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

A Refresher Course on Current Financial Reporting Standards

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YOUR HOSTS

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HKFRS 3
Business Combinations

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Key Areas:
- ❑ Scope of HKFRS 3
- ❑ Acquisition Costs
- ❑ Contingent consideration
- ❑ Goodwill
- ❑ Non-controlling interest
- ❑ Recognition and Measurement
- ❑ Separate Accounting Required

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Agenda

- ❑ Scope of HKFRS 3
- ❑ Business combination vs Asset Acquisition
- ❑ Acquisition accounting
- ❑ Measurement and Recognition issues
- ❑ Changes in ownership interests in a subsidiary
- ❑ Presentation and disclosure

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Scope of HKFRS 3

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

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

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Identifying a business combination

- ❑ Definition [HKFRS 3: Appendix A]

  " A transaction or other event in which an **acquirer** obtains **control** of one or more **business**..."

- ❑ An acquirer obtain control of an acquiree by:
  - transferring cash or other assets (including net assets that constitute a business);
  - incurring liabilities;
  - issuing equity interests;
  - providing more than one type of considerations; or
  - without transferring consideration, including by contract alone

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Definition of business

INPUT (economic resources) + PROCESSES (systems, standards, etc) = OUTPUTS (Return)

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

PROCESSES:
- excludes accounting, billing, payroll and other administrative systems

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

Input and processes:
- **Must be present for a business to exist**
- Doesn't need to be all the inputs and processes required
- Must be <u>capable</u> 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 BUSINESS or ASSET?

Co A → Acquires 100% → Co B

Situation 1:
Sole asset = A piece of land or an investment property

Situation 2:
Sole asset = A hotel + Co B operates the hotel

Acquisition of ASSET

1) When the acquisition of assets does not constitute a business
   - ⇒ Should NOT be accounted for as a business combination in accordance with HKFRS 3
   - ⇒ No goodwill / gain from bargain purchase arises

2) 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 <u>relative fair values</u> at the date of purchase.

3) Illustration: Annexes 1-3

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Business vs Asset Acquisition

Major differences in accounting treatment

	Business combination	**Asset acquisition**
Measurement of identifiable assets (including additional intangible assets)	Fair value	Cost of acquisition allocated based on relative fair values of individual assets
Goodwill	Recognized	Not recognized
Contingent liabilities	Recognized at fair value	Not recognized
Acquisition-related costs	Expensed as incurred	Capitalized as part of the cost of asset
Deferred tax	Initial recognition exemption not applied - more deferred tax recognized	Initial recognition exemption applies

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Application of Acquisition Method

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Acquisition method

- An entity shall account for each business combination by applying the acquisition method
- Applying the acquisition method requires:
  - **Step 1** – Identifying the acquirer
  - **Step 2** – Determining the acquisition date
  - **Step 3** – Recognising & measuring identifiable assets/liabilities/NCI
  - **Step 4** – Measuring consideration
  - **Step 5** – Recognising & measuring goodwill or gain from bargain purchase
  - **Step 6** – Post combination accounting

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Step 1:

Identifying An Acquirer

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Who is the Acquirer?

- Definition of the acquirer -> the entity that obtains control over the acquiree

- **Two-step approach**
  Step 1 - Apply the concept of control in HKAS 27 (Revised in 2008)
    - Who has the power to govern the financial and operating policies of an entity to obtain benefits from its activities?

  Step 2 - If the application of the control concept does not give conclusive answer, should consider additional guidance in HKFRS 3 (Revised in 2008)

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

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Who is the Acquirer? (cont'd)

Additional guidance in HKFRS 3 (revised in 2008)

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)
New entity formed which issues equity interests	One of the combining entities existed before the combination

