A Refresher Course on Current

Financial Reporting Standards 2015

Day 1

Time	Topic
09:00 - 10:00	Presentation of financial statements
10:00 - 11:00	Statement of cash flows
11:00 - 11:15	Break
11:15 - 12:30	Related party transactions
12:30 - 13:30	Lunch
13:30 - 15:00	Business combination
15:00 - 15:15	Break
15:15 - 16:00	Business combination
16:00 - 17:00	Operating segments

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A Refresher Course on Current Financial Reporting Standards 2015 (Day 1)

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COOPERATION REQUESTED

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HKAS 1
Presentation of Financial Statements

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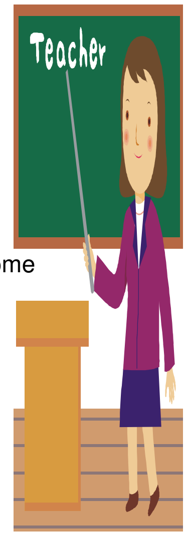
Learning Objective

- Introduction
- General Requirements
- Statement of Financial Position
- Statement of Profit or Loss and other Comprehensive Income
- Statement of Changes in Equity
- Statement of Cash Flows (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:

- Which standard should we refer to for the general requirements of presentation of financial statements?
- How many statements are there in a complete set of financial statements prepared under HKFRS/IFRS? What are their names?
- What are the general requirements / factors that we should consider when preparing a complete set of financial statements?
- How frequent should we prepare the financial statements? Are there any limitations on the period to be covered?

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"HKAS 1 prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content" [HKAS 1.1]

Note: Please refer to Appendix D for Amendments to HKAS 1 *Disclosure Initiative* which are effective for annual periods beginning on or after 1 January 2016

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Objective and scope

- HKAS 1 applies to all general purpose financial statements prepared under 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
- HKAS 1 applies to all types of entity and applies both to consolidated financial statements and separate financial statements, but does NOT govern the structure and content of condensed interim financial statements prepared under HKAS 34 *Interim Financial Reporting*

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Complete Set of Financial Statements

- A complete set of HKFRS financial statements comprises:
  - A statement of financial position at the end of the period
  - A statement of profit or loss and other comprehensive income for the period
  - A statement of changes in equity for the period
  - A statement of cash flows for the period
  - Notes, comprising significant accounting policies and other explanatory information
  - Comparative information in respect of the preceding period
  - A statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or where it reclassifies items in its financial statements. This information is only required when the opening balance sheet is materially affected by the restatement

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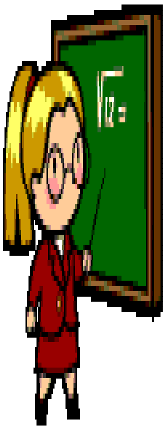
True and Fair presentation



- Financial statements shall 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 set out in the Framework
- The application of the HKFRS, with additional disclosure when necessary, is presumed to result in financial statements that achieve a true and fair view

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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 Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Accountants*

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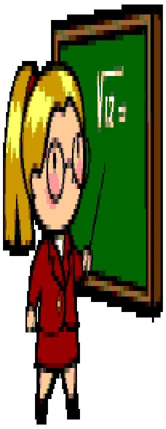
Compliance with HKFRSs



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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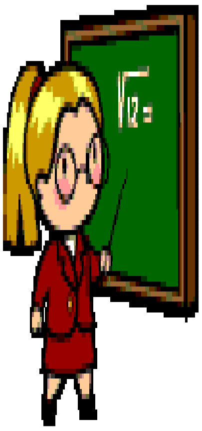
Going Concern



- 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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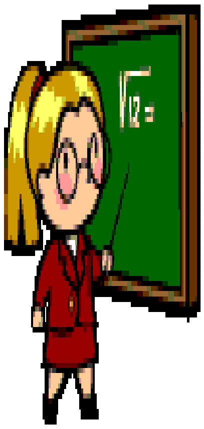

Going Concern Disclosure

- 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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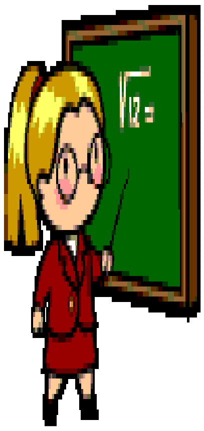

Going Concern

- 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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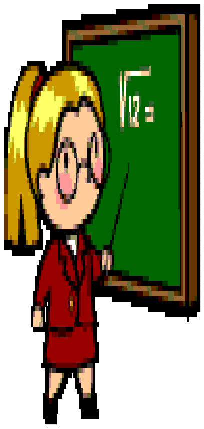

Accrual basis of accounting

- Accruals basis should be used in preparing the financial statements, except for cash flow information
- The elements of financial statements (assets, liabilities, equity, income and expenses) should be recognised only when they meet the definitions and recognition criteria of the conceptual framework

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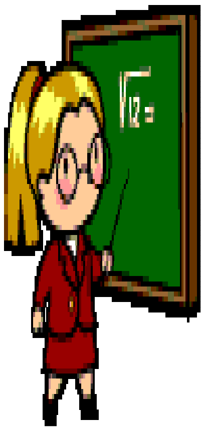

Materiality and Aggregation

- 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 2015 F/S approved for issue, the entity discovered depreciation expense for 2015 was overstated by $150. Ignored the error, reported profit for 2015 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

Is the error material?

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Offsetting/netting

- ❖ **Assets and liabilities, and income and expenses, are not offset unless required or permitted by a HKFRS**
- ❖ **Items that would not be considered to be offsetting of assets and liabilities include:** Accumulated depreciation of property plant and equipment; impairment provisions; accumulated amortisation of intangible assets; provisions for inventory obsolescence; provisions for bad debts
- ❖ **Items that would be considered to be acceptable offsetting of income and expenses include:**
  - Income and related expenses on transactions that do not generate revenue and are incidental to the main revenue generating activities:
    - disposal proceeds and carrying value on disposal of non-current investment and operating assets
    - Expenditure and related reimbursement under a contractual agreement (e.g., a supplier's warranty agreement)
  - Gains and losses arising from a group of similar items unless material where separate presentation is required:
    - foreign exchange gains and losses

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Frequency of reporting

- An entity shall present a complete set of financial statements (including comparative information) at least annually
- When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:

  a) The reason for using a longer or shorter period, and
  b) The fact that amounts presented in the financial statements are not entirely comparable

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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 2015)
  - the end of the previous period which is the same as the beginning of the current period (i.e. 31 Dec 2014)
  - the beginning of the earliest comparative period (1Jan 2014)

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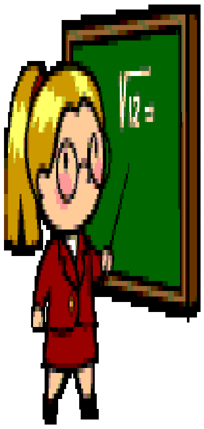
Business combinations and additional statements of financial position



Question:

- A pet food manufacturer acquired a competitor in November 2014 and accounted for the business combination under HKFRS 3 on a provisional basis in its 31 December 2014 annual financial statements. The business combination accounting was finalised in 2015 and the provisional fair values were updated. As a result, the 2014 comparatives were adjusted in the 2015 annual financial statements

Does the restatement require an opening SOFP (that is , an additional SOFP) as of 1 Jan 2014 under HKAS 1?

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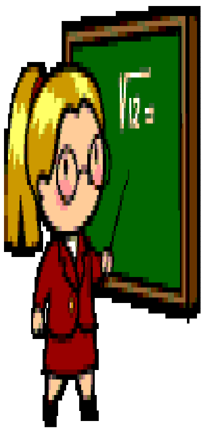
Consistency of Presentation



- 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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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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Statement of Financial Position

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Questions:

- What items should be presented on the statement of financial position?
- 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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Face of the statement of financial position

- HKAS 1 identifies items that should be disclosed on the face of the statement of financial position
- Most entities preparing HKFRS financial statements are required to present current and non-current assets and current and non-current liabilities, but HKAS 1 does not prescribe the order or format in which such items are to be presented

An entity shall present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.

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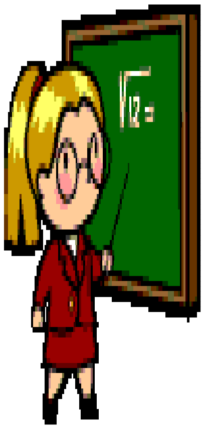
Current/non-current classification



- ❖ Make current/non-current distinction unless liquidity presentation is reliable and more relevant
- ❖ In liquidity presentation, present assets & liabilities 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

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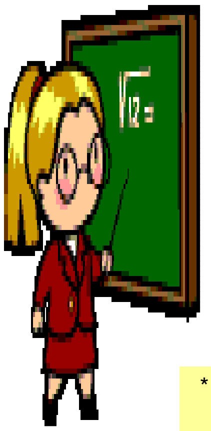
Current Assets



- ❖ Current assets if:
  - Expect to realise, sell or consume in entity's normal operating cycle*
  - Held for trading
  - Expects to realise in next twelve month of reporting period
  - The asset is cash or cash equivalent unless restricted from exchange or use for at least twelve months
- ❖ All other assets are classified as non-current

* An operating cycle is *"the time between the acquisition of assets for processing and their realisation in cash or cash equivalents"*

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Current Liabilities

- ❖ Current liability if:
  - Expect to settle in entity's normal operating cycle
  - The entity holds the liability primarily 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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Current Liabilities – example

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

Should the deposit be classified as current/non-current?

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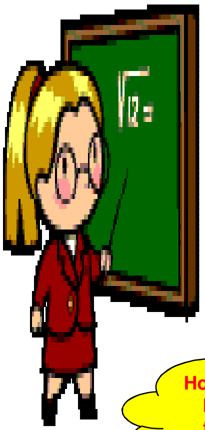
Classification of bank debt



An entity has an outstanding borrowing under a term loan facility with a bank that is due to be repaid six months after the end of the reporting period

Prior to the end of the reporting period, the entity and the lender agree a new facility that expires in three years, and into which the entity is able to roll the outstanding balance of its existing borrowing

The entity intends to roll over the existing borrowing into the new loan facility when the borrowing matures and to maintain the outstanding balance of the new facility for the duration of the new facility

How should this borrowing be shown in the entity's statement of financial position?

Would the answer be different if the existing loan and new facility were with different banks?

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Covenant breach reported after period end

An entity has a long-term loan with a bank. The terms of the loan require quarterly testing of certain covenant ratios. The bank requires the entity to file covenant compliance certificates within 60 days of the measurement date of the covenants. The entity's year end is 31 December 2014

The entity was within the acceptable parameters based on the calculation of the ratios for the third quarter, ie, 30 September 2014. The covenant testing date in the fourth quarter is 31 December 2014. The financial results were finalised in January 2015. The entity is due to file the covenant compliance certificates on 2 March 2015, which will show the breach

The entity believes that the breach in covenant does not occur until the filing date, as this is the date at which the bank would call the loan in the absence of any remedy

How should the loan balance be classified at year ended 31 December 2014?

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Covenant breach reported after period end

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How should the loan balance be classified at year ended 31 December 2014?

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Borrowing agreement includes a period of grace

A term loan agreement includes a provision that the borrower must sell a foreign branch of its operations by 31 December 2014

However, the agreement states that the borrower is permitted an additional 2 months to complete the sale if it is not able to sell the branch by that date. The borrower has not been able to find a buyer by 31 December 2014

How should the borrowings be classified in the financial statements for the year ended 31 December 2014?

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Statement of Profit and Loss and Other Comprehensive Income

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Presentation alternatives

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

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Presentation alternatives

The statement of profit or loss and other comprehensive income (statement of comprehensive income) shall present, in addition to the profit or loss and other comprehensive income sections:

(a) profit or loss;

(b) total other comprehensive income;

(c) comprehensive income for the period, being the total of profit or loss and other comprehensive income

If an entity presents a separate statement of profit or loss, it does not present the profit or loss section in the statement presenting comprehensive income

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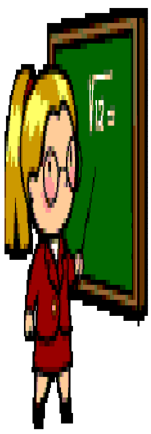
Presentation alternatives



An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period:

(a) profit or loss for the period attributable to:
- (i) non-controlling interests, and
- (ii) owners of the parent

(b) comprehensive income for the period attributable to:
- (i) non-controlling interests, and
- (ii) owners of the parent

If an entity presents profit or loss in a separate statement it shall present (a) in that statement

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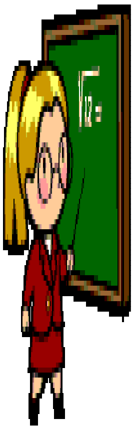

Information to be presented in the profit or loss section or the statement of profit or loss

- In addition to other items required by other HKFRSs, the 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
  - Impairment losses
  - Share of profit or loss of associates and joint ventures accounted for using the equity method
  - Tax expense
  - A single amount for the total of discontinued operations

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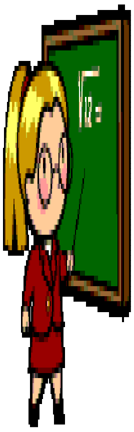

Other Comprehensive Income

The other comprehensive income section shall present line items for the amounts for the period of items of other comprehensive income (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method), classified by nature 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

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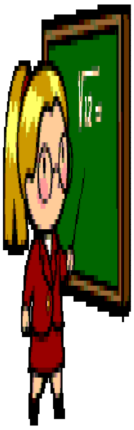
Other Comprehensive Income - Illustration



Other comprehensive income:	**2015**	**2014**
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	xxx	xxx
Remeasurements of defined benefit pension plans	xxx	xxx
Share of gain(loss)on property revaluation of associates	xxx	xxx
Income tax relating to items that will not be reclassified	xxx	xxx
	xxx	xxx
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	xxx	xxx
Available-for-sale financial assets	xxx	xxx
Cash flow hedges	xxx	xxx
Income tax relating to items that may be reclassified	xxx	xxx
	xxx	xxx
Other comprehensive income for the year, net of tax	xxx	xxx

* The items of other comprehensive income may be presented either (a) net of related tax effects or (b) before related tax effects with one amount shown for the aggregate amount of income tax relating to those items

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Amendments to HKAS 1 *Disclosure Initiative*

The other comprehensive income section shall present line items for the amounts for the period of:

(a) items of other comprehensive income (excluding amounts in paragraph (b)), classified by nature and grouped into those that, in accordance with other HKFRSs:
(a)(i) will not be reclassified subsequently to profit or loss; and
(b)(ii) will be reclassified subsequently to profit or loss when specific conditions are met.

(b) the share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that, in accordance with other HKFRSs:
(i) will not be reclassified subsequently to profit or loss; and
(ii) will be reclassified subsequently to profit or loss when specific conditions are met.

Note: Disclosure Initiative (Amendments to HKAS 1) was issued in January 2015 . An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. Entities

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Statement of Changes in Equity

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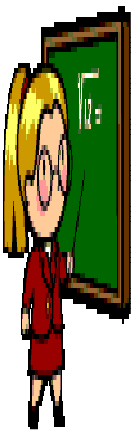
General requirements



- 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
  - For each component of equity an entity shall 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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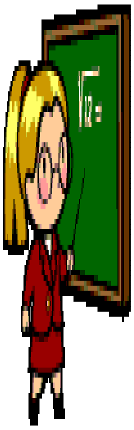
Transactions with owners



- 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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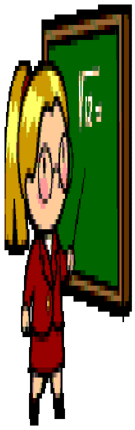

Scope

- 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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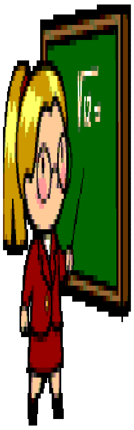

Overview of Notes

- 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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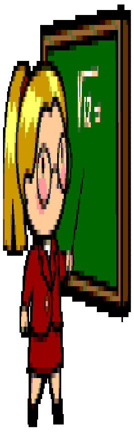

Order of Presentation

- 1^{st}: statement of compliance
- 2^{nd}: significant accounting policies applied
- 3^{rd}: supporting information for items presented in FS, follow sequence in FS
- 4^{th}: 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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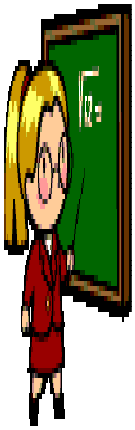

Accounting Policies

- 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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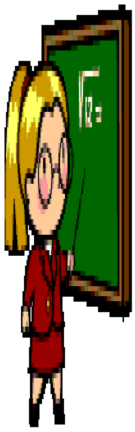

Judgment In Applying Accounting Policies

- 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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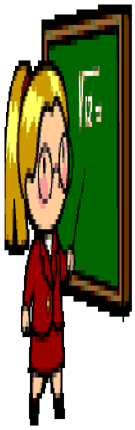
Key Sources of Estimation Uncertainty



- ❖ 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
  - ✓ 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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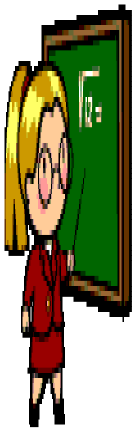
Key Sources of Estimation Uncertainty



- ❖ 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

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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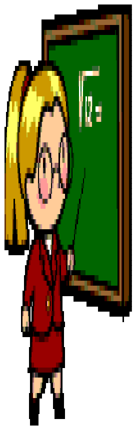
Capital Disclosures



- HKAS 1 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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Capital Disclosures - example

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 HK$'000	31/12/09 HK$'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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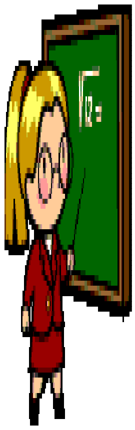
Other Disclosures – Details About The Entity



- 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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Accounting Policies, Estimates and Errors

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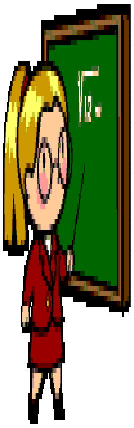

Scope

- 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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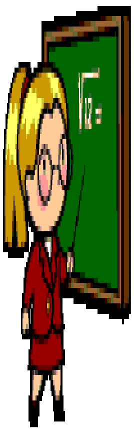

Consistency of Accounting Policies

- 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 2014, there is a voluntarily change in accounting policy. The cumulative effect of the change is a decrease of $100,000 in retained earnings at 1/1/2014 (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 1/1/2013 – reduced by $50,000
  - profit for 2013 and 2014 – reduced by $25,000 each

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Impracticability Exemption

- **Background:** In 2014, there is a voluntarily change in accounting policy. The cumulative effect of the change is a decrease of $100,000 in retained earnings at 1/1/2014 (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 1/1/2014
    - reduced by $100,000 (no adjustment to 2012 and 2013)
    - additional disclosures

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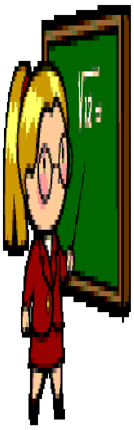

Accounting Estimate

- 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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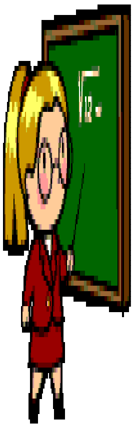
Errors



- ❖ 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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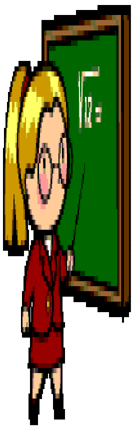

- For initial application of a HKFRS that have an effect on current or prior periods, or that may have an effect on future periods, the following information should be disclosed:
  - title of HKFRS
  - change in accounting policy is made in accordance with its transitional provisions, a description of 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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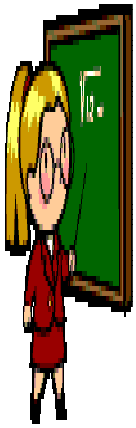
Disclosures



- 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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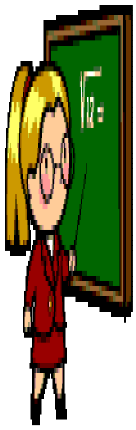

- For changes in accounting estimates, disclose:
  - Nature and amount of change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods
  - The fact that if the amount of effect in future periods is impracticable to estimate

- 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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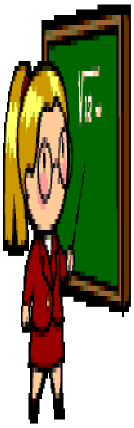
HKFRS in issue but not yet effective



- ❖ 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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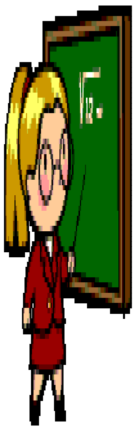

Scope

- ❖ Events after the end of the reporting period are those events, favorable and unfavorable, 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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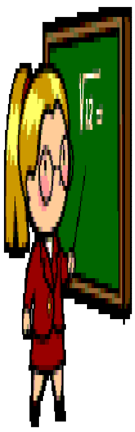

Accounting and Reporting

- ❖ 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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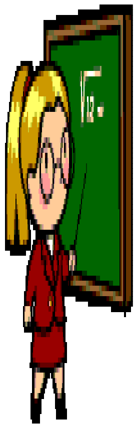
Example - Adjusting Event



- ❖ On 31/12/2014 Co A assessed its warranty obligation as $100,000. Before its 2014 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 31/12/2014 at $150,000
  - Adjusting events – latent defect existed at 31/12/2014. Measure warranty provision at $150,000 at 31/12/2014.

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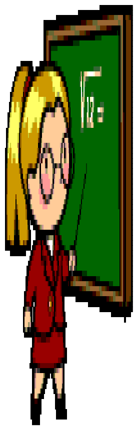
Example Non-adjusting Event



- ❖ On 28/2/2015, Co A's 2014 FS authorised for issue. Fair value of A's investment in B's publicly traded shares on 31/12/2014 = $20,000. On 28/2/2015 fair value of shares = $15,000.
  - Non-adjusting event – the change in fair value results from conditions that arose after 2014
  - 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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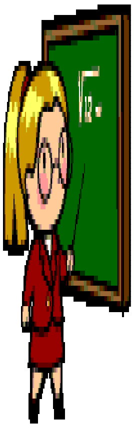
Disclosure Non-adjusting



- On 1/3/2015, Co A's 31/12/2014 FS authorised for issue when spot ex rate = $2.5 to FCU 1. At 31/12/2014 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 2015 when the exchange rate was $2.5: FCU 1. The deterioration of the exchange rate from $2: FCU 1 at 31 December 2014 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 2015 (Day 1)

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HKAS 7
Statement of Cash Flows

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Learning Objective

- What is cash and cash equivalents ?
- What is cash flow statement ?
- Classification of cash flows
- Foreign currency cash flows
- Non-cash transactions
- Consolidated cash flow statements
- Disclosures

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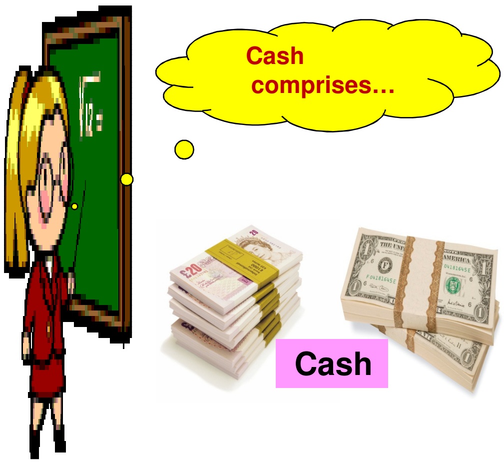
What is "Cash" ?



Demand deposits

- not defined in HKAS 7
- may be taken to refer to deposits where the reporting entity can withdraw cash without giving notice and without suffering any penalty

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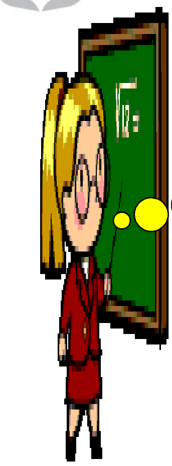
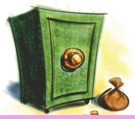
What is "Cash equivalents" ?



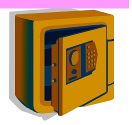
- Cash equivalents are defined as short-term*, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value
- Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes

*In order to qualify for short-term, the Standard states that the investment will normally have a **maturity of three months or less from the date of acquisition**



3-months fixed deposits

3-months bond investments



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Cash inflows and outflows

Statement of financial position
As at 1/1/2015

	HK$
Assets	
Current Assets	
- Cash and bank	**500**

Decrease in cash and bank balance from $500 to $350

Statement of financial position
As at 31/12/2015

	HK$'
Assets	
Current Assets	
- Cash and bank	**350**

- Read the statement of cash flows ...

Last year cash and cash equivalent amounted to HK$500. Why is there a decease ?

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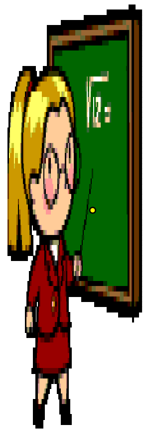
Purpose of preparing statement of cash flows



First, let me tell you the purpose of statement of cash flows…

- The cash flow statement reports the inflow or outflow of cash and cash equivalents
- The cash flow statement can be used to assess and forecast the company's ability to generate cash flows
- Indicate the adequacy of cash flows of the company despite it has a positive bottom line for the year
- Provided information about the historical changes in the cash and cash equivalents during the year, instead of as at the reporting date
- Etc….

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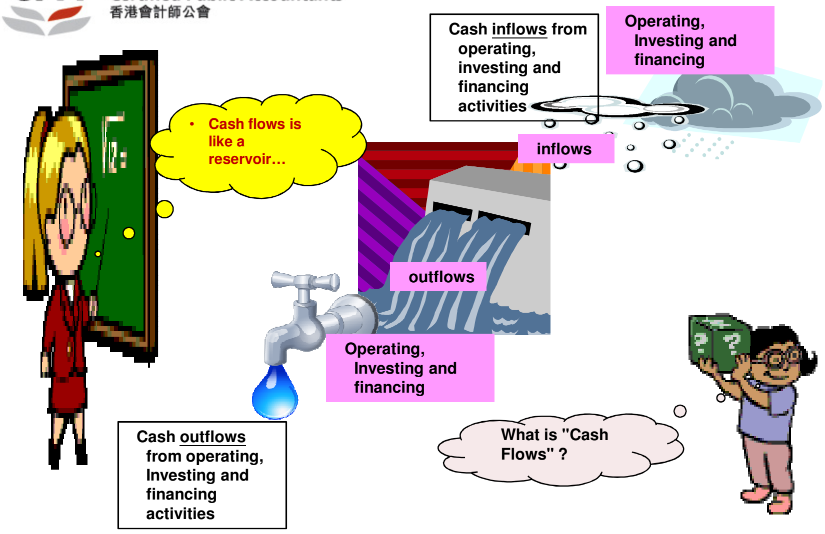
Classifications of cash flows



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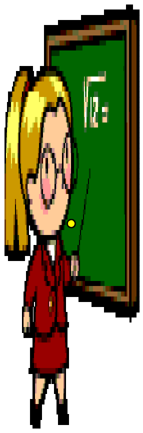
Cash inflows/outflows from/to operating activities



- Operating activities are defined as the **principal revenue-producing activities** of the entity and other activities that are not investing or financing activities

Cash payments to suppliers for goods and services

Cash receipts from sale of goods, rendering of services

Payment of wages and salaries to employees… etc

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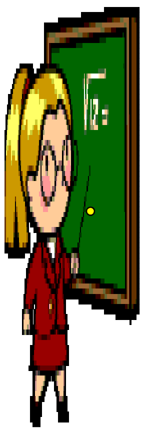
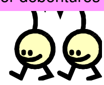
Cash inflows/outflows from/to investing activities

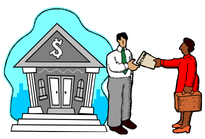


- Investing activities are defined as the **acquisition and disposal of long-term assets and other investments** not included in cash equivalents

Cash flows for purchase or sale of property, plant and equipment, intangible and other long-term assets

Cash flows for purchase / sale of shares or debentures of other entities





Cash advances and loans made to other parties, cash flows in relation to associates/ joint ventures (e.g. dividends received, loan advances)… etc

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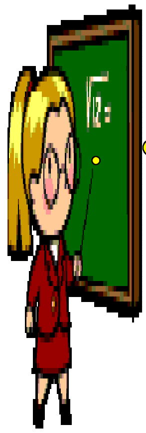
Cash inflows/outflows from/to financing activities



- Financing activities are defined as activities that result in <u>changes in the size and composition of the contributed equity</u> and <u>borrowings</u> of the entity

Cash proceeds from issuing shares, debentures, loans, notes, bonds etc

- Cash payments to owners to acquire or redeem the entity's shares
- Cash repayments of amounts borrowed
- Cash payments for a finance lease

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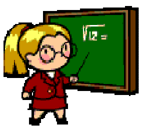
Association between the cash activities and the statement of financial position



Statement of cash flows for the year ended 31/12/2014

Operating Activities → Accounts receivables / Inventories / Trade payables / Accounts payable

Investing Activities → Investment in associates / Fixed assets / Intangible assets

Financing Activities → Short-term borrowings / Long-term borrowings / Equity

Statement of financial position As at 31/12/2014

Cash	
Accounts receivables	Trade payables
Inventories	Accounts payable
Investment in associates	Short-term borrowings
Fixed assets	Long-term borrowings
Intangible assets	Equity

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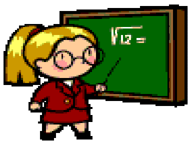
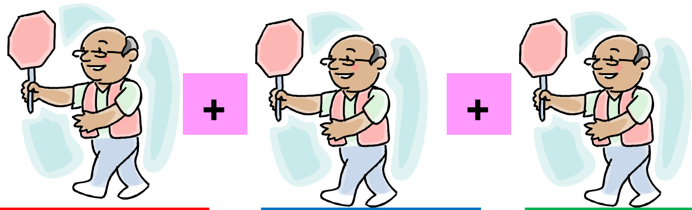
Increase/Decrease in cash and cash equivalents



Increase or decrease in cash and cash equivalents =



Operating activities + **Investing activities** + **Financing activities**

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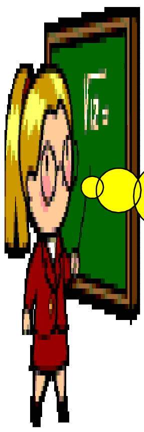
Presentation of operating activities



- **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**

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Illustration: Direct method

	2015	2015
	$'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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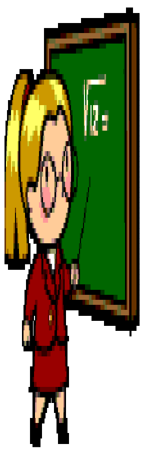
Indirect method



- 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

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Indirect method of presenting operating cash flows

	2014	2014
	$'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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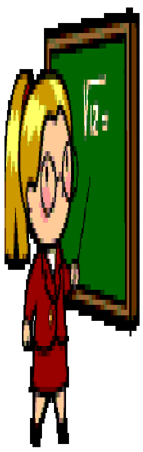

Interest and dividends

- 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**

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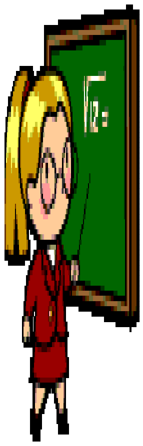
Interest and dividends (cont'd)



- 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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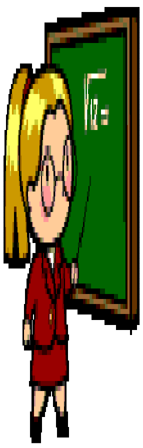
Shares classified as liabilities



- 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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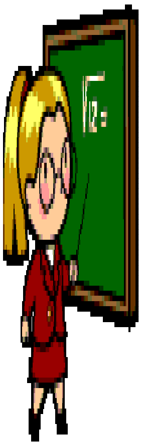
Treasury shares



- 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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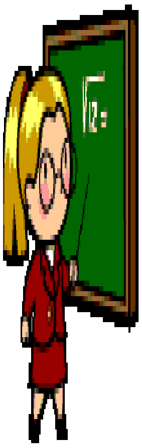
Assets held for rental and subsequently held for sale



- 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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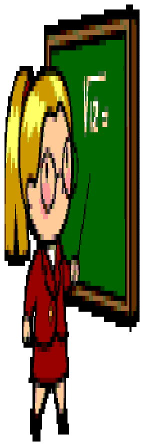

Taxes

- 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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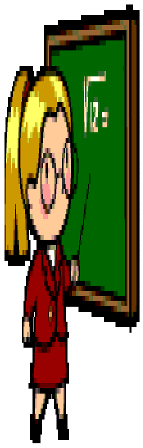

Taxes

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

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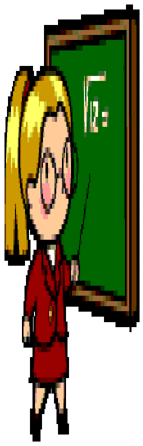

Factored receivables

- 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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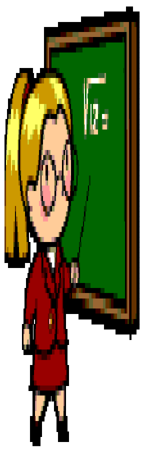

Finance lease payments

- 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

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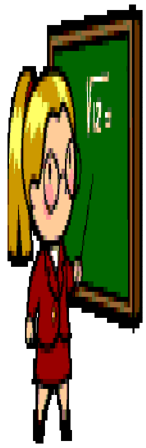
Offsetting



- Generally, all financing and investing cash flows are reported gross
- Receipts and payments may be reported on a net basis if (a) cash receipts and payments on behalf of customer rather than those of the entity and (b) cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short

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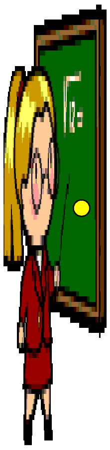
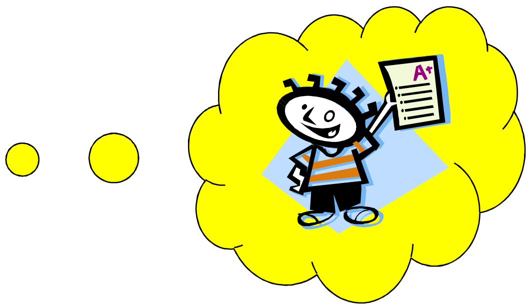
Quiz time





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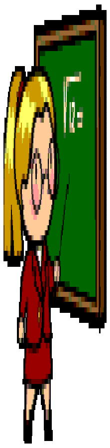

Quiz 1

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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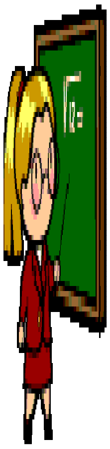

Quiz 2

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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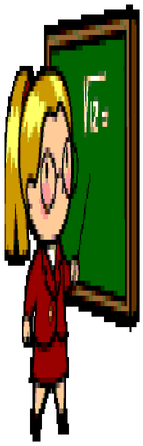

Quiz 3

Finance leases	**2015 $'000**	**2014 $'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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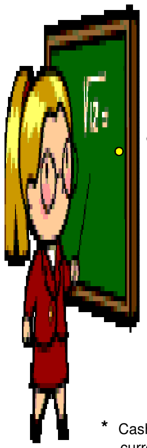
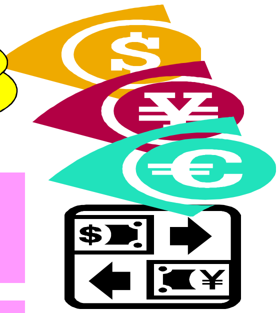
Foreign currency cash flows



Foreign currency cash flows arise in two instances…

- **when the reporting entity enters into an external transaction involving inflows or outflows in foreign currency** *
- **When the reporting group includes an overseas subsidiary and there are cash movements between that subsidiary and other entities in the group**



* Cash flows arising from an entity's foreign currency transactions are 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

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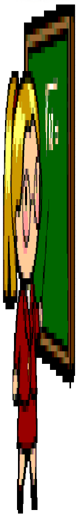
Foreign currency cash flows – Example 1



	Fx	Rate	Functional currency
Balance of cash held in foreign currency at 1 January 2014	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 2014	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 2014		**Functional currency 2013**
Share capital	**100**		**100**
Retained earnings	**200**	**(150-80+130)**	**0**
	300		**100**
Cash	**300**		**100**

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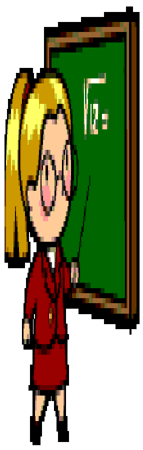
Foreign currency cash flows – Example 1 (cont'd)



	2014
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 2014	100
Effect of exchange rate fluctuations on cash held	**130**
Cash and cash equivalents at 31 December 2014	300

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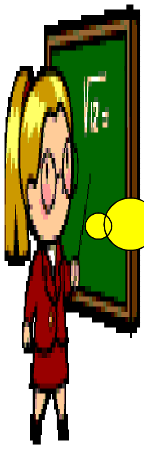
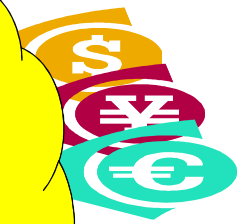
Foreign currency cash flows



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



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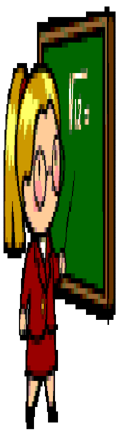
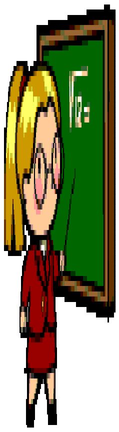
Foreign currency cash flows – Example 2



	Fx	Rate	Functional currency
Loan obtained during 2014	250	1.5:1	375
Translate at the end of the reporting period	250	2:1	500

Foreign currency cash flows – Example 2 (cont'd)



Statement of financial position (in FC)	2014		2013
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	**2014**		
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 2014	300		
Cash at 31 December 2014	675		

Note: Cash balance at the end of 2014 is held in its own functional currency (FC)

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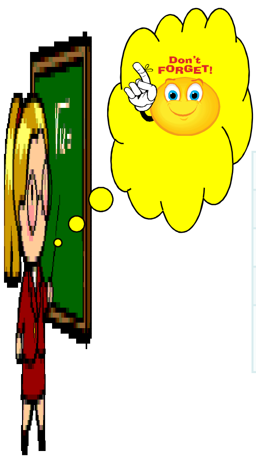
Foreign currency cash flows



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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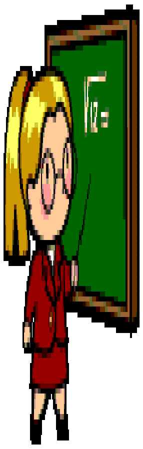
Consolidated cash flow statements



- 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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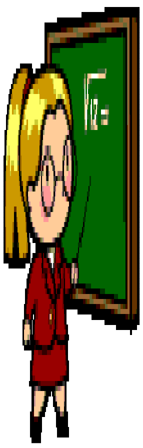
Acquisitions and disposals of subsidiaries



- 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"**

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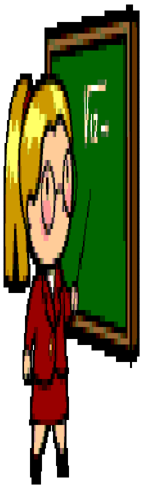
Acquisition of a subsidiary



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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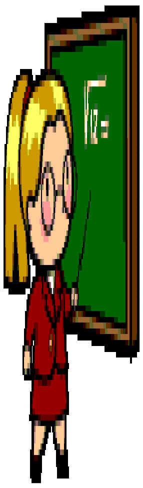
Disposal of a subsidiary



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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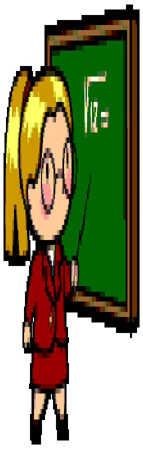
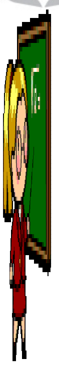
Acquisitions and disposals of subsidiaries



- 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

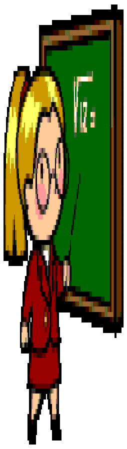
Disposal of a subsidiary



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)

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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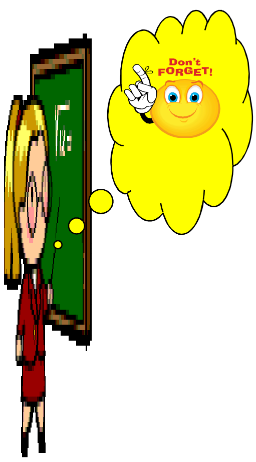
Acquisitions and Disposals of subsidiaries



- 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

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Acquisitions and Disposals of subsidiaries

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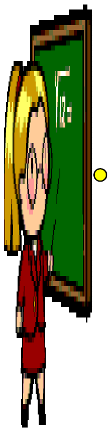

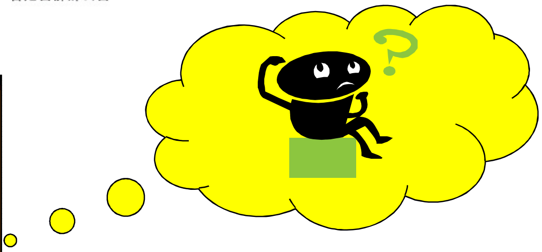

Movement of trade receivables	$
Opening balance	X
Trade receivable of subsidiary at the date of acquisition	X
Movement	X/(X)
Closing balance	X

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Acquisitions and Disposals of subsidiaries

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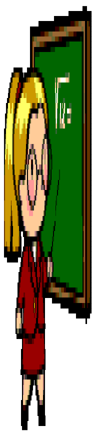

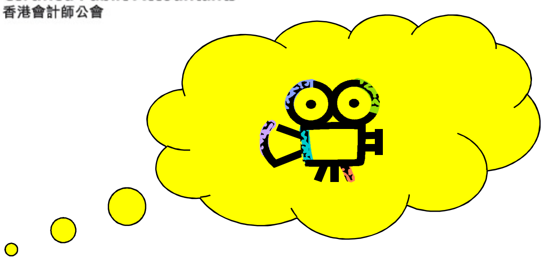

- When there has been a change in ownership interests in a subsidiary, but the transaction, event or circumstance has **not resulted in a loss of control**, the associated cash flows are classified as **financing activities**

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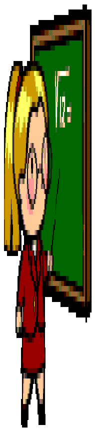
Non-controlling interests



- 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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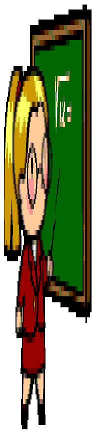
Investments in associates and joint ventures



- 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

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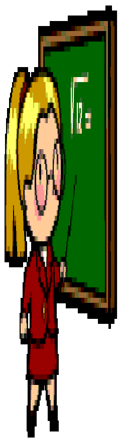
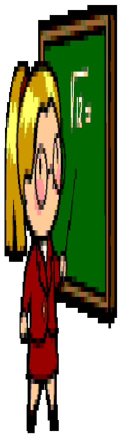


A typical Consolidated Statement of Cash Flows

	$'000	$'000
<u>**Operating activities**</u>		
Profit before tax	X	
<u>**Adjustments for:**</u>		
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



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

	$'000	$'000
<u>Investing activities</u>		
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)
<u>Financing activities</u>		
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		X
Exchange rate effects		X
Cash and cash equivalents at end of year/period		X

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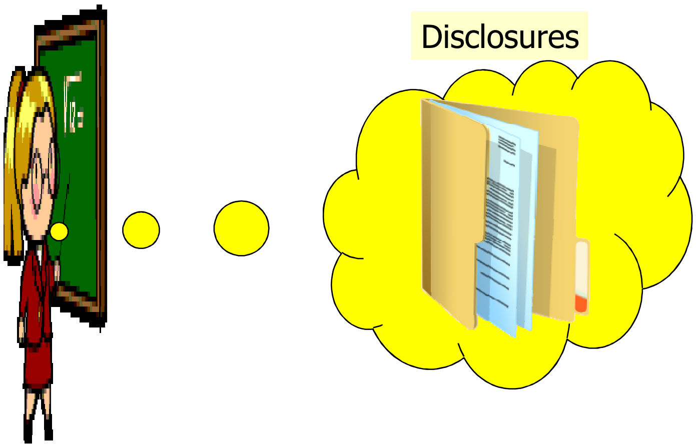
Disclosures



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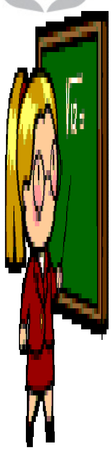
Non-cash transactions



- 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

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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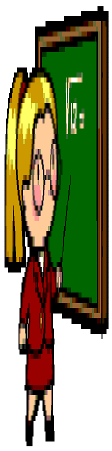
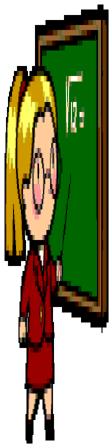
Components of cash and cash equivalents



- 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

Cash and cash equivalents	2014 HK$	2013 HK$
Cash and bank balances	XX	XX
Bank overdrafts	(XX)	(XX)
Cash and cash equivalents in the cash flow statement	XX	XX

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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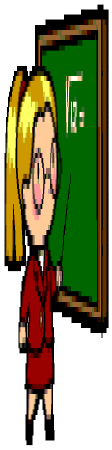
Additional recommended Disclosures



- 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 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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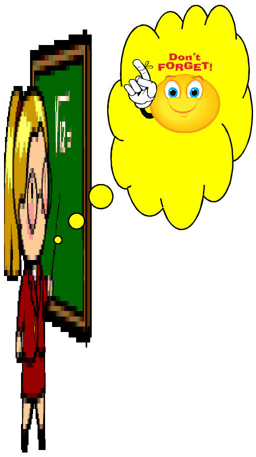
HKAS 7 Statement of cash flows



- 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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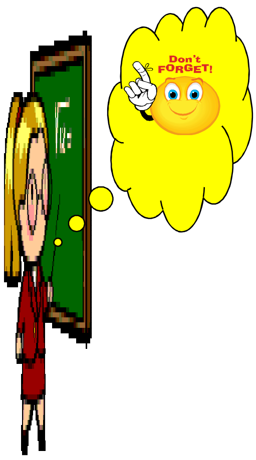
HKAS 7 Statement of cash flows



- 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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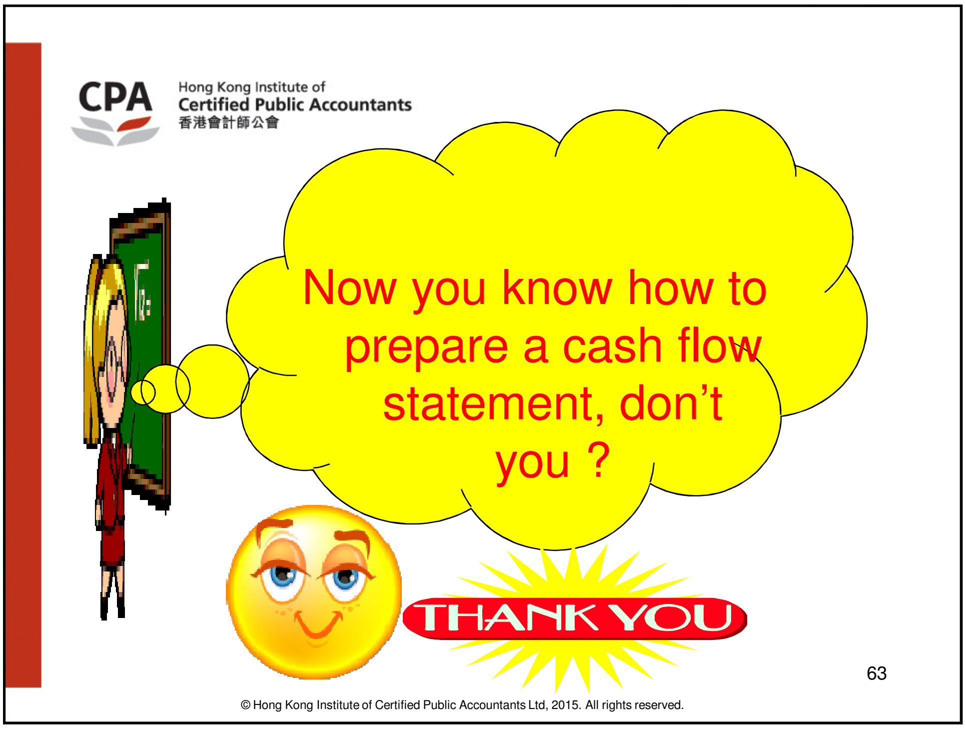
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Now you know how to prepare a cash flow statement, don't you ?
THANK YOU
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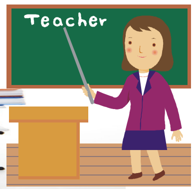
A Refresher Course on Current Financial Reporting Standards 2015 (Day 1)



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HKAS 24 Related Party Disclosures

Agenda

- ❑ Importance of identifying related party relationships
- ❑ Related Party Relationships – Person
- ❑ Related Party Relationships – Entities
- ❑ Non-related party relationships
- ❑ Changes in related party relationships
- ❑ Related party transactions
- ❑ Disclosure requirements
- ❑ Government related entities

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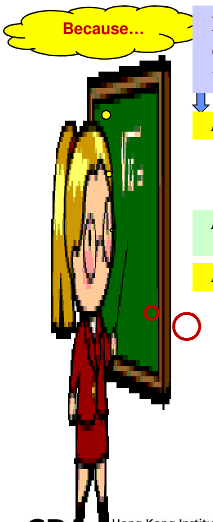
Importance of identifying related parties



Reported financial position and results may have been affected by the existence of related parties and by transactions and outstanding balances with related parties

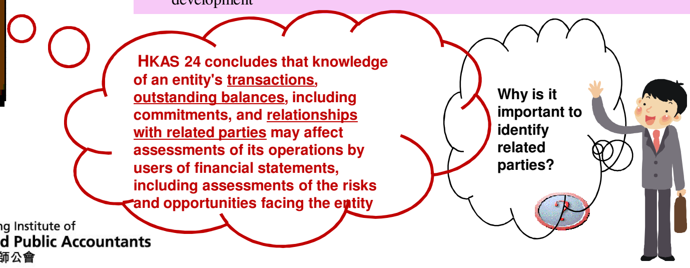
May lead to:

- Transactions being entered into between the related parties that would not be entered into between unrelated parties
- Transactions being effected at different amounts from those that would prevail between unrelated parties

Even if there are no transactions between the parties concerned, the mere existence of the relationship may be sufficient to affect the transactions of the reporting entity with other parties

For example:

- A subsidiary might be instructed by its parent not to engage in research and development



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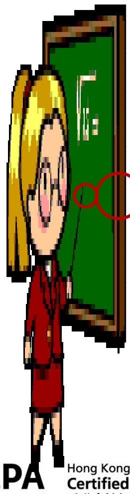
Related party - Definition



A related party can be a person, an entity or an incorporated business that is related to the entity that is preparing its financial statements

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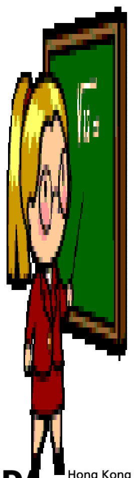
Related party disclosures



(2) Related parties		
The following transactions were carried out with related parties:		
(a) Sales of goods and services		
	2015	2014
Sales/purchases of goods		
- Associates	xxx	xxx
- Associates of ultimate parent	xxx	xxx
Sales of services		
- Ultimate parent	xxx	xxx
(b) Key management compensation		
Key management includes directors, members of the executive committee, company secretary and head of internal audit.		
-salaries and other short-term benefits	xxx	xxx
(c) Year-end balances arising from sales/purchases of goods/services		
Receivables/payables from related parties		
- Associates	xxx	xxx
- Associates of ultimate parent	xxx	xxx
(d) Loans to related parties		
- Loans to associates	xxx	xxx
- Loans to related parties	xxx	xxx

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Related party relationships

How do we decide who is a related party of the reporting entity ?

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Who is the "person" that is related to the entity ?

