate of the asset's selling price** less costs of disposal.
- Costs of disposal are the direct added costs only (not existing costs or overhead). [HKAS 36.28]

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Value in Use

The calculation of value in use should reflect the following elements: [HKAS 36.30]

- an **estimate of the future cash flows** the entity expects to derive from the asset
- expectations about **possible variations** in the amount or timing of those future cash flows
- the **time value of money**, represented by the current market risk-free rate of interest
- the price for bearing the **uncertainty inherent** in the asset
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset

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Estimate of future cash flows

Projected cash inflows from continuing use of asset		Projected cash outflows for continuing use of asset (directly attributed or allocated reasonably and consistently)		Net cash flows for disposal of asset at the end of its useful life

When estimating future cash flows…

- Cash flow projections should be based on reasonable and supportable assumptions that represent **management's best estimate** of the range of economic conditions that will exist over the **remaining useful life of the asset**.
- HKAS 36 presumes that **budgets and forecasts** should **not go beyond five years**, unless justified.
- For periods after five years, **extrapolate** from the earlier budgets using a **steady or declining growth rate**. The growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used.

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Estimate of future cash flows

When estimating future cash flows…

✓factors relate to the asset in its current condition

✓net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's fair value less costs to sell

✓ using appropriate discount rate appropriate for the currency in which the future cash flow will be generated. Translates the present value using the spot exchange rate at the date of the value in use calculation

✓Management should assess the reasonableness of its assumptions by examining the causes of differences between past cash flow projections and actual cash flows.

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Estimate of future cash flows

Cash flow projections do **NOT** include:

- × future restructurings to which the entity is not committed and expenditures to improve or enhance the asset's performance
- × cash inflows or outflows from financing activities, or income tax receipts or payments.
- × cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, receivable)
- × cash outflows that relate to obligations that have been recognised as liabilities (for example, pensions or provisions)

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Discount Rate

Discount rate is…

- ✓ **pre-tax rate** that reflects current market assessments of the time value of money and the risks specific to the asset
- ✓ reflect risks for which future cash flows have been adjusted and should equal **the rate of return** that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset.
- ✓ For impairment of an individual asset or portfolio of assets, it is the rate the entity would pay in a **current market transaction to borrow money to buy** that specific asset or portfolio.

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Discount Rate

Be aware…

- If the discount rate includes the effect of price increases attributable to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases attributable to general inflation, future cash flows are estimated in real terms
- If a market-determined asset-specific rate is not available, a surrogate must be used that reflects the time value of money over the asset's life as well as country risk, currency risk, price risk, and cash flow risk. The following would normally be considered:
  - the entity's own weighted average cost of capital;
  - the entity's incremental borrowing rate; and
  - other market borrowing rates.

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E. Recognition of an Impairment Loss

- An impairment loss should be recognised whenever recoverable amount is below carrying amount.
- The impairment loss is recognised in profit or loss (unless it relates to a revalued asset. Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.).
- Adjust depreciation for future periods.
- Adjust any deferred taxation recognised based on the revised carrying amount and its tax base.

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Example – deferred tax effect of an impairment loss

At the beginning of 20X2, the tax base of the identifiable assets of the Country A cash-generating unit is CU900. Impairment losses are not deductible for tax purposes. The tax rate is 40 per cent.

Beginning of 20X2	*Identifiable assets before impairment loss*	*Impairment loss*	*Identifiable assets after impairment loss*
	CU	CU	CU
Carrying amount (Example 2)	1,833	(473)	1,360
Tax base	900	-	900
Taxable temporary difference	933	(473)	460
Deferred tax liability at 40%	373	(189)	184

The recognition of an impairment loss on the assets of the Country A cash-generating unit reduces the taxable temporary difference related to those assets. The deferred tax liability is reduced accordingly.

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F. Cash-Generating Units

- Recoverable amount should be determined for the individual asset, if possible. If it is not possible to determine the recoverable amount (fair value less cost to sell and value in use) for the individual asset, then determine recoverable amount for cash-generating unit (CGU) to which the asset belongs.
- The CGU is the **smallest identifiable group of assets** that generates cash inflows that are largely **independent** of the cash inflows from **other assets or groups of assets**.

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Example 1: Identification of cash-generating units

A. Retail store chain

Background

- Store X belongs to a retail store chain M
- M also owns five other stores in the same province as X and 20 other stores in other provinces
- X makes all its retail purchases through M's purchasing centre
- Pricing, marketing, advertising and human resources policies etc are decided by M
- X and four other stores were purchased five years ago and goodwill was recognised

Question: What is the cash-generating unit for X?

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Example 1: Identification of cash-generating units

A. Retail store chain (cont'd)

Answers

- In identifying X's cash generating unit, consider:
  - how was the internal management reporting organised?
  - how was the business run? Store-by-store basis or by region/provinces?
- The stores are in different regions and probably have different customer bases. Hence, generation of cash inflow may be independent for each store
- In conclusion, although X is managed at a corporate level, it generates cash inflows that are largely independent of those of M stores. Therefore, it is likely that X is a cash generating unit

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Example 1: Identification of cash-generating units

B. Plant for an intermediate step in a production process

Background

- A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same entity
- X's products are sold to Y at a transfer price that passes all margins to X
- 80% of plant Y's final production is sold to customers outside the entity
- 60% of X's final production is sold to Y and the remaining 40% is sold to customers outside the entity

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Example1: Identification of cash-generating units

B. Plant for an intermediate step in a production process (cont'd)

Questions:

Case 1: What are the cash generating units for plant X and plant Y if X could sell the products it sells to Y in an active market. Internal transfer prices are higher than the market prices?

Case 2: What are the cash generating units of plant X and plant Y if there is no active market for X's products?

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Example 1: Identification of cash-generating units

B. Plant for an intermediate step in a production process (cont'd)

Answers

Case 1

- ❖ X could sell its products in an active market and so, generate cash inflows that would be largely independent of the cash inflows from Y
- ❖ Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y (HKAS 36.70)
- ❖ It is likely that Y is also a separate cash-generating unit. Y sells 80% of its products to customers outside of the entity. Therefore, its cash inflows can be regarded as largely independent.

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Example 1: Identification of cash-generating units

B. Plant for an intermediate step in a production process (cont'd)

Answers

Case 2

- ❖ The majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y
- ❖ The two plants are managed together
- ❖ As a consequence, it is likely that plant X and plant Y together are the smallest group of assets that generates cash inflows that are largely independent

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Example 1: Identification of cash-generating units

C. Single product entity

Background

- Entity M produces a single product and owns plants A, B and C
- Each plant is located in a different continent
- A produces a component that is assembled in either B & C
- The combined capacity of B & C is not fully utilised
- M's products are sold worldwide from either B or C, i.e., B's production can be sold in C's continent if the products can be delivered faster from B than from C
- Utilisation levels of B & C depend on the allocation of sales between the two sites

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Example 1: Identification of cash-generating units

C. Single product entity (cont'd)

Questions

Case 1: What are the cash generating units of A, B and C assuming there is an active market for A's products?

Case 2: What are the cash generating units of A, B and C assuming there is no active market for A's products?

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Example 1: Identification of cash-generating units

C. Single product entity (cont'd)

Answers

Case 1

- Active market for A's product: Likely that A is a separate cash-generating unit
- Cash flows for B and C depend on the allocation of production across the two sites: Unlikely that the future cash inflows for B and C can be determined individually although there is an active market for the products assembled by B and C
- It is likely that B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independent

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Example 1: Identification of cash-generating units

C. Single product entity (cont'd)

Answers

Case 2

- It is likely that the recoverable amount of each plant cannot be assessed independently because:
  a. There is no active market for A's products. Therefore, A's cash inflows depend on sales of the final product by B and C
  b. Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites
  - As a consequence, it is likely that A, B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independently

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Example 1: Identification of cash-generating units

D. Building half-rented to others and half-occupied for own use

Background

- M is a manufacturing company
- It owns a headquarters building that used to be fully occupied for internal use
- After down-sizing, half of the building is now used internally and half rented to third parties
- The lease agreement with the tenant is for five years

Question: What is the cash-generating unit of the building?

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Example 1: Identification of cash-generating units

D. Building half-rented to others and half-occupied for own use (cont'd)

Answers

- Primary purpose of the building: to serve as a corporate asset supporting M's manufacturing activities
- Therefore, the building as a whole cannot be considered to generate cash inflows that are largely independent of the cash inflows from the entity as a whole
- The building is not held as an investment
- Therefore, it would not be appropriate to determine the value in use of the building based on projections of future market related rents
- Cash-generating unit for the building is M as a whole

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G. Impairment of Goodwill

- Goodwill should be tested for impairment annually.
- To test for impairment, goodwill must be allocated to each of the acquirer's CGU, or groups of CGU, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.
- Each unit or group of units to which the goodwill is so allocated shall:
  - represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
  - not be larger than an operating segment determined in accordance with HKFRS 8 Operating Segments before aggregation

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G. Impairment of Goodwill (Con't)

- A cash-generating unit to which goodwill has been allocated shall be tested for impairment at least annually by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit:
  - If the recoverable amount of the unit > the carrying amount of the unit, the unit and the goodwill allocated to that unit is Not impaired.
  - If the carrying amount of the unit > the recoverable amount of the unit, the entity must recognise an impairment loss.

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G. Impairment of Goodwill (Con't)

Allocation of impairment loss

- The impairment loss is allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:
  - first, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
  - then, reduce the carrying amounts of the other assets of the unit (group of units) on pro rata basis.

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G. Impairment of Goodwill (Con't)

Allocation of impairment loss

- The carrying amount of an asset should not be reduced below the highest of:
  - its fair value less costs to sell (if determinable),
  - its value in use (if determinable), and
  - zero.

- If the preceding rule is applied, further allocation of the impairment loss is made pro rata to the other assets of the unit (group of units).

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Example 2: Calculation of value in use and recognition of an impairment loss

Background and calculation of value in use

- At the end of 20X0, entity T acquires entity M for CU10,000. M has manufacturing plants in three countries.

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Example 2: Calculation of value in use and recognition of an impairment loss

Schedule 1. Data at the end of 20X0

End of 20X0	*Allocation of purchase price* CU	*Fair value of identifiable assets* CU	*Goodwill* CU[(a)]
Activities in Country A	3,000	2,000	1,000
Activities in Country B	2,000	1,500	500
Activities in Country C	5,000	3,500	1,500
Total	10,000	7,000	3,000

(a) Activities in each country represent the lowest level at which the goodwill is monitored for internal management purposes (determined as the difference between the purchase price of the activities in each country, as specified in the purchase agreement, and the fair value of the identifiable assets).

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Example 2: Calculation of value in use and recognition of an impairment loss

- Goodwill has been allocated to the activities in each country: each activity must be tested for impairment annually or more frequently if there is any indication that it may be impaired (HKAS 36.90)
- Recoverable amounts of the cash-generating units are determined on the basis of value in use calculations
- At end of 20X0 and 20X1, the value in use of each cash-generating unit exceeds its carrying amount. Therefore the activities in each country and the goodwill allocated to those activities are regarded as not impaired.

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Example 2: Calculation of value in use and recognition of an impairment loss

- At the beginning of 20X2, a new legislation was passed in Country A which significantly restrict exports of T's main product. As a result, and for the foreseeable future, T's production in Country A will be cut by 40%
- The significant export restriction and the resulting production decrease require T to estimate the recoverable amount of Country A's operations at the beginning of 20X2
- T uses straight-line depreciation over a 12-year life for Country A's identifiable assets and anticipates no residual value

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Example 2: Calculation of value in use and recognition of an impairment loss

- To determine the value in use for the Country A cash-generating unit (see Schedule 2), T:
  - (a) prepares cash flow forecasts derived from the most recent financial budgets/forecasts for the next five years (years 20X2–20X6) approved by management
  - (b) estimates subsequent cash flows (years 20X7–20Y2) based on declining growth rates. The growth rate for 20X7 is estimated to be 3 per cent. This rate is lower than the average long-term growth rate for the market in Country A
  - (c) selects a 15 per cent discount rate, which represents a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the Country A cash-generating unit.

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Schedule 2. Calculation of the value in use of the Country A cash-generating unit at the beginning of 20X2

Year	*Long-term growth rates*	*Future cash flows*	*Present value factor at 15% discount rate*[3]	*Discounted future cash flows*
	CU			CU
20X2 (n=1)		230[1]	0.86957	200
20X3		253[1]	0.75614	191
20X4		273[1]	0.65752	180
20X5		290[1]	0.57175	166
20X6		304[1]	0.49718	151
20X7	3%	313[2]	0.43233	135
20X8	(2)%	307[2]	0.37594	115
20X9	(6)%	289[2]	0.32690	94
20Y0	(15)%	245[2]	0.28426	70
20Y1	(25)%	184[2]	0.24719	45
20Y2	(67)%	61[2]	0.21494	13
Value in use				1,360

1 Based on management's best estimate of net cash flow projections (after the 40% cut).

2 Based on an extrapolation from preceding year cash flow using declining growth rates.

3 The present value factor is calculated as $k = 1/(1+a)^n$, where a = discount rate and n = period of discount.

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Schedule 3. Calculation and allocation of the impairment loss for the Country A cash-generating unit at the beginning of 20X2

Beginning of 20X2	*Goodwill*	*Identifiable assets*	*Total*
	CU	CU	CU
Historical cost	1,000	2,000	3,000
Accumulated depreciation (20X1)	–	(167)	(167)
Carrying amount	1,000	1,833	2,833
Impairment loss	(1,000)	(473)	(1,473)
Carrying amount after impairment loss	–	1,360	1,360

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Example 2: Calculation of value in use and recognition of an impairment loss

Recognition and measurement of impairment loss

- The recoverable amount of the Country A cash-generating unit is CU1,360 (Schedule 2)
- T compares the recoverable amount of the Country A cash-generating unit with its carrying amount (Schedule 3)
- Carrying amount exceeds recoverable amount by CU1,473. T recognises an impairment loss of CU1,473 immediately in profit or loss
- Carrying amount of the goodwill that relates to Country A's operations is reduced to zero before reducing the carrying amount of other identifiable assets within Country A's cash-generating unit (HKAS 36.104)

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H. Reversal of an Impairment Loss

- Same approach as for the identification of impaired assets: assess at end of each reporting date whether there is an indication that an impairment loss may have decreased. If so, calculate recoverable amount.
- The increased carrying amount due to reversal should not be more than what the depreciated historical cost would have been if the impairment had not been recognised.
- Reversal of an impairment loss is recognised as income in the profit or loss, unless it is a revalued asset.
- Adjust depreciation for future periods.
- **Reversal of an impairment loss for goodwill is prohibited.**

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Example 3: Reversal of an impairment loss

Background

- Use the data for entity T as presented in Example 2, with supplementary information as provided in this example. In this example, tax effects are ignored
- In 20X3, the business situation is improving. The effects of the export laws on T's production are proving to be less drastic than initially expected by management. As a result, management estimates that production will increase by 30%
- This favourable change requires T to re-estimate the recoverable amount of the net assets of the Country A operations
- The cash-generating unit for the net assets of the Country A operations is still the Country A operations. Calculations similar to those in Example 2 show that the recoverable amount of the Country A cash-generating unit is now CU1,910

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Example 3: Reversal of impairment loss

Schedule 1. Calculation of the carrying amount of the Country A cash-generating unit at the end of 20X3

	Goodwill	*Identifiable assets*	*Total*
	CU	CU	CU
Beginning of 20X2 (Example 2)			
Historical cost	1,000	2,000	3,000
Accumulated depreciation	–	(167)	(167)
Impairment loss	(1,000)	(473)	(1,473)
Carrying amount after impairment loss	–	1,360	1,360
End of 20X3			
Additional depreciation (2 years)[(a)]	–	(247)	(247)
Carrying amount	–	1,113	1,113
Recoverable amount			1,910
Excess of recoverable amount over carrying amount			797

(a) After recognition of the impairment loss at the beginning of 20X2, T revised the depreciation charge for the Country A identifiable assets (from CU166.7 per year to CU123.6 per year), based on the revised carrying amount and remaining useful life (11 years).

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Example 3: Reversal of impairment loss

Schedule 2. Determination of the depreciated historical cost of the Country A identifiable assets at the end of 20X3

End of 20X3	*Identifiable assets*
	CU
Historical cost	2,000
Accumulated depreciation *(166.7 × 3 years)*	(500)
Depreciated historical cost	1,500
Carrying amount (Schedule 1)	1,113
Difference	387

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Example 3: Reversal of impairment loss

Schedule 3. Carrying amount of the Country A assets at the end of 20X3

End of 20X3	*Goodwill*	*Identifiable assets*	*Total*
	CU	CU	CU
Gross carrying amount	1,000	2,000	3,000
Accumulated amortisation	–	(414)	(414)
Accumulated impairment loss	(1,000)	(473)	(1,473)
Carrying amount	–	1,113	1,113
Reversal of impairment loss	0	387	387
Carrying amount after reversal of impairment loss	–	1,500	1,500

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Example 3: Reversal of impairment loss

- Favorable change in estimates used to determine the recoverable amount of the Country A's net assets since the last impairment loss was recognised. Therefore, T recognises a reversal of the impairment loss recognised in 20X2
- T increases the carrying amount of the Country A's identifiable assets by CU387 (Schedule 3), i.e. up to the lower of recoverable amount (CU1,910) and the identifiable assets' depreciated historical cost (CU1,500) (Schedule 2)
- This increase is recognised immediately in profit or loss.
- Impairment loss on goodwill is not reversed.

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Reversal of impairment loss

- HKAS 34 para 28 requires an entity to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements…. the frequency of en entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of annual results.
- To achieve consistent policy, the measurements for interim reporting shall be made on a year-to-date basis

Question:

Should an entity reverse impairment losses recognised in an interim period on goodwill if a loss would not have been recognised, or a smaller loss would have been recognised, had an impairment assessment been made only at the end of a subsequent reporting period?

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Reversal of impairment loss

Response:

HK (IFRIC)-Int 10

- An entity shall not reserve an impairment loss recognised in a previous interim period in respect of goodwill.
- This also applies to the impairment loss of an investment in either equity instrument or a financial asset carried at cost.

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Example 4: Treatment of future costs

Background

- At the end of 20X0, entity F tests a machine for impairment. The machine is a cash-generating unit. It is carried at depreciated historical cost and its carrying amount is CU150,000. It has an estimated remaining useful life of 10 years
- The machine's recoverable amount (i.e. higher of value in use and fair value less costs to sell) is determined on the basis of a value in use calculation. Value in use is calculated using a pre-tax discount rate of 14%

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Example 4: Treatment of future costs

- Management approved budgets reflect:
  - (a) estimated costs necessary to maintain the level of economic benefit expected to arise from the machine in its current condition; and
  - (b) that in 20X4, costs of CU25,000 will be incurred to enhance the machine's performance by increasing its productive capacity
- At the end of 20X4, costs to enhance the machine's performance are incurred. The machine's estimated future cash flows reflected in the most recent management approved budgets are given in Schedule 3 and a current discount rate is the same as at the end of 20X0.

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At the end of 20X0

Schedule 1. Calculation of the machine's value in use at the end of 20X0

Year	Future cash flows	Discounted at 14%
	CU	CU
20X1	22,165[1]	19,443
20X2	21,450[1]	16,505
20X3	20,550[1]	13,871
20X4	24,725[1,2]	14,639
20X5	25,325[1,3]	13,153
20X6	24,825[1,3]	11,310
20X7	24,123[1,3]	9,640
20X8	25,533[1,3]	8,951
20X9	24,234[1,3]	7,452
20X10	22,850[1,3]	6,164
Value in use		121,128

[1] Includes estimated costs necessary to maintain the level of economic benefit expected to arise from the machine in its current condition.

[2] Excludes estimated costs to enhance the machine's performance reflected in management budgets.

[3] Excludes estimated benefits expected from enhancing the machine's performance reflected in management budgets.

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Example 4: Treatment of future costs

- The machine's recoverable amount (value in use) is less than its carrying amount. Therefore, F recognises an impairment loss for the machine

Schedule 2. Calculation of the impairment loss at the end of 20X0

	Machine
	CU
Carrying amount before impairment loss	150,000
Recoverable amount (Schedule 1)	121,128
Impairment loss	(28,872)
Carrying amount after impairment loss	121,128

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Example 4: Treatment of future costs

Years 20X1–20X3

- No event occurs that requires the machine's recoverable amount to be re-estimated. Therefore, no calculation of recoverable amount is required to be performed

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Example 4: Treatment of future costs

At the end of 20X4

- The costs to enhance the machine's performance are incurred. Therefore, in determining the machine's value in use, the future benefits expected from enhancing the machine's performance are considered in forecasting cash flows

- This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. As a consequence, in accordance with paragraphs HKAS 36.110-111, the recoverable amount of the machine is recalculated at the end of 20X4

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Example 4: Treatment of future costs

At the end of 20X4

Schedule 3. Calculation of the machine's value in use at the end of 20X4

Year	*Future cash flows*[(a)]	*Discounted at 14%*
	CU	CU
20X5	30,321	26,597
20X6	32,750	25,200
20X7	31,721	21,411
20X8	31,950	18,917
20X9	33,100	17,191
20X10	27,999	12,756
Value in use		122,072

(a) Includes estimated benefits expected from enhancing the machine's performance reflected in management budgets.

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Example 4: Treatment of future costs

At the end of 20X4

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X4

	Machine
	CU
Carrying amount at the end of 20X0 (Schedule 2)	121,128
End of 20X4	
Depreciation charge (20X1 to 20X4 – Schedule 5)	(48,452)
Costs to enhance the asset's performance	25,000
Carrying amount before reversal	97,676
Recoverable amount (Schedule 3)	122,072
Reversal of the impairment loss	17,324
Carrying amount after reversal	115,000
Carrying amount: depreciated historical cost (Schedule 5)	115,000 [(a)]

(a) The value in use of the machine exceeds what its carrying amount would have been at depreciated historical cost. Therefore, the reversal is limited to an amount that does not result in the carrying amount of the machine exceeding depreciated historical cost.

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Example 4: Treatment of future costs

At the end of 20X4

Schedule 5. Summary of the carrying amount of the machine

Year	Depreciated historical cost	Recoverable amount	Adjusted depreciated charge	Impairment loss	Carrying amount after impairment
	CU	CU	CU	CU	CU
20X0	150,000	121,128	0	(28,872)	121,128
20X1	135,000	nc	(12,113)	0	109,015
20X2	120,000	nc	(12,113)	0	96,902
20X3	105,000	nc	(12,113)	0	84,789
20X4	90,000		(12,113)		
enhancement	25,000		–		
	115,000	122,072	(12,113)	17,324	115,000
20X5	95,833	nc	(19,167)	0	95,833

nc = not calculated as there is no indication that the impairment loss may have increased/ decreased.

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Example 4: Treatment of future costs

At the end of 20X4

- The machine’s recoverable amount (i.e. value in use) is higher than the machine’s carrying amount and depreciated historical cost (Schedule 4)

- Therefore, K reverses the impairment loss recognised for the machine at the end of 20X0 so that the machine is carried at depreciated historical cost

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I. Disclosure

- Disclosure by class of assets:
  - impairment losses recognised in profit or loss
  - impairment losses reversed in profit or loss
  - which line item(s) of the statement of comprehensive income
  - impairment losses on revalued assets recognised in other comprehensive income
  - impairment losses on revalued assets reversed in other comprehensive income
- Disclosure by reportable segment:
  - impairment losses recognised
  - impairment losses reversed

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I. Other Disclosure (Con't)

- If an individual impairment loss (reversal) is material disclose:
  - **events and circumstances** resulting in the impairment loss
  - amount of the loss
  - individual asset: nature and segment to which it relates
  - cash generating unit: description, amount of impairment loss (reversal) by class of assets and segment
  - if recoverable amount is fair value less costs to sell, disclose the **basis for determining fair value**
  - if recoverable amount is value in use, disclose the **discount rate and other key assumptions**
  - Sensitivity analysis

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Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2012 – continued

8. Other gains and losses

Source		Year ended 31/12/12	Year ended 31/12/11
		HK$'000	HK$'000
	Continuing operations		
HKAS 1.98(c)	Gain on disposal of property, plant and equipment	6	67
HKAS 40.76(d)	Gain arising on change in fair value of investment properties	50	298
HKAS 21.52(a)	Net foreign exchange gain/(loss)	78	(166)
HKFRS 7.20(a)	Gain/(loss) arising on change in fair value of financial assets designated as at FVTPL	-	-
HKFRS 7.20(a)	Gain/(loss) arising on change in fair value of financial assets classified as held for trading	8	(10)
HKFRS 7.20(a)	Gain/(loss) arising on change in fair value of financial liabilities designated as at FVTPL	-	-
HKFRS 7.20(a)	Gain/(loss) arising on change in fair value of financial liabilities classified as held for trading	-	-
HKFRS 7.20(a)	Cumulative gain/(loss) on disposal of available-for-sale investments	-	-
HKFRS 7.24(b)	Hedge ineffectiveness in cash flow hedges	89	68
HKFRS 7.24(c)	Hedge ineffectiveness in net investment hedges	-	-
HKAS 36.126	Impairment loss recognised in respect of property, plant and equipment	(1,204)	-
HKAS 36.126	Impairment loss recognised in respect of goodwill	(235)	-
HKFRS 7.20(e)	Impairment losses on financial assets		
	- trade receivables	(63)	(430)
	- available-for-sale equity investments	-	-
	- available-for-sale debt investments	-	-
	- held-to-maturity investments	-	-
	- loans carried at amortised cost	-	-
	Reversal of impairment losses on trade receivables	103	-
	Gain on effective settlement of legal claim against Subseven Limited (see note 50)	40	-
		(1,128)	(173)

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2012 – continued

HKAS 16.73(a)
HKAS 16.73(d), (e)
Sch 10:12(8)

18. Property, plant and equipment

Source		Leasehold land	Buildings	Property under construction	Plant and equipment	Equipment under finance lease	Total
		HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
	Cost						
	Balance at 1 January 2011	19,055	13,972	-	157,794	630	191,451
	Additions	-	895	-	10,657	40	11,592
	Disposals	-	-	-	(25,788)	-	(25,788)
	Effect of foreign currency exchange differences	(860)	-	-	(1,498)	-	(2,358)
	Balance at 31 December 2011	18,195	14,867	-	141,165	670	174,897
	Additions	-	-	-	20,183	-	20,183
	Disposals	(1,439)	-	-	(12,401)	(624)	(14,464)
HKAS 16.74(b)	Construction expenditure capitalised	-	-	-	-	-	-
	Derecognised on disposal of a subsidiary	-	-	-	(8,419)	-	(8,419)
	Acquisitions through business combinations	-	-	-	512	-	512
	Reclassified as held for sale	(1,260)	(1,357)	-	(22,045)	-	(24,662)
	Effect of foreign currency exchange differences	309	-	-	1,673	-	1,982
	Balance at 31 December 2012	15,805	13,510	-	120,668	46	150,029
	Accumulated depreciation and impairment						
	Balance at 1 January 2011	(2,132)	(1,551)	-	(22,887)	(378)	(26,948)
	Eliminated on disposals of assets	-	-	-	4,610	-	4,610
	Depreciation expense	(1,002)	(947)	-	(13,715)	(130)	(15,794)
	Effect of foreign currency exchange differences	(3)	(2)	-	451	-	446
	Balance at 31 December 2011	(3,137)	(2,500)	-	(31,541)	(508)	(37,686)
	Eliminated on disposals of assets	-	106	-	3,602	500	4,208
	Eliminated on disposal of a subsidiary	-	-	-	2,757	-	2,757
	Eliminated on reclassification as held for sale	140	153	-	6,165	-	6,458
HKAS 36.126(a)	Impairment losses recognised in profit or loss	-	-	-	(1,204)	-	(1,204)
HKAS 36.126(b)	Reversals of impairment losses recognised in profit or loss	-	-	-	-	-	-
	Depreciation expense	(801)	(774)	-	(11,002)	(10)	(12,587)
	Effect of foreign currency exchange differences	-	-	-	(392)	-	(392)
	Balance at 31 December 2012	(3,798)	(3,015)	-	(31,615)	(18)	(38,446)
	Carrying amounts						
	Balance at 31 December 2012	12,007	10,495	-	89,053	28	111,583
	Balance at 31 December 2011	15,058	12,367	-	109,624	162	137,211

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2012 – continued

HKAS 16.73(c)

The above items of property, plant and equipment are depreciated on a straight-line basis at the following rates per annum:

Leasehold land	Over the term of the lease
Buildings	Over the shorter of the term of the lease, and 20 – 30 years
Plant and equipment	7 – 20%
Equipment under finance lease	20%

Impairment losses recognised in the current year

HKAS 36.130(a) to (g)
HKAS 36.131

During the year, as the result of the unexpected poor performance of a manufacturing plant, the Group carried out a review of the recoverable amount of that manufacturing plant and the related equipment. These assets are used in the Group's electronic equipment reportable segments. The review led to the recognition of an impairment loss of HK$1.09 million, which has been recognised in profit or loss. The recoverable amount of the relevant assets has been determined on the basis of their value in use. The discount rate used in measuring value in use was 9% per annum. No impairment assessment was performed in 2011 as there was no indication of impairment.

Additional impairment losses recognised in respect of property, plant and equipment in the year amounted to HK$0.114 million. These losses are attributable to greater than anticipated wear and tear. These assets are also used in the Group's electronic equipment reportable segments.

HKAS 36.126(a)

The impairment losses have been included in profit or loss in the ['other gains and losses'] line item.

Sch 10:12(9)
Sch 10:31(c)

The carrying value of land shown above comprises:

	31/12/12	31/12/11
	HK$'000	HK$'000
Land in Hong Kong:		
Long lease	-	-
Medium-term lease	1,600	1,700
	1,600	1,700
Land outside Hong Kong:		
Freehold	-	-
Long lease	7,507	10,210
Medium-term lease	2,900	3,148
Short lease	-	-
	10,407	13,358
	12,007	15,058

Assets pledged as security

HKAS 16.74(a)
Sch 10:12(4)

Leasehold land and buildings with a carrying amount of approximately HK$22.5 million (31 December 2011: approximately HK$27.4 million) have been pledged to secure general banking facilities granted to the Group.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2012 – continued

21. Goodwill

Source		31/12/12 HK$'000	31/12/11 HK$'000
HKFRS 3.B67(d)	*Cost*		
	Balance at beginning of year	24,060	23,920
	Additional amounts recognised from business combinations occurring during the year (see note 50)	478	-
	Derecognised on disposal of a subsidiary (see note 51)	(3,080)	-
	Reclassified as held for sale (see note 12)	(1,147)	-
	Effect of foreign currency exchange differences	209	140
	Others [please describe]	-	-
	Balance at end of year	20,520	24,060
	Accumulated impairment losses		
	Balance at beginning of year	-	-
HKAS 36.126(a)	Impairment losses recognised in the year	(235)	-
	Derecognised on disposal of a subsidiary	-	-
	Reclassified as held for sale	-	-
	Effect of foreign currency exchange differences	-	-
	Balance at end of year	(235)	-
	Carrying amounts		
	Balance at 31 December	20,285	24,060

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2012 – continued

22. Impairment testing on goodwill

HKAS 36.134, 135

Goodwill has been allocated for impairment testing purposes to the following groups of cash-generating units:

- Leisure goods – retail outlets
- Electronic equipment – internet sales
- Construction operations – Murphy Construction
- Construction operations – other.

Before recognition of impairment losses, the carrying amount of goodwill (other than goodwill relating to discontinued operations) was allocated to groups of cash-generating units as follows:

	31/12/12	31/12/11
	HK$'000	HK$'000
Leisure goods – retail outlets	9,729	9,620
Electronic equipment – internet sales	9,056	8,478
Construction operations – Murphy Construction	235	235
Construction operations – other	1,500	1,500
	20,520	19,833

Leisure goods – retail outlets

The recoverable amount of this group of cash-generating units is determined based on a value in use calculation which uses cash flow projections based on financial budgets approved by the directors covering a five-year period, and a discount rate of 15% per annum (2011: 12.5% per annum).

Cash flow projections during the budget period are based on the same expected gross margins and raw materials price inflation throughout the budget period. The cash flows beyond that five-year period have been extrapolated using a steady 5% per annum growth rate which is the projected long-term average growth rate for the international leisure goods market. The directors believe that any reasonably possible change in the key assumptions on which the recoverable amount is based would not cause the carrying amount of the group of units to exceed the aggregate its recoverable amount.