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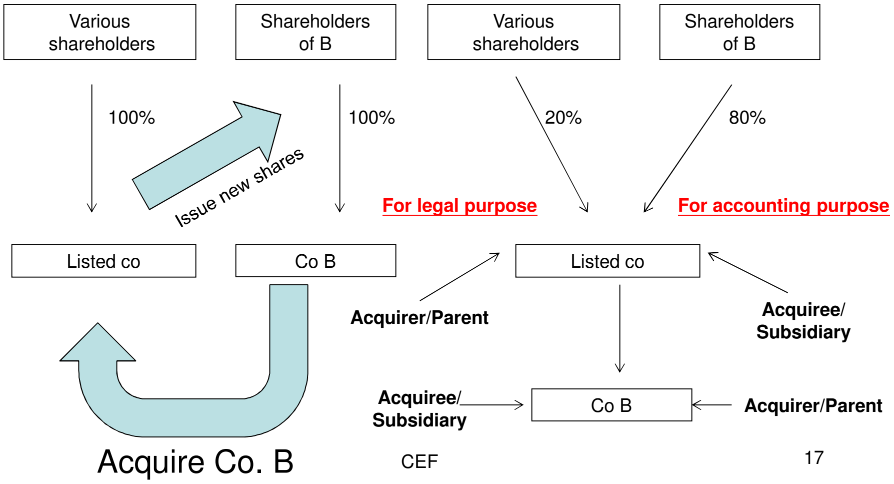
Who is the Acquirer? (cont'd)



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Who is the Acquirer? (cont'd)

- HKFRS 3(2008).B19 stated that “[a] reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance in HKFRS 3(2008).B13-B18”.
- Discuss further at later slides

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Step 2

Determining the Acquisition Date

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Acquisition date

- The **date** on which the acquirer **obtains control** of the acquiree
- Generally the date the acquirer
  - Legally transfers the consideration
  - Acquires the assets
  - Assumes the liabilities

Shall consider all pertinent facts and circumstances

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Acquisition date – Example

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

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

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Acquisition date – Example

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

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

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Acquisition date – Example

- On 1 Jan 2011, Co A acquired 100% equity interest of Co B and paid the required consideration. The change of shareholding of Co B requires approval from the government. The approval was finally obtained on 1 Mar 2011.

  - The transaction is conditional subject to the government approval
  - Therefore, the date of acquisition should be the date obtaining the approval from the government
  - Acquisition date = 1 Mar 2011

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Step 3

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

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Recognition principle

- As of the acquisition date, the acquirer should recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree [HKFRS 3.10]
- **Conditions for recognition**
  - Meet the definition of an asset or liability in the *Framework for the Presentation and Presentation of Financial Statements* at the acquisition date; [HKFRS 3.11]
  - Be part of the business acquired (the acquiree) rather than the result of a separate transaction. [HKFRS 3.12]
- An asset is identifiable if it meets either the separability or contractual-legal criteria [HKFRS 3.B33]

Application of the recognition principle may result in recognising some assets and liabilities that the acquiree had not previously recognised in its financial statements

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- **Separability criterion**
  - An intangible is separable if it is **capable of being separable 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. [HKFRS 3(2008).12a]

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- **Contractual-legal criterion**
  - An intangible that arises from contractual or other legal rights is identifiable regardless of whether those rights are transferable or separable from the acquiree or from other rights and obligations. [HKFRS 3.12b]
  - Intangible assets identified as having a contractual basis might also be separable but separability is not a necessary condition for an asset to meet the contractual-legal criterion. [HKFRS 3.IE17]

The recognition and measurement of intangible assets has always been one of the difficult areas of HKFRS 3 to apply in practice.

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Recognition principle (cont'd)

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

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

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Classification principle

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

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

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- **Two exceptions** to the principle that classifications or designations are based on the terms of the instruments and conditions at the acquisition date:
  - 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 such leases and insurance contracts on the basis of the contractual terms and other factors **at the inception of the contract** (or, if the terms of the contract have been modified in a manner that would change its classifications, at the date of that modification, which might be the acquisition date).

