Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Property related standards	• Case study • Group discussion	Ch. 4, 5, 6 and 8	Pg. 1 – 33
3. Resolving accounting issues	• Case study • Group discussion	Ch. 11, 14, 15 and 22	Pg. 34 – 45
4. Wrap up	• Presentation • Group discussion		
Workshop 2			
5. Reboot	• Presentation • Group discussion		To be released after completion of Workshop 2
6. Financial Instruments	• Case study • Group discussion	Ch. 18	
7. Consolidation	• Case study • Group discussion	Ch. 19, 27, 28, 29 and 30	
8. Leading a team and teamwork	• Group discussion		
9. Conclusion	• Presentation • Group discussion		

Property related standards – recognition

Case study 1

(a) Supermarket Chain Company (SCC) owns hundreds of large supermarkets and is expanding its operations continually. It purchased an office building in October 2010 with the original objective of developing it for SCC's head office. However, the management of SCC decided in January 2011 not to develop the office building for use as its head office. The office building is close to an airport, and because market prices for buildings in that location are increasing, SCC decided to keep the office building for future sale. Due to planning regulations, the office building can only be sold as a complete unit in one transaction.

From 1 April 2011, SCC allows one of its subsidiaries, Overnight Distribution Limited (ODL), to use approximately one third of the office building under an operating lease.

(b) Laurel Retail Company (LRC) owns shopping malls containing retail units which are leased out for rental income under operating leases to retailers. The retail units could be sold separately. LRC is not a retailer, and derives its income from property leases.

In order to diversify, on 1 October 2010, LRC purchased 100% of the share capital of Clothes Boutiques Limited (CBL), a clothing retailer. CBL has leased for several years 5 retail units in the Pacific Centre - a shopping mall containing 40 retail units which is owned by LRC.

Required:

In respect of (a) and (b) determine:

(i) which accounting standards are relevant,

(ii) the nature of each property, and

(iii) what recognition criteria should be used in the financial statements for the year ended 30 September 2011.

Hints:

You should only consider from the point of view of the company which owns the asset.

You should also consider whether there is any different accounting treatment in individual and group level financial statements.

Discussion points

Property related standards – recognition

Case Study 1 – SCC and LRC

What are the issues?

(a) SCC owns an office building which is held for capital appreciation. One third of the office building is leased to a subsidiary. The office building can only be sold as a complete unit in one transaction. The issues are:

- Does the office building qualify to be recognised as investment property?
- What are the implications of part of the office building being leased to a subsidiary?
- What valuation bases are available for the office building?

(b) LRC owns a shopping mall which is rented out in 40 separate retail units. Several units are leased to a subsidiary of LRC. The issues are similar to (a) above:

- Does the shopping mall qualify to be recognised as an investment property?
- What are the implications of part of the property being leased to a subsidiary?
- What valuation bases are available for the property?

Which accounting standards should be used?

HKAS 16: Property, plant and equipment

HKAS 40: Investment property

What are the requirements of the accounting standards?

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, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes

(b) sale in the ordinary course of business.

Owner-occupied property is property held by the owner (or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes. Owner-occupied property cannot qualify to be investment property.

(HKAS 40.5, LP Chapter 6 Section 1.1)

The standard provides the following examples of investment properties:

(a) Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

(b) Land held for a currently undetermined future use.

(c) A building owned by the reporting entity (or held by the entity under a finance lease) and leased out under an operating lease.

(d) A building that is vacant but held to be leased out under one or more operating leases.

(e) Property that is being constructed or developed for future use as investment property.

(HKAS 40.8, LP Chapter 6 Section 1.1)

(f) A building held by an entity and leased to a parent or another subsidiary. Note, however, that while this is regarded as an investment property in the individual entity's financial statements, in the consolidated financial statements this property will be regarded as owner-occupied (because it is occupied by the group) and will therefore be treated in accordance with HKAS 16.

(HKAS 40.15, LP Chapter 6 Section 1.1)

Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease) an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

(HKAS 40.10, LP Chapter 6 Section 1.1)

An entity shall choose as its accounting policy either the fair value model or the cost model and shall apply that policy to all of its investment property.

(HKAS 40.30, LP Chapter 6 Section 1.4)

How to apply the standards to the case

(a) **SCC**

SCC individual financial statements

The office building was originally purchased for future development into SCC's head office. If this was still the case, the office building could not be treated as investment property, because property held for future development before owner-occupation cannot be classified as investment property.

(HKAS 40.9 (c), LP Chapter 6 Section 1.1)

However, in January 2011, the management of SCC decided that the office building would not be developed for future owner-occupation, and instead would be held for future sale as the market price is increasing. The office building now meets the definition of investment property as assets held for long-term capital appreciation are an example of an investment property.

(HKAS 40.7, LP Chapter 6 Section 1.1)

Therefore from January 2011 the office building is recognised as investment property in SCC's financial statements.

From April 2011 one third of the office building is leased under an operating lease to a subsidiary of SCC. In SCC's individual financial statements, the part of the office building leased out should still be classified as investment property. Where an asset is leased to a group member, the lessor treats the property as investment property in its individual financial statements.

(HKAS 40.15 LP Chapter 6 Section 1.1 (f))

SCC has a choice of accounting policy for the office building. If the fair value model is used, the asset must be remeasured each year end and depreciation is not charged. Changes in fair value of investment properties are taken to the income statement and form part of profit or loss for the year.

If the cost model is used, then the asset falls under the scope of HKAS 16 Property, Plant and Equipment, with the asset measured at cost less accumulated depreciation.

(HKAS 40.30, LP Chapter 6 Section 1.4)

SCC consolidated financial statements

In SCC's consolidated financial statements consideration needs to be given as to whether the office building can still be classified as investment property. The issue is that at group level, in the consolidated accounts, that portion of the office building which is leased to the subsidiary is now owner-occupied as it is occupied by a group member.

The key issue here is whether the portion of the office building leased to the group member i.e. owner-occupied from the group's point of view could be sold separately**.**

(HKAS 40.10, LP Chapter 6 Section 1.1)

If the part of the office building occupied by the subsidiary could be sold separately, then the asset can be apportioned into component parts, and the portion which is owner–occupied (i.e. leased to the subsidiary) treated as an asset in its own right. It would not qualify as investment property because it is owner-occupied. It would have to be accounted for as Property, Plant and Equipment under HKAS 16. Then the component of the office building not leased to the subsidiary would be treated as a separate asset. It meets the definition of investment property and would be accounted for under HKAS 40.

However, in this case, the office building can only be sold as a complete unit, and the portion leased to the subsidiary cannot be sold in a separate transaction. In such a situation the office building cannot be separated into component parts and must be treated as a single asset. The whole office building can only be classified as investment property if an insignificant part of the property is owner-occupied. Because one third of the office building is leased to the subsidiary, this is not insignificant, and therefore at group level the office building cannot be classified as investment property. It must be treated as Property, Plant and Equipment under HKAS 16.

(b) **LRC**

<u>LRC individual financial statements</u>

The shopping mall meets the definition of an investment property, as it is held in order to earn rental incomes, and it is not owner-occupied. The fact that several units are rented to a subsidiary is irrelevant in determining the accounting treatment at the individual company level.

(HKAS 40.5, LP Chapter 6 Section 1.1)

LRC has a choice of accounting policy for its investment properties, which may be measured at cost or at fair value. If the fair value model is used, the asset must be remeasured each year end and depreciation is not charged. Changes in fair value of investment properties are taken to the income statement and form part of profit or loss for the year.

If the cost model is used, then the asset falls under the scope of HKAS 16 Property, Plant and Equipment, and the asset held at cost less accumulated depreciation.

(HKAS 40.30, LP Chapter 6 Section 1.4)

The choice of accounting policy for investment properties must be consistently applied across all of LRC's investment properties.

<u>LRC consolidated financial statements</u>

In the year ended 30 September 2011, from the group perspective, the shopping mall is partly owner-occupied because CBL, a member of the group, occupies 5 of the 40 retail units. Owner-occupied properties do not qualify as investment properties, and instead should be recognised under HKAS 16 Property, Plant and Equipment.

In this case the shopping mall can be separated into component parts which can be accounted for separately, as each of the retail units is leased separately and could be sold separately. If an asset can be separated into portions that could be sold separately (or leased out separately under a finance lease) an entity accounts for the portions separately.

(HKAS 40.10, LP Chapter 6 Section 1.1)

Therefore at group level, the shopping mall should be apportioned so that 35/40 is recognised as an investment property, with the remaining 5/40 recognised as property, plant and equipment because it is owner-occupied.

Recommendation / justification

SCC can recognise its office building as investment property in its individual financial statements, but at group level the office building must be accounted for as Property, Plant and Equipment. This is because from the group's point of view a significant part of the asset (one third) is owner occupied and cannot be separately accounted for because the office building can only be sold in a single transaction.