Individual (Person A)

Reporting entity (Company A)

A person or a close member of that person's family is related to a reporting entity if that person:

(i) has control of the reporting entity

(ii) has joint control of the reporting entity

(iii) has significant influence over the reporting entity

(iv) is a member of the key management personnel of the reporting entity

(v) is a member of the key management personnel of a parent of the reporting entity

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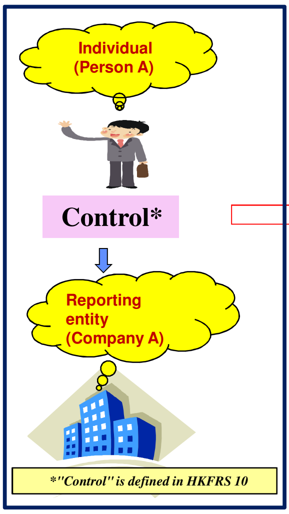
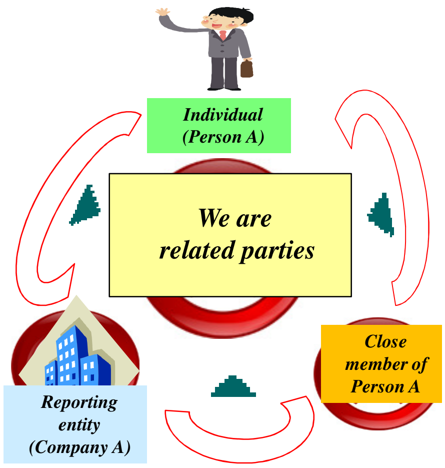
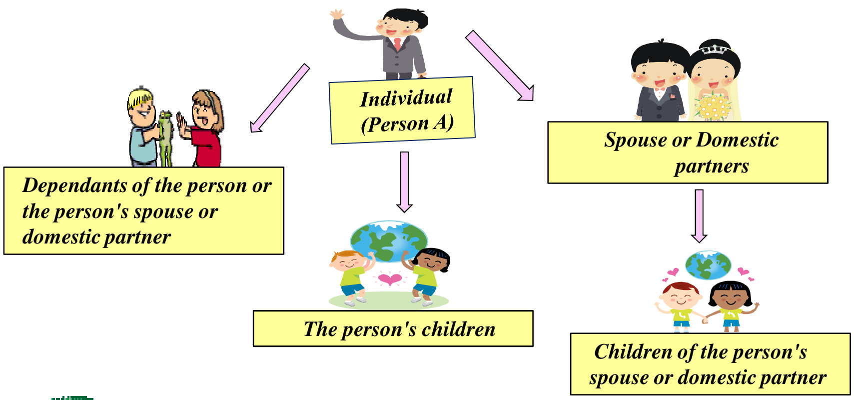
Situation 1: Control



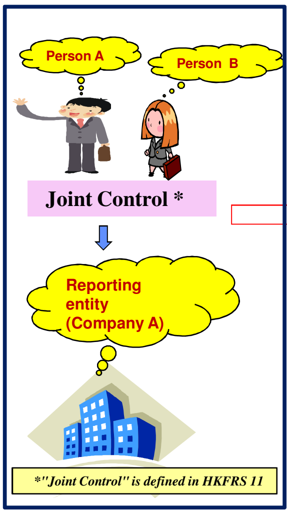


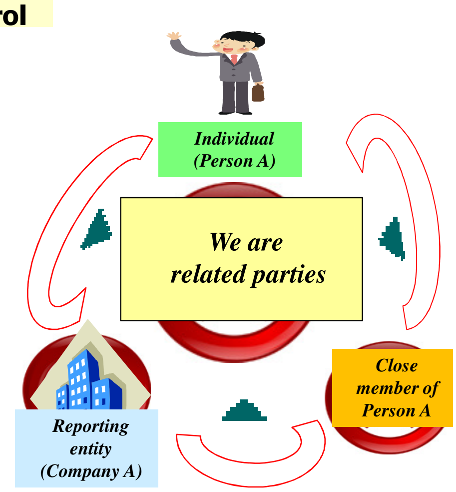
Close family members



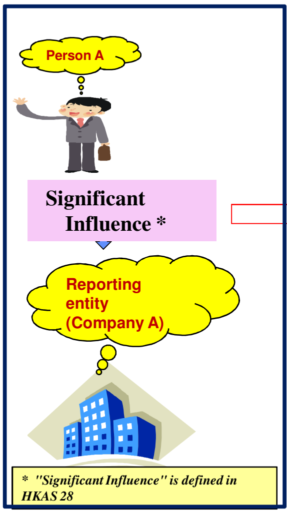
Close family members of a person are defined as those family members who may be <u>expected to influence</u>, or <u>be influenced by</u>, that person in their dealings with the entity

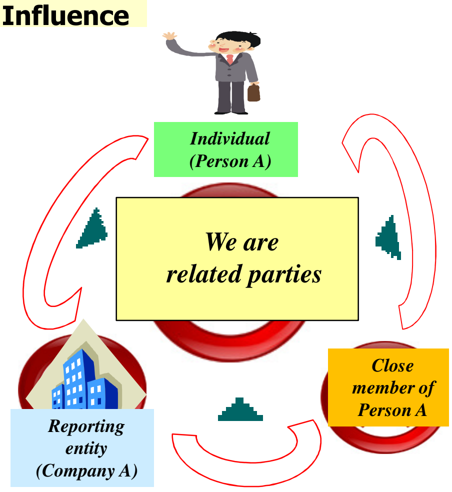
Situation 2: Joint Control



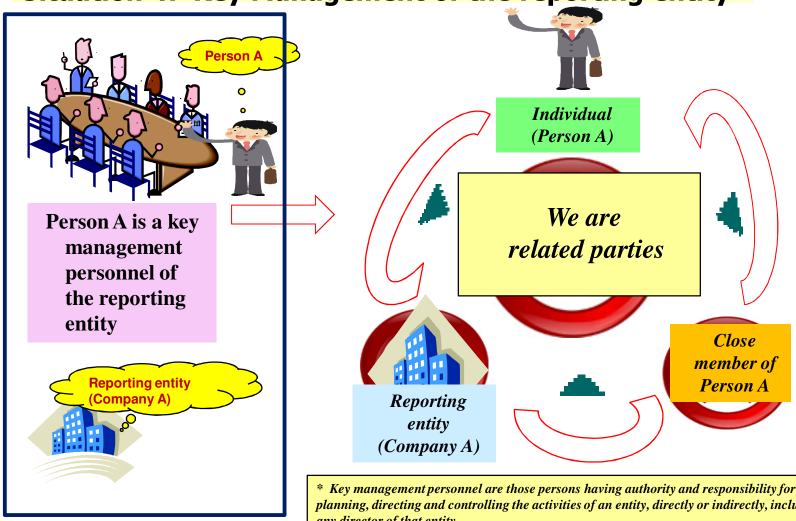


Situation 3: Significant Influence



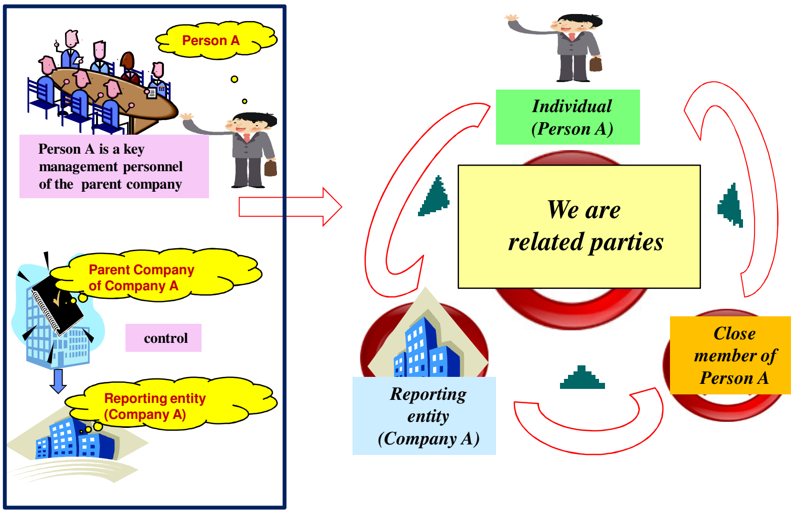


Situation 4: Key Management of the reporting entity



* *Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity, directly or indirectly, including any director of that entity*

Situation 4: Key Management of the parent company



Summary: Related party relationship - individual

Individual (Person A) and his/her close family members

Reporting Entity

Control

Joint Control

Significant Influence

Key management personnel

The individual and close family members are related party of the reporting entity

Related party relationship – Group Companies

Company A

Control

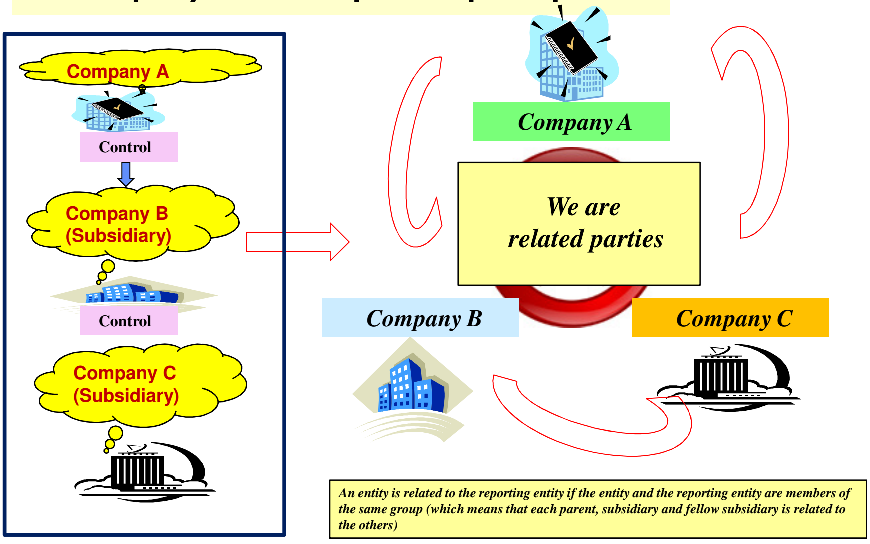
Company B (Subsidiary)

Company A

We are related parties

Company B

Related party relationship – Group Companies



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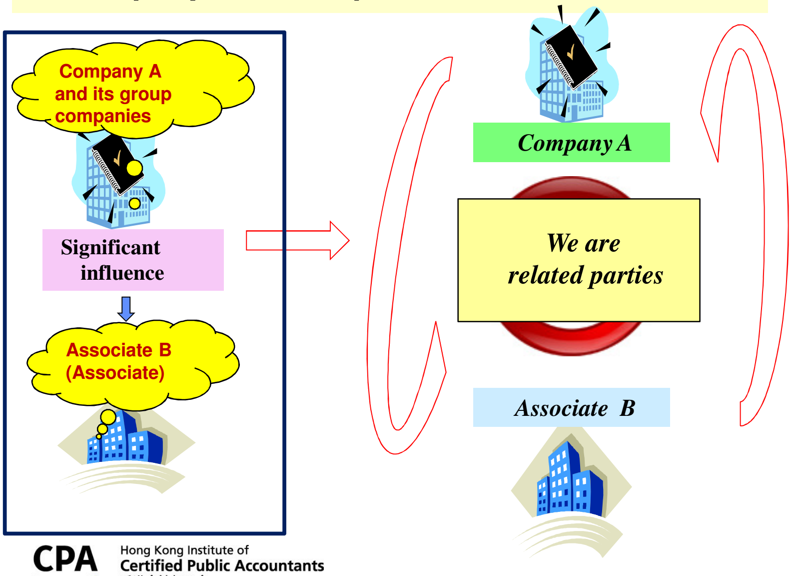
Related party relationship – Associate/Joint ventures



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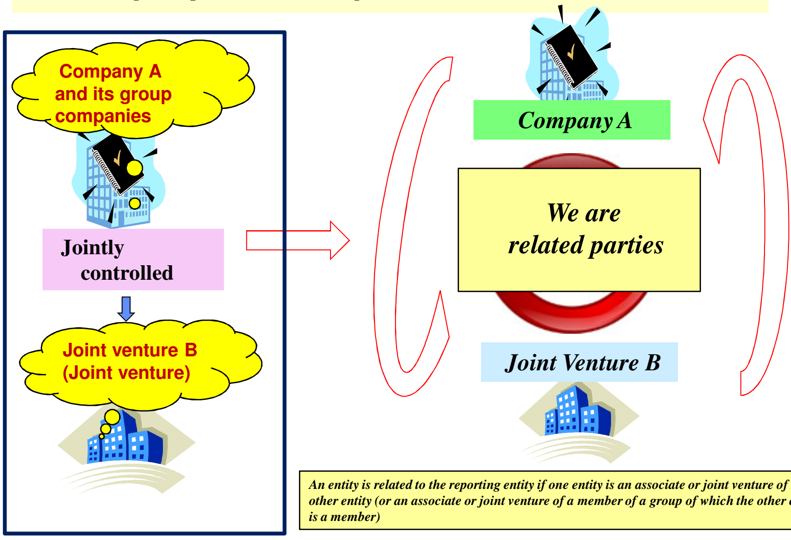
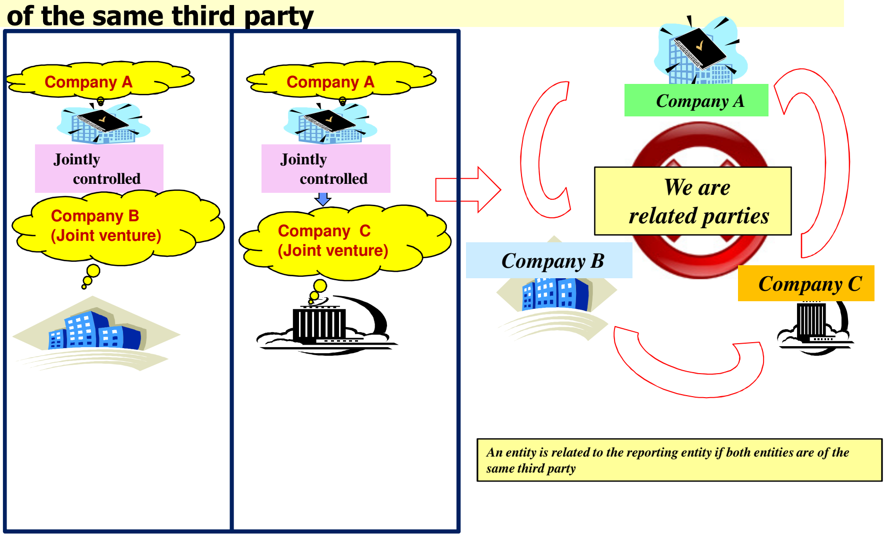
Related party relationship – Associate/Joint ventures



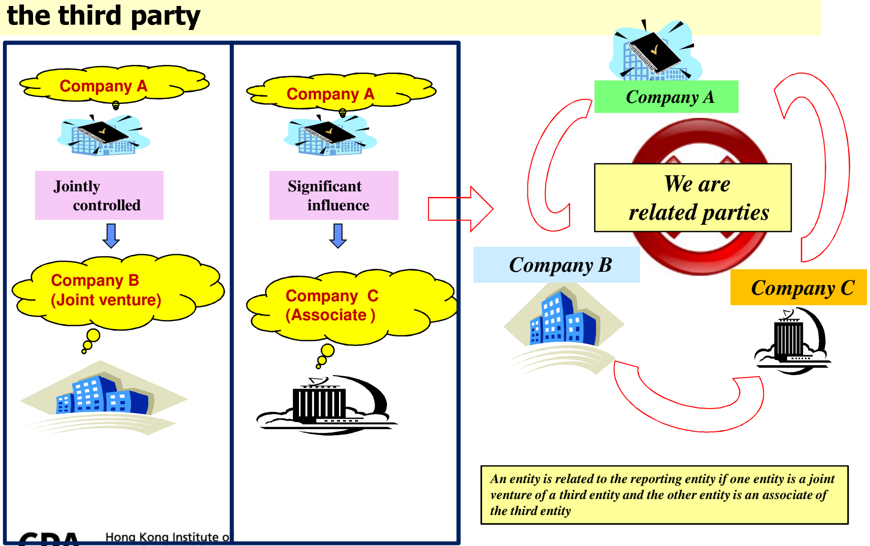
An entity is related to the reporting entity if one entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member)

Related party relationship – both entities are joint ventures of the same third party

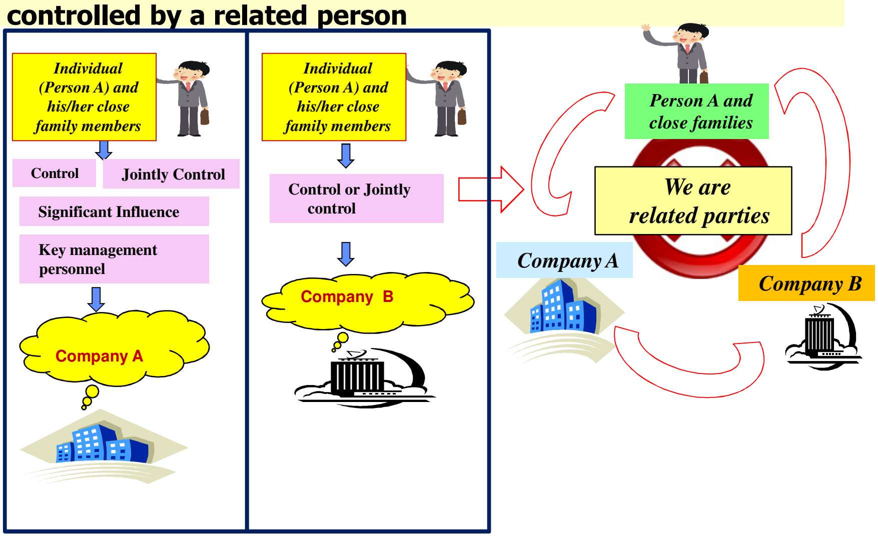


An entity is related to the reporting entity if both entities are of the same third party

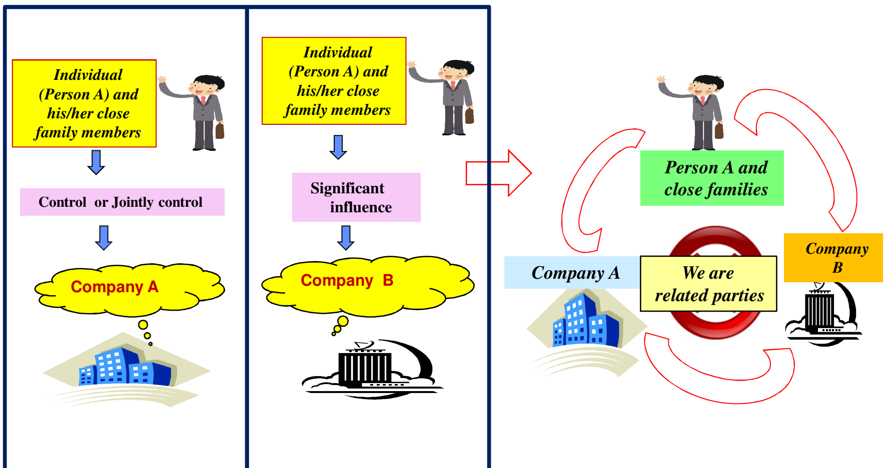
Related party relationship – one entity is a joint venture of the third party and the other entity is an associate of the third party



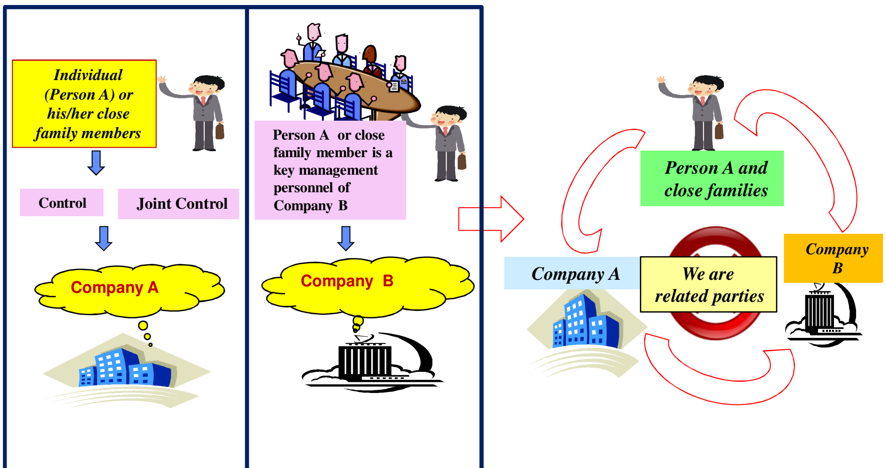
Related party relationship – the entity is controlled or jointly controlled by a related person



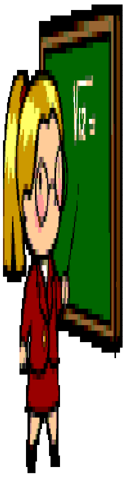
Related party relationship – control or jointly control of a company and significant influence of another company by a related individual



Related party relationship – a related person is a member of the key management personnel of the entity

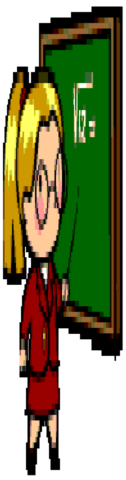


Parties that are not necessarily related



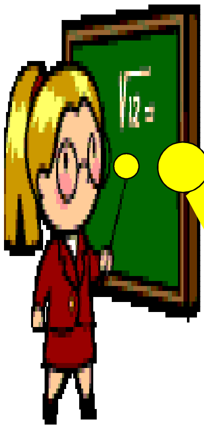
- Two entities simply because they have a director or other member of key management personnel in common, or because a member of key management personnel of one entity has significant influence over the other entity
- Two venturers simply because they share joint control over a joint venture
- Departments 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

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

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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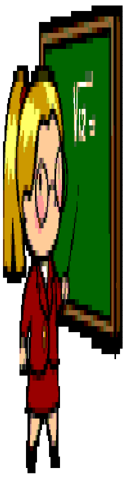
Related party transactions (cont'd)



- 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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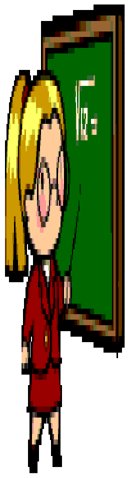
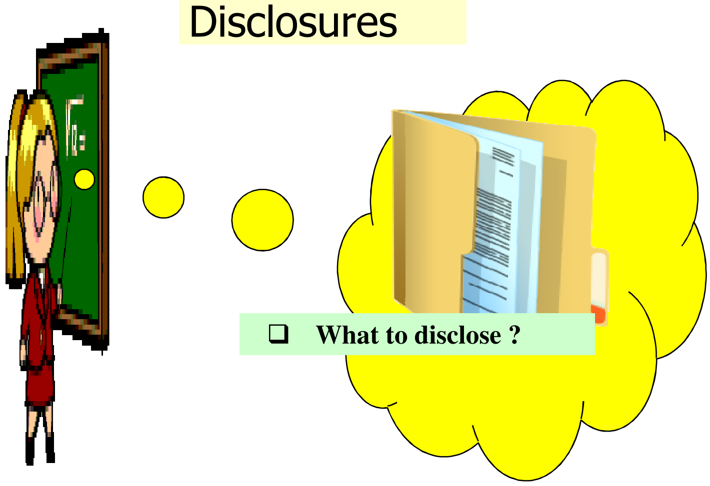
Related party transactions (cont'd)



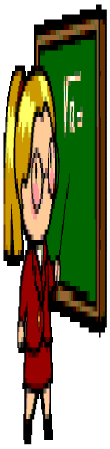
- Types of related party transactions that require disclosure in the period in which they occur: (cont'd)
  - Commitments to do something if a particular event occurs or does not occur in the future, including recognised and unrecognised executory contracts
  - Settlement of liabilities on behalf of 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]

Disclosures



Disclosure requirements

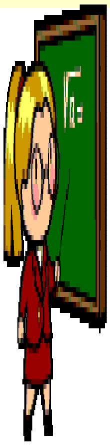


- **Disclosure of control – Parents and subsidiaries**
  - HKAS 24 requires disclosure of **relationships between a parent and its subsidiaries, irrespective of whether there have been transactions between them**

    [HKAS 24.13]

  - This disclosure is in addition to the requirements of HKAS 27 and HKFRS 12 [HKAS 24.15]

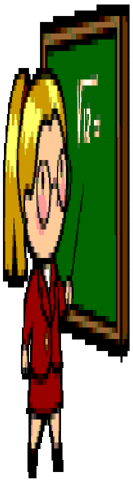
Disclosure requirements (cont'd)



- **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)]

Quiz time - 1



Mr A

↓

Entity L ← Both entities K and L produce consolidated financial statements filed with the local stock exchange

↓

Entity K

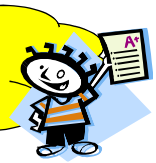
↓

XYZ Ltd ← XYZ Ltd does not publish financial statements for public use

↓ 100%

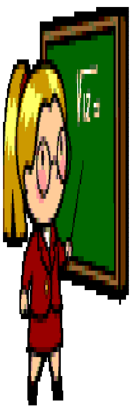
Entity C – the reporting entity

Which controlling parties need to be disclosed by entity C?



Quiz time – 1 (cont'd)

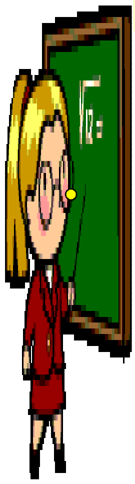
❑ Disclosure where ultimate controlling party is not an entity



Mr A → Entity L → Entity K → XYZ Ltd → Entity C

- ❑ 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)]

Quiz time - 2

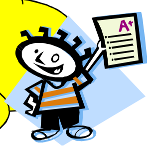


Mr X → Trust → Entity A → Entity B → (100%) Entity C

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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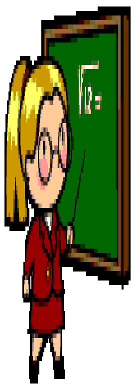
Quiz time – 2 (cont'd)

- **Example – Disclosure of controlling party that does not prepare financial statements**



Mr X → Trust → Entity A → Entity B → Entity C

- 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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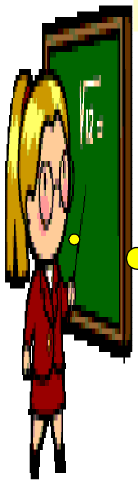
Quiz time - 3



Mr A

Trust

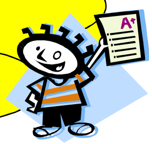
100%

Entity B

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?



Quiz time – 3 (cont'd)

- Example – A trust as the ultimate controlling party

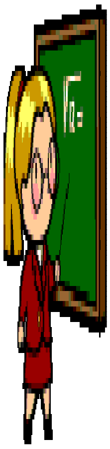
Mr A

Trust

100%

Entity B

- 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



Disclosure requirements (cont'd)

❑ **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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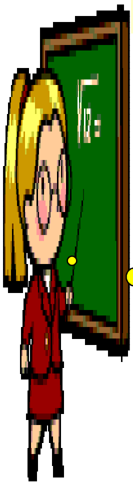

Quiz time - 4

Parent Company

100%

Subsidiary B

Person A is director of both Parent Company and Subsidiary B

- 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 services to the parent

How should these director's remuneration be disclosed in Parent Company and Subsidiary B's financial statements ?

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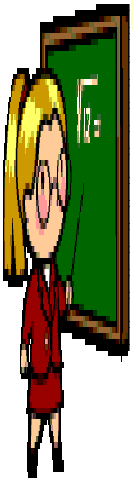


Quiz time – 4 (cont'd)

Parent Company

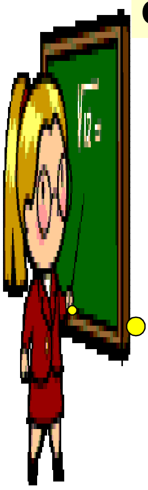
100%

Subsidiary B

Person A is director of both Parent Company and Subsidiary B

- 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 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



Quiz time – 5

Parent Company

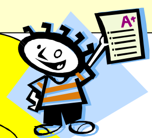
100%

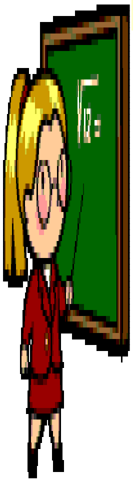
Subsidiary B

Person A is director of both Parent Company and Subsidiary B

- The subsidiary bears cost indirectly via a management charge for services received from the director
- The parent entity pays the director for his services as a director to both the subsidiary and the parent and recharges the subsidiary for the services as a director of the subsidiary

How should these director's remuneration be disclosed in Parent Company and Subsidiary B's financial statements ?





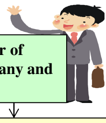
Quiz time – 5 (cont'd)

Parent Company

100%

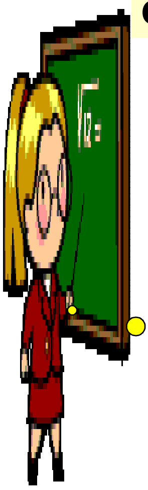
Subsidiary B

Person A is director of both Parent Company and Subsidiary B



- The subsidiary bears cost indirectly via a management charge for services received from the director
- The parent entity pays the director for his 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



Quiz time – 6

Parent Company

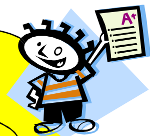
100%

Subsidiary B

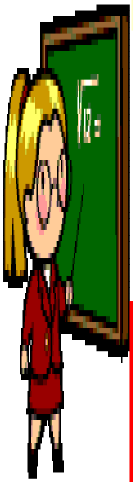
Person A is director of both Parent Company and Subsidiary B

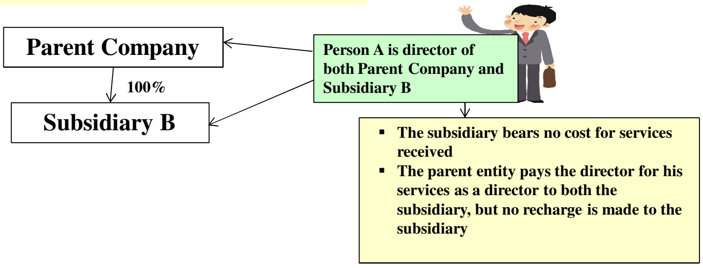
- The subsidiary bears no cost for services received
- The parent entity pays the director for his services as a director to both the subsidiary, but no recharge is made to the subsidiary

How should these director's remuneration be disclosed in Parent Company and Subsidiary B's financial statements ?



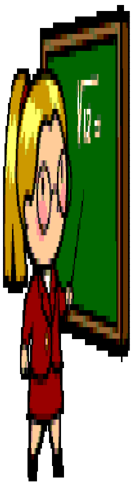
Quiz time – 6 (cont'd)





- ❑ 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

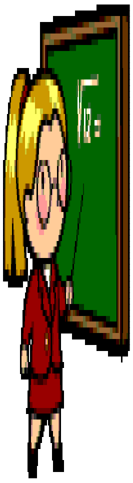
Disclosure requirements (cont'd)



- ❑ **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]

Disclosure requirements (cont'd)

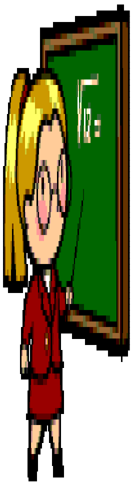


❑ Categories of disclosure

- 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]

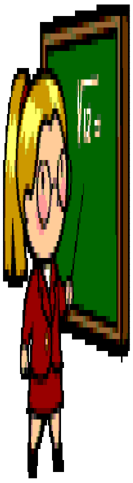
Disclosure requirements (cont'd)



❑ 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]

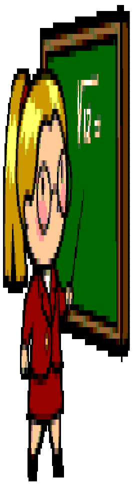


Disclosure requirements (cont'd)

❑ 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]

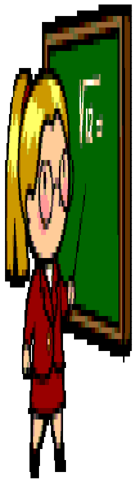


Disclosure requirements (cont'd)

❑ 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

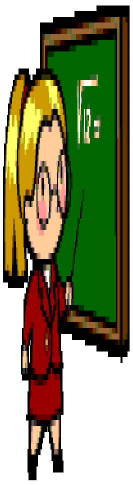
[HKAS 1.38]



Disclosure requirements (cont'd)

❑ **Subsidiaries acquired and disposed of in the year**

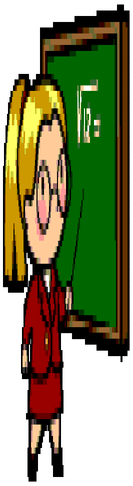
- **Consolidated financial statements**
  - Where a group has acquired a subsidiary, transactions between the members of the acquiring group and the acquired subsidiary prior to the date of acquisition are not disclosable in the consolidated financial statements
  - Where a group has disposed of a subsidiary 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



Disclosure requirements (cont'd)

❑ **Subsidiaries acquired and disposed of in the year**

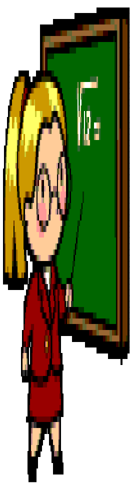
- **Parent's separate financial statements**
  - Where an entity acquires a subsidiary, only transactions between the parent and the subsidiary after the date of acquisition are disclosable in the entity's separate financial statements
  - Where an entity disposes of a subsidiary, only transactions between the parent and the subsidiary up to the date of disposal are disclosable in the entity's separate financial statements



Disclosure requirements (cont'd)

❑ **Subsidiaries acquired and disposed of in the year**

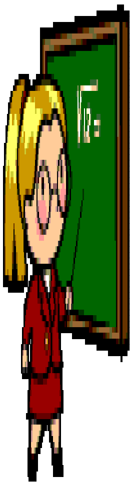
- **Subsidiary's financial statements**
  - Where an entity is acquired in the period, only transactions after the date of acquisition are disclosable in its financial statements because this is the period during which the related party relationship exists
  - Where a subsidiary is disposed of during 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



Disclosure requirements (cont'd)

❑ **Exemption from disclosure**

- Transactions eliminated on consolidation
- Parties that are not necessarily related
- Government-related entities



Disclosure requirements (cont'd)

❑ **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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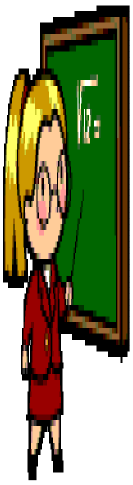

Disclosure requirements (cont'd)

❑ **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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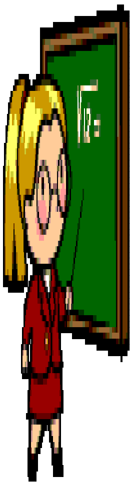
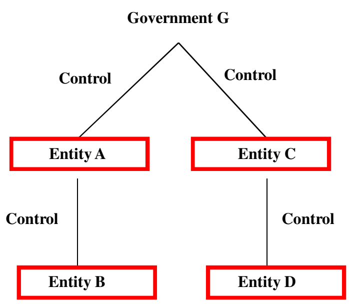


Disclosure requirements (cont'd)

- **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]

Disclosure requirements (cont'd)

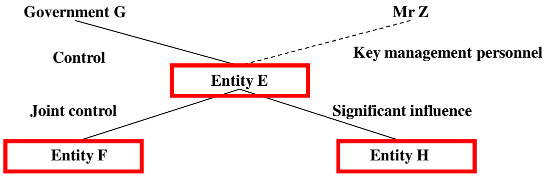
- **Example – Government control**



- 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)]

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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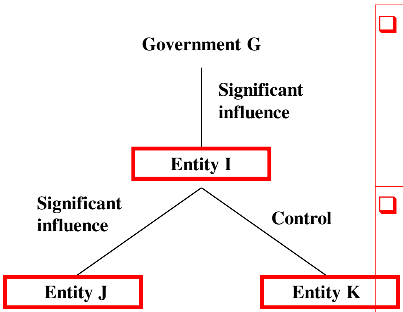
Disclosure requirements

- 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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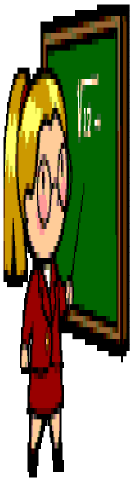
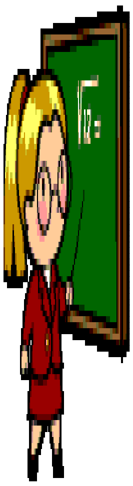
Non-disclosure and the position of the auditor



- 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]

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]

HKAS 24 Related Party Disclosures

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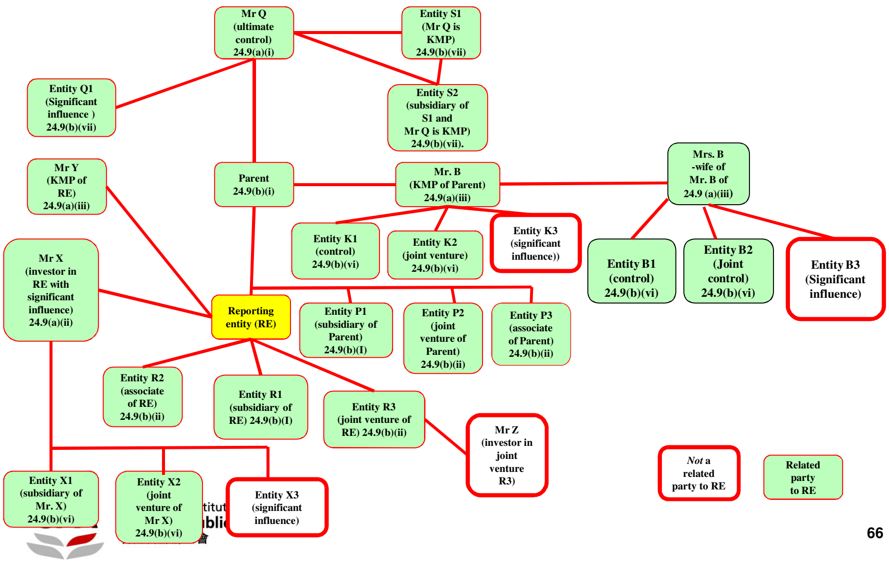
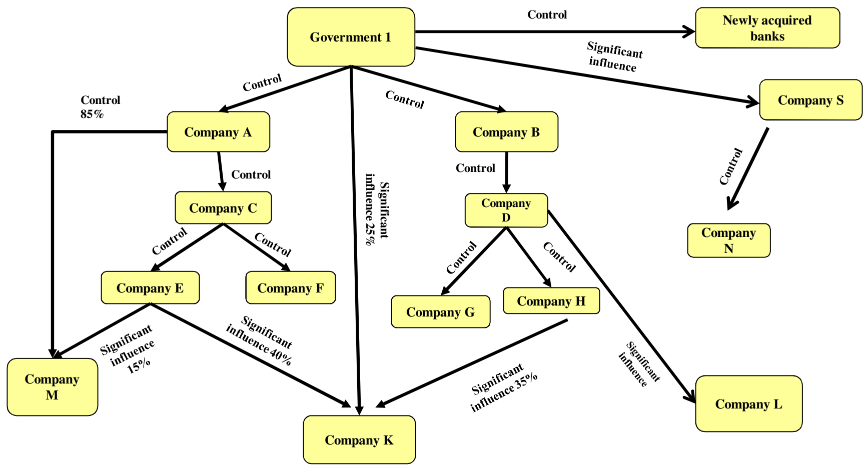
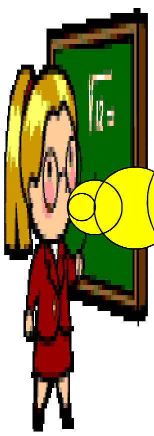
Summary of Related Party Relationship



Government-related entities in scope exemption





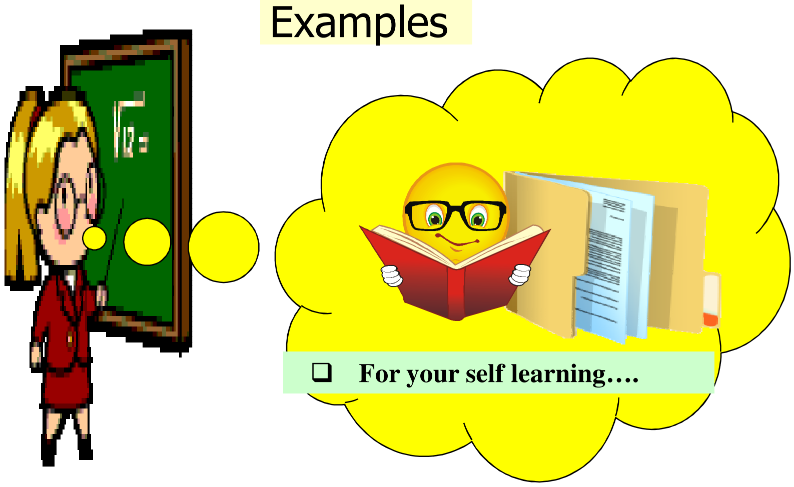
HKAS 24 is a disclosure standard

It sets out how related party relationships, transactions and balances, including commitments, should be identified and what disclosures should be made and when

Do you know who is a related party now?

More examples…

Examples



Related parties

Example – Directors of subsidiaries as key management personnel of a group

Parent A

Sub B   Sub C   Sub D

- 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?

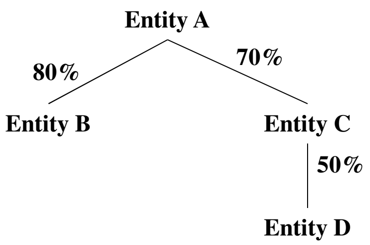
A director of a subsidiary is not automatically a related party of the group. The director is a related party of the group if he is determined to be a member of the group's key management personnel

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

Related parties

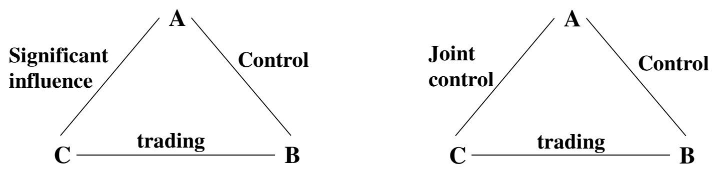
❑ Example – Joint venture of group member



- 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

Related parties

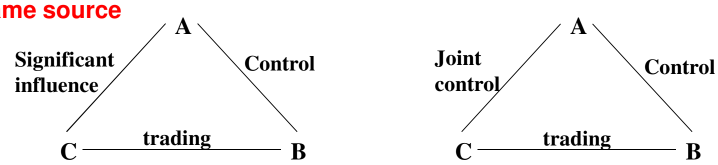
❑ Example – Control, significant influence or joint control from the same source



- Entities A and B are related parties [HKAS 24.9(b)(i)]
- Entities A and C are related parties [HKAS 24. 9(b)(ii)]

Related parties

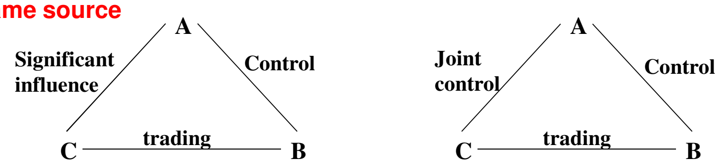
- **Example – Control, significant influence or joint control from the same source**



- 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

Related parties

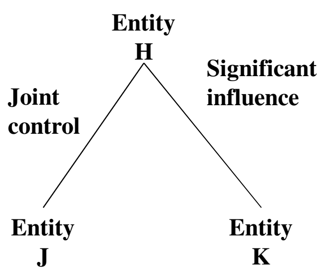
- **Example – Control, significant influence or joint control from the same source**



- 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

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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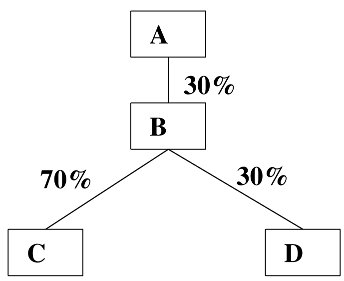
Related parties

❑ **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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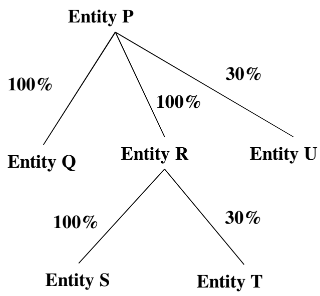
Related parties

❑ 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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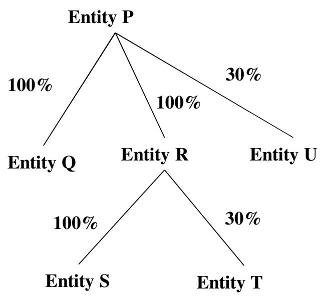
Related parties

❑ 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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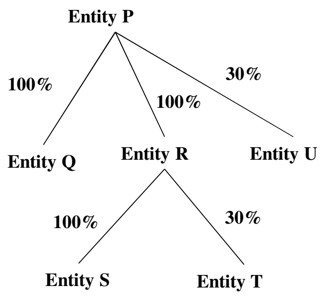
Related parties

❑ Example – Group holdings – subsidiaries and associates

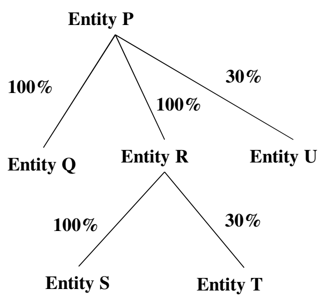


Entity T's financial statement

- 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

Related parties

❑ Example – Group holdings – subsidiaries and associates

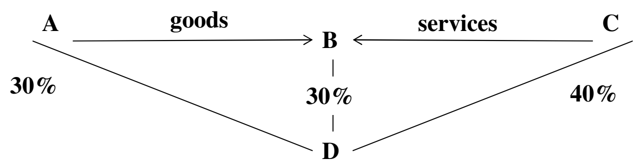


Entity U's financial statement

- 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.

Related parties

❑ **Example – Transactions between different investors in an associate**

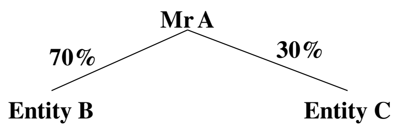


- Entities A, B and C are related parties of entity D, but not necessarily related parties of each other. Consequently, unless there is some other relationship between entities A, B and C (other than the fact that they are all investees in entity D) that would make them related parties, the transaction 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)]

Related parties

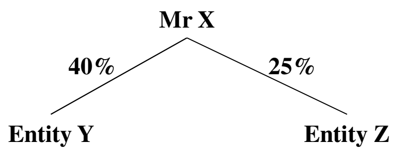
❑ **Example – Investor controls one entity and has significant influence over another**



- 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

Related parties

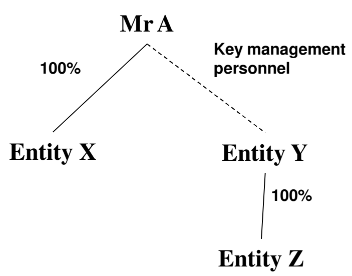
- **Example – Investor has significant influence over two entities**



- 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]

Related parties

- **Example – Key management personnel**

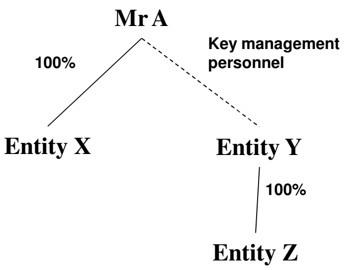


Entity X's financial statements

- 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)]

Related parties

❑ Example – Key management personnel

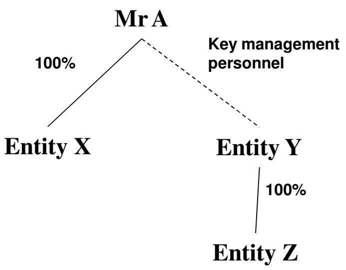


Entity Y's separate and consolidated financial statements

- 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

Related parties

❑ Example – Key management personnel

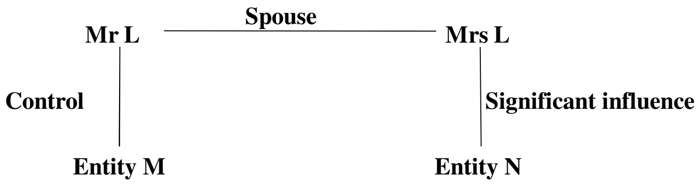


Entity Z's financial statements

- 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)]

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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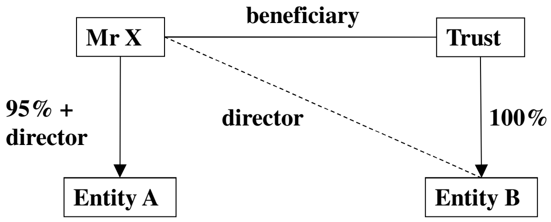
Related parties

- **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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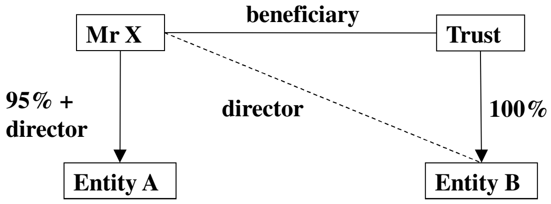
Related parties

❑ Example – Director's relationship with a trust



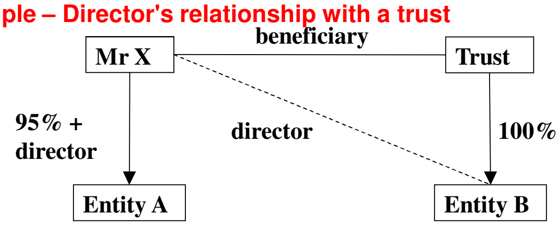
What if Mr X resigned as a director of entity A, but retained his 95% holding?

- 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)]

Related parties

❑ Example – Director's relationship with a trust

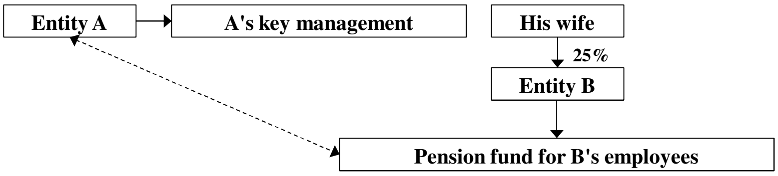


What if Mr X resigned as a director of entities A and B and transferred the 95% holding in entity A to the trust?

- 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***"

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

A Refresher Course on Current Financial Reporting Standards 2015 (Day 1)

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HKFRS 3
Business Combination

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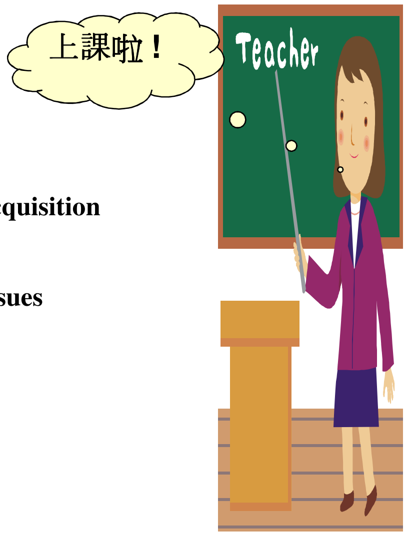
Learning Objectives



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

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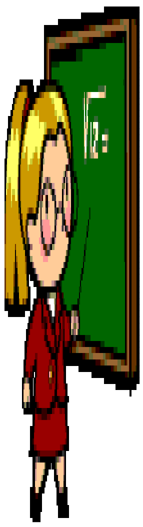

Scope of HKFRS 3

❑ 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 of entities or businesses under common control
- The acquisition by an investment entity, as defined in HKFRS 10, of an investment in a subsidiary that is required to be measured at fair value through profit or loss

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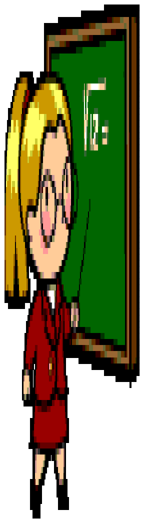

Identifying a business combination

- **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]

INPUT (economic resources) + **PROCESSES (strategic/ resources management process** = **OUTPUTS (Return)**

INPUT:
- employees
- materials
- rights of use
- non-current assets

PROCESSES:
- Administrative, billing, payroll and accounting processes are excluded

OUTPUTS:
- dividends
- lower cots
- economic benefits to stakeholders

Input and processes:
- Must be present for a business to exist
- Does not need to include all the processes and inputs that the seller used to operate it as a business
- Must be capable of being managed as a business
- If goodwill present presumed to be a business

Outputs:
- Output are not necessary
- Development stage entities can still be a business

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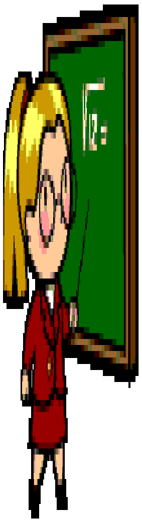
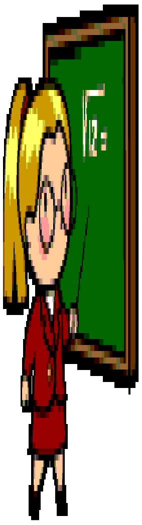


Acquisition of Asset

- When the acquisition of assets does not constitute a business
  - Should NOT be accounted for as a business combination in accordance with HKFRS 3
- 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

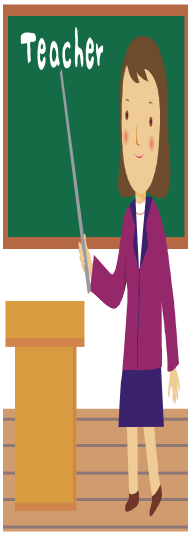


Business vs Asset Acquisition

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

Application of Acquisition Method



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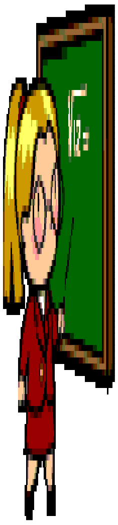

Acquisition method

- 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 – Measuring consideration and determining what is part of the business combination
  - Step 5 – Recognising and measuring goodwill or a gain from a bargain purchase

[HKFRS 3.4,5]

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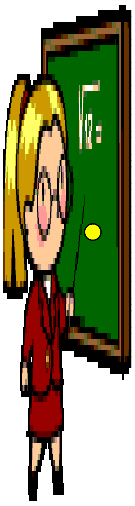

Step 1:

Identifying An Acquirer

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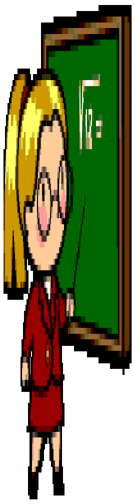

Who is the Acquirer?