Electronic equipment – internet sales

The recoverable amount of the 'electronic equipment – internet sales' segment as a cash-generating unit is determined based on a value in use calculation which uses cash flow projections based on financial budgets approved by the directors covering a five-year period, and a discount rate of 15% per annum (2011: 12.5% per annum). Cash flows beyond that five-year period have been extrapolated using a steady growth rate of 11% per annum (2011: 11%). This growth rate exceeds the long-term average growth rate for the international electronic equipment market by 0.5 percentage points. However, among other factors, the internet sales cash-generating unit benefits from the protection of a 20-year patent on the Series Z electronic equipment, granted in 2007, which is still acknowledged as one of the top models in the market. The steady growth rate of 11% is estimated by the directors based on past performance and their expectations of market development. The directors estimate that a decrease in growth rate by 1 to 5% would result in the aggregate carrying amount of the cash-generating unit exceeding the recoverable amount of the cash-generating unit by approximately HK$ 1 to 5 million. The directors believe that any reasonably possible change in the other key assumptions on which recoverable amount is based would not cause the 'electronic equipment – internet sales' carrying amount to exceed its recoverable amount.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2012 – continued

Construction operations – Murphy Construction

HKAS 36.130

The goodwill associated with Murphy Construction arose when that business was acquired by the Group in 2006. The business has continued to operate on a satisfactory basis, but without achieving any significant increase in market share. During the year, the government of A Land introduced new regulations requiring registration and certification of builders for government contracts. In the light of the decision to focus the Group's construction activities through the other operating units in Subthree Limited, the directors have decided not to register Murphy Construction for this purpose, which means that it has no prospects of obtaining future contracts. The directors have consequently determined to write off the goodwill directly related to Murphy Construction amounting to HK$235,000. No other write-down of the assets of Murphy Construction is considered necessary. Contracts in progress at the end of the year will be completed without loss to the Group.

The impairment loss has been included in profit or loss in the 'other gains and losses' line item.

Construction operations – other

The recoverable amount of the Group's remaining construction operations has been determined based on a value in use calculation which uses cash flow projections based on financial budgets approved by the directors covering a five-year period, and a discount rate of 15% per annum (2011: 12.5% per annum). Cash flows beyond that five-year period have been extrapolated using a steady 8% per annum growth rate. This growth rate does not exceed the long-term average growth rate for the construction market in A Land. The directors believe that any reasonably possible further change in the key assumptions on which the recoverable amount is based would not cause the carrying amount of the unit to exceed its recoverable amount.

The key assumptions used in the value in use calculations for the leisure goods and electronic equipment cash-generating units are as follows:

Budgeted market share	Average market share in the period immediately before the budget period, plus a growth of 1-2% of market share per year. The values assigned to the assumption reflect past experience and are consistent with the directors' plans for focusing operations in these markets. The directors believe that the planned market share growth per year for the next five years is reasonably achievable.
Budgeted gross margin	Average gross margins achieved in the period immediately before the budget period, increased for expected efficiency improvements. This reflects past experience, except for efficiency improvements. The directors expect efficiency improvements of 3 - 5% per year to be reasonably achievable.
Raw materials price inflation	Forecast consumer price indices during the budget period for the countries from which raw materials are purchased. The values assigned to the key assumption are consistent with external sources of information.

Question 1

Which one of the following independent statements about the concept of Control under HKFRS 10 is CORRECT?

A An investor controls an investee when it is exposed or has rights, to benefits from its involvement with the investee and has the ability to affect those benefits through its power over the investee.

B For the purpose of assessing power, only protective rights held by the investor and other parties are considered.

C For potential voting rights to the substantive, it must be currently exercisable.

D An investor with decision-making rights shall determine whether it is a principal or an agent. An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

E None of the above statements A, B, C and D is correct.

Question 2

Which of the following statements is CORRECT relating to the cash flows in the cash flows statements?

A Cash payment to owners to redeem the entity's shares is classified under investing activities

B Cash receipts from repayment of an advance made to a party other than a finance institution is classified under investing activities

C Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from investing activities.

D None of the above statement is correct

E All of the above statements are correct

Question 3

Which of the following independent statements about Joint Arrangement under HKFRS 11 are incorrect?

1. There are two types of joint arrangements under HKFRS 11, namely joint operation and joint venture.
2. If the parties can demonstrate past experience of voting together in the absence of a contractual agreement, this can still satisfy the requirements of "joint control".
3. A joint arrangement structured through a separate vehicle must be a joint venture.
4. A guarantee to third parties provided by the parties to the arrangement, e.g. service provided or financing provided to the arrangement, does not in itself determine that the joint arrangement is a joint operation.
5. A joint venturer accounts for its investment using the equity method or proportionate consolidation unless the entity is exempted from applying the equity method as specified in accordance with HKAS 28 (2011) Investments in Associates and Joint Ventures.

A. (1), (2) & (3)
B. (1), (3) & (4)
C. (2), (3) & (4)
D. (2), (3) & (5)
E. All of the above statements are incorrect

Question 4

Entity A purchased a piece of land on 15 December 20X0 but there was no plan on what the land would be used for. On 10 February 20X1, management approved the plan to develop a 15-storey building which will then be leased out under operating leases to generate rental income. The construction was completed in March 20X2 and was then leased out to third parties.
On 10 May 20X5, the management determined to use this building as the group head office as the lease term for the current office would soon be expired. On 1 April 20X6, after all the tenants had moved out, Entity A and its subsidiaries occupied the building and used it as office. Entity A occupied the first six floors as head office while the remaining floors were leased out to its subsidiaries.
Entity A elects to use fair value model to account for investment properties and cost model for own-use properties. The financial year end is 31 December.

Which one of the following independent statements are CORRECT?

1. Entity A should account for the land under HKAS 16 Property, plant and equipment on 31 December 20X0.
2. Property under construction is stated at its fair value on 31 December 20X1 unless the fair value cannot be determined reliably.
3. The building is accounted for as property, plant and equipment under HKAS 16 in entity A's separate financial statements on 31 December 20X5.
4. For the transfer from investment property carried at fair value to property, plant and equipment, the fair value at the date of change in use will be the properties' deemed cost for subsequent accounting in accordance with HKAS 16.
5. Entity A should account for the whole building as property, plant and equipment under HKAS 16 in its separate financial statements on 31 December 20X6.

A (1), (2) & (3)
B (2), (3) & (4)
C (2) & (3)
D (2) & (4)
E (2), (4) & (5)

Question 5

Entity Yellow has three subsidiaries, B, C and D. Entities B and C are wholly owned subsidiaries while entity D is 80% owned by Yellow. When Yellow acquired D, goodwill of HK$800,000 was recognised in Yellow's consolidated financial statements.

The functional currency of Yellow and B is HKD. C and D are foreign operations and their functional currency is RMB.

On 30 August 20X1, B granted a loan of HK$2 million to C and the settlement of this loan is neither planned nor likely to occur in the foreseeable future. On 25 October 20X1, Yellow disposed D in its entirety. Exchange differences of HK$500,000 relating to D have been accumulated in Yellow's foreign currency translation reserve in equity up to this date.

Which of the following independent statements are INCORRECT?

1. B's loan receivable from C forms part of Yellow's net investment in C and hence the related exchange differences recognised will also be recognised in the consolidated profit or loss.
2. The goodwill arising on the acquisition of D is translated using the exchange rate at the date of the transaction at each subsequent reporting date.
3. Before disposal of D, accumulated exchange differences of HK$125,000 have been allocated to and recognised as part of the non-controlling interests of D in the consolidated statement of financial position.
4. Upon disposal of D, accumulated exchange differences of HK$500,000 in Yellow's reserve are reclassified from reserve to consolidated profit or loss and included in the calculation of profit or loss on disposal.

A (1) & (2)

B (2) & (3)

C (1) & (3)

D (2) & (4)

E (3) & (4)

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A Refresher Course on Current

Financial Reporting Standards 2013

Day 5

Time	Topic
09:00 - 10:45	Income taxes and deferred taxation
10:45 - 11:00	Break
11:00 - 12:00	Operating segments
12:00 - 13:00	Presentation of financial statements
13:00 - 14:00	Lunch
14:00 - 14:45	Disclosure of interests in other entities
14:45 - 16:00	Fair value measurement
16:00 - 17:00	Examination

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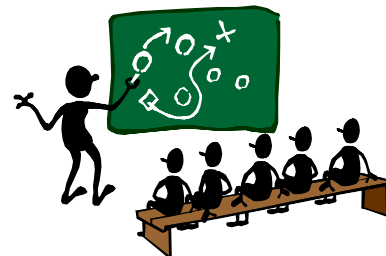
A Refresher Course on Current Financial Reporting Standards 2013 (Day 5)

HKAS 12 Income Taxes



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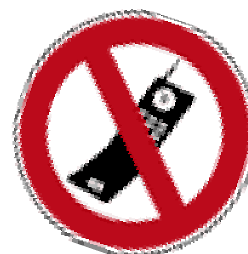

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HKAS 12
Income Taxes

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Agenda

Part 1 - HKAS 12 *Income Taxes*

Part 2 - Amendments to HKAS 12 *Income Taxes*

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Part 1

HKAS 12 *Income Taxes*

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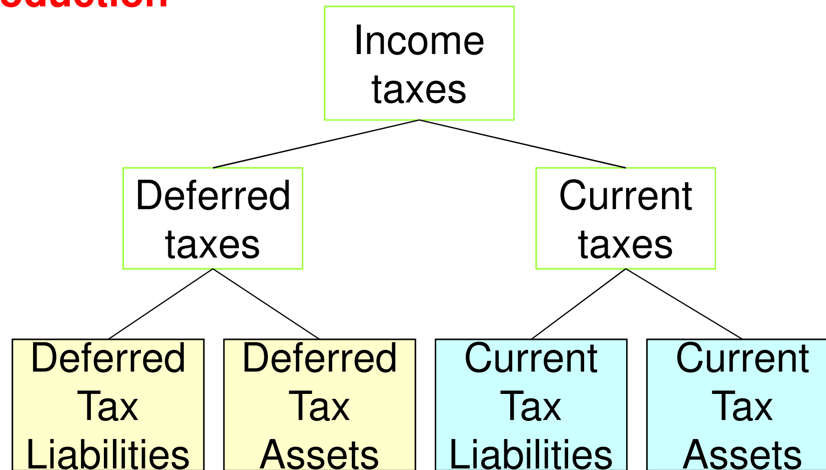
Introduction



Tax expense (tax income)

- is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

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Scope

- **HKAS 12 shall be applied in accounting for income tax**
  - HKAS 12.2 defines these as all domestic and foreign taxes that are based on taxable profits
  - Income taxes also include taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint venture on distributions to the reporting entity

"Taxable profit" = Taxable income minus deductible amounts (a net rather than a gross basis)

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Scoped Out

Sales taxes – Transactional taxes based on sales value	Scoped out from HKAS 12
Interest and penalties assessed on under-payment or late payment of income tax	Scoped out from HKAS 12
Tonnage tax paid on basis of tonnage transported, tonnage capacity or a notional profit	Scoped out from HKAS 12

Such taxes should be presented based on its nature, either as finance cost (e.g. interest) or operating expense (e.g. penalty)

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Current tax

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Definitions

- **Current tax:**
  - Current tax is defined as the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period [HKAS 12.5]
  - It is the tax that the entity expects to pay (recover) in respect of the financial period

- **Taxable profit (tax loss)**
  - Taxable profit (tax loss) is defined as the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable) [HKAS 12.5]

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Current Tax – Recognition

- **Basic requirements:** [HKAS 12.12-13]
  - Current tax for current and prior periods shall, to the extent unpaid, be recognised as a **liability**
  - If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an **asset**
  - The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an **asset**

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Current Tax – Recognition (cont'd)

- Generally, current tax is **recognised in profit or loss**
- **Exceptions**: [HKAS 12.58]
  - where the current tax arises as a result of a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity **or**
  - where the current tax arises from a business combination

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Current Tax – Measurement

- Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, **using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period**

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Current Tax – Presentation

- An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:
  - a) has a legally enforceable right to set off the recognised amounts; and
  - b) intends either
    - to settle on a net basis, or
    - to realise the asset and settle the liability simultaneously
- The tax expense (income) related to profit or loss from ordinary activities
  - shall be presented on the face of the income statement
- Other disclosures (to be discussed with deferred tax)

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Deferred tax

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Deferred Tax – Overview

- **HKAS 12 *Income Taxes* adopts:**
  - Balance sheet liabiity method
    - largely focuses on the statement of financial position by recognising the tax effects of temporary differences between the carrying amount of an asset or a liability and its tax base
  - Full provision approach
    - recognised all differences, except for some limited cases

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Deferred Tax - Definitions

- **Deferred tax liabilities:**
  - Deferred tax liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences [HKAS 12.5]
- **Deferred tax assets:**
  - Deferred tax assets are defined as the amounts of income taxes recoverable in future periods in respect of : [HKAS 12.5]
    - Deductible temporary differences;
    - the carryforward of unused tax losses; and
    - the carryforward of unused tax credits

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Principal steps in arriving at deferred tax assets/liabilities

Step 1: Calculate the tax base of each asset and liability in the statement of financial position

Step 2: Calculate the temporary difference (if any) for each of the above items

Step 3: Identify those temporary differences that will give rise to deferred tax assets or liabilities taking into account the recognition criteria and initial exemption laid down in the Standard

Step 4: Calculate the deferred tax attributable to those temporary differences by multiplying each temporary difference by the tax rate that is expected to apply when the temporary difference reverses based on enacted or substantively enacted tax rates

Step 5: Recognise the movement between the deferred tax balances in the opening and closing statements of financial position in profit or loss, in other comprehensive income, in equity, or as part of the initial accounting for a business combination

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Step 1: Deferred tax – Tax bases

- The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes
- The amount of the tax base can vary according to the manner in which the entity expects to recover the asset, or settle the liability
  - e.g. properties held for use
  - e.g. properties held for sale

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Step 2: Deferred tax - temporary differences

- ❑ Temporary difference is the difference between the carrying amount of an asset or liability in the statement of financial position and its tax base
- ❑ When the recovery of an asset (non-taxable assets) or settlement of a liability (non-deductible liabilities) has no tax consequences, the tax base is equal to the carrying amount (i.e., temporary difference is nil)
- ❑ Two types of temporary differences:
  - taxable temporary difference
  - deductible temporary difference

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Temporary difference

Examples of circumstances resulting in **taxable temporary differences**:

- **Depreciation** of an asset is **accelerated for tax purposes**
- **Interest revenue** is received in arrears and is **included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis**
- **Development costs** have been **capitalised** and will be **amortised** to the income statement but were **deducted in determining taxable profit** in the period in which they were **incurred**
- **Prepaid expenses** have already been **deducted on a cash basis** in determining the taxable profit of the current or previous periods
- **Financial assets or investment property are carried at fair value** which exceeds cost but **no equivalent adjustment is made for tax purposes**
- An entity **revalues property, plant and equipment** (under HKAS 16) but **no equivalent adjustment is made for tax purposes**

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Temporary difference (cont'd)

Examples of circumstances resulting in **deductible temporary differences**:

- **Accumulated depreciation** of an asset in the financial statements is **greater than the cumulative depreciation allowed up to the balance sheet date for tax purposes**
- The **net realisable value** of an item of **inventory**, or the recoverable amount of an item of property, plant or equipment, is **less than the previous carrying amount** and an entity therefore reduces the carrying amount of the asset, but that reduction is **ignored for tax purposes until the asset is sold**
- **Research costs** are recognised as an **expense** in determining accounting profit but are **not permitted as a deduction in determining taxable profit** until a later period
- **Income is deferred** in the balance sheet but has already been **included in taxable profit** in current or prior periods
- Financial assets or investment property are carried **at fair value which is less than cost**, but no equivalent adjustment is made for tax purposes

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Examples: Temporary difference

	Property held for use	Revalued property held for use	Bad debt expense	Deferred revenue
Carrying amount	500	1000	450 (gross amt of 500, less allowance for bad debt of 50)	800 (deferred revenue received in advance)
Tax base	300 (Tax written down value)	300 (Tax written value)	500 (allowance only deductible upon write-off)	0 (taxable on a cash receipt basis)
Temporary difference/ deductible temporary difference	200	700	(50)	(800)

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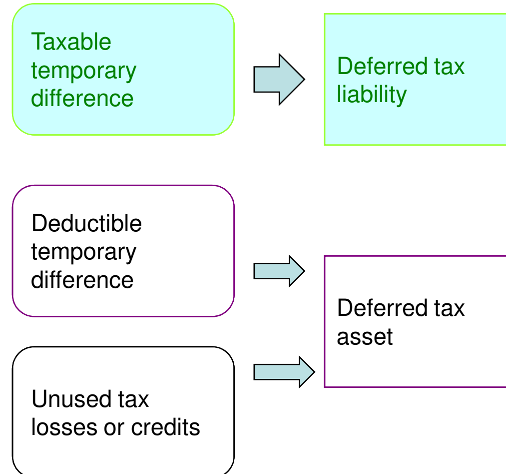
Step 3: Deferred tax – Temporary difference that gives rise to deferred assets and liabilities

- **Balance sheet liability method - full provision approach**

All recognised?

- **General rule: Recognise all unless specific exceptions apply** (to be discussed later)



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Taxable/deductible temporary differences

	Carrying amount – tax base	Type of temporary difference	Gives rise to…
Asset	Positive	Taxable	Deferred tax liability
Asset	Negative	Deductible	Deferred tax asset
Liability	Positive	Deductible	Deferred tax asset
Liability	Negative	Taxable	Deferred tax liability

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Step 4: Deferred tax – Measurement

Computation of deferred tax assets and liabilities

- To calculate the amount of a deferred tax asset or liability, HKAS 12 contains the following formula:

Deferred tax liabilities or assets = Taxable or deductible temporary difference × Tax rate

- A deferred tax asset can also arise from tax losses that have been carried forward. These deferred tax assets are calculated as follows:

Deferred tax asset = Unused tax losses and / or tax credit × Tax rate

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Step 4: Deferred tax – Measurement (cont'd)

Applicable tax rates and laws

- Deferred assets and liabilities shall be measured:
  - at the tax rates that are expected to apply to the period when the temporary difference reverses
  - based on tax rates and tax laws enacted or substantively enacted at the end of the reporting period

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Step 4: Deferred tax – Measurement (cont'd)

- Example:
  - A PRC joint venture is entitled to tax concessions during its initial years of operation
  - The standard income tax rate is 30%. However, the joint venture is fully exempted from PRC income tax for 2 years starting from its first profit-making year, followed by a 50% reduction in the PRC income tax rate for the next 3 years
  - The joint venture has an item of equipment that cost RMB 12,000, which is depreciated over 6 years for accounting purposes and 3 years for PRC income tax purposes, using the straight-line method. The first year that the joint venture has taxable profit is 2011

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Step 4: Deferred tax – Measurement (cont'd)

- The temporary differences arising as a result of the accelerated tax depreciation will reverse during years 2014, 2015 and 2016 as follows:

	Carrying amount	Tax base	Temporary difference	Reversal of temporary difference	Tax rate	Deferred tax liability
	RMB	RMB	RMB	RMB		RMB
2011	10,000	8,000	2,000	N/A	0%	300 (2,000x15%)
2012	8,000	4,000	4,000	N/A	0%	600 (4,000x15%)
2013	6,000	0	6,000	N/A	15%	1,200 (4,000x15%) +(2,000x30%)
2014	4,000	0	4,000	2,000	15%	900 (2,000x15%) +(2,000x30%)
2015	2,000	0	2,000	2,000	15%	600 (2,000x30%)
2016	0	0	-	2,000	30%	-

- **The above table illustrates that, where tax rates vary, it is necessary to estimate the tax rate that willl apply when the temporary difference reverses. In the example, it is predictable that the temporary difference arising in 2011 will reverse in 2014 and, therefore, the appropriate tax rate for deferred tax purposes is 15% rather than 0%. Similarly, the temporary differences arising in 2012 and 2013 will reverse in 2015 and 2016, and tax rates of 15% and 30% should therefore be applied for the temporary differences arising in 2012 and 2013 respectively.**

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Step 4: Deferred tax – Measurement (cont'd)

❑ **Progressive or graduated tax rates**

- When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse
  [HKAS 12.49]

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Step 4: Deferred tax – Measurement (cont'd)

❑ **Substantively enacted tax rates**

- Current and deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, in some jurisdictions, announcements of tax rates and tax laws by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate and tax laws
  [HKAS 12.48]

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Step 4: Deferred tax – Measurement (cont'd)

❑ **Changes in tax rates after the reporting period**

- Where there is a **change in tax rates or laws after the reporting period**, no adjustment is made to the carrying amounts of deferred tax assets and liabilities
- However, where the effect of the change is such that "non-disclosure could influence the economic decisions of users taken on basis of the financial statements", disclosure will be required in accordance with HKAS 10 *Event after the Reporting Period* [HKAS 10.21]

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Step 4: Deferred tax – Measurement (cont'd)

❑ **Discounting**

- HKAS 12 explicitly **prohibits** the use of discounting for the measurement of deferred tax assets and liabilities [HKAS 12.53]

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Step 4: Deferred tax – Measurement (cont'd)

- The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities

  [HKAS 12.51]

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Examples:

An item of PPE has a carrying amount of 100 and a tax base of 60	• **Tax rate of 20% would apply if the asset were sold**	• **The entity recognises a deferred tax liability of 8 (40 at 20%) if it expects to sell the item without further use or**
	• **Tax rate of 30% would apply to other income**	• **a deferred tax liability of 12 (40 at 30%) if it expects to retain the item and recover its carrying amount through use**

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Examples:

- An item of PPE with a cost of 100 and a carrying amount of 80 is revalued to 150
- No equivalent adjustment is made for tax purposes
- Cumulative depreciation for tax purposes is 30 and tax rate is 30%
- If the item is sold for more than cost, the cumulative tax depreciation of 30 will be included in taxable income, but sale proceeds in excess of cost will not be taxable

- Tax base = 70
- Taxable temporary difference = 80

- if the entity expects to recover the carrying amount by using the item, it must generate taxable income of 150, but will only be able to deduct depreciation of 70
- On this basis, there is a deferred tax liability of 24 (80 at 30%)
- If the entity expects to recover the carrying amount by selling the item immediately for proceeds of 150, the deferred tax liability is:

	Taxable temporary difference	Tax rate	Deferred tax liability
Cumulative tax depreciation	30	30%	9
Proceeds in excess of cost	50	nil	-
Total	80		9

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Step 5: Deferred tax - Recognition of movement

- Deferred tax should be recognised as income or an expense and included in the net profit or loss for the period, **except** to the extent that the movement in deferred tax: [HKAS 12.58, 61A & 66]
  - Relates to an item recognised in other comprehensive income, deferred tax also recognised in other comprehensive income
  - Relates to an item recognised in equity, deferred tax also recognised in equity
  - Arises in relation to a business combination, adjusts goodwill

.

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Example: Deferred tax liability arising on the revaluation of a property

- B Limited revalues a property from a carrying amount of $100,000 to $150,000. The tax base of the asset is $100,000. The carrying amount of the property is expected to be recovered through use. The applicable tax is 30%.

- A taxable temporary difference of $50,000 ($150,000-$100,000) arises on revaluation , giving rise to a deferred tax liability of $15,000 ($50,000 x 30%). The following entries record the revaluation and the deferred tax liability:

	DR	CR
	$	$
Property, plant and equipment	50,000	
Property revaluation reserve		50,000
Property revaluation reserve	15,000	
Deferred tax liability		15,000

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Example : Deferred tax liability arising on the revaluation of a property (Cont'd)

- In subsequent periods, the property will be depreciated for both accounting and tax purposes, changing the temporary difference. Any movements in the deferred tax liability are recognised in the income statement. For instance, if the carrying amount of the property at the end of the next reporting period is $120,000 and tax base is $90,000, there is a taxable temporary difference of $30,000 and a deferred tax liability of 9,000 ($30,000x30%). This movement for the year is recorded as follows:

	DR	CR
	$	$
Deferred tax liability ($15,000 -$9,000)	6,000	
Deferred tax (I/S)		6,000

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Presentation

❑ Classification:

- Tax assets and liabilities may not be combined with other assets and liabilities, but must be shown separately on the statement of financial position
- Deferred tax assets and liabilities must be presented separately from current tax assets and liabilities; and
- Deferred tax assets and liabilities must be classified as non-current

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Presentation *(cont'd)*

❑ Offset of current tax

- An entity should offset current tax assets and current tax liabilities if, and only if, the entity: [HKAS 12.71]
  - has a legally enforceable right to set off tax assets/tax liabilities; and
  - intends either to settle tax assets/liabilities on a net basis, or to realise the asset and settle the liability simultaneously
- An entity normally has a legally enforceable right to set off current tax assets against current tax liabilities when they relate to taxes levied by the same taxation authority, and that authority permits the entity to make or receive a single net payment [HKAS 12.72]

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Presentation (cont'd)

❑ Offset of current tax (cont'd)

- Where a company is preparing consolidated financial statements, current tax assets and liabilities arising from different group companies should not be offset unless: [HKAS 12.73]
  - the companies concerned have a legally enforceable right to make or receive a single net payment; and
  - the companies intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously

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Presentation (cont'd)

❑ Offset of deferred tax assets and liabilities

- An entity should offset deferred tax assets and deferred tax liabilities if, and only if: [HKAS 12.74]
  - the entity has a legally enforceable right to set off current tax assets against current tax liabilities; **and**
  - the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
    - the same taxable entity; or
    - different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered

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Disclosure

- ❑ **HKAS 12 has extensive disclosure requirements on income tax**

- ❑ Statement of comprehensive income
  - Major components of the tax charge or credit in the statement of comprehensive income are required to be separately identified, including:
    - Current tax expense or income;
    - Adjustments to current tax of prior periods
    - Deferred tax expense (income) relating to:
      - Origination and reversing of temporary differences
      - Changes in tax rates or new taxes

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Disclosure

- ❑ Reconciliation of tax charge or credit to accounting profit:
  - HKAS 12 requires the presentation of an explanation of the relationship between the tax expense (income) and accounting profit in either or both of the following forms:
    - A numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rates disclosing also the basis on which the applicable tax rates are computed; or
    - A numerical reconciliation between the average effective tax rate (being the tax expense (income) divided by the accounting profit) and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed
  - An explanation is required of changes in the applicable tax rates compared to the previous accounting period

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Disclosure: Reconciliation of tax charge

(i) Reconciliation in absolute terms	20X1	20X0
	$'000	$'000
Accounting profit	8,740	8,775
Tax at the applicable rate of 35% (20X0:40%)	3,059	3,510
Tax effect of expenses that are not deductible in determining taxable profit	122	480
Reduction in opening deferred tax liability resulting from reduction in tax rate	(1,127)	-
Tax expense	2,054	3,990

(ii) Reconciliation in percentage terms	20X1	20X0
	%	%
Applicable tax rate	35.0	40.0
Tax effect of expenses that are not deductible in determining taxable profit	1.4	5.5
Effect on opening deferred tax liability of reduction in tax rate	(12.9)	-
Average effective tax rate (tax expense divided by profit before tax	23.5	45.5

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Disclosure – Deferred tax

- For each type of temporary difference, unused tax loss and tax credit:
  - Amount of the deferred tax assets and liabilities recognised
  - Amount of deferred tax income or expense recognised in profit or loss
- The amount and expiry date of temporary differences, unused tax losses and tax credits; and
- The amount of temporary differences associated with investments in subsidiaries, branches and associate and interests in joint ventures, for which deferred tax liabilities have not been recognised.

and many others……(please refer to the standard itself for a comprehensive list)

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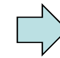
Deferred tax – Recognition exceptions

- **Balance sheet liability method - full provision approach**

All recognised?

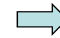
- **General rule: Recognise all unless specific exceptions apply** (to be discussed later)

Taxable temporary difference



Deferred tax liability

Deductible temporary difference



Unused tax losses or credits

Deferred tax asset

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Deferred tax – Recognition exceptions

- Initial recognition of an asset or liability which affects neither accounting profit or loss nor taxable profit or loss, other than from a business combination
- Initial recognition of goodwill
- An investment in a subsidiary, branch, associates or joint ventures, if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and it is probable that the temporary difference will not reverse in the foreseeable future
- Deferred tax assets recognised only to the extent that recoverability is probable

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Recognition exception – Initial recognition of an asset or liability

- Temporary differences are **not** permitted to be recognised where the difference arises in respect of the initial recognition of an asset or liability in a transaction that:
  - is not a business combination; and
  - at the time of the transaction, affects neither accounting profit (loss) nor taxable profit (tax loss)

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Recognition exception – Initial recognition of an asset or liability

- HKAS 12 requires the recognition of deferred tax on temporary differences arising on the initial recognition of an asset or liability when:
  - a transaction affects the income statement (e.g. anticipation of income receivable (asset), or accrual of costs payable (liability); or
  - a transaction affects taxable income (e.g. expenditure on assets such as computer equipment allowed for tax purposes when paid (asset), or deferral of income recognition in respect of funds that are taxable when received (liability); or
  - a business combination

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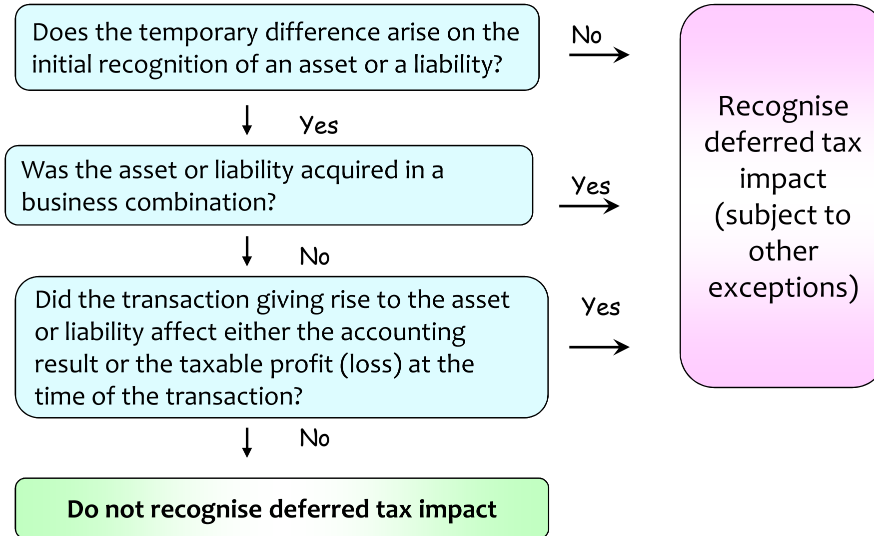
Recognition exception – Initial recognition of an asset or liability



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Example 1: Deferred tax liability arising on the recognition of an asset – asset depreciated at the same rate for tax and accounting purposes

Company A purchases an asset for $100,000. Only $60,000 is qualifying expenditure for tax purposes. The carrying amount of the asset will be recovered through use in taxable manufacturing operations. The asset is depreciated on a straight-line basis at 25% for **both** tax and accounting purposes.

	Carrying amount	Tax base	Temporary difference	Unrecognised difference	Deferred tax
Year	**$**	**$**	**$**	**$**	**$**
20X0	100,000	60,000	40,000	40,000	-
20X1	75,000	45,000	30,000	30,000	-
20X2	50,000	30,000	20,000	20,000	-
20X3	25,000	15,000	10,000	10,000	-
20X4	0	0	-	-	-

No deferred tax is ever recognised in respect of the original temporary difference

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Example 2: Deferred tax liability arising on the recognition of an asset – different depreciation rates for tax and accounting purposes

Facts same example 1, but the asset is depreciated at 25% for accounting purposes and 33 1/3% for tax purposes. The tax rate is 17.5%.

	Carrying amount	Tax base	Temporary difference	Un-recognised temporary difference	Recognised temporary difference	Deferred tax liability
Year	**$**	**$**	**$**	**$**	**$**	**$**
	A	B	A-B=C	D*	C-D=E	E x17.5%
20X0	100,000	60,000	40,000	40,000	-	-
20X1	75,000	40,000	35,000	30,000	5,000	875
20X2	50,000	20,000	30,000	20,000	10,000	1,750
20X3	25,000	0	25,000	10,000	15,000	2,625
20X4	0	0	-	-	-	-

* Being the initial temporary difference of 40,000 of which initial recognition exception applied

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Example 3: Deferred tax liability arising on the recognition of an asset – asset subsequently revalued

Fact as per example 1 (i.e. depreciation at 25% or both tax and accounting purposes), but assume that the asset is revalued for accounting purposes to $120,000 at the end of the first year.

	Carrying amount	Tax base	Temporary difference	Un-recognised temporary difference	Recognise d temporary difference	Deferred tax liability
Year	**$**	**$**	**$**	**$**	**$**	**$**
	A	B	A-B=C	D*	C-D=E**	EX17.5%
20X0	100,000	60,000	40,000	40,000	-	-
20X1	120,000	45,000	75,000	30,000	45,000	7,875
20X2	80,000	30,000	50,000	20,000	30,000	5,250
20X3	40,000	15,000	25,000	10,000	15,000	2,625
20X4	0	0	-	-	-	-

* Being the initial temporary difference of 40,000 of which initial recognition exception applied

** The recognised temporary difference is the amount by which the asset has been revalued upwards in comparison with the depreciated original cost (i.e. the difference between $120,000 and $75,000, being the carrying amount of the asset at the time of the revaluation).