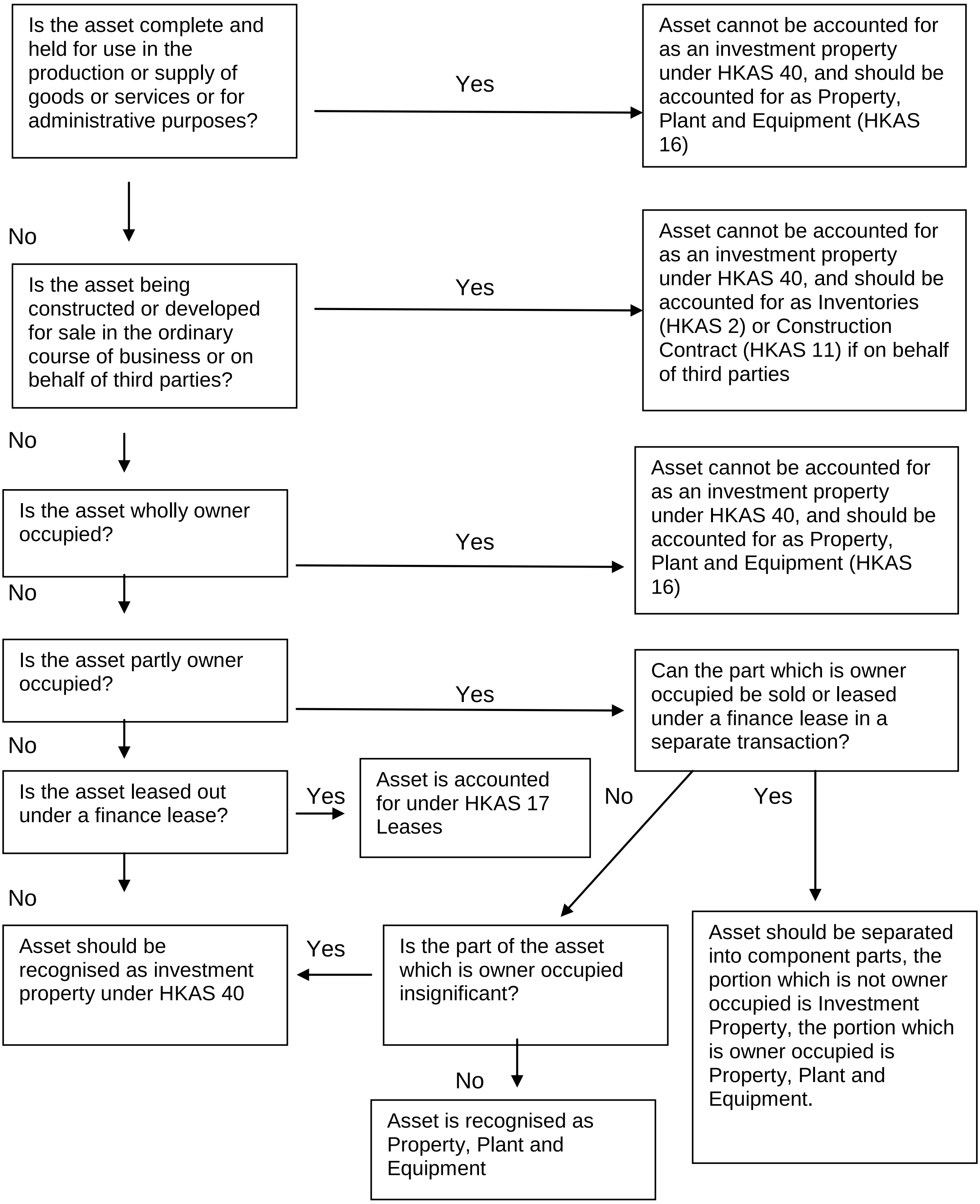
LRC can recognise the shopping mall as investment property in its individual financial statements, and at group level the portion of the shopping mall not leased to a subsidiary can continue to be recognised as investment property. This is because the retail units could be sold separately and can therefore be accounted for separately.

Key Learning Points:

1. Owner-occupied properties may not be classified as investment properties.
2. Where part of an investment property is leased to a group member under an operating lease, it is still treated as investment property in the lessor's individual financial statements.
3. Where part of an investment property is leased to a group member under an operating lease, at group level the part leased to group member is owner-occupied.
4. Whether the part leased to group member can be separately sold or leased under a finance lease determines the accounting treatment at group level.

Key Learning Points

Classification as investment property – decision tree



Property related standards – measurement

Case study 1 – additional information

Additional information is provided about the value of LRC's shopping mall, the Pacific Centre:

	Market value	Depreciated replacement cost
	HK$ '000	HK$ '000
1 October 2009	250,000	220,500
30 September 2010	280,000	230,000
30 September 2011	265,000	210,000

The market values had been provided by an independent property valuer, and reflect actual market conditions.

An extract from LRC's accounting policy note is shown below:

'It is group accounting policy to measure Property, Plant and Equipment at historic cost in accordance with HKAS 16, and a depreciation rate of 10% per annum is applied to buildings.

It is group accounting policy to measure Investment Property using the fair value model.'

At 30 September 2011 the recoverable amount of the shopping mall exceeds its carrying value.

Required:

(a) In respect of the Pacific Centre determine for the years ended 30 September 2010 and 2011:

(i) the amount at which it will be measured in the individual financial statements of LRC,

(ii) the amount at which it will be measured in the consolidated financial statements, and

(b) As far as the information provided allows, draft the relevant part of the disclosure note for investment properties to appear in LRC's consolidated financial statements for the year ended 30 September 2011.

Discussion points

Property related standards – measurement

Case Study 1 – LRC

What are the issues?

LRC owns a shopping mall which is rented out in 40 separate retail units. Several units are leased to CBL, a subsidiary of LRC.

- How should the shopping mall be measured in the individual and group financial statements? The scenario provides LRC's accounting policies which need to be applied.
- In the group accounts the shopping mall is part owner-occupied from 1 October 2010 – this is dealt with as Property, Plant and Equipment so follows a different accounting treatment.
- There are specific disclosure requirements for investment properties.

Which accounting standards should be used?

HKAS 16: Property, plant and equipment

HKAS 40: Investment property

What are the requirements of the accounting standards?

(a)

An entity shall choose as its accounting policy either the fair value model or the cost model and shall apply that policy to all of its investment property.

(HKAS 40.30, LP chapter 6 Section 1.4)

Where the fair value model is chosen, the following rules apply:

(1) An entity that chooses the fair value model should measure all of its investment property at fair value, except in the extremely rare cases where this cannot be measured reliably. In such cases it should apply the HKAS 16 cost model.

(2) A gain or loss arising from a change in the fair value of an investment property should be recognised in net profit or loss for the period in which it arises.

(3) The fair value of investment property should reflect the actual market conditions at the end of the reporting period.

(HKAS 40.35, 38, LP Chapter 6 Section 1.4.1)

Using the fair value model, investment properties are not depreciated.

If an entity chooses to use the cost model for its investment properties, the investment property should be measured at depreciated cost, less any accumulated impairment losses. (This means that the investment property is accounted for according to HKAS 16 Property, Plant and Equipment.)

(HKAS 40.56, LP Chapter 6 Section 1.4.3)

If an entity chooses the cost model, it should disclose the fair value of its investment property.

(b)

HKAS 40 contains detailed disclosure requirements. The following must be disclosed:

- Whether an entity applies the cost model or fair value model
- Whether property interests held as operating leases are included in investment property
- Criteria for classification as investment property
- Methods used to determine fair value and assumptions made
- Use of independent professional valuer (encouraged but not required)
- Amounts recognised in profit or loss for:
  - rental income from investment property
  - direct operating expenses from property that did generate rental income
  - direct operating expenses from property that did not generate rental income
  - cumulative change in fair value recognised in profit or loss on sale of an investment property from a pool of assets in which the cost model is used to a pool in which the fair value model is used
- Any restrictions or obligations associated with the investment property

For entities using the fair value model to measure investment properties there are additional disclosure requirements:

- A reconciliation of the carrying amount of the investment property at the beginning and end of the period, including separate details for those properties for which reliable fair value cannot be determined

- Disclosure of adjustments to valuations obtained (for example to avoid double counting)

- Where fair value cannot be established reliably:
    - A description of the property
    - Explanation of why fair value cannot be established reliably
    - A range of estimates within which fair value is likely to lie (where possible)
    - The carrying amount of any property disposed of and gain or loss recognised.

(HKAS 40.75, 76, LP Chapter 6 Section 1.8)

How to apply the standards to the case

(a) LRC individual financial statements

In LRC's individual financial statements, the whole shopping mall is treated as investment property (as justified in previous case study : *The shopping mall meets the definition of an investment property, as it is held in order to earn rental incomes, and it is not owner-occupied. The fact that several units are rented to a subsidiary from 1 October 2010 is irrelevant in determining the accounting treatment at the individual company level.*)

The case study states that the fair value model is the group's accounting policy for investment property. Therefore at each year end, the investment property must be revalued to market value to reflect the actual market conditions at the end of the reporting period.

Depreciated replacement cost is not relevant to the valuation of the asset at the year end as the market value of the shopping mall can be established.