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Measurement principle

Measure identifiable assets acquired and liabilities assumed at their **acquisition date fair value**. [HKFRS 3.17]

- **Not permitted to recognise a separate valuation allowance**
- **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

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Specific recognition and measurement items

- Intangible assets
- Contingent liabilities
- Pre-existing relationships
- Indemnification assets

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Examples of intangibles to be recognised in a business combination

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

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Recognition of intangible assets - example

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

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

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Intangible assets – operating 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.**
  - → An acquiree's lease classifications are not changed when accounting for the business combination, unless a lease contract is modified at the date of acquisition.

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Intangible assets – operating leases (cont'd)

- **Measurement where acquiree is the lessee:**
  - → **In general, the acquirer should not recognise any asset or liability related to an operating lease in which the acquiree is the lessee.** [HKFRS 3.B28]
  - → **The acquirer recognises an intangible asset if the terms of an operating lease are favourable relative to market terms, and a liability if the terms are unfavourable relative to market terms.** [HKFRS 3.B29]

Rental < Market rate => Asset

Rental > Market rate => Liability

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Intangible assets – operating leases (cont'd)

- **Measurement where acquiree is the lessor:**

  → Fair value of the leased asset (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

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Summary of 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
Income taxes
Employee benefits
Indemnification assets

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Exceptions to the recognition principles

Contingent liabilities

- In a business combination, the requirements of HKAS 37 are not applied in determining which contingent liabilities should be recognised as of the acquisition date

- HKFRS 3 requires that the acquirer should recognise a contingent liability assumed in a business combination as of the acquisition date if: [HKFRS 3.23]
  - → it is a present obligation that arises from past events; and
  - → its fair value can be measured reliably

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

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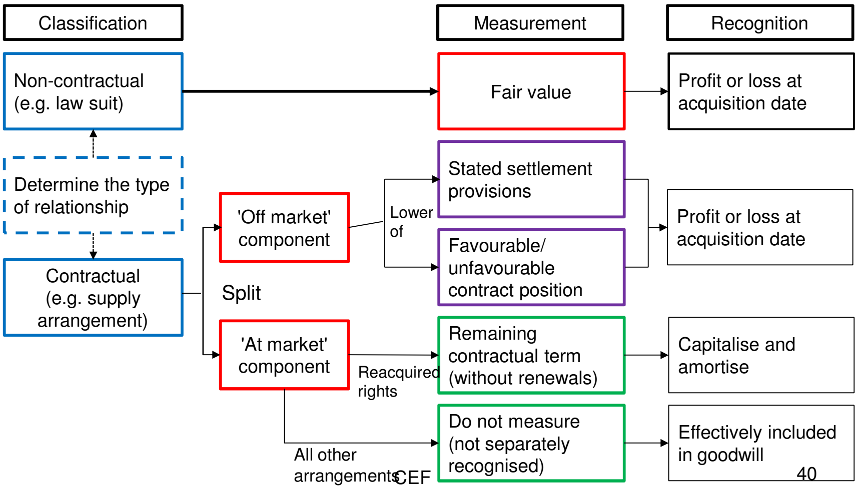
Exceptions to the measurement principle

Pre-existing relationship between acquirer and acquiree



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Exceptions to the measurement principle (cont'd)

Example – Re-acquired rights

- X decided to acquire Y for $5,000
- Assets of Y includes:

	FV
Franchise right	$2,000
Net assets	$1,500
	$3,500

X

Y

X entered into a franchise contract with Y at fixed annual fee (remaining term of 5 years)

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Example – Re-acquired rights (cont'd)

Case 1: Franchise fee at market rate at acquisition date

At market component:

→ Recognize franchise right as intangible of 2,000

→ Amortized over 5 years

→ Goodwill = (5,000 – 3,500) = 1,500

Case 2: Franchise fee are favourable to X comparing to market terms at acquisition date by 300

At market component:

→ Recognize franchise right as intangible of 2,000

Off market component:

→ Recognize a gain of 300

→ Goodwill = (5,000 + 300) – 3,500 = 1,800

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Exceptions to the measurement principle (cont'd)

Example: Settlement of pre-existing relationship – contractual supply agreement [HKFRS 3.IE54-IE57]