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Recognition exception – Initial recognition of goodwill

- HKAS 12 prohibits the recognition of a temporary difference in respect of goodwill at initial recognition
- Non-deductible goodwill – no deferred tax impact

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Example – Goodwill Exemption

Deferred tax implications for the CEF Group of companies

- CEF Ltd acquired DEF Ltd on 1 January 2012 for **$6 million** when the fair value of the net assets was **$4 million**, and the tax written down value of the net assets was **$3 million**.
- According to the local tax laws for CEF Ltd, impairment of goodwill is not tax deductible.

Answers

The CEF group	Carrying amount	Tax base	Temporary differences
Goodwill	$2 million	-	$2 million
Net assets	$4 million	$3 million	$1 million

Deferred tax liability?

- Provision is made for the temporary differences of net assets
- But NO provision is made for the temporary difference of goodwill
- As an entity shall not recognise a deferred tax liability arising from initial recognition of goodwill.

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Recognition exception – Investments in subsidiaries/associates/joint ventures

- Taxable temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures required to be recognised as deferred tax liability, except for taxable temporary differences where: [HKAS 12.39]
  - The investor is able to control the timing of the reversal; and
  - It is probable that the difference will not reverse in the foreseeable future
- Temporary difference may arise if:
  - Gain from sale investment is taxable
  - Dividends received from investment is taxable
- No temporary difference where recovery has no tax impact

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Recognition exception – Undistributed profits in an associate

- Example:
  - A Ltd. has an associate, B Ltd., which operates in the PRC. At 31 December 2012, A Ltd. had accounted for $20,000 profits of B Ltd., using the equity method of accounting
  - During the period, B Ltd. had paid dividends of $5,000 to B Ltd. No tax arises in A Ltd's country of operation on receipt of dividends. However, under the PRC, tax is withheld at 25% of dividends paid, and is not recoverable
  - Assuming that it is anticipated that the investment in B Ltd. will be recovered through distributions, in accounting for the incremental profits of $15,000 in its consolidated financial statements, A Ltd. should also recognise the tax consequences if those profits were remitted as dividends
  - A deferred tax liability of $3,750 ($15,000 x 25%) should therefore be recognised in the consolidated financial statements at 31 December 2012, in addition to the recognition of the tax consequences arising from the remittance of $5,000

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Recognition exception – Undistributed profits in a subsidiary

- Entity A has a subsidiary with a carrying amount of $2M and a tax base of $1.8M. Entiy A controls the distribution of dividends by the subsidiary
- Entity A does not have any need for the subsidiary to make a distribution and has active plans for the undistributed profits to be reinvested for expansion

Entity A can control the timing of the reversal and the temporary difference is not expected to reverse in the foreseeable future

Entity A cannot recognise a deferred tax liability on the temporary difference of $200K

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Recognition exception – Undistributed profits in a subsidiary

- Entity A has a subsidiary with a carrying amount of $2M and a tax base of $1.8M. Entity A controls the distribution of dividends by the subsidiary
- Entity A has a cash flow problem and needs to extract funding in the subsidiary in the form of a cash dividend

Although entity A can control the timing of the reversal, it is probable that the temporary difference will reverse in the foreseeable future

Entity A should recognise the deferred tax liability for the portion of the earnings to be remitted

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Recognition – Business combination

- Due to adjustments on acquisition (e.g., fair value adjustments on acquisition, additional assets/liabilities identified on acquisition, deferred tax not recognised by the acquiree) the carrying amount in the consolidated financial statements is different from the tax base
- No initial recognition exception on the temporary differences arising on business combination
- HKAS 12 requires recognition of the deferred tax impact of business combinations
- New temporary differences arise which are adjusted against goodwill/gain from bargain purchase

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Example – Business combination

Background

- On 1 January 2012, entity H acquired 100% of entity S for $3,500
- At the date of acquisition, entity S had net assets at carrying amount of $2,500 (including $140 recognised deferred tax liability)
- Fair value of owner-occupied property is revalued upward by$400
- An intangible asset is recognised at its fair value of $200
- A provision for an onerous lease contract of $300 is recognised
- Applicable tax rate is 20%

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Example – Business combination

Net assets at carrying amount	2,500
Fair value adjustment of property	400
Fair value of intangible assets	200
Provision for onerous contract	(300)
Deferred tax on:	
- fair value adjustment of property (20% X 400)	(80)
- fair value of intangible assets (20% X 200)	(40)
- provision for onerous contract (20% X 300)	60
Fair value of net assets acquired	2,740
Goodwill	760
Consideration paid	3,500

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Example: Elimination of unrealised profits on consolidation

Fact pattern:

- Entity H sold inventory costing $100 to its overseas subsidiary, entity S, for $160
- Entity H's tax rate: 30%
- Entity S's tax rate: 25%

The inventory remains on hand at year-end and unrealised profit of $60 to be eliminated on consolidation

No change in tax base

What is the deferred tax balance?

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Example: Elimination of unrealised profits on consolidation (cont'd)

Analysis:

- Entity H:
  - recognises a current tax liability of $18 ($60 profit at 30%)
  - does not recognise any deferred tax balances, no future tax consequences from entity H's point of view
- Entity S
  - entitled to a future deduction for $160 paid for the inventory
  - tax base for the inventory is $160
  - In entity S's individual financial statements, the tax base is equal to the carrying amount, and no temporary difference arises

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Example: Elimination of unrealised profits on consolidation (cont'd)

Analysis:

- Consolidated F/S of entity H
  - the carrying amount of the inventory is reduced from $160 to $100 on consolidation
  - A $60 deductible temporary difference arises, representing the difference between the carrying amount ($100) and the tax base ($160)
  - A deferred tax asset is calculated by multiplying the temporary difference of $60 by 25%, as the deduction is available to entity S at that rate when the unrealised profit is realised outside the group on sale of the inventory by S Limited
- The deferred tax asset arising of $15 is recognised on consolidation

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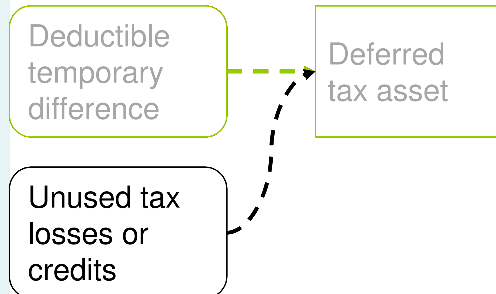
Recognition exceptions – Unused tax loss/credit

- A deferred tax asset shall be recognised for the carry-forward of
  - unused tax losses and
  - unused tax credits
    - to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised



- To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised,
  - the deferred tax asset is not recognised

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Recognition exceptions – Unused tax loss/credit (cont'd)

❑ Availability of future profits

- A deferred tax asset represents a future tax deduction
- It is valuable only if the entity will have future taxable profits against which the deduction can be offset

Important question to answer is when can it be considered probable that an entity will have sufficient taxable profits available in the future to enable the deferred tax asset to be recovered ?

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Recognition exceptions – Unused tax loss/credit

❑ **Examples criteria in assessing available taxable profit:**

a) whether there are sufficient taxable temporary differences (deferred tax liabilities) relating to the same taxation authority and the same taxable entity
b) whether it is probable that the entity will have sufficient taxable profits before the unused tax losses or unused tax credits expire; and
c) whether tax planning opportunities are available

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Recognition exceptions – Unused tax loss/credit

❑ **Recognition – Unrecognised deferred tax assets**

Periodic Re-assessment

- At each balance sheet date,
  - an entity re-assesses unrecognised deferred tax assets
- The entity recognises a previously unrecognised deferred tax asset
  - to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered

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Amendments to HKAS 12 Income Taxes

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Amendment to HKAS 12 – Deferred tax of investment properties

- General principle: Measurement of deferred tax assets or liabilities which reflect the tax consequences that would follow the manner in which management expects to recover or settle the carrying amount of the entity's assets or liabilities

Management may expect to recover the investment property by using it, by selling it, or by a combination of use and sale

Such expectation can affect the measurement of deferred taxes when different tax rates or tax bases apply to the profits generated from using and selling the investment property

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Highlights of amendments to HKAS 12

HKAS 12 has been updated to include:

- A rebuttable presumption that deferred tax on investment property measured using the fair value model in HKAS 40 should be determined on the basis that its carrying amount will be recovered through sale;

and

- A requirement that deferred tax on non-depreciable assets, measured using the revaluation model in HKAS 16, should always be measured on a sale basis

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Impact

Who will be affected ?

For entities holding investment property measured at fair value in territories where

a) the capital gains tax rate is different from the income tax rate, and/or;

b) the tax base from sale is different from tax base from use

Example :

For investment properties in Hong Kong, movement in the fair value will not be tax-affected as there is no capital gains tax in Hong Kong. Deferred tax liabilities will be reduced significantly

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Further considerations

The presumption can be rebutted…

- ❑ if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale
- ❑ this is not a policy choice
- ❑ it also applies when a deferred tax arises from measuring investment property in a business combination if the entity will use the fair value model for subsequent measurement

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Further considerations (cont.)

- ❑ For entities subject to Hong Kong tax, recovery of investment property through sale does not necessarily mean that the deferred tax liability on fair value gains is nil
  - Need to consider the possible claw back of previously granted tax allowances in respect of the property
  - If the IRD considers the investment property is held for trading purposes (i.e., disposal would not be deemed to be a capital transaction), the zero rate applicable to capital gains will not apply

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Further considerations (cont.)

❑ Impact on deferred tax assets

- Applying the presumption does not change the principles to be adopted when recognising and measuring deferred tax assets
- The amendment is likely to reduce significantly deferred tax liabilities
- The entity might need to reconsider the recoverability of the entity's deferred tax assets due to the changes in the nature and amount of deferred tax liabilities

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Illustrations

Example 1

- On 1 Jan 2010, entity B purchased an investment property for $100K
- The investment property does not have a freehold land component and is measured at fair value subsequently
- At 31 Dec 2012, the fair value of the investment property is $120K
- Tax depreciation of 4% of the cost per annum is claimed for investment properties
- . Income tax rate is 30%
- The cumulative tax depreciation claimed previously will be included in the taxable income if the investment property is sold for more than the tax written-down value
- Sale proceeds in excess of the cost are not taxed
- The tax written down value is $88K at 31 Dec 2012

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Scenario – B's management does not have any plan to sell the investment property but to hold it for rental income and capital appreciation. The investment property may be sold in the future.

HKAS 12 (before amendment)		Amendment to HKAS 12	
At 31 December 2012		At 31 December 2012	
	$'K		$'K
Fair value	120	Fair value in excess of cost ($20K x 0%)	0
Tax base	(88)	Claw back of depreciation	
Taxable temporary difference	32	allowance claimed ($12K x 30%)	3.6
Deferred tax liabilities at 30%	9.6	Total deferred tax liabilities	3.6
The lack of a plan to sell the investment property in the future may result in measuring the deferred tax on the basis of use		As the presumption of recovery through sale is not rebutted, deferred tax is measured based on the tax consequences of sale	

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Illustrations

Example 2

Background

An entity holds an investment property with the following details:

	Cost	Fair value	Cumulative tax depreciation
Land (unlimited useful life)	40	60	N/A
Buildings	60	90	30
Total	100	150	
	tax rate		
If sales > cost	20%		
Claw back of tax depreciation claimed if sales > cost	30%		

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Illustrations

Example 2 – if the presumption is NOT rebutted…

	Taxable temporary difference	Tax rate	Deferred tax liabilities
Claw back of depreciation allowance claimed	30	30%	9
Fair value in excess of cost (150-100)	50	20%	10
	80		19

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Illustrations

Example 2 – if the presumption is rebutted…

	Taxable temporary difference	Tax rate	Deferred tax liabilities
Buildings			
Fair value in excess of tax base (90 -30)	60	30%	18
Land (with unlimited useful life)			
Fair value in excess of tax base (60-40)	20	20%	4
	80		22

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Illustrations

Example 3

- Entity P acquired the entire shares of entity S for $500K on 31 Dec 2010
- The identifiable assets acquired included an investment property of fair value $250K and other net assets (excluding deferred tax on property) with a fair value of $100K
- Entity S purchased the investment property for $180K. The cumulative tax depreciation at 31 Dec 2010 is $45K
- Income tax rate is 30%
- The cumulative tax depreciation claimed previously will be included in the taxable income if the investment property is sold for more than the tax written-down value
- Sale proceeds in excess of the cost are not taxed

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HKAS 12 (before amendment)		**Amendments to HKAS 12**	**Amendments to HKAS 12**	
At 31 December 2010		Cost Model		Fair value
	$'K	$'K		$'K
Fair value	250	250	Fair value in excess of cost ($70K x 0%)	0
Tax base (180 – 45)	(135)	(135)	Claw back of depreciation allowance claimed ($45K x 30%)	
Taxable temporary difference	115	115		13.5
Deferred tax liabilities at 30%	34.5	34.5	Total deferred tax liabilities	13.5
The deferred tax on acquisition is the same regardless of which model (cost or fair model) is applied for subsequent measurement		P Co Ltd applies cost model and assumes recovery of the investment property through use	Assuming the presumption of recovery through sale is not rebutted, deferred tax is measured based on the tax consequences of sale	

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	HKAS 12 (before amendment)	Amendments to HKAS 12	
		Cost model	Fair value model
	$'K	$'K	$'K
Purchase consideration	500	500	500
Fair value of investment property	(250)	(250)	(250)
Fair value of other identifiable net assets	(100)	(100)	(100)
Deferred tax liability on the investment property	34.5	34.5	13.5
Goodwill	184.5	184.5	163.5

The choice of the accounting polices for subsequent measurement of investment properties acquired in a business combination might affect the goodwill

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Effective date

- An entity shall apply these amendments for annual periods beginning on or after 1 January 2012
- The amendments do not contain any transitional provisions, which means that they need to be applied retrospectively in accordance with HKAS 8, except if retrospective application is impracticable

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Disclosures

HKAS 8

Disclose the impact of retrospective application, including:

- Nature and description
- Impact in current and prior periods presented for each line item affected
- Impact on earnings per share (basic and diluted) (HKAS 8.28)

Disclose judgments made by management that have had the most significant effect on the financial statements (HKAS 1.122)

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Disclosure (cont.)

Present a statement of financial position as at the beginning of the earliest comparative period for a change in accounting policy adopted retrospectively or retrospective restatements / reclassifications (HKAS 1.10(f))

e.g., if the amendments are adopted early for a December year end entity. Present a statement of financial position as at

<u>31 December 2012</u> <u>31 December 2011</u> <u>1 January 2010</u>

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Disclosure (cont.)

(for a listed entity) Adjust the 5 year financial summary included in the annual report presented under para 19 of Appendix 16 / GEM 18.33.

When an entity has not applied the amendments (because they have been issued but are not yet effective), disclose:

- This fact
- Known or reasonably estimable information relevant to assessing the possible impact in the period of initial application (HKAS 8.30)

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Disclosure (cont.)

- When it is impracticable to adjust comparative information, disclosure such circumstances and a description of how and from when the change in accounting policy has applied (HKAS 8.28(h))

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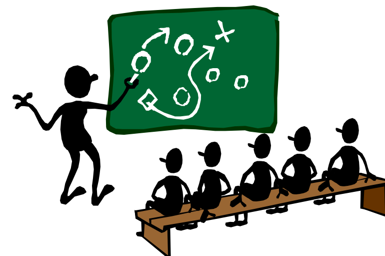
A Refresher Course on Current Financial Reporting Standards 2013 (Day 5)

HKFRS 8 *Operating Segments*



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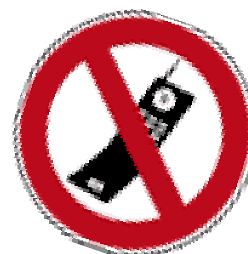

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HKFRS 8

Operating Segments

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Agenda

- Scope of HKFRS 8
- Identifying operating and reportable segments
- Measurement of segment items and reconciliations
- Entity-wide disclosures

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Background

- Replacement of HKAS 14 by HKFRS 8 *Operating Segments*
- HKFRS 8 have been effective since annual periods beginning on or after 1 January 2009

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Core principle

- The core principle of HKFRS 8 is as follows:

  "An entity shall **disclose information** to enable users of its financial statements to evaluate the **nature** and **financial effects** of the **business activities** in which it engages and the **economic environments** in which it operates"
  [HKFRS 8.1]

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Scope

- HKFRS 8 applies to the separate or individual financial statements of an entity and to the consolidated financial statements of a group with a parent: [HKFRS 8.2]
  - Whose debt or equity instruments are traded in a **public market**; or
  - That **files, or is in the process of filing** its (consolidated) financial statements with securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market

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Scope (cont'd)

- HKFRS 8 clarifies that it does ***not*** include the consolidated financial statements of a group that includes a listed non-controlling interest or a subsidiary with listed debt, but whose parent has no listed financial instruments [HKFRS 8.BC23]

- For the purpose above, a 'public market' is any domestic or foreign stock exchange, or an over-the-counter market, including local and regional markets [HKFRS 8.2]

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Scope (cont'd)

- Where a single financial report includes both consolidated financial statements and the separate financial statements falling within the scope of HKFRS 8, **segment information need be presented on a consolidated basis only** [HKFRS 8.4]

- If an entity that is not required to comply with HKFRS 8 (e.g. a private entity) chooses to disclose information about segments that does not comply with the requirements of that Standard, **the entity is not permitted to describe the information as 'segment information'** [HKFRS 8.3]

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Identifying operating and reportable segments

Step 1	1. Identification of operating segments with a management approach 2. Aggregation of operating segments if they are similar
Step 2	1. Determination of reportable segment 2. Reportable separately if exceeds the 10% quantitative threshold 3. Grouped remaining segments as 'all other segments' if they are similar

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Identification of operating segments

- Operating segments are identified based on the way in which financial information is organised and reported to the Chief Operating Decision Maker ('CODM')

- Who is the CODM?
  - **"Chief operating decision maker" (CODM):** refers to a function, rather than a specific title
  - Function of CODM: **allocate resources** to the operating segments and to **assess the performance** of the operating segments of an entity
  - Often the CODM of an entity is its **chief executive officer** or **chief operating officer** but, it may be a group of executive directors or others
  - An entity **cannot have more than one CODM**

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Identification of operating segments

- An operating segment is identified as a component of an entity: [HKFRS 8.5]
  - that engages in business activities from which it **may earn revenues and incur expenses** (including revenues and expenses relating to transactions with other components of the same entity),
  - whose **operating results** are **regularly reviewed** by the entity's **CODM** to make decisions about **resources to be allocated** to the segment and **assess its performance**, and
  - for which **discrete financial information** is available

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Identification of operating segments (cont'd)

- Operating segments can include, but are not limited to, **start-up operations, vertically integrated operations, and jointly controlled entities and associate**

- For the purpose of HKFRS 8, an entity's pension and other post-employment benefit plans are not considered operating segments [HKFRS 8.6]

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Example: Identifying operating segments

- Entity A has an operating unit that provides content to web sites
- Entity A derives revenue from three service lines – advertising, promotion and customer service
- The financial information reported to the CODM includes revenue by service line, but operating expenses and assets are reported on a combined basis for the entire operating unit. The financial information provided to the CODM does not include profit or loss information for the individual service lines

Analysis:

- The individual service lines are not separate operating segments
- Discrete financial information regarding each service line's profit and loss is not available and is not supplied to the CODM

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Example: Identifying operating segments

- Entity L produces various lawn and garden products e.g. swing seats and lawn movers, which comprises its operating segments
- During 2011, entity L began construction of a new plant for the purpose of producing barbecue grills
- Production is expected to begin in the first quarter of 2012 and management expects the barbecue operation to be the entity's second largest business component, in terms of revenue, within two years
- Discrete financial information about the operation is provided to and used by the CODM

Analysis:

- The barbecue grill operation may earn revenue
- HKFRS 8.5(a) criterion is met
- The barbecue grill operation, even though in a start-up stage, is an operating segment (discrete financial information is provided to and used by the CODM)

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Aggregation of operating segments

- **Two or more operating segments may be aggregated** into a single operating segments if aggregation is

  (i) is consistent with the core principle of HKFRS 8,
  (ii) the segments have **similar economic characteristics**, and
  (iii) the segments are **similar** in each of the following respects:
  - the nature of the products and services;
  - the nature of the production processes;
  - the type or class of customer for their products and services;
  - the methods used to distribute their products or provide their services; and
  - if applicable, the nature of the regulatory environment, e.g., banking, insurance or public utilities

  [HKFRS 8.12]

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Aggregation of operating segments (cont'd)

- The aggregation of operating segments is **performed before determining which segments are reportable**; therefore, operating segments may be aggregated even though individually they may exceed the quantitative thresholds for determining which ones are reportable
  [HKFRS 8.IG7]

The aggregation criteria are applied as tests and not as indicators. The ability to meet the criteria will depend on the individual facts and circumstances. A significant amount of judgment will be required when applying the aggregation test

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Example: Aggregating operating segments

- Parent A is a listed company in Hong Kong
- Parent A is engaged in various property projects
- The CODM is the Board of Directors of Parent A
- The CODM receives information regarding:
  - Residential building in Wan Chai
  - Residential building in Mid-level
  - Shopping mall in Admiralty
  - Commercial building in Central
  - Commercial building in TST

Analysis:

- Residential building in Wan Chai and Mid-level (aggregated in one operating segment)
- Shopping mall in Admiralty (one operating segment)
- Commercial building in Central and TST (aggregated in one operating segment)
- Three operating segments (after aggregation)

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Determination of reportable segments

- An entity shall report separately information about **each operating segment** that:
  - has been **identified in accordance with HKFRS 8.5 to HKFRS 8.10** as an operating segment **or results from aggregating two or more of those segments in accordance with HKFRS 8.12**, **and**
  - **exceeds the quantitative thresholds** in HKFRS 8.13

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Reportable Segments

❑ Quantitative Thresholds

An entity shall report separately information about an operating segment that meets **any** of the following quantitative thresholds: [HKFRS 8.13]

- The segment's **reported revenue**, including both sales to external customers and intersegment sales or transfers, is **10% or more of the combined revenue, internal and external, of all operating segments**
- The **absolute amount** of the segment's **reported profit or loss** is **10% or more of the greater,** in **absolute amount**, of **(i)** the combined reported profit of all operating segments that did not report a loss and **(ii)** the combined reported loss of all operating segments that reported a loss
- The segment's **assets** are **10% or more** of the **combined assets of all operating segments**

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Reportable Segments (cont'd)

Quantitative Thresholds (cont'd)

❑ The term "combined" in each of the three tests means the **total amounts for all operating segments before the elimination of intra-group transactions and balances** (i.e., not the entity's financial statement amounts). It does not include reconciling items and activities that do not meet the definition of an operating segment under HKFRS 8

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Reportable Segments (cont'd)

Example: Quantitative threshold

BX Co has four business segments. Allocation of resources are based on the segments' performance reviewed by the CODM. Details of the respective information of the companies are as follows. Which segments are reportable?

	A	B	C	D
	$	$	$	$
External Sales	50,000	85,000	24,000	12,200
Internal Transfers	110,000	84,000	12,000	3,800
Total revenues	**160,000**	**169,000**	**36,000**	**16,000**
Operating profit/(loss)	(17,400)	32,000	3,000	(3,600)
Fixed Asset	222,000	110,500	28,000	20,000

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Reportable Segments (cont'd)

Example: Quantitative threshold (cont'd)

Revenue test			
	Segment revenue	10% or more of total operating segments' revenue	Reportable segments
A	160,000	38,100	Yes
B	169,000	38,100	Yes
C	36,000	38,100	No
D	16,000	38,100	No
Total	**381,000**		

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Reportable Segments (cont'd)

Example: Quantitative threshold (cont'd)

Profit or loss test

	Segment profit (loss)	Higher of 10% of X or Y	Reportable segments
A	(17,400)	3,500	Yes
B	32,000	3,500	Yes
C	3,000	3,500	No
D	(3,600)	3,500	Yes
Combined reported profit (X)	**35,000**		
Combined reported loss (Y)	**21,000**		

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Reportable Segments (cont'd)

Example: Quantitative threshold (cont'd)

Asset test

	Fixed assets	10% of combined assets	Reportable segments
A	222,000	38,050	Yes
B	110,500	38,050	Yes
C	28,000	38,050	No
D	20,000	38,050	No
Combined total	**380,500**		

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Reportable Segments (cont'd)

Example: Quantitative Thresholds (cont'd)

- Based on the results of the revenue, profit or loss and asset tests, segments A, B and D are reportable segments

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Reportable Segments (cont'd)

Quantitative Thresholds (cont'd)

- If the **total of external revenue** reported by operating segments constitutes **less than 75% of total revenue** reported in the entity's financial statements, then **additional operating segments are identified as reportable segments** (even if they do no meet the quantitative threshold criteria) **until at 75% of the total revenue reported in the financial statements is included in reportable segments** [HKFRS 8.15]

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Reportable Segments (cont'd)

Remaining operating segments (cont'd)

- **Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed**, if management believes that information about the segment would be useful to users of the financial statements or more reportable segments need to be identified to meet the 75% test

  [HKFRS 8.13]

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Reportable Segments (cont'd)

Remaining operating segments

- An entity may **combine information** about operating segments that do not meet the quantitative thresholds with information about other operating segments that **do not meet the quantitative thresholds to produce a reportable segment only if** the operating segments have **similar economic characteristics** and **share a majority of the aggregation criteria listed in HKFRS 8.12** [HKFRS 8.14]

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Reportable Segments (cont'd)

Example: Identification of additional segments to reach 75% revenue threshold

- Entity J has determined its reportable segments in accordance with HKFRS 8 and has noted that the reportable segments constitute 68% of consolidated revenue. All remained operating segments are of similar size. How should Entity J determine which operating segments to report separately?

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Reportable Segments (cont'd)

Example: Identification of additional segments to reach 75% revenue threshold (cont'd)

- HKFRS 8 does not specify which of the remaining operating segments should be selected to achieve the 75% threshold, and the operating segment chosen does not necessarily need to be the next largest by any of the measures
- **Judgment should be used**, and each situation will be **based on the individual facts and circumstances.** Those additional operating segments included in order to achieve the 75% threshold are treated no differently from any other reportable segment (i.e. the required disclosures are the same)

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Reportable Segments (Cont'd)

Remaining operating segments (cont'd)

- Information about **other business activities and operating segments** that are **not reportable shall be combined and disclosed in an "all other segments"** category separately from other reconciling items in the reconciliations required by HKFRS 8.28. The sources of the revenue included in the "all other segments" category shall be described
  [HKFRS 8.16]

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Measurement

- The amount of each segment item reported should be the measure reported to the CODM for the purposes of making decisions about allocating resources to the segments and assessing their performance (i.e., may not be the same as the measure for financial reporting purposes)
- Reconciliations of differences should be disclosed

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Example: Measurement

- Entity A operates a chain of grocery stores using the weighted average cost method of assigning costs to inventory and cost of goods sold for financial reporting purposes
- However , entity A reports provided to the CODM use last-in, first-out (LIFO) for evaluating the performance of segment operations
- Can entity A uses the weighted average cost method for HKFRS 8 segment reporting?

Analysis:

- The entity should use LIFO for its HKFRS 8 disclosures, even though it uses the weighted average cost formula for measuring inventory for inclusion in its HKFRS financial statements
- HKFRS 8 does not require segment information to be presented in the same manner as that used in the HKFRS financial statements. The method used in preparing the financial information for the CODM determines which measure is used for the HKFRS 8 operating segment note

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Measurement (cont'd)

Restatement of previously reported information

[HKFRS 8.29]

- If an entity **changes the structure of its internal organisation** in a manner that causes the **composition of its reportable segments to change**, the corresponding information for earlier periods, including interim periods, shall be restated unless the information is not available and the cost to develop it would be excessive
- Following a change in the composition of its reportable segments, an entity **shall disclose whether it has restated** the corresponding items of segment information for earlier periods

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Measurement (cont'd)

Restatement of previously reported information (cont'd)
[HKFRS 8.30]

- If segment information for earlier periods, including interim periods, is **not restated** to reflect the change, the entity shall disclose in the year in which the change occurs segment information for the current period on **both the old basis and the new basis of segmentation**, unless the necessary information is not available and the cost to develop it would be excessive

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Disclosures – General information

- An entity shall disclose the following for each period for which a statement of comprehensive income is presented:

  1. **General information on the reportable segments**
     - factors used to identify the entity's reportable segments, and
     - types of products and services from which each reportable segment derives its revenues

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Disclosures – Segment profit or loss

- An entity shall disclose the following for each period for which a statement of comprehensive income is presented:

  1. ……(slide 38)
  2. **Information about reported segment profit or loss**
     - including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement

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Disclosures – Segment profit or loss

An entity shall also disclose the following about each reportable segment <u>if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker, or are otherwise regularly provided to the chief operating decision maker;</u> even if not included in that measure of segment profit or loss:

- revenues from external customers;
- revenues from transactions with other operating segments of the same entity;
- interest revenue *(please see next slide);*
- interest expense *(please see next slide)*;
- depreciation and amortisation;
- material items of income and expense disclosed in accordance with HKAS 1 *Presentation of Financial Statements*;
- equity accounted earnings;
- income tax; and
- material non-cash items other than depreciation and amortisation

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Disclosures - Interest revenue and interest expense

- An entity shall **report interest revenue separately from interest expense for each reportable segment** **unless** a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment

- In that situation, an entity **may report that segment's interest revenue net of its interest expense** and disclose that it has done so

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Disclosures – Segment assets

- **HKFRS 8 requires that a measure of total assets be disclosed for each reportable segment only if such information is regularly provided to the CODM**

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Disclosures - Segment assets (cont'd)

- The following information should be disclosed by each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the CODM, or are otherwise provided regularly to the CODM even if not included in the determination of segment assets:
  - **Equity accounted investees; and**
  - **Additions to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets; and rights arising under insurance contracts**

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Disclosures – Jointly controlled entities and associates

- When the investee is identified as a reportable segment and the CODM receives financial statements of the investee, **disclose the investee' s revenue, a measure of profit or loss, assets and other amounts required by HKFRS 8, as reported in the investee's financial statements**
- **Difference** between the amounts reported in the segment disclosure to the proportionate amounts reported in the entity's financial statements will be included in the **reconciliation items**

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Disclosures – Reconciliations

- An entity shall disclose the following for each period for which a statement of comprehensive income is presented:

  1. ….. (slide 38)
  2. ….. (slide 39)
  3. **Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts**

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Disclosures – Reconciliations

- **An entity shall provide all of the following reconciliations to be disclosed of all of the following:**

The total of the reportable segments' revenues	**The entity's revenue**
The total of the reportable segments' profit or loss	**The entity's profit or loss before tax**
The total of the reportable segments' assets	**The entity's assets***
The total of the reportable segments' liabilities	**The entity's liabilities***
The total of the reportable segments' amount for every other material item of information disclosed	**The corresponding amount for the entity**

*** Required if such amounts are regularly provided to the CODM**

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Examples - Reconciliations

	Property development	Associate – provision of management service	Total
Revenue from external customers	xxx	xxx	xxx
Reportable segment profit	xxx	xxx	xxx
Other material non-cash items:			
- Depreciation and amortisation	xxx	xxx	xxx
- Impairment of assets	xxx	xxx	xxx

Revenues	
Total revenue for reportable segment	xxx
Less: share of revenues of the associate	xxx
Other reconciling items	xxx
Entity 's revenues shown in the HKFRS financial statements	xxx

	Reportable segments total	Adjust-ments	Entity's total
Other material items	xxx	xxx	xxx
Depreciation and amortisation	xxx	xxx	xxx
Impairment of assets	xxx	xxx	xxx
Others (pls. describe)	xxx	xxx	xxx

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Entity-wide disclosure

- **HKFRS 8 require the following entity-wide disclosures, regardless of whether the information is used by the CODM in assessing segment performance**

  - Revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact shall be disclosed

  - Revenues from external customers attributed to:
    - the entity's country of domicile; and
    - all foreign countries in total

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Entity-wide disclosure (cont'd)

- Report geographical information on non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts located in the entity's country of domicile and in all foreign countries in total
- If revenues/assets for an individual foreign country are material, those revenues/assets shall be disclosed separately
- The amounts of revenues reported shall be **based on the financial information used to produce the entity's financial statements**

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Entity-wide disclosure (cont'd)

- An entity shall provide information about the extent of its reliance on its major customers
- If revenues from transactions with **a single external customer** amount to **10% or more** of an entity's revenues, the entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues
- The entity **need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer**

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Entity-wide disclosure (cont'd)

Information about major customers (cont'd)
[HKFRS 8.34]

- For the purposes of HKFRS 8, a group of entities known to a **reporting entity to be under common control** shall be considered a single customer, and **a government** (national, state, provincial, territorial, local or foreign) and **entities known to the reporting entity to be under the control of that government** shall be considered a single customer

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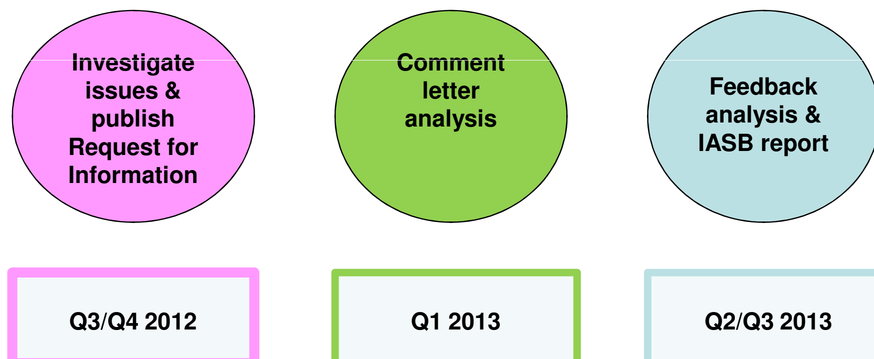
Post-implementation review of IFRS 8

- Project milestones



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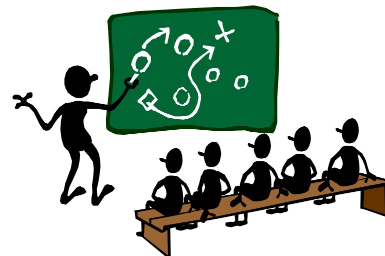
A Refresher Course on Current Financial Reporting Standards 2013 (Day 5)

Presentation of financial statements



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Presentation of financial statements

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AGENDA

- Introduction
- General Requirements
- Statement of Financial Position
- Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Cash Flow (HKAS 7)
- Notes to Financial Statements
- Accounting Policies, Estimates and Errors (HKAS 8)
- Event After the Reporting Period (HKAS 10)

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INTRODUCTION

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Questions:

1.Which standard should we refer to for the general requirements of presentation of financial statements?