Any revaluation gains or losses are recognised in profit or loss and the investment property is not depreciated.

The investment property should be accounted for as follows:

Year ended 30 September 2010

	HK$'000	**Accounting entry**
Opening carrying value 1 October 2009	250,000	
Revaluation gain	30,000	**Debit** Investment Property **Credit** Statement of Comprehensive Income
Closing carrying value 30 September 2010	280,000	

HKAS 40 does not specify where the credit to the statement of comprehensive income should be disclosed. Because LRC generates its income from property rentals, it would most likely choose to disclose the credit as other operating income.

Note that the revaluation gain is the only amount recognised in profit or loss for the year in respect of the investment property, as no depreciation is charged on the asset.

Year ended 30 September 2011
The asset continues to be accounted for as investment property. The fact that it is partly leased to a subsidiary from 1 October 2010 does not affect its classification in the individual accounts.

	HK$'000	Accounting entry
Opening carrying value 1 October 2010	280,000	
Revaluation loss	(15,000)	**Debit** Statement of Comprehensive Income **Credit** Investment Property
Closing carrying value 30 September 2011	265,000	

The revaluation loss is recognised in profit or loss for the year. The double entry for the revaluation loss effectively reverses part of the revaluation gain recognised in the previous year.

LRC consolidated financial statements

Year ended 30 September 2010

The accounting treatment for the shopping mall for 2010 is straightforward and is the same as the treatment in LRC's individual financial statements. This is because the property is not wholly owner-occupied and accounted for at fair value. No consolidation adjustment is required as LRC have not acquired CBL.

Year ended 30 September 2011

As justified in the previous case study: *From 1 October 2010, from the group perspective, the shopping mall is partly owner-occupied because CBL, a member of the group, occupies 5 of the 40 retail units. Owner-occupied properties do not qualify as investment properties, and instead should be recognised under HKAS 16 Property, Plant and Equipment.*

In this case the shopping mall can be separated into component parts which can be accounted for separately, as each of the retail units is leased separately and could be sold separately. According to HKAS 40 if these portions could be sold separately (or leased out separately under a finance lease) an entity accounts for the portions separately.

Therefore from 1 October 2010 the shopping mall is separated into two component parts. The accounting treatment for the 5 owner-occupied retail units must be according to HKAS 16 Property, Plant and Equipment. Group accounting policy is that Property, Plant and Equipment is measured at cost, and to apply a depreciation rate of 10% per annum. This accounting treatment should be applied to 5 of the 40 retail units of the shopping mall. This portion of the shopping mall should not be revalued at the year end.

The remaining 35 of the 40 retail units must continue to be measured using the fair value model of HKAS 40, with revaluation gains or losses recognised in profit or loss for the year, and no depreciation should be charged.

On 1 October 2010 therefore the carrying value of the shopping mall of HK$ 280 million must be allocated between the two components and accounted for as follows:

1. Allocated to property, plant and equipment: 280 million x 5/40 = HK$35 million

   Depreciation must be charged at 10% per annum according to group accounting policy, so the consolidated financial statements must include depreciation expense of HK$ 3.5 million.

2. Allocated to investment property: 280 million x 35/40 = HK$245 million

Revaluation loss must be recognised at 35/40 of the revaluation loss recognised in the consolidated financial statements: 15,000 x 35/40 = HK$ 13.125 million.

A summary of the required accounting treatment in the consolidated financial statements is shown below:

Property, plant and equipment	**HK$'000**
Reclassification on 1 October 2010	35,000
Depreciation at 10%	(3,500)
Closing carrying value 30 September 2011	31,500

Investment property	**HK$'000**
Opening carrying value 1 October 2010	245,000
Revaluation loss	(13,125)
Closing carrying value 30 September 2011	231,875 (w)

(w) Closing value of investment property = 265 million x 35/40 = HK$231.875 million

Therefore consolidation adjustments must be made in order to reflect the above in the consolidated financial statements:

		HK$'000	**HK$'000**
DR	Property, plant and equipment	35,000	
CR	Investment property		35,000
	Being initial reclassification at 1 October 2010		
DR	Depreciation expense	3,500	
CR	Property, plant and equipment		3,500
	Being depreciation charge on PPE		
DR	Investment property	1,875	
CR	Income statement		1,875
	Being difference in revaluation loss recognised at group level		

A reconciliation of the investment property recognised at individual and at group level at 30 September 2011 helps to illustrate the accounting impact described above:

Investment property	**HK$'000**
Recognised in LRC individual accounts	265,000
Reclassified to PPE in group accounts	(35,000)
Reduction in revaluation loss in group accounts	1,875
Recognised in LRC group accounts	231,875 (w)

(b) LRC's consolidated financial statements should contain the following disclosure note for the year ended 30 September 2011:

Description of accounting policy

LRC uses the fair value model to measure investment properties. The Pacific Centre shopping mall meets the criteria to be classified as an investment property because it is not used in the production or supply of goods or services or for administrative purposes, is not held for sale, and is not owner-occupied.

Fair value has been determined by an independent property valuer, and is based on market values reflecting conditions at the reporting date.

The Pacific Centre generated rental income of HK$ X during the year. Also included in the statement of comprehensive income for the year is a loss recognised on the movement in fair value of the property of HK$ 13.125 million.

A reconciliation of the opening and closing balance for the property is given below:

	30 September 2011 HK$'000	**30 September 2010 HK$'000**
Opening carrying value 1 October	280,000	250,000
Reclassified to Property, plant and equipment	(35,000)	-
Revaluation (loss) / gain	(13,125)	30,000
Closing carrying value 30 September	231,875	280,000

Recommendation / justification

Year ended 30 September 2010

The shopping mall is treated as an investment property and measured at fair value of HK$ 280 million in both the individual and consolidated financial statements, with a revaluation gain of HK$ 30 million recognised in profit.

Year ended 30 September 2011

The acquisition of a subsidiary which leases a portion of the shopping mall affects the shopping mall's accounting treatment in the consolidated accounts. The asset is treated as two separate components and its carrying value at the year end is:

Component owner-occupied (held at cost less depreciation):	HK$ 31,500,000
Component not owner-occupied (held at fair value):	HK$ 231,875,000
Total carrying value:	HK$ 263,375,000

Key Learning Points

1. Entities have a choice to measure investment properties at cost or at fair value.
2. If the fair value model is used:
    - The asset is remeasured to market value at the reporting date
    - The revaluation gain or loss must be recognised in profit or loss
    - The asset is not depreciated
    - Specific disclosures must be made in notes to the financial statements
3. If the cost model is used the asset should be measured and disclosed according to HKAS 16. The fair value of the property must be disclosed in a note to the financial statements.
4. Investment properties which are partly owner occupied, and where the component parts could be sold separately, must be accounted for in component parts at group level.

Property related standards – recognition

Case study 2

Poppy Manufacturing Limited (PML) operates a number of manufacturing plants producing large items of machinery to customer specifications. The company has a financial year ended 30 September 2011. Due to a change in the company's business strategy, PML has evaluated the future use of two of its manufacturing plants. Each manufacturing plant is a cash generating unit.

(a) Manufacturing Plant A

On 1 April 2011, the board of PML committed to a plan to sell Plant A, and began to market it. Plant A manufactures high technology machinery and the board concluded that a purchaser would be found within 9 months. PML intends to sell all of the assets of Plant A (including property, plant and equipment, goodwill and inventories) with its operations and any uncompleted customer orders at the sale date will be transferred to the purchaser. Plant A is being marketed at HK$600 million, which is a fair value established by an independent business advisor.

(b) Manufacturing Plant B

On 30 June 2011, the board of PML committed to sell Plant B, and began to market it. Plant B's operations ceased on 31 July 2011. Only the property, plant and equipment of Plant B is for sale, comprising a large factory and warehouse, which are being marketed subject to PML obtaining planning permission for conversion of the buildings. The planning permission has been applied for, but a decision will not be made until November 2011.

Required:

In respect of (a) and (b):

(i) determine which accounting standards are relevant,

(ii) explain and justify how each manufacturing plant should be classified and measured in the financial statements for the year ended 30 September 2011.

Discussion points

Property related standards – recognition

Case Study 2 – PML

What are the issues?

Assets or groups of assets (disposal groups) should be classified as held for sale if certain criteria are met. This is important because classification as held for sale impacts the measurement and disclosure of the assets in the financial statements. In this case study students need to determine and discuss:

(i) whether the held for sale criteria have been met for each manufacturing plant,

(ii) how the assets should be classified, and whether they should be treated as individual assets or as disposal groups, and

(iii) the recognition and measurement of the assets / disposal groups.

Which accounting standards should be used?

HKFRS 5 - Non-current assets held for sale and discontinued operations

HKAS 16 – Property, plant and equipment

What are the requirements of the accounting standards?

HKFRS 5 states that a non-current asset (or disposal group) should be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through its continuing use.

In order for this to be the case:

(a) the asset must be available for immediate sale in its present condition, and

(b) its sale must be highly probable (i.e., significantly more likely than not).