- A Co purchases electronic components from T Co under a 5-year supply contract at fixed rates. The contract allows A Co to terminate the contract before the end of the initial 5-year term by paying $6M penalty
- With three years remaining under the supply contract, A Co pays $50M to acquire T Co, which is the fair value of T Co based on what other market participants would be willing to pay
- Included in the total fair value of T Co is $8M related to the fair value of the supply contract with A Co. The $8M represents $3M component that is "at market" and $5M component that is unfavourable to A Co
- T Co has no other identifiable assets or liabilities related to the supply contract and A Co has not recognised any assets or liabilities related to the supply contract before the business combination

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Example: Settlement of pre-existing relationship – contractual supply agreement (cont'd)

Considerations:

- Contractual pre-existing relationship? ⟶ Yes
- Settlement amount ? ⟶ Lower of settlement ($6M) and the unfavorable aspect of the contract relative to its market terms ($5M)
- Amount to extinquish pre-existing relationship? ⟶ $5M
- Consideration transferred for business combination? ⟶ $45M

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Example: Settlement of pre-existing relationship – contractual supply agreement (cont'd)

- Suppose that HKFRS had required A Co to recognise a $6M liability for the supply contract before the business combination
- In that situation, A Co recognises a $1M settlement gain on the contract in profit or loss at the acquisition date (the $5M measured loss on the contract less the $6M loss previously recognised)
- In other words, A Co has in effect settled a recognised liability of $6M for $5M, resulting in a gain of $1M

Whether the acquirer had recognised previously an amount in its financial statements related to a pre-existing relationship will affect the amount recognised as a gain or loss for the effective settlement of the relationship

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Exceptions to the measurement principle (cont'd)

Share-based payment awards

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

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Exceptions to the measurement principle (cont'd)

Assets held for sale

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

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Exceptions to both recognition and measurement principles

Income tax

- 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"
- 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

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

Employee benefits

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

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

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
- For example, the seller may indemnify the acquirer against losses above a certain amount on a liability arising from a particular contingency
- As a result, the acquirer obtains an indemnification asset [HKFRS 3.27]

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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 identified item (i.e., contingent liability) is measured at fair value
- The indemnification asset should also be measured at fair value using the same assumptions

  → not necessarily mean that they are recognised at the same amount (e.g. a cap for indemnification)

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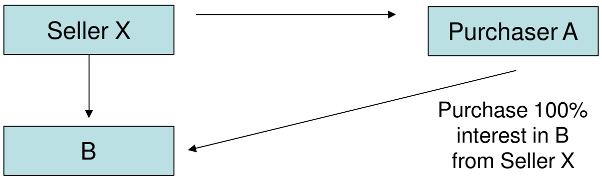
Indemnification asset - example

Seller X indemnifies (cap at $150) Purchaser A
for B's contingent liability (FV = $200)



- Seller X will indemnify Purchaser A if B is required to settle the contingent liability. Seller X will pay A the same amount with a cap of $150
- At the date of acquisition, recognize:
  - contingent liability at $200
  - contingent asset at $150 (cap)

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Step 4

Recognising & measuring goodwill or a gain from a bargain purchase

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Recognising and measuring goodwill

The aggregate of • consideration transferred (acquisition-date fair value) • non-controlling interest in the acquiree and • Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree	>	The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed	=	**Goodwill**

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

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Recognising and measuring gain from a bargain purchase

The aggregate of

- consideration transferred (acquisition-date fair value)
- non-controlling interest in the acquiree and
- Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree

<

The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed

=

Bargain Purchase

- ❖ Reassess the fair values originally determined
- ❖ Any remaining excess is recognised in profit or loss immediately
- ❖ Anomalous transactions, may occur in force liquidation/ distress sale
- ❖ Exception of future losses/costs to be incurred is not a valid reason

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How to calculate goodwill or gain on bargain purchase?