2.How many statements are there in a complete set of financial statements prepared under HKFRS/IFRS? What are their names?

3.What are the general requirements / factors that we should consider when preparing a complete set of financial statements?

4.How frequent should we prepare the financial statements? Are there any limitations on the period to be covered?

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BASIC CONCEPTS

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Basic Requirements

- Scope: The scope of the Standard is all general purpose financial statements prepared and presented in accordance with HKFRSs

- General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs

- Considerations for financial statements presentation :
  - **Consistency**
  - **Comparable**
  - **Going concern**
  - **Materiality**
  - **Offsetting**

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Basic Requirements

- The Standard applies equally to all entities that present consolidated financial statements and separate financial statements, but does NOT apply to condensed interim financial statements prepared in accordance with HKAS 34 *Interim Financial Reporting*

- Except for cash flow information, HKAS 1 requires financial statements to be prepared using the **accruals basis** of accounting

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Components of a Complete Set of Financial Statements

- A complete set of financial statements should include:
  - A statement of financial position at the end of each period
  - A statement of comprehensive income for a period
  - A statement of changes in equity for the period
  - A statement of cash flows for the period
  - Notes, comprising a summary of significant accounting policies and other explanatory information
- Reports and statements presented outside the financial statements are outside the scope of HKFRSs

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Consistency of Presentation

- The presentation and classification of items in the financial statements should be retained from one period to the next unless:
  - Significant change in the nature of the entity's operations (e.g. major acquisition or disposal) or review of presentation and find another presentation or classification more appropriate (i.e., reliable and more relevant), *OR*
  - A HKFRS requires a change in presentation
- If change, restate comparatives and disclose nature, amount and reason

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Comparative Information

- Except when HKFRSs permit, comparative information should be given for the previous period, for all amounts reported in the financial statements.
- As a minimum, two statements of financial position and two of each of the other statements and related notes are required.
- When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items or when it reclassifies items; and the impact is material to the information in the SOFP, it is required to present, as a minimum:
  - three statements of financial position for
    - the end of the current period (e.g. 31 Dec 2012)
    - the end of the previous period which is the same as the beginning of the current period (i.e. 31 Dec 2011)
    - the beginning of the earliest comparative period (1Jan 2011)
  - two of each of the other statements and related notes

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Comparative Information

- When the presentation and classification of items in the financial statements is amended, comparative amounts are reclassified unless this is impracticable. When comparative amounts are reclassified, disclosure is required of:
  - ✓ nature of the reclassification
  - ✓ the amount of each item or class of items that is reclassified; and
  - ✓ the reason for the reclassification
- When it is impracticable to reclassify comparative amounts, disclosure is required of:
  - ✓ the reason for not reclassifying the amounts; and
  - ✓ the nature of the adjustments that would have been made if the amounts had been reclassified

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Identification of financial statements

❖ Clearly identify each of the financial statements and notes and distinguish them from other information in the same document

❖ Display prominently (and repeat when necessary):
- name of the reporting entity; and any change from the end of the preceding reporting period
- individual or group financial statements
- presentation currency and level of rounding
- reporting date or the period covered

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Materiality and Aggregation

❖ Present separately:
- each material class of similar items
- items of a dissimilar nature or function unless they are immaterial

❖ Material if could, individually or collectively, influence economic decisions of users
- depends on size and nature of the omission or misstatement
- judged in the surrounding circumstances

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Materiality Decisions

Questions:

Is the error material?

- Before its 20X0 FS approved for issue, the entity discovered depreciation expense for 20X0 was overstated by $150. Ignored the error, reported profit for 20X0 is $600,000.
- Same as above, except had the error been corrected, the entity would have breached a borrowing covenant on a significant long-term liability.

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Offsetting

- Assets and liabilities, and income and expenses, are not offset unless required or permitted by a HKFRS
- Measuring assets net of valuation allowances (e.g. inventories or debtors) is not regarded as offsetting for the purposes of applying HKAS 1

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Source: Deloitte iGAAP 2012

Example – Withholding tax

Background: Co A pays a dividend to Co B. Co B receives a net amount as Co A is required to deduct withholding tax on dividends that it pays to the tax authorities on Co B's behalf.

Question: Should Co B present the dividends received net of tax or gross?

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Going Concern

- HKAS 1 requires management to make an assessment of the entity's ability to continue as a going concern when preparing financial statements
- Under the *Framework*, financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future
  - Foreseeable future means at least twelve months from the end of the reporting period but not limited to that period
- Financial statements should be prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading

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Going Concern Disclosure

- Disclose material uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern
- If financial statements are not prepared on a going concern basis, disclose:
  - that fact
  - the basis on which the financial statements are prepared
  - the reason why the entity is not regarded as a going concern

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Going Concern

- If an entity will cease or has ceased trading, consider
  - whether statutory financial statements will be required. This will depend on the legal and regulatory requirements in the jurisdiction concerned.
  - The need to write down assets for impairment
  - The need to provide for contractual commitments which may have become onerous
  - Any needs to reclassify any non-current assets/liabilities to current assets / liabilities

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Frequency of reporting

- HKAS 1 states that a complete set of financial statements, including comparative information, should be presented at least "annually"
- The financial statements may cover a period longer or shorter than twelve months, but requires the following disclosures:
  - the period covered by the financial statements
  - the reason for using a longer or shorter period; and
  - the fact that the amounts presented in the financial statements are not entirely comparable

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Compliance with HKFRSs

- Financial statements must not be described as complying with HKFRSs unless they comply with all of the requirements of HKFRSs
- An entity whose financial statements comply with HKFRSs must make an explicit and unreserved statement of such compliance in the notes
- For example:

3.1 Statement of compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards.

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Compliance with HKFRSs

For compliance with HKFRSs, the financial statements must:

- ❖ Comply with HKAS and HKFRS
- ❖ Comply with HK(IFRIC) and HK(SIC)
- ❖ In the absence of specific guidance in HKFRSs (in descending order)
  - Apply the requirements in HKFRSs dealing with similar and related issues
  - Apply the IASB *Framework;* or
  - Apply pronouncements of national standard setters to the extent that these are consistent with other HKFRSs, other HK(IFRICs) and the IASB *Framework*

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True and Fair Presentation

- ❖ Financial statements should present a true and fair view of the financial position, financial performance and cash flows of an entity

- ❖ True and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses

- ❖ The application of the HKFRS is presumed to result in presentation of the financial position, financial performance and cash flows of an entity that achieve a true and fair view

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Statutory requirements

❖ Please also note the Hong Kong Companies Ordinance requires the following:

✓ the preparation of a profit and loss account and balance sheet; and the accounts must give a true and fair view of the profit or loss and of the state of affairs of the company, and comply with the requirements of the Schedule

✓ Where a company has a subsidiary at the end of the financial year, the group accounts should be prepared unless the company is, at the end of the financial year, a wholly-owned subsidiary of another body corporate.

✓ A directors' report to be attached to every balance sheet laid before a company in general meeting.

✓ a company's accounts, together with the director's report and auditor's reports should be laid before the company at its AGM and the accounts shall be made up to a date falling not more than 6 months or in the case of a private company and a company limited by guarantee not more than 9 months, before the date of the meeting.

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Statement of Financial Position

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Questions:

1.As a minimum, what items should be presented on the statement of financial position?

2.What factors should we consider when classifying an item as a current or non-current asset? Or a current or non-current liability?

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Information to be presented in the SOFP

- The statement of financial position should include, at a minimum, line items that present the following amounts:
  - Property, plant and equipment
  - Investment property
  - Intangible assets
  - Financial assets (other than investments accounted for using the equity method, trade and other receivables and cash and cash equivalents, which are presented separately)
  - Investments accounted for using the equity method
  - Biological assets
  - Inventories
  - Trade and other receivables
  - Cash and cash equivalents

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Information to be presented in the SOFP (Cont'd)

- The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with HKFRS 5
- Trade and other payables
- Provisions
- Financial liabilities (other than trade and other payables, and provisions, which are presented separately)
- Liabilities and assets for current tax
- Deferred tax liabilities and deferred tax assets
- Liabilities included in disposal groups classified as held for sale
- Non-controlling interests, presented within equity; and
- Issued capital and reserves attributable to owners of the parent.

Additional line items, headings and subtotals are presented in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position

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Current/non-current distinction

- Make current/non-current distinction unless liquidity presentation is reliable and more relevant
- In liquidity presentation, present assets & liabilities in order of liquidity
- Refer to Appendix 1 for an example of SOFP presented in order of liquidity
- Whichever method of presentation is adopted, for each asset or liability line item that combines amounts expected to be recovered or settled:
  - ✓ No more than 12 months after the reporting period; and
  - ✓ More than 12 months after the reporting period,

  The amount expected to be recovered or settled after more than 12 months should be disclosed. [HKAS 1.61]

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Current Assets

- Current assets if:
  - Expect to realise, sell or consume in entity's operating cycle
  - Held for trading
  - Expects to realise in next twelve month of reporting period
  - Cash or cash equivalent unless restricted from exchange or use for at least twelve months
- All other assets are classified as non-current

Current assets include assets, e.g. inventories and trade receivables that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets primarily held for the purpose of trading e.g. financial assets classified as held for trading in accordance with HKAS 39 and the current portion of non-current financial assets

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Current Liabilities

- Current liability if:
  - Expect to settle in entity's normal operating cycle
  - Held for trading
  - Due to be settled within twelve month after the reporting period
  - Entity does not have an unconditional right to defer settlement for at least twelve months after the reporting period
- All other liabilities are classified as non-current

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Source: Deloitte iGAAP 2012

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Current Liabilities – example

Background: A primary school requires a deposit to be paid upon enrolment into the school. Should the student leave the school, this deposit is refundable with one school-term's notice (four months). The majority of students enrol into just one primary school and, having completed the six year study period, receive the deposit back at the end of that six year period.

Question: Should the deposit be classified as current/non-current?

Answer: Despite the historical evidence that indicates that the majority of the deposits are only repaid after the six-year period, the deposit are payable on four months notice. HKAS 1 states that a liability should be classified as current when the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Therefore, the deposits should be classified as current liabilities.

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Example – Breaches of covenants

- At December 31, 2010 Co A was in breach of a covenant in a loan that is otherwise repayable 3 years later. The breach entitles (but not obliged) the bank to require immediate repayment

  At December 31, 2010 the loan is a current liability – at December 31, 2010 Company A does not have an unconditional right to defer settlement for at least twelve months

- Same as above, except after the end of the reporting period (December 31, 2010) but before the financial statements were approved for issue, the bank formally agreed not to demand early repayment of the loan

  At December 31, 2010 the loan is a current liability – at December 31, 2010 Co A does not have an unconditional right to defer settlement for at least twelve months

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Breaches of covenants

- When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach.

An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.

- However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

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Recap: Classifications of Financial Liabilities

- Financial liabilities are classified as current when they are due to be settled within twelve months after the reporting period even if:
  - The original term was for a period longer than twelve months; and
  - An agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.

- If an entity expects and has the discretion to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current. But when refinancing or rolling over the obligation is not at the discretion of the entity, the potential to refinance is not considered.

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Recap: Classifications of Financial Liabilities

- For loans classified as current liabilities, HKAS 1 states that if the following events occur between the end of the reporting period and the date the financial statements are authorised for issue, those events are disclosed as **non-adjusting events**.
  - ✓ refinancing on a long-term basis
  - ✓ Rectification of a breach of a long-term loan arrangement; and
  - ✓ The granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least 12 months after the reporting period.

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HK Int 5 Presentation of Financial Statements – classification by the borrower of a term loan that contains a repayment on demand clause

- Term loans – loans which are repayable on a specific date or in instalments over a period of time, usually in excess of one year.
- Loan facility agreements for such loans will set out the basic terms and may also include specific clauses which define default events which would give the lender the right to accelerate the repayment terms if those events occur.
- Some even include an overriding repayment on demand clause, which gives the lender the right to demand repayment at any time at their sole discretion and irrespective of whether a default event has occurred.

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HK Int 5 Presentation of Financial Statements – classification by the borrower of a term loan that contains a repayment on demand clause

- The classification of a term loan is
  - ✓ determined by reference to the **rights and obligations** of the lender and the borrower, as **contractually agreed** between the two parties and in force as of the reporting date.
  - ✓ subject to loan agreements which include a clause which gives the lender the **unconditional right to call the loan** at any time. Under such case, the term loan is classified as **current** in its statements of financial position.
  - ✓ Not determined by the probability of the lender choosing to exercise its rights within the next 12 months after the reporting date.

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Example of "Repayment on demand" clause

"By signing this letter, you [the Obligor] expressly acknowledge that we [the Lender] may suspend, withdraw or make demand for repayment of the whole or any part of the Facilities at any time notwithstanding the fact that the following covenants/undertakings are included in this letter and whether or not the Guarantor is in breach of any such covenants/undertakings."

"As a general banking practice and notwithstanding any terms and conditions specified above, the Lender reserves its overriding right to cancel or to modify the Facility, or to demand immediate repayment of all outstanding balances whether due or owing, actual or contingent under the Facility without prior notice."

"Notwithstanding anything contained in this letter, the Facilities are subject to the Bank's overriding right of repayment on demand, to review, amend, and/or cancel any or all of the Facilities at its sole discretion."

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Comfort letters

- A letter indicating by the lender that loan will not be called within the next 12 months
- Reminders:
  - Letter has to be legally enforceable
  - Wording needs to be clear that the bank provides an undertaking that it will not exercise the "repayment on demand clause" in the period covered by the letter, or it will only have the right to exercise the clause if some specified trigger default event occurs during that future period.
  - No sufficient if the letter only refers to the lender's current intentions or expectations about the future

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Other matters to consider

Breach of covenants on bank loans and other facilities

Disclosure of price sensitive information

Effect of reproduction of issued financial statements

Net current liabilities - going concern uncertainties ??

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Presentation and disclosures

- Refer to Appendix 2 for the illustrative disclosures released by the Institute.

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Share Capital and Reserves

- HKAS 1 requires several disclosures as follows:
  - The number of shares authorised
  - The number of shares issued and fully paid
  - The number of shares issued but not fully paid
  - The par value per share, or the fact that the shares have no par value
  - A reconciliation of the number of shares outstanding at the beginning and at the end of the period
  - The rights, preferences and restrictions attaching to that class including restriction on dividends and the repayment of capital
  - Shares in the entity held by its subsidiaries or associates
  - Shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts
  - A description of the nature and purpose of each reserve within equity has to be given, either in the statement of financial position or in the notes.

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Statement of Comprehensive Income

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Questions:

1.As a minimum, what items should be presented on the statement of comprehensive income?

2.What are some of the examples of other comprehensive income?

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Presentation alternatives

- ❖ Accounting policy choice – one performance statement or two
- ❖ Single statement of comprehensive income
  - ▪includes all income and expenses
  - ▪separate line items include
    - profit or loss
    - total other comprehensive income
    - comprehensive income for the period, being the total of profit or loss and other comprehensive income

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Two statements

- ❖ Two statements
  - ▪statement of profit or loss
  - ▪statement of comprehensive income
- ❖ Income statement
  - ▪ ends with profit or loss
- ❖ Statement of comprehensive income
  - ▪ starts with profit or loss
  - ▪ present each item of other comprehensive income separately
  - ▪ ends with total comprehensive income

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Disclose allocations

- ❖ Profit or loss and comprehensive income are before allocating those amounts to non-controlling interests and owners of the parent

- ❖ Disclose the allocations of those amounts to
- ▪ non-controlling interests
- ▪ owners of the parent

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Minimum Requirements

- ❖ As a minimum, profit or loss section or the statement of profit or loss includes line items that present the following amounts for the period:
  - ▪ revenue
  - ▪ finance costs
  - ▪ share of profit or loss of associates and joint ventures
  - ▪ tax expense
  - ▪ a single amount for the total of discontinued operations

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Other Comprehensive Income

- Other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other HKFRSs

- The components of other comprehensive income include:
  - Changes in revaluation surplus (HKAS 16 and HKAS 38)
  - Actuarial gains and losses on defined benefit plans recognised in accordance with paragraph 93A of HKAS 19
  - Gains and losses arising from translating the financial statements of a foreign operation or from functional to presentation currency (HKAS 21)
  - Gains and losses on remeasuring available-for-sale financial assets (HKAS 39)
  - The effective portion of gains and losses on hedging instruments in a cash flow hedge (HKAS 39)

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Example : One statement of comprehensive income (components presented in gross)

XYZ Group – Statement of Comprehensive Income for the year ended 12.31.20Y0

	20Y0	20X9
Revenue	390,000	355,000
Expenses	(250,000)	(275,000)
Net profit before tax	140,000	80,000
Profits tax expense	(25,000)	(15,000)
Profit for the year from continuing operations	115,000	65,000
Loss for the year from discontinued operations	(30,500)	-
Profit for the year	84,500	65,000
Other comprehensive income:		
Exchange differences on translating of foreign operations	5,000	10,000
Available for sale financial assets	2,400	3,500
Cash flow hedges	1,200	2,200
Gain on property valuation	8,000	7,000
Actuarial gains(loss) on defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to components of other comprehensive income	(4,000)	(3,900)
Other comprehensive income for the year, net of tax	12,333	19,433
Total comprehensive income for year	96,833	84,433

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Example : One statement of comprehensive income (components presented in gross) – Cont'd

XYZ Group -Statement of Comprehensive Income for the year ended 12.31.20Y0		
	20Y0	20X9
Profit attributable to:		
Owners of the parent	76,271	58,890
Non-controlling interest	8,229	6,110
	84,500	65,000
Total comprehensive income attributable to :		
Owners of the parent	86,604	75,123
Non-controlling interest	10,229	9,310
	96,833	84,433

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Example: Two statements - a separate income statement - a statement of comprehensive income

XYZ Group – Income Statement for the year ended 12.31.20Y0		
	20Y0	20X9
Revenue	390,000	355,000
Expenses	(250,000)	(275,000)
Net profit before tax	140,000	80,000
Profits tax expense	(25,000)	(15,000)
Profit for the year from continuing operations	115,000	65,000
Loss for the year from discontinued operations	(30,500)	-
Profit for the year	84,500	65,000
Profit attributable to:		
Owners of the parent	76,271	58,890
Non-controlling interest	8,229	6,110
	84,500	65,000

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Example: Two statements approach - a separate income statement - a statement of comprehensive income

XYZ Group – Statement of Comprehensive Income for the year ended 12.31.20Y0

	20Y0	20X9
Profit for the year	84,500	65,000
Other comprehensive income:		
Exchange differences on translating of foreign operations	5,000	10,000
Available for sale financial assets	2,400	3,500
Cash flow hedges	1,200	2,200
Gain on property valuation	8,000	7,000
Actuarial gains(loss) on defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to components of other comprehensive income	(4,000)	(3,900)
Other comprehensive income for the year, net of tax	12,333	19,433
Total comprehensive income for year	96,833	84,433
Total comprehensive income attributable to:		
Owners of the parent	86,604	75,123
Non-controlling interest	10,229	9,310
	96,833	84,433

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Other Comprehensive Income – Income Tax

- The components of other comprehensive income may be presented either:
  - Net of related tax effects; or
  - Before related tax effects with one amount shown for the aggregate amount of income tax relating to those components
- Where the income tax effects are aggregated into a single item in the statement, it is still necessary to disclose in the notes the amount of tax attributable to each item of other comprehensive income as required by HKAS 1.90

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Example: Other Comprehensive Income (components presented in net)

Other comprehensive income for the year after tax:	**20X7**	**20X7**
Exchange differences on translating foreign operations	4,000	8,000
Available-for-sale financial assets	(18,000)	20,000
Cash flow hedges	(500)	(3,000)
Gains on property revaluation	600	2,700
Actuarial gains (losses) on defined benefit pension plans	(500)	1,000
Share of other comprehensive income of associates	400	(700)
Other comprehensive income for the year, net of tax	(14,000)	28,000

Ref.: IAS 1(2007).IG 6

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Example – Disclosure of income tax relating to each component of other comprehensive income

Disclosure of tax effects relating to each component of other comprehensive income

Notes

Year ended 31 December 20X7

(in thousands of currency units)

	20X7			20X6		
	Before-tax amount	Tax (expense) benefit	Net-of-tax amount	Before-tax amount	Tax (expense) benefit	Net-of-tax amount
Exchange differences on translating foreign operations	5,334	(1,334)	4,000	10,667	(2,667)	8,000
Available-for-sale financial assets	(24,000)	6,000	(18,000)	26,667	(6,667)	20,000
Cash flow hedges	(667)	167	(500)	(4,000)	1,000	(3,000)
Gains on property revaluation	933	(333)	600	3,367	(667)	2,700
Actuarial gains (losses) on defined benefit pension plans	(667)	167	(500)	1,333	(333)	1,000
Share of other comprehensive income of associates	400	–	400	(700)	–	(700)
Other comprehensive income	(18,667)	4,667	(14,000)	37,334	(9,334)	28,000

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Reclassification Adjustments

- Reclassification adjustments are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income (OCI) in the current or previous period.
- Requires disclosure relating to components of OCI either in the statement of comprehensive income or in the notes.

Transfer of a "reserve" to "reserve", e.g. transfer of property, plant and equipment revaluation surplus to retained earnings on disposal is NOT a reclassification adjustment. Instead, such transfer should be presented in the Statement of Changes in Equity

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Reclassifications Adjustment – Examples

XYZ Group
Disclosure of components of other comprehensive income[h]
Notes
Year ended 31 December 20X7
(in thousands of currency units)

		20X7		20X6
Other comprehensive income:				
Exchange differences on translating foreign operations[i]		5,334		10,667
Available-for-sale financial assets:				
Gains arising during the year	1,333		30,667	
Less: Reclassification adjustments for gains included in profit or loss	(25,333)	(24,000)	(4,000)	26,667
Cash flow hedges:				
Gains (losses) arising during the year	(4,667)		(4,000)	
Less: Reclassification adjustments for gains (losses) included in profit or loss	3,333		–	
Less: Adjustments for amounts transferred to initial carrying amount of hedged items	667	(667)	–	(4,000)
Gains on property revaluation		933		3,367
Actuarial gains (losses) on defined benefit pension plans		(667)		1,333
Share of other comprehensive income of associates		400		(700)
Other comprehensive income		(18,667)		37,334
Income tax relating to components of other comprehensive income[j]		4,667		(9,334)
Other comprehensive income for the year		(14,000)		28,000

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Improvements to HKAS 1 (revised)

Improvements in 2011 – effective on or after 1 July 2012

Para	Main changes
Relevant para	From "Statement of comprehensive income" to " Statement of profit or loss and other comprehensive income" . From "income statement" to "statement of profit or loss".
10A	An entity may present a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section. An entity may present the profit or loss section in a separate statement of profit or loss. If so, the separate statement of profit or loss shall immediately precede the statement presenting comprehensive income, which shall begin with profit or loss.
82A	The other comprehensive income section shall present line items for amounts of other comprehensive income in the period, classified by nature (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method) and grouped into those that, in accordance with other HKFRSs: (a) will not be reclassified subsequently to profit or loss; and (b) will be reclassified subsequently to profit or loss when specific conditions are met. See Appendix 3 for illustrative disclosures.

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Statement of Changes in Equity

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General requirements

- ❖ Shows all changes to equity including
- ▪ total comprehensive income (and the allocation to owners of the parent and non-controlling interest)
- ▪ for each component of equity
- • the effects of retrospective application and retrospective restatement
- • a reconciliation between the carrying amount at the beginning and end of the period showing

1) profit or loss;
2) OCI;
3) transactions with owners in their capacity as owners; showing separately contributions by and distribution to owners and changes in ownership interests in subsidiaries that do not result in a loss of control

- • Present, either in the statement of changes in equity or in the notes, an analysis of other comprehensive income by item

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Transactions with owners

- ❖ Dividend - disclose and present the amount of dividends recognised as distributions to owners during the period, and the related amount per share, either in the statement of changes in equity or in the notes
- ❖ Capital contributions – cash contribution by parents or waiver of an inter-company debt by the parent or through the assumption of the subsidiary's liabilities by the parent that are classified as equity under HKAS 32
- ❖ Issuance of shares
- ❖ Purchase of treasury shares
- ❖ Value of employee services for employees share option scheme

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Statement of Cash Flows

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Scope

- The statement of cash flows provides information about the changes in cash and cash equivalent of an entity for a reporting period, showing separately changes from operating activities, investing activities and financing activities

- HKAS 7 sets out the information that is to be presented in a statement of cash flows and how to present it

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Notes to the Financial Statements

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Overview of Notes

- Notes are presented systematically and cross-reference to financial statements
- Notes present information about
  - Basis of preparation
  - Specific accounting policies used
  - Information about judgements and key sources of estimation uncertainty
- Notes disclose
  - the information required by the HKFRSs that is not presented elsewhere
  - other information that is relevant to an understanding of the financial statements

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Order of Presentation

- 1st: statement of compliance
- 2nd: summary of significant accounting policies applied
- 3rd: supporting information for items presented in FS, follow sequence in FS
- 4th: other disclosures including contingent liabilities and unrecognised contractual commitments; and non-financial disclosures, for example and entity's financial risk management objectives and policies

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Accounting Policies

- Disclose:
  - measurement bases used
  - other relevant accounting policies used
  - information about judgements made in applying accounting policies that have the most significant effect on the financial statements
  - information about key sources of estimation uncertainty that have a significant risk of causing a material adjustment within 1 year (including their nature and carrying amount)

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Source: PwC illustrative HKFRS corporate consolidated financial statements 2011

Judgement In Applying Accounting Policies

- Example:

4.2 Critical judgements in applying the entity's accounting policies

(a) Revenue recognition

The group has recognised revenue amounting to HK$950,000 for sales of goods to L&Co in the UK during 2011. The buyer has the right to return the goods if their customers are dissatisfied. The group believes that, based on past experience with similar sales, the dissatisfaction rate will not exceed 3%. The group has, therefore, recognised revenue on this transaction with a corresponding provision against revenue for estimated returns. If the estimate changes by x%, revenue will be reduced/increased by HK$10,000.

(b) Impairment of available-for-sale equity investments

The group follows the guidance of IAS/HKAS 39 to determine when an available-for-sale equity investment is impaired. This determination requires significant judgement. In making this judgement, the group evaluates, among other factors, the duration and extent to which the fair value of an investment is less than its cost; and the financial health of and short-term business outlook for the investee, including factors such as industry and sector performance, changes in technology and operational and financing cash flow.

If all of the declines in fair value below cost were considered significant or prolonged, the group would suffer an additional loss of HK$1,300,000 in its 2011 financial statements, being the transfer of the accumulated fair value adjustments recognised in equity on the impaired available-for-sale financial assets to the income statement.

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Key Sources of Estimation Uncertainty

- When there are uncertainties that have a significant risk of causing material adjustment to the carrying amount of assets and liabilities within the next financial year, the notes should disclose:
  - ✓ information about the assumptions concerning the future; and
  - ✓ other major sources of estimation uncertainty at the end of the reporting period
  - ✓ Include details of the nature of assets and liabilities and their carrying amount at the end of the reporting period

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Key Sources of Estimation Uncertainty

- Some examples include:
  - ✓ recoverable amount of classes of PPE
  - ✓ effect of technological obsolescence on inventories
  - ✓ provisions subject of the future outcome of litigation in progress; and
  - ✓ long-term employee benefit liabilities such as pension obligations

Some other HKFRSs include specific requirements for disclosures that would otherwise be required by HKAS 1, for example:

- HKAS 37 – major assumptions concerning future events affect classes of provisions
- HKFRS 7 – significant assumptions used in estimating fair values of financial assets and liabilities carried at fair values
- HKAS 16 – significant assumptions used in estimating fair values of revalued items of PPE

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Key Sources of Estimation Uncertainty - Example

(a) Estimated impairment of goodwill

The group tests annually whether goodwill has suffered any impairment, in accordance with the accounting policy stated in note 2.6. The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates (note 7).

An impairment charge of HK$4,650,000 arose in the wholesale CGU in Step-land (included in the Russian operating segment) during the course of the 2010 year, resulting in the carrying amount of the CGU being written down to its recoverable amount. If the budgeted gross margin used in the value-in-use calculation for the wholesale CGU in Step-land had been x% lower than management's estimates at 31 December 2010 (for example, 46% instead of 56%), the group would have recognised a further impairment of goodwill by HK$100,000 and would need to reduce the carrying value of property, plant and equipment by HK$300,000.

If the estimated cost of capital used in determining the pre-tax discount rate for the wholesale CGU in Step-land had been x% higher than management's estimates (for example, 13.8% instead of 12.8%), the group would have recognised a further impairment against goodwill of HK$300,000.

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Key Sources of Estimation Uncertainty - Example

Example:

4.2 Key sources of estimation uncertainty

The following are the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

4.2.3 Useful lives of property, plant and equipment

As described at 3.18 above, the Group reviews the estimated useful lives of property, plant and equipment at the end of each annual reporting period. During the financial year, the directors determined that the useful life of certain items of equipment should be shortened, due to developments in technology.

The financial effect of this reassessment, assuming the assets are held until the end of their estimated useful lives, is to increase the consolidated depreciation expense in the current financial year and for the next 3 years, by the following amounts:

	CU'000
2007	9
2008	7
2009	4
2010	2

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Capital Disclosures

- HKAS 1(revised) requires entities to disclose information which enables users of FS to evaluate the entity's objectives, policies and processes for managing capital. Therefore, the following disclosures are required:
  - Qualitative information about its objectives, policies and processes for managing capital;
  - Summary quantitative data about what it manages as capital;
  - Any changes in the foregoing from the previous period;
  - Whether the entity has complied with any externally imposed capital requirements to which it is subject; and
  - The consequence of non-compliance when the entity has not complied with the externally imposed capital requirements
- The Standard requires these disclosures to be based on the information provided internally to the entity's key management personnel

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The Group manages its capital to ensure that entities in the Group will be able to continue as a going concern while maximising the return to stakeholders through the optimisation of the debt and equity balance. The Group's overall strategy remains unchanged from 2009.

The capital structure of the Group consists of net debt (which includes borrowings, loan from government, convertible notes and obligations under finance leases), cash and cash equivalents and equity attributable to owners of the Company (comprising issued share capital, share premium, reserves and retained profits).

Gearing ratio

The Group's risk management committee reviews the capital structure on a semi-annual basis. As part of this review, the committee considers the cost of capital and the risks associated with each class of capital. Based on the committee's recommendation, the Group has a target gearing ratio of 25-30% determined as the proportion of net debt to equity. The Group expects to increase its gearing ratio closer to 30% through the issue of new debts and the payment of dividends.

The gearing ratio at the end of the reporting period was as follows:

	31/12/10	31/12/09
	HK$'000	HK$'000
Debts (Note 1)	60,580	60,012
Cash and cash equivalents (see note 52)	(20,473)	(22,010)
Net debt	40,107	38,002
Equity (Note 2)	146,286	145,762
Net debt to equity ratio	27%	26%

Notes:

1) Debt comprises long-term and short-term borrowings, loan from government, convertible notes and obligations under finance leases as detailed in notes 36, 37, 38 and 39 respectively.