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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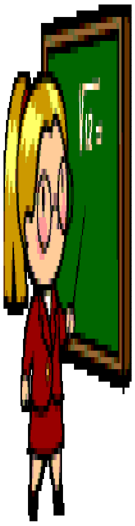


Has the acquirer obtained control?

- **Two-steps approach [HKFRS 3.7]**

Step 1 - An entity should refer to the definition of control of an investee in HKFRS 10:

- An investor controls an investee when the investor 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 [HKFRS 10: Appendix A]

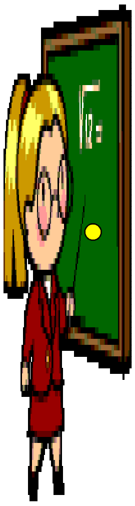
Step 2 - When application of HKFRS 10 does not indicate which of the combining entities is the acquirer, a number of additional factors for consideration are set out in HKFRS 3: B14 to B18

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



Step 2

Determining the Acquisition Date

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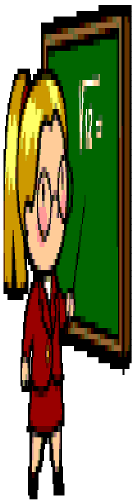

Acquisition date

- The **date** on which the acquirer **obtains control** of the acquiree
- 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 3.8 – 3.9]

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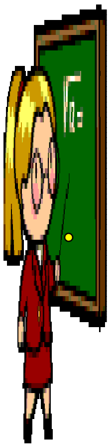
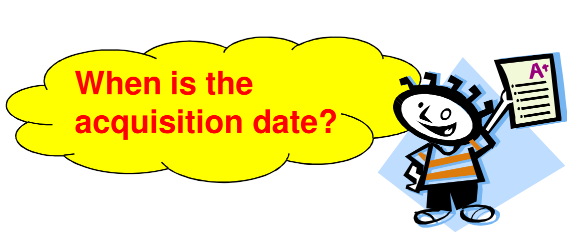
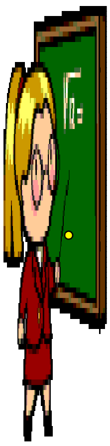
Quiz time - 1



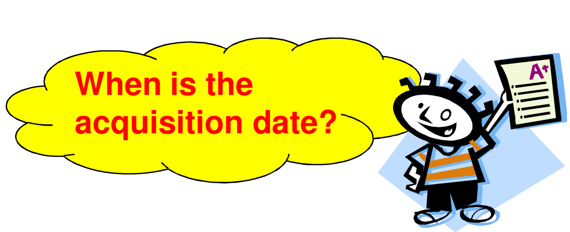
- On 1 Dec 2014, Entity A agreed to pay $20M as a consideration for the acquisition of 100% of the equity interest of Entity B. The agreement states that Entity A obtains the control of Entity B as of the date of the agreement. Entity A paid the consideration of $20M on 1 January 2015

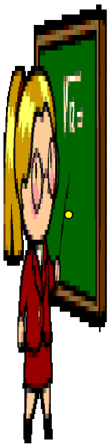


Quiz time - 2



- On 1 March 2015, 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 December 2014. Entity A paid the consideration of $20M on 1 April 2015

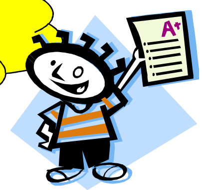




Quiz time - 3

- On 1 Jan 2015, 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 2015

When is the acquisition date?



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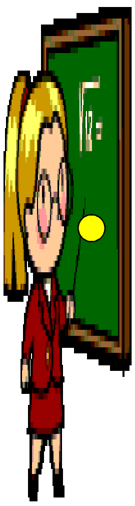

Step 3

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

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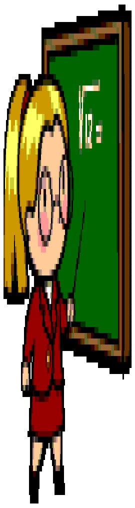
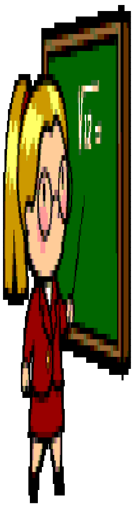


Recognition principle

- 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**



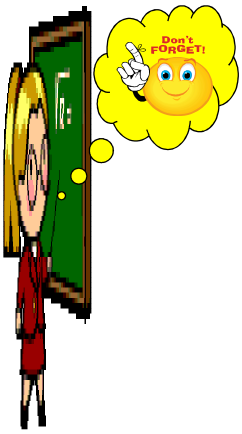
Recognition principle (cont'd)

- **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]

Recognition principle (cont'd)

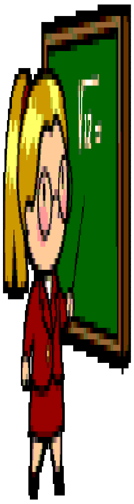


- **Points to remember on the acquisition date accounting and the recognition principle:**
  - The assets and liabilities should **exist at the acquisition date.** Assets and liabilities that arise after the acquisition date are not recognised [HKFRS 3.11]
  - The identifiable assets acquired and liabilities 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]
  - 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]

Recognition principle (cont'd)

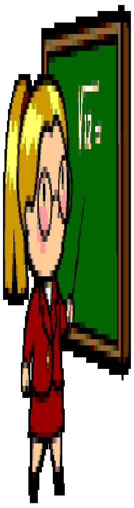
- The acquirer subsumes into goodwill the value of an acquired intangible asset that is **not identifiable** as of the acquisition date [HKFRS 3.B37]
- The acquirer also subsumes into goodwill any value attributed to items that **do not qualify as assets** at the acquisition date [HKFRS 3.B38]

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

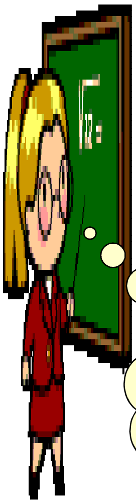
Measurement principle (cont'd)



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

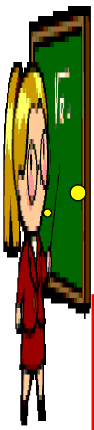
- Measure the fair value in accordance with its use by **other market participants** instead of assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them
  [HKFRS 3.B43]

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
  - Classifications of financial liabilities as at fair value through profit or loss
  - Designation of a derivative as a hedging instrument
  - Assessment of whether an embedded derivative should be separated from a host contract

Classification principle (cont'd)

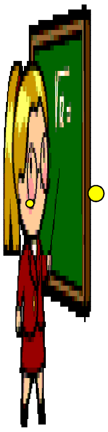


Two Exceptions

- 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*

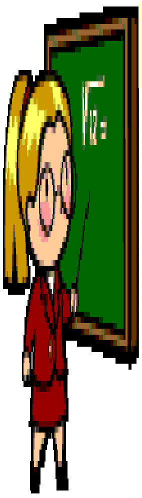
The acquirer classifies operating leases and insurance contracts on the basis of the contractual terms and other factors **at the inception of the contract** (or, if the terms of the contract have been modified in a manner that would change its classifications, at the date of that modification, which might be the acquisition date)

Specific recognition and measurement items



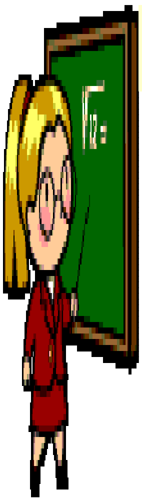
HKFRS 3 includes specific guidance on how operating leases should be recognised and measured when accounting for a business combination

Specific recognition and measurement item - Operating leases



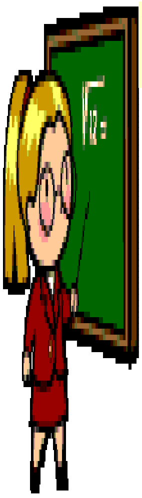
- **Classification as operating or finance:**
  - **Classification** of a lease contract as either an operating or a finance lease at the acquisition date is **based on factors at the inception of the lease**, which is generally before the acquisition date
  - If the **terms of the contract have been 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**

Specific recognition and measurement item - Operating leases

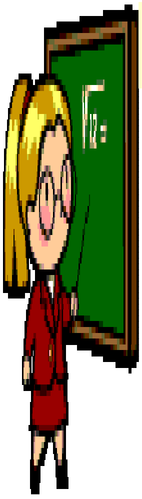


- **Measurement where acquiree is the lessee:**
  - Where the acquiree is a lessee under an operating lease, an acquirer does not generally recognise an asset for the interest in a leased asset and a liability for the lease payments
  - An acquirer recognises a net asset or liability to the extent that 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]

Specific recognition and measurement item - Operating leases (cont'd)

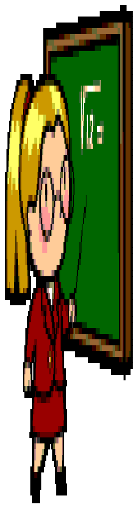


- **Measurement where acquiree is the lessor:**
  - Fair value of the leased asset (e.g. investing property) should take into account the terms of the lease
  - The acquirer should **NOT** recognise the lease agreement as a separate asset or liability [HKFRS 3.B42]



Specific recognition and measurement item - 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]



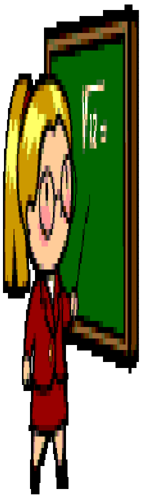
Specific recognition and measurement item - Intangible assets (cont'd)

- 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]



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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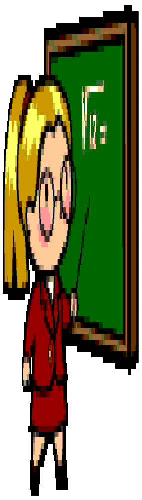
Recognition of intangible assets - example



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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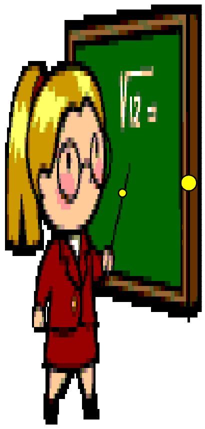
Recognition and measurement exceptions



Recognition and measurement exceptions

Recognition exceptions
Contingent liabilities

Measurement exceptions
Reacquired rights
Share-based payment awards
Assets held for sale

Recognition

Measurement

Both recognition and measurement exceptions
Indemnification assets
Income taxes
Employee benefits

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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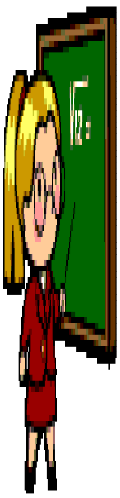
Exceptions to the recognition principles – Contingent Liabilities (cont'd)



The acquirer recognises a contingent liability assumed in a business combination at the acquisition date <u>even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation</u>

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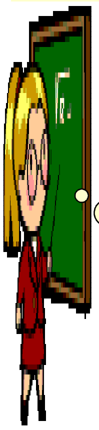
Exceptions to the recognition principles (cont'd)

❑ **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

Exceptions to recognition and measurement principles – Indemnification Assets



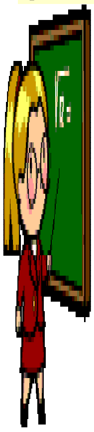
- The seller in a business combination may **contractually indemnify the acquirer** for the **outcome of a contingency or uncertainty related to all or part of a specific asset or liability**

e.g., the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency

e.g., entity is the subject of an uncertain tax position and the vendor agrees to refund the acquirer if any costs are incurred as a result of the investigation, up to a cap

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

Exceptions to both recognition and measurement principles – Indemnification Assets (cont'd)

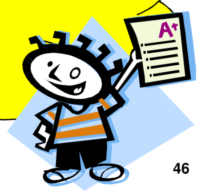


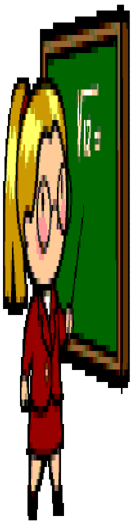
- Acquirer **recognise an indemnification asset** at the **same time** when the **acquirer recognises the indemnified item**, assuming that there is no uncertainty over the recovery of the indemnification asset
- The **indemnified item** (i.e., contingent liability) is measured at **fair value.** The **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)

Quiz time - 4

- 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

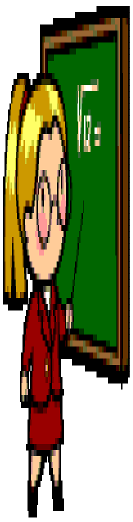
How should entity E account for the contingent liability (assume the fair value of the contingent liability is $7M) and the indemnification asset?





Exceptions to both recognition and measurement principles – Income Taxes

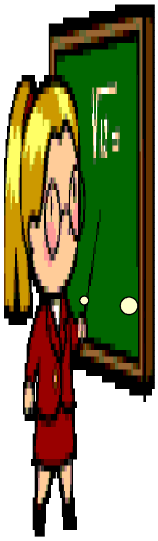
- The acquirer shall recognise and measure a deferred asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with HKAS 12 "Income Taxes"
  [HKFRS 3.24]
- The acquirer shall account for the potential tax effects of temporary differences and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



Exceptions to both recognition and Measurement principles – 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]

Exceptions to the measurement principle – Re-acquired Rights



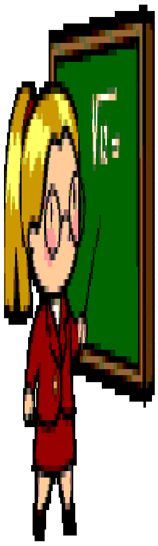
- As part of a business combination, an **acquirer may re-acquire a right** that it had **granted** to the **acquiree** to use one or more of the acquirer's recognised or unrecognised assets

e.g., right to use the acquirer's trade name under a franchise agreement

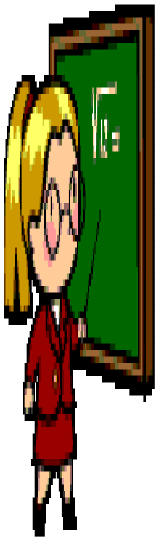
e.g., right to use the acquirer's technology under a technology licensing agreement

Re-acquired right is an identifiable intangible assets that the acquirer recognises separately from goodwill [HKFRS 3.B35]

Exceptions to the measurement principle – Reacquired Rights (cont'd)



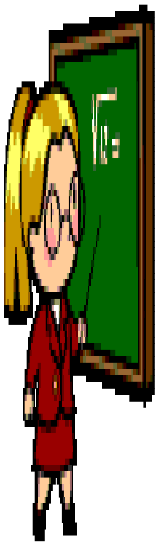
Re-acquired rights are not measured at fair value because the value is determined based only on the right's remaining contractual life without considering renewals



Exceptions to the measurement principle – Share-based payment awards

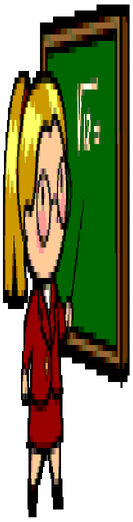
- The acquirer shall **measure a liability or an equity instrument** related to share-based payment transactions of the acquiree **or** the **replacement of an acquiree's share-based payment transactions with share-based payment transactions of the acquirer** in accordance with the method in HKFRS 2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

[HKFRS 3.30]



Exceptions to the measurement principle – 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**

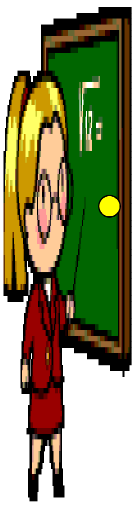


Non-controlling Interest (NCI)

- 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]



Step 4

Measuring consideration and determining what is part of the business combination

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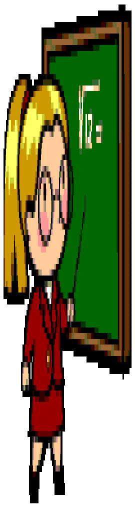

❑ Consideration transferred

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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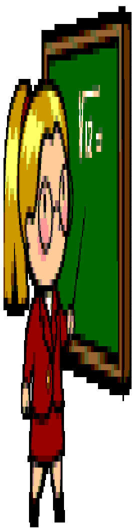

❑ Consideration transferred (cont'd)

- 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 HKFRS 9**

[HKFRS 3.53]

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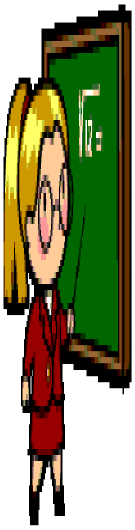
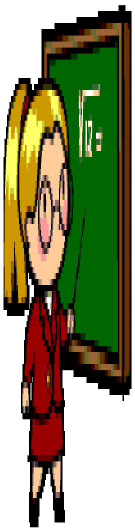


❑ Cost of business combination

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]



❑ 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]

- If the **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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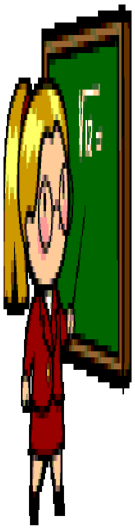
❑ Cost of business combination (cont'd)

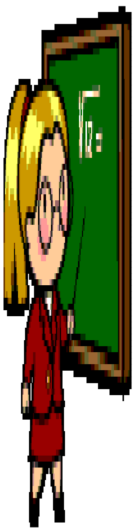


Provisional fair values

- 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]

❑ Cost of business combination (cont'd)

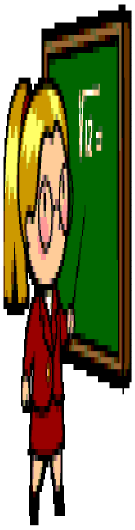


Provisional fair values (cont'd)

- 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]

❑ Cost of business combination (cont'd)

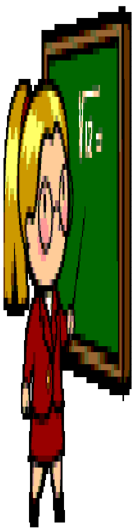


Provisional fair values (cont'd)

- 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]

❑ Cost of business combination (cont'd)



Provisional fair values (cont'd)

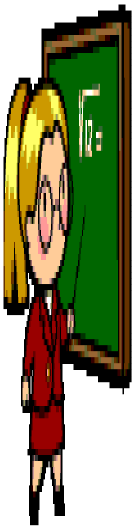
- During the measurement period, the acquirer shall recognise adjustments to the provisional amounts **as if** the accounting for the business combination had been **completed at the acquisition date**. Thus, the acquirer shall **revise comparative information** for prior periods presented in financial 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]

❑ Cost of business combination (cont'd)

Contingent consideration

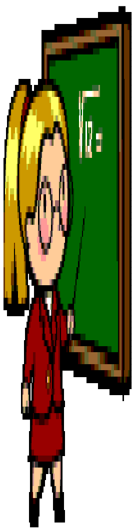
- Contingent consideration is usually, **an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree** as part of the exchange for control of the acquiree if specified future events occur or conditions are met [HKFRS 3 App A]
- Contingent consideration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

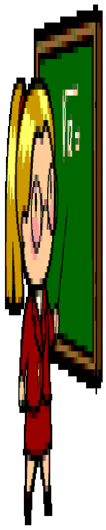


❑ Cost of business combination (cont'd)

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]





❑ Determination what is part of the business combination transaction

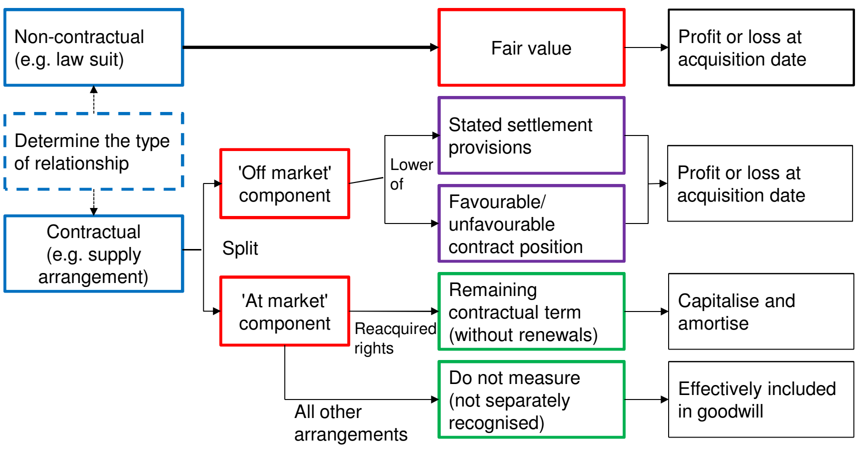
- **Pre-existing relationship**

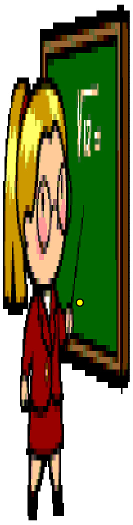
  - The acquirer and acquiree may have a relationship that **existed before** they contemplated the **business combination**, referred to as **"pre-existing relationship"**

  - 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)

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

Pre-existing relationship between acquirer and acquiree

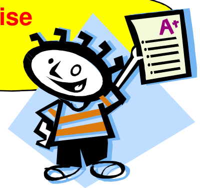


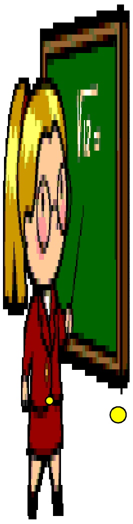


Quiz time - 5

- 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?

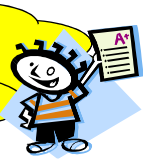


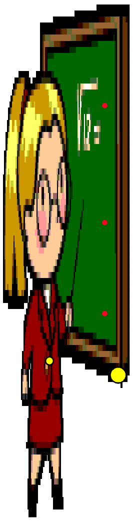


Quiz time - 6

- 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.

How much does Entity A recognise on settlement of the contract?





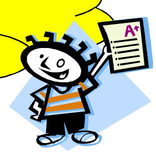
Quiz time - 7

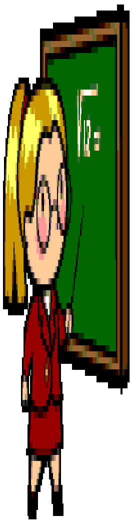
Franchisor P acquires the business of operating Franchisee S for $30,000. In connection with acquisition, P reacquires previously granted franchise rights. The re-acquired franchise right is valued at $3,000 in accordance with the measurement guidance in HKFRS 3

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

How much does Entity P recognise on settlement of the contract?

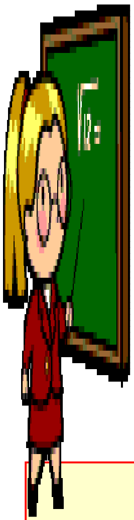




❑ Determination what is part of the business combination transaction

- **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

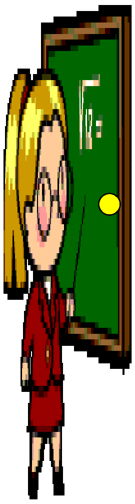
[HKFRS 3.B54]



Contingent payment to employees (cont'd)

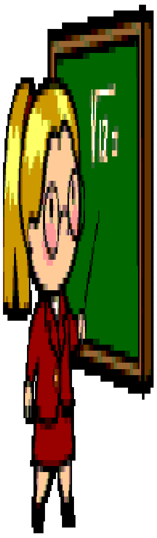
- The acquirer shall consider the following indicators to determine whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or a separate transaction [HKFRS 3.B55]
  - Contingent employment
  - Duration of continuing employment
  - Level of remuneration
  - 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



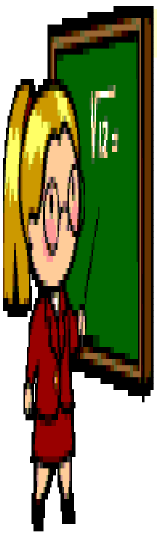
Step 5

Recognising & measuring goodwill or a gain from a bargain purchase



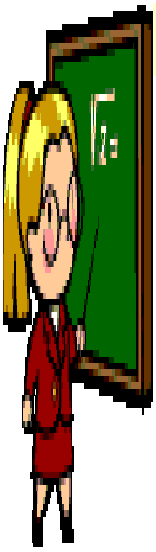
Recognition and measuring goodwill

- The acquirer shall recogonise **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



Recognising and measuring goodwill (cont'd)

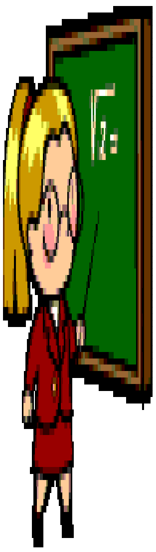
- **Goodwill:** recognise as an asset at date of acquisition
- **Do not amortise**
- **Test for impairment** at least annually, or more frequently when there are indicators of impairment [apply HKAS 36]



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

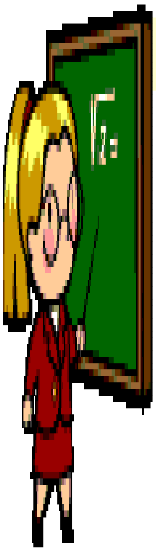
  b) the **net of the acquisition-date amounts** of the **identifiable assets acquired and the liabilities assumed** measured in accordance with HKFRS 3



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



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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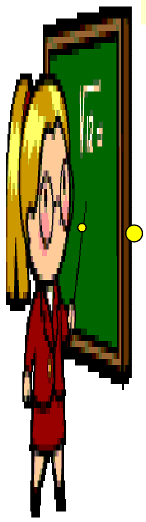

Quiz time - 8

F

80%

G

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

Any goodwill or bargain purchase at acquisition ?

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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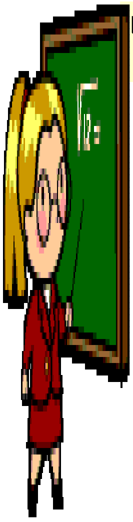
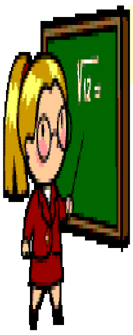


❑ Additional guidance for applying the acquisition method to particular types of business combinations

▪ 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
- Example: On 31 December 2014, 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**
- 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



❑ 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**

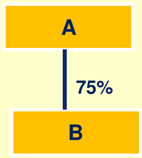
Previous interests	Effects on step acquisition
At fair value through profit or loss	No additional effects
Available for sale investment	Treat as disposal -> reclassify cumulative G/L from equity to profit or loss
Equity method	Treat as disposal -> reclassify share of associate / JCE's reserve to profit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

Example 1 - 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	2014	2015
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 1 - Financial asset under HKAS 39 becomes a subsidiary (cont'd)

Step acquisition with NCIs

- **In 2014, 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 2015, 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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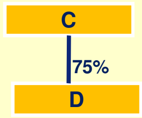
Example 2 – Associate becomes subsidiary

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	2014	2015
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

Example 2 – Associate becomes subsidiary (cont'd)

Step acquisition with NCIs

- In 2015, 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 2015, 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

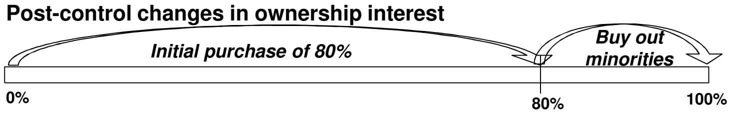
Increased shareholding in subsidiary

- 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**	

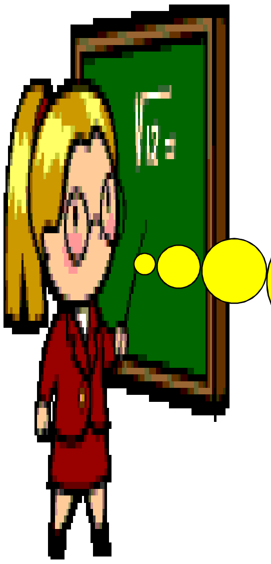
Example 3 – Buy out NCI

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**



❑ Key Disclosures

❑ 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)

Acquisition of a subsidiary – illustration

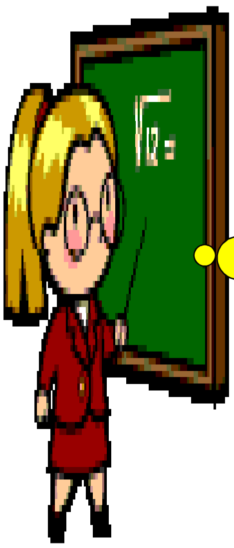
[X]. Acquisition of a subsidiary

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]

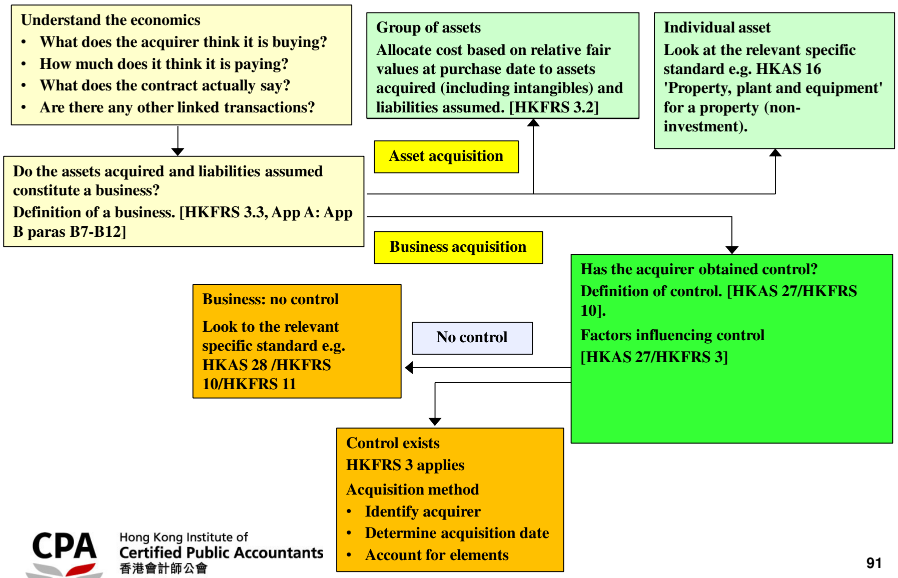
Pro Forma Group's Revenue and Results

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.

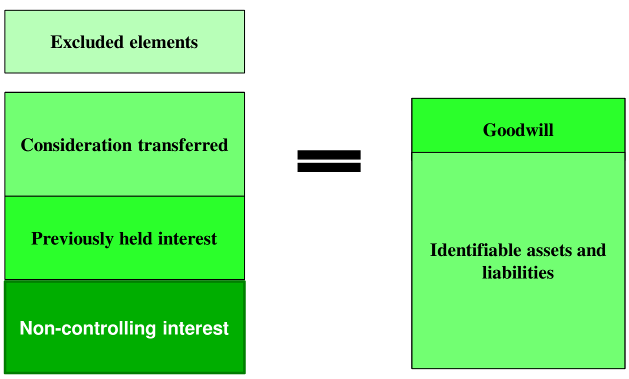


Accounting for Business Combination - An Overview

Process for accounting for business combinations (1)



Process for accounting for business combinations (2)



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]

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]

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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HKFRS 8
Operating Segments

4

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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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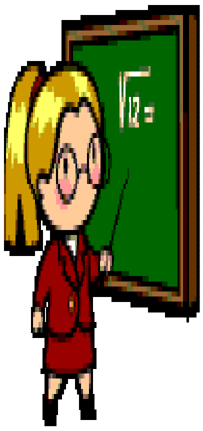

Scope

- 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

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 2014, entity L began construction of a new plant for the purpose of producing barbecue grills
- Production is expected to begin in the second quarter of 2015 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
- 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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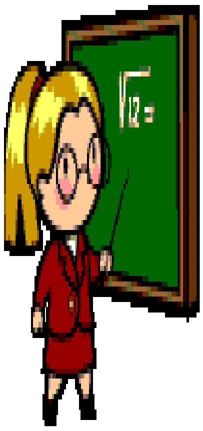

Reportable Segments (cont'd)

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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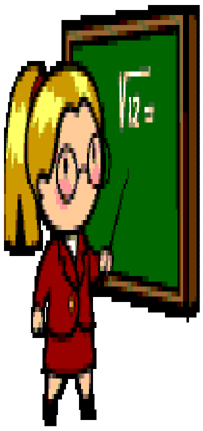

Reportable Segments (cont'd)

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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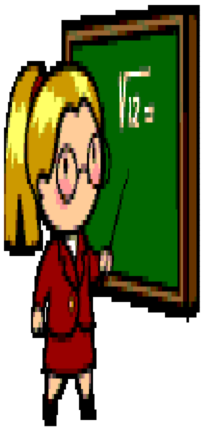
Reportable Segments (cont'd)



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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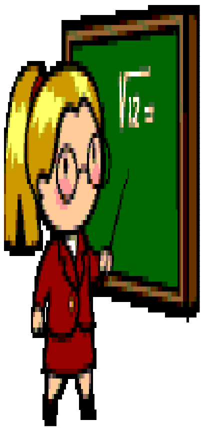
Measurement (cont'd)



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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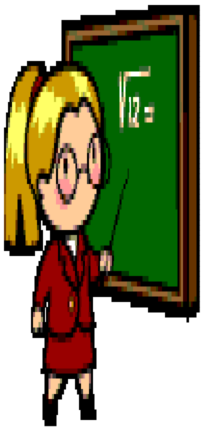

Disclosures – General information

- 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 36)**
  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, net defined benefit assets; and rights arising under insurance contracts**

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Disclosures – Jointly ventures 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 36)
  2. ….. (slide 37)
  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]

- A group of entities known to a reporting entity to be **under common control** shall be considered a single customer
- Judgement is required to assess whether a government including government agencies and similar bodies whether local, national or international and entities known to the reporting entity to be under the control of that government shall be are considered a single customer. In assessing this, the reporting entity shall consider the extent of economic integration between those entities.

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Thank you for your attention

Appendix D
Amendments to HKAS 1 *Disclosure Initiative*

The following sets out amendments required for this Standard resulting from amendments to HKAS 1 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

Paragraphs 10, 31, 54–55, 82A, 85, 113–114, 117, 119 and 122 are amended, paragraphs 30A, 55A, 85A–85B and 139P are added and paragraphs 115 and 120 are deleted. Paragraphs 29–30, 112, 116, 118 and 121 have not been amended but are included for ease of reference. Deleted text is struck through and new text is underlined.

Complete set of financial statements

10 **A complete set of financial statements comprises:**

- **(a) a statement of financial position as at the end of the period;**
- **(b) a statement of profit or loss and other comprehensive income for the period;**
- **(c) a statement of changes in equity for the period;**
- **(d) a statement of cash flows for the period;**
- **(e) notes, comprising ~~a summary of~~ significant accounting policies and other explanatory information;**
- **(ea) comparative information in respect of the preceding period as specified in paragraphs 38 and 38A; and**
- **(f) a statement of financial position as at the beginning of the preceding period when an entity 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 in accordance with paragraphs 40A–40D.**

An entity may use titles for the statements other than those used in this Standard. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'.

...

Materiality and aggregation

29 **An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.**

30 Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.

30A When applying this and other HKFRSs an entity shall decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements, which include the notes. An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.

31 Some HKFRSs specify information that is required to be included in the financial statements, which include the notes. An entity need not provide a specific disclosure required by a HKFRS if the information resulting from that disclosure is not material. This is the case even if the HKFRS contains a list of specific requirements or describes them as minimum requirements. An entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in HKFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

...

Information to be presented in the statement of financial position

54 **~~As a minimum, t~~The statement of financial position shall include line items that present the following amounts:**

(a) ...

55 **An entity shall present additional line items (including by disaggregating the line items listed in paragraph 54), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.**

55A When an entity presents subtotals in accordance with paragraph 55, those subtotals shall:

(a) be comprised of line items made up of amounts recognised and measured in accordance with HKFRS;

(b) be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;

(c) be consistent from period to period, in accordance with paragraph 45; and

(d) not be displayed with more prominence than the subtotals and totals required in HKFRS for the statement of financial position.

...

Information to be presented in the other comprehensive income section

82A **The other comprehensive income section shall present line items for the 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~~ for the period of:**

(a) items of other comprehensive income (excluding amounts in paragraph (b)), classified by nature and grouped into those that, in accordance with other HKFRSs:

(a)(i) will not be reclassified subsequently to profit or loss; and

(~~b~~)(ii) will be reclassified subsequently to profit or loss when specific conditions are met.

(b) the share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that, in accordance with other HKFRSs:

(i) will not be reclassified subsequently to profit or loss; and

(ii) will be reclassified subsequently to profit or loss when specific conditions are met.

...

85 **An entity shall present additional line items (including by disaggregating the line items listed in paragraph 82), headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.**

85A When an entity presents subtotals in accordance with paragraph 85, those subtotals shall:

(a) be comprised of line items made up of amounts recognised and measured in accordance with HKFRS;

(b) be presented and labelled in a manner that makes the line items that constitute the subtotal clear and understandable;

(c) be consistent from period to period, in accordance with paragraph 45; and

(d) not be displayed with more prominence than the subtotals and totals required in HKFRS for the statement(s) presenting profit or loss and other comprehensive income.

85B An entity shall present the line items in the statement(s) presenting profit or loss and other comprehensive income that reconcile any subtotals presented in accordance with paragraph 85 with the subtotals or totals required in HKFRS for such statement(s).

...

Structure

112 **The notes shall:**

(a) present information about the basis of preparation of the financial statements and the specific accounting policies used in accordance with paragraphs 117–124;

(b) disclose the information required by HKFRSs that is not presented elsewhere in the financial statements; and

(c) provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

113 **An entity shall, as far as practicable, present notes in a systematic manner. In determining a systematic manner, the entity shall consider the effect on the understandability and comparability of its financial statements. An entity shall cross-reference each item in the statements of financial position and in the statement(s) of profit or loss and other comprehensive income, and in the statements of changes in equity and of cash flows to any related information in the notes.**

114 ~~An entity normally presents notes in the following order, to assist users to understand the financial statements and to compare them with financial statements of other entities:~~ Examples of systematic ordering or grouping of the notes include:

(a) giving prominence to the areas of its activities that the entity considers to be most relevant to an understanding of its financial performance and financial position, such as grouping together information about particular operating activities;

(b) grouping together information about items measured similarly such as assets measured at fair value; or

(c) following the order of the line items in the statement(s) of profit or loss and other comprehensive income and the statement of financial position, such as:

(~~a~~)(i) statement of compliance with HKFRSs (see paragraph 16);

(~~b~~)(ii) ~~summary of~~ significant accounting policies applied (see paragraph 117);

(~~c~~)(iii) supporting information for items presented in the statements of financial position and in the statement(s) of profit or loss and other comprehensive income, and in the statements of changes in equity and of cash flows, in the order in which each statement and each line item is presented; and

(~~d~~)(iv) other disclosures, including:

(~~i~~)(1) contingent liabilities (see HKAS 37) and unrecognised contractual commitments~~,~~; and

(~~ii~~)(2) non-financial disclosures, eg the entity's financial risk management objectives and policies (see HKFRS 7).

115 [Deleted] ~~In some circumstances, it may be necessary or desirable to vary the order of specific items within the notes. For example, an entity may combine information on changes in fair value recognised in profit or loss with information on maturities of financial instruments, although the former disclosures relate to the statement(s) presenting profit or loss and other comprehensive income and the latter relate to the statement of financial position. Nevertheless, an entity retains a systematic structure for the notes as far as practicable.~~

116 An entity may present notes providing information about the basis of preparation of the financial statements and specific accounting policies as a separate section of the financial statements.

Disclosure of accounting policies

117 **An entity shall disclose ~~in the summary of~~ its significant accounting policies comprising:**

(a) the measurement basis (or bases) used in preparing the financial statements~~,~~; and

(b) the other accounting policies used that are relevant to an understanding of the financial statements.

118 It is important for an entity to inform users of the measurement basis or bases used in the financial statements (for example, historical cost, current cost, net realisable value, fair value or recoverable amount) because the basis on which an entity prepares the financial statements significantly affects users' analysis. When an entity uses more than one measurement basis in the financial statements, for example when particular classes of assets are revalued, it is sufficient to provide an indication of the categories of assets and liabilities to which each measurement basis is applied.

119 In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position. Each entity considers the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity. Disclosure of particular accounting policies is especially useful to users when those policies are selected from alternatives allowed in HKFRSs. An example is disclosure of whether an entity applies the fair value or cost model to its investment property (see HKAS 40 *Investment Property*). Some HKFRSs specifically require disclosure of particular accounting policies, including choices made by management between different policies they allow. For example, HKAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment.

120 [Deleted] ~~Each entity considers the nature of its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity. For example, users would expect an entity subject to income taxes to disclose its accounting policies for income taxes, including those applicable to deferred tax liabilities and assets. When an entity has significant foreign operations or transactions in foreign currencies, users would expect disclosure of accounting policies for the recognition of foreign exchange gains and losses.~~

121 An accounting policy may be significant because of the nature of the entity's operations even if amounts for current and prior periods are not material. It is also appropriate to disclose each significant accounting policy that is not specifically required by HKFRSs but the entity selects and applies in accordance with HKAS 8.

122 **An entity shall disclose, ~~in the summary of~~ along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.**

...

Transition and effective date

...

139P *Disclosure Initiative* (Amendments to HKAS 1), issued in January 2015, amended paragraphs 10, 31, 54–55, 82A, 85, 113–114, 117, 119 and 122, added paragraphs 30A, 55A and 85A–85B and deleted paragraphs 115 and 120. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. Entities are not required to disclose the information required by paragraphs 28–30 of HKAS 8 in relation to these amendments.

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A Refresher Course on Current

Financial Reporting Standards 2015

Day 2

Time	Topic
09:00 - 10:30	Non-current asset held for sale and discontinued operation
10:30 - 10:45	Break
10:45 - 12:15	Foreign currencies translation
12:15 - 13:00	Borrowing costs

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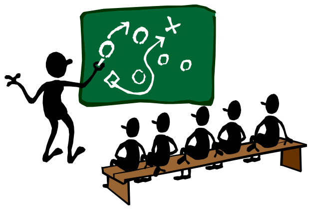
A Refresher Course on Current Financial Reporting Standards 2015 (Day 2)

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

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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

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

Criteria (para 7,8)

- **Available for immediate sale in present condition**
- and
- **The sale is highly probable**

Recorded at the lower of carrying amount and fair value less costs to sell

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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*)

Available for immediate sale in present condition

AND

The sale is highly probable

- Appropriate level of Management is committed to a plan to sell
- Active program to locate a buyer and complete the sale initiated
- Sale generally completed within 12 months from the date of classification
- Actively marketed at a reasonable price
- Requirements to complete indicate plan won't change or be withdrawn

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?

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?

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?

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 B of HKFRS 5 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 extend 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]
- HKAS 28 (2011) → 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 the equity method

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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
- **Fair value** – the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participant at the measurement date
- **Costs to sell** – the incremental costs directly attributable to the disposal of an asset (or disposal group); excluding finance costs and income tax expenses; measured at their present value when the sale is expected to occur beyond one year

B. Measurement of assets held for sale

Initial Measurement

- **Step 1:** Plan to dispose of an asset or CGU is an impairment indicator -> test for impairment under HKAS 36
- **Step 2**: Carrying amounts of all assets & liabilities measured under applicable HKFRSs immediately before its initial classification
- **Step 3:** Classify as held for sale
- **Step 4**: Measure non-current assets/disposal group as a whole at the lower of carrying amount and fair value less costs to sell
- **Step 5:** If fair value less costs to sell < carrying amount, impairment identified

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 "s*coped 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 <u>any goodwill allocated</u> to the cash-generating unit (group of units); and

(b) then, to the <u>other assets of the unit (group of units) pro rata</u> 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
- to the extent that it does not relate to the reversal of any impairment of goodwill
- not in excess of cumulative impairment loss (HKAS 36 & HKFRS 5)

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Extracted from PwC Manual of Accounting 2014

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 2014

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 2014

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 2014

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 2014

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 2014

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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Extracted from PwC Manual of Accounting 2014

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:	**Statement of financial position** • 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

C. Presentation & Disclosure (cont'd)

	Summary
HKFRS 5 requires that an entity:	**Statement of financial position** • 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 **Statement of comprehensive income** • 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:	**Notes to the financial statements** • 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:	**Notes to the financial statements** • 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 profit or loss** 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

** unless the property, plant and equipment and intangible assets are carried at revaluated amount in which case the change will be treated as revaluation increase or decrease

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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

Component* of an entity that ***has been disposed of***

OR

Component* of an entity that is ***classified as held for sale***

AND

- represents a separate major line of business or geographical area of operations, or
- part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or
- a subsidiary acquired exclusively with a view to resale

*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

Further thoughts:

What are the amounts that should be included under "the results of Discontinued operation"?

- Allocation of overhead costs
- transactions between continuing and discontinuing operations
- Costs incurred as a result of disposal
  - ✓ compensation of a manager of a discontinued operation by the entity
  - ✓ Penalty incurred by the entity to a supplier on termination of 3-year contract

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.

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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H. Annual improvements 2012-2014

- Clarify the application of the guidance in IFRS 5 regarding the case of a change in a disposal plan from a plan to sell a division by means of an initial public offering to a plan to spin off a division and distribute a dividend in kind to its shareholders.
- If an entity reclassifies an asset (or disposal group) directly from being held for sale o being held for distribution to owners, or directly from being held for distribution to owners to being held for sale → consider as a continuation of the original plan of disposal.
- Follow the classification, presentation and measurement requirements in HKFRS 5 that are applicable to the new method of disposal
- Apply prospectively in accordance with HKAS 8
- Effective for annual periods beginning on or after 1 January 2016. Earlier application is permitted

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Thank you for your attention

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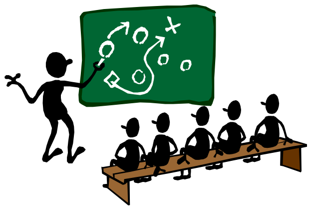
A Refresher Course on Current Financial Reporting Standards 2015 (Day 2)

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
- Disclosures

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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* / HKFRS 9 *Financial Instruments;*

✓ translating the results and financial position of foreign operations that are included in the financial statements of the entity by 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 arrangement 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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Which of the following items are classified as Monetary items?

- Deferred income
- Allowance for stock obsolescence
- Allowance for doubtful debts
- Equity securities
- Inventories
- Debt securities
- Tax refund/payable
- Investments in associate
- Accrued expenses
- Trade receivable
- Shareholders' equity
- Deposits
- Intangible assets
- Goodwill
- Bank balances and loans
- Property, plant and equipment
- Cash

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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
- Functional 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:

Parent

SPE (Foreign operation)

- 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:

Parent

Treasury function

- 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 exists 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:

Parent

"Money-box" entity

- 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 ?

(Bank)

Co A (functional currency: Euro)

Offer debt Sterling 20M

Offer debt Sterling 20M

Offer debt Sterling 30M

Co Q (incorporated in UK)
The entire Sterling 50M was invested in building a manufacturing facility to serve the Taiwan market. Co Q intends to repay the loan to the third party from the profit generated through its manufacturing operations

Provide guarantee Sterling 30M

Co P (incorporated in the US)
the Sterling 20M loan from the bank was used to invest in marketable securities in the global markets

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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 - HKD

- 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 - RMB

- 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 2013:
  - Foreign currencies:

(v) Foreign currencies

Items included in the financial statements of each of HSBC's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). HSBC's consolidated financial statements are presented in US dollars which is also HSBC Holdings' functional currency.

- **Agile Property Holdings Limited:**
  Annual report for ye 31 December 2013:
  - Functional and presentation currency

(a) 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.
- HKAS 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

Exchange difference arising from monetary items ?

Yes → Exchange difference on monetary items form part of the net investment in a foreign operation?

- **Yes →**
  - exchange difference recognised in profit or loss in the separate financial statements of the reporting entity, or the individual financial statements of the foreign operation, as appropriate
  - exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised, in the consolidated financial statements that include the foreign operation, in other comprehensive income; they will be reclassified from equity to profit or loss on disposal of the net investment. [HKAS 21.32]
- **No →**
  - Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognised or in previous financial statements are reported in profit or loss in the period [HKAS 21.28]

No → Gain or loss on a non-monetary item is recognised in other comprehensive income?

- **Yes →**
  - Any exchange component of that gain or loss shall be recognised in other comprehensive income [HKAS 21.30]
- **No →**
  - Any exchange component of that gain or loss shall be recognised in profit or loss [HKAS 21.30]

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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 an 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 presenting profit or loss and other comprehensive income (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:

- 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:

Entity A (HK$ functional currency) —— HK$ loan (Not net investment in entity B) ——> Entity B (RMB functional currency)

  - 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 joint ventures under HKAS 28.