(HKFRS 5.7, LP Chapter 4 Section 2)

Further guidance is given on determining whether a sale is highly probable. The following criteria should be applied, with the standard implying that all criteria should be met in order to classify as held for sale:

(a) Management must be committed to a plan to sell the asset.

(b) There must be an active programme to locate a buyer.

(c) The asset must be actively marketed for sale at a price that is reasonable in relation to its current fair value.

(d) The sale should be expected to take place within one year from the date of classification.

(e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

(f) The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

(HKFRS 5.8, LP Chapter 4 Section 2.1)

The above criteria may be applied to an individual asset, or to a group of assets known as a disposal group. A disposal group is defined as 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. A disposal group could be a subsidiary, a cash generating unit or a single operation within an entity.

(HKFRS 5 Appendix A, LP Chapter 4 Section 1.1)

When an asset or disposal group is classified as held for sale certain accounting implications arise:

Measurement - On transfer to the held for sale category, a non-current asset (or the net assets of a disposal group) should be measured at the lower of carrying amount and fair value less costs to sell. In practice this means that an impairment test is conducted on transfer to the held for sale category.

(HKFRS 5.15, LP Chapter 4 Section 3.1)

Subsequent measurement - Once classified as held for sale (or part of a disposal group held for sale), a non-current asset is not depreciated or amortised.

(HKFRS 5.25, LP Chapter 4 Section 3.2)

Presentation - The major classes of assets and liabilities held for sale should be separately disclosed either in the statement of financial position or in a note, and should not be offset.

(HKFRS 5.38, LP Chapter 4 Section 4.1)

How to apply the standards to the case

Manufacturing Plant A

The issue is whether Plant A should be classified as held for sale from 1 April 2011. It seems that Plant A meets the definition of a disposal group, as it is a collection of assets which is a cash generating unit, and the group of assets are to be sold as a group in a single transaction.

(HKFRS 5 Appendix A, LP Chapter 4 Section 1.1)

Having determined that Plant A is a disposal group, the next step is to apply the criteria of HKFRS 5 to see if it should be classified as held for sale.

The **first criterion** is that the asset or disposal group must be **available for immediate sale in its present condition.** This means that there must be the intention and ability to sell the asset or disposal group in its present condition.

(HKFRS 5.7, LP Chapter 4 Section 2)

The impact of the uncompleted customer orders is important in determining whether Plant A can be sold in its present condition. The case study states that the whole operations of Plant A, including any uncompleted orders will form part of the sale transaction, and therefore the assets contained in Plant A are capable of being sold in their current condition as the purchaser will be purchasing not just the assets but also the operations being carried out by the assets. Therefore the first criterion in determining whether Plant A should be classified as held for sale has been met.

The **second criterion** is that the sale must **be highly probable**, and guidance is given in HKFRS 5 about applying this criterion. HKFRS 5 suggests that for this criterion to be met, an appropriate level of management must be **committed to a plan to sell** and have the authority to sell the asset or disposal group. The fact that the board of PML have committed to the plan indicates that there is intention to sell Plant A.

(HKFRS 5.8, LP Chapter 4 Section 2.1)

In addition, there should be an **active programme** to locate a buyer and complete the sale. The case study states that the board have begun to market Plant A, indicating that an active programme has commenced.

HKFRS 5 also suggests that the asset / disposal group must be **marketed at fair value** if it is to be classified as held for sale. The case study indicates that this is the case, as Plant A's fair value has been established by an independent business advisor, and marketed at that value.

The board of PML have begun to market Plant A and consider that a purchaser will be found within 9 months. HKFRS 5 states that for a sale to be classified as highly probable, and therefore meeting the held for sale criteria, the sale should be expected to take place **within 12 months**. Therefore this part of the criteria has been met.

Therefore, it appears that both classification criteria (i.e. available for sale in immediate condition, and highly probable sale) have been met for Plant A, which therefore should be classified as a held for sale disposal group from 1 April 2011.

<u>Manufacturing Plant B</u>

Plant B is also a disposal group, comprising several items of property, plant and equipment.

The issue is whether Plant B should be classified as held for sale from 30 June 2011. The same criteria as discussed above for Plant A should be applied i.e.:

(a) the asset must be available for immediate sale in its present condition, and

(b) its sale must be highly probable (i.e., significantly more likely than not).

(HKFRS 5.7, LP Chapter 4 Section 2)

In this situation, Plant B's sale seems dependent on planning permission being obtained to convert the assets to a different use. In such a case the properties are not available for sale in present condition as the plant is being marketed on the basis of the planning permission being granted, which has not yet occurred. Therefore Plant B cannot be classified as held for sale until the planning permission is obtained.

Plant B must remain classified as Property, Plant and Equipment and accounted for under HKAS 16 in this accounting period.

Recommendation / justification

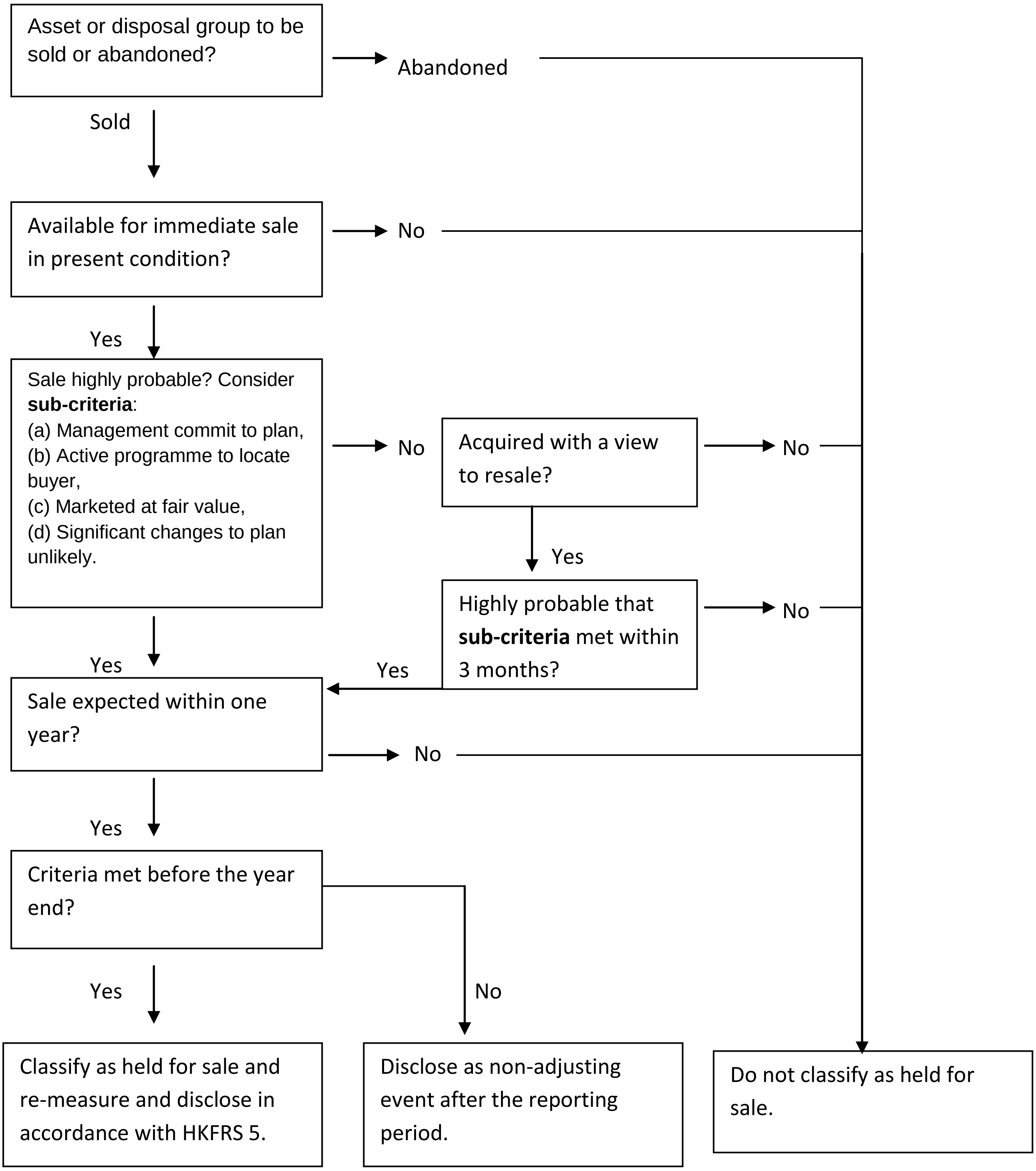
Plant A must be classified as a disposal group held for sale from 1 April 2011. From that date the assets must not be depreciated (even though they are still in operational use). The disposal group should be measured at lower of carrying value and fair value less costs to sell, with any loss recognised in profit and loss.

Plant B should remain classified as Property, Plant and Equipment as the HKFRS 5 criteria for classification as held for sale have not been met. The assets should be tested for impairment as there is indication that their recoverable amount may be less than carrying value.