2) Equity includes all capital and reserves attributable to owners of the Company.

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Other Disclosures – Details About The Entity

- The following should be disclosed in the FS:
  - The domicile and legal form of the entity;
  - Its country of incorporation;
  - The address of its registered office (or principal place of business, if different) ;
  - a description of the nature of the entity's operations and its principal activities;
  - the name of the parent and the ultimate parent of the group; and
  - If the entity is a limited life entity, information about the length of its life.

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Disclosure of Details of Entity - Example

1. General

The Company is incorporated in Bermuda as an exempted company with limited liability and its shares are listed on The Stock Exchange of Hong Kong Limited. Its parent and ultimate holding company is Group Holdings Limited (incorporated in the British Virgin Islands). The addresses of the registered office and principal place of business of the Company are disclosed in the corporate information section of the annual report.

The consolidated financial statements are presented in Hong Kong dollars, which is the same as the functional currency of the Company.

The principal activities of the Company and its subsidiaries (the "Group") are the manufacture and sale of widgets and toys. The Group was also engaged in the manufacture of bicycles and construction businesses, which were discontinued in the current year (see note 11).

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Question:

When an entity produces an additional balance sheet/statement of financial position as required by HKAS 8, the additional balance sheet/statement of financial position should be as at the date of the beginning of the preceding period. Do we need to prepare the notes to support this balance sheet?

Answer:

Amendment to HKAS 1

- No notes are required to support this balance sheet.
- When management provides additional comparative information voluntarily – for example, statement of profit or loss, balance sheet – it should present the supporting notes to these additional statements.
- Applies retrospectively for annual periods beginning on or after 1 January 2013. Early adoption is permitted.

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Accounting Policies, Estimates and Errors

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Scope

- HKAS 8 prescribes the criteria for selecting and changing accounting policies
- The Standard specifies accounting for
  - changes in account estimates
  - corrections of errors in prior period financial statements

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Consistency of Accounting Policies

- Select and apply its accounting policies consistently for similar transactions, other events and conditions

- Change accounting policy only if
  - is required by change to HKFRSs (compulsory)
  - results in reliable and more relevant information (voluntary)
  - corrections of errors in prior period financial statements

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Consistency of Accounting Policies

- **Background:** An entity owns an office building that has been classified as PPE and accounted for under HKAS 16 using the cost model. During the current year, management vacated the property and leased it out to a third party. The entity's accounting policy for its investment property under HKAS 40 is to use the fair value model.
- **Question:** Is this a change in accounting policy?

Answer: This change in use of the building does not result in a change of accounting policy. The entity's policies for each type of property remain unchanged but the property in question is accounted for as an investment property from the date when its use changed. No retrospective restatement is required.

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Retrospective Application

❖ **Background:** In 20Y0, there is a voluntarily change in accounting policy. The cumulative effect of the change is a decrease of $100,000 in retained earnings at 1/1/20Y0 (ie. $25,000 less profit for each of the past four years). The entity presents two years of comparative information.

❖ **Question:** How should this change be accounted for?

❖ **Answer:** Presented as a restatement of :

- retained earnings at 1/1/20X8 – reduced by $50,000
- profit for 20X8 and 20X9 – reduced by $25,000 each

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Impracticability Exemption

❖ **Background:** In 20Y0, there is a voluntarily change in accounting policy. The cumulative effect of the change is a decrease of $100,000 in retained earnings at 1/1/20Y0 (ie. $25,000 less profit for each of the past four years). The entity presents two years of comparative information. It is impracticable to determine the individual period effects of the change of policy.

❖ **Question:** How should this change be accounted?

❖ **Answer:** Presented as a restatement of :

- retained earnings at 1/1/20Y0
  - reduced by $100,000 (no adjustment to 20X8 and 20X9)
  - additional disclosures

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Accounting Estimate

- The use of reasonable estimates is an essential part of accounting
- Changes in accounting estimates result from new information or new developments and, accordingly, are not correction of errors
- Account for changes in accounting estimates prospectively
- Disclose:
  - nature of change and the effect of the change on assets, liabilities, income and expense for the current period
  - if practicable, estimates of the effect of the change in one or more future periods

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Errors

- Prior period errors are omissions from, and misstatements in, financial statements for prior periods arising from a failure to use, or misuse of, reliable information that:
  - was available when financial statements for those periods were authorised for issue, and
  - could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements
- Correct prior period errors retrospectively (i.e., restate comparative figures)
- Disclose
  - nature of the error
  - financial effects (each line-item)
  - an explanation if it is not practicable to determine the financial effects

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Question 1

- Co A acquired a yacht for $1m on 1/1/2001 and appropriately assessed its useful life at 30 years with a residual value of $100,000. Straight-line method was determined most appropriate for depreciation
- At 31/12/2009, as a result of research in 2009, Co A assessed the yacht as follows: useful life at 20 years; residual value at nil; fair value at $800K; and straight –line depreciation as most appropriate method
- Is this a change in accounting policy / estimate / an error?

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Question 2

- Same as above, except, the research was publicly available in late 2005. Co A believed the research to be valid but chose to ignore it until 2009.
- Is this a change in accounting policy / estimate / an error?

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Disclosures

- Where an entity has applied an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or when it reclassifies items in its financial statements, it shall present, as a minimum, three statements of financial position, two of each of the other statements and related notes. An entity presents SOFP as at:
  - (i) the end of the current period,
  - (ii) the end of the previous period
  - (iii) the beginning of the earliest comparative period

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Disclosures

- For initial application of a HKFRS that have an effect on current or prior periods, or that may have an effect on future periods, the following information should be disclosed:
  - title of HKFRS
  - change in accounting policy is made in accordance with its transitional provisions, a description of the such provisions and whether there is any effect on future periods, if applicable
  - nature of change in accounting policy
  - the amount of adjustment for each line item affected and the basic and diluted EPS for the current and prior period presented
  - Amount of adjustments relating to periods prior to the earliest period presented in the F/S
  - If retrospective application has not been practicable for a prior period presented, or for earlier periods, circumstances why impractical and a description of how and from when the change in policy has been applied

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Disclosures

- For voluntary changes in accounting policy that have an effect on current or prior periods, or that may have an effect on future periods, the following information should be disclosed:
  - Nature of the change in policy
  - Reason why the new policy give more reliable and relevant information
  - Amount of the adjustments for the current period & each prior period
  - Effects of changes in accounting policies for each component of equity
  - Amount of adjustments relating to periods prior to the earliest period presented in the F/S
  - If retrospective application has not been practicable for a prior period presented, or for earlier periods, circumstances why impractical and a description of how and from when the change in policy has been applied
  - Such disclosures need not be repeated in subsequent years' F/S

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Disclosures

- For changes in accounting estimates, disclose:
- Nature and amount of change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods
- The fact that if the amount of effect in future periods is impracticable to estimate
- For correction of period errors, disclose:
- the nature of the prior period error
- the amount of the correction for each line item affected; and basic and diluted EPS if HKAS 33 applies
- the amount of correction at the beginning of the earliest prior period presented; and
- If retrospective restatement is impracticable for a prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected

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HKFRS in issue but not yet effective

- Entities should make certain disclosures on new standard or interpretation published (but has not yet come into effect) after the end of the reporting period, but before date of authorisation of F/S,
  - ✓ title of the new HKFRS
  - ✓ nature of future change in policy
  - ✓ date the standard/interpretation should be applied
  - ✓ a discussion of the impact or if that impact is not known or reasonably estimable, a statement to that effect

- For pronouncements where there is an option that would impact the entity, the management expectation on whether the entity will use the option should be disclosed

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Events After the Reporting Period

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Scope

- Events after the end of the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue

- Two types of events:
- Adjusting events – those that provide evidence of conditions that existed at the end of the reporting period

- Non-adjusting events – those that are indicative of conditions that arose after the end of the reporting period

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Accounting and Reporting

- Adjusting events – adjust the amounts recognised (and update disclosures made) in its financial statements

- Non-adjustment events – do not adjust the amounts recognised in its financial statements. However, disclose:

  - The nature of the event, and

  - An estimate of its financial effect, or a statement that estimate cannot be made

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Example - Adjusting Event

- On 31/12/2010 Co A assessed its warranty obligation as $100,000. Before its 2010 financial statements were authorised for issue, Co A discovered a latent defect in one of its lines of products. It reassessed its warranty obligation at 31/12/2010 at $150,000

- Adjusting events – latent defect existed at 31/12/2010. Measure warranty provision at $150,000 at 31/12/2010.

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Example Non-adjusting Event

- On 28/2/2011 Co A's 2010 FS authorised for issue. Fair value of A's investment in B's publicly traded shares on 31/12/2010 = $20,000. On 28/2/2011 fair value of shares = $15,000.

- Non-adjusting event – the change in fair value results from conditions that arose after 2010

- Co A does not adjust the amounts recognised in its financial statements. However, it must give additional disclosure given the impact is significant.

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Disclosure Non-adjusting

- ❖ On 1/3/2011, Co A's 31/12/2010 FS authorised for issue when spot ex rate = $2.5 to FCU 1. At 31/12/2010 spot ex rate = $2 to FCU 1. Co A measured its FCU $2,000,000 unhedged non-current liability at $4,000,000 in the statement of financial position.

- Notes 20 Events after the end of the reporting period

  The financial statements were authorised for issue on 1 March 2011 when the exchange rate was $2.5: FCU 1. The deterioration of the exchange rate from $2: FCU 1 at 31 December 2010 has increased the expected settlement amount of the FCU-denominated liability by $1,000,000

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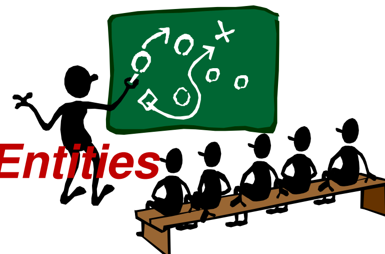
A Refresher Course on Current Financial Reporting Standards 2013 (Day 5)

HKFRS 12

Disclosure of Interests in Other Entities



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HKFRS 12 *Disclosure of Interests in Other Entities*

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Background

- In May 2011, the IASB issued *IFRS 12 Disclosures of Interests in Other Entities* as part of a suite of new standards that address intercompany investments
- Reasons for issuing this standard
  – Lack of transparency about the risks to which a reporting entity was exposed from involvement with structured entities
  – Users of financial statements have consistently requested improvements to the disclosure of a reporting entity's interests in other entities to help identify the profit or loss and cash flows available to the reporting entity and determine the value of a current or future investment

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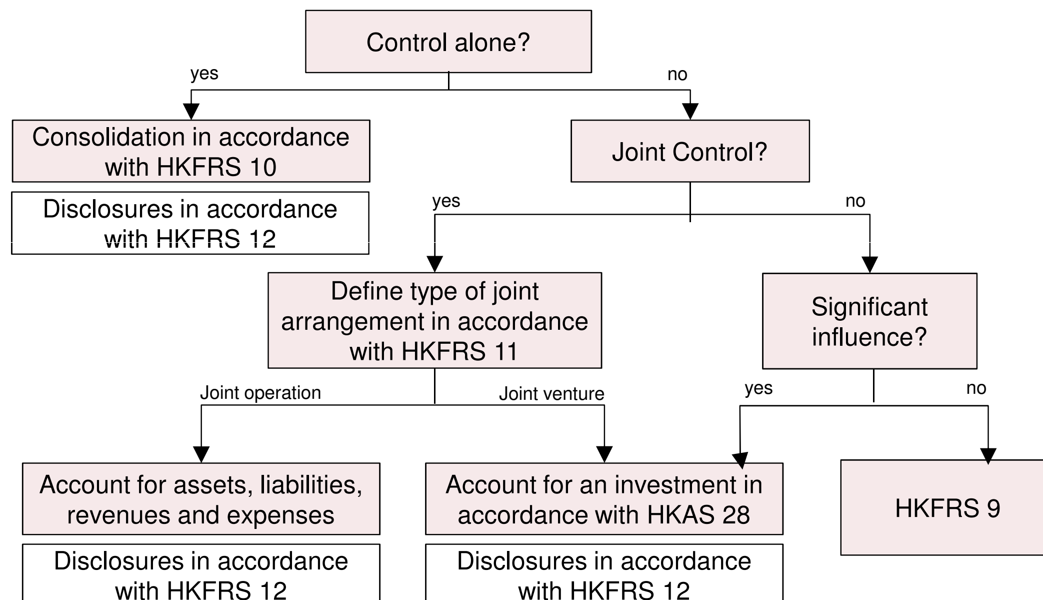
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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Objectives

- Disclosures should enable users of financial statements to evaluate:

Nature of, and risks associated with, its interests in other entities	Effects of those interests on its financial position, financial performance and cash flows

- To meet the objectives

Information about interests in • Subsidiaries • Joint arrangements and associates • **Structured entities**	Significant judgements and assumptions (and changes) made by the investor in determining • Nature of its interest in another entity or arrangement • Type of joint arrangement

- Effective date: 1 January 2013, early adoption is allowed

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Interest in other entities

- contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity
- an interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees
- includes the means by which an entity has control or joint control of, or significant influence over, another entity
- An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship.

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Structured entities

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

Features of structured entities:

- Restricted activities
- A narrow and well-defined objective
- Insufficient equity to permit it to finance its activities without subordinated financial support
- Financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks

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Structured entities

Examples of structured entities:

- Securitisation vehicles
- Asset-backed financings
- Some investment funds

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General requirements

- HKFRS 12 specifies minimum disclosures that an entity must provide
- An entity shall disclose whatever additional information which is considered is necessary if the minimum disclosures required by HKFRS 12 and other HKFRSs, taken together, are not sufficient to meet the objective
- HKFRS 12 requires an entity to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the requirements
- An entity shall aggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics

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General requirements

- Disclosure the method of aggregation
- A quantitative and qualitative analysis, taking into account the different risk and return characteristics of each entity, is made in order to determine the aggregation level
- As a minimum, information is given for:
  - (a) subsidiaries;
  - (b) joint ventures;
  - (c) joint operations;
  - (d) associates; and
  - (e) unconsolidated structured entities

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General requirements

- Within the boundaries of the minimum, HKFRS 12 identifies the following examples of further potential sub-aggregation
  - (a) nature of activities (e.g. R & D vs revolving credit card securitisation)
  - (b) industry classification
  - (c) geography (e.g. country or region)

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Significant judgements and assumptions

- Disclose the significant judgements and assumptions made in deciding
  - (i) whether it has control, joint control or significant influence over another entity;
  - (ii) the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle

(a) it does not control another entity even though it holds more than half of the voting rights of the other entity.
(b) it controls another entity even though it holds less than half of the voting rights of the other entity.
(c) it is an agent or a principal (see paragraphs 58–72 of HKFRS 10).
(d) it does not have significant influence even though it holds 20 per cent or more of the voting rights of another entity.
(e) it has significant influence even though it holds less than 20 per cent of the voting rights of another entity

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Information about a company's interests in subsidiaries

To enable users of the consolidated financial statements to understand and evaluate:

1. the composition of the group
2. the interest that non-controlling interests (NCIs) have in the group's activities and cash flows;

   For each subsidiary with material NCI, refer to Appendix 4 for details
3. the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;

   For example, restriction on transfer cash or other assets, dividend and other capital contributions being paid, or loans and advances being made or paid

The summarised financial information shall be the amounts before intercompany eliminations.

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Information about a company's interests in subsidiaries (cont'd)

To enable users of the consolidated financial statements to understand and evaluate:

4. the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
   - the terms of any contractual arrangements that could require parent or its subsidiaries to provide financial support, including events or circumstances that could expose the reporting entity to loss
   - type of and reasons for the support the group entity has provided if there is no contractual obligation to do so
   - any current intentions to provide financial or other support, including assistance in obtaining financial support

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Information about a company's interests in subsidiaries (cont'd)

To enable users of the consolidated financial statements to understand and evaluate:

5. the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control
   - a schedule showing the effects on the equity attributable to owners to the parent of any changes in ownership interest
6. the consequences of losing control of a subsidiary during the reporting period
   - any gain or loss calculated in accordance with HKFRS 10
   - portion of that gain or loss attributable to measuring any investment retained in the former subsidiary at its fair value at the date when control is lost
   - line items in profit or loss in which the gain or loss is recognised

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Information about a company's interests in joint arrangements and associates

- To enable users of the consolidated financial statements to evaluate:
  - the nature, extent, and financial effects of its interests in joint arrangements and associates, including details of its contractual relationship with other investors with joint control of, or significant influence over, joint arrangements and associates
    (a) For each material joint arrangement and associate, refer to Appendix 4 for details.
    (b) For others that are not individually material, the following aggregate amounts (separately for joint ventures and associates):
      - profit or loss from continuing operations
      - post-tax profit or loss from discontinued operations
      - other comprehensive income
      - total comprehensive income

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Information about a company's interests in joint arrangements and associates (cont'd)

- The summarised financial information shall be the amounts included in the HKFRS financial statements of the joint venture or associates (adjusted for any fair value adjustments and differences in accounting policies, if any).
- Disclose a reconciliation of the summarised financial information presented to the carrying amount of interest in the joint venture or associate

(c) any significant restrictions on the ability of joint ventures or associates to transfer funds to the entity (e.g. cash dividends, repay loans or advances made)

(d) the unrecognised share of losses of a joint venture or associate, both for the reporting period and cumulatively when applying equity method

- the risks associated with its interests in joint ventures and associates
  - total commitments (for example, contribute funding or resources, acquire another party's ownership interest in a joint venture)

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Information about a company's interests in unconsolidated structured entities

A. Nature of interests

- Qualitative and quantitative information on nature, purpose, size and activities of the structured entity and how the structured entity is financed
- If an entity holds no interest in a structured entity but has sponsored the entity, disclose:
  - how it determined which structured entities it has sponsored
  - income from those structure entities in the reporting period, including a description of the types of income
  - carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period

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Information about a company's interests in unconsolidated structured entities

B. Nature of risks

- Disclose in tabular format, a summary of
  - (a) carrying amounts of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities
  - (b) line items in the statement of financial position in which those assets and liabilities are recognised
  - (c) Entity's estimate of its maximum exposure to loss from those interests, how that estimate was made. Disclose the fact and reason if the entity cannot quantify the maximum exposure to loss from those interests
  - (d) Comparison of (b) and (c)

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Information about a company's interests in unconsolidated structured entities

B. Nature of risks (cont'd)

- If during the reporting period an entity has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated structured entity in which it previously had or currently has an interest (for example, purchasing assets of or instruments issued by the structured entity), disclose:
  - (a) the type and amount of support provided, including situations in which the entity assisted the structured entity in obtaining financial support; and
  - (b) the reasons for providing the support.
- Disclose any current intentions to provide financial or other support to an unconsolidated structured entity, including intentions to assist the structured entity in obtaining financial support.

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Related disclosures

- The disclosure requirements presented in these slides are not exhaustive. Please refer to HKFRS 12 for more details.
- Consider also the disclosure requirements under HKAS 24 Related party disclosures

  For example, related party relationships of (i) parent and subsidiaries, (ii) investors and their associates and joint ventures etc…

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	Disclosures about interests in other entities
Transitional requirements without relief	The entity would be required to disclose all information required by HKFRS 12 in all periods presented.
Transitional requirements after relief	***Disclosures limited to one year*** • In addition to limiting the accompanying comparative information to be disclosed under HKFRS 12, there **is further relief from the disclosures for unconsolidated structured entities**. These disclosures may be made **prospectively** from the date of initial application – i.e. from 1 January 2013 for an entity with a calendar year end that does not early adopt the standards.

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References

- Refer to Appendix 5 for the illustrative disclosures extracted from Deloitte illustrative financial statements 2011 (with early adoption)

Links:

- http://www.iasplus.com/en/publications/hong-kong-publications/models/hong-kong-financial-reporting-standards-2014-illustrative-financial-statements-2011/file
- http://www.pwchk.com/webmedia/doc/634883393624099721_illustrative_ifrs_hkfrs_dec2012.pdf

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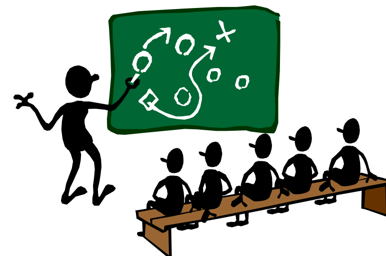
HKFRS 13
Fair value measurement



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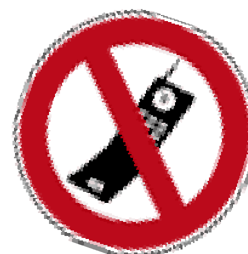

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HKFRS 13 Fair value measurement

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Agenda

Part 1: Background

Part 2: Scope

Part 3: Fair value principles

Part 4: Application issues

Part 5: Valuation techniques

Part 6: Fair value hierarchy

Part 7: Disclosures

Part 8: Application of fair value measurement – Greek government bonds

Part 9: Consequential amendments to other HKFRSs

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Part 1
Background

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Background

- HKFRS 13 define fair value, sets out in a single standard a framework for measuring fair value and requires disclosures about fair value measurement
- Applies when other HKFRSs require or permit fair value measurements
- Does not introduce any new requirements to measure an asset or a liability at fair value, change what is measured at fair value in HKFRSs or address how to present changes in fair value
- Part of the Memorandum of Understanding between IASB and US FASB
- Aligned IFRSs and US GAAP to have the same definition and meaning of fair value and the same disclosure requirements about fair value measurements

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Background

- HKFRS 13 provides clear and consistent guidance for measuring fair value and addressing valuation uncertainty in markets that are no longer active
- It also increases the transparency of fair value measurements by requiring detailed disclosures about fair values derived using models
- Some of those disclosures, including the fair value hierarchy, were already introduced in 2009 through an amendments to HKFRS 7 *Financial Instruments: Disclosures* and are now relocated to HKFRS 13
- Effective for annual periods beginning on or after 1 January 2013. Earlier application permitted
- Applied prospectively from the beginning of the annual period in which it is adopted

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Part 2
Scope

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Scope

Measurement and disclosure requirements of HKFRS 13 do not apply to:

- HKFRS 2 *Share-based Payment*
- HKAS 17 *Leases*
- Measurements that are similar to fair value but that are not fair value
  - Net realisable value (HKAS 2 *Inventories*) or
  - Value in use (HKAS 36 *Impairment of Assets*)

The measurement and disclosure requirements do apply to measurements based on fair value, e.g. fair value less costs to sell in HKFRS 5 Non-current assets held for sale and discontinued operations

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Scope

Disclosure requirements of HKFRS 13 do not apply to:

- Plan assets measured at fair value in accordance with HKAS 19 *Employee Benefits*
- Retirement benefit plan investments measured at fair value in accordance with HKAS 26 *Accounting and Reporting by Retirement Benefit Plans*
- Assets for which recoverable amount is fair vale less costs of disposal in accordance with HKAS 36

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Part 3
Fair value principles

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Definition of fair value

HKFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

- An exit price
- Same as in US GAAP
- Emphasizes fair value as a market-based measurement, not an entity-specific measurement

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- HKFRS 13 stipulates the following factors that should be considered in fair value measurement
  - a. the asset or liability
  - b. the market
  - c. market participants
  - d. the price
- In addition, there are considerations that are specific to:
  - a. non-financial assets
  - b. liabilities
  - c. equity
  - d. financial assets and financial liabilities with offsetting positions

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The asset or liability

- When measuring fair value, an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date
- Such characteristics include, for example:
  - The condition and location of the asset; and
  - Restrictions, if any, on the sale or use of the asset
- HKFRS 13 generally does not specify the unit of account, e.g. a single asset or liability or a group of assets and/or liabilities, for measuring fair value
- The unit of account for the asset or liability shall be determined in accordance with the particular standard giving rise to the requirement to measure fair value

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Example 1 – Restriction on the sale of an equity instrument

- An entity holds an equity instrument (a financial asset) for which sale is legally or contractually restricted for a specified period (e.g. such a restriction could limit sale to qualifying investors)
- The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants
- In that case, the fair value of the instrument would be measured on the basis of the quoted price for an identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction
- Would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period

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- The adjustment will vary depending on all the following:
  - (a) the nature and duration of the restriction
  - (b) the extent to which buyers are limited by the restriction (e.g. there might be a large number of qualifying investors)
  - (c) qualitative and quantitative factors specific to both the instrument and the issuer

When measuring fair value, an entity shall take into account characteristics of the asset!

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Example 2 – Restriction on the use of an asset

- A donor contributes land in an otherwise developed residential area to a not-for-profit neighbourhood association
- Currently used as a playground
- The donor specifies that the land must continue to be used by the association as a playground in perpetuity
- Upon review of relevant legal and other documentation , the association determines that the fiduciary responsibility to meet the donor's restriction would not be transferred to market participants if the association sold the asset - the donor restriction on the use of the land is specific to the association

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- The association is not restricted from selling the land
- Without the restriction on the use of the land by the association, the land could be used as a site for residential development
- In addition, the land is subject to an easement (i.e. a legal right that enables a utility to run power lines across the land)

Question:

What are the characteristics of the land that should be consider when measuring its fair value?

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Following is an analysis of the effect on the fair value measurement of the land arising from the restriction and the easement:

(a) Donor restriction on use of land

- The donor restriction on the use of the land is specific to the association
- Would not be transferred to market participants
- Fair value of the land would be the higher of the following, regardless of the restriction on the use of the land by the association:
  - i) Fair value used as a playground
  - ii) Fair value as a site for residential development

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(b) Easement for utility lines

- Easement for utility lines is specific to (ie a characteristic of) the land
- Would be transferred to market participants with the land
- Fair value measurement would take into account the effect of the easement, regardless of whether the highest and best use is as a playground or as a site for residential development

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The transaction/the market

- A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions
- A fair value measurement assumes that the transaction to sell the asset or transfer the liability take place either:

  - in the principal market for the asset or liability; or

  - in the absence of a principal market, in the most advantageous market for the asset or liability

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- *Principal market*
  The market with the greatest volume and level of activity for the asset or liability

- *Most advantageous market*
  The market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs

- In many instances, the principal market and the most advantageous market would be the same

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- In either case, the entity must have access to the principal (or most advantageous) market at the measurement date
- The concepts of principal market and most advantageous market are considered from the perspective of the entity
- Because different entities, and different businesses within a single entity, may have access to different markets, the principal or most advantageous market for the same asset or liability may vary from one entity to another, or between businesses within an entity

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Market participants

- An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest
- Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
  a. Independent (not related parties in HKAS 24)
  b. Knowledgeable
  c. Able to enter into a transaction
  d. Willing to enter into a transaction

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The price

- Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique
- Not adjusted for transaction costs – not a characteristic of the asset or liability
- Transactions costs are considered to be a characteristic of the transaction
- Transaction costs are considered when determining the most advantageous market

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Transaction costs is defined in HKFRS 13 as:

- The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:
  - (a) They result directly from and are essential to that transaction
  - (b) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made
- Transaction costs do not include transport costs
- If location is a characteristic of an asset, e.g. crude oil held in the Arctic circle, the price in the principal (or most advantageous) market is adjusted for the costs that would be incurred to transport the asset to that market
- For example, costs to transport the crude oil from the Arctic circle to the appropriate market

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Example – Principal market

Company M holds an asset that is traded in three different markets as follows:
(Note: Company M buys and sell in Market Z)

	Market X	Market Y	Market Z
Volume (annual)	30,000	12,000	6,000
Trade per month	30	12	10
Price	50	48	53
Transport costs	(3)	(3)	(4)
Possible fair value	47	45	49
Transaction costs	(1)	(2)	(2)
Net proceeds	46	43	47

1. Which one is the principal market ?
2. Which one is the most advantageous market?
3. What is the fair value?

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Example – Principal market

- The principal market for the asset in this example is Market X because it has the highest volume and level of activity.
- The most advantageous market is Market Z because it has the highest net proceeds.
- M bases its fair value on prices in Market X when information about the volume and level of activity of each market is reasonably available and M is able to access Market X. Pricing is taken from this market even though M does not normally transact in that market and it is not the most advantageous market. In this case, fair value would be 47, considering transport costs but not transaction costs, even though M normally transacts in Market Z and could maximise net proceeds in that market.
- If M is unable to access Market X and Y, or information allowing a conclusion on what market has the greatest volume and level of activity is not reasonably available, then M would use Market Z and net proceeds would be 47. In this case, fair value would be 49.

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Most advantageous market is the market that maximises the amount that would be received to sell the assets after taking into transport and transaction costs.

Fair value of the asset is adjusted for transport cost but not transaction costs.