Fair value of consideration transferred

+

Amount of any NCI

+

Fair value of any previously held interest

less

Fair value of identifiable assets and liabilities acquired (100%)

equals

GOODWILL or BARGAIN PURCHASE GAIN arising from the combination

Measurement choice:
• Net assets (excluding goodwill)
• Fair value (including goodwill)
Transaction by transaction basis

Gain or loss recognised in profit or loss

Goodwill only measured at the acquisition date when obtain control

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F

80%

G

Example – Simple acquisition with NCI

Fact pattern

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

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

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Non-controlling Interest (NCI)

- ❖ Non-controlling interest – the equity in a subsidiary not attributable, directly or indirectly, to a parent
- ❖ Under HKFR 3, non-controlling interests can be measured on two bases –

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

  Option 2: by reference to the NCI's share of the identifiable net assets of the acquiree
- ❖ Choice applies for each business combination – not an accounting policy
- ❖ Test for impairment [HKAS 36, Appendix C]: only relevant when Option 2 is applied
- ❖ Allocate to non-controlling interest even when the allocation will result in non-controlling interest having deficit balance
- ❖ [HKAS 27]

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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

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Consideration transferred (cont'd)

- The consideration should exclude directly attributable costs:
  - Transaction costs should be expensed when incurred
  - Costs of issuing equity instruments are deducted from equity
    - The equity instruments issued should be measured at fair value on the acquisition date
  - Costs of issuing/arranging financial liabilities are included in the measurement of the liability

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How to determine cost of Business combination?

Issue equity instruments as consideration

- if market price exists - use price at date of exchange (i.e.acquisition date)
- if market price doesn't exist/unreliable - use other valuation technique
- published price at date of exchange – best evidence and shall be used
- unreliable – only when affected by the thinness of the market

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

- Illustration: Annex 4

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How to determine cost of business combination? (cont'd)

Acquisition-related costs

- **Business combination:** acquisition-related costs (e.g. legal and consulting fees incurred directly for the business combination) should be expensed when they are incurred.
- **Acquisition of associates/JCE** (IFRIC Update July 2009)
  - General principle: Assets not measured at fair value are initially measured at cost that include:
    - ➢ purchase price
    - ➢ other directly attributable costs (e.g. professional fees, transfer tax)
  - Cost of investment in associate (and JCE) comprise purchase price and directly attributable expenditure

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How to determine cost of business combination? (cont'd)

Cost Adjustments

(1) Contingent consideration => subsequent change to cost dependent on specific contingent events

(2) Adjustment to provisional fair values

(3) Recognition of deferred tax assets after initial accounting is complete

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How to account for contingent consideration?

- Contingent consideration is defined as: [HKFRS 3.Appendix A]
  - 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

    classified as a liability or equity on the basis of the definitions of an equity instrument and a financial liability in accordance with HKAS 32.11 [HKFRS 3(2008).39]

  - Contingent consideration may also give the acquirer the right to the return of previously transferred consideration if specified conditions are met

    Classified as an asset by the acquirer [HKFRS 3(2008).40]

- Contingent consideration should be **measured at fair value at the date of acquisition.** No need to consider the "probable test" or "reliability measureable test"

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Contingent Consideration: Subsequent Accounting

- Changes based on additional information about facts and circumstances at the acquisition date, and that occur within the measurement period, are **recognised as adjustments against the original accounting for the acquisition.** [HKFRS 3.58]

→ Retrospectively adjusted and may impact goodwill

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- For changes in the value of contingent consideration resulting from events after the acquisition date e.g. meeting an earning target, reaching a specified share price, or reaching a milestone on a research and development project → not a measurement period adjustments → therefore, such changes accounted for separately from the business combination → **NOT adjust previously recognised goodwill.** [HKFRS 3.58]

- **Treatments depends on classifications**

Contingent consideration → Equity

- NO re-measurement
- Subsequent settlement accounted for within equity

Contingent consideration → Asset/Liability

- Financial instruments (HKAS 39) → $\triangle$ Fair value → profit or loss /OCI
- Non-financial assets/liabilities → HKAS 37 or other HKFRSs

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Contingent consideration - example

- Entity P acquired 100% equity interest in Entity S. P obtained control over S.
- A contingent consideration in the sales and purchase agreement:
- **Case 1:**
  – If the profit of S in the coming year reaches $1 million, P will issue 10,000 additional shares.
  – Otherwise, P will not issue any additional shares.
- **Case 2:**
  – P will issue variable number of additional shares depending on the profitability of S.
  – If up to $0.5 million, P will issue 5,000 shares.
  – If up to $ 1 million, P will issue 10,000 shares.