Key Learning Points

The criteria of HKFRS 5 must be applied to determine whether an asset or disposal group should be classified as held for sale. The application of the criteria can be subjective (e.g. determining whether sale is “highly probable” may depend on management judgment).

The following decision tree summarises the application of the HKFRS 5 criteria to an asset or disposal group.



Property related standards – measurement

Case study 2 (PML) – additional information

Further information is now provided in respect of Manufacturing Plant A.

At 1 April 2011, the carrying values of the assets of Plant A were as follows:

	HK$ million
Buildings	300
Plant	150
Other items of property, plant and equipment	50
Goodwill	30
Inventories	110
Other current assets	35
Total	675

An independent business advisor has determined that the fair value of Plant A's assets and operations is HK$ 600 million at 1 April 2011. In order to successfully sell the assets and operations, management estimate that selling costs of HK$ 50 million will be incurred.

PML's accounting policy is to depreciate buildings at a rate of 5% per annum, and plant and other items of property, plant and equipment at 15% per annum.

At 30 September 2011, Plant A's inventories have a carrying value of HK$ 50 million, and other current assets are valued at HK$ 20 million. There are no changes to the fair value of Plant A's other assets at 30 September 2011.

In August 2011 the board of PML discussed the planned sale of Plant A. An extract from the board minutes contains the following: "We are pleased with the progress made in selling Plant A, several potential purchasers have been identified and we are confident that the sale will take place by December 2011. We are selling Plant A due to a decline in demand for the type of machinery made at the plant, and the proceeds of the disposal will be used for strategic expansion into a new market."

Required:

(a) Determine the amount at which the assets of Plant A should be measured in PML's statement of financial position:

(i) at 1 April 2011, and

(ii) prepare the necessary journals to be posted.

(b) Determine the carrying amount of Plant A at 30 September 2011.

(c) Prepare any necessary disclosure notes required in the financial statements for the year ended 30 September 2011 in respect of Plant A.

Discussion points

Property related standards – measurement

Case Study 2 – PML

What are the issues?

Assets held for sale are subject to specific measurement, presentation and disclosure requirements. Students need to demonstrate understanding of:

(i) Which assets should be included in a disposal group.

(ii) How a disposal group should be measured on transfer to the held for sale category, including the allocation of any impairment loss.

(iii) The subsequent measurement rules for assets in a disposal group.

(iv) The specific disclosure requirements for assets in a disposal group.

Which accounting standards should be used?

HKFRS 5 - Non-current assets held for sale and discontinued operations

What are the requirements of the accounting standards?

When an asset or disposal group is classified as held for sale certain accounting implications arise:

Measurement - On transfer to the held for sale category, a non-current asset (or the net assets of a disposal group) should be measured at the lower of carrying amount and fair value less costs to sell.

(HKFRS 5.15, LP Chapter 4 Section 3.1)

Where fair value less costs to sell is lower than carrying amount, the asset or disposal group held for sale must be reduced in value, and the difference between carrying amount and fair value less costs to sell must be recognised as an impairment loss. Assets held for sale are outside the scope of HKAS 36 Impairment of Assets, and the guidance on impairments provided within HKFRS 5 applies instead.

(HKFRS 5.20, LP Chapter 4 Section 3.3)

The loss recognised for a disposal group reduces the carrying amount of the non-current assets of the disposal group that are within the scope of HKFRS 5 in the following order:

1. Any goodwill within the disposal group
2. Other assets on a pro rata basis.

(HKFRS 5.23, LP Chapter 4 Section 3.3)

Subsequent measurement - Once classified as held for sale (or part of a disposal group held for sale), a non-current asset is not depreciated or amortised.

(HKFRS 5.25, LP Chapter 4 Section 3.2)

Presentation and disclosure - The major classes of assets and liabilities held for sale should be separately disclosed either in the statement of financial position or in a note, and should not be offset. Re-presentation of prior year comparatives is not required to reflect those assets classified as held for sale only in the current year.

(HKFRS 5.38-40, LP Chapter 4 Section 4.1)

The following disclosures are required when a non-current asset (or disposal group) is either classified as held for sale or sold during a reporting period:

(a) A description of the non-current asset (or disposal group)

(b) A description of the facts and circumstances of the disposal

(c) Any gain or loss recognised when the item was classified as held for sale

(d) If applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with HKFRS 8 Operating Segments.

(HKFRS 5.41, LP Chapter 4 Section 4.2)

How to apply the standards to the case

At 1 April 2011

The assets of the disposal group include all property, plant and equipment, goodwill and current assets, with a total carrying value of HK$ 675 million.

The disposal group's carrying value must be compared with its fair value less costs to sell to determine if any impairment loss needs to be recognised. The fair value of the disposal group is HK$ 600 million, and selling costs of HK$ 50 million are to be incurred, therefore the fair value less costs to sell of the disposal group is HK$ 550 million. Therefore on transfer to the held for sale category, the disposal group must be recognised at HK$ 550 million, and an impairment loss of HK$ 125 million (HK$ 675 million – HK$ 550 million) must be recognised.

(HKFRS 5.15, LP Chapter 4 Section 3.1)

The impairment loss of HK$125 million must be allocated in a specific order. The first asset to be written off is any goodwill contained in the disposal group. Plant A has HK$ 30 million of goodwill which will be written off in full. The remaining impairment loss is written off pro-rata over the other non-current assets of Plant A (see working below).

(HKFRS 5.23, LP Chapter 4 Section 3.3)

The current assets of the disposal group do not bear any impairment loss because they do not fall under the scope of HKFRS 5.

Working: Allocation of impairment loss of Plant A on transfer to the held for sale category.

	Initial carrying value at 1 April 2011 HK$ million	**Impairment loss HK$ million**	**Re-measured value on transfer to held for sale category HK$ million**
Buildings	300	*(57)	243
Plant	150	*(28.5)	121.5
Other items of property, plant and equipment	50	*(9.5)	40.5
Goodwill	30	(30)	-
Inventories	110	-	110
Other current assets	35	-	35
Total	**675**	**(125)**	**550**

*Allocation of impairment loss of HK$ 125 million calculated as follows:

1. Write off goodwill of HK$ 30 million in total.
2. Allocate remaining impairment loss of HK$ 95 million pro-rata:

Buildings:	95 x 300/500	= 57
Plant:	95 x 150/500	= 28.5
Other PPE	95 x 50/500	= 9.5

The journal to record the impairment loss on transfer of Plant A to the held for sale category is (HK$ million):

DR	Operating expenses	125
CR	Goodwill	30
CR	PPE	95

Subsequent measurement

From 1 April 2011 the measurement rules of HKFRS 5 apply to the non-current assets of the disposal group. The key implication is that non-current assets are not depreciated once they are classified as held for sale.

(HKFRS 5.25, LP Chapter 4 Section 3.2)

Therefore the non-current assets remain at their value on transfer to the category. The depreciation rates given in the case study are therefore irrelevant.

The current assets continue to be measured according to the relevant accounting standards, therefore at 30 September 2011 the inventories and other current assets should be measured at HK$ 50 million and HK$ 20 million respectively.

Plant A's assets should be recognised as follows in the statement of financial position at 30 September 2011:

	30 September 2011 HK$ million
Buildings	243
Plant	121.5
Other items of property, plant and equipment	40.5
Goodwill	-
Inventories	50
Other current assets	20
Total	**475**

Presentation and disclosure

At 30 September 2011, the combined assets of the disposal group should be separately presented in the statement of financial position. The prior year figures are not restated, therefore assuming that PML had no held for sale assets in 2010, presentation in the statement of financial position of PML is as follows:

	30 September 2011 HK$ millions	**30 September 2010 HK$ millions**
Non-current assets	X	X
Current assets	X	X
Assets of disposal group classified as held for sale	475	-
Total assets	**X**	**X**

Any liabilities of Plant A would be separately disclosed in the liabilities section of the statement of financial position and not netted off the HK$ 475 million disclosed in the assets section.

HKFRS 5 requires that the main categories of assets within the disposal group are separately disclosed, this is permitted to be disclosed in the notes to the financial statements.

In addition, further narrative and numerical disclosure is required according to HKFRS 5.41 to provide more information about the disposal group. Using the details given in the case study, a disclosure note could be provided as follows:

"PML announced on 1 April 2011 its intention to sell Manufacturing Plant A, which manufactures high technology machinery. Plant A's sale is expected to be completed by December 2011, and the proceeds from its sale will be used to finance strategic expansion. On 1 April 2011 the assets of Plant A were re-measured, and an impairment loss of HK$ 125 million was recognised in operating expenses for the accounting period."

Recommendation / justification

Plant A is impaired on its transfer to the assets held for sale category, and the impairment loss reduces its goodwill to a zero balance, and the other non-current assets are impaired on a pro-rata basis.

As required by HKFRS 5, the non-current assets are not subject to depreciation once they have been transferred to the assets held for sale category, but current assets need to be re-measured at the year-end as they are not in the scope of HKFRS 5.