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Part 4
Application issues

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Highest and best use for non-financial assets

- HKFRS 13 requires the fair value of a non-financial asset to be measured based on its highest and best use from a market participant's perspective
- Does not apply to financial instruments, liabilities or equity
- Highest and best use refers to the use of a non-financial asset by market participants that would maximize the value of the asset or the group of assets and liabilities with which the asset would be used
- A fair value measurement considers a market participant's ability to generate economic benefits by:
  - using a non-financial asset; or
  - selling it to another market participant who will use the asset in its highest and best use

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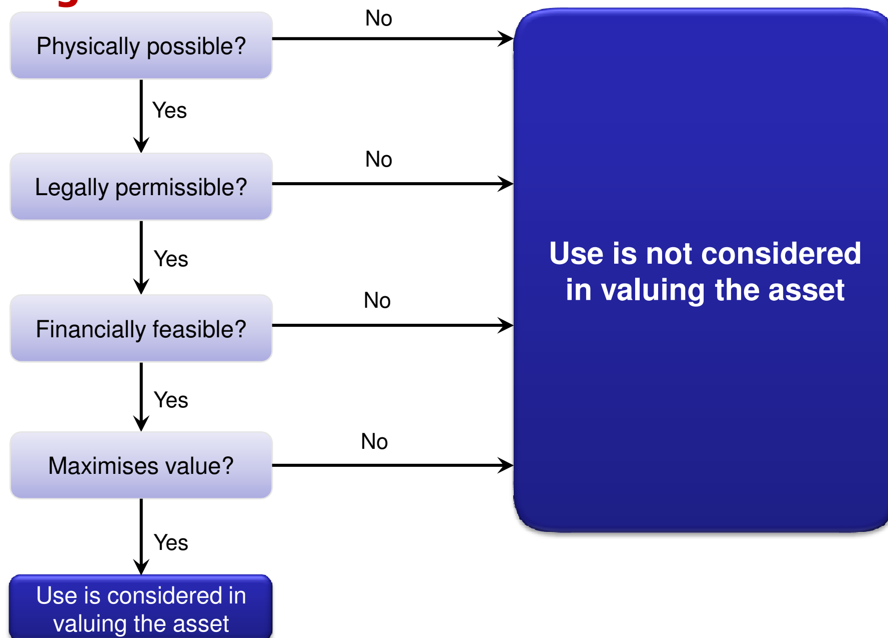
Highest and best use for non-financial assets



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- Highest and best use is determined from the perspective of market participants, even if the entity intends a different use
- However, HKFRS 13 allows management to presume that its current use of an asset is the highest and best use unless market or other factors suggest otherwise

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Example 1 – Highest and best use

- Company A acquires a brand in a business combination
- But decided not to use the brand – assuming that its removal from the market will generate greater incremental value to Company A as a result of increased revenues from its existing brands
- However, a market participant would choose to continue to use the brand
- Therefore, the fair value of the brand would be based on that as the highest and best use to a market participant

	Market participant	Company A
Direct benefits	100	0
Indirect benefits	0	120
Total incremental benefits	100	120
Fair value	100	100

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Example 2 – Highest and best use

- An entity acquires land in a business combination
- Currently developed for industrial use as a site for a factory – presumed to be its highest and best use unless market or other factors suggest a different use
- Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings
- The highest and best use of the land would be determined by comparing both of the following:

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(a) the value of the land as currently developed for industrial use (ie used in combination with other assets, such as factory, or with other assets and liabilities)

(b) the value of the land as a vacant site for residential use (ie on a stand-alone basis), taking into account the following:

- costs of demolishing the factory
- other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site

The highest and best use of the land would be determined on the basis of the higher of those values

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Liabilities and an entity's own equity instruments

- Measured using quoted prices for the transfer of identical or similar instruments, but would remain outstanding
- Not an extinguishment or settlement cost
- Fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation
- Non-performance risk is assumed to be the same before and after the transfer of the liability. It includes, but may not be limited to, an entity's own credit risk
- A separate input or adjustment to reflect a restriction on an entity's ability to transfer a liability or own equity instruments to another party is not applied in fair value measurement of the liability of the entity's own instruments
- Such restriction is assumed to be reflected implicitly or explicitly in the other inputs used by the market participants to price such instruments

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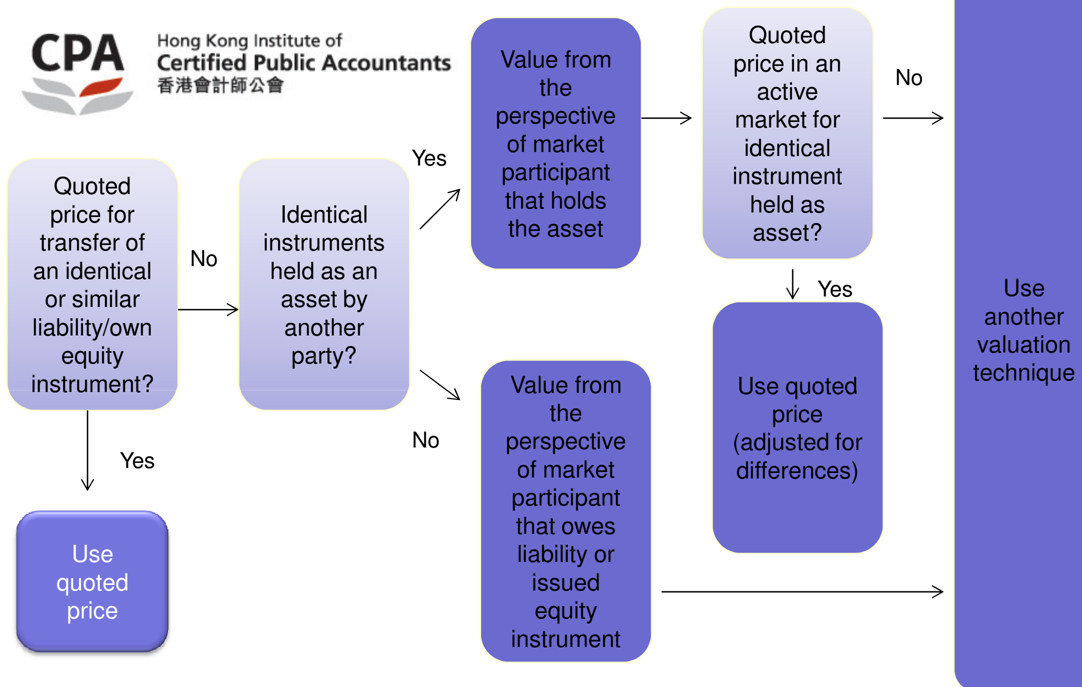

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Financial instruments

Measurement exception – net exposure

- HKFRS 13 allows an exception whereby if an entity manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or counterparty risks
- Permitted to apply an exception to measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date
- Exposure to market risks – the market risks net exposure should be substantially the same as regards both their nature and duration

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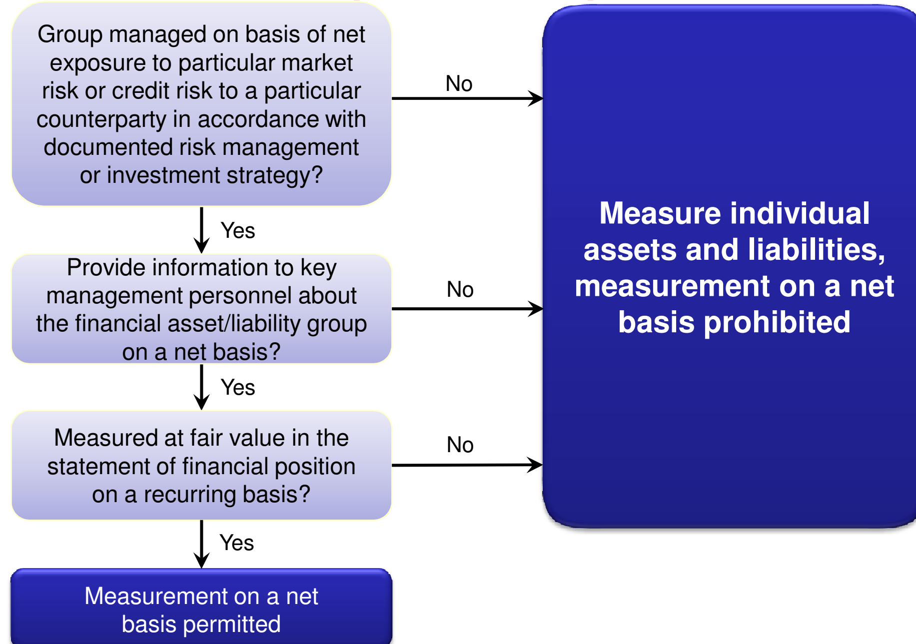
Measurement exception – net exposures



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- The above exception does not change the presentation requirement for financial assets and financial liabilities
- Presentation is dealt with in other HKFRSs (e.g. HKAS 32 *Financial Instruments: Presentation*)
- Where gross presentation is required, the fair value of the group should be allocated to the assets and liabilities within the group on a reasonable and consistent basis

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Fair value at initial recognition

- When an asset is acquired or a liability is assumed, the transaction price is the price paid to acquire the asset or received to assume the liability – An entry price
- In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability – An exit price
- Although conceptually different, in many cases the exit price and entry price are equal and therefore fair value at initial recognition generally equals the transaction price
- A day one gain or loss arises when the transaction price for an asset and / or liability differs from the fair value used to measure it at initial recognition.

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However, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist

- the transaction is between related parties
- the transaction takes place under duress or the seller is forced to accept the price in the transaction (e.g. the seller is experiencing financial difficulty)
- the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value, e.g. if the transaction price represents the purchase of multiple items
- the market in which the transaction takes place is different from the principal market (or most advantageous market)

HKFRS 13 requires day one gains or losses to be recognised in profit or loss unless another HKFRS specifies otherwise.

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Part 5
Valuation techniques

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General principles

- The valuation technique should be:
  - appropriate in the circumstances
  - sufficient data are available to measure fair value
  - maximising the use of relevant observable inputs
  - minimising the use of unobservable inputs
- Valuation techniques used to measure fair value shall be applied consistently
- Three widely used valuation techniques are:
  - market approach
  - cost approach
  - income approach

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a. Market approach

- Uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business
- Examples are:
  - valuation techniques using market multiples derived from comparable transactions
  - matrix pricing – a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities' relationship to other benchmark quoted securities

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b. Cost approach

- Reflects the amount that would be required currently to replace the service capacity of an asset (ie current replacement cost)
- Assumes that fair value is the cost to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence (including physical deterioration, functional (technological) obsolescence and economic (external) obsolescence)
- Not relevant for financial assets

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c. Income approach

- Converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount
- Examples are
  - Present value techniques
  - Option pricing models, such as Black-Scholes-Merton formula, that incorporates present value techniques and reflect both the time value and the intrinsic value of an option
  - Multi-period excess earnings method (for intangible assets, such as customer relationships or technology)

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Part 6
Fair value hierarchy

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Fair value hierarchy

- Similar to the hierarchy established under HKFRS 7 *Financial Instruments: Disclosures*
- Categorised into three levels
- Highest priority given to unadjusted quoted prices in active market for identical assets or liabilities (Level 1 inputs)
- Lowest priority given to unobservable inputs (Level 3 inputs)
- Based on inputs to valuation techniques used to measure fair value, not the valuation techniques used to measure fair value

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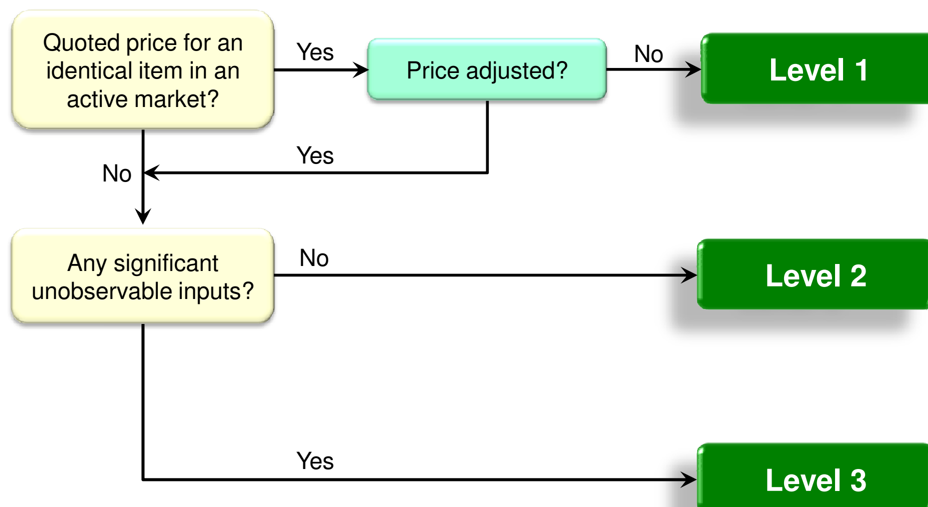
Fair value hierarchy



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- In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised within different levels of the fair value hierarchy
- Fair value measurement is categorised in its entirety in the same level as the lowest level input that is significant to the entire measurement
- For example, a fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on
  - the inputs that are significant to the entire measurement
  - the level of the fair value hierarchy within which those inputs are categorised
- Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, shall not be taken in account when determining the level of fair value hierarchy within which a fair value measurement is catergorised.

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Level 1 inputs

- Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date
- Active market refers to a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis
- A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except:

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- an entity holds a large number of similar (but not identical) assets or liabilities that are measured at fair value
- a quoted price in an active market does not represent fair value at the measurement date
- measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset.

Any adjustment to the quoted price will result in a fair value measurement being categorised into a lower level of the fair value hierarchy.

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Level 2 inputs

- Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly
- Level 2 inputs include:
  - quoted prices for similar assets or liabilities in active markets
  - quoted prices for identical or similar assets or liabilities in markets that are not active
  - inputs other than quoted prices that are observable for the asset or liability, such as interest rates, credit spreads or yield curves

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- If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability.
- Adjustments to Level 2 inputs may be necessary depending on the characteristics of the asset or liability being measured
- An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs

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Examples:

- *Receive-fixed, pay variable interest rate swap based on the LIBOR swap rate*

  A Level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap

- *Building held and used*

  A Level 2 input would be the price per square metre for the building derived from observable market data, e.g. multiples derived from prices in observed transactions involving comparable buildings in similar locations.

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Level 3 inputs

- Unobservable inputs for the asset or liability
- Used only when observable inputs are not available
- Both the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique should be considered
- Level 3 inputs should be developed using the best information available in the circumstances, which might include an entity's own data. However, the entity's own data should be adjusted if reasonably available information indicates that other market participants would use different data

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Examples:

- *Interest rate swap*

  A Level 3 input would be an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data

- *Cash generating unit.*

  A Level 3 input would be a financial forecast (e.g. of cash flows or profit or loss) developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions.

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Premium, discounts and blockage factors

What valuation adjustments are permitted?

- Only when they reflect a characteristic of an asset or liability

What valuation adjustments are **NOT** permitted?

- Premiums or discounts that reflect size as a characteristic of the entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity)

In all cases, if there is a quoted price in an active market (i.e. a Level 1 input*)*, an entity shall use that price without adjustment when measuring fair value.

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Significant decrease in volume/level of activity

- Fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that item compared to its normal market activity
- Following factors shall be considered
  a. There are few recent transactions
  b. Price quotations are not developed using current information
  c. Price quotations vary substantially either over time or among market-makers
  d. Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability

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e. Significant increase in implied liquidity risk premiums, yields or performance indicators for observed transactions or quoted prices when compared with previous estimates
f. Wide bid-ask spread or significant increase in the bid-ask spread
g. Significant decline in the activity of, or there is an absence of, a market for new issues for the (or similar) asset or liability
h. Little information is publicly available

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If there has been a significant decrease in the volume or level of activity,

- The entity needs to perform further analysis.
- Conclusion of the analysis can be:
  a. the transaction or quoted price still represents fair value. A decline in volume/activity, on its own, may not indicate that the quoted price does not represent fair value
  b. the transaction or quoted price does not represent fair value. In such cases, an adjustment will be necessary if:
    - the entity uses those prices as a basis for measuring fair value; and
    - the adjustment may be significant to the fair value measurement in its entirety.
  c. the transaction is not orderly.
- A change in valuation technique or the use of multiple valuation techniques may be appropriate, if the volume or level of activity has significantly decreased

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Identifying transactions that are not orderly

- Not appropriate to conclude that all transactions in a market are not orderly simply due to significant decrease in volume/level of activity
- Indications that transactions are not orderly include:
  a. Not adequate exposure to the market for a period before measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions
  b. Usual and customary marketing period, but the seller marketed the asset or liability to a single market participant
  c. Seller is distressed (in or near bankruptcy or receivership)
  d. Seller was forced to sell to meet regulatory or legal requirements
  e. Transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability

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If evidence indicates that a transaction is / is not orderly?

a. A transaction is NOT orderly -> place little or no weight on transaction price
b. A transaction is orderly -> take into account the transaction price. The weight placed on such a transaction price depends on the circumstances, e.g. volume and timing of transaction.
c. Cannot determine if transaction is orderly or not -> place less weight on those transactions when compared with transactions that are known to be orderly

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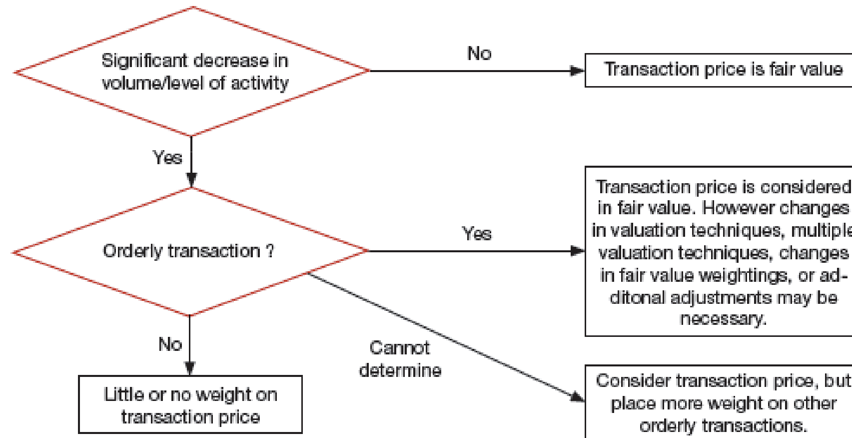
Considerations in determining the level of reliance on market prices



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Part 7
Disclosures

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Objectives

- HKFRS 13 requires disclosure of sufficient information to help financial statement users to assess:
  - a. valuation techniques and inputs used to develop both recurring and non-recurring measurements of assets and liabilities carried at fair value after initial recognition
  - b. the effect of the measurements on profit or loss or other comprehensive income of recurring Level 3 fair value measurements

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- To meet the above-mentioned objectives, an entity shall consider all the following:
  - a. the level of detail necessary to satisfy the disclosure requirements
  - b. how much emphasis to place on each of the various requirements
  - c. how much aggregation or disaggregation to undertake
  - d. whether users of financial statements need additional information to evaluate the quantitative information disclosed
- If the disclosures provided are insufficient to meet the above-mentioned objectives, an entity shall disclose additional information necessary to meet those objectives

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Recurring vs Non-recurring

- Recurring fair value measurements of assets or liabilities
  – those that other HKFRSs require or permit in the statement of financial position at the end of each reporting period (eg financial instruments in HKAS 39 *Financial Instruments: Recognition and Measurement*
- Non-recurring fair value measurements of assets or liabilities
  – those that other HKFRSs require or permit in the statement of financial position in particular circumstances (eg when an entity measures an asset held for sale at fair value less costs to sell in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

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	Measured at fair value on a recurring basis	Measured at fair value on a non-recurring basis (after initial recognition)	Not measured at fair value, but fair value is required to be disclosed
Fair value at end of reporting period	✓	✓	✓
Reasons for measurement		✓	
Level of fair value hierarchy	✓	✓	✓
Amounts of transfers between Level 1 and Level 2, reasons for transfers and policy for determining when transfers occurred	✓		
If highest and best use differs from current use, that fact, and why being used that way	✓	✓	✓

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	Measured at fair value on a recurring basis	Measured at fair value on a non-recurring basis (after initial recognition)	Not measured at fair value, but fair value is required to be disclosed
For Level 2 and 3, a description of valuation technique(s) and inputs used	✓	✓	✓
For Level 2 and 3, any changes in valuation technique(s), and reasons for change	✓	✓	✓
For Level 3, quantitative information about significant unobservable inputs	✓	✓	
For Level 3, description of valuation processes	✓	✓	

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	Measured at fair value on a recurring basis	Measured at fair value on a non-recurring basis (after initial recognition)	Not measured at fair value, but fair value is required to be disclosed
For Level 3, reconciliation of opening and closing balance	✓		
For Level 3, unrealised gains/losses from remeasurement	✓		
For Level 3, narrative description of sensitivity to changes in unobservable inputs	✓		
For Level 3, quantitative sensitivity to changes in unobservable inputs (for financial assets and liabilities only)	✓		

Please refer to HKFRS 13 for details of disclosure requirements.

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Part 8
Application of fair value measurement – Greek government bonds
(Appendix 6 & 7)

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Background

- There continue to be significant economic concerns in some European countries that are members of the single currency (the eurozone) as well as potential uncertainty about the single currency itself.
- Greece continues to experience economic decline
- The fiscal and economic difficulties may have a significant impact on entities that hold sovereign debt from any of the troubled eurozone economies
- However, any entity that is owed money by the government or a quasi-governmental body from the troubled eurozone economies has sovereign debt risk; management needs to consider whether sovereign debt, trade debtors and other holdings are impaired

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- European leaders have proposed a financial assistance package for Greece ('the package')
- The proposed financial assistance package is expected to require holders of the Greek government bonds (GGBs) to accept a reduction in the nominal value of the bonds of at least 50%
- Any GGBs classified as available for sale (AFS) should be measured at year-end fair value
- Any assertions that investments in GGBs are not impaired should be viewed with scepticism

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Accounting for available-for sale sovereign debt

(Extract from letter from IASB Chairman to ESMA – Appendix 6)

- AFS financial assets are measured at fair value with changes in fair value measurement presented in other comprehensive income
- However, if it is determined that those assets are impaired, the company recognises the accumulated decline in fair value in profit or loss
- In other words, the impairment calculation for AFS financial assets is based on the fair value of the assets

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Issues

- It appears that some companies are not following IAS 39 *Financial Instruments: Recognition and Measurement* when determining whether the GGBs that they classify as AFS are impaired
- Some companies holding GGBs classified as AFS have stated that they are relying on internal valuation methodologies, rather than on market prices, to measure the fair value of the assets as at 30 June 2011
- The reason generally given for using models rather than market prices is that the market for GGBs is currently inactive (and therefore, in their view, does not provide reliable pricing information)

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Accounting treatment

- In measuring fair value, IAS 39 prioritises the use of quoted prices in active markets over the use of valuation models developed using internal assumptions
- IAS 39 describes an active market for a financial instrument as one in which 'quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis'
- It is important to note that the description of an active market does not focus solely on trading activity

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- Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices varying significantly over time or among market participants, or the prices not being current
- However, those factors alone do not necessarily mean that a market is no longer active
- A company cannot ignore observable transaction prices when it is clear that market participants are regularly entering into transactions for the same or similar financial assets, even if they are doing so less frequently than they have in the past

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- Although the level of trading activity in Greek government bonds has decreased, transactions are still taking place
- IAS 39 is clear that unless there is evidence that the prices in those transactions do not represent fair value (for example, because those transactions are forced or because they require significant adjustment because of timing differences between the transaction date and the measurement date, which are matters of judgement and depend on the facts and circumstances), the observed transactions prices should be used to measure fair value
- Even when a model is used to measure fair value, that model must reflect current market conditions (including those as evidenced by observable transaction prices) and it should include appropriate adjustments that market participants would make for credit and liquidity risks

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- The model must maximise the use of relevant observable inputs (eg market data) and minimise the use of unobservable inputs (eg the company's own assumptions)
- A company cannot ignore relevant market data (including observable transaction prices) when it is clear that market participants would use that data in determining the price at which they would be willing to enter into a transaction for the financial asset
- It would therefore not be in accordance with either the requirements in, or the intent of, IAS 39 to measure a loss on government bonds classified as AFS financial assets solely by assessing the present value of the future cash flows arising from a proposed restructure of those bonds

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Sovereign debt in IFRS financial statements

(Extract from public statements by ESMA – Appendix 7)

- As part of its objective to coordinate European enforcement activities, ESMA has collected information with respect to IFRS half-year financial statements ended on 30 June 2011, published by listed European financial institutions
- On this basis, there is evidence that some accounting practices of issuers with regard to Greek sovereign debt exposures varied across the European Economic Area

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- Out of 34 financial institutions with AFS instruments…

Level of hierarchy	Number of Financial institutions
Level 1	20
Level 2	3
Level 3	4
Not possible to identify the measurement method used	4
No impairment losses	3
Total	34

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With regards to the measurement of exposure to Greek Sovereign bonds, it is ESMA's opinion that:

- Greek sovereign bonds classified as available for sale or held for trading should have been reported at fair value using the fair value hierarchy as outlined in paragraph 27A of IFRS 7
- To determine the fair value, issuers should analyse whether a market is active or not at the reporting date
- This means analysing whether quoted prices are readily and regularly available for each instrument (by maturity, and where relevant by issuance) and whether those prices represent actual and regularly occurring market transactions on an arm's length basis

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- Based on trading data obtained from the Bank of Greece, it is ESMA's opinion that, as of 30 June 2011, the market was active for some Greek sovereign bonds but could be judged inactive for some others
- Issuers should consequently have used level 1 fair value measurement as defined under IFRS 7 for instruments with active markets
- For those instruments for which the market was not active, a level 2 measurement method should have been applied (using models which include observable market data from similar instruments, such as Greek bonds with close maturities or prices for credit default swaps, if relevant)
- The same fair value measurement considerations also apply when assets are reclassified from available-for-sale to loans and receivables

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Part 9

Consequential amendments to other HKFRSs

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Consequential amendments to other HKFRSs primarily include:

- Aligning terminology with HKFRS 13, e.g. changing "market value" to "fair value"
- Improving consistency in describing fair value measurement, e.g. "determining" or "estimating" fair values is changed to "measuring" fair value
- Deleting fair value guidance and instead cross-referencing to HKFRS 13
- Adding new disclosures in HKAS 36 to reflect additional fair value measurement disclosures when entities measure recoverable amount using fair value less costs to sell
- Articulating differences between fair value less costs to sell (modified to fair value less costs of disposal by HKFRS 13) and value in use in HKAS 36

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Thank you for your attention

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CONSOLIDATED STATEMENT OF FINANCIAL POSITION

At 31 December 2010

		At 31 Dec 2010			As restated At 31 Dec 2009			As restated At 1 Jan 2009		
	Note	Current $m	Non-current $m	Total $m	Current $m	Non-current $m	Total $m	Current $m	Non-current $m	Total $m
ASSETS										
Cash and cash equivalents	18	19,361	-	19,361	14,738	-	14,738	27,784	-	27,784
Financial assets at fair value through profit or loss		-	-	-	-	-	-	3,020	-	3,020
Financial assets measured at fair value through profit or loss	19	9,949	1,241	11,190	12,466	1,559	14,025	-	-	-
Available-for-sale financial assets		-	-	-	-	-	-	19,394	-	19,394
Financial assets at amortised cost		-	-	-	-	-	-	3,664	47	3,711
Financial assets measured at amortised cost	20(a)	7,021	783	7,804	4,157	768	4,925	-	-	-
Accounts receivable, prepayments and deposits	21	9,203	3	9,206	11,334	3	11,337	8,535	3	8,538
Fixed assets	22(a)	-	295	295	-	303	303	-	370	370
Lease premium for land	23	-	25	25	-	-	-	-	-	-
Deferred tax assets	30(e)	-	3	3	-	4	4	-	5	5
Total assets		45,534	2,350	47,884	42,695	2,637	45,332	62,397	425	62,822
LIABILITIES AND EQUITY										
Liabilities										
Margin deposits from Clearing Participants on derivatives contracts	24	22,702	-	22,702	20,243	-	20,243	41,840	-	41,840
Cash collateral from HKSCC Clearing Participants	25	3,594	-	3,594	3,432	-	3,432	3,600	-	3,600
Accounts payable, accruals and other liabilities	26	9,946	-	9,946	11,827	-	11,827	8,894	-	8,894
Deferred revenue		473	-	473	424	-	424	393	-	393
Taxation payable		320	-	320	261	-	261	141	-	141
Other financial liabilities	27	58	-	58	42	-	42	118	-	118
Participants' contributions to Clearing House Funds	28	2,039	-	2,039	723	276	999	198	252	450
Provisions	29(a)	28	29	57	33	26	59	36	25	61
Deferred tax liabilities	30(e)	-	18	18	-	18	18	-	31	31
Total liabilities		39,160	47	39,207	36,985	320	37,305	55,220	308	55,528
Equity										
Share capital	32			1,078			1,076			1,075
Share premium	32			416			376			347
Shares held for Share Award Scheme	32			(219)			(52)			(65)
Employee share-based compensation reserve	33			56			43			47
Investment revaluation reserve	34			-			-			97
Designated reserves	28, 35			580			563			552
Retained earnings	37			6,766			6,021			5,241
Shareholders' funds				8,677			8,027			7,294
Total liabilities and equity				47,884			45,332			62,822
Net current assets				6,374			5,710			7,177
Total assets less current liabilities				8,724			8,347			7,602

Approved by the Board of Directors on 2 March 2011

Ronald Joseph ARCULLI
Director

LI Xiaojia, Charles
Director

2. Principal Accounting Policies (continued)

(b) Basis of preparation (continued)

Change in presentation of statements of financial position

In previous years, the Group and HKEx presented current and non-current assets, and current and non-current liabilities, as separate classifications in the statements of financial position. From 2010 onwards, the Group and HKEx decided to present their assets and liabilities in order of liquidity in the statements of financial position as it provides information that better reflects the manner in which the assets and liabilities are managed in the business operations of the Group, particularly following the changes made on adopting HKFRS 9, and is thus more relevant.

The comparative figures have been restated to conform with the revised presentation. There is no financial impact to the Group and HKEx.

Change in units of presentation of accounts

In previous years, the consolidated accounts were presented in Hong Kong dollars (HKD), rounded to the nearest thousand. From 2010 onwards, the Group and HKEx decided to present the consolidated accounts in HKD, rounded to the nearest million, as it simplifies the accounts and provides a better view on material items.

Effects of HKFRSs issued after 31 December 2010 and up to the date of approval of the consolidated accounts

Subsequent to 31 December 2010 and up to the date of approval of these consolidated accounts, the HKICPA has issued certain revised HKFRSs but they are not applicable to the Group's operations.

(c) Consolidation

The consolidated accounts include the accounts of HKEx and all of its subsidiaries made up to 31 December.

Subsidiaries and controlled special purpose entities are entities over which HKEx, directly or indirectly, has the power to govern the financial and operating policies generally accompanying a holding of more than one half of the voting rights or issued share capital.

The accounts of subsidiaries and controlled special purpose entities are included in the consolidated accounts from the date on which control commences until the date that control ceases. The assets and liabilities of the controlled special purpose entity, HKEx Employee Share Trust, are included in HKEx's statement of financial position and the HKEx shares held by the HKEx Employee Share Trust are presented as a deduction in equity as Shares held for Share Award Scheme. All material intra-group transactions and balances have been eliminated on consolidation.

In HKEx's statement of financial position, investments in subsidiaries are stated at cost less provision for any impairment, if necessary. The results of subsidiaries are accounted for by HKEx on the basis of dividends received and receivable.

Illustrative disclosures in respect of

Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*

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Illustrative disclosures in respect of the application of Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*

The following sets out extracts from a set of financial statements for the year ended 31 December 2010 prepared by a fictitious company, XYZ Limited, incorporated in Hong Kong applying Hong Kong Interpretation 5 for the first time and as a result, certain bank borrowings have been reclassified as current liabilities.

[Note: The disclosures are only for illustrative purposes. They should not be considered the only acceptable form of presentation and do not attempt to cater for all entity-specific facts and circumstances. Alternative presentations to those proposed in this publication may also be acceptable.]

XYZ Limited

Statement of financial position at 31 December 2010 (Expressed in Hong Kong dollars)

	Note	As at 31 December 2010	As at 31 December 2009	As at 1 January 2009
		$'000	$'000	$'000
			(restated)	(restated)
ASSETS				
Non-current assets				
Etc.		[•]	[•]	[•]
		[•]	[•]	[•]
Current assets				
Etc.		[•]	[•]	[•]
		[•]	[•]	[•]
Total assets		[•]	[•]	[•]
LIABILITIES AND EQUITY				
Current liabilities				
Trade and other payables		[•]	[•]	[•]
Bank borrowings	20	18,000	13,000	12,000
Current taxation		[•]	[•]	[•]
Provisions		[•]	[•]	[•]
		[•]	[•]	[•]
Non-current liabilities				
Bank borrowings	20	34,000	32,000	29,000
Deferred tax liabilities		[•]	[•]	[•]
Provisions		[•]	[•]	[•]
		[•]	[•]	[•]
Total liabilities		[•]	[•]	[•]
Equity				
Share capital		[•]	[•]	[•]
Reserves		[•]	[•]	[•]
		[•]	[•]	[•]
Total liabilities and equity		[•]	[•]	[•]

Approved and authorized for issue by the Board of Directors on [Date] and are signed on its behalf by:

(Name, Director) (Name, Director)

The notes on pages [X] to [Y] form part of these financial statements.

Note : As required by HKAS 1.10(f), a statement of financial position is presented at the beginning of the earliest comparative period when the entity has applied new accounting policies retrospectively in the year.

Notes to the financial statements
For the year ended 31 December 2010 - continued

Changes in accounting policies

HKAS 8.28

In November 2010 the HKICPA issued Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*. The Interpretation is effective immediately and is a clarification of an existing standard, HKAS 1 *Presentation of Financial Statements*. It sets out the conclusion reached by the HKICPA that a term loan which contains a clause which gives the lender the unconditional right to demand repayment at any time shall be classified as a current liability in accordance with paragraph 69(d) of HKAS 1 irrespective of the probability that the lender will invoke the clause without cause.

In order to comply with the requirements of Hong Kong Interpretation 5, the Company has changed its accounting policy on the classification of term loans that contain a repayment on demand clause. Under the new policy, term loans with clauses which give the lender the unconditional right to call the loan at any time are classified as current liabilities in the statement of financial position. Previously such term loans were classified in accordance with the agreed repayment schedule unless the Company had breached any of the loan covenants set out in the agreement as of the reporting date or otherwise had reason to believe that the lender would invoke its rights under the immediate repayment clause within the foreseeable future.

The new accounting policy has been applied retrospectively by re-presenting the opening balances at 1 January 2009, with consequential reclassification adjustments to comparatives for the year ended 31 December 2009. The reclassification has had no effect on reported profit or loss, total comprehensive income or equity for any period presented.

Effect of adoption of Hong Kong Interpretation 5 on the statement of financial position

	At 31 December 2010	*At 31 December 2009*	*At 1 January 2009*
	$'000	$'000	$'000
Increase/(decrease) in			
Current liabilities			
Bank borrowings	3,500	4,000	5,000
Non-current liabilities			
Bank borrowings	(3,500)	(4,000)	(5,000)

Notes to the financial statements
For the year ended 31 December 2010 – continued

9. Finance costs

10th Sch (13(1)(b))

	2010	*2009*
	$'000	$'000
Interest on bank borrowings		
- Wholly repayable within five years	3,352	2,788
- Not wholly repayable within five years	184	137
Total finance costs	3,536	2,925

The analysis shows the finance costs of bank borrowings, including term loans which contain a repayment on demand clause, in accordance with the agreed scheduled repayments dates set out in the loan agreements. For the years ended 31 December 2010 and 2009, the interest on bank borrowings which contain a repayment on demand clause amounted to HK$184,000 and HK$137,000 respectively.

[Note: It is acceptable to classify the interest on the bank loans with instalments which fall due after more than five years, but are subject to a repayment on demand clause, either as "wholly repayable within five years" or "not wholly repayable within five years", provided that the approach adopted is applied in a consistent manner and it is clear from the note which approach has been taken.]

Notes to the financial statements
For the year ended 31 December 2010 – continued

20. Bank borrowings

HKFRS 7.7

The analysis of the carrying amount of bank borrowings is as follows:

	2010 $'000	*2009* $'000 (restated)	*1 January 2009* $'000 (restated)
Current liabilities			
Bank overdrafts	1,300	700	800
Portion of term loans from banks due for repayment within one year	8,000	8,200	5,800
Portion of term loans from banks due for repayment after one year which contain a repayment on demand clause	8,700	4,100	5,400
	18,000	13,000	12,000
Non-current liabilities			
Bank loans	34,000	32,000	29,000

HKFRS 7.31

Bank borrowings bear average coupons of [x]% annually (2009:[y]% annually)

HKFRS 7.8(f) & HKAS 1.61

The interest-bearing bank borrowings, including the term loans repayable on demand, are carried at amortised cost. None of the portion of term loans due for repayment after one year which contain a repayment on demand clause and that is classified as a current liability is expected to be settled within one year.