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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
  - ✓ when the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes a foreign operation

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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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Refer to HKAS 21 for full list of disclosures

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/HKFRS 9) [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]
- 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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Thank you for your attention

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A Refresher Course on Current Financial Reporting Standards 2015 (Day 2)

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Please make sure that your mobile phones and pagers have been switched off or turned to the vibration mode

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HKAS 23
Borrowing Costs

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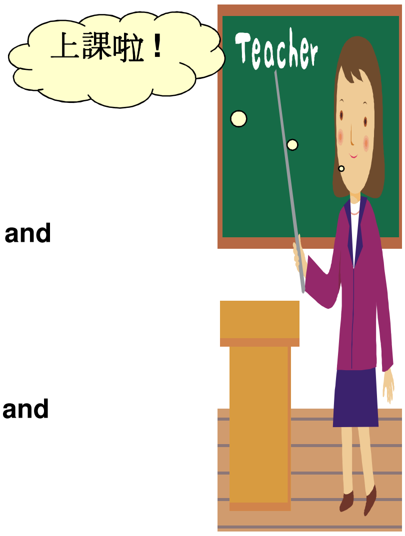
Learning Objectives

- Borrowing Costs - Core principal
- Qualifying assets – Definition and examples
- Borrowing costs eligible for capitalisation
- Commencement, suspension and cessation of capitalisation



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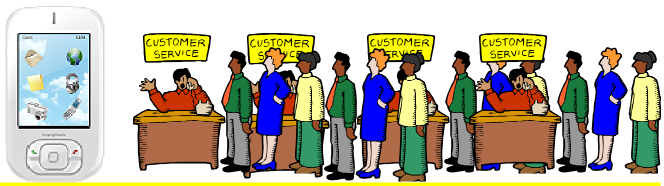
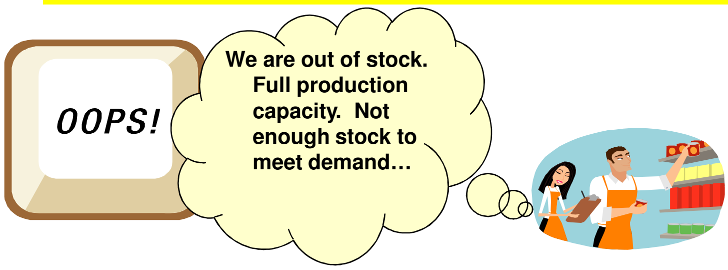
Background



Lots of customers standing in line to buy our phone "Phone for the year 2014"



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Background

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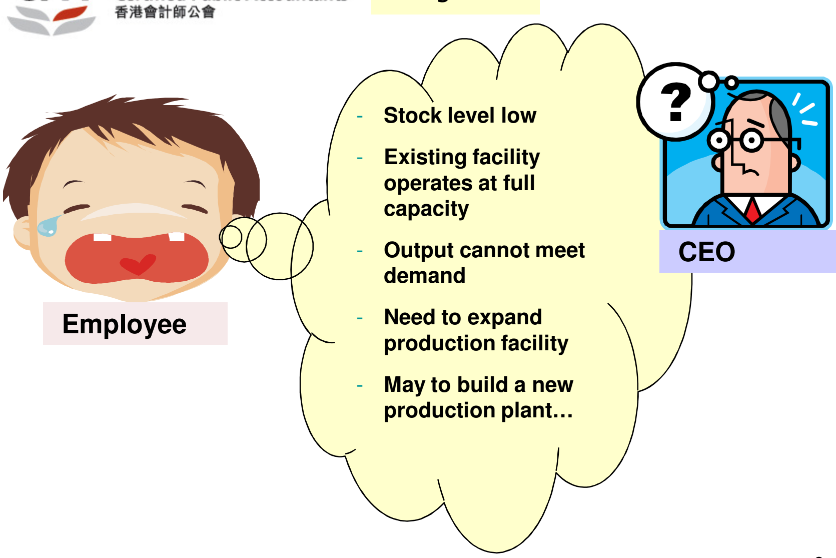
Background



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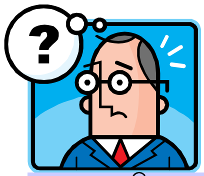
Background

Employee

Costs of expansion of production plant may include:

- Land cost
- Building materials costs
- Labour costs
- Design, renovation fees and other attributable costs
- Borrowing costs



CEO

Please explain what are costs involved for building a new production plant

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HKAS 23 – Core principle

Borrowing Costs

⇩

Definition of borrowing costs: Interest and other costs that an entity incurs in connection with the borrowing of funds

⇩

Borrowing costs **directly attributable** to the acquisition, construction or production or a qualifying asset form part of the cost of that asset

⇩

Borrowing costs (interest expense) **capitalised**

⇩

Other borrowing costs

⇩

Recognised as an expense

What… what is that?

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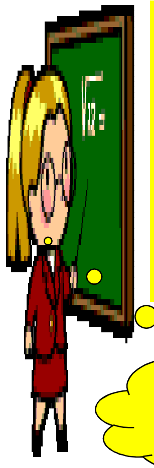
What is "qualifying asset" ?

The core principal of HKAS 23 is that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense [HKAS 23.1]

I want to know what is "qualifying asset?"



A qualifying asset is defined as an asset that necessarily takes a <u>substantial period</u> of time to get ready for its <u>intended use</u> or <u>sale</u> [HKAS 23:5]

For examples…

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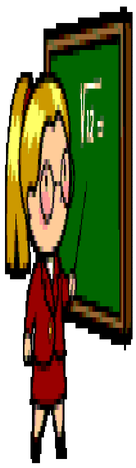
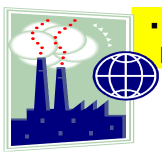
Examples of "qualifying asset" ?

Depending on the circumstances, any of the following may be qualifying assets:

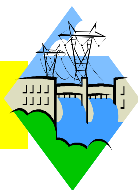


- **Inventories, except inventories that are manufactured , or otherwise produced, in large quantities on a repetitive basis**



- **Manufacturing plants**

- **Intangible assets**



- **Power generation facilities**

- **Investment properties**

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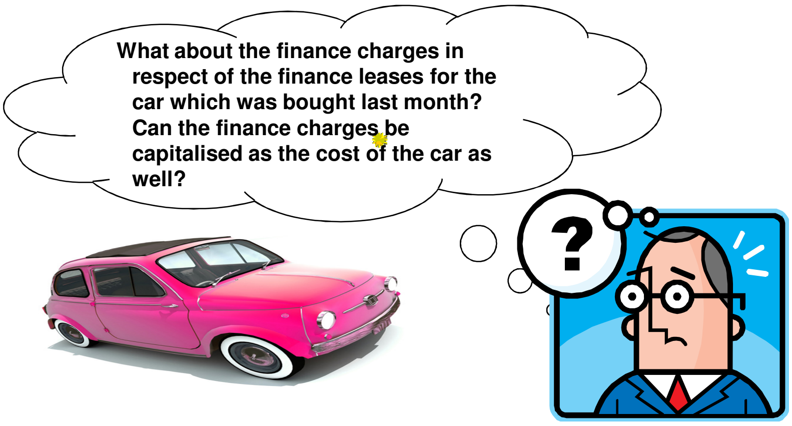
Is an asset purchased under a finance lease a qualifying asset ?



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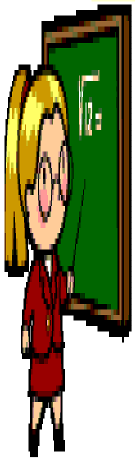
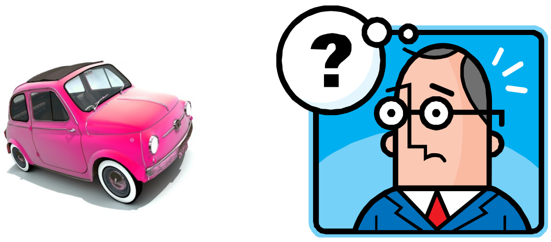
The following are not qualifying assets:



- **Assets that are ready for their intended use or sale when acquired**
- **Financial assets**
- **Inventories that are manufactured, or otherwise produced, over a short period of time**



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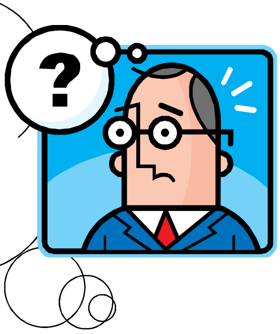
Are investments accounted for using equity method a qualifying asset ?

If I invest in a construction contract via participating interests in a single-purpose entity. The entity is an associate as defined in HKAS 28 and will be accounted for using the equity method of accounting. If we borrow funds for the purpose of funding the construction activities in these vehicles, should we capitalise borrowing costs as part of the carrying amount of the investments?



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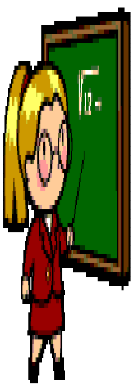
Are investments accounted for using equity method a qualifying asset ?



- **NO**
- **Borrowing costs should not be capitalised in these circumstances**
- **Investments in associates are financial assets**
- **HKAS 23:7 states that financial assets are not qualifying assets**

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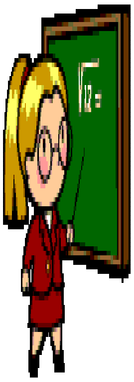
Are investments in joint operations for entities that have adopted HKFRS 11 a qualifying asset ?



- **When an entity recognises its share of the assets and liabilities of a joint operation, capitalisation of borrowing costs is required to the extent that any of those assets are qualifying assets**
- **The investor's share of the qualifying assets of a joint operation are accounted for as qualifying assets of the investor and, therefore, capitalisation of borrowing costs incurred to fund the construction of those qualifying assets is required, provided that all of the conditions of HKAS 23 are met**

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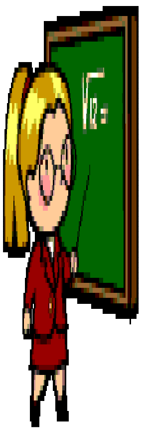
Qualifying assets



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

- Commencement of construction

- Manufacturing plants under construction

- Ready for its intended use

For example: three years

* The Standard does not provide any guidance on what constitutes a "substantial period of time". Te specific facts and circumstances should be considered in each case. For example, it is likely that a period of twelve months or more might be considered "substantial"

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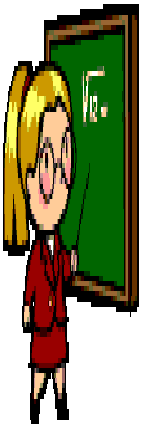
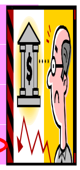
Capitalisation

Capitalisation is recognising the costs incurred as part of the cost of the relating asset



E.g. Costs for construction of the manufacturing plant

- land costs
- construction costs
- labor costs
- borrowing costs



Borrowing costs may include:

- Interest expense calculated using the effective interest method, including
  - Interest on specific borrowings to obtain the qualifying asset
  - Interest on general borrowings

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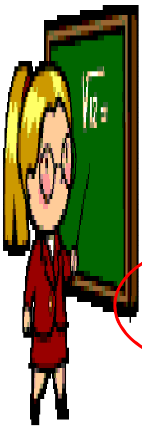
Borrowing costs eligible for capitalisation



Specific borrowing costs

- **When funds are borrowed specifically for the purpose of acquiring or constructing a qualifying asset, the amount of borrowing costs eligible for capitalisation is the actual borrowing cots incurred on those funds during the period [HKAS 23:12]**
- **any investment income earned on the temporary investment of the funds, pending their expenditure on the qualifying asset, should be deducted from the actual borrowing costs incurred to arrive at the borrowing costs eligible for capitalisation [HKAS 23:13]**

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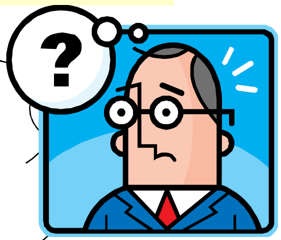
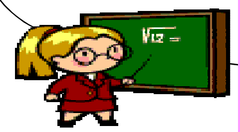
Borrowing costs eligible for capitalisation

If the company borrows HK$20M to finance the construction of the factory. The funds are to be drawn down on a monthly basis in four equal amounts. Payment of construction costs occurs throughout each month, rather than coinciding with the draw-downs. During each month, the entity invests any excess funds drawn down in accordance with the financing arrangements in short-term bank deposits. How much interest cost can be capitalised ?





- **The company should capitalise, as part of the cost of construction of the factory, the actual borrowing costs on the HK$20M borrowing (incurred during the period of construction), less the interest income derived from the temporary investments in bank deposits**

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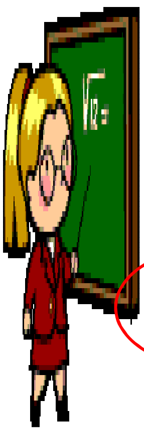
Borrowing costs eligible for capitalisation



General borrowing costs

- **When a qualifying asset is funded from a pool of general borrowings, the amount of the borrowing costs to be capitalised is determined by [HKAS 23:14] :**
  - applying an appropriate capitalisation rate to the expenditure on the qualifying asset
  - Capitalisation rate is calculated as:

    $$\frac{\textbf{Total borrowing costs for the period}}{\textbf{Weighted average total borrowings}}$$

  - Expenditure to which the capitalisation rate is applied
  - Borrowing cots capitalised limited to the borrowing costs incurred

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General borrowing costs: example

- During the year ended 31 December 2013, the company commenced the construction of the manufacturing plant and incurred the following expenditure:

	HK$' 000
June 1	5,000
October 1	10,000
November 1	10,000

- The company 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

* There was no movement on long-term loans in the period

** 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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General borrowing costs – example (cont'd)

- The appropriate capitalisation rate to be applied to the expenditure on the qualifying asset is calculated as follows:

$$\frac{\text{Total borrowing costs for the period}}{\text{Weighted average total borrowings}} = \frac{6,400}{62,000} = 10.32\%$$

- 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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- General borrowings

Expenditure to which the capitalisation rate is applied

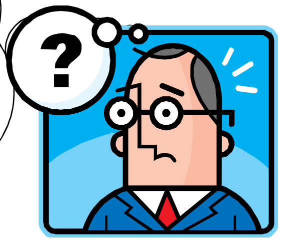
- The amount of expenditure on a qualifying asset used in the calculation should consist only of payments of cash, transfers of other assets or the assumption of interest-bearing liabilities, and should be reduced by any pre-sale deposits, progress payments or grants received in connection with the qualifying 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

Borrowing costs capitalised limited to the borrowing costs incurred

- 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

Calculation in the consolidated financial statements

What about if a group consists of the parent and two subsidiaries. Subsidiary 1 is engaged in the construction of the manufacturing 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. The terms of the loan from Subsidiary 2 to Subsidiary 1 specify that it is repayable on demand. Any interest to be capitalised ?



- **Borrowing costs capitalised limited to the borrowing costs incurred in a group context ?**

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Calculation in the consolidated financial statements

- **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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Calculation in the consolidated financial statements

- **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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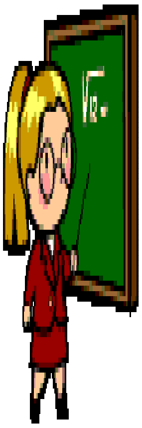
Period of capitalisation



Commencement date	Suspension	Cessation date
Commencement date for capitalisation is the date when **the three conditions** for capitalisation are first met	Capitalisaion of interest is suspended during extended periods in which active development is interrupted	Capitalisation should cease when substantially all of the activities necessary to prepare the qualifying asset for its intended use or sale are complete

Capitalisation Period

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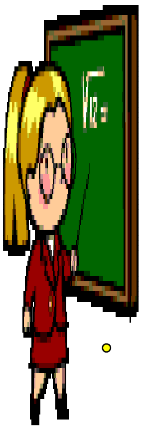
Commencement date for capitalisation



The commencement date for capitalisation is the date when the following **three conditions** are first met:

- ❖ expenditures for the asset are being incurred
- ❖ borrowing costs are being incurred; and
- ❖ activities that are necessary to prepare the asset for its intended use or sale are being undertaken

Capitalisation begins when all three conditions are first met

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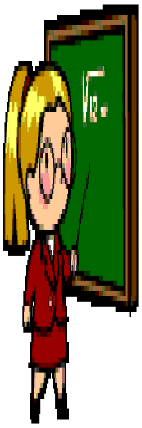
Commencement date for capitalisation



For example: Construction of manufacturing plant

(1) Expenditure for the assets are being incurred

e.g. Labor costs and material costs incurred

(2) Borrowing costs are being incurred

e.g. Finance costs on specific construction loans or general borrowings

(3) Activities that are necessary to prepare the asset for its intended use or sale are being undertaken

e.g. Initial technical and administrative work, e.g. activities associated with obtaining permits, prior to the commencement of the physical construction of the aset

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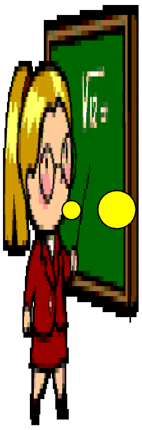
Suspension of capitalisation



Capitalisation of borrowing costs should generally continue as long as the three conditions are met. If the entity suspends activities related to development for an extended period,

Example:

- waiting for parts to arrive
- cash flow difficulties
- desire to hold back development due to economic downdown

- **capitalisation of borrowing costs should also cease until such time as activities are resumed**

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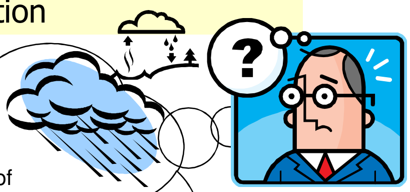
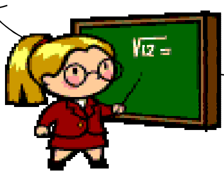
Suspension of capitalisation



What about temporary delays that are necessary or expected in the process of getting an asset ready for its intended use, or which result from a natural delay such as adverse weather conditions that are common to the location, is suspension of capitalisation required?



- **Capitalisation may continue during a temporary delay caused by an external event, e.g. rain or flooding, technical or legal obstacles that are typical part of the process**

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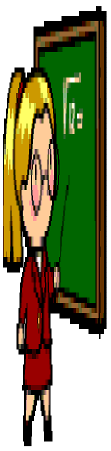
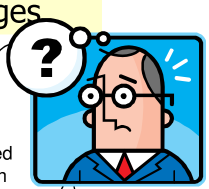
Qualifying assets – construction in stages



- **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 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**



What about a qualifying asset which is constructed in stages, and each stage or part can be used or sold individually while construction of the remaining development continues ?

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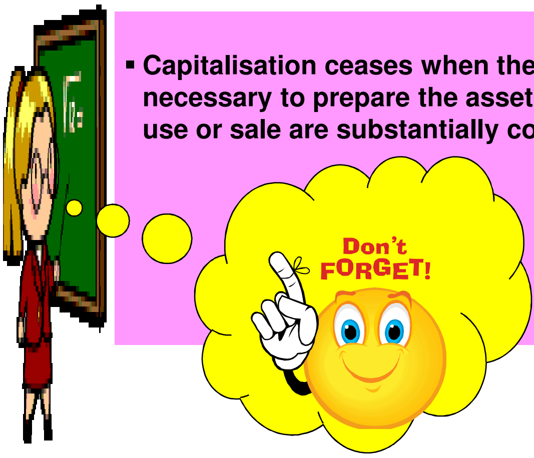
Cessation of capitalisation



- **Capitalisation ceases when the activities necessary to prepare the asset for its intended use or sale are substantially complete**

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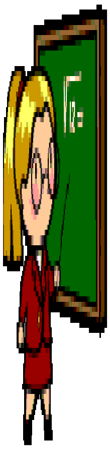
Recognition of an impairment loss or write-down



- **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**
  - **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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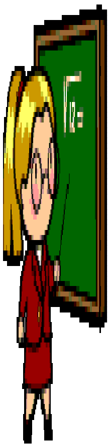
Disclosures



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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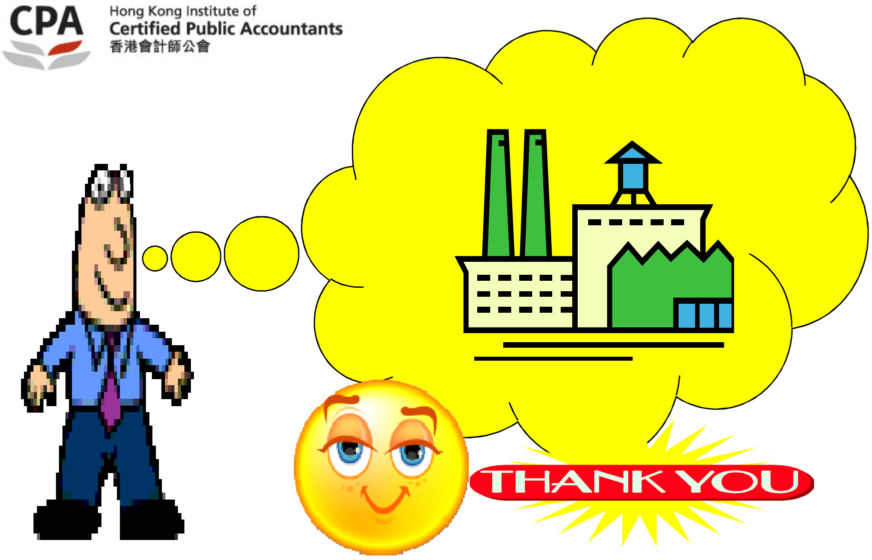

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A Refresher Course on Current

Financial Reporting Standards 2015

Day 3

Time	Topic
09:00 - 11:00	Financial instruments
11:00 - 11:15	Break
11:15 - 12:15	Financial instruments (cont'd)
12:15 - 13:00	Provision and contingencies
13:00 - 14:00	Lunch
14:00 - 15:45	Consolidate and separate financial statements
15:45 - 16:00	Break
16:00 - 17:00	Consolidated and separate financial statements (cont'd)

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A Refresher Course on Current Financial Reporting Standards 2015 (Day 3)

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COOPERATION REQUESTED

Please make sure that your mobile phones and pagers have been switched off or turned to the vibration mode

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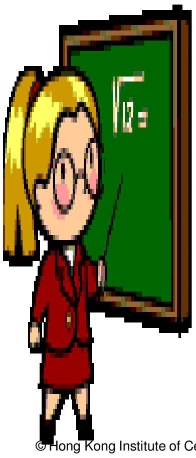
Hong Kong Financial Reporting Standards

❖ **HKFRS - Our focus in this session**



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

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HKAS 32

Financial Instruments: Presentation

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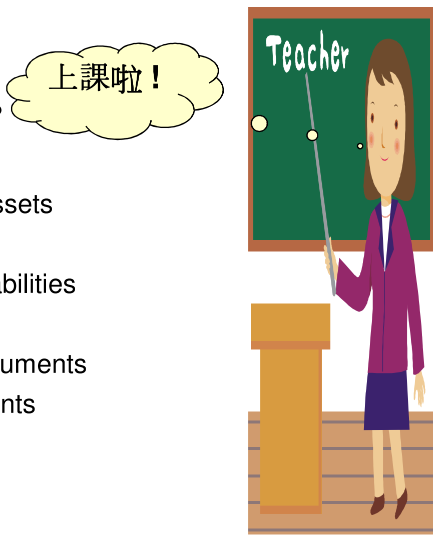
Learning Objectives

- ❑ What is financial instrument ?
- ❑ What is financial asset?
- ❑ Common types of financial assets
- ❑ What is financial liability ?
- ❑ Common types of financial liabilities
- ❑ What is equity instrument ?
- ❑ Common types of equity instruments
- ❑ Compound financial instruments



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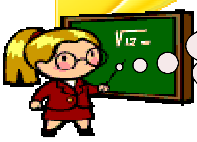
During 2015, ABC Company Limited has the following investments…

- 100,000 shares in CEF Co Ltd (15%)
- Bond Investment in CPA Ltd
- IFRS Fund



Are these financial instruments?

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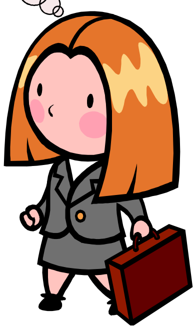
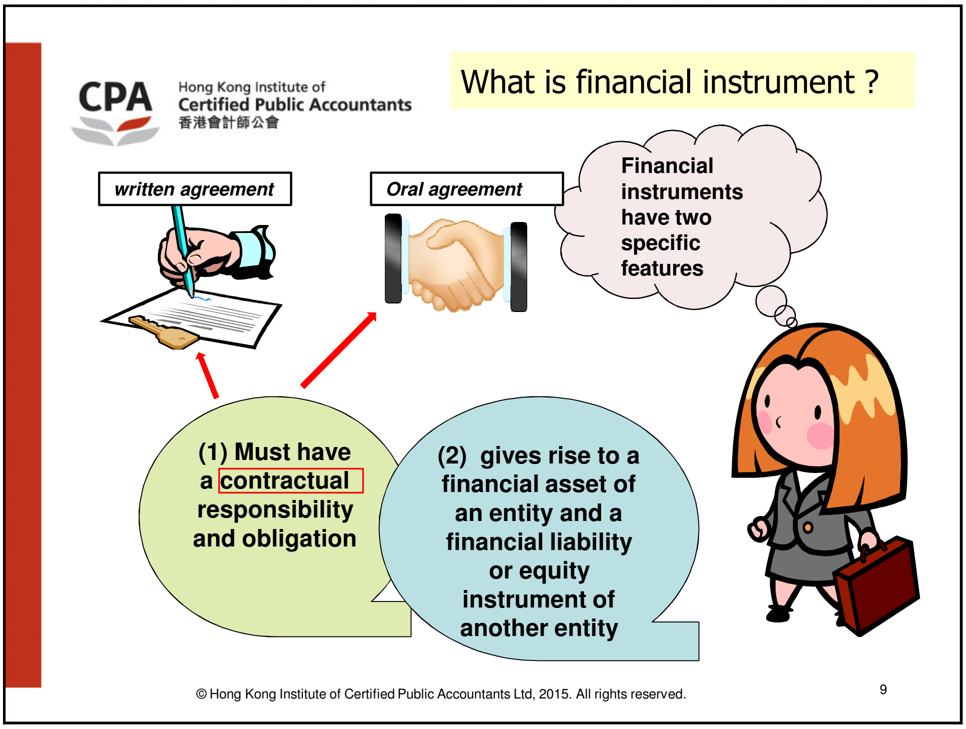
What is financial instrument ?

Financial instruments have two specific features



(1) Must have a contractual responsibility and obligation

(2) gives rise to a financial asset of an entity and a financial liability or equity instrument of another entity



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What is financial instrument ?
written agreement
Oral agreement
Financial instruments have two specific features
(1) Must have a contractual responsibility and obligation
(2) gives rise to a financial asset of an entity and a financial liability or equity instrument of another entity
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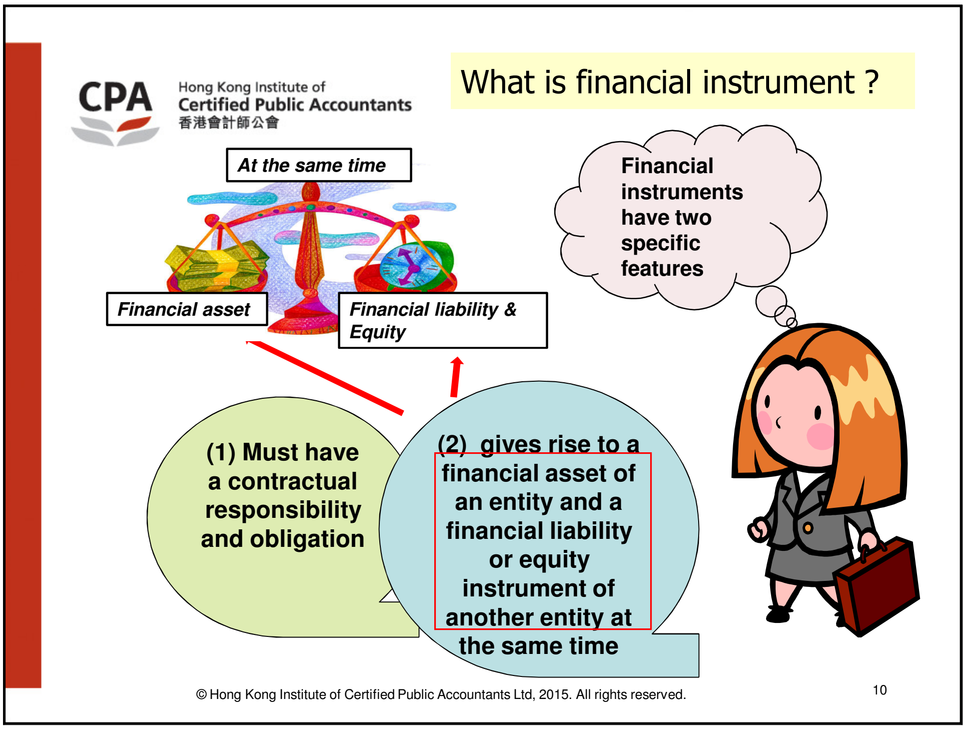

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What is financial instrument ?
At the same time
Financial asset
Financial liability & Equity
Financial instruments have two specific features
(1) Must have a contractual responsibility and obligation
(2) gives rise to a financial asset of an entity and a financial liability or equity instrument of another entity at the same time
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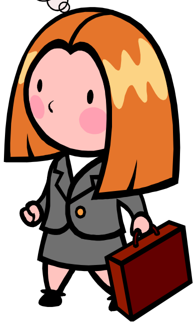
What is financial instrument ?

Financial Assets

Financial Liabilities

Equity Instruments

There are three types of financial instruments



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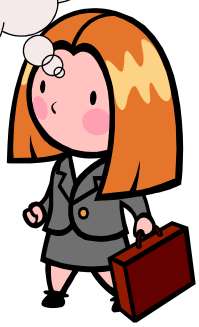
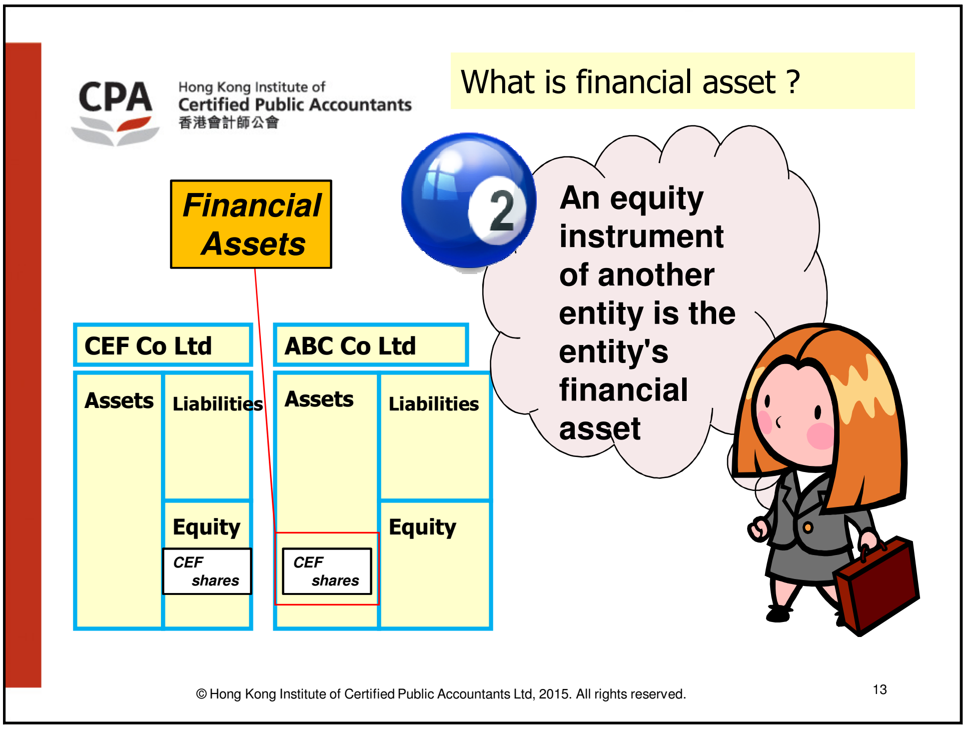
What is financial asset ?

Cash is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements

Cash is a financial asset

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What is financial asset ?
Financial Assets
2
An equity instrument of another entity is the entity's financial asset
CEF Co Ltd
Assets
Liabilities
Equity
CEF shares
ABC Co Ltd
Assets
CEF shares
Liabilities
Equity
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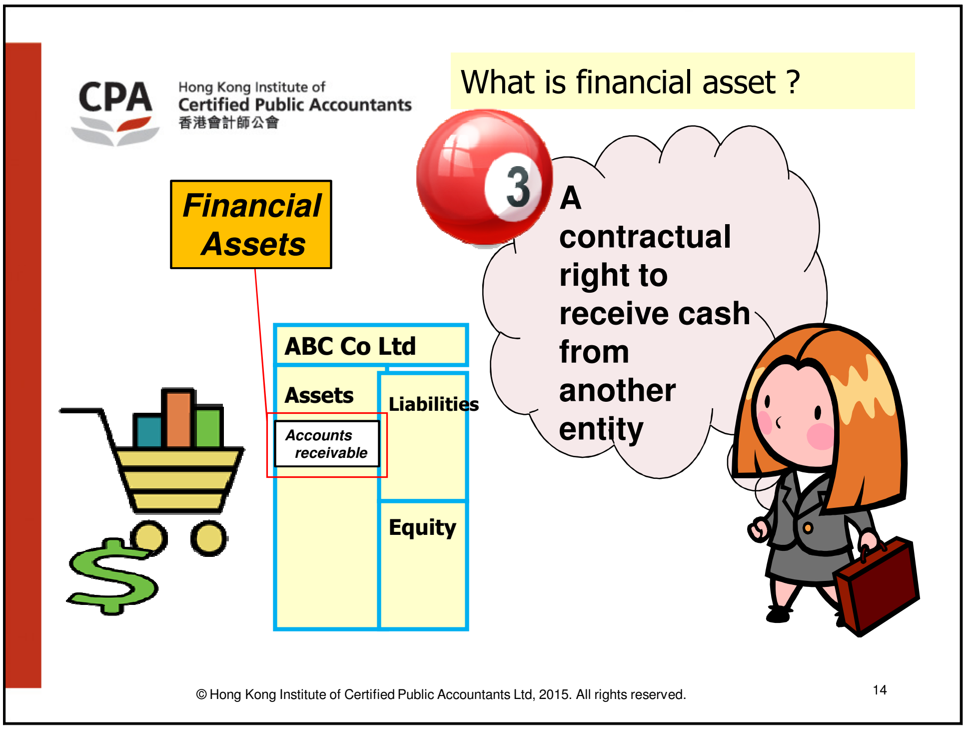
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What is financial asset ?
Financial Assets
3
A contractual right to receive cash from another entity
ABC Co Ltd
Assets
Accounts receivable
Liabilities
Equity
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What is financial asset ?

4

A contractual right to receive another financial asset from another entity

Financial Assets

CEF Co Ltd	
Assets	**Liabilities**
	Bond payable
Bond	**Equity**

ABC Co Ltd	
Assets	**Liabilities**
Bond receivable	
	Equity

A financial assets other than cash

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What is a financial asset ?

5

To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity

The option is a derivative financial asset from the time the entity becomes a party to the option contract

ABC Co Ltd

ABC Co Ltd holds an option to purchase equity shares in a listed CEF Co Ltd for $5 per share at the end of a 90 day period

The call option gives ABC Co Ltd a contractual right to exchange cash of $5 for an equity shares in CEF Co Ltd at the end of 90 day period

As the terms will be favorable to ABC Co Ltd at the end of term, it will exercise the call option

Since ABC stands to gain if the call option is exercised, the exchange is potentially favourable to ABC Co Ltd

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Definition of a financial asset

Financial Assets

- Cash
- An equity instrument of another entity
- A contractual right
  - To receive cash or another financial asset from another entity
  - To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity
- A contract that will or may be settled in the entity's own equity instruments and is:
  - A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments
  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

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Common types of financial assets

Cash	**Bank Deposits**	**Investments in equity shares**
Bills receivable	**Financial Assets**	**Investments in bonds**
Trade receivable	**Other receivables**	**Investments in funds**

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Common types of financial assets

- **Bank Deposits**

Represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability

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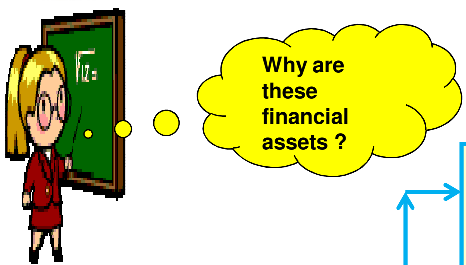
Common types of financial assets



- **Bills receivable**
- **Trade receivable**
- **Other receivable**

Contractual right to receive cash in the future for the holder. In this case, one party's contractual right to receive cash is matched by the other party's corresponding obligation to pay

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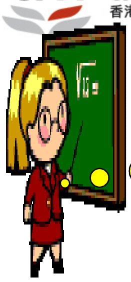
Common types of financial assets



Why are these financial assets ?

Shares investments

Represents equity instruments of another entity

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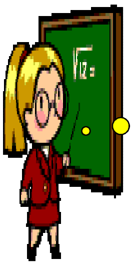
Common types of financial assets



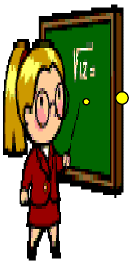
Why are these financial assets ?

Bond investments

Fund investments

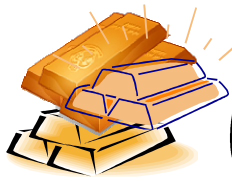
These type of financial instruments is one for which the economic benefit to be received is a financial asset other than cash. For example, the bonds are financial assets because they represent obligations of the issuer of the bonds to pay cash

Are these financial assets ?

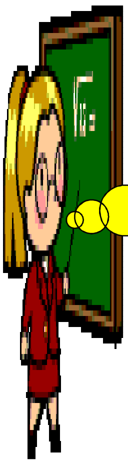


Are these financial assets ?

?	Income tax receivable
?	Gold Bullion
?	Inventories
?	Prepayments



Are these financial assets ?



Taxation is not based on a contract between the entity and the tax authority, but arising from statutory

✗	Income tax receivable
	Gold Bullion
	Inventories
	Prepayments

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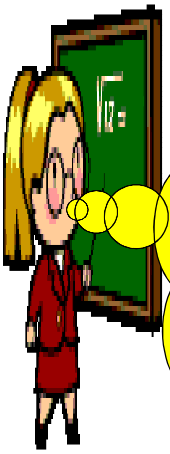
Are these financial assets



Gold bullion is not a financial instruments like cash. It is a commodity. Although the bullion market is highly liquid, there is no contractual right to receive cash or another financial instrument inherent in bullion

- ✗ Income tax receivable
- ✗ Gold Bullion
- Inventories
- Prepayments

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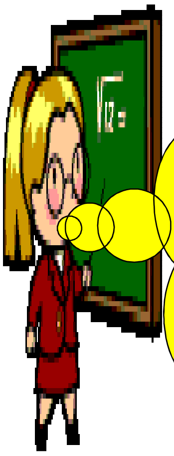
Are these financial assets



The non-financial assets of a business (e.g. inventories, PPE and intangibles) are inputs for some productive process. They are expected to contribute, along with other inputs, to the production and sale of goods or services. They must be used in a productive activity, and effectively transformed into goods or service, which must be sold, before there is any rights to receive cash. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset

- ✗ Income tax receivable
- ✗ Gold Bullion
- ✗ Inventories
- Prepayments

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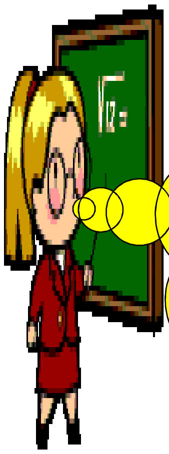
Are these financial assets



The anticipated future economic benefit of the prepaid expense is the receipt of goods or services, not cash or another assets. They are not financial assets

- ✗ Income tax receivable
- ✗ Gold Bullion
- ✗ Inventories
- ✗ Prepayments

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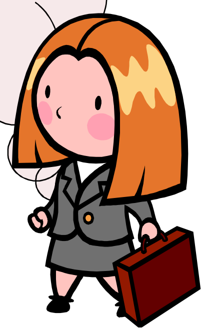
What is financial liability?

Financial liability

A contractual obligation to deliver cash to another company

ABC Co Ltd

Assets	Liabilities
	Accounts payable
$	Equity



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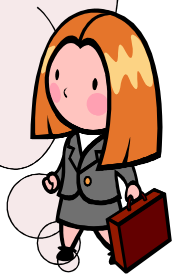
What is financial liability?

Financial Liability

CEF Co Ltd		ABC Co Ltd	
Assets	**Liabilities**	**Assets**	**Liabilities**
	Bond payable	*Bond receivable*	
	Equity		**Equity**
Bond			

2 A contractual right to deliver financial asset other than cash to another company



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What is a financial liability ?

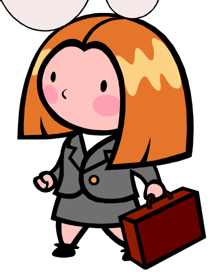
The option is a derivative financial liability from the time the entity becomes a party to the option contract

3 To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity

CEF Co Ltd

CEF Co Ltd writes an option under which the counterparty can force CEF Co Ltd to sell equity shares in listed Co B for $5 per share at any time in the next 90 days period, CEF Co Ltd has a <u>contractual obligation to exchange equity shares in another entity for cash</u> of $5 per share on potentially unfavorable terms if the holder exercises the option, because the market price per share exceeds the exercise price of $5 per share at the end of the 90 days period

Since CEF Co Ltd stands to lose if the option is exercised, the exchange is potentially unfavorable to CEF Co Ltd



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Definition of a financial liability

Financial Liability

- A contractual obligation
  - To deliver cash or another financial asset to another entity
  - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity
- A contract that will or may be settled in the entity's own equity instruments and is
  - A non-derivative contract for which the entity is or may be obliged to deliver a variable number of its own equity instruments
  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

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Common types of financial liabilities

Bank borrowings	Bank overdrafts	Loans payable
Bills payable	Financial Liabilities	Interest payable
Trade payable	Account payable	Other payable

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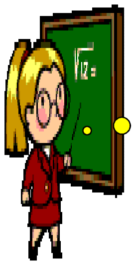
Common types of financial liabilities



Why are these financial liabilities ?

Because they all have a contractual obligation to deliver cash or another financial assets of another entity

- ✓ Bills payable
- ✓ Trade payable
- ✓ Accounts payable
- ✓ Other payable
- ✓ Bank borrowings
- ✓ Bank overdrafts
- ✓ Loans payable
- ✓ Interest payable

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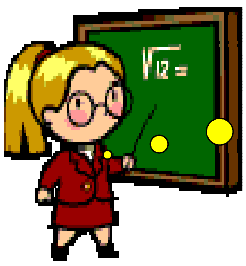
Are these financial liabilities?



Are these financial liabilities ?

- ? Income tax payable
- ? Provision for warranty
- ? Deferred revenue

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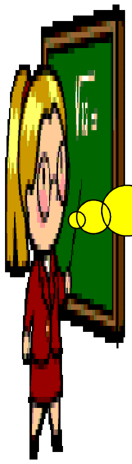
Are these financial liabilities ?



Taxation is not based on a contract between the entity and the tax authority, but arising from statutory

- ✗ Income tax payable
- Provision for warranty
- Deferred revenue

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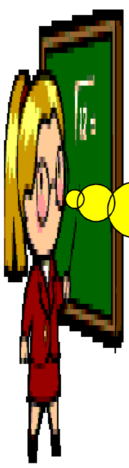
Are these financial liabilities ?



The anticipated future obligation of the warranty is the payment of goods or services, not cash or another assets. They are not financial liabilities

- ✗ Income tax payable
- ✗ Provision for warranty
- Deferred revenue

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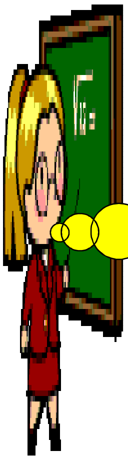
Are these financial liabilities ?



The future obligation for the cash received in advance is the payment of goods or services, not cash or another assets. They are not financial liabilities

- ✗ Income tax payable
- ✗ Provision for warranty
- ✗ Deferred revenue

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What are equity instruments?

Equity Instrument

- 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**

The instrument includes no contractual obligation

(i) To deliver cash or another financial asset to another entity, or
(ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer

If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
(ii) A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instrument

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Principles of assets, liability or equity classifications

a. Contractual rights/obligations to receive/settle in cash or another financial asset

b. Fixed for fixed requirement

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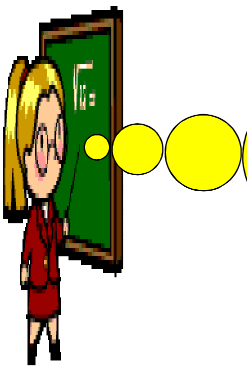
Contractual right/obligation to receive/settle in cash or another financial asset



- **Classification of a financial instrument at initial recognition should be:**
  - **according to the <u>substance of the contractual arrangement, not its legal form</u>, and**
  - **the definitions of a financial asset, financial liability and an equity instrument**

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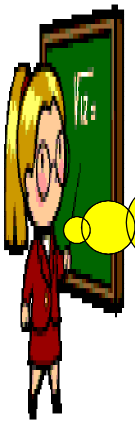
Contractual obligation to settle in cash or another financial asset



The overriding criterion to determine whether there is a contractual obligation to settle in cash or another financial asset is:

- If the entity **does not** have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the contract is **not** an equity instrument

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Liability vs. Equity

Issuer: Interest bearing loan

Interest	**Mandatory payment**	→	**financial liability**
		no unconditional right to avoid deliver cash	
Principal	**Repayable on maturity**	→	**financial liability**

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Liability vs. Equity

Issuer: 6% mandatorily redeemable preference shares with mandatory fixed dividend

Dividends – **Mandatorily periodic fixed dividend payments**

Preferred shares face value – **Mandatory redemption by the issuer for a fixed amount at a fixed future date**

contractual obligation to deliver cash for both dividend and repayment of principal to the shareholders cannot be avoided

The preferred share is a financial liability in its entirety

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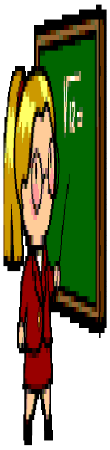
Fixed for fixed requirement



- A contract is <u>not an equity instrument solely</u> 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 <u>variability in either the number of own equity delivered</u> and/or <u>variability in the amount of cash or other financial assets received, or whether both are fixed</u>
- 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**

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

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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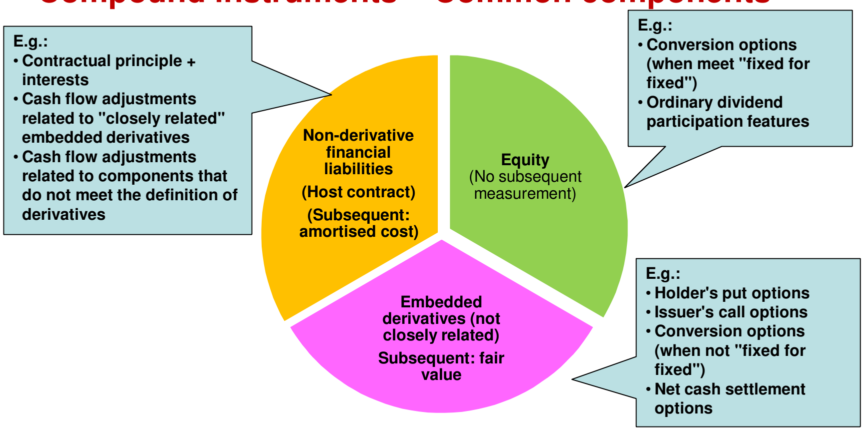
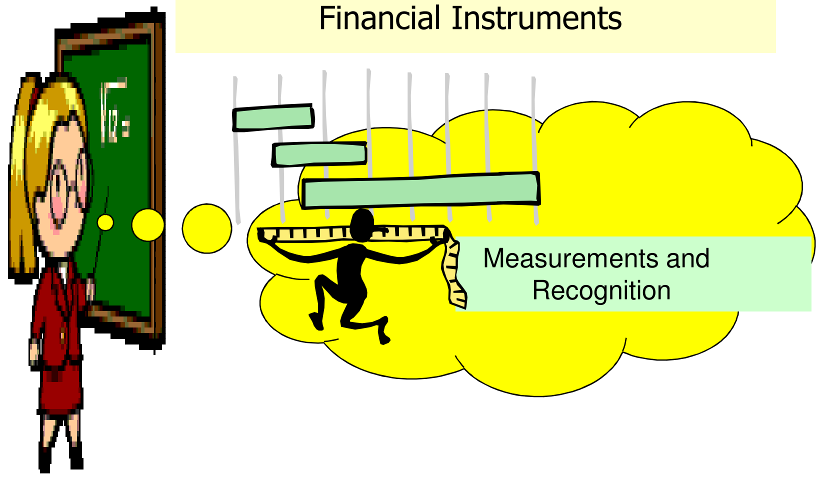
Compound instruments – Common components

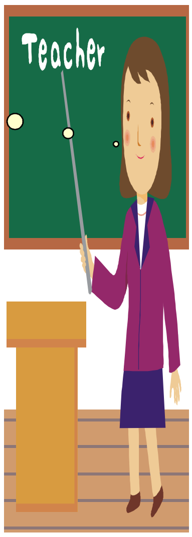


Note: For CB that contains significant "non closely-related" embedded derivative(s), the issuer can, upon initial recognition, designate the whole contract as at fair value through profit or loss.

Financial Instruments



Learning Objectives



- ❑ Why do we have to categorise financial assets ?
- ❑ Why do we have to categorise financial liabilities ?
- ❑ Types of financial assets and financial liabilities under HKAS 39
- ❑ Recognition and measurements of financial instruments

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HKFRSs that deal with the accounting for financial instruments

Transaction date | Valuation date | Reporting date | Derecognition date

Initial recognition	Subsequent measurement	Preparation of financial statement & note disclosures	Derecognition
• HKAS 39 *Financial Instruments: Recognition and Measurement*	• HKAS 39 *Financial Instruments: Recognition and Measurement*	• HKAS 32 *Financial Instruments: Presentation*	• HKAS 39 *Financial Instruments: Recognition and Measurement*
• HKFRS 9 *Financial assets & liabilities – Classification and initial recognition*	• HKFRS 9 *Financial assets & liabilities – Classification and initial recognition*	• HKFRS 7 *Financial Instruments: Disclosures*	• HKFRS 9 *Financial assets & liabilities – Classification and initial recognition*
• HKAS 32 *Classification of financial liability and equity*			

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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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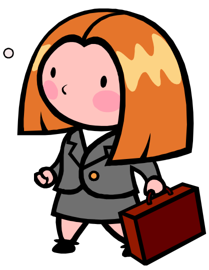
Why is it necessary to categorise financial assets and financial liabilities ?

Because it affects the initial and subsequent measurements

Initial recognition | Initial measurement | Subsequent measurement | Derecognition

And it will also affects their disclosures under HKFRS 7



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Financial assets of ABC Co Ltd

CEFShares Limited
- Listed Company
- EPS - $3
- Dividend - $2
- Held for long-term investment purpose

IFRS Bond
- Face value: $20M
- Duration: 2 years
- Maturity date: 2015
- Coupon rate: 2%
- Intend to earn interest and hold to maturity

CPA Fund
- Set up 2 years ago
- Volatility ±10%
- Hold for short-term

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Classification of financial assets for measurement

- ***At fair value through profit or loss (FVTPL)***
- ***Held-to-maturity***
- ***Loans and receivables***
- ***Available-for-sale***

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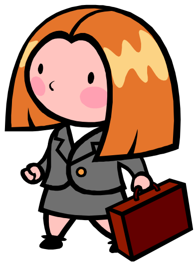
At fair value through profit and loss

Financial assets at fair value through profit and loss can further categorised as:

(1) Held for trading financial asset

(2) Financial asset designated as fair value through profit and loss



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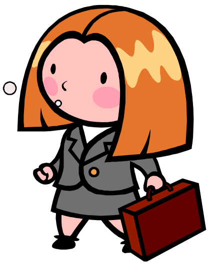
At fair value through profit and loss

Held for trading financial asset

Hold for short-term purpose

ABC Company Limited	
Asset	**Liability**
CPA Fund	**Equity**

CPA Fund
- Set up 2 years ago
- Volatility + 10%
- Hold for short-term



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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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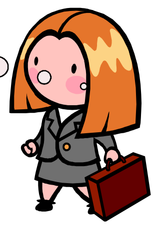
At fair value through profit and loss

Financial assets at fair value through profit and loss can further categorised as:



(1) Held for trading financial asset

(2) Financial asset designated as fair value through profit and loss

Three options to designate the financial assets at fair value through profit and loss

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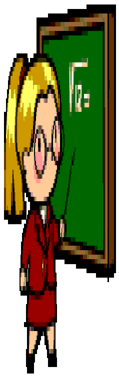
Financial assets/liabilities at fair value through profit or loss (FVTPL)



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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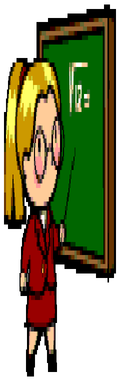
Financial assets/liabilities at fair value through profit or loss (FVTPL)



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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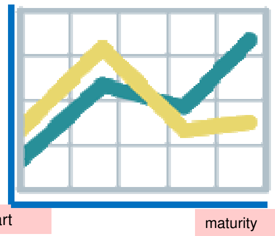
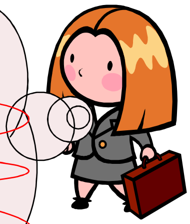
Held-to-maturity financial assets



Held-to-maturity investments are non-derivative financial assets 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 designates as at fair value through profit or loss, those that the entity designates as available-for-sale and those that meet the definition of loans and receivables

HTM investments are non-derivative financial instruments:

- fixed or determinable payments
- fixed maturity
- entity has the positive intention to hold to maturity
- ability to hold to maturity



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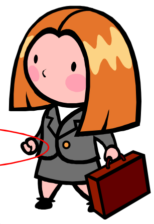
Held-to-maturity financial assets

IFRS Bond
- Face value: $20M
- Duration: 2 years
- Maturity date: 2015
- Coupon rate: 2%
- Intend to earn interest and hold to maturity



Principal + Interest

Fixed or determinable payment

2015

Fixed maturity date

not affected by pricing volatility

Positive intention

Ability to hold to maturity

Indifferent to future opportunities to profit from changes in the security's fair value and intends to accept the debt security's stipulated contractual cash flows, including the repayment of principal at maturity

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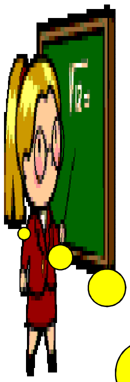
Loans and receivables



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

Usually arises from sales of goods, provision of services and provision of cash

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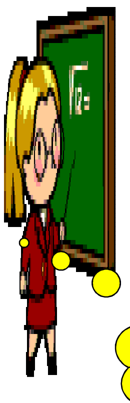
Available-for-sale financial assets (AFS)



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

Usually held for long-term investment purpose and not for trading

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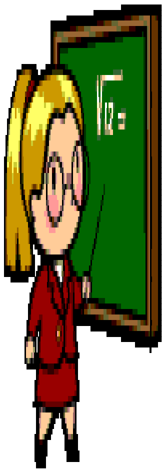

Classification of financial liabilities

- **At fair value through profit or loss (FVTPL)**
  - **Held for trading**
  - **Designated as at FVTPL**
- Others (measured at amortised cost)

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Types of Financial Instruments

- **Non-derivative financial instruments**
- **Derivative instruments**
- **Embedded derivatives**

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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 to an **underlying**
  - It requires no or little **initial net investment**; and
  - It is settled at a **future** date

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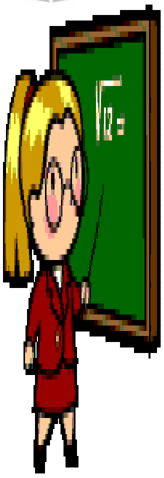
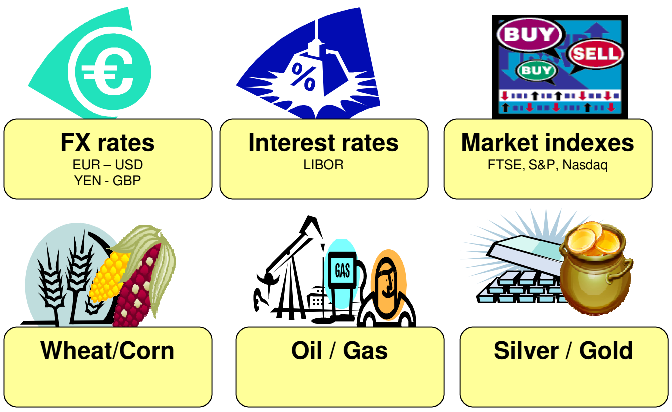


Derivatives - What is an underlying ?