Separate presentation is required for the assets held for sale in the statement of financial position at the year-end, and additional disclosure is required in the notes to the financial statements to enable users of the accounts to understand the type of assets contained in the disposal group, the amount of the impairment loss suffered on the transfer to the held for sale category, the facts and circumstances of the intended disposal, and the expected timing of the disposal.

Key Learning Points

1. Measurement of asset / disposal groups held for sale:

- At the time of classification as held for sale. Immediately before the initial classification as held for sale, the carrying amount of the asset / disposal group will be measured in accordance with applicable HKFRSs.
- On classification as held for sale. Non-current assets or disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.
- Any impairment loss is recognised in profit or loss (unless the asset had been measured at revalued amount).

2. Non-current assets or disposal groups that are classified as held for sale shall not be depreciated.

3. Assets classified as held for sale, and the assets and liabilities included within a disposal group classified as held for sale, must be presented separately on the face of the statement of financial position.

4. Disclosures:

- 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*

Resolving accounting issues

Case study 1

Geranium Manufacturing Limited (GML) manufactures garden furniture. The company's board of directors have met to discuss three matters which may need to be reflected in the financial statements for the year ended 31 August 2011:

(i) In September 2011 the internal auditors discovered a fraud involving inventories. The warehouse manager had been deliberately overstating the value of inventories to conceal thefts. It is estimated that inventory was overstated by HK$ 5.25 million at 31 August 2011.

(ii) On 4 October 2011 a court case involving GML reached a conclusion. GML were ordered to pay damages of HK$ 10 million to an employee who was seriously injured in an accident at GML's factory which happened in May 2011.

(iii) On 1 October 2011 GML began to implement a restructuring plan which will involve the closure of a major manufacturing facility. The plan was announced to the public on 15 September 2011, and it is now estimated that costs of closing the facility will be HK$ 3.5 million, of which HK$ 2.5 million relate to redundancy costs, and HK$ 1 million relate to retraining of employees.

GML's draft financial statements for the year ended 31 August 2011 report profit of HK$ 35 million, and total assets of HK$ 180 million. The financial statements are due to be authorised for issue on 31 October 2011, and do not currently reflect any of the events described above.

Required:

Using the information provided:

Discuss the implications of the matters discussed at the meeting for the financial statements of GML for the year ended 31 August 2011. Prepare any journals and necessary disclosures. Ignore tax.

Remark

You should use the 5-step thinking process to analyse the case study going forward.

Discussion points

Resolving accounting issues – events after the reporting period

Case Study 1 – GML

What are the issues?

GML's year end (i.e. end of the reporting period) is 31 August 2011. Three matters have arisen after the end of the reporting period which may need to be adjusted in the financial statements. Students will need to decide:

(i) whether the events are material

(ii) whether the events described are adjusting or non-adjusting events after the reporting period

(iii) the nature of any necessary adjustment or disclosure in the financial statements

Which accounting standards should be used?

HKAS 10 – Events after the reporting period

HKAS 37 – Provisions, Contingent Liabilities and Contingent Assets

What are the requirements of the accounting standards?

Events after the reporting period are those events, both favourable and unfavourable, which occur between the end of the reporting period and the date when the financial statements are authorised for issue.

(HKAS 10.3, LP Chapter 22, Section 5.2)

There are two types of event after the reporting period:

Adjusting events after the reporting period – these are events that provide evidence of conditions that existed at the end of the reporting period.

Non-adjusting events after the reporting period – these are events that do not provide evidence of conditions that existed at the end of the reporting period.

(HKAS 10.3, LP Chapter 22 Section 5.2)

Adjusting events, if material, should be reflected by adjustment to financial statements.

Non-adjusting events should not be adjusted in the financial statements, but they should be disclosed where material in a note to the financial statements. The note should describe the nature of the non-adjusting event, and an estimate of its financial effect (or a statement that such an estimate cannot be made).

(HKAS 10.8-10, LP Chapter 22 Section 5.4)

How to apply the standards to the case

GML's financial statements are due to be authorised for issue on 31 October 2011, and the three matters discussed by the board may need to be adjusted or disclosed before the financial statements are authorised.

(i) Inventory fraud

The discovery of the fraud in September 2011 happened after the end of the reporting period of 31 August, and is therefore an event after the end of the reporting period. The amount of the fraud is material at 5.25/35 = 15% of draft profit for the year. The key issue is whether the discovery provides evidence of a condition that existed at the end of the reporting period i.e. whether it meets the definition of an adjusting event according to HKAS 10.3.

The fraud and the related inventory loss both existed at the reporting date, therefore this meets the definition of an adjusting event. The discovery of a fraud that shows that the financial statements are incorrect is given as an example of an adjusting event in the accounting standard.

(HKAS 10.9 (e), LP Chapter 22 Section 5.3.1)

An adjustment is necessary to the financial statements to remove the material error caused by the fraud. The following journal should be made:

DR Cost of sales	HK$ 5.25 million
CR Inventory	HK$ 5.25 million

(ii) Settlement of court case

The settlement of the court case happens after the end of the reporting period, but it relates to a situation which occurred before the end of the reporting period. The settlement after the end of the reporting period of a court case that confirms the reporting entity had a present obligation at the end of the reporting period should be treated as an adjusting event.

(HKAS 10.9 (a), LP Chapter 22 Section 5.3.1)

The amount of damages is material at 10/35 = 29% of draft profit for the year. A provision should therefore be recognised at 31 August 2011 at HK$ 10 million. The following journal should be made:

DR Operating expenses	HK$10 million
CR Provisions	HK$ 10 million

A disclosure note should be included in the financial statements in accordance with HKAS 37 Provisions, Contingent Liabilities and Contingent Assets to explain the nature of the provision.

(iii) Restructuring

The implementation of the restructuring plan commences after 31 August 2011, so this is an event after the reporting period. As with the inventory fraud, the key issue is whether the implementation of the plan is an adjusting event.

The plan was announced on 15 September 2011, after the end of the reporting period, and so the implementation of the plan does not provide additional evidence of a year-end condition. The start of implementing the restructuring plan is therefore a non-adjusting event. Announcing, or commencing the implementation of a major restructuring plan is given as an example of a non-adjusting event given in the accounting standard.

(HKAS 10.22 (e), LP Chapter 22 Section 5.3.2)

Therefore, the financial statements should not be adjusted, and the reported profit and total assets are unaffected by the restructuring plan.

However, disclosure is required of material non-adjusting events after the reporting period where non-disclosure could influence the economic decisions made by users.

(HKAS 10.21, LP Chapter 22 Section 5.4.2)

The costs of restructuring of HK$ 3.5 million amount to 10% of profit and 2% of total assets, so are material. Disclosure should therefore be made in a note to the financial statements to describe the restructuring plan and the amounts involved.