P

100%

S

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Contingent consideration – example (cont'd)

Case 1:

– If the profit of S in the coming year reaches $1 million, P will issue 10,000 additional shares

– Otherwise, P will not issue any additional shares.
- "Fixed for fixed" requirement in HKAS 32 is met?
- There is only one variability in the outcome
- The number of additional shares to be delivered is fixed
- The contingent consideration is treated as equity
  ➢measured at fair value at the date of business combination + no remeasurement at subsequent reporting dates

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Contingent consideration – example (cont'd)

Case 2:

- P will issue variable number of additional shares depending on the profitability of S
- If up to $0.5 million, P will issue 5,000 shares
- If up to $ 1 million, P will issue 10,000 shares

  - Contingent consideration fails the fixed for fixed requirement in HKAS 32?
  - The number of ordinary shares to be delivered is not fixed – it depends on the profitability of S
  - The contingent consideration should be classified as financial liability and measured at fair value at subsequent reporting dates with the resulting gain or loss recognised in profit or loss

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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(2008).B54]

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

- Contingent employment
- Duration of continuing employment
- Level of remuneration
- Incremental payment to employees
- Number of shares owned
- Linkage to the valuation
- Formula for determining consideration
- Other agreements and issues

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

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Share-based payment transactions in a business combination

❖ An acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree.

❖ Exchanges of share option 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.B55]

❖ HKFRS 3 uses the term 'market-based measure' to describe the basis of measurement in HKFRS 2.

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- **Acquirer obliged to replace awards:** If the acquirer is obliged to replace the acquiree awards, either all or a portion of the market-based measure of the acquirer's replacement awards is included in measuring the consideration transferred in the business combination [HKFRS 3.B56]

- **Acquirer makes voluntary awards:** If the acquiree's awards expire as a consequence of a business combination and the acquirer replaces those awards even though it is not obliged to do so, all of the market-based measure of the replacement awards is recognised as remuneration cost in the post-combination financial statements [HKFRS 3.B56]

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Adjustments to 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 financial statements should be prepared using the provisional amounts for the items for which the accounting is incomplete [HKFRS 3.45]

- HKFRS 3 permits adjustments to items recognised in the original accounting for a business combination, for a maximum of one year after the acquisition date, where new information about facts and circumstances existing at the acquisition date is obtained

- Refer to Annex 5

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❖ The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional values recognised for a business combination [HKFRS 3.45]

❖ The measurement period ends on the **earlier** of:
- the acquirer receives the information it was seeking about facts and circumstances that exists as of the acquisition date
- the acquirer learns that more information is not available
- one year from the acquisition date

Consider all pertinent factors including date when additional information is obtained and reason for change of provisional amounts

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- **Within 12 months of the acquisition date (Initial accounting period)**
  - Must state the values assigned originally are provisional values
  - Retrospectively adjust the carrying amount of the asset, liability or contingent liability against goodwill or "discount"
  - Comparative information presented for the periods before the completion of initial accounting should be presented as if the initial accounting has been completed from acquisition date

- **After 12 months from the acquisition date**
  - Account for the adjustments in accordance with HKAS 8, either as an error or changes in estimates relates to "adjustment to INITIAL ACCOUNTING" [HKFRS 3.50]