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Derivatives - Initial investment

Usually require **no** initial investment

- Foreign exchange forwards
- Interest rate swaps

Generally **little** initially net investment

- Option contracts
- Future contracts

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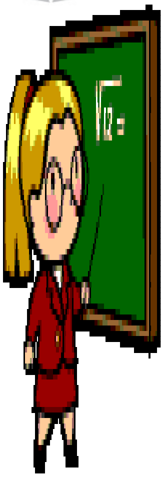

Derivatives – Settlement at a future date

Settlement of a derivative may be:

- **Net** in cash
- **Gross** in cash or other financial asset
- It may also occur through physical delivery of the underlying

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Derivatives - Measurement

- **Initially measurement:** Fair value, normally the transaction price
- **Subsequent measurement:** @FVTPL, unless designated as hedging

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Types of Financial Instruments

- **Non-derivative financial instruments**
- **Derivative instruments**
- **Embedded derivatives**

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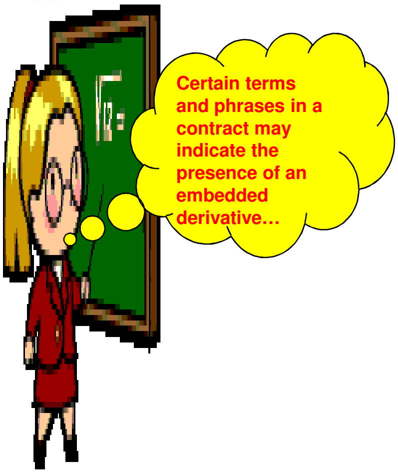
Embedded derivative



What are the common terms…

- *Right to cancel/extend…*
- *Indexed to/adjusted by…*
- *Referenced to…*
- *Right to repurchase…*
- *Right to return…*
- *Early exercise rights…*
- *Pricing based on the following formula…*
- *Right to purchase/sell additional units…*

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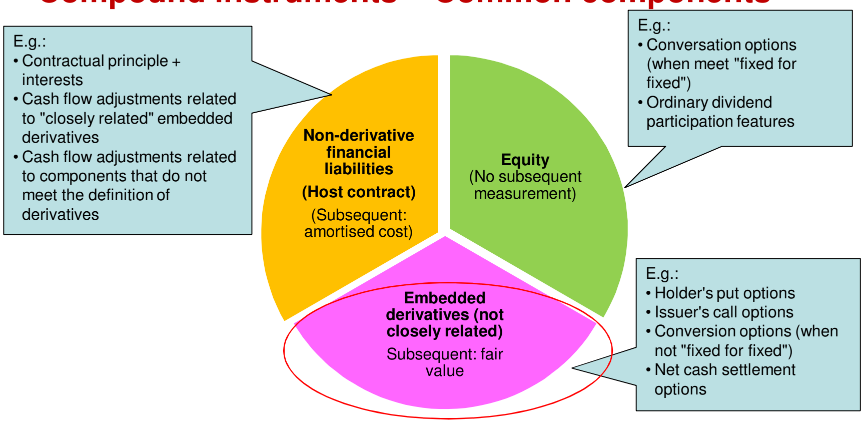
Compound instruments – Common components



Note: For CB that contains significant "non closely-related" embedded derivative(s), the issuer can, upon initial recognition, designate the whole contract as at fair value through profit or loss.

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Embedded derivative

Hybrid Contract

Host contract (e.g. debt, equity, lease, insurance)

Embedded derivatives
- foreign currency forward contract
- inflation swap
- equity conversion options
- foreign currency option
- leveraged interest swap

Embedded derivatives – Assessment at initial recognition

Is the hybrid contract either designated as at fair value through profit or loss or meets the definition of held for trading?
- Yes → Do not separate embedded derivative
- No → Would a separate instrument with the same terms as the embedded derivative meet the definition of a derivative?
  - No → Do not separate embedded derivative
  - Yes → Is the embedded derivative closely related to the host contract?
    - Yes → Do not separate embedded derivative
    - No → Separate embedded derivative

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Hybrid contract - Valuation at initial recognition

Embedded derivative 1 **Embedded derivative 2** **Embedded derivative 3**	▪ Non-option based on derivatives – zero fair value ▪ Option based derivatives – valued using contractual term ▪ Multiple embedded derivatives – separately accounted for only when they are: - relating to different risks - readily separable and - independent of each other
Host Contract	Host contract being the residual

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Hybrid contract - Valuation at initial recognition (cont'd)

If unable to determine reliably the fair value of an embedded derivative:

FV of hybrid instrument minus FV of host contract

If not determinable

Whole hybrid contract designated as FVTPL

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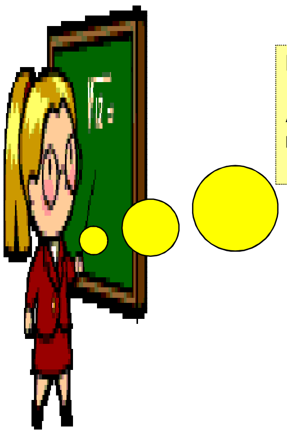

Embedded derivatives are everywhere !

Assessment of closely and not closely relationship requires judgement and complex

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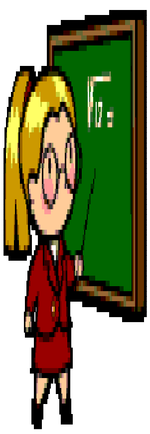

Financial Instruments –

Initial and subsequent measurements

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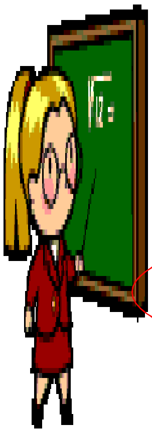
Initial measurement of financial assets and liabilities



- 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 assets

Classifications	Financial asset	Measurement basis	Changes in carrying amount	Impairment (if objective evidence)
At fair value through profit or loss	Debt	Fair value	Profit or loss	No
	Equity	Fair value	Profit or loss	No
	Derivatives not designated as effective hedging instruments	Fair value	Profit or loss	-
Loans and receivables	Debt	Amortised cost	Profit or loss (note 3)	Yes

Note 3 :
- interest calculated using the effective interest method, foreign exchange differences resulting from changes in amortised cost, impairment and reversal of impairment, where relevant, are taken to profit or loss

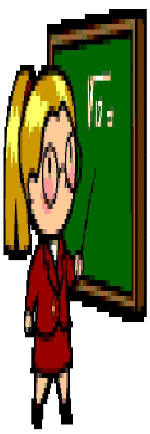
Subsequent measurement of financial assets (cont'd)

Classifications	Financial asset	Measurement basis	Changes in carrying amount	Impairment (if objective evidence)
Held-to-maturity investments	Debt	Amortised cost	Profit or loss (note 3)	Yes
Available-for- sale financial assets	Debt	Fair value	OCI (note 2) Profit or loss (note 3)	Yes
	Equity	Fair value	OCI (note 2) Profit or loss (note 4)	Yes
	Equity (note 1)	Cost (fair value not reliably measurable)	Profit or loss (note 4)	Yes

Note
1. equity instruments that do not have any quoted market price in an active market and whose fair value cannot be reliably measured and derivative assets that are linked to and must be settled by delivery of such unquoted equity instruments
2. change in fair value including related foreign exchange differences other than those noted in note 3 or 4 where relevant
3. Interest calculated using the effective interest method, foreign exchange differences resulting from changes in amortised cost, impairment and reversal of impairment, where relevant, are taken to profit or loss
4. Dividends and impairment are taken to profit or loss. Foreign exchange difference on (non-monetary) equity AFS investments taken to equity and recycled to profit or loss on disposal or impairment

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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Subsequent measurement of 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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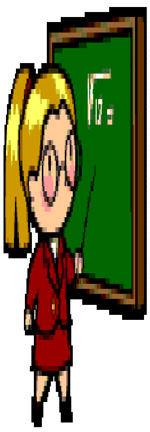
Financial guarantee contracts



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

Decision tree: The treatment of issued financial guarantees

Does the contract require specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument ?

- No → Apply HKAS 39 and account for contract as derivative (financial liability at fair value through profit or loss)
- Yes ↓

Was the financial guarantee designated at inception as at fair value through profit or loss?

- Yes → Apply HKAS 39 and account for contract as derivative (financial liability at fair value through profit or loss)
- No ↓

Has the issuer previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts and elected to apply HKFRS 4 to such contracts?

- No → **Apply HKAS 39(43) and (47)(c):**

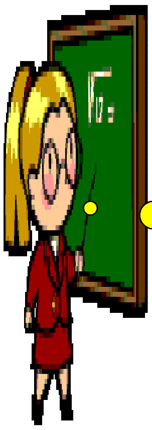
  After initial recognition at fair value, the issuer shall measure contract at **higher of:**

  •Amount determined in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

  •Amount initially recognised less when appropriate cumulative amortisation in accordance with HKAS 18 *Revenue*

- Yes → **Apply HKFRS 4 *Insurance Contracts***

Reclassifications of financial instruments



Permitted or 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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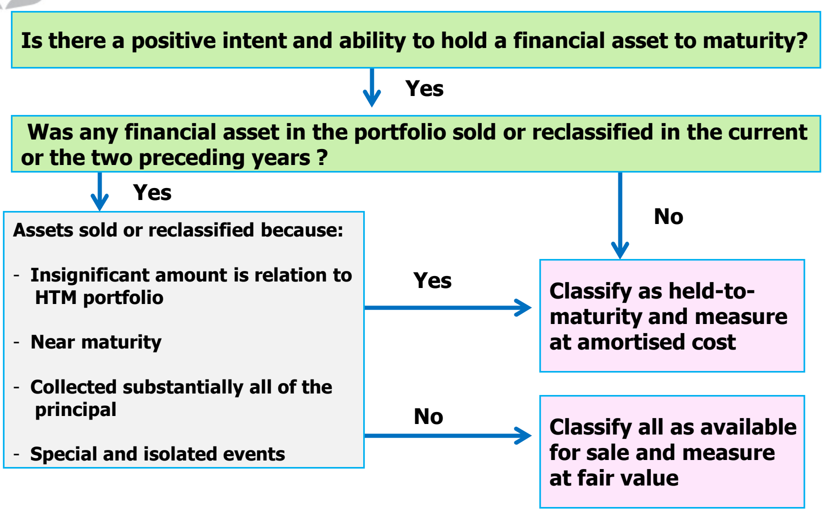
Reclassifications from HTM to AFS: Tainting Rules



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Financial Instruments – 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

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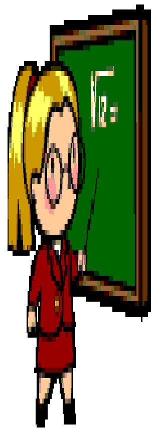
Impairment of financial assets



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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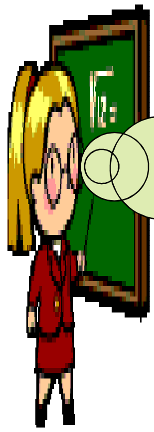

The Standard provides additional guidance about impairment indicators that are specific to investments in equity instruments. They apply in addition to the impairment indicators described in the previous slide, which focus on the assessment of impairment in debt instruments…(see next slide)

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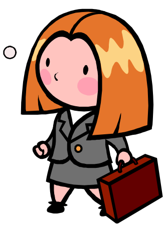
Additional impairment indicators that may indicate that the equity investment's cost may not be recovered are:

- **Significant adverse changes in the technological, market, economic or legal environment in which the issuer operates**
- **A significant or prolonged decline in the fair value of an investment in an equity instrument below cost**

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' decline in fair value should be evaluated against the original cost at initial recognition and prolonged should be evaluated against the period in which the fair value of the investment has been below that original cost
- '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

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Impairment of equity investments – significant or prolonged decline in fair value (cont'd)

- 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
- 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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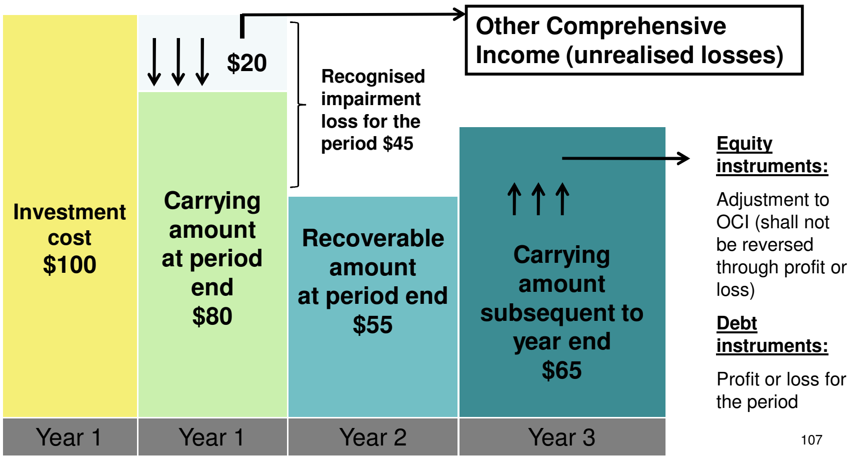
Impairment loss/reversals: available-for-sale financial assets



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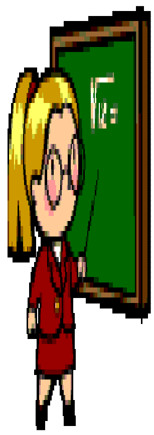
Impairment of financial assets carried at amortised cost – debt instrument



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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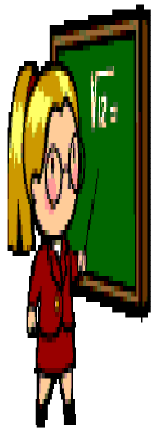
Impairment of financial assets carried at amortised cost – debt instrument



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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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

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HKAS 39

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

Fair value hedge

Cash flow hedge

Net investment hedge

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Hedge Accounting: Types of Hedging Relationships

1. Fair value hedge - hedge of the variability of <u>changes in fair value of a recognised asset or liability or a firm commitment</u>
2. Cash flow hedge - hedge of exposure to <u>variability in cash flows on a recognised asset or liability, or a forecasted transaction</u>
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)

Effective Hedge

- **Fair value hedge**
  - (a) The gain or loss from re-measuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount (for a non-derivative hedging instrument) shall be recognised in profit or loss
  - (b) The gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss
- **Cash flow hedge**
  - Effective portion
    - Recognised in other comprehensive income
    - For cash flow hedge, the portion of the hedging instrument that is deferred in the equity is the lesser of:
      - The cumulative gain or loss on the hedging instrument from the inception of the hedge; and
      - The cumulative change in fair value (PV) of the expected future cash flows on the hedged item from the inception of the hedge
  - Ineffective portion
    - Recognised in profit or loss

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Hedge accounting (HKAS 39.89,95,102) (continued)

Effective Hedge

- **Hedges of a net investment**
  - Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment shall be accounted for similarly to cash flow hedges

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HKFRS 9

Financial Instruments

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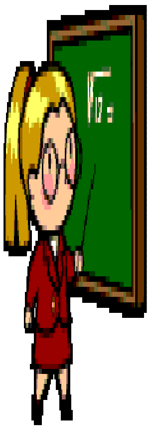
Overview



- The final version of HKFRS 9 Financial Instruments was issued in September 2014*

Classification and Measurement	
Impairment	
General Hedge Accounting	
Macro Hedge Accounting	Separate project

* IFRS 9 was issued in July 2014

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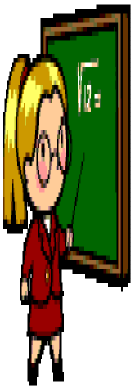

Major amendments of HKFRS 9 compared with HKAS 39:

Scope	None
Classification and measurement of financial assets	• Classification and measurement based on the entity's business model and the contractual cash flow characteristics • Different accounting treatments for "debt" instruments vs equity instruments designated at fair value through other comprehensive income
Classification and measurement of financial liabilities	• No amendments regarding classification • New requirements for the accounting of changes in the fair value of an entity's own debt where the FVO as been applied
Embedded derivatives	• Hybrid contracts with a financial asset as a host contract are classified in their entirely based on the contractual cash flow characteristics criterion
Amortised cost measurement	• None
Impairment	• Expected loss model
Hedge Accounting	• More closely aligns hedge accounting with risk management activities • Accounting policy choice to apply hedge accounting model in HKAS 39 in its entirely or the accounting for portfolio fair value hedges under HKAS 39 if applying HKFRS 9 hedge accounting

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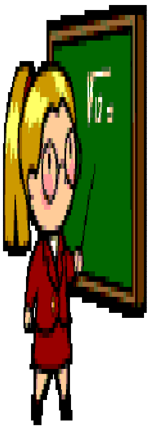

Classification and Measurement of Financial Assets under HKFRS 9

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Initial measurement of financial instruments

All financial instruments are **initially measured at fair value, plus or minus**, in the case of a financial asset or financial liability not a fair value through profit or loss, **transaction costs**

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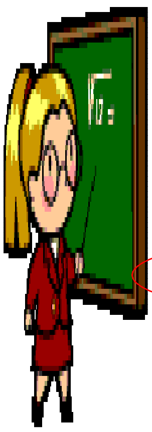
Classification approach under HKFRS 9



HKFRS 9 divides all financial assets that are in the scope of HKAS 39 into **two classifications**

- those measured <u>at amortised cost</u>
- those measured <u>at fair value</u>

Classification is made at the time the financial asset is initially recognised, namely when the entity becomes a party to the contractual provisions of the instrument

Classification of financial assets

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Business Model

= **Held to collect** contractual cash flows

|| **Held to collect** contractual cash flows and for **sale**

+

Contractual Cash Flow Characteristics

Principal + **Interest on the principal amount outstanding**

- **Time value of money**
- **Credit risk**
- **Other basic lending risks or costs**

✓ → = **Amortised Cost**

✓ → || **Fair Value (change to OCI)**

Fair Value Option in case of an accounting mismatch

✗ → **Fair Value (Δ P&L)**

FVTOCI-Option for investments in equity instruments that are not held for trading

Business Model Test

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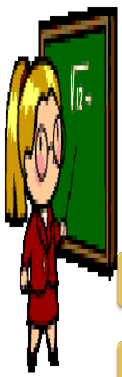

Business model is determined by the entity's key management personnel

Entity's business model for managing the financial assets

For contractual cash flows	For contractual cash flows and for sales	Others
Amortised costs	FVTOCI (reclassification on disposal and impairment)	FVTPL
		FVTOCI**

Mandatory → Amortised costs / FVTOCI / FVTPL

Designation (subject to fulfilling criteria) → **FVTPL***

* Apply to debt instruments

** One time irrevocable option for pure vanilla equity investments

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Business model to hold assets for contractual cash flows

- Financial assets are manage to realise contractual cash flows over the life of the instrument
- Consider the frequency, value and timing of sales in prior periods and the reasons and expectations of future sales activity

Debt instruments measured at amortised costs

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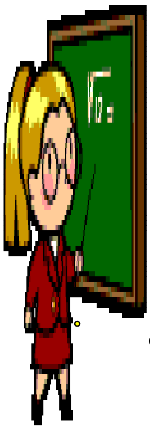
Business model for both collecting contractual cash flows and selling financial assets



- Various objectives that may be consistent with this business model:
  - managing liquidity needs
  - maintain a particular interest yield profile
  - matching duration of financial assets and financial liabilities
- Greater frequency of sales compared to "amortised cost" model

Debt instruments measured at fair value through other comprehensive income ('FVTOCI')

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Debt instruments measured at FVTOCI

- Effective interest expense and foreign exchange gain/loss accounted through P/L
- Measure impairment in the same manner as for assets measured at amortised costs
- Amount in OCI represents difference between fair value and amortised cost
- Reclassify cumulative gain/loss in OCI to P/L on derecognition

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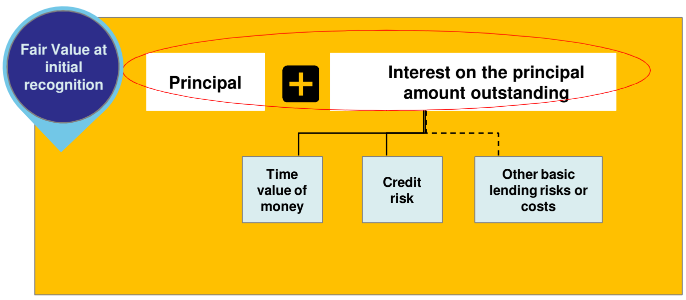
Contractual cash flow characteristics



Note: Leverage may increase variability of contractual cash flows to an extent that the cash flows may not reflect the economic characteristics of interest

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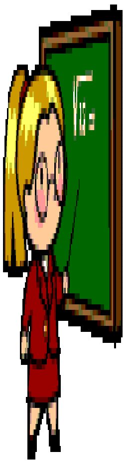
Does this meet the contractual cash flows?



✓	**Bond with a stated maturity date. Interest and principal are linked to inflation index of the country in which currency bond is denominated (no leverage; principal is protected)**
✓	**Bond with a stated maturity date and capped variable interest rate**
✓	**Full recourse loan, secured by collateral**
✗	**Bond convertible into equity instruments**
✗	**Loan that pays an inverse floating interest rate**
✗	**Contractual leveraged return**

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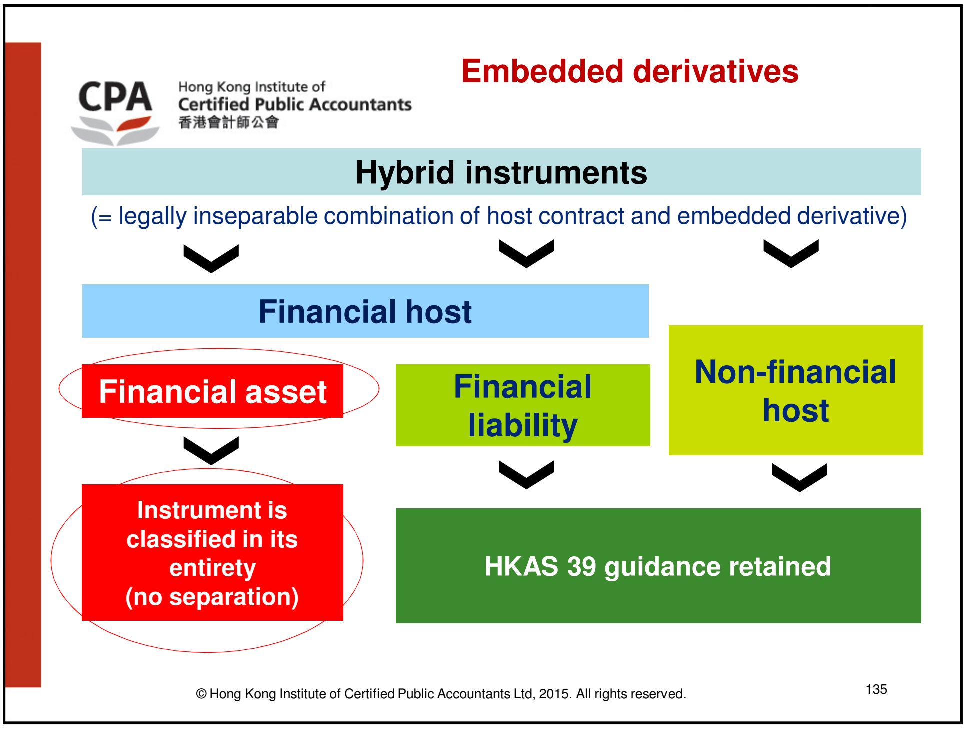
Fair value option (FVO) for financial assets

Even if an instruments meets the two amortised cost tests, 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


Embedded derivatives
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Hybrid instruments
(= legally inseparable combination of host contract and embedded derivative)
Financial host
Financial asset
Financial liability
Non-financial host
Instrument is classified in its entirety (no separation)
HKAS 39 guidance retained
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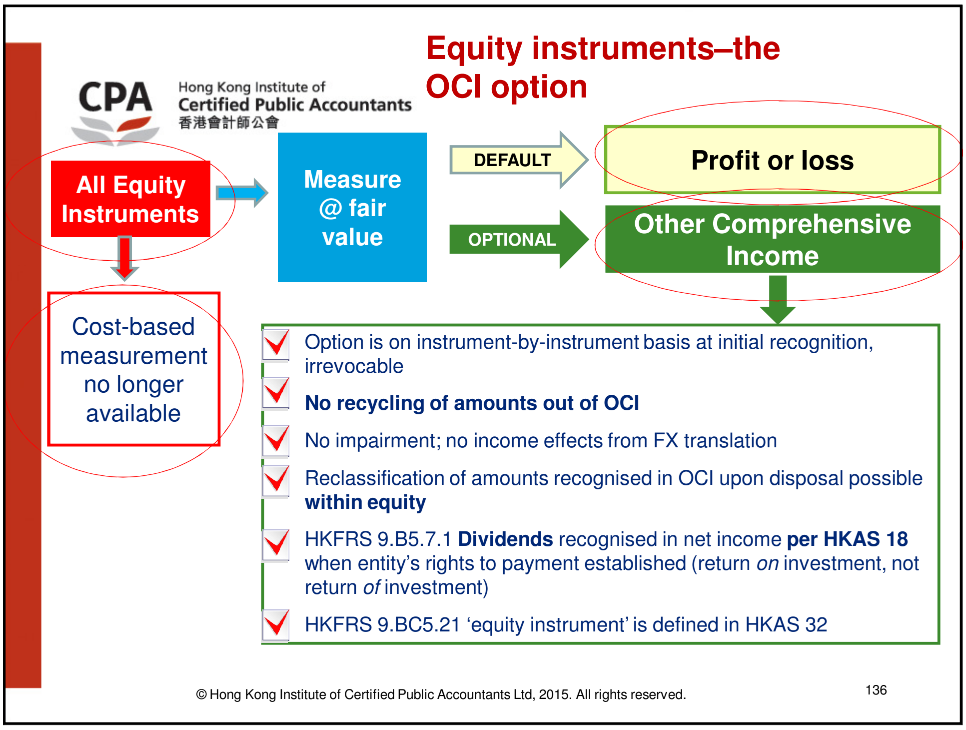
Equity instruments–the OCI option
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All Equity Instruments
Measure @ fair value
DEFAULT
Profit or loss
OPTIONAL
Other Comprehensive Income
Cost-based measurement no longer available
Option is on instrument-by-instrument basis at initial recognition, irrevocable
No recycling of amounts out of OCI
No impairment; no income effects from FX translation
Reclassification of amounts recognised in OCI upon disposal possible within equity
HKFRS 9.B5.7.1 Dividends recognised in net income per HKAS 18 when entity's rights to payment established (return on investment, not return of investment)
HKFRS 9.BC5.21 'equity instrument' is defined in HKAS 32
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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
- Reclassification is to be applied **prospectively** from the reclassification date, which is the first day of **the first reporting period following** the change in business model
- Reclassification triggers **disclosure** requirements

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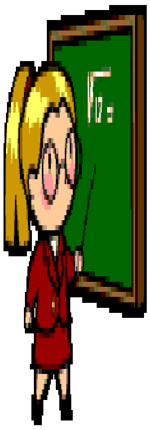

Classification and Measurement of Financial Liabilities under HKFRS 9

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Classification and measurement of financial liabilities

Classification and measurement of financial liabilities are similar to HKAS 39 except for two issues:

Held for trading → **Fair Value Through Profit or Loss**

Fair Value Option → **Fair Value Through Profit or Loss**

Other liabilities → **Amortised Cost**

Elimination of cost exemption for derivative liabilities settled physically by delivery of unquoted equities

Changes in liability's credit risk are to be recognised in OCI with offsetting entry in P/L

No recycling!

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HKFRS 9 contains an option to designate a financial liability as at FVTPL

- Eliminate accounting mismatch ✓
- Manage on fair value basis ✓
- Embedded derivative(s) ✓

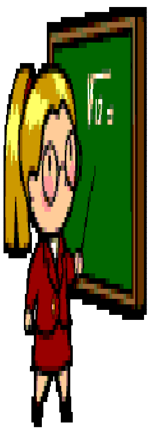
An entity shall present a gain or loss on a financial liability designated as at fair value through profit or loss as follows:

- 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

- If the requirements above create or enlarge an accounting mismatch in profit or loss, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss

Embedded Derivatives



- The embedded derivative concept of HKAS 39 is included in HKFRS 9 and continues to apply to financial liabilities

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Impairment under HKFRS 9

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Scope for impairment assessment under HKFRS 9

Financial assets in the scope of HKFRS 9

Subsequent measurement …

- **FVTPL/ FVTOCI Option** for certain equity instruments → ✗ **Outside the scope of the impairment model**
- **AC** → ✓ **Within the scope of the impairment model**
- **FVTOCI** → ✓ **Within the scope of the impairment model**

Loan commit-ments (unless @ FVTPL) → ✓ **Within the scope of the impairment model**

Financial guarantees (unless @ FVTPL) → ✓ **Within the scope of the impairment model**

Lease receivables → ✓ **Within the scope of the impairment model**

Contract assets (HFRS 15) → ✓ **Within the scope of the impairment model**

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Incurred loss model under HKAS 39

- An impairment loss should be recognised when and only when, there is “objective evidence” that an impairment has occurred
- “Objective evidence” includes significant financial difficulty of the issuer, actual breach of contract and a high probability of bankruptcy
- Criticisms of the current model under HKAS 39:
  - delaying recognition of credit losses, resulting in overestimating income
  - changes in credit risk are not recognised on a timely basis
  - application of “significant or prolonged’ for AFS equity instruments

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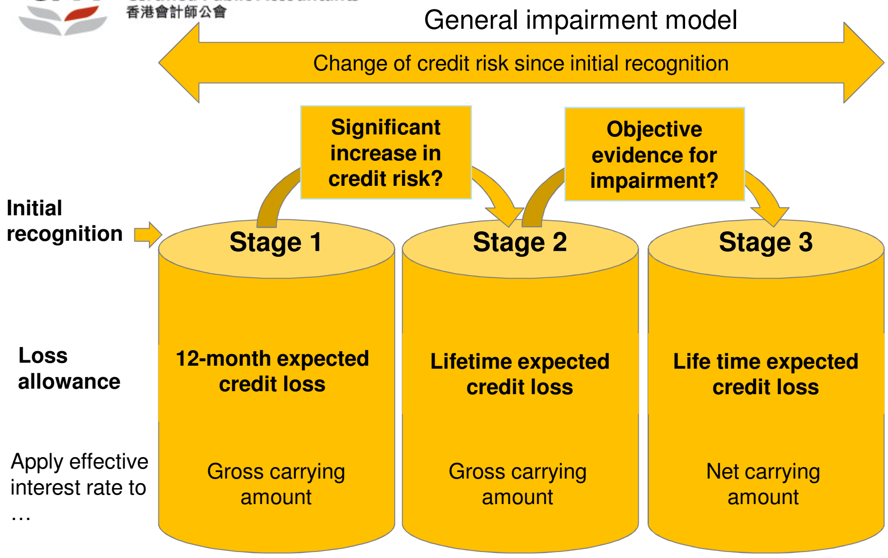
Expected Loss Model under HKFRS 9

General impairment model



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Expected Loss Model – definitions

12-month expected credit losses	The portion of **lifetime expected credit losses** that represent the **expected credit losses** that result from default events on a financial instrument that are possible within the 12 months after the reporting date.
expected credit losses	The weighted average of **credit losses** with the respective risks of a default occurring as the weights.
lifetime expected credit losses	The **expected credit losses** that result from all possible default events over the expected life of a financial instrument.

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HKFRS 9 vs. HKAS 39

	HKAS 39	HKFRS 9	
At initial recognition…	✗	**12-month expected credit loss**	Stage 1
Significant increase in credit risk …	✗	**Lifetime expected credit loss**	Stage 2
Credit-impaired …	**Lifetime expected credit loss**	**Lifetime expected credit loss**	Stage 3

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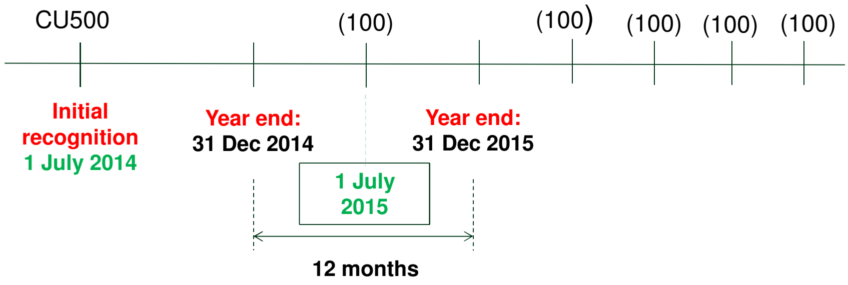
Example - Computation of expected losses



- Bank A granted a loan of CU500 on 1 July 2014, repayable in 5 annual instalments, bearing interest at 10%p.a.

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Example - Computation of expected losses

<u>Stage 1</u>

- Probability of default within 12 months = 1%
- Loss given default ("LGD") = 30%
- 12-month expected losses = 1% x 30% x CU500 = CU1.5

<u>Stage 2</u>

- Probability of default for life time = 10%
- LGD = 30%
- Life time expected losses = 10% x 30% x CU500 = CU15

Note: example excludes interest on loan and discounting effects on impairment.

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Exemptions from the general model

- Lease receivables
- Contract assets with significant financing component
- Trade receivables with a significant financing component

Policy choice

General model

Stage 1 Stage 2 Stage 3

- Contract assets without significant financing component
- Trade receivables without a significant financing component

Simplified model

Stage 2 Stage 3

Purchased or originated credit-impaired financial assets

Special provisions

- No loss allowance on initial recognition
- Apply a credit-adjusted effective interest rate (based on the expected cash flows at inception including expected credit losses)

Stage 3

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HKFRS 9 – Impairment of financial assets

When determining whether credit risk of a financial asset has increased significantly since initial recognition [HKFRS 9.5.5.11]

Reasonable and supportable forward-looking information available without undue cost or effort?

Yes → cannot rely solely on past due information

No → may use past due information

Rebuttable presumption:

Credit risk on a financial assets has increased significantly since initial recognition when contractual payments are more than 30 days past due

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Impairment under HKFRS 9 – other considerations

- **Transfer out of Stage 1 : Significant increase in credit risk ?**
  - Relative model : Credit risk on initial recognition compare with credit risk at reporting date
  - Indicators of changes in credit risk
- **Transfer out of Stage 2**
  - Credit impaired
  - Breach of contract, lenders grant a concession , financial difficulty of borrower, bankruptcy, disappearance of active market etc.

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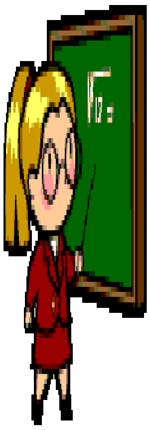

Hedge Accounting under HKFRS 9

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HKFRS 9 – Hedge Accounting

Objective: Better alignment with risk management objectives

- The three types of hedge accounting remain
- Some changes to the types of transactions eligible for hedge accounting
- Effectiveness test overhauled
- Additional disclosures

Available for early application -
If early applied, MUST also apply the other requirements of HKFRS 9

Hedge Accounting Requirements under HKFRS 9

Key elements that have not changes

Applying hedge accounting remains a choice	No change in mechanics of fair value, cash flow and net investment hedge *
No change to the requirement to measure and recognise ineffectiveness	Most written options continue to be prohibited as hedging instruments

* *Except for fair value hedges of equity instruments for which the OCI option has been exercised*

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Key changes introduced by HKFRS 9

Hedging Instrument

- Non-derivatives at FVTPL
- Time value / Forward element
- Foreign currency basis spread

+

Hedged Item

- Separate risk components
- Groups of items, including net positions
- Aggregate exposures

Designate and document

- Cash flow hedge
- Fair value hedge
- Net investment hedge

Effectiveness assessment

✓ No more 80-125% test

Ineffectiveness measurement

"Mechanics" (a/c entries)

Disclosures

✓ More disclosures

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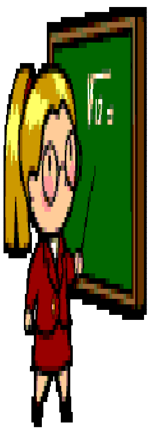

Effective date and Transition

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Various versions of HKFRS 9

Version	Details
HKFRS 9 (2009)	Classification of financial assets
HKFRS 9 (2010)	Classification of financial liabilities and derecognition
HKFRS 9 (2013)	Hedge accounting
HKFRS 9 (2014)	Impairment and amendments on classification of financial assets

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Effective date and transition

Effective for:

- Annual periods beginning on or after 1 January 2018
- Retrospective application with certain exceptions
- May elect to early apply only the requirements for the presentation of gains and losses on financial liabilities designated at FVTPL
- May elect to apply earlier versions of HKFRS 9 if and only if the entity's relevant date of initial application is before 1 February 2015

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Disclosures

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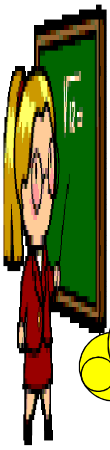

Disclosures requirements for financial instruments are **onerous**

HKFRS 7 deals with the disclosure requirements for financial instruments

HKFRS 13 deals with the disclosure for fair value measurements of financial instruments

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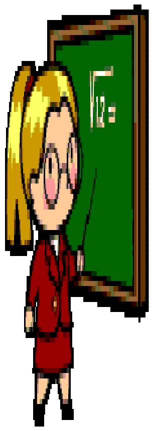
HKFRS 7 *Financial Instruments: Disclosures*



Important:

For detailed disclosures requirements of financial instruments 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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Sophisticated structures in business dealings nowadays made accounting for financial instruments more complex than you thought it would be …

See you in seminars and workshops on related topics forthcoming organised by HKICPA…

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A Refresher Course on Current Financial Reporting Standards 2015 (Day 3)

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HKAS 37

Provisions, Contingent Liabilities and Contingent Assets

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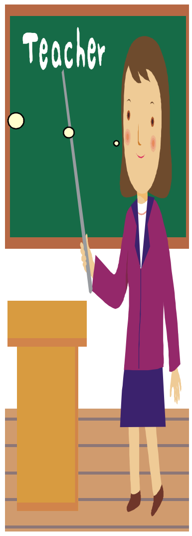
Learning Objectives

- Objectives and scope
- Provisions vs other liabilities
- Recognising provisions under HKAS 37
- Contingent liability/asset
- Measurement
- Restructuring costs
- Onerous contract



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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

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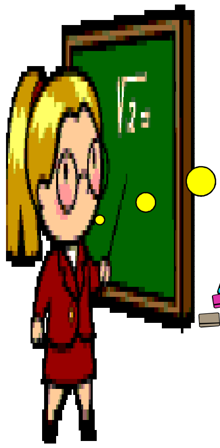
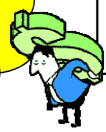
Importance of HKAS 37



The recognition and disclosure requirements are designed to prohibit:



creation of provisions where there is no liability

the undisclosed release of provisions into profit or loss

the use of old provisions created for one purpose to meet new expenditure for a different purpose

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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**
  - **Financial instruments (including guarantees)** that are within the scope of HKAS 39
  - **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.

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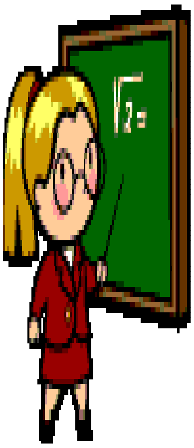

What is an executory contract?

- 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

Executory contracts do not fall within the scope of HKAS 37, unless they are onerous

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Executory contract

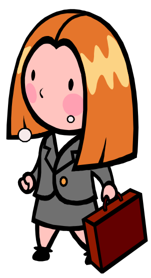
On Jan 1, 2013, Co A entered into a contract with Co X to manufacture and delivery 100 units of goods at five different dates in the future. Payment is due on delivery of the units.

Is the contract executory on Jan 1, 2013 ? ✓ *Because neither Co A nor Co X has performed any of its obligations*

Is the contract still executory on March 1, 2013 when Co X produced and delivered 200 units of goods to Co A and Co A has paid in full for those 200 units? ✓ *Because both Co A nor Co X have partially performed their obligations to an equal extent*

Is the contract still executory on June 1, 2013 when Co X has produced and delivered the full 500 units, but Co A has only paid for 400 units in total ✗ *Because the two parties have not performed under the terms of the contract to an equal extent*

Co A is required to recognise a liability for the final 100 units of good for which it has not yet paid



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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”

What is a provision?

- A provision is defined in HKAS 37 as **“a liability of uncertain timing or amount”**

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Use of the term provision

- 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

- ***Accruals are often presented as part of trade and other payables, whereas provisions are reported separately***
- ***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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Provisions versus other liabilities

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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Recognising provision under HKAS 37

- 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

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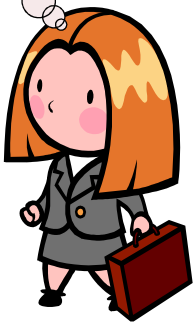
Recognition criteria: present obligation as a result of past event

Past event: sale of goods	Past event: sale of goods
Present obligation stem from a legal agreement ("legal obligation")	*Present obligation stem from the entity's action ("constructive obligation")*
Manufacturer gives warranty to the buyer under the terms of a contract for sale	**Retail store has a published policy of providing refunds**

A present obligation can stem from a legal agreement (a "**legal obligation**") or may be constructive in nature (a "**constructive obligation**")



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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**

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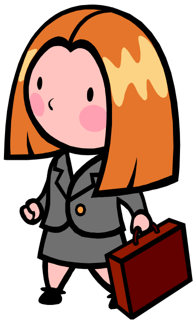
2 Outflow of economic benefit is probable

Provision	=	Present obligation from past event	+	Outflow is probable	+	Ability to measure

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)



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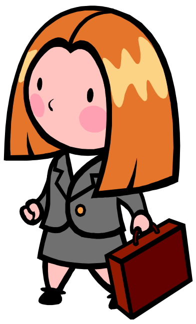
3 A reliable estimate

Provision	=	Present obligation from past event	+	Outflow is probable	+	Ability to measure

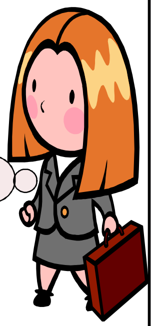
The standard emphasises that, in nearly all cases, an entity will be able to determine a range of possible outcomes and will generally be competent to make an estimate of an obligation that will be sufficiently reliable to use in recognising a provision



Contingent liability

Contingent liability	=	Possible obligation from past event	and/or	Outflow is not probable	and/or	Unable to measure

- 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



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
- **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
- Contingent liabilities are **not recognised** in the statement of financial position **unless they were assumed in a business combination**

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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**	✗	**Unless the possibility of a transfer of benefits is remote, disclose as 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**	✗	**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	✗	**Disclose a contingent liability** (note: this situation is likely to be very rare)

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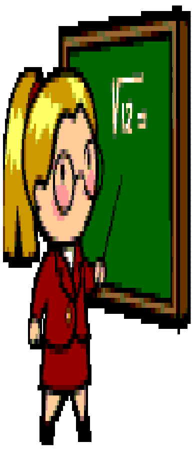
Illustration of the recognition criteria (cont'd)

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	✗	Consider whether the requirements of **HKAS 10 *Events after the Reporting Period*** require the disclosure of the non-adjusting event that has arisen

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

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

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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 37.26 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 <u>sufficient objective evidence</u> 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

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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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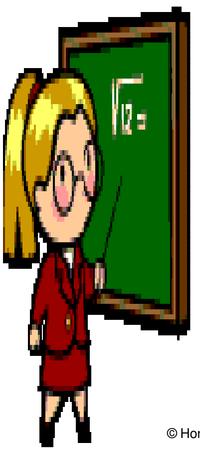
Examples: Estimation techniques – large population



- 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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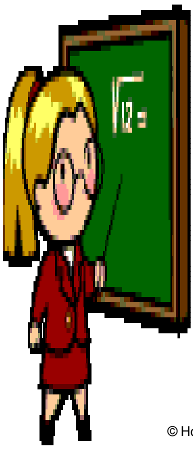
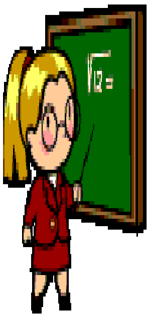
Estimation techniques – Single obligations



- If the provision is for a single item, **the most likely outcome usually is the best estimate**

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

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

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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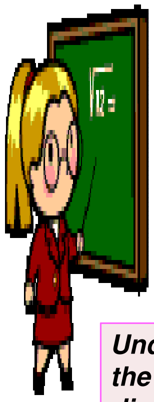
Choice of discount rate



- 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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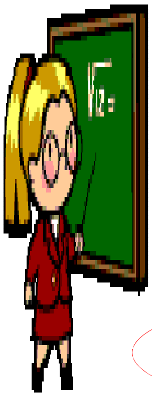
Discount rate (cont'd)



- 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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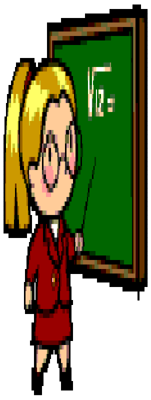
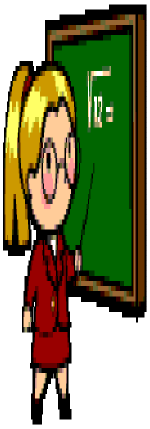
Continued recognition and reversal



- 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**

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

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Unwinding the discount

- Entity A has litigation pending. Legal advice 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

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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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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 2013 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 2014
  - No other steps were taken to implement the decision until that date
  - The current financial year of the entity ends at 31 December 2013
  - 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 2013

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Examples: Restructuring

- Scenario:
  - In a monthly meeting held on 12 December 2013 the board of an entity resolved to close down a division
  - In a special meeting on 20 December 2013 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 2013
  - 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 2013 for the best estimate of the costs of closing the division

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Restructuring (cont'd)

- 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**
- 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
- **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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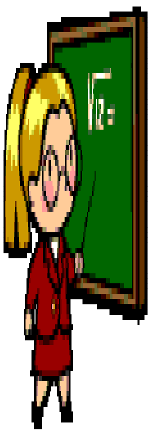
Restructuring (cont'd)



- 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
- Restructuring provisions **include only incremental costs associated directly with the restructuring**
- The Standard **prohibits recognition of provision for costs associated with ongoing activities**

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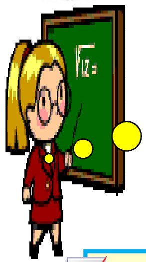
Restructuring (cont'd)



Do I need to provide for these restructuring costs?

- ✓ employee termination benefits that relate directly to the restructuring
- ✓ contract termination costs e.g. lease termination penalties
- ✓ expected costs from when operations cease until final disposal
- ✗ costs of retaining or relocating continuing staff
- ✓ onerous contract provisions
- ✗ marketing and administrative costs
- ✗ investment in new systems and distribution network
- ✓ consulting fee that relate directly to the restructuring
- ✗ loyalty bonuses or amounts paid to staff as an incentive to stay

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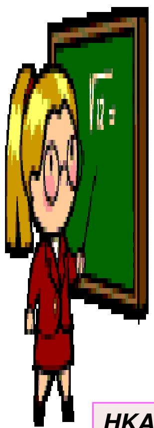
Determining whether a contract is onerous



- 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

- 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).

What would be the cost to determine whether the contract is onerous?

The cost used to determine whether the contract is onerous should be $60

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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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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**

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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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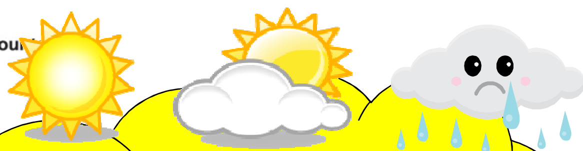

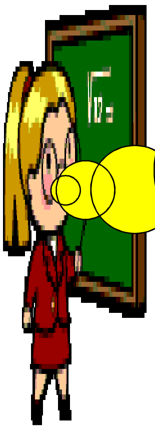

HKAS 37 seeks to stop artificial smoothing" of results

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

THANK YOU

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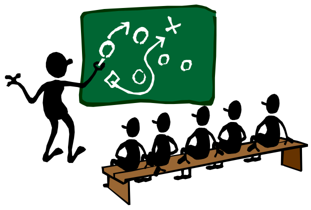
A Refresher Course on Current Financial Reporting Standards 2015 (Day 3)

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*
- 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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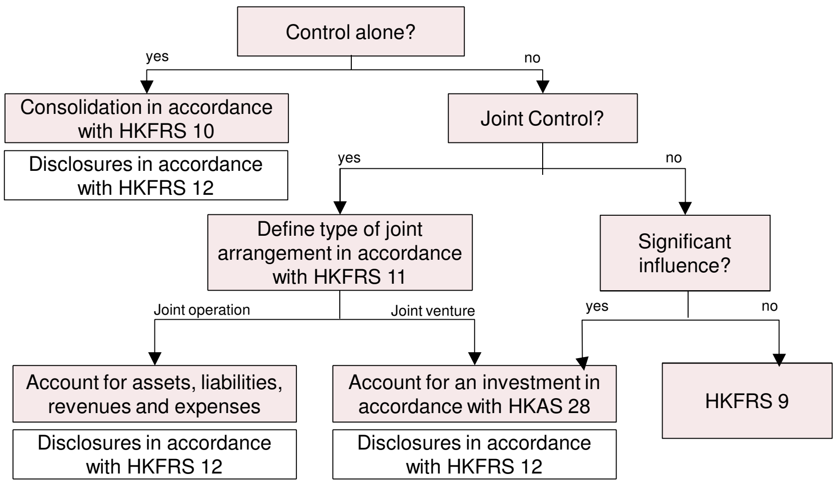
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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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
- Effective for annual periods **beginning on or after 1 Jan 2014** – early application is permitted

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What is 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 qualify 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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Amendments to HKFRS 10

- Clarify that the exception from preparing consolidated FS is available to intermediate parents which are subsidiaries of investment entities
- Clarify the accounting treatment on subsidiaries which act as an extension of an investment entity

	Subsidiary does not provide investment-related services	Subsidiary provides investment-related services
Non-investment entity subsidiary	Fair value	Consolidate
Investment entity subsidiary	Fair value	Fair value

- Effective from 1 January 2016. Earlier application is permitted
- Retrospective application

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.