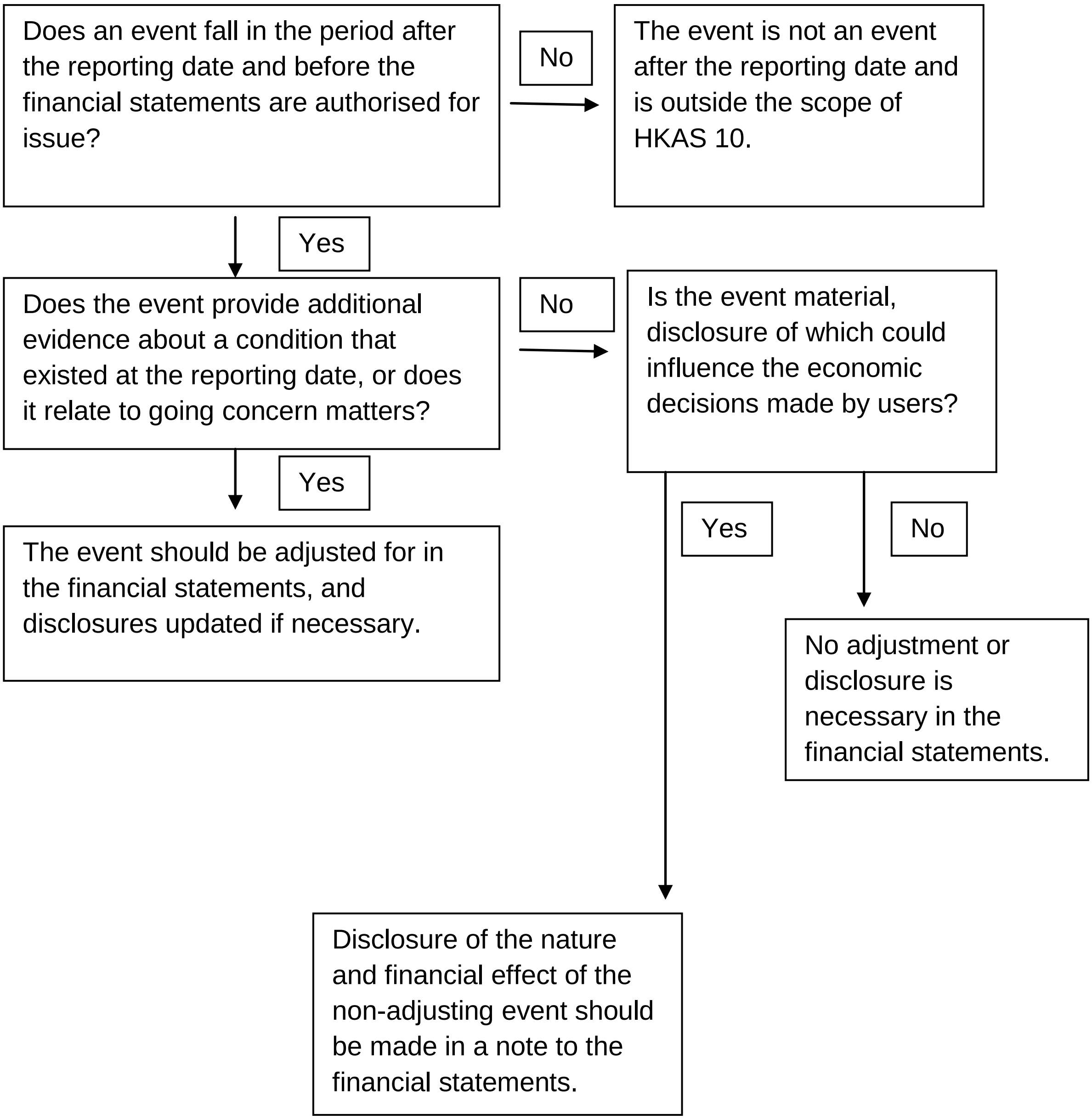
Recommendation / justification

GML's financial statements require adjustment for the adjusting events in respect of the fraud and the court case, which will result in a reduction of HK$ 15.25 million to profit, HK$5.25 million to total assets, and an increase of HK$10 million to total liabilities. The redrafted profit for the year ended 31 October 2011 will be HK$ 19.75 million (HK$ million 35 – 10 – 5.25), and the redrafted total assets will be HK$ 174.75 million (HK$ million 180 – 5.25).

The implementation of the restructuring plan is a non-adjusting event which requires disclosure, but not adjustment in the financial statements.

Key Learning Points

A decision tree for application of HKAS 10 is a useful summary of the key learning points:



Resolving accounting issues

Case study 2

Computer Supplies Limited (CSL) sells computer software to financial services companies, and provides a software support service to its customers. Once the software is installed at customers' premises, CSL has no continuing management involvement and bears no risks associated with the software. The details relating to transactions with two new customers are shown below:

(i) Software was successfully installed at Premier Investments Limited (PIL) on 1 October 2010. PIL has an in-house software support team, so CSL are supplying only the software and no support service to PIL. The total sales value of the software supplied is HK$ 100 million, and an invoice for this amount was raised on 1 October 2010. In order to secure this significant sale, CSL agreed at the time of the sale that PIL would pay half of the amount immediately, and half on 30 September 2013.

(ii) A sale has been negotiated with Financial Advisors Limited (FAL) with a total revenue of HK$ 25 million, which was paid on 31 July 2011. Part of this amount relates to off-the-shelf software, which was successfully installed at FAL's premises on 30 June 2011. The remainder of the revenue relates to a three-year software support service. When the off-the-shelf software is sold separately, its fair value is HK$16 million.

CSL has a financial year ended 30 September 2011, and has not yet accounted for the two transactions outlined above. CSL has an imputed rate of interest of 8%.

Required:

In respect of CSL, identify and explain the correct accounting treatment for the two transactions outlined above. Calculate the amount of revenue to be recognised for the year ended 30 September 2011 and prepare the relevant journals.

Discussion points

Resolving accounting issues – revenue recognition

Case Study 2 – CSL

What are the issues?

The two transactions involve the application of different sections of HKAS 18.

(i) The issue for the transaction with PIL is the measurement of revenue. It is a single element transaction, but part of the payment is being deferred for three years, requiring that part of the revenue to be measured at fair value (present value) in the statement of comprehensive income.

(ii) The transaction with FAL is a multiple element transaction, containing two separate components which must be accounted for separately. The component relating to a service must be deferred and recognised over the period in which the service is provided. The element relating to software installed can be recognised immediately.

Which accounting standard should be used?

HKAS 18 Revenue

What are the requirements of the accounting standard?

Measurement of revenue

Revenue should be recognised at the fair value of the consideration received or receivable.

(HKAS 18.9 LP Chapter 14 Section 2.3)

When consideration is deferred, the fair value of the amount receivable may be less than the nominal amount of cash receivable. In this case, the arrangement effectively constitutes a financing transaction resulting in both revenue income and interest income. The fair value of sales consideration is determined by discounting all amounts receivable using an imputed rate of interest.

The difference between the fair value and nominal amount of consideration is recognised as interest revenue.

(HKAS 18.11, LP Chapter 14 Section 2.3.1)

The accounting treatment described above results in the deferred revenue being recognised at present value (which is its fair value) in the statement of comprehensive income. The receivable recognised in the statement of financial position which has been effectively discounted is unwound each accounting period, and its increase in value recognised as interest income.

Timing of recognition of revenue

HKAS 18 requires that revenue is recognised when criteria have been met. The criteria provide guidance in determining whether the seller has transferred to the buyer the significant risks and rewards of ownership. The key issue is that for revenue to be recognised, risk and reward must have transferred to the purchaser, and the vendor has no continuing obligation to the purchaser.

(HKAS 18.14, LP Chapter 14 Section 2.5)

The standard also states that it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, a sale may include both a transfer of goods and the provision of future services. The revenue from the latter should be deferred and recognised as income over the period in which the service is performed.

(HKAS 18.13, LP Chapter 14 Section 2.4)

How to apply the standard to the case

<u>Transaction (i)</u>

CSL has the right to recognise the revenue from this transaction, as the software has been fully installed at the customer premises and CSL has no further obligation to the customer, bearing no further risks and having no continued involvement. The sale of goods criteria have been met.

In terms of measurement, the revenue for this transaction must be considered in two parts. The agreed sale price of HK$ 100 million is being paid in two equal instalments. One half is payable immediately during the accounting period, but half is being paid on 30 September 2013, three years after the point of sale. This means that the HK$50 million being paid in 2013 is in substance a financing arrangement, and that amount of the revenue should be measured at fair value, being the present value of the revenue at the point of sale. CSL has an imputed rate of interest of 8%, and this should be used to discount the HK$50 million to present value.

The accounting journals on 1 October 2010 (at the point of sale) are:

DR Cash	HK$ 50 million
CR Revenue	HK$ 50 million

Being the part of revenue paid immediately on 1 October 2010.

DR Receivables HK$ 39.7 million

CR Revenue HK$ 39.7 million

Being the part of revenue payable on 30 September 2013 discounted using 8% discount factor (50 x $1/1.08^{3}$ or 0.794).

Therefore the total sales revenue recognised for transaction (i) is HK$ 89.7 million at 1 October 2010.

At 30 September 2011, the receivable must be increased in value (unwound) as the amount is now twelve months closer to being received. The receivable is increased by HK$ 3.18 million (HK$ 39.7 million x 8%) to HK$ 42.88 million. HK$ 3.18 million is recognised in the statement of comprehensive income as interest income, as it is in substance a finance arrangement.

DR Receivable HK$ 3.18 million

CR Interest income HK$ 3.18 million

Being adjustment to unwind the discounted receivable.

Because the receivable represents an inflow of economic benefit which will be received 2 years after the year end, it should be classified as a non-current asset.

Transaction (ii)

The transaction is a multiple element transaction containing two separately identifiable parts – the supply and installation of off-the-shelf software, and a three year software support service.

The element of the revenue generated from the supply and installation of software should be recognised on 30 June 2011, as CSL has transferred risk and reward at this point. The fair value of this element of the transaction is HK$ 16 million and should be accounted for by:

DR Receivable HK$ 16 million

CR Revenue HK$ 16 million

The remaining element of revenue HK$ 9 million (HK$ 25 million - HK$ 16 million) relates to a three year support service. This cannot be recognised immediately, as CSL has a continuing obligation to provide this service for three years from 30 June 2011. Therefore the amount should be accounted for as deferred revenue, and gradually recognised in profit over the three year period. In 2011 the following journals should be posted:

DR Receivable HK$ 9 million

CR Deferred revenue HK$ 9 million

Being initial recognition at 30 June 2011.

DR Deferred revenue HK$ 0.75 million

CR Revenue HK$ 0.75 million

Being the part of revenue relating to support service recognised for the three month period to 30 September 2011 (9 million / 3 years x 3/12).

Therefore the total revenue recognised in the statement of comprehensive income in respect of transaction (ii) is HK$ 16.75 million, and the statement of financial position recognises deferred revenue of HK$ 8.25 million (HK$ 9 million – HK$ 0.75 million).

Part of the deferred revenue should be presented within current liabilities as it represents inflow of economic benefit within 12 months. The current portion of the deferred revenue is HK$ 3 million (HK$ 9 million / 3 years).The remainder of the deferred revenue of HK$ 5.25 million (HK$ 8.25 million - HK$ 3 million) should be presented within non-current liabilities.