Notes to the financial statements
For the year ended 31 December 2010 – continued

HKFRS 7.7 & 31

20. Bank borrowings (continued)

A16(22)(1)

At 31 December 2010, interest-bearing bank loans and overdrafts were due for repayment as follows:

	2010 $'000	*2009* $'000
Overdrafts repayable on demand	1,300	700
Portion of term loans due for repayment within one year	8,000	8,200
	9,300	8,900
Term loans due for repayment after one year (Note 1):		
After 1 year but within 2 years	10,000	9,000
After 2 years but within 5 years	30,000	25,000
After 5 years	2,700	2,100
	42,700	36,100
	52,000	45,000

Note 1 - The amounts due are based on the scheduled repayment dates set out in the loan agreements and ignore the effect of any repayment on demand clause.

10th Sch (10)

At 31 December 2010, the bank loans and overdrafts were secured as follows:

	2010 $'000	*2009* $'000
Unsecured bank overdrafts	1,300	700
Bank loans		
- secured	17,000	15,000
- unsecured	33,700	29,300
	52,000	45,000

10th Sch (12(4))
HKAS 16.74(a)

[*details of security given*]

HKFRS 7.25

[*details of fair value of current and non-current bank borrowings*]

All of the banking facilities are subject to the fulfilment of covenants relating to certain of the Company's balance sheet ratios, as are commonly found in lending arrangements with financial institutions. If the company was to breach the covenants the drawn down facilities would become repayable on demand. In addition, certain of the Company's term loan agreements contain clauses which give the lender the right at its sole discretion to demand immediate repayment at any time irrespective of whether the Company has complied with the covenants and met the scheduled repayment obligations.

The Company regularly monitors its compliance with these covenants, is up to date with the scheduled repayments of the term loans and does not consider it probable that the bank will exercise its discretion to demand repayment for so long as the Company continues to meet these requirements. Further details of the Company's management of liquidity risk are set out in note 35(b). As at 31 December 2010 none of the covenants relating to drawn down facilities had been breached (2009: $nil).

Notes to the financial statements
For the year ended 31 December 2010 – continued

35. Financial risk management

(a) Credit risk

Etc.

(b) Liquidity risk

HKFRS 7.31-35 & 39(c)

The Company's policy is to regularly monitor its liquidity requirements, its compliance with lending covenants and its relationship with its bankers to ensure that it maintains sufficient reserves of cash and readily realisable marketable securities and adequate committed lines of funding from major financial institutions to meet its liquidity requirements in the short and longer term.

HKFRS 7.39(a)

The following tables show the remaining contractual maturities at the end of the reporting period of the Company's bank borrowings, based on undiscounted cash flows (including interest payments computed using contractual rates or, if floating, based on rates current at the balance sheet date) and the earliest date the Company can be required to pay.

Specifically, for term loans which contain a repayment on demand clause which can be exercised at the bank's sole discretion, the analysis shows the cash outflow based on the earliest period in which the entity can be required to pay, that is if the lenders were to invoke their unconditional rights to call the loans with immediate effect. The maturity analysis for other bank borrowings is prepared based on the scheduled repayment dates.

HKFRS 7.B11C(a)

	2010 Maturity Analysis - Undiscounted cash outflows					
	On demand $'000	*Within 1 year* $'000	*More than 1 year but less than 2 years* $'000	*More than 2 years but less than 5 years* $'000	*More than 5 years* $'000	***Total undiscounted cash outflows*** $'000
Bank overdrafts	1,300	-	-	-	-	1,300
Term loans subject to a repayment on demand clause	9,920	-	-	-	-	9,920
Other bank loans	-	7,300	9,259	29,885	-	46,444
	11,220	7,300	9,259	29,885	-	57,664

	2009 (restated) Maturity Analysis - Undiscounted cash outflows					
	On demand $'000	*Within 1 year* $'000	*More than 1 year but less than 2 years* $'000	*More than 2 years but less than 5 years* $'000	*More than 5 years* $'000	***Total undiscounted cash outflows*** $'000
Bank overdrafts	700	-	-	-	-	700
Term loans subject to a repayment on demand clause	4,715	-	-	-	-	4,715
Other bank loans	-	8,241	8,865	27,610	-	44,716
	5,415	8,241	8,865	27,610	-	50,131

Notes to the financial statements
For the year ended 31 December 2010 – continued

35. Financial risk management (continued)

(b) Liquidity risk (continued)

The table that follows summarises the maturity analysis of term loans with a repayment on demand clause based on agreed scheduled repayments set out in the loan agreements. The amounts include interest payments computed using contractual rates. As a result, these amounts were greater than the amounts disclosed in the "on demand" time band in the maturity analysis contained in page 6. Taking into account the Company's financial position, the directors do not consider that it is probable that the bank will exercise its discretion to demand immediate repayment. The directors believe that such term loans will be repaid in accordance with the scheduled repayment dates set out in the loan agreements.

	Maturity Analysis - Term loans subject to a repayment on demand clause based on scheduled repayments					
	On demand	*Within 1 year*	*More than 1 year but less than 2 years*	*More than 2 years but less than 5 years*	*More than 5 years*	***Total undiscounted cash outflows***
	$'000	$'000	$'000	$'000	$'000	$'000
31 December 2010	-	1,275	1,594	4,970	3,687	11,526
31 December 2009	-	642	754	2,291	2,643	6,330

Part I: Illustrative presentation of financial statements

Examples of statement of profit or loss and other comprehensive income when IAS 39 *Financial Instruments: Recognition and Measurement* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

	20X7	**20X6**
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates[(a)]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[(c)]	400	(700)
Income tax relating to items that will not be reclassified[(d)]	(166)	(1,000)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations[(b)]	5,334	10,667
Available-for-sale financial assets[(b)]	(24,000)	26,667
Cash flow hedges[(b)]	(667)	(4,000)
Income tax relating to items that may be reclassified[(d)]	4,833	(8,334)
	(14,500)	25,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500

continued...

...continued

Examples of statement of profit or loss and other comprehensive income when IAS 39 *Financial Instruments: Recognition and Measurement* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

Other comprehensive income for the year, after tax:	**20X7**	**20X6**
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	600	2,700
Actuarial gains (losses) on defined benefit pension plans	(500)	1,000
Share of gain (loss) on property revaluation of associates	400	(700)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	4,000	8,000
Available-for-sale financial assets	(18,000)	20,000
Cash flow hedges	(500)	(3,000)
	(14,500)	25,000
Other comprehensive income for the year, net of tax[d]	(14,000)	28,000

(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(b) This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

(c) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(d) The income tax relating to each item of other comprehensive income is disclosed in the notes.

XYZ Group – Statement of profit or loss for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements and the classification of expenses within profit or loss by nature)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Other income	20,667	11,300
Changes in inventories of finished goods and work in progress	(115,100)	(107,900)
Work performed by the entity and capitalised	16,000	15,000
Raw material and consumables used	(96,000)	(92,000)
Employee benefits expense	(45,000)	(43,000)
Depreciation and amortisation expense	(19,000)	(17,000)
Impairment of property, plant and equipment	(4,000)	–
Other expenses	(6,000)	(5,500)
Finance costs	(15,000)	(18,000)
Share of profit of associates[(e)]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

(e) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements)

(in thousands of currency units)

	20X7	20X6
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[f]	400	(700)
Income tax relating to items that will not be reclassified[g]	(166)	(1,000)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	5,334	10,667
Available-for-sale financial assets	(24,000)	26,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified[g]	4,833	(8,334)
	(14,500)	25,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500

Alternatively, items of other comprehensive income could be presented, net of tax. Refer to the statement of profit or loss and other comprehensive income illustrating the presentation of income and expenses in one statement.

(f) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(g) The income tax relating to each item of other comprehensive income is disclosed in the notes.

Examples of statement of profit or loss and other comprehensive income when IFRS 9 *Financial Instruments* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates[a]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments[b]	(24,000)	26,667
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[c]	400	(700)
Income tax relating to items that will not be reclassified[d]	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations[b]	5,334	10,667
Cash flow hedges[b]	(667)	(4,000)
Income tax relating to items that may be reclassified[d]	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500

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Examples of statement of profit or loss and other comprehensive income when IFRS 9 *Financial Instruments* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

Profit attributable to:		
Owners of the parent	97,000	52,400
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Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

Other comprehensive income for the year, after tax:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	600	2,700
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Actuarial gains (losses) on defined benefit pension plans	(500)	1,000
Share of gain (loss) on property revaluation of associates	400	(700)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	4,000	8,000
Cash flow hedges	(500)	(3,000)
	3,500	5,000
Other comprehensive income for the year, net of tax[d]	(14,000)	28,000

(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(b) This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

(c) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(d) The income tax relating to each item of other comprehensive income is disclosed in the notes.

XYZ Group – Statement of profit or loss for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements and the classification of expenses within profit or loss by nature)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Other income	20,667	11,300
Changes in inventories of finished goods and work in progress	(115,100)	(107,900)
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Employee benefits expense	(45,000)	(43,000)
Depreciation and amortisation expense	(19,000)	(17,000)
Impairment of property, plant and equipment	(4,000)	–
Other expenses	(6,000)	(5,500)
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Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

(e) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements)

(in thousands of currency units)

	20X7	20X6
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
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Share of gain (loss) on property revaluation of associates[f]	400	(700)
Income tax relating to items that will not be reclassified[g]	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified[g]	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500

Alternatively, items of other comprehensive income could be presented, net of tax. Refer to the statement of profit or loss and other comprehensive income illustrating the presentation of income and expenses in one statement.

(f) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(g) The income tax relating to each item of other comprehensive income is disclosed in the notes.

Appendix 4

Welcome to the website of the IFRS Foundation and the IASB

Paul Pacter: Improving disclosures about intercompany investments

12 March 2012

In May 2011 the IASB issued IFRS 12 *Disclosure of Interests in Other Entities* as part of a suite of new standards that address intercompany investments. IFRS 12 contains the note disclosures that companies must make about their interests in subsidiaries, joint arrangements (eg joint ventures), associates and unconsolidated structured entities. It takes effect from 1 January 2013, although companies may elect to apply it earlier.

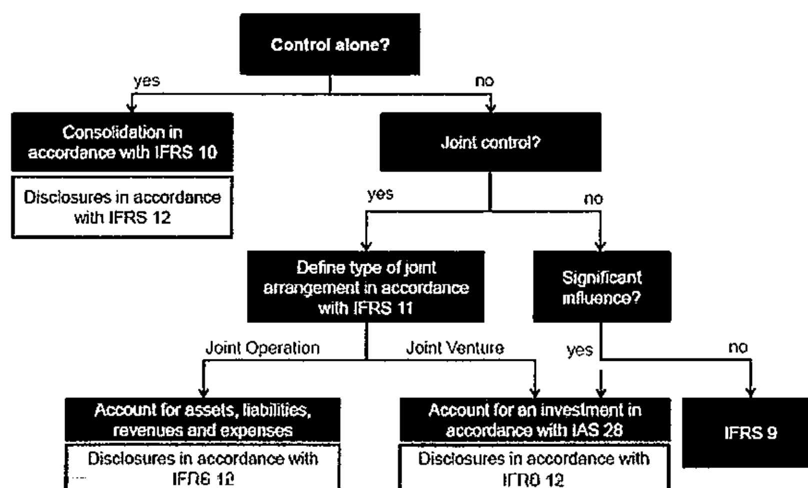
IFRS 12 requires four broad categories of disclosures—namely, information about:

1. **the significant judgements and assumptions** a company has made in deciding whether it has control, joint control or significant influence over another entity;
2. a company's interests in **subsidiaries**;
3. a company's interests in **joint arrangements and associates**; and
4. the nature, extent, and risks relating to a company's interests in **unconsolidated structured entities**.

From an investor's perspective, this fourth category is probably IFRS 12's biggest disclosure enhancement. Information about unconsolidated structured entities was not explicitly required before, and was largely unavailable in financial statements prepared in accordance with earlier IFRSs.

IFRS 12 was part of a suite of three new standards, issued concurrently, that address intercompany investments. The other two were IFRS 10 *Consolidated Financial Statements* and IFRS 11 *Joint Arrangements*. The existing standards that cover the accounting for investments in associates and passive investments of less than 20 per cent were largely unaffected. **Click here** to see more information on those standards.

The following diagram illustrates the interaction between the IFRSs that cover investments in other entities:



Objective of IFRS 12

The objective of IFRS 12 is to require the disclosure of information that enables users of a company's financial statements to evaluate:

- the nature of a company's interests in subsidiaries, joint arrangements, associates, and unconsolidated structured entities;
- the risks associated with those interests; and
- the effects of those interests on its financial position, financial performance and cash flows.

Most often, a company's interest in another entity is evidenced by holding equity or debt instruments. But that is not always the case. Such interests also include other forms of involvement, for example, providing funding, liquidity support, credit enhancements and guarantees. The IFRS 12 disclosures apply to all of those involvements.

Before looking more closely at the specific requirements of IFRS 12, there is an important point to bear in mind. The IFRS 12 disclosures are a **minimum.** Each entity is required to assess whether the disclosures required by IFRS 12 and other IFRSs, taken together, provide sufficient information to evaluate the nature, risks and effects of the company's interests in other entities. If the conclusion from that assessment is that further disclosures are needed, a company must present them to comply with IFRS 12.

Figure 1 below summarises the minimum required descriptive disclosures and **Figure 2** summarises the minimum required financial information.

Significant judgements and assumptions

IFRS 12 requires a company to disclose the significant judgements and assumptions made in deciding whether it has control, joint control or significant influence over another entity.

In deciding whether one entity controls another, IFRS 10 requires the company to assess whether it currently has the power to direct the activities of the other entity for its own benefit. If it does have that power, it must prepare consolidated financial statements, even if the company has less than a 50 per cent voting interest. Similarly, a company must consider any substantive **potential** voting rights that it holds (via options, warrants, contingent issuance agreements and the like) in deciding whether it has 'de facto control' over another entity. Clearly, those assessments involve judgements, and IFRS 12 requires companies to disclose those judgements and related assumptions.

Likewise, disclosure would be required if a company concludes that it should not consolidate another entity because it is acting as an agent of another party rather than on its own behalf (for example, a company that manages an investment fund by contract).

IFRS 12 also covers disclosures about investments in joint arrangements. If a company is a party to a joint arrangement, IFRS 11 requires the company to determine whether the investee is a joint venture (in which case the equity method set out in IAS 28 *Investments in Associates* applies) or a joint operation (in which case IFRS 11 requires the investor to account for its share of the various assets, liabilities, revenue and expenses of the joint operation). IFRS 12 requires companies to explain the basis on which they made the joint venture versus joint operation decision.

Information about a company's interests in subsidiaries

For subsidiaries, the objective is to disclose information that enables users of a company's consolidated financial statements to understand and evaluate:

- the composition of the group;
- the interest that non-controlling interests have in the group's activities and cash flows;
- the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
- the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
- the consequences of changes in its ownership interest in a subsidiary that do not result in loss of control; and
- the consequences of losing control of a subsidiary during the reporting period.

Information about a company's interests in joint arrangements and associates

For joint arrangements and associates, the objective is to disclose information that enables users of a company's financial statements to evaluate:

- the nature, extent, and financial effects of its interests in joint arrangements and associates, including details of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates.
- the risks associated with its interests in joint ventures and associates.

Figure 1 – Required descriptive and other disclosures

	Subsidiary that is wholly owned	Subsidiary that is less than wholly owned	Joint operation	Joint venture	Associate

Name of subsidiary, joint arrangement, or associate		✓	✓	✓	✓
Nature of relationship			✓	✓	✓
Principal place of business and country of incorporation		✓	✓	✓	✓
Proportion of ownership and voting rights held by non-controlling interest (NCI)		✓			
Method of accounting (equity method or fair value)				✓	✓
Fair value, if equity method is used and investee is quoted				✓	✓
Profit or loss allocated to NCI		✓			
Accumulated NCI		✓			
Unrecognised losses for equity method investments				✓	✓
Restrictions on access to a subsidiary's assets	✓	✓			
Risks associated with consolidated structured entities	✓	✓			
Changes in ownership interest that do not result in loss of control	✓	✓			
Consequences of losing control in the period	✓	✓			
Dividends paid to NCI		✓			
Dividends received				✓	✓
Different reporting date of investor and investee	✓	✓		✓	✓
Commitments				✓	✓
Contingent liabilities				✓	✓

Figure 2 – Required summarised financial information

	Subsidiary that is wholly owned	Subsidiary that is less than wholly owned	Joint operation	Joint venture	Associate
Current assets		✓		✓	✓
Cash and cash equivalents included in current assets				✓	
Non-current assets		✓		✓	✓
Current liabilities		✓		✓	✓
Current financial liabilities included in				✓	

current liabilities (excluding payables and provisions)					
Non-current liabilities		✓		✓	✓
Non-current financial liabilities included in non-current liabilities (excluding payables and provisions)				✓	
Revenue		✓		✓	✓
Depreciation and amortisation				✓	
Interest income				✓	
Interest expense				✓	
Income tax expense or income				✓	
Profit or loss from continuing operations				✓	✓
Post-tax profit or loss from discontinued operations				✓	✓
Profit or loss		✓			
Other comprehensive income				✓	✓
Total comprehensive income		✓		✓	✓

Information about a company's interests in unconsolidated structured entities

The disclosures that IFRS 12 requires about unconsolidated (ie off-balance-sheet) structured entities are all new. Our previous standards had nothing similar. The objective here is to ensure that users of financial statements are able to:

- understand the nature and extent of a company's interests in unconsolidated structured entities; and
- evaluate the risks associated with those interests.

To meet the first objective, a company would disclose (among other things) the nature, purpose, size and activities of the structured entity and how those activities are financed. Even if a company no longer has an interest in an unconsolidated structured entity at the reporting date, some disclosures will be required if the company set up and sponsored the structured entity in the first place.

To meet the second objective, a company would present a tabular (or other) summary that includes:

- the carrying amounts (and line items) of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities.
- the company's estimate of its maximum exposure to losses from those interests, and how that estimate was made. If the company cannot quantify its maximum exposure to loss from unconsolidated structured entities, it must disclose that fact and the reasons.

If, during the reporting period, a company has voluntarily provided financial or other support to an unconsolidated structured entity in which it previously had, or currently has, an interest (for example, by purchasing assets of or instruments issued by the structured entity), it must disclose the type, amount, and reasons for that support.

Additionally, if a company intends to provide financial or other support to an unconsolidated structured entity, or to assist that structured entity in obtaining financial support, it must disclose that fact.

Related disclosures in other IFRSs

Companies also need to provide other disclosures about interests in other entities. For example, parents and subsidiaries are related parties under IAS 24 *Related Party Disclosures*, as are investors and their associates and joint ventures. IAS 24 requires disclosures about related party transactions and also about relationships between a parent and its subsidiaries, even if there are no transactions between them. In addition, IFRS 7 *Financial Instruments: Disclosures* requires various disclosures about the nature and extent of risks arising from financial instruments.

Respond to the author

Paul Pacter is a member of the IASB and a guest author of *Investor Perspectives*. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB/IFRS Foundation. The IASB/IFRS Foundation disclaims any and all responsibility.

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Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

4. Critical accounting judgements and key sources of estimation uncertainty

Note: HKFRS 12.7 requires entities to disclose information about significant judgements and assumptions they have made in determining (i) whether they have control of another entity, (ii) whether they have joint control of an arrangement or significant influence over another entity, and (iii) the type of arrangement when the arrangement has been structured through a separate vehicle.

Critical judgements in applying accounting policies

The following are the critical judgements, apart from those involving estimations (see below), that the directors have made in the process of applying the Group's accounting policies and that have the most significant effect on the amounts recognised in the consolidated financial statements.

HKFRS 12.7(a)
HKFRS 12.9(b)

Control over C Plus Limited

Note 59 describes that C Plus Limited is a subsidiary of the Group although the Group has only 45 per cent ownership interest and voting rights in C Plus Limited. C Plus Limited is listed on the stock exchange of C Land. The Group has the 45 per cent ownership since June 2009 and the remaining 55 per cent of shareholdings are owned by thousands of shareholders that are unrelated to the Group. Details of C Plus Limited are set out in note 59.

The directors assessed whether or not the Group has control over C Plus Limited based on whether the Group has the practical ability to direct the relevant activities of C Plus Limited unilaterally. In making their judgement, the directors considered the Group's absolute size of holding in C Plus Limited and the relative size of and dispersion of the shareholdings owned by the other shareholders. After assessment, the directors concluded that the Group has sufficiently dominant voting interest to direct the relevant activities of C Plus Limited and therefore the Group has control over C Plus Limited.

HKFRS 12.7(b)
HKFRS 12.9(e)

Significant influence over A Plus Limited

Note 24 describes that A Plus Limited is an associate of the Group although the Group only owns 17% ownership interest in A Plus Limited. The Group has significant influence over A Plus Limited by virtue of the contractual right to appoint two out of the six directors to the board of directors of that company.

17. Earnings per share

Impact of changes in accounting policies

HKAS 8.28(f)(ii)

Changes in the Group's accounting policies during the year are described in detail in note 2. To the extent that those changes have had an impact on results reported for 2011 and 2010, they have had an impact on the amounts reported for earnings per share.

The following table summarises that effect on both basic and diluted earnings per share.

	Increase (decrease) in profit for the year attributable to the owners of the Company		Increase (decrease) in basic earnings per share		Increase (decrease) in diluted earnings per share	
	Year ended 31/12/11	Year ended 31/12/10	Year ended 31/12/11	Year ended 31/12/10	Year ended 31/12/11	Year ended 31/12/10
	HK$'000	HK$'000	Cents per share	Cents per share	Cents per share	Cents per share
Changes in accounting policies relating to:						
- Application of HKFRS 10 (see note 2)	-	-	-	-	-	-
- Application of HKFRS 11 (see note 2)	-	-	-	-	-	-
- Others (please specify)	-	-	-	-	-	-
	-	-	-	-	-	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

24. Investments in associates

Details of the Group's investments in associates are as follows:

	31/12/11	31/12/10
	HK$'000	HK$'000
Cost of investments in associates		
Listed in Hong Kong	-	-
Listed outside Hong Kong	-	-
Unlisted	2,624	2,824
Share of post-acquisition profits and other comprehensive income, net of dividends received	2,695	2,766
	5,319	5,590

HKFRS 12.21(a)

Details of each of the Group's material associates at the end of the reporting period are as follow:

Name of entity	Form of entity	Place of incorporation	Principal place of operation	Class of shares held	Proportion of nominal value of issued capital held by the Group	Proportion of voting power held	Principal activities
A Plus Limited	Incorporated	A Land	A Land	Ordinary	17%	17% (Note 1)	Transport
B Plus Limited	Incorporated	B Land	B Land	Ordinary	56%	56% (Note 2)	Finance

Note: To illustrate the disclosure requirements of HKFRS 12, it is assumed that the Group only has two material associates, A Plus Limited and B Plus Limited.

Notes:

HKFRS 12.9(e)

1) The Group is able to exercise significant influence over A Plus Limited because it has the power to appoint two out of the six directors of that company under the Articles of Association of that company.

HKFRS 12.9(d)

2) The Group holds 56% of the issued share capital of B Plus Limited. However, under a shareholders' agreement, the other shareholder controls the composition of the board of directors of B Plus Limited and therefore the Group does not control B Plus Limited. The directors of the Company consider that the Group does have significant influence over B Plus Limited and it is therefore classified as an associate of the Group.

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

24.1 Summarised financial information of material associates

HKFRS 12.B14

Summarised financial information in respect of each of the Group's material associates is set out below. The summarised financial information below represents amounts shown in the associate's financial statements prepared in accordance with HKFRSs [adjusted by the Group for equity accounting purposes].

HKFRS 12.21(b)(i)

All of these associates are accounted for using the equity method in these consolidated financial statements.

HKFRS 12.21(b)(ii)
HKFRS 12.B12
HKFRS 12.B14

A Plus Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	19,151	18,442
Non-current assets	18,460	17,221
Current liabilities	(15,981)	(14,220)
Non-current liabilities	(6,206)	(8,290)

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	5,790	5,890
Profit or loss from continuing operations	2,271	2,262
Post-tax profit (loss) from discontinued operations	-	-
Profit (loss) for the year	2,271	2,262
Other comprehensive income for the year	-	-
Total comprehensive income for the year	2,271	2,262
Dividends received from the associate during the year	-	-

HKFRS 12.B14(b)

Reconciliation of the above summarised financial information to the carrying amount of the interest in the associate recognised in the consolidated financial statements:

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the associate	15,424	13,153
Proportion of the Group's ownership interest in the associate	17%	17%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the associate	2,622	2,236

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

HKFRS 12.21(b)(ii)
HKFRS 12.B12
HKFRS 12.B14

B Plus Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	7,570	7,269
Non-current assets	4,574	3,579
Current liabilities	(3,562)	(3,061)
Non-current liabilities	(4,228)	(4,216)

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	2,554	2,560
Profit or loss from continuing operations	783	833
Post-tax profit (loss) from discontinued operations	-	-
Profit (loss) for the year	783	833
Other comprehensive income for the year	-	-
Total comprehensive income for the year	783	833
Dividends received from the associate during the year	30	22

HKFRS 12.B14(b)

Reconciliation of the above summarised financial information to the carrying amount of the interest in the associate recognised in the consolidated financial statements:

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the associate	4,354	3,571
Proportion of the Group's ownership interest in the associate	56%	56%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the associate	2,438	2,000

HKFRS 12.21(c)(ii)
HKFRS 12.B16

Aggregate information of associates that are not individually material	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The Group's share of profit (loss) from continuing operations	42	358
The Group's share of post-tax profit (loss) from discontinued operations	-	-
The Group's share of other comprehensive income	-	-
The Group's share of total comprehensive income	42	358

HKFRS 12.22(c)

Unrecognised share of losses of an associate	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The unrecognised share of loss of an associate for the year	-	-

	31/12/11 HK$'000	31/12/10 HK$'000
Cumulative share of loss of an associate	-	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

24.2 Change in ownership interest in an associate

HKAS 28.25

In December 2011, the Group disposed of a 30% interest in E Plus Limited to a third party for proceeds of HK$1.245 million (received in January 2012). The Group has retained the remaining 10% interest as an available-for-sale investment whose fair value at the date of disposal was HK$360,000, that is determined using a discounted cash flow model (please describe key factors and assumptions used in determining the fair value). Prior to the disposal, the Group held a 40% interest in E Plus Limited and accounted for the investment as an associate. This transaction has resulted in the recognition of a gain in profit or loss, calculated as follows.

	HK$'000
Proceeds of disposal	1,245
Plus: fair value of investment retained (10%)	360
Less: carrying amount of investment on the date of loss of significant influence	(1,024)
Gain recognised	581

The gain recognised in the current year comprises a realised profit of HK$477,000 (being the proceeds of HK$1.245 million less HK$768,000 carrying amount of the interest disposed of) and an unrealised profit of HK$104,000 (being the fair value less the carrying amount of the 10% interest retained). A current tax expense of HK$143,000 arose on the gain realised in the current year, and a deferred tax expense of HK$32,000 has been recognised in respect of the portion of the profit recognised that is not taxable until the remaining interest is disposed of.

24.3 Significant restriction

HKFRS 12.22(a)

[When there are significant restrictions on the ability of associates to transfer funds to the Group in form of cash dividends, or to repay loans or advances made by the Group, the Group should disclose the nature and extent of significant restrictions in the financial statements. Please see HKFRS 12.22(a) for details.]

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

25. Investments in joint ventures

Details of the Group's investments in joint ventures are as follows:

	31/12/11	31/12/10
	HK$'000	HK$'000
Cost of investments in joint ventures		
Listed in Hong Kong	-	-
Listed outside Hong Kong	-	-
Unlisted	1,820	1,820
Share of post-acquisition profits and other comprehensive income, net of dividends received	2,179	1,842
	3,999	3,662

Note: Similar to the disclosures applicable to associates, HKFRS 12 requires the following information to be disclosed for each of the Group's material joint ventures. In this model, the Group only have two joint ventures, A JV Limited and B JV Limited, and for illustrative purposes, both entities are assumed to be material to the Group.

HKFRS 12.21(a) Details of the Group's material joint ventures at the end of the reporting period is as follows:

Name of entity	Form of entity	Place of incorporation	Principal place of operation	Class of shares held	Proportion of nominal value of issued capital held by the Group	Proportion of voting power held	Principal activities
A JV Limited	Incorporated	Hong Kong	Hong Kong	Ordinary	25%	25%	Manufacture of electronic equipment
B JV Limited	Incorporated	Hong Kong	Hong Kong	Ordinary	40%	40%	Manufacture of electronic equipment

25.1 Summarised financial information of material joint ventures

HKFRS 12.B14 Summarised financial information in respect of the Group's material joint ventures is set out below. The summarised financial information below represents amounts shown in the joint ventures' financial statements prepared in accordance with HKFRSs [adjusted by the Group for equity accounting purposes].

HKFRS 12.21(b)(i) The joint ventures are accounted for using the equity method in these consolidated financial statements.

HKFRS 12.21(b)(ii)
HKFRS 12.B12
HKFRS 12.B14

A JV Limited	31/12/11	31/12/10
	HK$'000	HK$'000
Current assets	5,454	7,073
Non-current assets	23,887	20,769
Current liabilities	(2,836)	(3,046)
Non-current liabilities	(13,721)	(13,033)

HKFRS 12.B13

The above amounts of assets and liabilities include the following:		
Cash and cash equivalents	-	-
Current financial liabilities (excluding trade and other payables and provisions)	-	-
Non-current financial liabilities (excluding trade and other payables and provisions)	(13,721)	(13,033)

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
HKFRS 12.B12	Revenue	6,436	6,076
	Profit or loss from continuing operations	1,021	733
	Post-tax profit (loss) from discontinued operations	-	-
	Profit (loss) for the year	1,021	733
	Other comprehensive income for the year	-	-
	Total comprehensive income for the year	1,021	733
	Dividends received from the joint venture during the year	-	-

HKFRS 12.B13 The above profit (loss) for the year include the following:

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Depreciation and amortisation	200	180
Interest income	-	-
Interest expense	56	48
Income tax expense	-	-

HKFRS 12.B14(b) Reconciliation of the above summarised financial information to the carrying amount of the interest in the joint venture recognised in the consolidated financial statements:

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the joint venture	12,784	11,763
Proportion of the Group's ownership interest in the joint venture	25%	25%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the joint venture	3,196	2,941

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

HKFRS 12.21(b)(ii)
HKFRS 12.B12
HKFRS 12.B14

B JV Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	1,091	1,414
Non-current assets	7,344	4,154
Current liabilities	(568)	(609)
Non-current liabilities	(5,861)	(3,157)

HKFRS 12.B13

The above amounts of assets and liabilities include the following:		
Cash and cash equivalents	-	-
Current financial liabilities (excluding trade and other payables and provisions)	-	-
Non-current financial liabilities (excluding trade and other payables and provisions)	(5,861)	(3,157)

HKFRS 12.B12

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	1,288	1,215
Profit or loss from continuing operations	204	147
Post-tax profit (loss) from discontinued operations	-	-
Profit (loss) for the year	204	147
Other comprehensive income for the year	-	-
Total comprehensive income for the year	204	147
Dividends received from the joint venture during the year	-	-

HKFRS 12.B13

The above profit (loss) for the year include the following:

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Depreciation and amortisation	36	33
Interest income	-	-
Interest expense	5	8
Income tax expense	-	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

HKFRS 12.B14(b)

Reconciliation of the above summarised financial information to the carrying amount of the interest in the joint venture recognised in the consolidated financial statements:

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the joint venture	2,006	1,802
Proportion of the Group's ownership interest in the joint venture	40%	40%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the joint venture	803	721
The Group's share of profit (loss) from continuing operations	-	-
The Group's share of post-tax profit (loss) from discontinued operations	-	-
The Group's share of other comprehensive income	-	-
The Group's share of total comprehensive income	-	-

HKFRS 12.21(c)(i)
HKFRS 12.B16

Aggregate information of joint ventures that are not individually material	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The Group's share of profit (loss) from continuing operations	-	-
The Group's share of post-tax profit (loss) from discontinued operations	-	-
The Group's share of other comprehensive income	-	-
The Group's share of total comprehensive income	-	-

HKFRS 12.22(c)

Unrecognised share of losses of a joint venture	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The unrecognised share of loss of a joint venture for the year	-	-

	31/12/11 HK$'000	31/12/10 HK$'000
Cumulative share of loss of a joint venture	-	-

25.2 Significant restriction

HKFRS 12.22(a)

[When there are significant restrictions on the ability of joint ventures to transfer funds to the Group in form of cash dividends, or to repay loans or advances made by the Group, the Group should disclose the nature and extent of significant restrictions in the financial statements. Please see HKFRS 12.22(a) for details.]