Control = Power + Exposure to variability in returns + Link between power and returns

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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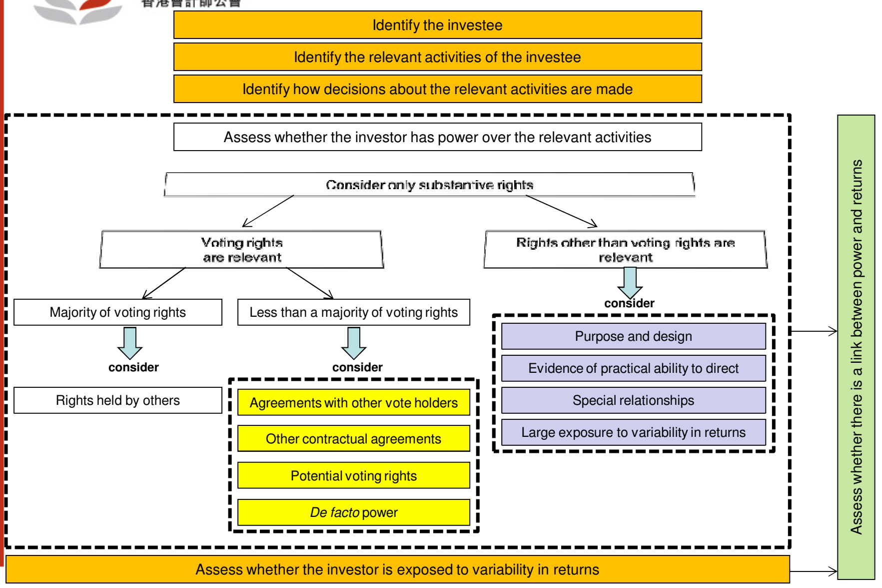
The new model at a glance



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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 consolidate 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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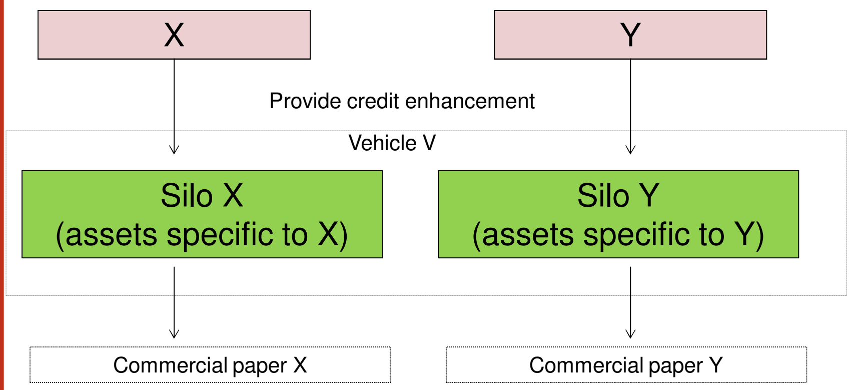
Example: Silo structure

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

III. Identify how decisions about the relevant activities are made

B. More complex cases

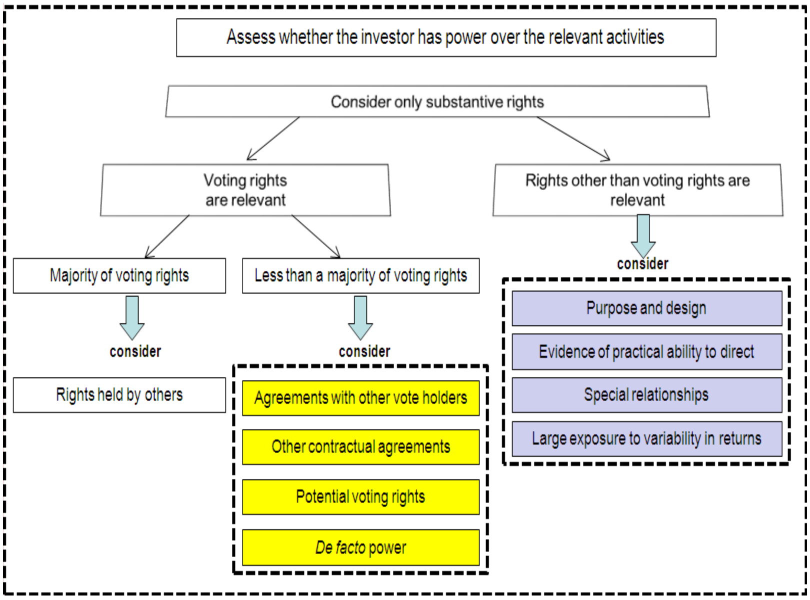
- Assessing what is determinative in assessing control, i.e. voting or other rights, and identifying the controlling party by analyzing the following:
  - ✓ the purpose and design of the investee
  - ✓ what the relevant activities are
  - ✓ how decisions about those activities are made
  - ✓ whether 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

Power

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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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

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	Scenario 3 - 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	• 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. 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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C. 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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C. 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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C. 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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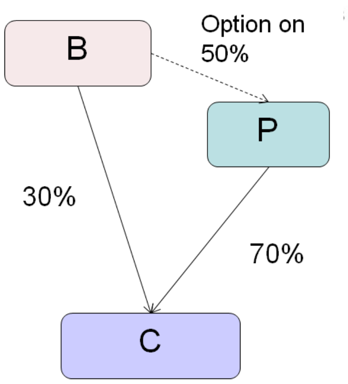
C. Voting rights

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

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 current 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.

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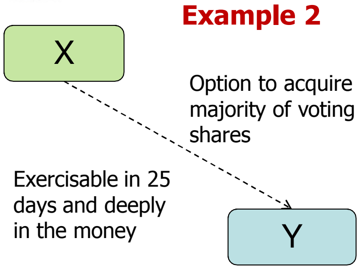
Example 2



- 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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C. Voting rights

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

- 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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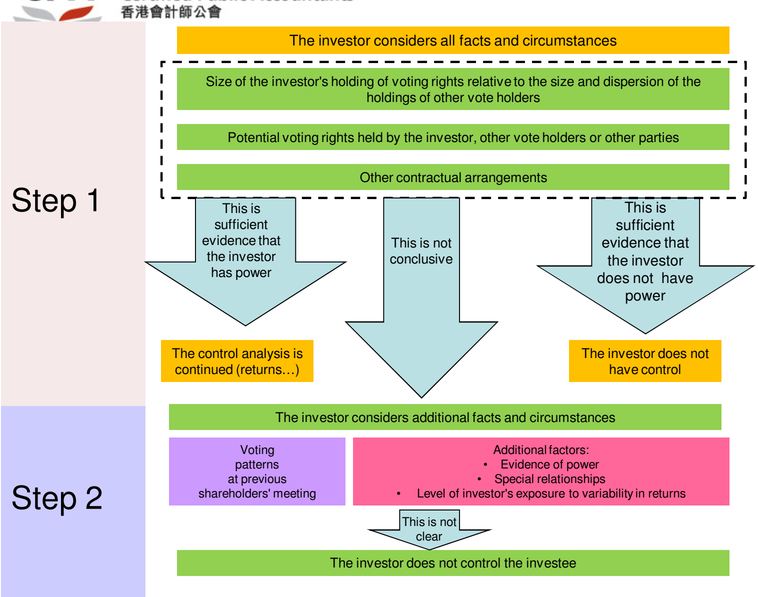

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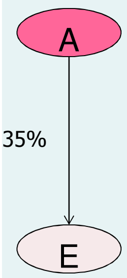
Examples		Any power?
Scenario 1 A 48% E	• the rest of 52% voting rights are held by thousands of shareholders, none individually hold more than 1% • None of the shareholders has any arrangements to consult each other or make collective decisions. • Coordination between other shareholders would not be easy	Based on the absolute size of A's holding and the relative size of other shareholders, it is likely that <u>A has sufficient dominant voting interest</u> 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 <u>A does not have power</u> as only two other investors would need to cooperate to be able to prevent A from controlling E.

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 <u>it has power over the investee</u>
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 • <u>Additional facts and circumstances shall be considered</u>

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.

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 <u>the ability to use its power to affect the investor's returns from its involvement with the investee</u>
- 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

Principal = Power + Exposure to variability in returns + Use of **POWER** to generate returns for itself

Agent = Power + Exposure to variability in returns + Use of **delegated POWER** for the benefit of others

NO CONTROL

Principal vs agent

Step 1:
A single party holds substantive rights to **remove the decision maker (removal rights) without cause**
→ The decision maker is an **Agent**

Step 2:
Evaluate 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

Principal vs agent

Step 2:
Evaluate 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
NCI – balance sheet	60	
NCI – Profit and loss		60
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 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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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.

Source: Deloitte-iGAAP 2012

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- 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
  - Total comprehensive income for the period attributable to (i) NCI and (ii) owners of the parent

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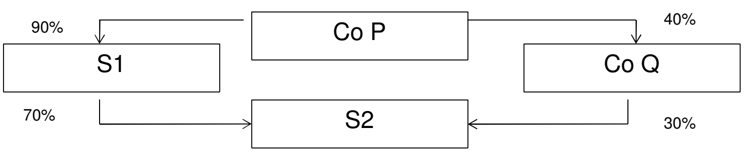
Source: Insights into IFRS 2011/12

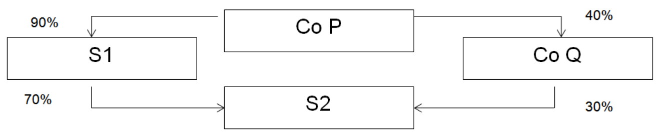
Percentage attributable to NCI

- 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:





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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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%)

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	No		Yes
Investee disposed of prior to date of initial application		Same	No

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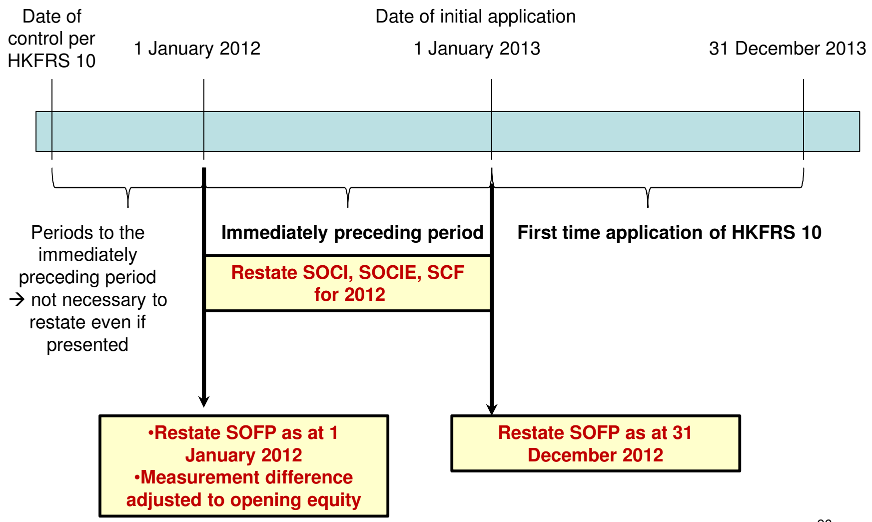
A) Consolidation upon initial adoption of HKFRS 10



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According to HKFRS 10, control Obtained …	
Before effective date of HKFRS 3 (2008)…..	**After effective date of HKFRS 3 (2008) …….**
• Apply HKFRS 3 (2008) or HKFRS 3 (2005)	• Apply HKFRS 3 (2008)
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.	

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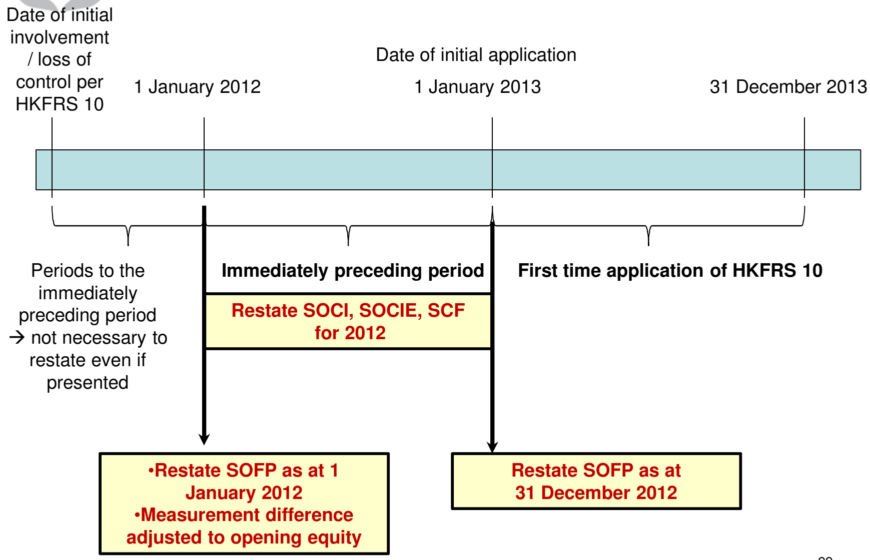
B) Deconsolidation upon initial adoption of HKFRS 10

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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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 ended 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.
- Assess investments stated at cost for impairment under HKAS 36
- Except that, separate financial statements shall be prepared in accordance with all applicable HKFRSs.

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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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Impairment

- HKAS 36 applies to investments in subsidiaries, associates and joint ventures that are accounted for at cost
- Investments accounted for under HKAS 39 are dealt with in HKAS 39
- Note the following impairment indicators:
  - ✓ impairments in the underlying assets in the financial statements of the subsidiaries, associates or joint ventures
  - ✓ Goodwill on consolidation is impaired

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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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Amendments to HKAS 27

Key amendments:

An entity can now account for investments in subsidiaries, joint ventures and associates in its separate financial statements:

- at cost; or
- in accordance with IFRS 9; or
- <u>using the equity method as described in IAS 28</u>

of separate financial statements as those produced in addition to:

- consolidated financial statements by an entity with subsidiaries; or
- financial statements prepared by an entity which has no subsidiaries but has investments in associates or joint ventures required to be equity accounted under HKAS 28.

Effective date and transition provision:

- For annual periods beginning on or after <u>1 January 2016</u>. Early adoption is permitted
- Apply in accordance with HKAS 8

A Refresher Course on Current

Financial Reporting Standards 2015

Day 4

Time	Topic
09:00 - 11:00	Associates and Joint arrangements
11:00 - 11:15	Break
11:15 - 12:15	Disclosure of interest in entities
12:15 - 12:45	Revision exercise
12:45 - 13:45	Lunch
13:45 - 15:00	Accounting for properties
15:00 - 15:15	Break
15:15 - 16:00	Accounting for properties
16:00 - 17:00	Provision and contingencies

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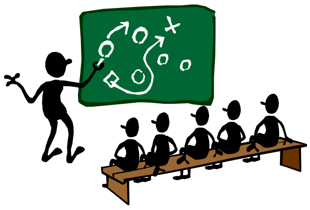
A Refresher Course on Current Financial Reporting Standards 2015 (Day 4)

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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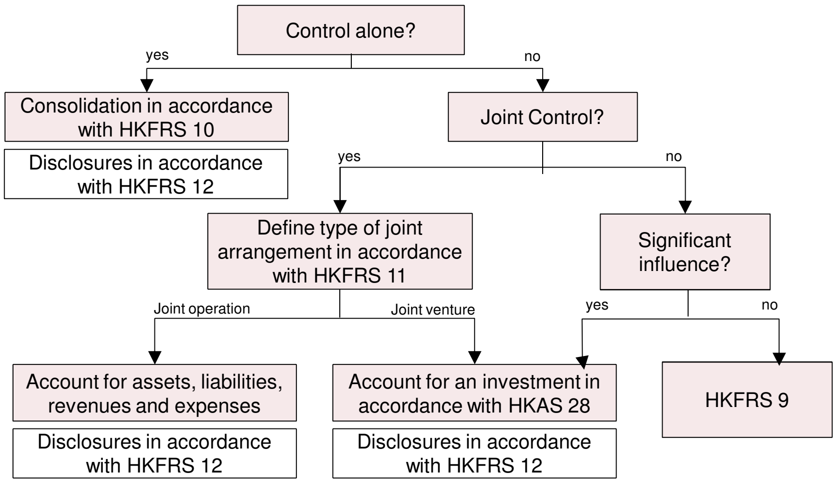
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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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

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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 demonstrated

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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 exercised 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?

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Significant influence

Question:

If an investor invests in preferred shares of an entity, what factors should we consider whether a preferred share investment is substantively the same as an ordinary share investment?

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.

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;

+/- Changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income "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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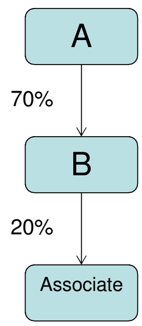
Example 1 - aggregation of group interests

Background

- Company A has a 70 per cent interest in Group B. Group B has a 20 per cent investment in an associate.
- 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, what will be the amounts shown in the respective line items on the consolidated financial statements of A in relation to the associate?



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Example 1 - aggregation of group interests (Cont'd)

Answer

- Consolidated statement of financial position:
  1. Investment in the associate = HK$20m
  2. Non-controlling interest = HK$6m
- Consolidated statement of comprehensive income / profit or loss:
  1. Share of the associate's profit = HK$8m (20 per cent x HK$40m), not HK$5.6m (20 per cent x HK$40m x 70 per cent).
  2. Profit attributable to:
     Equity holders of the parent = HK$5.6m
     Non-controlling interest = HK$2.4m
- 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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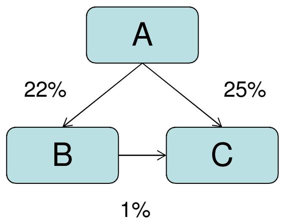
Example 2 – Indirect interest in an associate

Assume B accounted for the 1% interest in C as an investment.

What should be the % interest used in equity accounting for entity C in the consolidated financial statements of A?



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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.
  - (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

(f) 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
- Amendments to HKAS 28 published in January 2015

Reporting entity

Associate / Joint Venture (investment entity)

➢ Option to retain the fair value measurement applied by the investment entity, or unwind the fair value measurement and perform a consolidation at the level of the investment entity.

➢ Effective 1 January 2016

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Equity method

(g) 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

Equity method

(g) Reporting periods of associate and joint ventures

Questions:

Investor P prepares financial statements up to 31 March year end. One of its associates, entity A, prepares financial statements up to 31 December and P uses this financial statements for equity accounting of A.

1. On 1 February, A suffered a major fire at one of its factories. This event was a non-adjusting post balance sheet event in A's financial statements.
2. Entity A distributed dividend to its shareholder on 25 March. P recorded a dividend income from A in its financial statements up to 31 March but the distribution was not reflected in A's financial statements up to 31 December.

What should P do when preparing the equity accounting of entity A ?

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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? (ignore tax impact)

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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

(i) Non-monetary contributions by investors (cont'd)

- Amendments to HKAS 28 published in October 2014
- The amendments resolve the a current inconsistency between HKFRS 10 and HKAS 28
- The accounting treatment depends on whether the non-monetary assets sold or contributed to an associate or joint venture constitute a 'business'
- Full gain or loss will be recognised by the investor where the nonmonetary assets constitute a 'business'
- If the assets do not meet the definition of a business, the gain or loss is recognised by the investor to the extent of the other investors' interests.
- Apply prospectively from 1 January 2016

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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%).

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.

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 partly 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

(I) 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

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

- **Amounts previously recognised in the OCI**

  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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Equity method

Questions:

1. Entity A has a 40% interest in entity B. Its sells 75% of its interest for a consideration of $7.5m. The carrying value of the associate of entity B at the date of partial disposal is $9m and it has an AFS reserve of $0.5m. The remaining 10% interest in entity B has a fair value of $2.5m. What is the amount of disposal gain or loss?

2. Entity A has a 40% interest in an associate, entity B. During the period, entity A sells a quarter (10%) of its stake in entity B for $80m. Entity B continues to be an associate of entity A after the partial disposal.

   At the date of partial disposal, B's carrying value in A's consolidated financial statements are as follows:

Investment in associate (including Goodwill)	$150
AFS reserve (represent cumulative share of B's OCI)	$20

   What is the amount of partial disposal gain or loss?

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Exemption from applying equity method

1. 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)

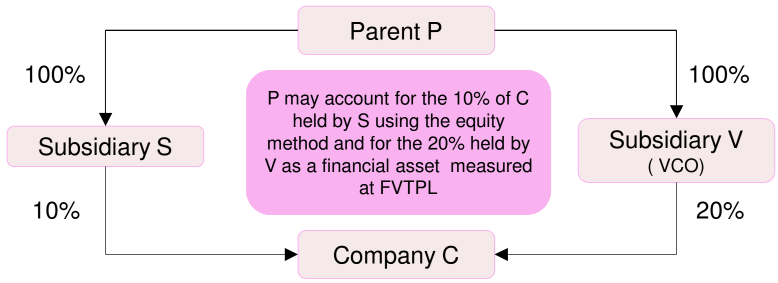
2. For investment in an associate or a joint venture held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds

- **option** to measure these investments at fair value through profit or loss in accordance with HKFRS 9.

3. Portion of investment in an associate held indirectly through venture capital organisations, or mutual funds, unit trusts and similar entities

- **option** to measure that portion of investment at fair value through profit or loss in accordance with HKFRS 9 regardless of whether these entities have significant influence over that portion of the investment
- the remaining portion is accounted for under equity method

Example: Parent P has two wholly-owned subsidiaries. V is a venture capital organisation (VCO). S owns 10 percent in Company C and V owns 20 percent in C. V assesses that it has significant influence over C and applies the venture capital exemption in its consolidated financial statements. P assesses that it has significant influence over C as a result of its indirect combined 30 percent shareholding in C.



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 disposal, any retained interest in the investment is accounted for in accordance with HKAS 39/HKFRS 9 or by using the equity method if the retained interest continues to be an associate or a joint venture

Transactions	How should we classify the held-for-sale portion?
Example 1	**HKAS 28 (2011)**
Group has a 35% stake in an associate and sells 30%. The remaining 5% is accounted for as an AFS financial asset after disposal.	- Only the 30% stake that is to be disposed of is classified as held-for-sale - after disposal, the remaining 5% is re-measured at fair value and is then accounted for as an AFS financial assets.

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Transactions	How should we classify the held-for-sale portion?
Example 2	**HKAS 28 (2011)**
The Group owns a 33.3% stake in a joint venture and sells 5.3%. The remaining 28% becomes an associate and continues to be equity accounted for.	- The 5.3% stake disposed of is required to be classified as held-for-sale provided that HKFRS 5 criteria are met - After disposal, the remaining 28% interest in associate does not need to be re-measured!

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Classification as held for sale (cont'd)

- When an investment, or a portion of an investment, in an associate or a joint venture previously classified as held for sale no longer meets the criteria to be so classified, it shall be accounted for using the equity method retrospectively as from the date of its classification as held for sale. Financial statements for the periods since classification as held for sale shall be amended accordingly.

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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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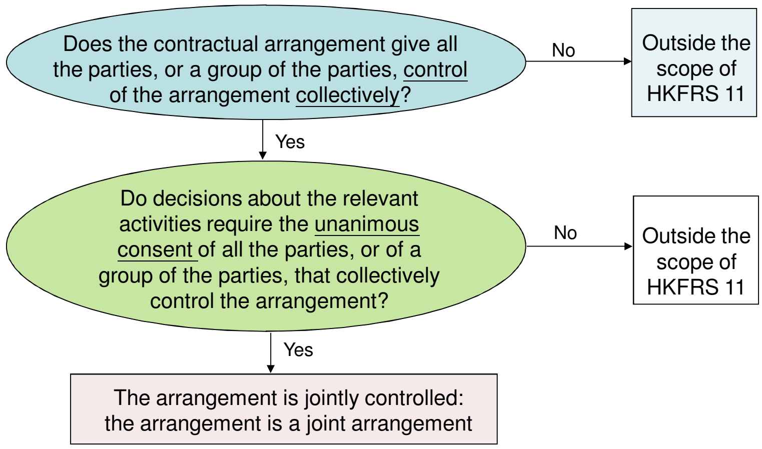
Assessing joint control



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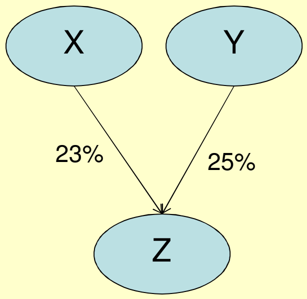
Is the control joint?

- 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

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?

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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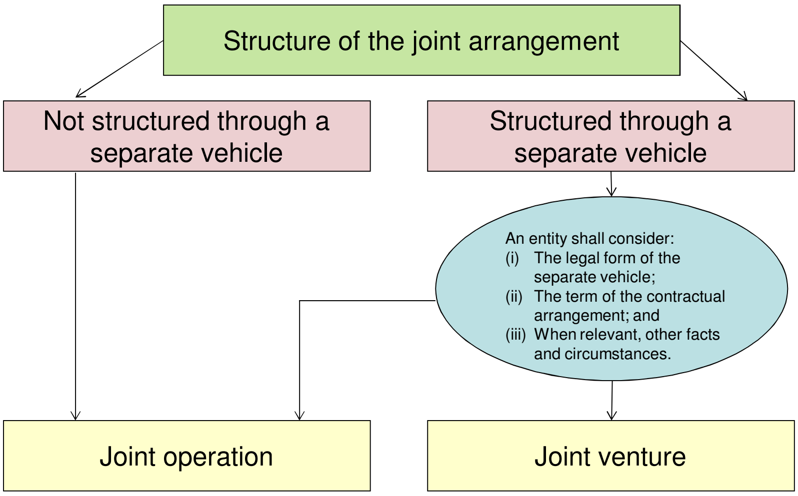
B. Classification of a joint arrangement



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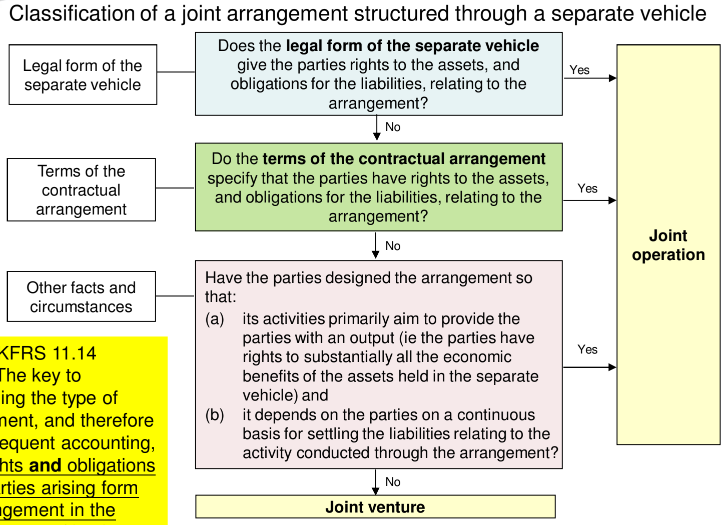
Classification of a joint arrangement structured through a separate vehicle



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 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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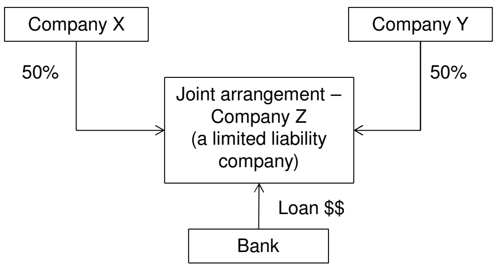
Example 1



- 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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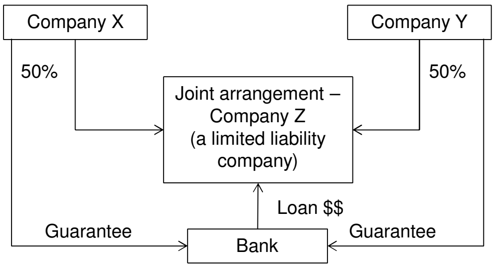
Example 2

- **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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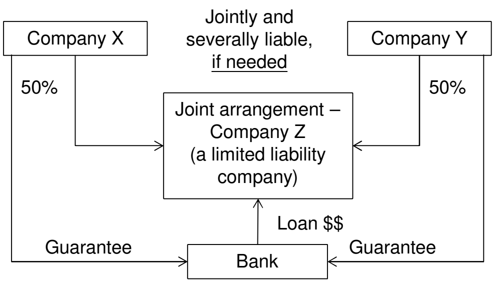
Example 3

- **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.

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

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.

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

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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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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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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Joint operators - Acquisition of interests in joint operations

- Amendments to HKFRS 11 issued in May 2014
- For both initial interest and additional interests in a joint operation
- If the activity of the joint operation constitutes a business as defined in HKFRS 3

  → apply, to the extent of its share, in accordance with para 20 of HKFRS 11 and all of the principles on business combinations accounting in HKFRS 3 and other HKFRSs, that do not conflict with the guidance in HKFRS 11
- In cases where the joint operator retains joint control after acquisition of additional interests

  →NO NEED to remeasure the previously held interests
- Apply prospectively for annual periods beginning on or after 1 January 2016

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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

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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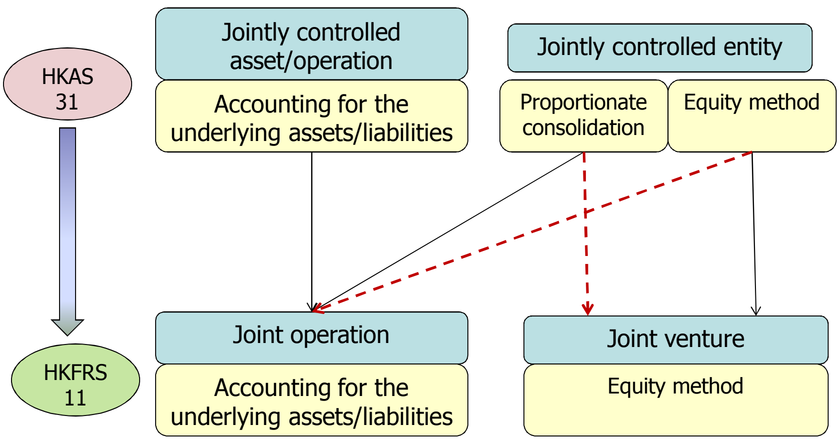
Key changes

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	–	–

	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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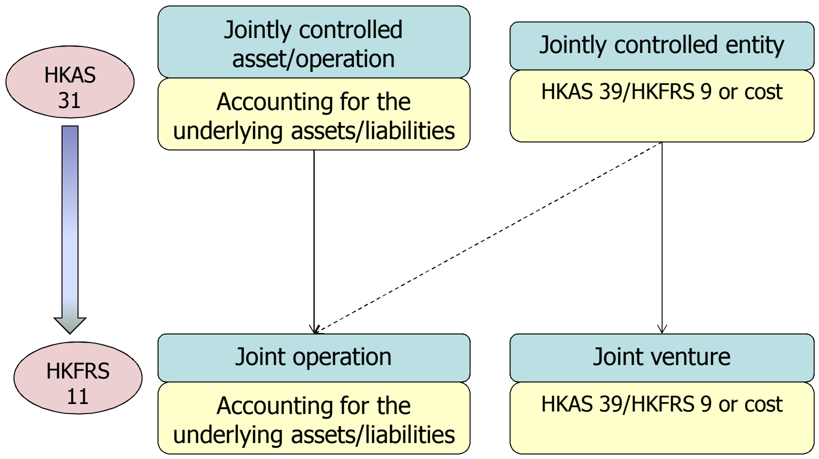
Separate financial statements



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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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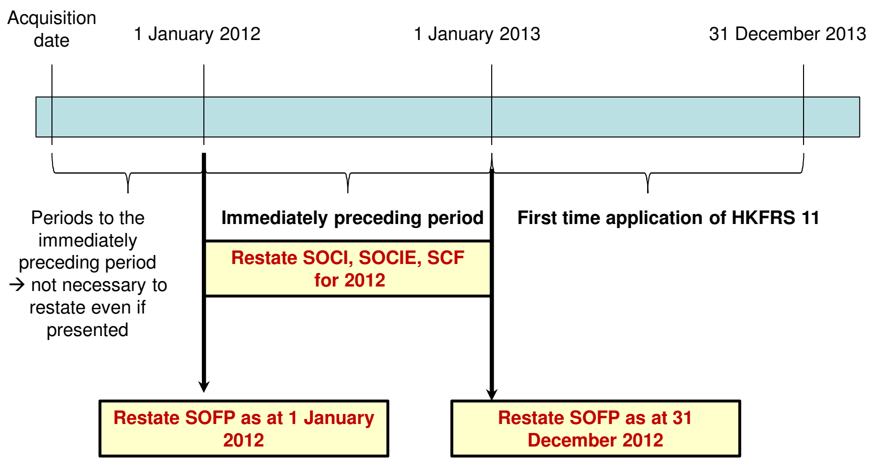
Transitional relief



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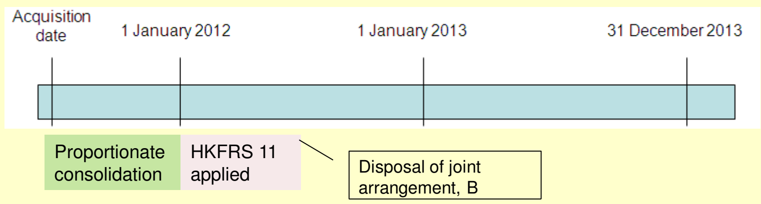
Question

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.



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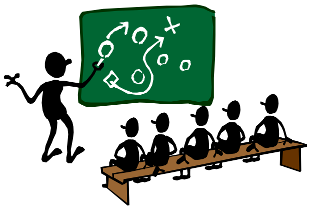
A Refresher Course on Current Financial Reporting Standards 2015 (Day 4)

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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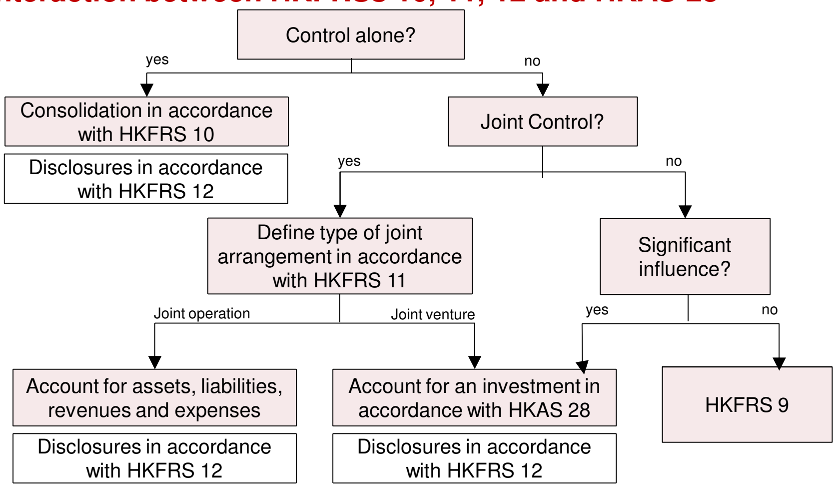
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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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

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

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

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 2 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.

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 2 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.

References

- Refer to Appendix 3 for the illustrative disclosures extracted from Deloitte illustrative annual financial statements 2014.

Thank you for your attention

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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:
  - Owner-occupied 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 : Owner occupied 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 for 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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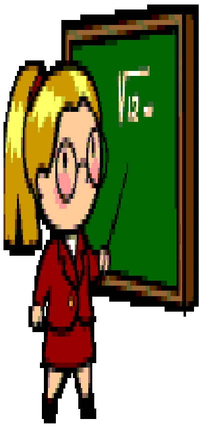
General Recognition Criteria

What can be recognised as a PPE?



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

- ✓ initially recognised 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

Element of cost

- **The purchase price**
- **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
- **Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located**

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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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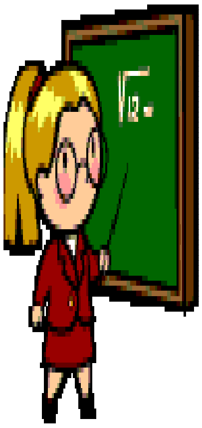
Measurement of cost - Others



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]

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?

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

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]

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

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

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

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

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

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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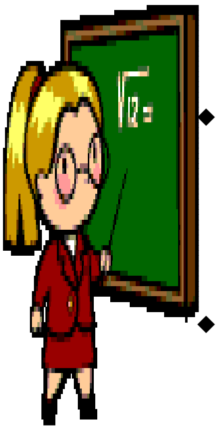
Derecognition



- 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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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

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

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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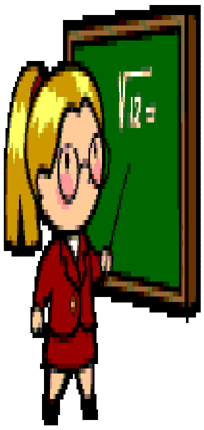
Cost Model



- 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]

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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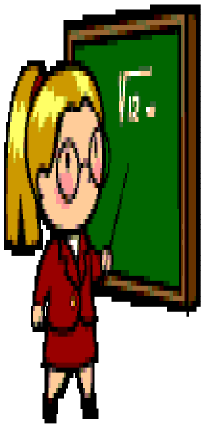
Disposal



- 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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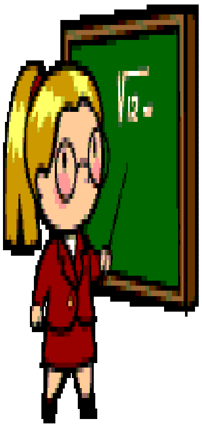
Additional Disclosures for the Fair Value Model [HKAS 40.76]



- 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 [HKAS 2.6]

Properties held / developed with a view for sale in the ordinary course of business

- 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)

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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.

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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Thank you for your attention

<table>
<tr><th colspan="3">Assessing the terms of the contractual arrangement</th></tr>
<tr><th></th><th>Joint operation</th><th>Joint venture</th></tr>
<tr><td>The terms of the contractual arrangement</td><td>The contractual arrangement provides the parties to the joint arrangement with rights to the assets, and obligations for the liabilities, relating to the arrangement.</td><td>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).</td></tr>
<tr><td>Rights to assets</td><td>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).</td><td>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.</td></tr>
<tr><td rowspan="2">Obligations for liabilities</td><td rowspan="2">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).</td><td>The contractual arrangement establishes that the joint arrangement is liable for the debts and obligations of the arrangement.</td></tr>
<tr><td>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.</td></tr>
</table>

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

Paul Pacter: Improving disclosures about intercompany investments

12 March 2012

In May 2011 the IASB issued IFRS 12 D *isclosure 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.

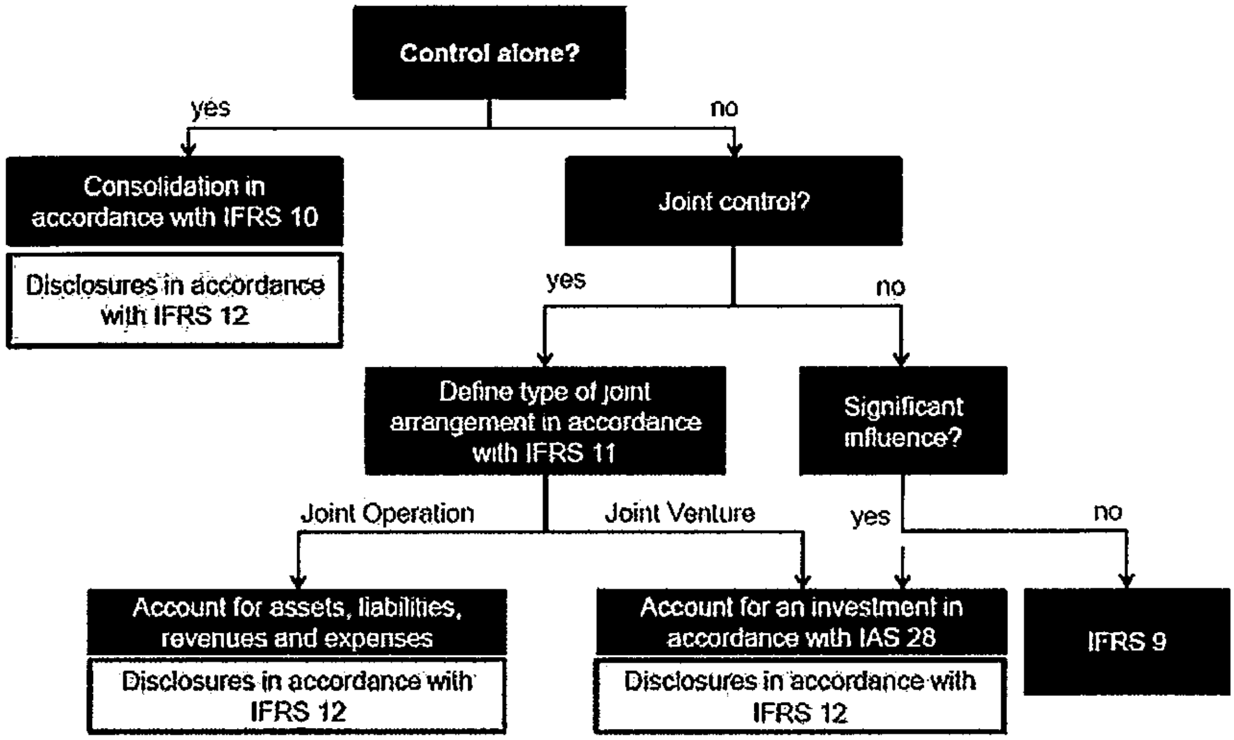
IFRS 12 requires four broad categories of disclosures—namely, information about:

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*.

Source	Hong Kong GAAP Limited
	Notes to the consolidated financial statements for the year ended 31 December 2014 – continued
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% 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% ownership since June 2011 and the remaining 55% 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.
HKFRS 12.7(b), (c)	Classification of A JV Limited and B JV Limited as joint ventures
	A JV Limited and B JV Limited are limited liability companies whose legal form confers separation between the parties to the joint arrangements and the companies themselves. Furthermore, there are no contractual arrangements or any other facts and circumstances that specify that the parties to the joint arrangements have rights to the assets and obligations for the liabilities of the joint arrangements. Accordingly, A JV Limited and B JV Limited are classified as joint ventures of the Group. See note 25 for details.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – continued

24. Interests in associates

Details of the Group's interests in associates are as follows:

Source		31/12/14 HK$'000	31/12/13 HK$'000
Sch 10:9(1)(a)	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(b)(iii)	Fair value of listed investments (Note)	-	-

HKFRS 13.97

Note: As at 31 December 2014, the fair value of the Group's interest in [A Plus Limited], which is listed on [the Stock Exchange of Hong Kong Limited], was HK$[X] million (31 December 2013: HK$[X] million) based on the quoted market price available on [the Stock Exchange of Hong Kong Limited], which is a level 1 input in terms of HKFRS 13.

HKFRS 28.38

Alt Where loan to associates forms part of the net investment in the associates

	31/12/2014 HK$'000	31/12/2013 HK$'000
Cost of investment in associates		
Listed in Hong Kong	X	X
Listed outside Hong Kong	X	X
Unlisted	X	X
Share of post-acquisition losses and other comprehensive income [, net of dividends received]	(X)	(X)
	X	X
Loan to associates	X	X
Less: share of post-acquisition losses that are in excess of the cost of the investments	(X)	(X)
	X	X

Note: Under this alternative, the cost of investment in associates and the loan to associates should be presented as separate line items in the consolidated statement of financial position.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – continued

HKFRS 12.21(a)
s129(1)&(2)
s129(4)&(5)

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 ownership interest held by the Group	Proportion of voting rights held by the Group	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

Commentary:

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 has control over 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.

HKFRS 12.22(b)

Alt When the financial statements of an associates used in applying equity method are as of a date or for a period that is different from that of the entity

The financial year end date for B Plus Limited is 31 October. For the purpose of applying the equity method of accounting, the consolidated financial statements of B Plus Limited for the year ended 31 October 2014 (Year ended 31 December 2013: 31 October 2013) have been used as the Group considers that it is impracticable for B Plus Limited to prepare a separate set of financial statements as of 31 December. Appropriate adjustments have been made accordingly for the effects of significant transactions between that date and 31 December 2014.]

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – continued

24.1 Summarised financial information of material associates

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.

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)

A Plus Limited

	31/12/14 HK$'000	31/12/13 HK$'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 31/12/14 HK$'000	Year ended 31/12/13 HK$'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:

	31/12/14 HK$'000	31/12/13 HK$'000
Net assets of the associate	15,424	13,153
Proportion of the Group's ownership interest in A Plus Limited	17%	17%
Goodwill	-	-
Effect of fair value adjustments at acquisition	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in A Plus Limited	2,622	2,236

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2014 – continued

HKFRS 12.21(b)(ii)
HKFRS 12.B12
HKFRS 12.B14(a)

B Plus Limited

	31/12/14 HK$'000	31/12/13 HK$'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 31/12/14 HK$'000	Year ended 31/12/13 HK$'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:

	31/12/14 HK$'000	31/12/13 HK$'000
Net assets of the associate	4,354	3,571
Proportion of the Group's ownership interest in B Plus Limited	56%	56%
Goodwill	-	-
Effect of fair value adjustments at acquisition	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in B Plus Limited	2,438	2,000

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2014 – continued

HKFRS 12.21(c)(ii)
HKFRS 12.B16

Aggregate information of associates that are not individually material	Year ended 31/12/14 HK$'000	Year ended 31/12/13 HK$'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
Aggregate carrying amount of the Group's interests in these associates	259	1,354

HKFRS 12.22(c)

Unrecognised share of losses of an associate	Year ended 31/12/14 HK$'000	Year ended 31/12/13 HK$'000
The unrecognised share of loss of an associate for the year	-	-
	31/12/14 HK$'000	31/12/13 HK$'000
Cumulative share of loss of an associate	-	-

24.2 Change in ownership interest in an associate

HKAS 28.22

In the prior year, the Group held a 40% interest in E Plus Limited and accounted for the investment as an associate. In December 2014, 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 2015). The Group has accounted for the remaining 10% interest as an available-for-sale investment whose fair value at the date of disposal was HK$360,000, which was determined using a discounted cash flow model (please describe key factors and assumptions used in determining the fair value). 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 the 40% 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 2014 – continued

25. Joint ventures

Commentary:

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 has only two joint ventures, A JV Limited and B JV Limited, and for illustrative purposes, both entities are assumed to be material to the Group.

Details of the Group's investments in joint ventures are as follows:

	31/12/14 HK$'000	31/12/13 HK$'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
HKFRS 12.21(b)(iii) Fair value of listed investments (Note)	-	-

HKFRS 13.97

Note: As at 31 December 2014, the fair value of the Group's interest in [A JV Limited], which is listed on [the Stock Exchange of Hong Kong Limited], was HK$[X] million (31 December 2013: HK$[X] million) based on the quoted market price available on [the Stock Exchange of Hong Kong Limited], which is a level 1 input in terms of HKFRS 13.

HKAS 28.38

Alt Where loan to joint ventures forms part of the net investment in the joint ventures

	31/12/2014 HK$'000	31/12/2013 HK$'000
Cost of investment in joint ventures		
Listed in Hong Kong	X	X
Listed outside Hong Kong	X	X
Unlisted	X	X
Share of post-acquisition losses and other comprehensive income [, net of dividends received]	(X)	(X)
	X	X
Loan to joint ventures	X	X
Less: share of post-acquisition losses that are in excess of the cost of the investments	(X)	(X)
	X	X

Note:Under this alternative, the cost of investment in joint ventures and the loan to joint ventures should be presented as separate line items in the consolidated statement of financial position.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – continued

HKFRS 12.21(a)

Details of the Group's material joint ventures at the end of the reporting period are as follows:

s129(1)&(2)
s129(4)&(5)

Name of entity	Form of entity	Place of incorporation	Principal place of operation	Class of shares held	Proportion of ownership interest held by the Group	Proportion of voting rights held by the Group	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.

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)

A JV Limited

	31/12/14 HK$'000	31/12/13 HK$'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)

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2014 – continued

Source		Year ended 31/12/14 HK$'000	Year ended 31/12/13 HK$'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 A JV Limited during the year	-	-

HKFRS 12.B13 The above profit (loss) for the year include the following:

	Year ended 31/12/14 HK$'000	Year ended 31/12/13 HK$'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 A JV Limited recognised in the consolidated financial statements:

	31/12/14 HK$'000	31/12/13 HK$'000
Net assets of A JV Limited	12,784	11,763
Proportion of the Group's ownership interest in A JV Limited	25%	25%
Goodwill	-	-
Effect of fair value adjustments at acquisition	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in A JV Limited	3,196	2,941

Source	Hong Kong GAAP Limited		
	Notes to the consolidated financial statements for the year ended 31 December 2014 – continued		
HKFRS 12.21(b)(ii) HKFRS 12.B12 HKFRS 12.B14(a)	**B JV Limited**	31/12/14 HK$'000	31/12/13 HK$'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)
		Year ended 31/12/14 HK$'000	Year ended 31/12/13 HK$'000
HKFRS 12.B12	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 31/12/14 HK$'000	Year ended 31/12/13 HK$'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 2014 – continued

HKFRS 12.B14(b)

Reconciliation of the above summarised financial information to the carrying amount of the interest in B JV Limited recognised in the consolidated financial statements:

	31/12/14 HK$'000	31/12/13 HK$'000
Net assets of the joint venture	2,006	1,802
Proportion of the Group's ownership interest in B JV Limited	40%	40%
Goodwill	-	-
Effect of fair value adjustments at acquisition	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in B JV Limited	803	721

HKFRS 12.21(c)(i)
HKFRS 12.B16

Aggregate information of joint ventures that are not individually material	Year ended 31/12/14 HK$'000	Year ended 31/12/13 HK$'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 31/12/14 HK$'000	Year ended 31/12/13 HK$'000
The unrecognised share of loss of a joint venture for the year	-	-

	31/12/14 HK$'000	31/12/13 HK$'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.]

HKFRS 12.22(b)

Alt When the financial statements of a joint venture used in applying equity method are as of a date or for a period that is different from that of the entity

The financial year end date for B JV Limited is 31 October. For the purpose of applying the equity method of accounting, the consolidated financial statements of B JV Limited for the year ended 31 October 2014 (Year ended 31 December 2013: 31 October 2013) have been used as the Group considers that it is impracticable for B JV Limited to prepare a separate set of financial statements as of 31 December. Appropriate adjustments have been made accordingly for the effects of significant transactions between that date and 31 December 2014.]

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2014 – continued

51. Disposal of a subsidiary

On 30 November 2014, the Group disposed of Subzero Limited which carried out its entire toy manufacturing operations.

Consideration received

Source		Year ended 31/12/14 HK$'000	Year ended 31/12/13 HK$'000
HKAS 7.40(b)	Consideration received in cash and cash equivalents	7,854	-
	Deferred sales proceeds (see 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 31/12/14 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	(822)
Non-current liabilities	
Borrowings	(4,342)
Deferred tax liabilities	(471)
Net assets disposed of	7,145

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2014 – 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.

s128(1),(2)
App 16.9(1),(2)
GR 18.10(1),(2)

Name of subsidiary	Place of incorporation / registration / operations	Class of shares held	Paid up registered capital	Proportion of ownership interest held by the Company				Proportion of voting power held by the Company		Principal activities
				Directly		Indirectly				
				2014	2013	2014	2013	2014	2013	
				%	%	%	%	%	%	
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 roads
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

Commentary:

HKFRSs do not explicitly require an entity to disclose a list of its subsidiaries in the consolidated financial statements. Nevertheless, local laws or regulations may require an entity to make such a disclosure. The above disclosure is for information only and may have to be modified to comply with the additional local requirements.

s128(4)&(5)
App 16.9(2)
GR 18.10

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, Subfour and Subfive Limited are wholly foreign-owned enterprises.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – continued

App 16.9(2)
GR 18.10(2)

None of the subsidiaries had issued any debt securities at the end of the year.

Alt 1 If a subsidiary has debt securities

None of the subsidiaries had issued any debt securities at the end of the year except for Subzero Limited which has issued HK$[X] million of convertible bonds, in which the Group has [no interest/HK$[X] million interest].

Alt 2 If a number of subsidiaries had issued debt securities, some of which are held by the Group

The following subsidiaries had issued HK$[X] debt securities at the end of the year:

	Total HK$'000	Held by Group HK$'000	Held by third parties HK$'000
Subzero Limited	X	X	X
Subone Limited	X	X	X
Subtwo Limited	X	X	X

Alt 3 Where there are non-voting deferred shares not held by the Group

The deferred shares, which are not held by the Group, carry practically no rights to dividends nor to receive notice of nor to attend or vote at any general meeting of the relevant companies nor to participate in any distribution on winding up. The Company has been granted an option by the holders of the deferred shares to acquire these shares at a nominal amount.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – 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 31/12/14	31/12/13
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

59.2 Details of non-wholly owned subsidiaries that have material non-controlling interests

HKFRS 12.10(a)(ii)
HKFRS 12.12(a)-(f)

The table below shows details of non-wholly-owned subsidiaries of the Group that have material non-controlling interests:

HKFRS 12.B11

Commentary:

1) *For illustrative purposes, the following non-wholly subsidiaries are assumed to have non-controlling interests that are material to the Group.*

2) *The amounts disclosed below do not reflect the elimination of intragroup transactions.*

Name of subsidiary	Place of incorporation and principal place of business	Proportion of ownership interests and voting rights held by non-controlling interests 31/12/14	31/12/13	Profit allocated to non-controlling interests 31/12/14	31/12/13	Accumulated non-controlling interests 31/12/14	31/12/13
				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
Individually immaterial subsidiaries with non-controlling interests						14,831	11,540
						27,956	23,253

HKFRS 12.9(b)

(i) C Plus Limited is listed on the stock exchange of A Land. Although the Group has only 45% 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% ownership interests in C Plus Limited are owned by thousands of shareholders that are unrelated to the Group, none individually holding more than 2%.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – 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	31/12/14 HK$'000	31/12/13 HK$'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 31/12/14 HK$'000	Year ended 31/12/13 HK$'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

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2014 – continued

C Plus Limited	31/12/14 HK$'000	31/12/13 HK$'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 31/12/14 HK$'000	Year ended 31/12/13 HK$'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)

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2014 – continued

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.]