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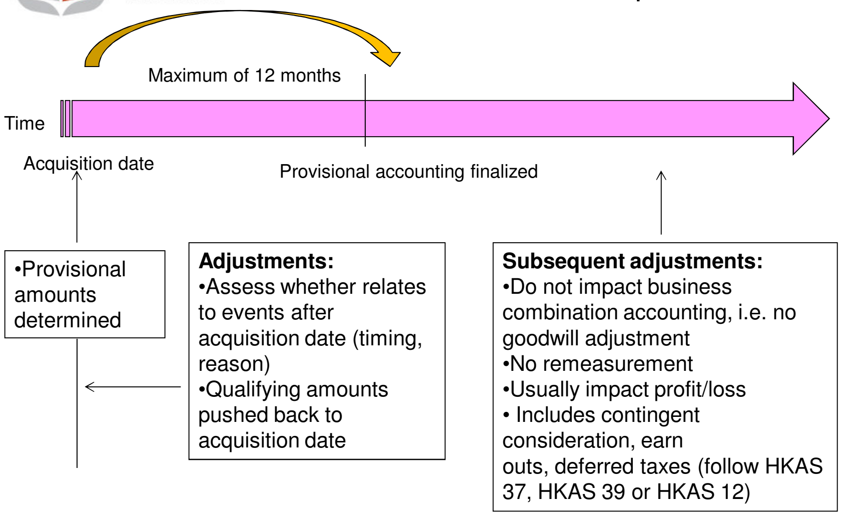
Measurement period



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Measurement period

Which events would trigger an adjustment to acquisition date fair value?

Event during measurement period	Adjust?
Finalization of property, plant and equipment valuation six months after acquisition date	✓
Changes in contingent consideration resulting from acquiree meeting an earnings target	✗
Legal case underway at acquisition date, court ruling happens during measurement period	?

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Recognition of deferred tax assets after initial accounting is complete

- If potential tax benefits (as at acquisition date) subsequently meet the recognition criteria, account for deferred tax assets in accordance with HKAS 12
- Reduce carrying amount of goodwill as an expense
- Must not result in the recognition or an increase of "discount" on acquisition

Within measurement period as a result from new information about facts and circumstances that existed at acquisition date, recognise the acquired deferred tax benefit and reduce goodwill (up to zero)
All other acquired deferred tax benefits realised are recognised in profit or loss / OCI

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Changes in ownership interests in a subsidiary

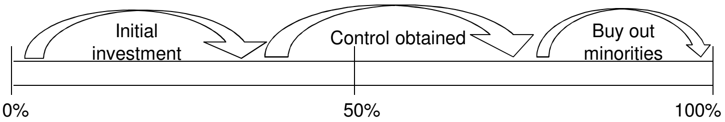
Changes in ownership interests

Increases in ownership interests

Apply:
HKAS 28
HKAS 31
HKAS 39

Business combination:
Fair value existing holding
fair value acquired net assets
calculate goodwill

Equity transaction:
No adjustment to
goodwill
no gain/loss



Obtaining control is a significant economic event that triggers remeasurement

How to calculate goodwill or gain on bargain purchase?

Fair value of consideration transferred

Amount of any NCI

Fair value of any previously held interest

Measurement choice:
•Net assets (excluding goodwill)
•Fair value (including goodwill)
Transaction by transaction basis

Less

Fair value of identifiable assets and liabilities acquired (100%)

Equals

GOODWILL or BARGAIN PURCHASES GAIN arising from the combination

Gain or loss recognised in profit or loss

Goodwill <u>only</u> measured at the acquisition date <u>when obtain control</u>

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Example – Step acquisition with NCI

Fact pattern

- Entity H acquires Entity J in a step acquisition
- Step 1 (25%) gives H significant influence over J (equity accounting is adopted)
- Step 2 (55%) results in H controlling J
- Key information is as follows:

H

25% ➪ 80%

J

	Step 1	Step 2
Date of acquisition	20X6	20X9
Interest acquired	25%	55%
Total purchase consideration (FV)	50	225
Fair value of net identifiable assets	175	350
Fair value of original 25% holding		100
Fair value of NCI		75