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

51. Disposal of a subsidiary

On 30 November 2011, the Group disposed of Subzero Limited which carried out its entire toy manufacturing operations.

Consideration received

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
HKAS 7.40(b)	Consideration received in cash and cash equivalents	7,854	-
	Deferred sales proceeds (note 30)	960	-
HKAS 7.40(a)	Total consideration received	8,814	-

HKAS 7.40(d) ***Analysis of asset and liabilities over which control was lost***

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Current assets		
Cash and cash equivalents	288	-
Trade receivables	1,034	-
Inventories	2,716	-
Non-current assets		
Property, plant and equipment	5,662	-
Goodwill	3,080	-
Current liabilities		
Payables	(973)	-
Non-current liabilities		
Borrowings	(4,342)	-
Deferred tax liabilities	(471)	-
Net assets disposed of	6,994	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

Gain on disposal of subsidiary

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
	Consideration received	8,814	-
	Net assets disposed of	(6,994)	
	Non-controlling interests	-	-
	Cumulative gain/loss on available-for-sale financial assets reclassified from equity on loss of control of subsidiary	-	-
	Cumulative exchange gain in respect of the net assets of the subsidiary and related hedging instruments reclassified from equity to profit or loss on loss of control of subsidiary	120	-
HKFRS 12.19	Gain on disposal	1,940	-

HKFRS 12.19(b) — The gain on disposal is included in the profit for the year from discontinued operations in the consolidated [statement of comprehensive income/income statement] (see note 11).

Net cash inflow on disposal of subsidiary

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
	Consideration received in cash and cash equivalents	7,854	-
HKAS 7.40(c)	Less: cash and cash equivalent balances disposed of	(288)	-
		7,566	-

55. Commitments

HKFRS 12.23(a)
HKFRS 12.B18 - B19

The Group's commitments, including its share of commitments made jointly with other joint venturers relating to its joint venture, A JV Limited, is as follows:

	31/12/11 HK$'000	31/12/10 HK$'000
Commitments to contribute funds for the acquisition of property, plant and equipment	983	192
Commitments to provide loans	-	-
Commitments to acquire other venturer's ownership interest when a particular event occurs or does not occur in the future (please specify what the particular event is)	-	-
Others (please specify)	-	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

57. Contingent liabilities and contingent assets

Source		31/12/11	31/12/10
	Contingent liabilities	HK$'000	HK$'000
HKFRS 12.23(b)	Contingent liabilities incurred by the Group arising from its interests in a joint venture (i)	110	116
HKFRS 12.23(b)	Contingent liabilities incurred by the Group arising from its interests in associates (please disclose the details)	-	-
HKFRS 12.23(b)	Group's share of associates' contingent liabilities (ii)	150	14
HKFRS 12.23(b)	Group's share of joint venture's contingent liabilities (please specify the details)	-	-

(i) A number of contingent liabilities have arisen as a result of the Group's interests in joint ventures. The amount disclosed represents the aggregate amount of such contingent liabilities for which the Group as an investor is liable. The extent to which an outflow of funds will be required is dependent on the future operations of the joint ventures being more or less favourable than currently expected. The Group is not contingently liable for the liabilities of other venturers in its joint ventures.

(ii) The amount disclosed represents the Group's share of contingent liabilities of associates. The extent to which an outflow of funds will be required is dependent on the future operations of the associates being more or less favourable than currently expected.

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

59. Subsidiaries

59.1 General information of subsidiaries

HKFRS 12.10(a)

Details of the Group's material subsidiaries at the end of the reporting period are set out below.

Name of subsidiary	Place of incorporation / registration / operations	Class of shares held	Paid up registered capital	Proportion ownership interest held by the Company				Proportion of voting power held		Principal activity
				Directly		Indirectly				
				2011	2010	2011	2010	2011	2010	
				%	%	%	%	%	%	
Subzero Limited	Hong Kong	Ordinary	HK$50,000,000	-	-	-	100	-	100	Manufacture of toy
Subone Limited	Hong Kong	Ordinary	HK$1,000	-	-	90	100	90	100	Manufacture of electronic equipment
Subtwo Limited	PRC	Registered	RMB5,000,000	-	-	100	100	100	100	Construction of residential properties
Subthree Limited	Malaysia	Ordinary	RMB10,000,000	-	-	70	70	70	70	Manufacture of leisure good
Subfour Limited	PRC	Registered	USD100	100	100	-	-	100	100	Manufacture of electronic equipment
Subfive Limited	PRC	Registered	USD5,000	100	100	-	-	100	100	Manufacture of electronic equipment
Subsix Limited	Hong Kong	Ordinary	HK$100	-	-	80	-	80	-	Manufacture of electronic equipment
Kowloon Limited	Hong Kong	Ordinary	HK$100	-	-	100	-	100	-	Manufacture of electronic equipment
C Plus Limited	C Land	Ordinary	USD100	45	45	-	-	45	45	Manufacture of electronic equipment

The above table lists the subsidiaries of the Group which, in the opinion of the directors, principally affected the results or assets of the Group. To give details of other subsidiaries would, in the opinion of the directors, result in particulars of excessive length.

Subtwo Limited, Subfour and Subfive Limited are wholly foreign owned enterprises.

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

HKFRS 12.10(a)
HKFRS 12.4
HKFRS 12.B4(a)
HKFRS 12.B5-B6

At the end of the reporting period, the Company has other subsidiaries that are not material to the Group. A majority of these subsidiaries operate in A Land. The principal activities of these subsidiaries are summarised as follows:

Principal activities	Principal place of business	Number of subsidiaries	
		31/12/11	31/12/10
Manufacture of electronic equipment	A Land	1	1
	B Land	2	2
		3	3
Manufacture of leisure goods	A Land	2	2
Construction	A Land	1	1
Toys manufacturing	A Land	Nil	1
		6	7

Note: HKFRS 12.10(a) requires entities to disclose the composition of the group. The list above discloses information about the Group's material subsidiaries (wholly- and non-wholly-owned subsidiaries). The above illustrates one example as to how the requirements set out in HKFRS 12 can be met. When local laws or regulations require the list of investments in subsidiaries to be disclosed, the above disclosures should be modified to comply with the additional local requirements.

59.2 Details of non-wholly subsidiaries that have material non-controlling interests

HKFRS 12.10(a)(ii)
HKFRS 12.12

The table below shows details of non-wholly-owned subsidiaries of the Group that have material non-controlling interests:

Note: For illustrative purposes, the following non-wholly subsidiaries are assumed to have non-controlling interests that are material to the Group.

Name of subsidiary	Place of incorporation and principal place of business	Proportion of ownership interests and voting rights held by non-controlling interests		Profit (loss) allocated to non-controlling interests		Accumulated non-controlling interests	
		31/12/11	31/12/10	31/12/11	31/12/10	31/12/11	31/12/10
				HK$'000	HK$'000	HK$'000	HK$'000
Subthree Limited	Malaysia	30%	30%	1,020	980	10,680	9,660
C Plus Limited (i)	C Land	55%	55%	392	464	2,445	2,053

HKFRS 12.9(b)

(i) C Plus Limited is listed on the stock exchange of C Land. Although the Group has only 45 per cent ownership in C Plus Limited, the directors concluded that the Group has a sufficiently dominant voting interest to direct the relevant activities of C Plus Limited on the basis of the Group's absolute size of shareholding and the relative size of and dispersion of the shareholdings owned by other shareholders. The 55 per cent ownership interests in C Plus Limited are owned by thousands of shareholders that are unrelated to the Group, none individually holding more than 2 per cent.

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

HKFRS 12.12(g)
HKFRS 12.B10
HKFRS 12.B11

Summarised financial information in respect of each of the Group's subsidiaries that has material non-controlling interests is set out below. The summarised financial information below represents amounts before intragroup eliminations.

Subthree Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	32,100	31,400
Non-current assets	10,238	10,441
Current liabilities	(1,617)	(4,299)
Non-current liabilities	(5,121)	(5,342)
Equity attributable to owners of the Company	24,920	22,540
Non-controlling interests	10,680	9,660

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	6,200	6,101
Expenses	(2,800)	(2,834)
Profit (loss) for the year	3,400	3,267
Profit (loss) attributable to owners of the Company	2,380	2,287
Profit (loss) attributable to the non-controlling interests	1,020	980
Profit (loss) for the year	3,400	3,267
Other comprehensive income attributable to owners of the Company	-	-
Other comprehensive income attributable to the non-controlling interests	-	-
Other comprehensive income for the year	-	-
Total comprehensive income attributable to owners of the Company	2,380	2,287
Total comprehensive income attributable to the non-controlling interests	1,020	980
Total comprehensive income for the year	3,400	3,267
Dividends paid to non-controlling interests	-	-
Net cash inflow (outflow) from operating activities	4,405	2,050
Net cash inflow (outflow) from investing activities	(330)	1,148
Net cash inflow (outflow) from financing activities	(3,489)	(315)
Net cash inflow (outflow)	586	2,883

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

C Plus Limited	31/12/11	31/12/10
	HK$'000	HK$'000
Current assets	1,530	3,517
Non-current assets	3,625	1,070
Current liabilities	(280)	(266)
Non-current liabilities	(430)	(588)
Equity attributable to owners of the Company	2,000	1,680
Non-controlling interests	2,445	2,053

	Year ended 31/12/11	Year ended 31/12/10
	HK$'000	HK$'000
Revenue	2,165	2,285
Expenses	(1,453)	(1,441)
Profit (loss) for the year	712	844
Profit (loss) attributable to owners of the Company	320	380
Profit (loss) attributable to the non-controlling interests	392	464
Profit (loss) for the year	712	844
Other comprehensive income attributable to owners of the Company	-	-
Other comprehensive income attributable to the non-controlling interests	-	-
Other comprehensive income for the year	-	-
Total comprehensive income attributable to owners of the Company	320	380
Total comprehensive income attributable to the non-controlling interests	392	464
Total comprehensive income for the year	712	844
Dividends paid to non-controlling interests	-	-
Net cash inflow (outflow) from operating activities	(263)	(241)
Net cash inflow (outflow) from investing activities	-	-
Net cash inflow (outflow) from financing activities	(160)	(120)
Net cash inflow (outflow)	(423)	(361)

59.3 Change in ownership interest in a subsidiary

HKFRS 12.18

During the year, the Group disposed of 10% of its interest in Subone Limited, reducing its continuing interest to 90%. The proceeds on disposal of HK$213,000 were received in cash. An amount of HK$179,000 (being the proportionate share of the carrying amount of the net assets of Subone Limited) has been transferred to non-controlling interests. The difference of HK$34,000 between the increase in the non-controlling interests and the consideration received has been credited to retained earnings.

59.4 Significant restriction

HKFRS 12.13

[When there are significant restrictions on the Company's or its subsidiaries' ability to access or use the assets and settle the liabilities of the Group, the Group should disclose the nature and extent of significant restrictions. Please see HKFRS 12.13 for details.]

59.5 Financial support

HKFRS 12.14-17

[When the Group gives financial support to a consolidated structured entity, the nature and risks (including the type and amount of support provided) should be disclosed in the financial statements. Please see HKFRS 12.14 – 17 for details.]

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4 August 2011

Steven Maijoor, Chair
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Sent via email

Dear Mr Maijoor,

Accounting for available-for sale (AFS) sovereign debt

There have been indications in the market that some European companies are applying the accounting requirements for fair value measurement and impairment losses in a way that seems to differ from the objective of IAS 39 *Financial Instruments: Recognition and Measurement*. This is evident particularly in their accounting for distressed sovereign debt, including Greek government bonds. Those indications have now been confirmed by recently published financial reports, which show inconsistent application of IAS 39 across Europe. This is a matter of great concern to us.

We are aware that, as an accounting standard-setter, the IASB does not have the authority to ensure compliance with International Financial Reporting Standards (IFRSs). However, the IASB and ESMA have a mutual interest in ensuring the highest quality in the application of IFRSs. Although we do not usually comment on how our standards are applied, because this case demonstrates visibly inconsistent application, we believe that it is appropriate for us to bring this matter to your attention.

I thought it would be helpful to provide you with some information about the objective of fair value measurement in IAS 39 and the use of models when the market for a particular financial instrument is not active. This letter does not address financial assets classified as held-to-maturity or loans and receivables.

In October 2008 the IASB staff published a report summarising the discussions of our Fair Value Expert Advisory Panel, which was set up in response to the recommendations made by the Financial Stability Board to address the measurement and disclosure of financial instruments when markets are no longer active. That report was well-received and was found to be helpful in the last financial crisis. Many respondents to our exposure draft on fair value measurement indicated that they found it consistent with the fair value measurement concepts in IAS 39 (as well as in US generally accepted accounting principles, or GAAP), which are described in this letter. That guidance is now in IFRS 13 *Fair Value Measurement*, which we issued in May.

Fair value of AFS financial assets

AFS financial assets are measured at fair value with changes in fair value measurement presented in other comprehensive income. However, as you know, IAS 39 requires a company to recognise any impairment loss in profit or loss when there is objective evidence that those financial assets are impaired. If it is determined that those assets are not impaired, the company continues to recognise the decline in fair value in other comprehensive income. If it is determined that those assets are impaired, the company recognises the accumulated decline in fair value in profit or loss. In other words, the impairment calculation for AFS financial assets is based on the fair value of the assets.

It appears that some companies are not following IAS 39 when determining whether the Greek government bonds that they classify as AFS are impaired. They are using the assessed impact on the present value of future cash flows arising from the proposed restructure of those bonds, rather than using the amount reflected by current market prices as required in IAS 39.

In addition, some companies holding Greek government bonds classified as AFS have stated that they are relying on internal valuation methodologies, rather than on market prices, to measure the fair value of the assets as at 30 June 2011. The reason generally given for using models rather than market prices is that the market for Greek government bonds is currently inactive (and therefore, in their view, does not provide reliable pricing information).

Determining whether a market is active

In measuring fair value, IAS 39 prioritises the use of quoted prices in active markets over the use of valuation models developed using internal assumptions.

IAS 39 describes an active market for a financial instrument as one in which ‘quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm’s length basis’. It is important to note that the description of an active market does not focus solely on trading activity. That is because when measuring fair value, the issue is not about the level of market activity *per se*, but about whether an observed transaction price represents fair value.

Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices varying significantly over time or among market participants, or the prices not being current. However, those factors alone do not necessarily mean that a market is no longer active. A company cannot ignore observable transaction prices when it is clear that market participants are regularly entering into transactions for the same or similar financial assets, even if they are doing so less frequently than they have in the past.

Although the level of trading activity in Greek government bonds has decreased, transactions are still taking place. IAS 39 is clear that unless there is evidence that the prices in those transactions do not represent fair value (for example, because those transactions are forced or because they require significant adjustment because of timing differences between the transaction date and the measurement date, which are matters of judgement and depend on the facts and circumstances), the observed transactions prices should be used to measure fair value.

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Using models when measuring fair value

The objective of a fair value measurement, whether using an observed market price or a valuation model, is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date. In other words, the goal is to arrive at a current market price. This can be done by using an observed price, or by replicating a market price using a valuation model. In addition, the objective of the measurement is the same *irrespective* of current market conditions.

Even when a model is used to measure fair value, that model must reflect current market conditions (including those as evidenced by observable transaction prices) and it should include appropriate adjustments that market participants would make for credit and liquidity risks. Furthermore, the model must maximise the use of relevant observable inputs (eg market data) and minimise the use of unobservable inputs (eg the company's own assumptions). A company cannot ignore relevant market data (including observable transaction prices) when it is clear that market participants would use that data in determining the price at which they would be willing to enter into a transaction for the financial asset.

It would therefore not be in accordance with either the requirements in, or the intent of, IAS 39 to measure a loss on government bonds classified as AFS financial assets solely by assessing the present value of the future cash flows arising from a proposed restructure of those bonds. It is hard to imagine that there are buyers willing to buy those bonds at the prices indicated by the valuation models being used. In my view it is therefore difficult to justify that those models would meet the objective of a fair value measurement.

Yours sincerely

Hans Hoogervorst, Chair

European Securities and Markets Authority

Date: 25 November 2011
ESMA/2011/397

PUBLIC STATEMENT

Sovereign Debt in IFRS Financial Statements

As a result of recent sovereign debt[1] developments and the increased market interest in this area, there has been a lot of focus on the accounting practices of listed companies, and financial institutions in particular, with respect to their exposures to sovereign debt.

On 28 July 2011 ESMA issued a Statement[2] stressing the need for enhanced transparency and the importance of applying the relevant International Financial Reporting Standards (IFRS). ESMA also encouraged issuers to provide information on their exposures to sovereign debt on a country-by-country basis in their financial statements.

Since then ESMA conducted together with national competent authorities a fact-finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements based on a sample of financial institutions listed in EU regulated markets.

The consistent application of IFRS, which covers standards for recognition, measurement and disclosure, is important for the proper functioning of financial markets. ESMA publishes this Statement to promote consistent application of European securities and markets legislation, and notably of IFRS. It contains two Sections:

— Section 1 discusses accounting issues related to sovereign debt in IFRS annual financial statements ending 31 of December 2011. The Section highlights elements that should be considered by issuers and their auditors in relation to exposure to sovereign debt when preparing their financial statements for the upcoming year-end.

— Section 2 is an ESMA Opinion "*Accounting for Exposure to Greek Sovereign Debt – Considerations with respect to IFRS Interim Financial Statements for Accounting Periods ended on 30 June 2011.* The Opinion provides a summary of the outcome of the fact-finding exercise together with elements that should have been considered by issuers and their auditors as part of the IFRS interim financial statements for periods ended 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

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[1] Sovereign debt, for the purpose of this statement, refers to bonds issued by and loans given to central and local government and governmental bodies.
[2] http://www.esma.europa.eu/popup2.php?id=7685

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Section 1: Sovereign Debt in Annual IFRS Financial Statements

ESMA would like to stress the need for transparency and the importance of appropriate and consistent application of the recognition, measurement and disclosure principles provided for in IFRS. This Section should not be understood as constituting guidance or recommendations on how to apply IFRS, but rather as assisting issuers in preparing their annual financial statements.

Issuers having securities traded on an EU regulated market and that have material exposure to sovereign debt should consider the following elements as part of the preparation of their year-end IFRS financial statements:

Existence of impairment for sovereign debt related financial assets

The assessment of objective evidence that a financial asset is impaired should be based on the criteria in paragraph 59 of IAS 39 – *Financial instruments: Recognition and Measurement* such as: financial difficulty of the obligor, breach of contract, concession granted to the borrower, disappearance of an active market or decrease in the estimated future cash flows. IAS 39 paragraph 60 specifically notes that a credit downgrade is not, of itself, evidence of impairment, nor is a decline in the instrument's fair value, although it may be evidence of impairment when considered with other available information. In addition, when assessing the existence of a loss event, consideration should also be given to the fact that default risk is related to the obligor and not to a specific financial instrument issued by that party.

Therefore, ESMA emphasises that issuers should carefully analyse facts and circumstances at the reporting date. They should provide in the IFRS financial statements all relevant disclosures related to the criteria used in assessing the existence of objective evidence of impairment for financial assets and present all the assumptions and uncertainties regarding the impact on future estimated cash-flows.

Measurement of financial assets related to sovereign debt exposure

ESMA reminds issuers of the following IAS 39 measurement principles regarding the different accounting categories of financial assets:

— For financial assets classified as held to maturity or loans and receivables:

Sovereign debt classified as held to maturity or loans and receivables are measured at amortized cost using the effective interest rate method[3]. If there is objective evidence that assets are impaired, an estimate of impairment losses should be determined based on appropriate reassessment of expected future cash-flows using the original effective interest rate. In cases where a restructuring plan is in place, such estimation should be based using details from the plan, unless a derecognition of the original asset has taken place and a new financial asset is recognised. Where a restructuring plan exists (see also below the paragraph on *Greek sovereign debt – specific accounting matters*), but it is not yet in place and/or the details are still unknown, issuers should ensure that a best estimate is determined based on all the information available, including any further indications of material losses in addition to those induced by the plan.

[3] In case the bonds have been reclassified out of the fair value through profit or loss category or the available for sale category the effective interest rate calculated at the moment of the transfer should be used.

— For financial assets classified as available-for-sale or held-for-trading

Sovereign debt classified as available-for-sale or held for trading is recognized in the statement of financial position at fair value. If there is objective evidence that assets are impaired, an impairment loss has to be recognised in the profit or loss account for the assets classified at available-for-sale. In order to determine the fair value, issuers should analyse whether a financial instrument is regarded as quoted in an active market or not at the reporting date by analysing whether quoted prices are readily and regularly available for each instrument (by issuance) and whether those prices represent actual transactions between willing parties on an arm's length basis. In this context we believe that the literature provided by the IASB Expert Advisory Panel – *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*[4] constitutes relevant guidance. Though IFRS 13 (*IFRS 13 – Fair Value Measurement*) is not endorsed in the European Union it could be relevant as part of that analysis.

When a market for a financial instrument is active, issuers should use the quoted prices, which are defined as level 1 fair value measurements under IFRS 7 – *Financial Instruments: Disclosures*. For those instruments for which the market is not active, level 2 measurements should be applied by using models which make maximum use of market inputs, such as inputs from observable similar or linked instruments, such as other bonds, preferably issued by the same sovereign state, with similar maturities.

Disclosures in the year-end IFRS financial statements

ESMA would like to stress the importance for issuers to provide all relevant disclosures related to exposure to sovereign debt in order to comply with the requirements of IFRS 7. ESMA would also like to underline that in order to achieve a fair presentation, as stated under IAS 1 – *Presentation of Financial Statements,* issuers are required to provide any additional disclosures when compliance with IFRS 7 does not suffice to enable users to understand the impact of sovereign debt to the financial position and performance of the issuer. This is particularly important for areas in which management judgement is applied, as allowed by IFRSs.

In addition, ESMA believes that in the case where a market is not active for a specific instrument, the issuer should provide supplementary disclosures explaining the underlying rationale, assumptions and the sources used as inputs to the valuation.

Moreover, ESMA would encourage providing quantitative and qualitative information on sovereign debt related instruments such as credit default swaps (CDS) and other instruments, directly referencing to sovereign debt such as financial guarantees, forward contracts, options and other derivatives. This could include the level and the risks to which the issuer is exposed, as well as the estimated level of protection in case a CDS was acquired by an issuer.

Greek sovereign debt - specific accounting matters

As a result of significant financial and economic difficulties experienced by Greece, a particular focus is given to Greek sovereign debt. European leaders proposed in July 2011 a financial assistance package for Greece in which private bondholders would be asked to contribute towards the relief of Greece's debt burden via a voluntary bond exchange (known as the Private Sector Involvement). That proposal would have resulted in a 21% net present value loss for private bondholders based on an assumed discount rate of 9% and a significant extension in the overall maturity profile of the country's debts.

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[4] http://www.iasb.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf

The economic situation in Greece has continued to deteriorate and on 26 October 2011 European leaders proposed changes to the plan for Private Sector Involvement. At the date of this release the specific terms of the participation to the plan are unknown and negotiations are still ongoing, but based on the Euro Summit Statement we understand that the plan would request private bondholders to accept a 50% reduction in the nominal value of the bonds.

ESMA together with national competent authorities conducted a fact finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements of a wide sample of financial institutions listed in EU regulated markets. Based on this review, there is evidence that accounting practices of financial institutions with regard to sovereign debt exposures varied, in particular with respect to the extent of debt exposures subject to impairment losses, the methods for calculation of impairment losses and methodologies used for fair value measurement. Therefore, the second Section of this Statement contains an Opinion regarding accounting for exposure to Greek Sovereign debt in the IFRS interim financial statements for accounting periods ended on 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

Future actions

ESMA will, together with national competent authorities, continue to strictly monitor the application of IFRS and consider whether further actions are needed in order to ensure the appropriate accounting treatment of exposure to sovereign debt by European issuers.

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Section 2: Opinion – Accounting for Greek Sovereign Debt – Considerations with respect to IFRS interim financial statements for accounting periods that ended on 30 June 2011

I. Introduction and legal basis

1. As a result of recent developments in the area of sovereign debt and the increased market interest in this area, ESMA issues an opinion to promote the effective and consistent application of European securities and markets legislation and notably of International Financial Reporting Standards and relevant sectoral legislation.

2. ESMA's competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EC) No 1095/2010 (the "Regulation"). In accordance with Article 44(1) of the Regulation the Board of Supervisors has adopted this opinion.

II. General observations

3. As part of its objective to coordinate European enforcement activities, ESMA has collected information from National Competent Authorities (NCAs) with respect to IFRS half-year financial statements ended on 30 June 2011, published by listed European financial institutions. On this basis, there is evidence that some accounting practices of issuers with regard to Greek sovereign debt exposures varied across the European Economic Area.

4. The main identified divergences for the 53 financial institutions included in our fact-finding exercise relate to the following:

   — It has been observed that there are differences regarding recognition or non-recognition of impairment losses. Data collected show that for example two financial institutions which had decided not to participate in the July International Institute of Finance plan (the "July IIF plan") did not recognise any impairment. Another difference relates to bonds with maturities after July 2020, for which some financial institutions indicated recognition of impairment losses and some did not.

   — Regarding bonds classified as held to maturity, 10 out of 23 financial institutions with investments in this category used the estimation of the 21% "haircut" on the face value of the bonds provided in the July IIF plan as the estimation for the impairment loss. Some banks used the original effective interest rate resulting in impairment losses between 17% and 23% while others used the new discount rate indicated in the July IIF plan for calculating the impact on the estimated future cash-flows.

   — Other differences appeared with respect to financial assets classified as available for sale (AFS), for which different valuation methods have been used by issuers. Out of 34 financial institutions with AFS instruments, 20 used fair values based on market data corresponding to level 1 valuation as defined by IFRS 7. Other financial institutions judged that the markets for the investments in their portfolio were not active and therefore used level 2 (3 financial institutions). Presumably because they thought either that there were no transactions taking place or because the transactions that were taking place were not orderly transactions, four

issuers used level 3 measurements. For another 4 issuers it was not possible to identify the measurement method used. Finally 3 issuers did not recognise any impairment losses, but only a decrease in value accounted for in other comprehensive income.

— It appeared that there were some cases in which the consequences of different accounting practices could be assessed as non-material.

III. Description of accounting considerations

5. While ESMA acknowledges that the supervision of financial reporting and necessary potential enforcement actions that may arise rests with NCAs, it is important that consistent application of IFRS is achieved in the European Union. To achieve that goal, the existing European IFRS Enforcement Coordination Mechanism (EECS) provides ESMA with a very valuable tool.

6. The present opinion is based on discussions that took place between ESMA and NCAs within EECS in order to coordinate the enforcement activities in the particular area of accounting for exposures to Greek sovereign debt. EECS has been specifically mandated to consider all technical issues related to this matter, including but not limited to: the arguments used by issuers relating to triggering events when recognising an impairment loss, measurement methods used in compliance with the fair value hierarchy, and determination of criteria for assessing whether markets are active or inactive. This Opinion forms an element for NCA's when considering an enforcement decision.

7. ESMA acknowledges that materiality plays an important role in identifying the appropriate type of enforcement action to be considered by NCAs where a misstatement is identified in the IFRS financial statements. When a material misstatement in the financial information is detected enforcers should take appropriate action to achieve appropriate disclosure of such a misstatement and, where relevant, public correction of the misstatement.

8. In ESMA's opinion, the following elements should have been considered by issuers and their auditors when preparing their IFRS interim financial statements published for periods that ended on 30 June 2011. Some of these elements might also be relevant for issuers and their auditors when preparing or auditing future financial statements.

9. Regarding the existence of objective evidence of impairment and determination of an asset being impaired, it is ESMA's opinion that:

— There was objective evidence of impairment of Greek sovereign bonds as of 30 June 2011, based on at least two of the criteria to be considered according to paragraph 59 of IAS 39 – *Financial Instruments: Recognition and Measurement*: significant financial difficulty of the debtor and decrease in the fair value of the investment. The European Council's decision on 21 July 2011 with respect to the private sector initiative is indicative of a concession granted by private investors and confirms the significant financial difficulty of the debtor as of 30 June 2011 and raises concerns about whether the bonds would be paid in full. Issuers should have provided indications on the facts and circumstances and the conditions that existed at that date in their reports.

— The conditions existing as of 30 June 2011 had an impact on the estimated future cash-flows that could be reliably estimated. Indicators of the possible impact on contractual cash flows

were available as part of the haircut indicated in the July IIF plan, in which a number of financial institutions confirmed their participation. In some circumstances, transactions observed in the market were also indicative of the fact that future estimated cash flows will be impacted, even if other scenarios than the implementation of the July IIF plan were taken into account by market participants. Consequently financial assets related to exposure to Greek sovereign bonds with maturities before July 2020 were impaired.

— Regarding Greek bonds with maturities after July 2020, which were not included in the July IIF plan, the facts considered above should have been analysed as indicating that the contractual cash-flows were at risk of being impacted by the financial difficulties. Default risk is related to the debt issuer and not to a financial instrument issued by the debt issuer. The estimation of the size of such an impact on the future cash flows is a matter of judgement.

10. With regards to the measurement of exposure to Greek Sovereign bonds, it is ESMA's opinion that:

— For their interim financial statements issuers should have determined impairment losses on the Greek sovereign bonds classified as held-to-maturity using the original effective interest rate[3], notwithstanding whether they expressed their participation in the plan put forward by the IIF or not. According to IAS 34 paragraph 41, the preparation of interim financial reports generally requires a greater use of estimation methods than annual reports. Taking into consideration the uncertainties that existed at the time the interim financial statements were prepared, the 21% haircut could be accepted in some circumstances as being a possible estimate based on reasonable judgement for measuring impairment losses for financial assets measured at amortised cost. It could be regarded as a practical expedient, assuming that the assessment of expected cash flows at the original effective interest rate would have resulted in materially the same level of impairment.

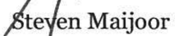
— Greek sovereign bonds classified as available for sale or held for trading should have been reported at fair value using the fair value hierarchy as outlined in paragraph 27A of IFRS 7 – *Financial Instruments: Disclosures*. In order to determine the fair value, issuers should analyse whether a market is active or not at the reporting date. This means analysing whether quoted prices are readily and regularly available for each instrument (by maturity, and where relevant by issuance) and whether those prices represent actual and regularly occurring market transactions on an arm's length basis (paragraph 71 of Appendix A to IAS 39). Based on trading data obtained from the Bank of Greece, it is ESMA's opinion that, as of 30 June 2011, the market was active for some Greek sovereign bonds but could be judged inactive for some others. Issuers should consequently have used level 1 fair value measurement as defined under IFRS 7 for instruments with active markets. For those instruments for which the market was not active, a level 2 measurement method should have been applied (using models which include observable market data from similar instruments, such as Greek bonds with close maturities or prices for credit default swaps, if relevant). The same fair value measurement considerations also apply when assets are reclassified from available for sale to loans and receivables.

11. Regarding disclosures of exposure to Greek Sovereign bonds, in line with the statement published by ESMA on 28 July 2011 it is ESMA's opinion that issuers should have included all information required under IAS 34 – *Interim Financial Reporting*. This means that, as a minimum, the issuer should have provided: the level of exposure to Greek Sovereign debt as of 30 June (including details about maturities), the accounting treatment applied for the debt and its impairment losses together with a description of key judgments used in the assessment of whether the asset was impaired or not

about maturities), the accounting treatment applied for the debt and its impairment losses together with a description of key judgments used in the assessment of whether the asset was impaired or not and key assumptions underpinning the assessment of the impairment losses for each class of instruments (IAS 34 paragraph 15B).

12. This opinion will be published on ESMA's website.

Done at Paris, 24 November 2011



Steven Maijoor

ESMA Chair

For the Board of Supervisors

Notes to editors

1. ESMA is an independent EU Authority that was established on 1 January 2011 according to EU Regulation No. 1095/2010 as published on December 15, 2010, in the Official Journal of the European Union (L 331/84). The Authority contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA).

2. ESMA's work on securities legislation contributes to the development of a single rule book in Europe. This serves two purposes; firstly, it ensures the consistent treatment of investors across the Union, enabling an adequate level of protection of investors through effective regulation and supervision. Secondly, it promotes equal conditions of competition for financial service providers, as well as ensuring the effectiveness and cost efficiency of supervision for supervised companies. As part of its role in standard setting and reducing the scope of regulatory arbitrage, ESMA strengthens international supervisory co-operation. Where requested in European law, ESMA undertakes the supervision of certain entities with pan European reach.

3. ESMA also contributes to the financial stability of the European Union, in the short, medium and long-term, through its contribution to the work of the European Systemic Risk Board, which identifies potential risks to the financial system and provides advice to diminish possible threats to the financial stability of the Union. ESMA is also responsible for coordinating actions of securities supervisors or adopting emergency measures when a crisis situation arises.

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