App 16.28
Sch 10

60. Information about the statement of financial position of the Company

Commentary:

Entities incorporated outside Hong Kong (for example, Bermuda and Cayman Islands) are not required to comply with s 123 and s 124(1) of the Companies Ordinance (Cap. 32), which set out the general provisions as to the contents and form of accounts and the obligation to lay group accounts before the company in a general meeting respectively. Nevertheless, such entities, if they are listed on the Hong Kong Stock Exchange, are required to comply with the Listing Rules.

Appendix 16.28 to the Listing Rules states that a listed entity (whether or not it is incorporated in Hong Kong) should include disclosures required under the Tenth Schedule, amongst other sections, of the Companies Ordinance (Cap. 32) in its financial statements. The Tenth Schedule requires, amongst others, the following disclosures to be made in the entity's financial statements:

- *investments in subsidiaries, distinguished between listed and unlisted investments;*
- *amounts due to/from subsidiaries;*
- *movements in the entity's reserves;*
- *lease terms of land situated in Hong Kong and outside Hong Kong;*
- *auditors remuneration, including expenses; and*
- *a description of and the amount of shares and debentures of the company held by its subsidiaries or their nominees.*

Listed entities incorporated outside Hong Kong may present the above disclosures either:

- *as a separate primary financial statement, or*
- *as a note to their consolidated financial statements.*

The disclosures below illustrate the second approach above.

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A Refresher Course on Current

Financial Reporting Standards 2015

Day 5

Time	Topic
09:00 - 10:30	Revenue recognition
10:30 - 10:45	Break
10:45 - 12:00	Revenue recognition
12:00 - 13:00	Income taxes

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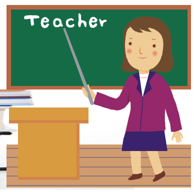
A Refresher Course on Current Financial Reporting Standards 2015 (Day 5)



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HKAS 18 Revenue

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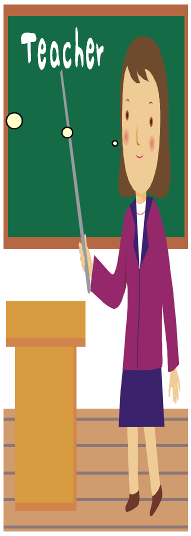
Learning Objectives

上課啦！

- ❑ Importance of revenue
- ❑ Transactions that would arise revenue
- ❑ Transactions that would not arise revenue
- ❑ Revenue recognition from sales of good
- ❑ Revenue recognition from rendering of services
- ❑ Revenue recognition from use by others of entity assets
- ❑ Multiple deliverables
- ❑ Latest developments



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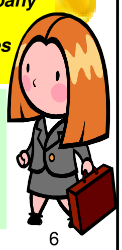
Importance of revenue

Revenue is really that important? ??

Good Wife Cleaning Limited, CEO

- ***Revenue is the top line in the income statement***
- ***Revenue is often considered to be the measure of the size and hence growth of the company***
- ***Key variables in a number of calculations and ratios that management and others may consider to be important indicators of its financial performance***
- ***Revenue directly impacts the gross margin and operating profit of the company as well as the calculation of EPS and a range of non-GAAP measures including EBITDA***

❑ It can be argued that the amount shown as revenue is the single most important item to the users of the financial statements



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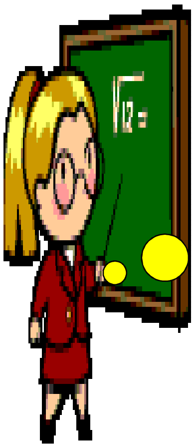


❑ Revenue

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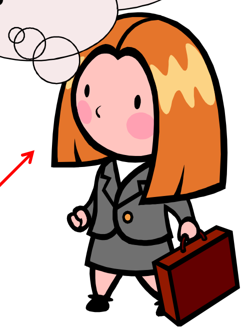
Definition of Revenue

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants

Let's see what's the definition of revenue



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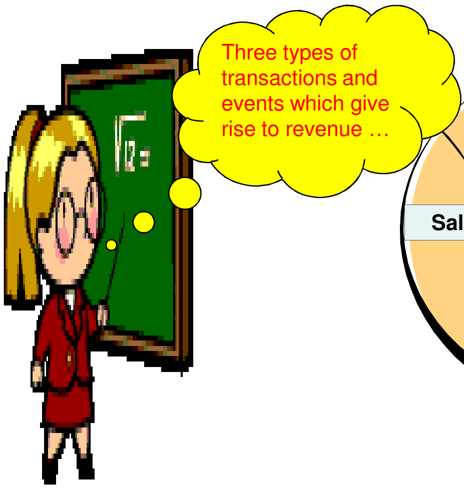
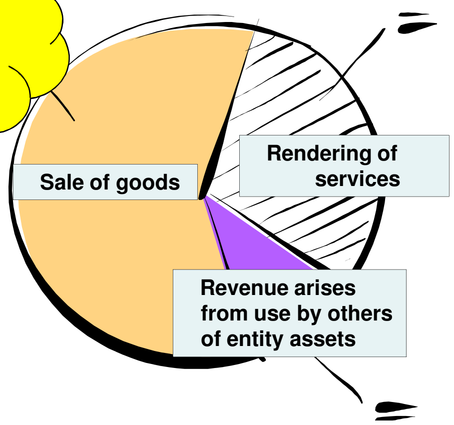
Transactions and events from which revenue arises





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Sale of goods

Sale of goods

- ***Goods include goods manufactured for sales (manufacturing business) or goods purchased for sale (retailing business)***

Good Wife Cleaning Limited

Good Wife Company manufactures cleaning products

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Recognition criteria - Sale of goods

Revenue from sale of goods should be recognised when all of the following criteria have been satisfied:

- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods
- the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold
- the amount of revenue can be measured reliably
- It is probable that economic benefits associated with the transaction will flow to the entity
- the costs incurred or to be incurred in respect of the transaction can be measured reliably

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Recognition criteria - Sale of goods

- **the entity has transferred to the buyer the significant risks and rewards of ownership of the goods**
- the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold
- the amount of revenue can be measured reliably
- It is probable that economic benefits associated with the transaction will flow to the entity
- the costs incurred or to be incurred in respect of the transaction can be measured reliably

This is what we normally known as "sale without recourse"

E.g. When Good Wife Cleaning Limited sold the broom to the department store, has risks and rewards of ownership of the broom been transferred?

Good Wife Cleaning Limited → ***ABC store***

Analysis:

Sale - $100

- *Good Wife Cleaning Limited does not bear the risk of damages after the broom was sold to ABC Store*
- *Good Wife Cleaning Limited does not share the profit on the sale of the broom by ABC Store to their customers*

Conclusion:

Significant risks and rewards of ownership was transferred when Good Wife Cleaning Limited sold the brooms to ABC Store

Recognition criteria - Sale of goods

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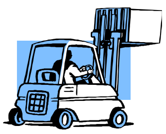
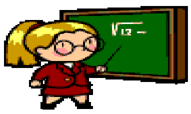
E.g. Did Good Wife Cleaning Limited had continuing management involvement and control over the brooms sold ?

- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods
- **the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold**
- the amount of revenue can be measured reliably
- It is probable that economic *benefits associated with the transaction* will flow to the entity
- the costs incurred or to be incurred in respect of the transaction can be measured reliably

Analysis:



- *Good Wife Cleaning Limited has no involvement of warehouse management and storage of ABC Store*
- *Good Wife Cleaning Limited does not involve the pricing strategy of ABC Store*



Conclusion:

Good Wife Cleaning Limited retains neither continuing managerial involvement to the degree of usually associated with ownership nor effective control over the brooms sold

Recognition criteria - Sale of goods

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- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods
- the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold
- **the amount of revenue can be measured reliably**
- it is probable that economic benefits associated with the transaction will flow to the entity
- the costs incurred or to be incurred in respect of the transaction can be measured reliably

E.g. Can the amount from the sale of the brooms reliably measured ?

Sales contract :

broom - $100/unit

This month sold 1000 units

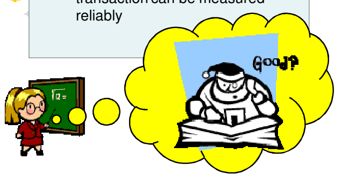
Analysis:

- *Unit price @ $100*
- *Sales : 1000*

Revenue : $100,000

Conclusion:

Good Housewife can reliably measured the revenue from the sale of brooms



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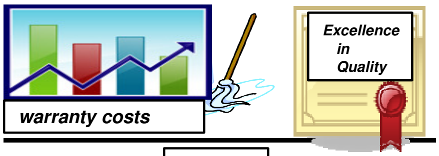
Recognition criteria - Sale of goods

- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods
- the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold
- the amount of revenue can be measured with the transaction will flow to the entity
- **it is probable that economic benefits associated with the transaction will flow to the entity**
- **the costs incurred or to be incurred in respect of the transaction can be measured reliably**

E.g. Can the costs incurred or to be incurred on the broom sold measured reliably ?
Is it probable that the economic benefits associated with the transaction will flow to the entity ?



warranty costs

Analysis:

- *warranty costs approximates to 3% of the revenue amount recognised*
- *Normal sales terms are COD. If sale on credit, ABC Store has very good repayment record*

Conclusion:

The related costs incurred or to be incurred on the sale of brooms can be reliably measured and inflow of economic benefits to Good Housewife Cleaning Limited is probable

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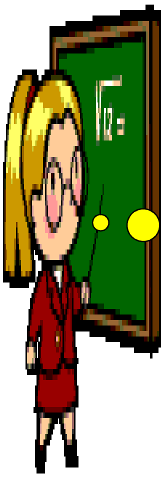
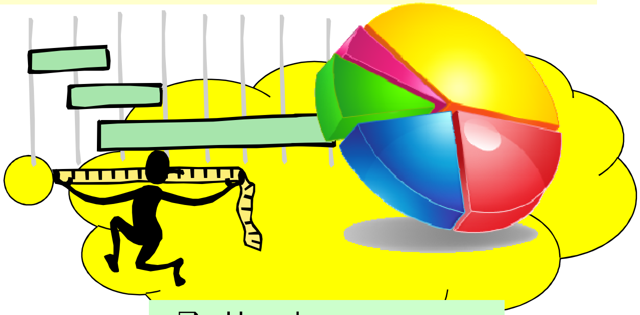
Measurement of revenue





- ❑ How do we measure revenue ?

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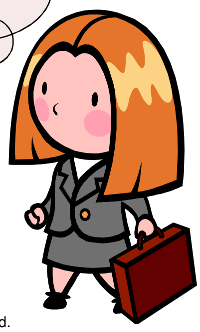
Measurement of revenue

Revenue is measured at the **fair value** of the consideration received or receivable

How should I measure the revenue recognised from the sale of the brooms ?



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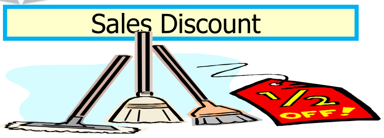
Measurement of revenue

Sales Discount

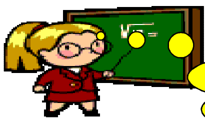


Sales discount
Unit price @ $100
Sales discount : 50%
Revenue: $50 / unit

Volume Discount

Buy 4, Get 1 free

Volume discount
Unit price @ $100
Buy 4, Get 1 Free
Revenue: $400



Revenue is measured net of trade discounts and volume rebates allowed by the entity

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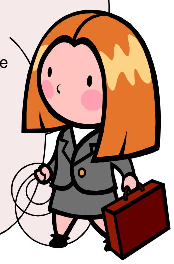
Measurement of revenue

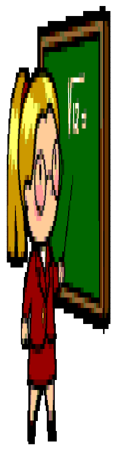
Any difference in the revenue amount when sales terms are cash on delivery or on a 30-days credit terms ?

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**



Extended credit terms



Questions:

- Good Wife Cleaning Limited sells inventories for $100,000 under an extended credit term to a special customer 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 sale

Scenario 1: Good Wife Cleaning Limited believes that the customer would be able to obtain financing from other sources at an interest rate of 10%

Scenario 2: If the customer had paid cash for the inventories, the sales price would have been $80,000

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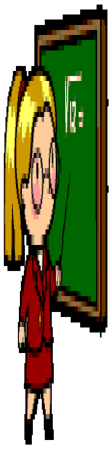
Extended credit terms (cont'd)

Scenario 1: Deferred consideration: discounting based on interest rate



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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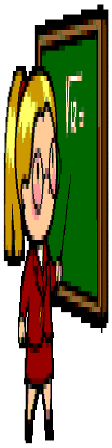
Extended credit terms (cont'd)

Scenario 1: Deferred consideration: discounting based on interest rate – 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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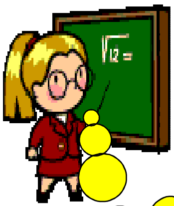
Extended credit terms (cont'd)

Scenario 2: Deferred consideration: discounting based on interest rate



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 is

	{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

* 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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Extended credit terms (cont'd)

Scenario 2: Deferred consideration: discounting based on interest rate – cont'd

Initial recognition at date of sale:

	DR	CR
Trade receivable	80,000	
Sales revenue		80,000

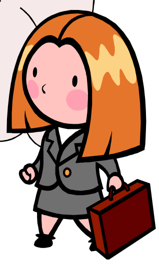
Yearly income

	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

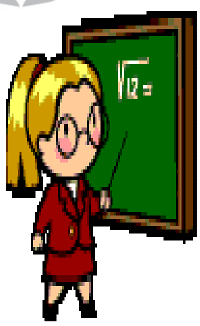
Barter transactions

Companies usually trade for cash or the right to receive cash. Sometimes, however, transactions are undertaken that involve the swapping of goods or services. Can revenue be recognised in exchange or barter of goods or services?

HKAS 18 does not permit revenue to be recognised in an exchange or barter of similar goods or services



Measurement of revenue: Exchange of goods or services



Revenue not recognised

(Similar nature & Value)

Exchange goods and services

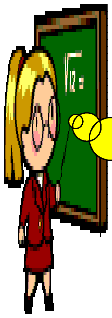
(Different nature & Value)

Revenue recognised

- The revenue is measured at the fair value of the goods or services received, adjusted for any cash payments made by either buyer or the seller

- If the fair value of the goods or services received cannot be measured reliably, revenue is recognised at the fair value of the goods or services given up , adjusted for any cash payments made or received

Rendering of services



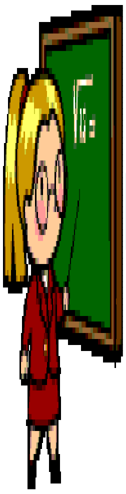
- *Revenue should relate only to work that has been performed and should not include any element relating to work that has yet to be carried out*

Rendering of services

- ***When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period***

Good Wife Cleaning Limited

Rendering of services



Can outcome of transaction be estimated reliably?

yes: Revenue associated with the transaction is recognised by reference to the stage of completion of the transaction at the end of the reporting period (i.e. using the percentage of completion method)

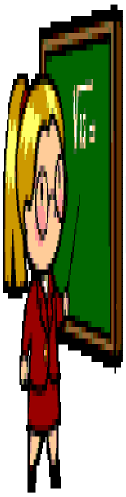
no: Are expenses incurred likely to be recovered?

- yes: Revenue is recognised to the extent of expenses incurred that are likely to be recovered. Thus, no profit is recognised on the transaction
- no: No revenue is recognised and the costs incurred are recognised as an expense

Conditions for the outcome of a transaction to be estimated reliably:

- ❑ The amount of revenue an be measured reliably
- ❑ It is probable that the economic benefits associated with the transaction will flow to the entity
- ❑ The stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- ❑ The costs incurred for the transaction and the costs to complete the transaction can be measured reliably

Rendering of services



Can outcome of transaction be estimated reliably?

- yes → Revenue associated with the transaction is recognised by reference to the stage of completion of the transaction at the end of the reporting period (i.e. using the percentage of completion method)
- no → Are expenses incurred likely to be recovered?
  - yes → Revenue is recognised to the extent of expenses incurred that are likely to be recovered. Thus, no profit is recognised on the transaction
  - no → No revenue is recognised and the costs incurred are recognised as an expense

Methods to determine the stage of completion:

- ***Surveys of work performed***
  - *The Standard does not give further guidance on who might carry out such surveys, but normally it should be someone who has relevant experience and knowledge*
- ***Services performed to date as a percentage of total services to be performed***
- ***The proportion of the estimated total costs of the contract incurred to date***
  - *The Standard stresses that only costs that reflect actual services performed in the year end are included in costs incurred and only costs that reflect services performed or to be performed are included in the estimated total costs*

Rendering of services

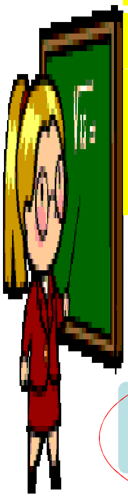
Example: Good Wife Cleaning Limited

Good Wife Limited has a 3-year service contract relating to daily cleaning services for $360,000 commencing January 1, 2014. How much service income should Good Wife recognised for its financial year ending December 31, 2014 ?

For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis, unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed

3-years cleaning contract

Rendering of services



Rendering of services

- ***When the outcome of a transaction involving the rendering of services cannot be estimated reliably, either:***
  - ***Revenue is recognised to the extent of expenses incurred that are likely to be recovered. Thus, no profit is recognised on the transaction; or***
  - ***If it is not probable that the costs incurred will be recovered, no revenue is recognised and the costs incurred are recognised as an expense***

Can outcome of transaction be estimated reliably?

no

Are expenses incurred likely to be recovered?

yes

Revenue is recognised to the extent of expenses incurred that are likely to be recovered. Thus, no profit is recognised on the transaction

no

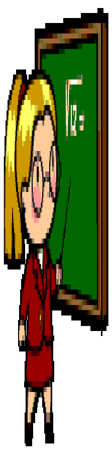
No revenue is recognised and the costs incurred are recognised as an expense

yes

Revenue associated with the transaction is recognised by reference to the stage of completion of the transaction at the end of the reporting period (i.e. using the percentage of completion method)

- ***When the uncertainties that led to no profit being recognised on the transaction no longer exist, revenue is recognised on the percentage of completion basis***

Example – Membership or services when the customer is entitled to a full refund



Question:

- Co A sells one-year memberships in a facility it operates. The terms that if the customer is unhappy with the facility for any reason within 30 days of joining the facility, the customer can request a full refund of the membership fee paid upon sign up. After 30 days, the membership is non-refundable
- Co A's experience is that approximately 20% of its customers request a refund during the 30-day period

When should Co A begin to recognise revenue?

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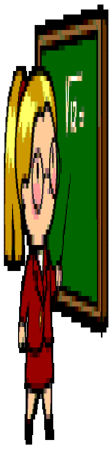
Example – Membership or services when the customer is entitled to a full refund (cont'd)



Analysis:

If it is possible to make a reliable estimate of the level of expected refunds, Co A should begin recognising the membership fee from the date the membership contract is signed, with an appropriate reduction in the amount recognised as revenue for estimated refunds

If it is not possible to make a reliable estimate of the level of expected refunds, revenue recognition should be deferred until the 30-day money-back period elapses

Accordingly, in the circumstances described, revenue recognition begins when the contract is signed, with a reduction in the amount recognised as revenue relating to the 20% of expected refunds, if such an adjustment reflects a reliable estimate of the level of expected refunds

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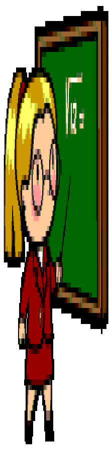
Example - Performance-based fee part way through the performance period



Question:

- Co A, an investment manager, will earn a bonus $1 million if the managed fund's performance exceeds the performance of the Hang Seng Index by 20% for the calendar year 2014
- Co A's financial year ended 31 March 2014. At that time, the fund was outperforming the Hang Seng Index by 25%

Should Co A recognise revenue in relation to the bonus at 31 March 2014 and if so, $250,000 (one-quarter of year's worth) or $1M, the expected total bonus?

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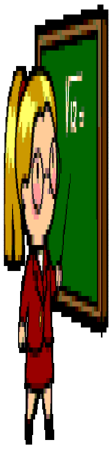
Example - Performance-based fee part way through the performance period (cont'd)



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

Co A will not receive any bonus unless the annual return exceeds the performance of the Hang Send Index by 20%. Because the markets are very volatile, it is unlikely that Co A will be able to estimate reliably at 31 March 2014 whether the return for the year ended 31 Dec 2014 will exceed the performance of the Hang Seng Index

Consequently, no amount of the bonus can be determined reliably at 30 March 2014 and Co A should not recognise any of the bonus at 31 March 2014

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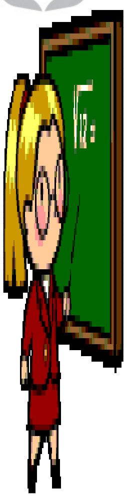
Revenue arises from use by others of entity assets: Interest income



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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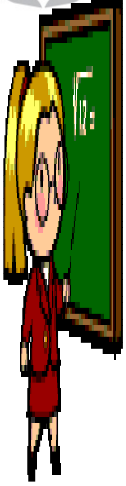
Revenue arises from use by others of entity assets: Interest income



Recognition criteria: Interest revenue

When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between:

- Pre-acquisition portion → Offset the amount recognised at acquisition for interest receivable
- Post-acquisition portion → Recognised as interest income

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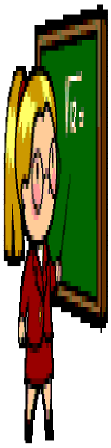
Example - Unpaid interest accrued before acquisition of investment



Question:

- Good Wife Cleaning Limited purchases $1M face value bonds for $1,030,000 on 1 April 2013. The bonds pay interest at 12% per annum on 31 December and 30 June each year

How much interest income should Good Wife Cleaning Limited at date of acquisition of the bond and for year ended 30 June 2014?

Analysis:

- The investor will receive $60,000 as interest for the period from 1 January 2013 to 30 June 2013, 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 2013 will be as follows:

On acquisition: Dr. investment 1M, Dr, interest receivable: 30000, Credit Cash: 1,030,000
Interest payment date: Dr. Cash 60000, Credit Interest 30,000, Interest receivable: 30000

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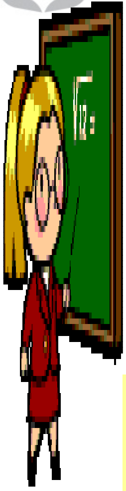
Revenue arises from use by others of entity assets: Royalty income

Recognition criteria: Royalty income



Royalty revenue should be recognised on an accrual basis in accordance with the substance of the relevant agreement 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

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

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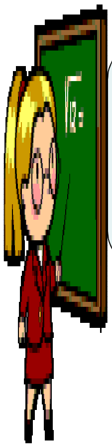
Revenue arises from use by others of entity assets: Dividend income

Recognition criteria: Dividend revenue



Revenue should be recognised when:

It is probable the economic benefits associated with the transaction will flow to the entity

and

The amount of the revenue can be measured reliably

and

The shareholder's right to receive payment is established

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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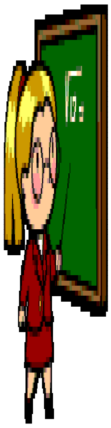
Transactions that would not arise income

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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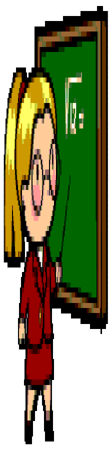
Example - On-line retailer



Question:

- Co A operates a website selling used books. Co A enters a contract with Co B, a used bookshop. The terms and conditions of the contract are such that Co A:

  - stores, transports and invoices the goods sold to the customer

  - earns a fixed margin on the products sold, but has no flexibility in establishing the sales price

  - has the right to return the goods to Co B without penalty

  - is responsible for the goods while the goods are stored in Co A's warehouse but Co B bears the risk of obsolete goods
- The credit risk rests with Co B

Should Co A recognise revenue on the transfer of the goods to the customer on a gross or net base ?

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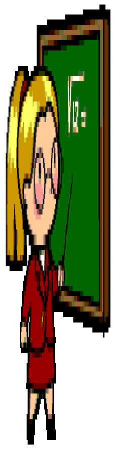
Example – On-line retailer (cont'd)

Analysis:



Co A has the option to return the goods and Co B bears the inventory risk

Co B retains continuing managerial involvement over the goods by being able to set the sales price

Co A is acting as an agent for the principal, Co B. Co B does not transfer the risks and rewards of ownership of the goods to Co A

Co A should recognise an agency fee or commission revenue in its income statement for the sales made on Co B's behalf, that is, on a net basis

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Transactions that would not arise income

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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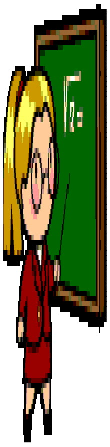
Multiple deliverables

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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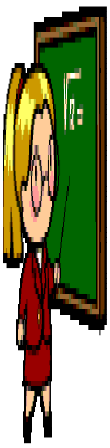
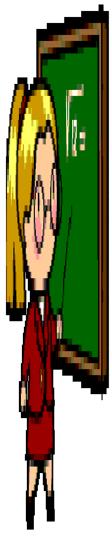
Multiple deliverables

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

Multiple deliverables



During the year, Good Wife Cleaning Limited sells cleaning equipment for $10,000 and offers 3-year cleaning service for an extra charge of $3000. As a promotion package, Good Wife Cleaning Limited includes 3-year service as part of sale of the cleaning equipment for total price $12,000

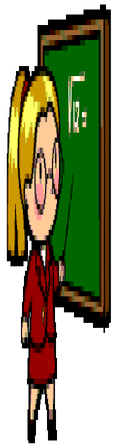
+

Good Wife Cleaning Limited

Should Good Wife Cleaning Limited recognise $12,000 revenue and when ?

Multiple deliverables (cont'd)

Analysis:



- Multiple element transaction
- Revenue from sale of cleaning equipment = 12,000 / 13,000 x 10,000 = 9,231 (recognised at delivery)
- Revenue from cleaning service of $2,769 recognised over 3 year service period

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Revenue Recognition: Way forward

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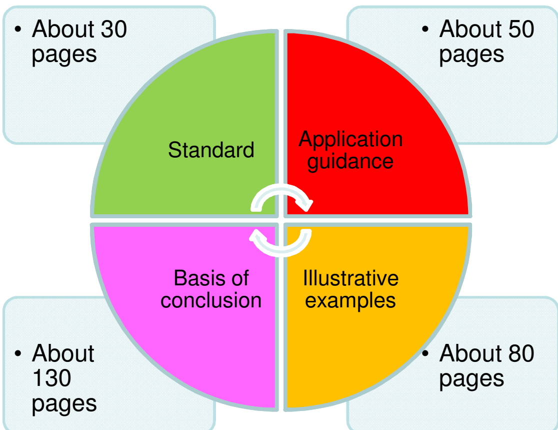
Overview of HKFRS 15
Revenue from Contracts with Customers



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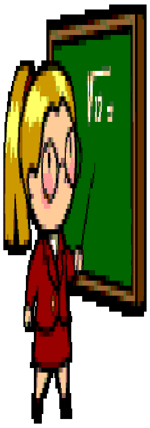
The new standard on revenue recognition



HKFRS 15 Revenue from contracts with customers

- Issued on in May, 2014
- Effective for an entity's first annual HKFRS financial statements for periods beginning on or after 1 January 2017. Early application is permitted *

- FASB proposed to defer the effective date to 2018 or 2019. IASB discussed in April 2015 and proposed one year deferral to 2018. EFRAG board recommended adoption in 2017.

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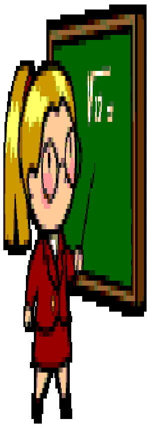
HKFRS 15 *Revenue from Contracts with Customers*

Existing requirements	
HKAS 11 HKAS 18 HKAS 18 HK-IFRIC 15	Construction contracts Sale of goods Provision of services Real estate sales before completion
HKAS 18	Royalties
HK-IFRIC 13	Customer loyalty programmes
HK-IFRIC 18 HK(SIC) 31	Transfers of assets from customers Barter Transactions
HKAS 18 HKAS 18	Interest income Dividend income

New requirements	
HKFRS 15	One revenue standard to deal with all types of revenue-generating transactions - does not have different requirements for 'sale of goods' and 'provision of services'
HKAS 39 or HKFRS 9	Interest income Dividend income

HKFRS 15 *Revenue from Contracts with Customers*

Scope of HKFRS 15



- HKFRS 15 applies to all <u>contracts with customers</u> except for those being scoped out and accounted for under another HKFRS (e.g. leases, insurance contracts, financial instruments, non-monetary exchanges)
- A customer is a party that has contracted to obtain goods or services that are an output of the entity's <u>ordinary activities</u>

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HKFRS 15 *Revenue from Contracts with Customers*

The 5-step model

Step 1
- Identify the contract(s) with the customer

Step 2
- Identify the separate performance obligations ('POs')

Step 3
- Determine the transaction price

Step 4
- Allocate the transaction price to separate POs

Step 5
- Recognise revenue when (or as) each PO is satisfied

- HKAS 11 and HKAS 18 have different requirements regarding 'sales of goods', 'provision of services' and 'construction contracts'
- Under HKFRS 15, the above 5 steps apply regardless of whether the transaction is a 'sale of goods' or 'provision of service' contract

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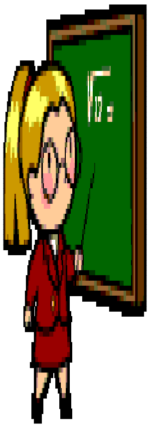
HKFRS 15 *Revenue from Contracts with Customers*

Step 1 — Identify the contracts with customers

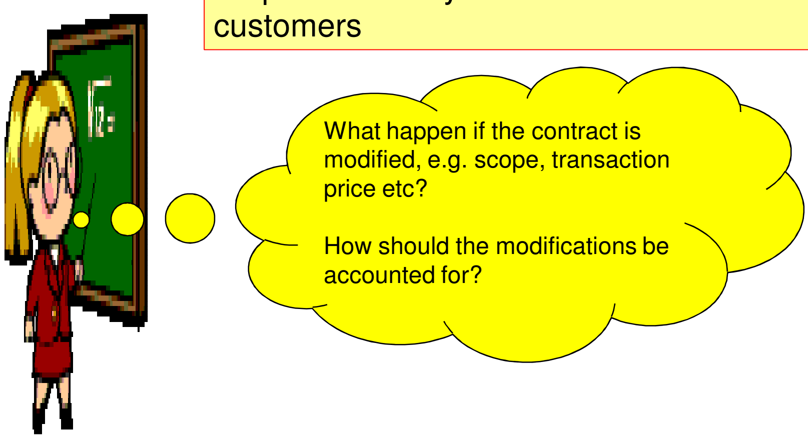


Contract

An agreement between two or more parties that creates enforceable rights and obligations (not necessarily written)

- Approved
- Rights of each party identified
- Payment terms identified
- Commercial substance
- Collectability

Step 1 — Identify the contracts with customers



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Specific guidance on contract modifications

Does the modification add deliverables and increase contract price by « normal » price that customer would pay for them?

- **No** → Would remaining deliverables qualify as distinct?
  - **No** → Account retrospectively (Example 2)
  - **Yes** → Account prospectively (Example 1 – Scenario 1B)
- **Yes** → Treat as separate contract (Example 1 - Scenario 1A)

Will need to be assessed on facts and circumstances

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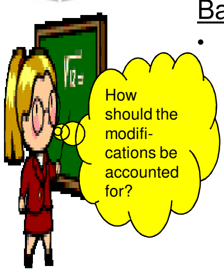
Example 1 – Additional products for a price that reflects the stand-alone selling price

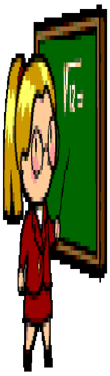


Background

- Entity A promises to sell 120 products to a customer for $12,000 at $100 per product. The products are transferred to the customer over a six-month period
- Entity A transfers control of each product at a point in time
- After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

		Date of modification
Original contract	60 products	60 products ($100 each)
Scenario 1A		30 products ($95 each)
Scenario 1B		30 products ($80 each)

Example 1 – Additional products for a price that reflects the stand-alone selling price (cont'd)



Scenario 1A

- At the time of contract modification, the price for the additional 30 products is an additional $95 per product ($2,850/30)
- The pricing for the additional products reflects the stand-alone selling price of the products at the time of the contract modification and the additional products are distinct (in accordance with HKFRS15.27) from the original products
- Therefore, in accordance with HKFRS15.20, the contract modification for the additional 30 products is a **new and separate contract** for future products that does not affect the accounting for the existing contract
- Entity A recognises revenue of $100 per product for the 120 products in the original contract and $95 per product for the 30 products in the new contract

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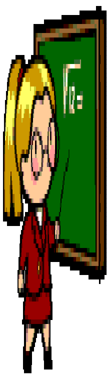
Example 1 – Additional products for a price that does not reflect the stand-alone selling price



Scenario 1B

- The parties initially agree on a price of $80 per product for each of the additional 30 products
- However, the customer discovers that the initial 60 products transferred contained minor defects that were unique to those delivered products
- Entity A promises a partial credit of $15 per product to compensate for the poor quality of those products ($15 credit × 60 products = $900), to be incorporated into the price that the entity charges for the additional 30 products
- Thus the price of the additional 30 products is $50 per product ($2,400 - $900 = $1,500, divided by 30). That price comprises the agreed-upon price of $80 per product, less the credit of $900 spread over the 30 products

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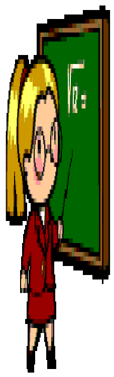
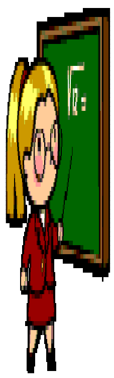
Example 1 – Additional products for a price that does not reflect the stand-alone selling price (cont'd)



Analysis

- At the time of modification, Entity A recognises the $900 as a reduction of the transaction price and thus revenue for the initial 60 products transferred
- In accounting for the sale of the additional 30 products, Entity A determines that the negotiated price of $80 per product does not reflect the stand-alone selling price of the additional products
- Consequently, the modification does not meet the conditions in HKFRS 15.20 to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the modification is accounted for as a termination of the original contract and the creation of a new contract (HKFRS 15.21(a))
- The amount to be recognised as revenue for each of the remaining products would be a blended price of CU93.33 {[($100 × 60 products not yet transferred under the original contract) + ($80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}

Example – Modification resulting in a cumulative catch-up adjustment to revenue



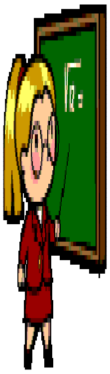
Background

- Construction Co. A will construct a commercial building for a customer on customer-owned land
- Consideration is 1 million
- HKFRS 15.35(b) is met: a performance obligation satisfied over time because the customer controls the building during construction
- Initial assessment of the contract:

	HK$
Transaction price	1,000,000
Expected costs	(700,000)
Expected profit (30%)	300,000

- Measurement: input method, base on costs incurred

Example – Modification resulting in a cumulative catch-up adjustment to revenue (cont'd)

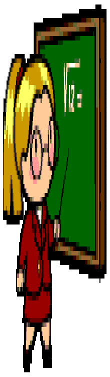


Year 1

- 60% of performance obligation has been satisfied, Construction Co. A recognised the followings:

	HK$
Revenue	600,000
Costs	(420,000)
Gross profit	180,000

Example – Modification resulting in a cumulative catch-up adjustment to revenue (cont'd)



1st quarter of Year 2

- Both parties to the contract agree to modify the contract by changing the floor plan of the building
- So, transaction price and expected cost is revised:

REVISED budget	HK$
Transaction price	1,250,000
Expected costs	(920,000)
Expected profit	330,000

- In assessing the contract modification, the remaining services to be provided using the modified contract are not distinct from the services transferred on or before the date of contract modification. Therefore,
  - » the contract remains a single performance obligation
  - » the modification is accounted for as if it were part of the original contract

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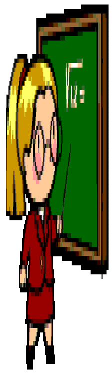
Example – Modification resulting in a cumulative catch-up adjustment to revenue (cont'd)



Date of modification

- Assume costs incurred as at modification date = $506,000
- Revised progress and estimates: 55% ($506,000 actual cost / $920,000 revised budget cost)
- Revenue recognised at the modification date (including cumulative catch-up adjustment): $87,500 ($1,250,000 x 55% - $600,000)

	Cumulative	**Year 1**	**Year 2 - up to date of modification**
	HK$	HK$	HK$
Revenue	687,500	600,000	87,500
Costs	(506,000)	(420,000)	(86,000)
Gross profit	181,500	180,000	1,500

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Step 2 — Identify separate performance obligations in the contract

Performance obligation:
A promise in a contract with a customer to transfer a good or service to the customer

- Implicit
- Explicit
- Written
- Verbal

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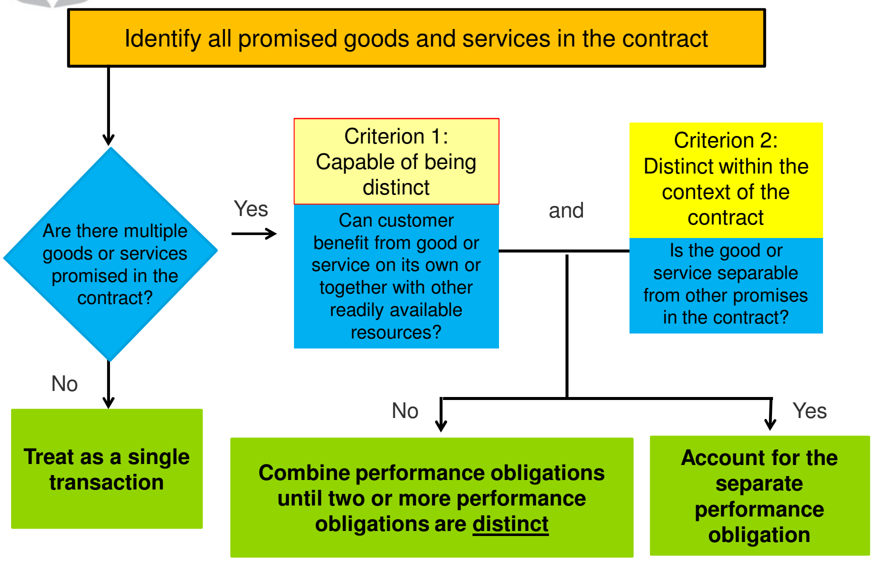
Step 2 — Identify separate performance obligations in the contract



Step 2 — Identify separate performance obligations in the contract

Criterion 1: Capable of being distinct

:

- Indicators that the good/service is distinct:
  - *'Other readily available resource'* is a good/service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained form the entity

Individual distinct good or service	Group of inseparable goods or service	Series of distinct 'services'
e.g. consumer good	e.g. construction of a building	e.g. daily cleaning service

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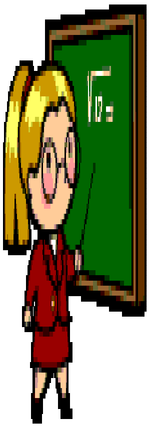
Step 2 — Identify separate performance obligations in the contract



Criterion 2: Distinct within the context of the contract

- Indicators that the good/service is distinct:
  - ✓ good or service does not provide a significant service of integrating the good or service with other goods or services into a bundle that represent the combined output
  - ✓ entity does not significantly modify or customise another good or service promised in the contract
  - ✓ good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract

Judgment required

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Distinct performance obligations?

Scenario 1

- Co A exclusively licenses a compound to Co B
- Co A is contractually obliged to provide research services for two years. Co A can switch suppliers after two years

How many performance obligations?

A. One

B. More

Distinct performance obligations?

Scenario 2

- Manufacturer sells cars to Dealer
- Manufacturer offers free maintenance services to any customer that purchases the vehicle from the Dealer

How many performance obligations?

A. One
B. More

Distinct performance obligations?

Scenario 3

- Customer joins Fitness Club as a member for 2 years
- Customer pays an entrance fee upfront

How many performance obligations?

A. One
B. More

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Distinct performance obligations?

Scenario 4

- Toy Co sells toys to customer. Control passes at shipping point
- Customer requests that Toy Co's transport division ships the toys
- Customer can change the delivery location any time after shipping

How many performance obligations?

A. One
B. More

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Distinct performance obligations?

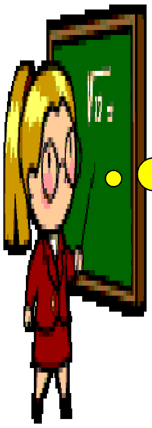
Scenario 5

- ElevatorCo sells an elevator with installation service to a customer

How many performance obligations?

A. One
B. More
C. Depends

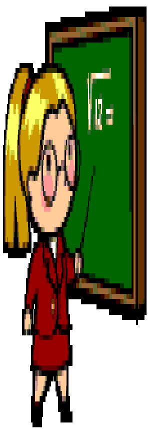
Step 2 — Identify separate performance obligations in the contract



What about product warranty ?

Is it a separate performance obligation that is distinct ?

Step 2 — Identify separate performance obligations in the contract - Warranties



Assurance-type warranty

Provide assurance that the related product will function and complies with agreed-upon specifications

Not a distinct service account under HKAS 37

Service-type warranty

Provide a service in additional to the assurance

A distinct service allocation a portion of transaction price

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Warranties - Example

Background

- Customer X purchases a television set from Company Y at $10,000

Scenario 2a

- Company Y offers a product warranty period of 12 months at no additional charge

Scenario 2b

- Customer X has option to extend the warranty period for further 24 months at $500 at the time of purchase

Question

- Are the warranties constitute separate performance obligations?

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Step 2 — Identify separate performance obligations in the contract – Customer options for additional goods or services

What are potential customer options?

- Customer loyalty programme
- Extended warranty options
- Renewal options (e.g. maintenance services, club membership fee)

- The customer's option to purchase additional goods or services would give rise to a separate performance obligation only if the option provides a material right to the customer that it would not receive without entering into that contract

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Step 2 — Identify separate performance obligations in the contract – Customer options for additional goods or services

Does the option provide **a material right** to customer that it would not receive without entering into the contract ?

If YES, then

Estimate the standalone selling price of the option and allocate a portion of the sale price to the option

- The customer's option to purchase additional goods or services would give rise to a separate performance obligation only if the option provides a material right to the customer that it would not receive without entering into that contract

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Example – Option that provides the customer with a material right

Background

Entity B sold Product A for $100 and gave the customer a 40% discount voucher for any future purchases up to $100 in the next 30 days

Entity B intends to offer 10% discount on all sales during the next 30 days, the 10% discount cannot be used in addition to the 40% discount

Accounting response

- Only the additional 30% discount constitutes a material right
- Assume 80% likelihood that a customer will redeem the voucher and will, on average, purchase $50 of additional products
- Stand-alone selling price of the discount voucher – $50 x 30% x 80% = $12

Performance obligation	Stand-alone selling price (HK$)	Allocated transaction price (HK$)
Product A	100	89
Discount voucher	12	11
	112	100

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Example – Awards granted with and without an initial sales transaction

Background

- All visitors to Supermarket B, irrespective of whether they make any purchases, can pick up a voucher entitling them to a reduction of $1 off the price of Product X which has a selling price of $10
- Customers who buy Product W would receive a voucher entitling them to a $5 reduction in the selling price of Product X
- Only one voucher can be used for any purchase of Product X.

Question

- How should Supermarket B account for the vouchers?

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Example – Awards granted with and without an initial sales transaction (cont'd)

Response

$1 voucher

- No contract with the customer arising from the $1 vouchers, thus not within the scope of HKFRS 15
- If a customer uses a $1 voucher to purchase product X for $9, the revenue recognised will be $9 as this is the cash consideration to which Supermarket B is entitled in exchange for Product X (taking into account the $1 vouchers)

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Example – Awards granted with and without an initial sales transaction (cont'd)

Response (cont'd)

$5 voucher

- Customers are entitled to a $5 voucher as part of a sale transaction, thus these vouchers are within the scope of HKFRS 15
- Material right to the extent of $4, being the incremental right (other customers get $1 discount without having to buy Product W), is a separate performance obligation
- To consider likelihood that the voucher will be exercised in determining stand-alone selling price of the material right

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Step 3 — Determine the transaction price

Transaction price = Amount to which entity expects to be entitled in exchange for transferring goods or services

Consider the effects of :

- **Variable considerations (including discounts, rebates, refunds, returns, incentives, etc.)**
- **Non-cash consideration**
- **Any significant financing component**
- **Consideration payable to customer**

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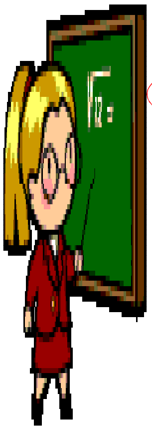
Determine the transaction price - variable consideration



- Variable consideration includes discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses and penalties
- Determine the method that better predicts the consideration
  - Expected value probability weighted amounts for a range of possible consideration amounts
  - Most likely amount – single most likely amount from a range of possible consideration amounts

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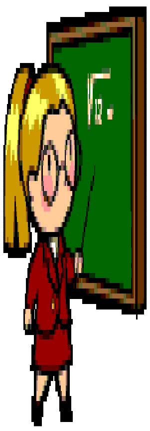
Estimates of variable consideration



- Variable consideration should only be included in the transaction price to the extent it is highly probable that a significant reversal in the amount of cumulative revenue will not occur
- **Should consider both the likelihood and** the magnitude of the revenue reversal
  - Is the amount highly susceptible to factors outside the seller's influence?
  - Does it take a long time to resolve the uncertainty?
  - Does the seller have experience/evidence to predict the value?
  - Does the seller offer a broad range of price concessions for similar contracts?
  - Does the contract have large number and broad range of possible amounts?

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Example - Variable consideration

Entity sells machinery for $100m with up to a 5% bonus based on meeting future efficiency targets over 5 years.

Additional facts
- **No similar contracts**
- **Customer behaviour affects efficiency**
- **History shows range anywhere between 0-5%**

Bonus included in the transaction price only if **highly probable** that it will not be subject to significant reversal?

Uncertainty over long period of time	Limited experience with similar contracts	Susceptible to factors outside control	Broad range of outcomes
✓	✓	✓	✓

Revenue: $100m until uncertainty resolved

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Example - Variable consideration

Entity sells machinery for $100m with up to a 5% bonus based on meeting future efficiency targets over 5 years.

Additional facts
- **Has similar contracts with a broad range of customer**
- **95% of bonuses between 3-4%**

Bonus included in the transaction price only if **highly probable** that it will not be subject to significant reversal?

Uncertainty over long period of time	Limited experience with similar contracts	Susceptible to factors outside control	Broad range of outcomes
✓	✗	✗	✗

Revenue: C103m until uncertainty resolved

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Example - Variable consideration

Entity sells machinery for $100m with up to a 5% bonus based on meeting future efficiency targets over 5 years.

Reassessment
Before contract is complete, management becomes 95% certain the entire bonus will be received

Bonus included in the transaction price only if **highly probable** that it will not be subject to significant reversal?			
Uncertainty over long period of time ✓	Limited experience with similar contracts ✗	Susceptible to factors outside control ✗	Broad range of outcomes ✗

Revenue: Additional 2m recognised….
even though uncertainty not resolved

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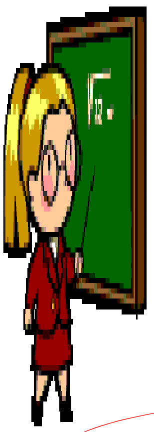
Example – Right of return



- Contract: Entity A sells 100 T-shirts to Customer B at $10 each
- Customer B only has the right to return the shirts
- Estimated sales margin: 50%
- Based on historical experience, Entity A expects 10% returns from such sales
- Assuming revenue is recognised at point in time

What are the appropriate accounting entries?

Example – Right of return

Calculate the transaction price for the arrangement

Accounting entry	HKAS 18	HKAS 18	HKFRS 15
	Alternative 1	Alternative 2	
Revenue	Dr. Cash 1,000 Cr. Revenue (900) Cr. Provision (100)	Dr. Cash 1,000 Cr. Revenue (900) Cr. Provision (100)	Dr. Cash 1,000 Cr. Revenue (900) Cr. Provision (100)
Cost of sales (COGS)	Dr. COGS 500 Cr. Inventory (500)	Dr. Provision 50 Dr. COGS 450 Cr. Inventory (500)	Dr. Return asset 50 Dr. COGS 450 Cr. Inventory (500)

Example – Volume discount incentive

Background

- Entity A enters into a contract on 1 January 20x8 to sell Product A for $100 per unit
- If the customer purchases more than 1,000 units in 20x8, the price is retrospectively reduced to $90 per unit

31 March 20x8

- Sold 75 units and customer not likely will exceed 1,000 unit
- Highly probable that a significant reversal will not occur
- Revenue recognized = 75 units x $100
  = $7,500

30 June 20x8

- Customer unexpectedly purchased additional 500 units due to acquisition of a new subsidiary
- Entity A estimates that the 1,000 units threshold will be met
- Retrospectively reduce the price per unit to $90

- Revenue recognized = (500 units x $90) – (75 units x $10)
  = $45,000 – $750
  = $44,250

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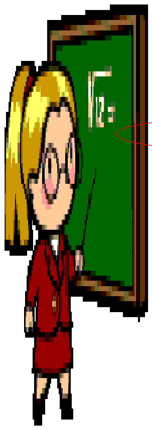
Determine the transaction price - Time value of money



Significant financing component

- Adjust if customer or entity receives significant benefit of financing
- No adjustment when:
  - Period between performance and payment is one year or less
  - Variable based on factors outside the control of the customer or entity
  - Advance payment but transfer at the customer's discretion
  - Difference between consideration and selling price arises for other reasons than to provide financing

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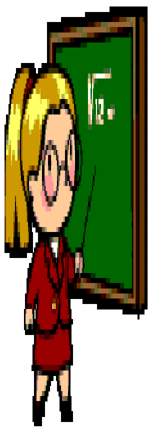
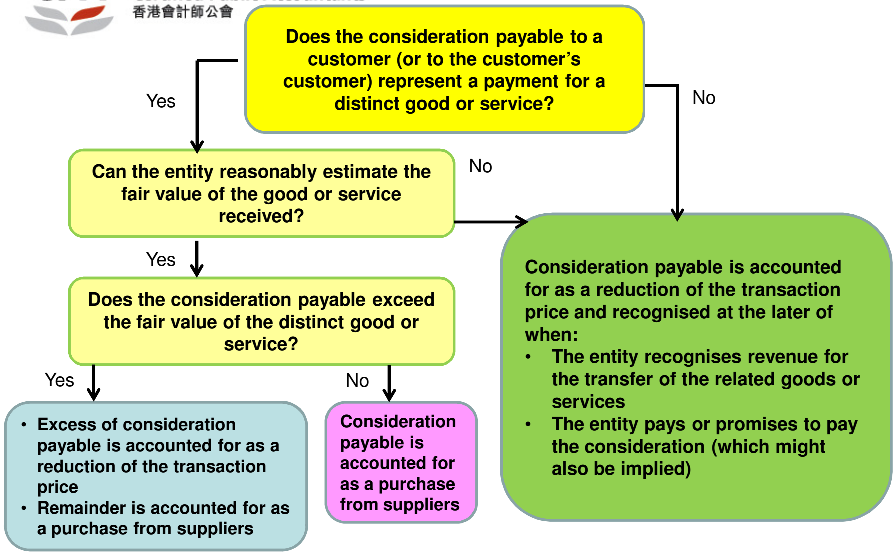
Determine the transaction price - Non-cash consideration



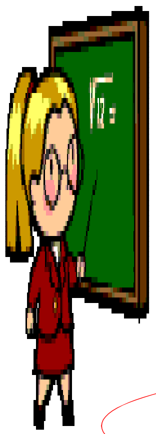
Non-cash consideration

- Measure the non-cash consideration at fair value
- If changes in the fair value are for reasons **other than** only the **form** of the consideration → subject to variable consideration constraint.
- Examples:
  - Provision of financial advisory services with shares of customer as consideration
    - 10,000 shares on completion of services
    - 3,000 additional shares as performance bonus if certain targets are achieved

Determine the transaction price - Consideration payable to customer



Example – consideration payable to customer



Background

- A manufacturer of consumer goods contracts with a customer, a large global chain of retail stores, to sell goods to it for 1-year
- The customer commits to buy at least $15 million of products during the year
- The manufacturer (entity) makes a non-refundable payment of $1.5 million to the customer at inception of the contract to compensate the latter for the changes it needs to make to its shelving to accommodate the entity's products

Question

- Is the non-refundable payment made in exchange for a distinct good or service that transfers to the entity?