The receivable is fully paid before the year end, so there is no current asset remaining in the statement of financial position in respect of this transaction.

Recommendation / justification

CSL's financial statements should reflect the substance of its sales transactions in accordance with HKAS 18.

Extracts from the financial statements at 30 September 2011 include the following:

	Transaction (i) HK$ million	**Transaction (ii) HK$ million**	**Total HK$ million**
Statement of comprehensive income			
Revenue	89.7	16.75	106.45
Interest income	3.18		3.18
Statement of financial position			
Non-current assets: Receivable	42.88		42.88
Current liabilities: Deferred income		3.00	3.00
Non-current liabilities: Deferred income		5.25	5.25

Key Learning Points

1. Revenue should only be recognised on goods when the HKAS 18 sale of goods criteria have been met.

2. Revenue must be measured at fair value, which is present value for revenue subject to deferred payment terms.

3. Transactions should be assessed for their economic substance, and separated into identifiable components when necessary.

Resolving accounting issues

Case study 3

Rombald Electricals Limited (REL) operates from a factory in Hong Kong, where it manufactures washing machines and other domestic appliances for distribution throughout South-East Asia. The majority of sales are made on credit, and REL maintains both a specific and general provision for doubtful debts.

The factory from which REL operates was bought on 1 April 2009 at a construction cost of HK$30million, of which HK$12million was deemed the construction cost agreed with the Inland Revenue Department. The factory is being depreciated over a period of 50 years. The company also owns an investment property held at fair value in accordance with HKAS 40. This property cost HK$28million on 1 April 2007. 60% of the cost was the agreed cost incurred on the construction of the building.

Tax allowances are provided on the cost of the owner occupied industrial building which does not relate to land as follows:

- 20% initial allowance in the year of purchase
- 4% straight line annual allowance. This is given when the building is in industrial use and may be given in the first year of ownership as well as an initial allowance.

Commercial buildings do not benefit from the initial 20% allowance, however 4% straight line annual allowances may be claimed on the non-land element of the cost.

The general provision for doubtful debts is not tax deductible until such time as the debt becomes bad.

Relevant extracts from the draft 2011 financial statements of the company are as follows:

Statement of financial position of REL at 31 March	**2011**	**2010**
	HK$000	HK$000
Property, plant and equipment – factory	29,520	29,760
Investment property	34,000	31,500
General provision for doubtful debts	4,000	5,600

The deferred tax provision in 2010 amounted to HK$230,000.

The rate of tax is 16%.

You should refer to appendix 1 for extracts from the draft tax computation of REL to be submitted to the Inland Revenue Department.

Required:

(a) **What deferred tax provision should be included in REL's financial statements at the 31 March 2011 year end?**

(b) **What are the disclosure requirements of HKAS 12 in relation to deferred tax?**

DRAFT

Extract of tax computation

ROMBALD ELECTRICALS LIMITED – YEAR ENDED 31 MARCH 2011

Commercial building allowance

	2007/08
	HK$
TWDV b/f	14,784,000
4% annual allowance	(672,000)
TWDV c/f	14,112,000
Qualifying expenditure b/f and c/f	16,800,000

Industrial building allowance

	2009/10
	HK$
TWDV b/f	9,120,000
4% annual allowance	(480,000)
TWDV c/f	8,640,000
Qualifying expenditure b/f and c/f	12,000,000

Discussion points

Resolving accounting issues – deferred tax

Case study 3 – REL

What are the issues?

Rombald Electricals Limited (REL) owns a factory and investment property in Hong Kong. It manufactures and sells domestic appliances. The following issues must be considered:

(a) How is deferred tax calculated in relation to the owner-occupied factory?
(b) How is deferred tax calculated in relation to the investment property?
(c) How is deferred tax calculated in relation to the general provision for doubtful debts?
(d) What amounts are reported in the financial statements in respect of deferred tax?
(e) What disclosures are required in respect of deferred tax?

Which accounting standard(s) should be used?

HKAS 12 Income Taxes

What are the requirements of the accounting standard(s)?

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences; deferred tax assets are the amounts of income taxes recoverable in future periods in respect of deductible temporary differences. Temporary differences are differences between the carrying value of an item and its tax base. The tax base of an item is the amount attributable to that item for tax purposes. Taxable temporary differences are those which result in taxable amounts in future periods; deductible temporary differences are those which result in amounts which are deductible in future periods.

(HKAS 12.5 , LP Chapter 15 Section 2)

A deferred tax liability must be recognised for all taxable temporary differences, except to the extent that it arises from the initial recognition of goodwill or the initial recognition of an item in a transaction which is not a business combination and does not affect accounting or taxable profits at the time of the transaction.

(HKAS 12.15 , LP Chapter 15 Section 3)

A deferred tax asset must be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from 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 nor taxable profits.

(HKAS 12.24 , LP Chapter 15 Section 4)

Deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

(HKAS 12.47 , LP Chapter 15 Section 5.2)

The measurement of deferred tax liabilities and deferred tax assets should reflect the tax rate applicable to the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

(HKAS 12.51 , LP Chapter 15 Section 5.2.2)

If a deferred tax liability or asset arises from investment property that is measured using the fair value model in HKAS 40, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Therefore, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset should reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale.

(HKAS 12.51C , LP Chapter 15 Section 5.3.2)

Deferred tax is recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from transactions recognised in other comprehensive income or directly in equity or a business combination.

(HKAS 12.58 , LP Chapter 15 Section 6)

An entity should set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.

(HKAS 12.75 , LP Chapter 15 Section 7)

How to apply the standard to the case

Factory

Tax relief is given only on the construction cost of the buildings. Therefore the HK$18million arising upon initial recognition of land has no deferred tax effect.

In respect of the construction cost of HK$12million, deferred tax arises on the temporary difference, calculated as the difference between the carrying amount and the tax base at the reporting date:

		HK$000
Tax base		
As provided in appendix to question		8,640
Carrying value		
Cost	12,000	
Depreciation (2/50 x 12m)	(480)	
		11,520
Taxable temporary difference		2,880
Deferred tax liability 16% x 2,880		461

Investment property

Again, tax relief is given only on the agreed construction cost of the investment property buildings.

In respect of investment properties held at fair value, HKAS 12 has recently been amended to include a rebuttable presumption that the carrying value of the property will be recovered through sale rather than use.

As there is no capital gains tax in Hong Kong, the effect is that deferred tax only arises in respect of the clawback of capital allowances given, and not in respect of the excess of fair value over cost. Therefore deferred tax is calculated as:

		HK$000
Tax base		
As provided in appendix to question		14,112
Carrying value	(60% x 34,000)	20,400
Difference		6,288
Of this difference:		
Permanent difference (60% (34m – 28m))		3,600
Taxable temporary difference (= allowances given)		2,688
Therefore deferred tax liability 16% x 2,688		430

General provision for doubtful debts

Tax relief is provided on the general provision for doubtful debts only when a debt becomes bad, therefore the tax base of the general provision is nil.

The temporary difference arising is therefore the full amount of the provision, being HK$4million.

This is a deductible temporary difference and results in a deferred tax asset of HK$640,000 (16% x 4million).

Summary

All of the elements of deferred tax relate to the same jurisdiction (Hong Kong), and it is assumed that there is a right to set off the asset and liability. Therefore the net deferred tax liability at the year end is:

	HK$000
Factory	461
Investment property	430
Provision for doubtful debts	(640)
	251

The net provision has therefore increased by HK$21,000 (251 – 230). This is recognised in profit or loss for the period.

Recommendation / Justification

The following journal records the movement in deferred tax provision for the year ended 31 March 2011 (HK$000):

DR	Tax charge	21	
CR	Deferred tax liability		21

Extracts from the financial statements of Rombald Electricals Limited:

Statement of financial position as at 31 March	**2011**	**2010**
	HK$000	HK$000
Deferred tax provision	251	230

Statement of comprehensive income for the year ended 31 March	**2011**
	HK$000
Income tax charge	
Deferred tax	21

Disclosure requirements

HKAS 12 requires REL to make the following disclosures in relation to deferred tax:

- The amount charged as an expense or income to profit or loss
- In respect of each type of temporary difference:
    - the amount of deferred tax assets and liabilities recognised in the statement of financial position for each period presented, and
    - the amount of deferred tax income or expense recognised in profit or loss.

Key Learning Points:

1. Deferred tax liabilities arise in relation to taxable temporary differences; deferred tax assets arise in relation to deductible temporary differences.
2. A temporary difference is calculated as the difference between the tax base and carrying value of an item.
3. A deferred tax amount is calculated by applying the relevant tax rate to a temporary difference. Tax rates which have been enacted or substantively enacted by the period end should be applied.
4. In the case of an investment property held at fair value, it is assumed that the carrying value of the asset will be recovered through sale.
5. In Hong Kong, as there is no capital gains tax, deferred tax on an investment property held at fair value will arise only in relation to the claw back of capital allowances already given.