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Example – consideration payable to customer (cont'd)

Response

- The entity does not obtain control of any rights to the customer's shelves
- Therefore the payment to the customer is not in exchange for a distinct good or service that transfers to the entity
- Consequently, the $1.5 million payment is accounted for as a reduction of the transaction price when the entity recognises revenue for the transfer of the goods

- Reduction at 10% ($1.5 million ÷ $15 million)
- If entity invoiced $2 million in the first month → revenue recognised = 2m x 90% = $1.8 million

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Step 4 — Allocate transaction price

Allocate revenue between elements based on standalone selling price of each separate performance obligation

Standalone selling price = Observable price at which an entity would sell a promised good or service separately to a customer

→ If not directly observable, standalone selling price shall be estimated

➢ Suitable methods for estimating the stand-alone selling price include:
- An adjusted market assessment approach
- An expected cost plus a margin approach
- A residual approach (in certain limited circumstances)

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Allocation methodology

Adjusted market assessment approach	Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay
Expected cost plus a margin approach	Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service
Residual approach (Appropriate only if the stand alone selling price is highly variable or uncertain)	Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price

Example – Allocation methodology

Background

- Products A, B and C are sold to customer at CU100
- Performance obligations for each product A, B and C is satisfied at different points in time
- Product A – regularly sold, stand-alone selling price is directly observable
- Products B and C – No stand-alone selling price is directly observable

Question

- How to determine the consideration of Products A, B and C?

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Example – Allocation methodology (cont'd)

Response

- According to HKFRS 15.78, stand-alone selling price is estimated as follows:

Product	Stand-alone selling price	Method
	CU	
Product A	50	Directly observable (see paragraph 77 of IFRS 15)
Product B	25	Adjusted market assessment approach (see paragraph 79(a) of IFRS 15)
Product C	75	Expected cost plus a margin approach (see paragraph 79(b) of IFRS 15)
Total	150	

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Example – Allocation methodology (cont'd)

Response

- Customer receives discount for purchasing the bundle because CU150 (sum of stand-alone selling price) exceeds promised consideration of CU100
- After considering HKFRS 15.82, the discount of CU50 is allocated proportionately across Products A, B and C (HKFRS 15.76), as follows:

Product	Allocated transaction price	
	CU	
Product A	33	(CU50 ÷ CU150 × CU100)
Product B	17	(CU25 ÷ CU150 × CU100)
Product C	50	(CU75 ÷ CU150 × CU100)
Total	100	

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Example – Allocating a discount to one or more performance obligations

Background

- Products A, B and C are sold regularly on an individual basis at the following stand-alone selling prices:

Product	Stand-alone selling price
	CU
Product A	40
Product B	55
Product C	45
Total	140

- In addition, Products B and C are regularly sold together for CU60.
- Entity X sells Products A, B and C in exchange for CU100.
- Discount on overall transaction = CU40

Question

How to allocate the discount?

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Example – Allocating a discount to one or more performance obligations (cont'd)

Response

- Because Entity X regularly sells Products B and C together for CU60 and Product A for CU40, it has evidence that the entire discount should be allocated to Products B and C (HKFRS 15.82).
- If control of Products B and C are transferred at different times, then the CU60 transaction price allocated to these 2 products will be allocated to them individually as follows:

Product	Allocated transaction price	
	CU	
Product B	33	(CU55 ÷ CU100 total stand-alone selling price × CU60)
Product C	27	(CU45 ÷ CU100 total stand-alone selling price × CU60)
Total	60	

Example – Discount and residual approach

Background

- Products A, B and C are sold regularly on an individual basis at the following stand-alone selling prices:

Product	Stand-alone selling price
	CU
Product A	40
Product B	55
Product C	45
Total	140

Products B and C are regularly sold together for CU60.

- Entity X sells Products A, B, C and D for CU130.
- Stand-alone selling price for Product D is highly variable as it is sold to different customers for a broad range of amounts (CU15–CU45).
- Entity X decides to estimate the stand-alone selling price of Product D using the residual approach.

Question

How should the stand-alone selling price of Product D be estimated?

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Example – Discount and residual approach (cont'd)

Response

- First determine whether any discount should be allocated to the other performance obligations in the contract (HKFRS 15.82 and 83)
- As Products B and C together are regularly sold for CU60 and Product A for CU40, it has observable evidence that CU100 should be allocated to these three products and a CU40 discount should be allocated to Products B and C together
- Using the residual approach, Entity X estimates the stand-alone selling price of Product D as follows:

Product	Stand-alone selling price	Method
	CU	
Product A	40	Directly observable (see paragraph 77 of IFRS 15)
Products B and C	60	Directly observable with discount (see paragraph 82 of IFRS 15)
Product D	30	Residual approach (see paragraph 79(c) of IFRS 15)
Total	130	

The resulting CU30 allocated to Product D is within the range of its observable selling prices (CU15–CU45). Entities should ensure that the result of allocation is consistent with the requirements of transaction price allocation.

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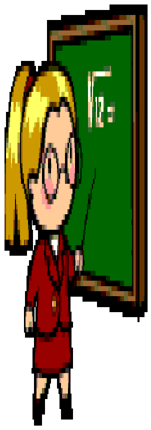
Step 5: Recognise revenue on transfer to customer



Recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when the customer obtains **control** of that asset

Control:

- Ability to direct the use of an asset;
- Obtain substantially all of the remaining benefits from that asset
- Ability to prevent other entities from directing the use of and obtaining benefits from an asset

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Step 5: Recognise revenue on transfer to customer

When should revenue be recognised?

Performance satisfied over time = Revenue recognised over time if one of the following criteria is met:

- Seller's performance creates or enhances asset controlled by customer

OR

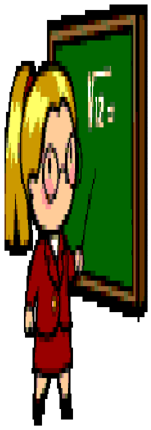
- Customer simultaneously receives and consumes benefit of seller's performance as seller performs

OR

- Seller creates an asset that **does not have alternative use to seller** and the **seller has right to be paid for performance to date**

IF NOT = Revenue recognised at a point in time

Revenue recognised overtime



Possible methods for measuring progress for revenue recognised overtime

- Output method
- Input method

Note:
Should apply a single method consistently to similar performance obligations and in similar circumstances

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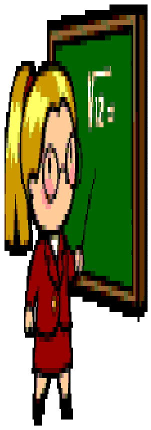
Output method vs Input method

Method	**Description**	**Examples**
Output	Based on direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services promised under the contract	• Surveys of performance to date • Appraisals of results achieved • Milestones reached • Time elapsed
Input	Based on an entity's efforts or inputs toward satisfying a performance obligation, relative to the total expected inputs to the satisfaction of that performance obligation	• Resources consumed • Costs incurred • Time elapsed • Labour hours expended • Machine hours used

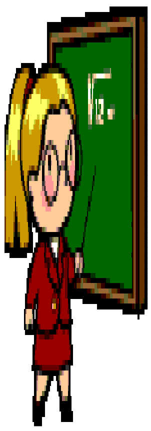
Recognise revenue when a customer obtains control of the promised asset



If criteria for revenue recognised overtime are not met, revenue is recognised at point in time based on the following indicators:

- a present right to payment
- legal title
- physical possession
- Significant risks and rewards of ownership
- customer has accepted the asset

Point in time versus over time



Consider the following situation

- Entity H agrees to produce 10,000 car frames for Customer I for a transaction price of $10,000,000
- Entity H has the right to payment for work performed including a reasonable margin if Customer I cancels while production is partially completed
- There is no alternative use for the frames as they reflect a particular car model designed by the customer

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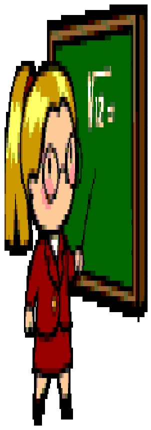
Point in time or over time (cont'd)



Entity H has completed 50% of the production and delivered 2,000 car frames to Customer I

How much revenue should Entity H recognise for the work performed to date?

A. $2,000,000
B. $5,000,000

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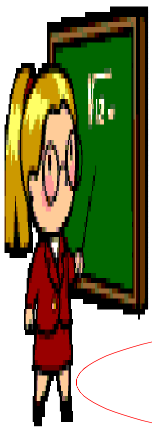
Example – Upfront fee



Background

- Customer A enters into a 2-year contract with a recreation club
- Customer A is required to pay $1,000 when the contract is entered into with the recreation club (commonly labeled as “joining fee”, “set up fee” or “membership fee”, etc)
- During the 2-year contract period, Customer A is required to make a monthly payment of $100
- The $1,000 payments is non-refundable even if Customer A does not use the recreation club at all

Question

- When should the recreation club recognise $1,000 as revenue? Upon receipt or over a period of time?

Example – Upfront fee

Step 1: Identify the contracts	Step 2: Identify separate performance obligations	Step 3: Determine transaction price	Step 4: Allocate transaction price to separate performance obligations	Step 5: Determine when to recognise revenue for each performance obligation
Step 1: There is one contract between Customer A and recreation club	Step 2: There is only ONE performance obligation, i.e. to allow Customer A to use the recreation club for a period of 2 years	Step 3: Transaction price = \$1,000+ \$100 X 24 = \$3,400	Step 4: Allocate the entire transaction price to the performance obligation	Step 5: Since Customer A can use the recreation club for 2 years, total consideration of \$3,400 is recognised as revenue over the 2 years. Upfront fee is not recognised as revenue upon receipt (even it is non-refundable)

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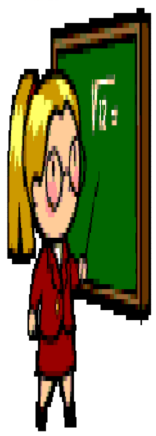
Disclosure requirements



Overall objective:

Enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

- Disclosures
  - Information about contracts with customers
    - Disaggregation of revenue
    - Contract balances
    - Performance obligations (POs) including transaction price allocated to the remaining POs
  - Information about judgment used
  - Information about costs to obtain or fulfill a contract

Onerous disclosure requirements under HKFRS 15. Please refer to the standard for details.

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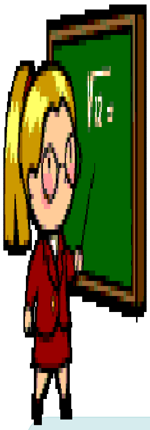
Effective date and transition



Effective date

- Effective for annual periods beginning on or after 1 January 2017

Transition

Option:

- Retrospective transition (restate comparatives with practical expedients), or
- Limited retrospective (no restatement - adjust cumulative effect to opening balance)

This standard is not effective until 2017 but given the retrospective application and significant impact – Important to start thinking about the impact

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The Institute will be holding Technical Updates Seminars and Workshops on this topic in more details. Please refer to the Institute website http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/tue/

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A Refresher Course on Current Financial Reporting Standards 2015 (Day 5)

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HKAS 12 Income Taxes

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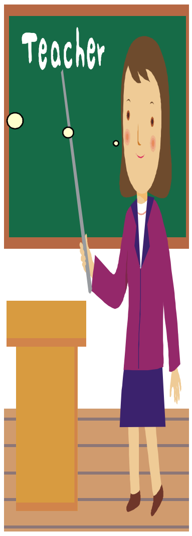
Learning Objectives

上課啦！

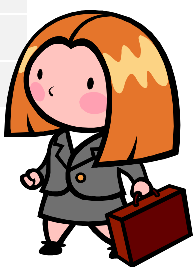
- ❑ Components of income tax
- ❑ Accounting profits vs. Taxable profits
- ❑ Carrying amount vs. Tax base
- ❑ What is temporary difference ?
- ❑ Current tax vs. deferred tax
- ❑ Initial recognition exemptions
- ❑ The latest development on deferred tax of investment properties



▪ Statement of Comprehensive Income

	HK$' 000
Revenue	xxx
Cost of sales	xxx
Gross profit	xxx
…..	
Profit before tax	150
Income tax	(160)
Net loss after tax	(10)

It is a profit before tax, but after tax, it is a loss ???



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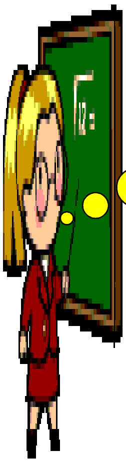
Components of income tax



What is income tax ?

Income tax is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax

Income tax = Current tax + Deferred tax

Current tax = Taxable profits X Tax rate

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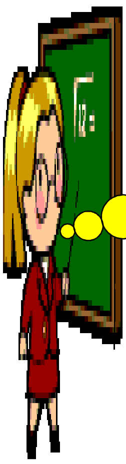
Components of income tax



These are not income tax

Sales taxes – Transactional taxes based on sales value

Interest and penalties assessed on under-payment or late payment of income tax

Hong Kong Stamp duty, PRC Business tax, VAT and Consumption tax

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Components of income tax

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)

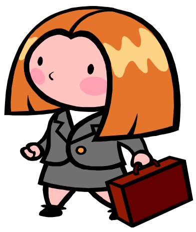
Taxable profits : illustration

Statement of Comprehensive Income

	HK$'
Royalty income	20,000
Meals expense	5,000
Bad debt expense	2,500
Depreciation	3,500
.....	
Profit before tax	150,000
Income tax	???
Net loss after tax	???

For tax purpose

- *Royalty income is tax exempt*
- *Meal expense is not deductible*
- *Bad debt expense of $500 not deductible until write off*
- *Tax depreciation is $4300*



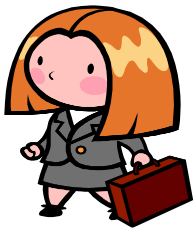
Taxable profit:

Accounting profit	150,000
Less: nontaxable royalty	(20,000)
Plus: nondeductible meals	5,000
Plus: nondeductible bad debts	500
Less: add'l tax depreciation	(8,000)
Taxable Profit	127,500

Current tax : illustration

Taxable profit:

Accounting profit	150,000
Less: nontaxable royalty	(20,000)
Plus: nondeductible meals	5,000
Plus: nondeductible bad debts	500
Less: add'l tax depreciation	(8,000)
Taxable Profit	127,500



Current tax	=	Taxable profits X Tax rate
$21,038	=	$127,500 X 16.5%

- 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

use the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period

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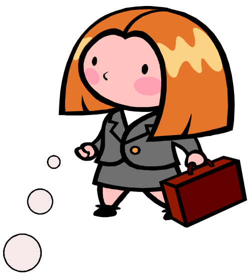
Deferred tax: illustration

	Statement of Comprehensive Income	For tax purpose
	HK$	HK$
Royalty income	20,000	-
Meals expense	5,000	-
Bad debt expense	2,500	2,000
Depreciation	3,500	4,300
…..		
Profit before tax	150,000	
Income tax	???	
Net loss after tax	???	

- *Bad debt expense of $500 not deductible until write off*
- *The additional depreciation charge allowed now are taxable in the future*



Deferred tax liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences

Deferred tax assets are defined as the amounts of income taxes recoverable in future periods

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Deferred tax calculation – five-step approach

- Calculate the tax base of each asset and liability in the statement of financial position
- Calculate the temporary difference (if any) for each of the above items
- 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
- Calculate the deferred tax balances using appropriate tax rate
- Recognise deferred tax in profit or loss, other comprehensive income (OCI), equity or an adjustment to goodwill

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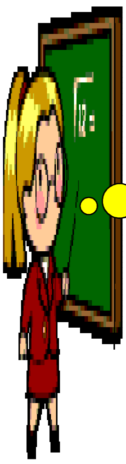
Step 1 - Computation of tax base



Tax base

"...the amount attributed to that asset or liability for tax purposes"

"...the amount of tax base can vary according to the manner in which the entity expects to recover the asset, or settle the liability"

Tax base for properties held for use in taxable activity may have different tax base as compared with that of properties held for sale

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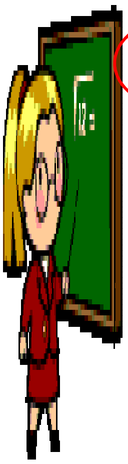
Basic equation for tax base calculation



Tax base of asset = **Carrying Amount** - **Future Taxable Amounts** + **Future Deductible Amounts**

Tax base of liability = **Carrying Amount** - **Future Deductible Amounts** + **Future Taxable Amounts**

Liability of Revenue nature

= **Carrying Amount** - **Revenue received in advance**

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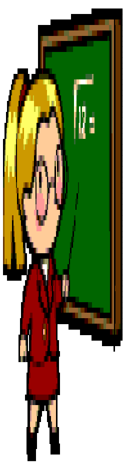
Basic equation for tax base calculation



Example: Property held for use

Carrying amount: $500

Tax written down value: $300

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
300	=	500	-	500	+	300

Tax base equals the tax written down value

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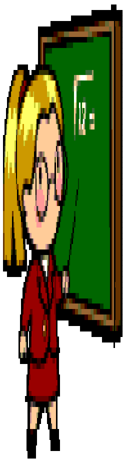
Basic equation for tax base calculation



Example: Property held for disposal

Carrying amount: $500	*Gain on disposal taxable*
Tax written down value: $300	

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
300	=	500	-	500	+	300

Tax base equals the tax written down value

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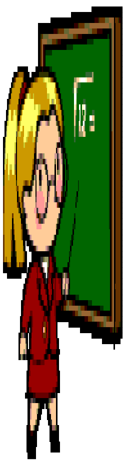
Basic equation for tax base calculation



Example: Revalued property held for use

Cost: $500

Revalued amount: $1000

TWDV: $300

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
300	=	1000	-	1000	+	300

Tax base equals the tax written down value

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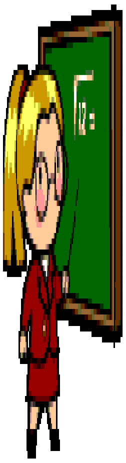
Basic equation for tax base calculation (cont'd)



Example: Revalued property held for disposal

Note: gain on disposal is taxable, but limited to allowances previously claimed

Cost: $500

Revalued amount: $1000

TWDV: $300

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
800	=	1000	-	200	+	0

Tax base is $800

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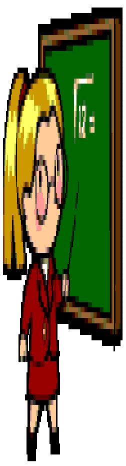
Basic equation for tax base calculation (cont'd)



Example: Pre-operating expense

Pre-operating expense : $5000
For financial reporting: Expensed when incurred
For tax purpose: deductible over 5 years

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
4000	=	0	-	0	+	4000

Tax base is $4000

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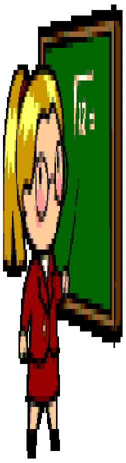
Basic equation for tax base calculation (cont'd)



Example: Bad debt expense

Gross receivable : $500
Allowance made: $50
Allowance deductible on incurred base

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
500	=	450	-	0	+	50

Tax base is $500

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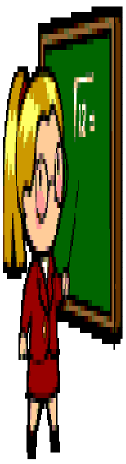
Basic equation for tax base calculation (cont'd)



Example: Deferred income

Deferred income received in advance: $800
Taxable on a cash receipt basis

Tax Base	=	Carrying Amount	-	Revenue received In advance
Nil	=	800	-	800

No tax base

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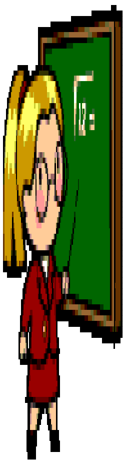
Step 2 – Calculate the temporary difference



- 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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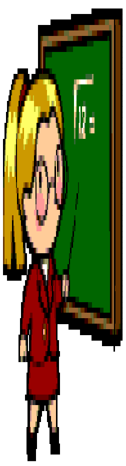
Compute temporary difference



Example: Property held for disposal

Carrying amount: $500	***Gain on disposal taxable***
Tax written down value: $300	

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
300	=	500	-	500	+	300

Temporary difference is 500 – 300 = $200

Compute temporary difference

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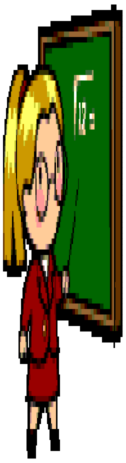

Example: Revalued property held for use

Cost: $500

Revalued amount: $1000

TWDV: $300

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
300	=	1000	-	1000	+	300

Temporary difference is 1000 – 300 = 700

Compute temporary difference

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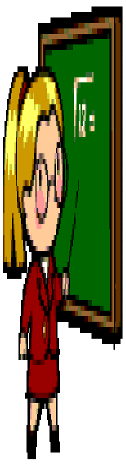

Example: Revalued property held for disposal

Note: gain on disposal is taxable, but limited to allowances previously claimed

Cost: $500

Revalued amount: $1000

TWDV: $300

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
800	=	1000	-	200	+	0

Temporary difference = 1000 minus 800 = 200

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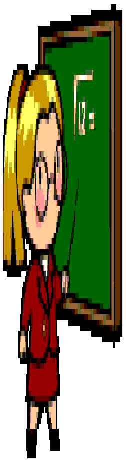
Compute temporary difference



Example: Pre-operating expense

Pre-operating expense : $5000
For financial reporting: Expensed when incurred
For tax purpose: deductible over 5 years

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
4000	=	0	-	0	+	4000

Temporary difference is 4000

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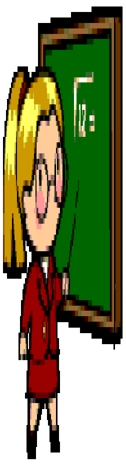
Compute temporary difference



Example: Bad debt expense

Gross receivable : $500
Allowance made: $50
Allowance deductible on incurred base

Tax Base	=	Carrying Amount	-	Future Taxable Amount	+	Future Deductible Amounts
500	=	450	-	0	+	50

Temporary difference is 50

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Step 3: Identify the temporary differences that give rise to deferred tax assets or liabilities

- **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 → Deferred tax asset

Unused tax losses or credits → Deferred tax asset

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Taxable/deductible temporary differences - summary

	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: Calculate the deferred tax balance

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- **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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Applicable tax rate

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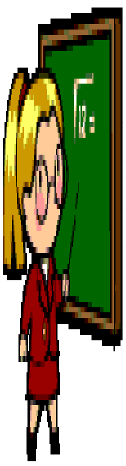

- **Applicable tax rates and laws**
  - Deferred assets and liabilities shall be measured:
    - at the tax rates that are expected to apply to the period when the temporary difference reverses
    - based on tax rates and tax laws enacted or substantively enacted at the end of the reporting period

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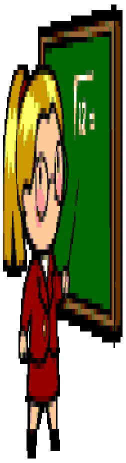
Example: Reduced PRC tax rate



- **Facts**
  - A PRC established Co A is subject to PRC income tax rate of 25%
  - In 2011, Co A is accredited as "High Technology Entity" and will be entitled to a reduced tax rate of 15% for four years starting from 1 January 2012
  - Co A has an item of equipment that cost RMB12,000 on January, 2009 which is depreciated over 6 years for accounting purposes and 3 years for PRC income tax purpose, using the straight-line method

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Example – Reduced PRC tax rate (cont'd)

Before tax rate changed from 25% to 15%

	Carrying amount	Tax base	Temporary difference	Reversal of temporary difference	Tax rate	Deferred tax liability
	RMB	RMB	RMB	RMB		RMB
Jan 1, 2009	12,000	12,000	-	-	-	-
2009	10,000	8,000	2,000	N/A	25%	500
2010	8,000	4,000	4,000	N/A	25%	1,000
2011	6,000	-	6,000	N/A	25%	1,500
2012	4,000	-	4,000	2,000	25%	1,000
2013	2,000	-	2,000	2,000	25%	500
2014	-	-	-	2,000	25%	-

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❑ Example – Reduced PRC tax rate (cont'd)

After tax rate changed from 25% to 15%

		Before change of rate		After change of rate	
	Reversal of temporary difference	Reversal tax rate	Deferred tax liability	Reversal tax rate	Deferred tax liability
	RMB		RMB		RMB
2012	2,000	25%	500	15%	300
2013	2,000	25%	500	15%	300
2014	2,000	25%	500	15%	300
Deferred tax liability as at 1 Jan 2012			1,500		900

Reduction of deferred tax liability of RMB600 credited to profit or loss during 2011

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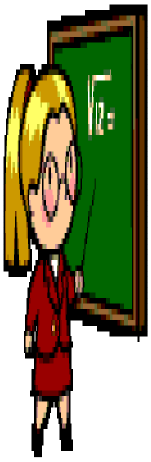
Change in tax rate



❑ 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
- Disclosure is required if the effect on the current and deferred tax assets/liabilities is significant

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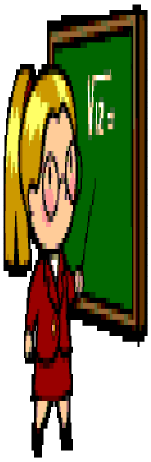
Substantively enacted tax rates



- **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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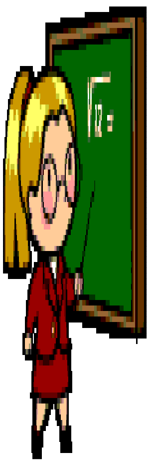
Discounting



- **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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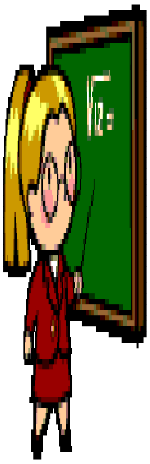
Step 5: Recognition of movements



- 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:
  - Relates to an item recognized in other comprehensive income, deferred tax also recognized in other comprehensive income
  - Relates to an item recognized in equity, deferred tax also recognized 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 recognized 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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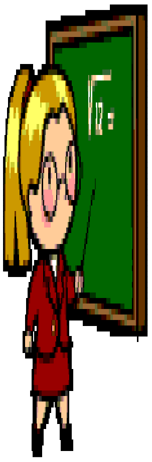
Presentation and Disclosure

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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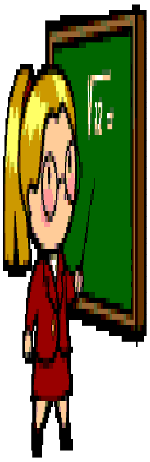
Presentation and Disclosure



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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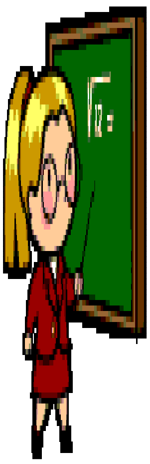
Presentation and Disclosure



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 <u>unless:</u>

  [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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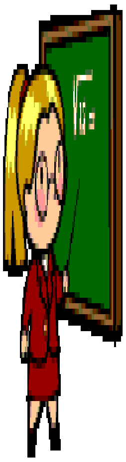
Presentation and Disclosure



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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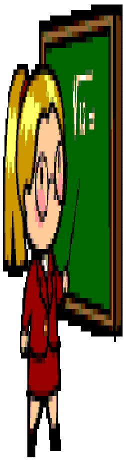
Presentation and Disclosure



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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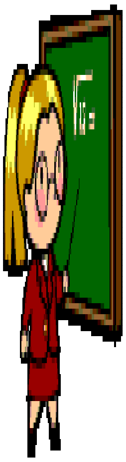
Presentation and Disclosure

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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Presentation and Disclosure

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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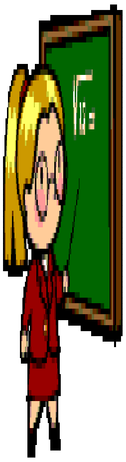
Presentation and Disclosure



Disclosure – Deferred tax

- For each type of temporary difference, unused tax loss and tax credit:
  - Amount of the deferred tax assets and liabilities recognized
  - 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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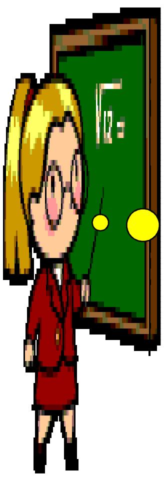
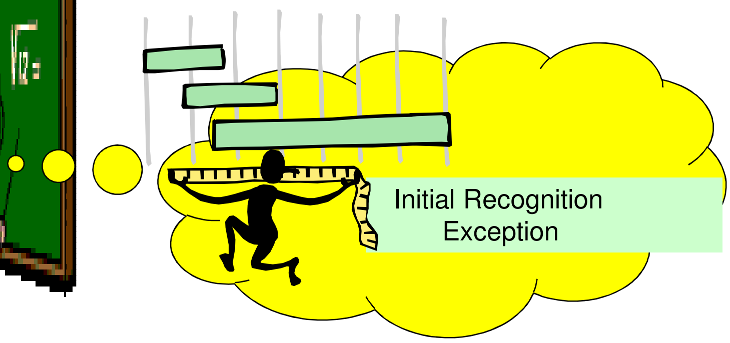
Deferred Tax - Recognition Exceptions





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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
- ❑ Certain differences related to investments in subsidiaries, branches, associates or joint ventures, if the parent, investor or venture 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 recognized only to the extent that recoverability is probable

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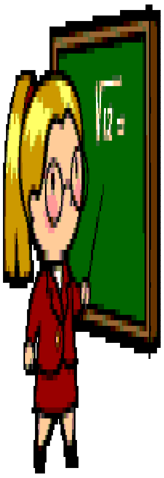
Recognition exception – Initial recognition of an asset or liability



- ❑ 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

Does the temporary difference arise on the initial recognition of an asset or a liability? — No → Recognise deferred tax impact (subject to other exceptions)

↓ Yes

Was the asset or liability acquired in a business combination? — Yes → Recognise deferred tax impact (subject to other exceptions)

↓ No

Did the transaction giving rise to the asset or liability affect either the accounting result or the taxable profit (loss) at the time of the transaction? — Yes → Recognise deferred tax impact (subject to other exceptions)

↓ No

Do not recognise deferred tax impact

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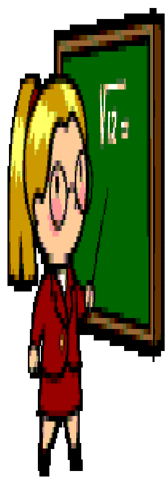
Recognition exception – Initial recognition of an asset or liability



Case 1

- A PRC entity purchases a domestically-produced machine in the PRC for $100
- For tax purposes, as an encouragement to purchase domestically-produced goods, $140 will be deductible over five years
- A deductible temporary difference of $40 arises at the time of purchase

Recognise a deferred tax asset ?

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Recognition exception – Initial recognition of an asset or liability

Case 2

- Co A acquired an office equipment fro $1,200
- For accounting purposes, the asset is depreciated over 3 years, residual value is zero
- Tax rate is 12%
- For tax purposes only $300 is qualifying expenditure and deductible over 2 years

How to calculate the deferred tax?

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Recognition exception – Initial recognition of an asset or liability

Suggested Solution

	Carrying amount	Tax base	Temporary difference	Unrecognised Difference *	Recognised difference	Deferred tax liability
2010	1,200	300	900	900	-	
2011	800	150	650	600	50	6
2012	400	-	400	300	100	12
2013	-	-	-	-	-	-

• Being the initial temporary difference (900) of which initial recognition exception applied

•Note: Subsequent changes in the unrecognised deferred tax liability or asset relating to initial temporary difference will not be recognised along with the depreciation periods

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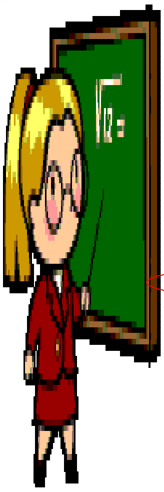

Recognition exception – Initial recognition of goodwill

- 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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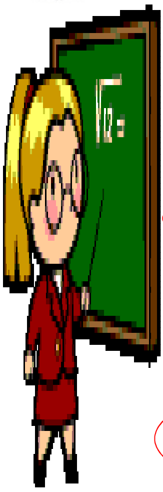
Recognition exception – Investments in subsidiaries/associates/joint ventures



- ❑ 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
- ❑ Taxable temporary differences required to be recognised as deferred tax liability, except for taxable temporary differences where:
  - 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

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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 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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Withholding tax - Example

Distribution of dividends by PRC enterprises subject to 10% withholding tax on profits generated from 1 Jan 2008 onwards

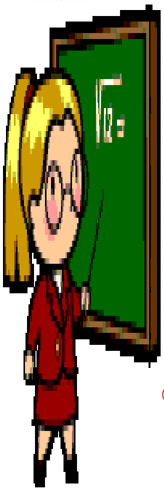
Parent Company

Subsidiary S
(2013 profit = $1m)

Associate A
(2013 profit = $2m)

Both Sub S and Associate A were incorporated in mainland China

Withholding tax - Example



Consolidated financial statements of Parent co

- Recognised deferred tax liability of Associate A:
  - RMB 2M * 20% X 10% = RMB 40,000
- Deferred tax liability of Subsidiary S:
  - RMB 1M X 10% = RMB 100,000
- **Not** recognised if “it is probable that the temporary difference will not reverse in the foreseeable future”

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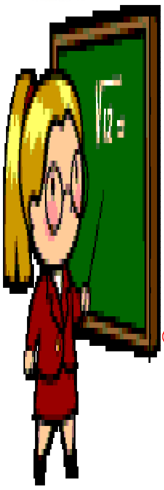
Recognition – business combination



- 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 2013, 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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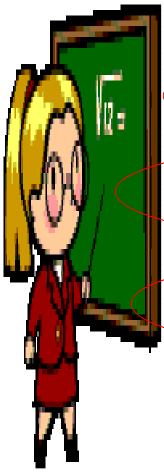
Consolidation of group entities' deferred taxes



- Gather deferred tax worksheets on company level
- Scrutinise consolidation adjustments to identify adjustments that create additional temporary differences; and
- Perform deferred tax adjustments immediately after the consolidation adjustments identified

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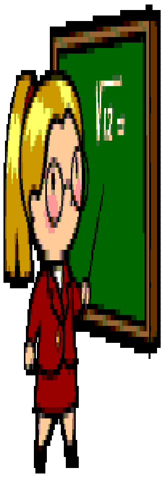
Consolidation adjustments



- Areas create additional temporary differences:
  - Eliminations of unrealised profits/losses
  - Adoption of group accounting policies
  - Fair value adjustments on acquisition (business combination)
  - Undistributed profits in subsidiaries
  - Equity accounting for associates and joint ventures

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Elimination of unrealised profits on consolidation

- 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

There is no change in tax base

What is the deferred tax balance?

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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
- 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)

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Example 5: 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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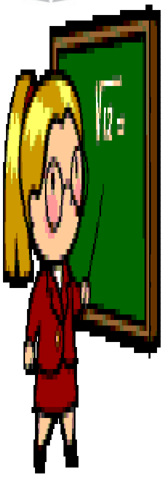

Deferred tax of investment properties measured at Fair value model

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Investment properties measured at fair value model

- Amendments introduce an exception to the principle regarding the measurement of deferred tax for investment properties measured using the fair value model

- Specifically,
  - Rebuttable presumption that the carrying amount of IPs is recovered entirely by sale
  - Investment property that is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over through use, rather than through sale, the presumption is rebutted and the principle in HKAS 12 should be followed

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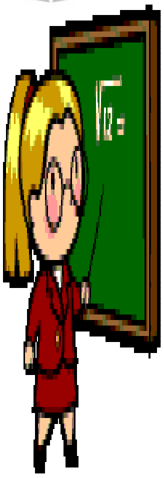
Investment properties measured at fair value model



- Entities that hold investment properties that are measured using the fair value model, and operate in jurisdictions that there is no capital gain tax (e.g. Hong Kong), no need to provide deferred tax on fair value gains and losses (in Hong Kong, the tax consequence on 'Balancing Charge' shall be considered)

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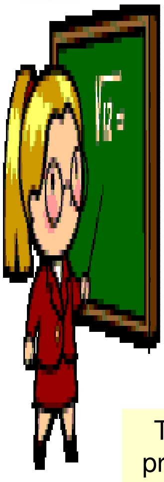
Further considerations



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

The presumption cannot be rebutted for an investment property or portion of an investment property that is non-depreciable (that is, freehold land)

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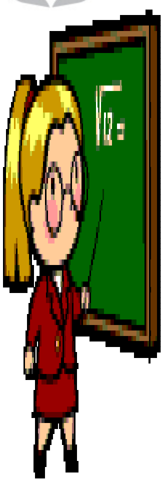
Further considerations (cont.)



- ❑ 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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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

Deductible temporary difference

Unused tax losses or credits

Deferred tax asset

- 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

❑ 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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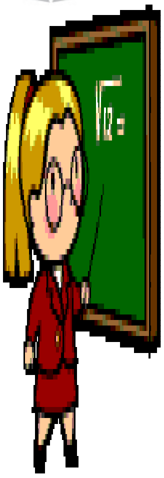

Recognition exceptions – Unused tax loss/credit

❑ **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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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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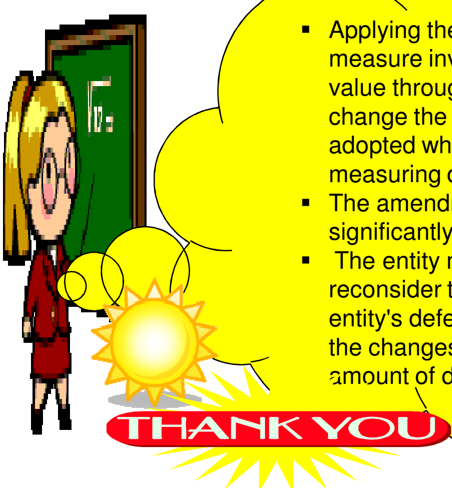

- Applying the presumption to measure investment property at fair value through sale does not change the principles to be adopted when recognising and measuring deferred tax assets
- The amendment is likely to reduce significantly deferred tax liabilities
- The entity might need to reconsider the recoverability of the entity's deferred tax assets due to the changes in the nature and amount of deferred tax liabilities

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A Refresher Course on Current

Financial Reporting Standards 2015

Day 6

Time	Topic
09:00 - 10:00	Impairment of non-financial assets
10:00 - 11:00	Fair value measurement
11:00 - 12:00	Examination

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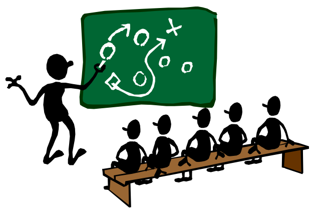
A Refresher Course on Current Financial Reporting Standards 2015 (Day 6)

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

4

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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 under the scope of HKAS 39
- investment property carried at fair value (see HKAS 40)
- biological assets related to agricultural activity carried at fair value less costs of disposal (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 of disposal and its value in use
- Fair value: 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 (see HKFRS 13)
- Costs of disposal: incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.
- 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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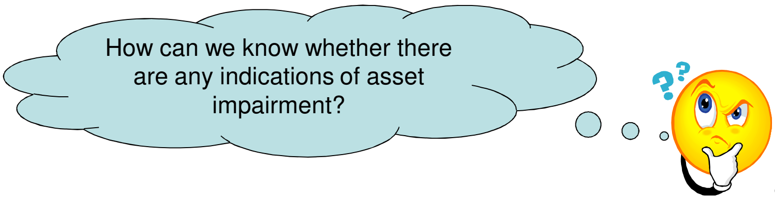
C. Identifying an asset that may be impaired

Timing of assessment – general requirements

- At the end of each reporting period, review all assets (under scope of HKAS 36) to look for any indication that an asset may be impaired
- 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)

External indicators:

- 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 indicators:

- 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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C. Identifying an asset that may be impaired (Con't)

Dividend from a subsidiary, 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.

These lists are not intended to be exhaustive.

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.

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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 life
  - 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. Determining Recoverable Amount

Recoverable amount→ higher of fair value less costs of disposal and value in use (VIU)

Fair value less costs of disposal or VIU?

- If either fair value less costs of disposal 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 of disposal cannot be determined, then recoverable amount is value in use.
- For assets to be disposed of, recoverable amount is fair value less costs of disposal.

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Fair Value Less Costs of disposal

1. If there is a **binding sale agreement** in an arm's length transaction, use the price under that agreement less costs of disposal.
2. If there is an **active market** for that type of asset, use market price less costs of disposal.
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]

1. an **estimate of the future cash flows** the entity expects to derive from the asset
2. expectations about **possible variations** in the amount or timing of those future cash flows
3. the **time value of money**, represented by the current market risk-free rate of interest
4. the price for bearing the **uncertainty inherent** in the asset
5. 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 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 (cont'd)

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 of disposal
- ✓ 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 (cont'd)

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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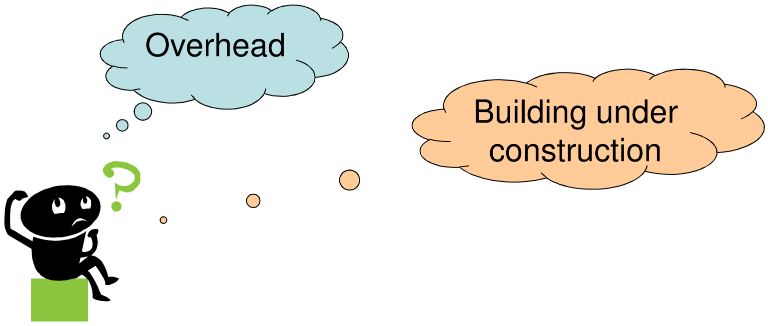
Estimate of future cash flows (cont'd)

What should we consider when dealing with the following cash flows?



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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 **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 reference :
  - rate implicit in the current market transactions for similar assets; or
  - from the weighted average cost of capital of a listed entity that use similar assets (in terms of services and risks)

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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.

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.

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 of an individual asset available ?

NO → Cash-generating unit (CGU)

YES → Individual asset

When?

(a) the asset's value in use cannot be estimated to be close to its fair value less costs of disposal (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows that are largely independent of those from other assets.

F. Cash-Generating Units

When considering a CGU……

- It 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**
- Consider how management monitors operations / decisions are made
- If an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit
- It is identified consistently from period to period, unless a change is justified

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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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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:

1. reduce the carrying amount of **any goodwill allocated** to the cash-generating unit (group of units); and

↓

2. reduce the carrying amounts of the **other assets of the unit (group of units) on pro rata basis**.

↓

3. The carrying amount of an asset should not be reduced below the highest of its fair value less costs of disposal, its value in use, and zero

↓

4. 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

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: <u>assess at end of each reporting date</u> whether there is an indication that an impairment loss may have decreased. If so, calculate recoverable amount.
- <u>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.</u>
- 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.
- **<u>Reversal of an impairment loss for goodwill is prohibited.</u>**

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Example 3: Reversal of an impairment loss

<u>Background</u>

- 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).

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 an 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:
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- 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 of disposal) 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 of disposal, disclose the **basis for determining fair value**
  - if recoverable amount is value in use, disclose the **discount rate and other key assumptions**
  - Sensitivity analysis

Refer to HKAS 36 for the list of disclosure requirements

Common issues

- Projected growth rates appeared unrealistically high
- Projected cash flows include tax payments, future enhancement costs and benefits, restructuring etc
- Projected cash flows appear not coming from the CGU / assets
- Discount rate appeared unreasonably low
- Apply a pre-tax cash flow on WACC
- Double counting of risk
- Impairment test of goodwill relating to non-wholly-owned subsidiaries

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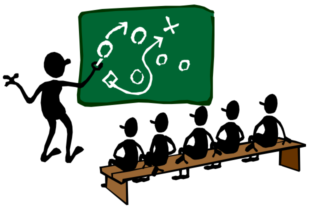
A Refresher Course on Current Financial Reporting Standards 2015 (Day 6)

HKFRS 13
Fair value measurement



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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: 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
- Aligned IFRSs and US GAAP to have the same definition and meaning of fair value and the same disclosure requirements about fair value measurements
- 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

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

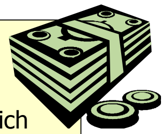
- An exit price
- Same as in US GAAP
- Emphasizes fair value as a market-based measurement, not an entity-specific measurement

- Factors to consider in fair value measurement:
  a. the asset or liability
  b. the market
  c. market participants
  d. the price
- Other specific considerations:
  a. non-financial assets
  b. liabilities
  c. equity
  d. financial assets and financial liabilities with offsetting positions

A. 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

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

How would you measure the fair value of the equity instrument?

- 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
- 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

Example 2 – Restriction on the use of an asset

- A donor contributes land to a not-for-profit neighbourhood association, which currently uses it 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
- 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)

What are the characteristics of the land that should be consider when measuring its fair value?

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

(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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B. The transaction/the market

A fair value measurement assumes that the transaction to sell the asset or transfer the liability take place either:

- ***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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C. 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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D. 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
- 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

Company M holds an asset that is traded in three different markets as follows:
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Transport costs	(3)	(3)	(4)
Possible fair value	47	45	49
Transaction costs	(1)	(2)	(2)
Net proceeds	46	43	47

Principal market

Most advantageous market

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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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A. Highest and best use for non-financial assets

- 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
- Does not apply to financial instruments, liabilities or equity
- 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
- 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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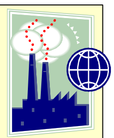
Example 2 – Highest and best use



- 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 the higher of :

1) 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); and
2) the value of the land as a vacant site for residential use (ie on a stand-alone basis), taking into account :
   (i) costs of demolishing the factory; and
   (ii) 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

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B. Liabilities and an entity's own equity instruments

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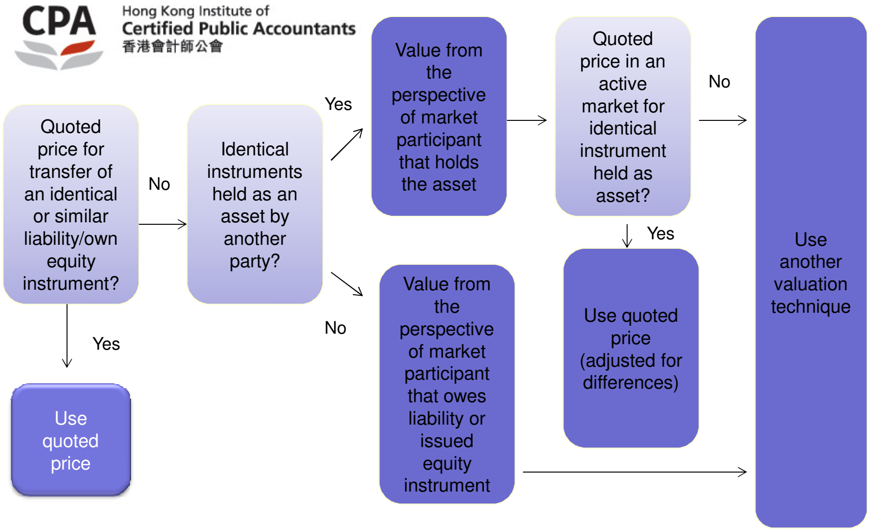

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C. Financial instruments

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
  →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
- 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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D. 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

Valuation techniques	Description	Examples
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	Valuation techniques using market multiples derived from comparable transactions
Cost approach	• 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	Depreciated replacement cost method
Income approach	Converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount	Discounted cash flows, option pricing models

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Part 6
Fair value hierarchy

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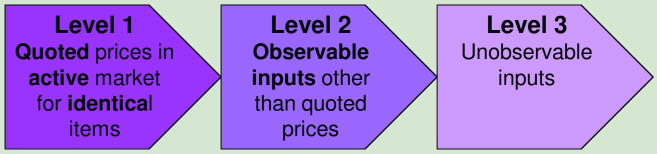
Fair value hierarchy



- Highest priority to Level 1 inputs
- Lower priority to Level 3 inputs
- Based on inputs to valuation techniques used to measure fair value, not the valuation techniques used to measure fair value
- Item categorised in its entirety based on the lowest level of significant input

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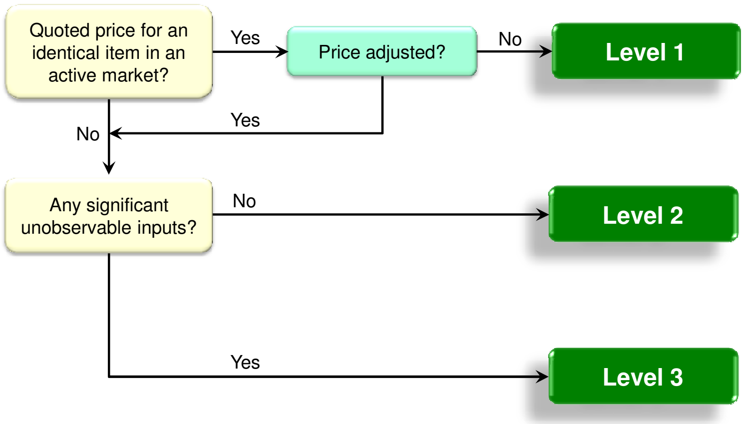
Fair value hierarchy



Which levels of fair value hierarchy do the following fair value measurement belong to?

Properties	Valuation methods and inputs	Which levels?
Example 1: A residential apartment in Kowloon Tong	- Market approach - recent transaction prices of similar units in the same block of building - HK$20k / sq ft x 1,000 sq ft	
Example 2: Same as example 1	- Same as example 1 - Certain adjustments made include: (-3%) for floor level , (+2%)for size, (+3%) for interior decoration	
Example 3: A commercial property in Central	- Income capitalisation approach - Major inputs include contracted annual rent, capitalisation rate, market rents etc.	
Example 4: Properties under development in Tseung Kwan O	- Residual approach - Projected value upon completion less expected costs to completion with adjustments for profit margin and risk for holding/developing the property	

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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
- Some of the indicators include:
  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
  e. Wide bid-ask spread or significant increase in the bid-ask spread
  f. Significant decline in the activity of, or there is an absence of, a market for new issues for the (or similar) asset or liability
  g. 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 <u>does not</u> 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

- 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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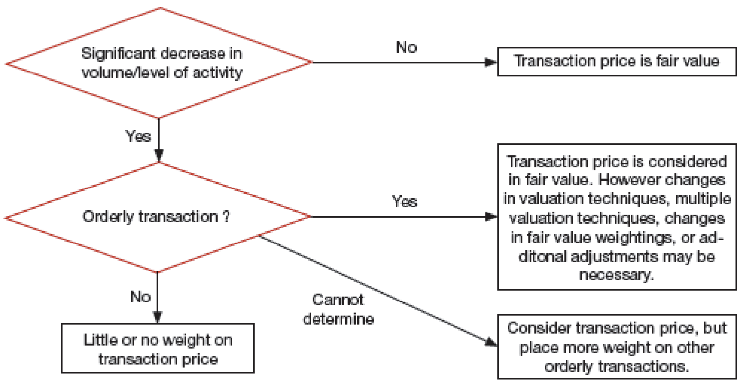
Considerations in determining the level of reliance on market prices



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Part 7
Disclosures

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Disclosures

- Disclose information that helps users to assess
  - for assets and liabilities measured at fair value on a recurring or non-recurring basis after initial recognition, valuation techniques and inputs used to develop those measurement
  - for recurring fair value measurement using significant unobservable inputs (Level 3), the effect of measurement on profit or loss or other comprehensive income for the period
- Fair value disclosures are required depending upon the nature of the fair value measurement (e.g. whether it is recognised in the financial statements or merely disclosed) and the level in which it is classified
- Disclosures are required separately for each class of assets and liabilities

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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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Disclosures

	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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Disclosures

	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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Please refer to HKFRS 13 for details of disclosure requirements.

	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)	✓		

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Part 8
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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