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Example – Step acquisition with NCI (cont'd)

350 X 20%

	NCI net assets	NCI fair value
Fair value of consideration (55%)	225	225
Non-controlling interest (20%)	70	75
Fair value of previously held interest (25%)	100	100
	395	**400**
Fair value of net identifiable assets acquired	350	350
Goodwill	45	50

Difference between fair value (100) and the carrying amount recognized as gain or loss

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Example – Step acquisition with NCI (cont'd)

350 X 20%

	NCI net assets	NCI fair value
Fair value of consideration (55%)	225	225
Non-controlling interest (20%)	70	75
Fair value of previously held interest (25%)	100	100
	395	**400**
Fair value of net identifiable assets acquired	350	350
Goodwill	45	50

Difference between fair value (100) and the carrying amount recognized as gain or loss

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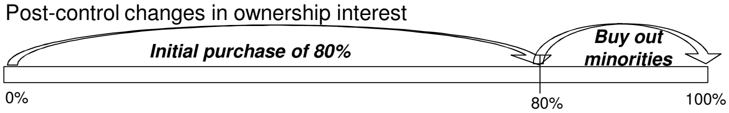
Example – Buy out NCI

Post-control changes in ownership interest



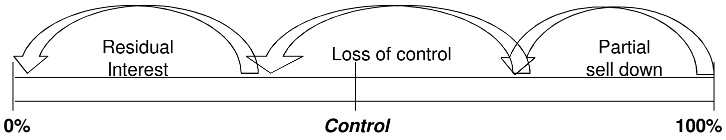
Entity F owned a 80% subsidiary, Entity G, F acquires further 20% interest in G from the NCI for $300. Carrying amount of Entity G's net assets is $1,000 (20% equates to $200). Entity F's other assets are recognized at $2,000.

	Net assets	
	80%	**100%**
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**

Changes in ownership interests

Decreases in ownership interests

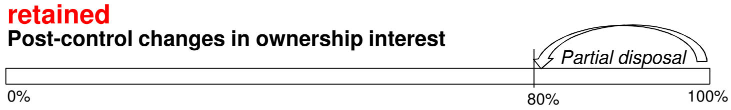
Apply: HKAS 28 HKAS 31 HKAS 39	**Loss of control – disposal:** - fair value residual holding - reclassify OCI - recognize a gain/loss	**Equity transaction:** - no adjustment to goodwill - no gain/loss



Obtaining control is a significant economic event that triggers remeasurement

Example - Disposal of ownership interest with control retained

Post-control changes in ownership interest



Entity F disposed of 20% interest in Entity G to NCI for $250. Carrying amount of Entity G's net assets is $1,200. Entity F's other assets are recognized at $2,000.

	Identifiable net assets	
	80%	**100%**
Net identifiable assets of G	1,000	1,000
Goodwill arising in the combination of G	200	200
Entity F's other assets (including cash)	2,000	2,250
Consolidated net assets of F	**3,200**	**3,450**
Non-controlling interest	-	240
Reserves	-	10
Other equity	3,200	3,200
Total equity	**3,200**	**3,450**

$1,200 x 20%

$250 - $240

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Re-attribute other comprehensive income

HKAS 21.48C

"On the partial disposal of a subsidiary that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation the entity shall reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income."

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Re-attribute other comprehensive income

Question:

•For ACQUISITION of additional interest in existing subsidiary, shall apply HKAS 21.48C by analogy?

i.e. to reclass the translation differences included in carrying amount of NCI to "exchange reserve" attributable to owners of the Company?

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Disposal of ownership interests with loss of control

Adjustments on loss of control

1. Derecognizes the carrying amount of assets (including liabilities of the subsidiary, and NCI
2. Recognize the fair value of the consideration received
3. Recognize the fair value of any residual interest (if retains noncontrolling interest, i.e. becoming a JCE, associate or investment)
4. Reclassify to profit or loss any amounts previously recognized other comprehensive income (for example, available for investment reserve) relating to the subsidiary's assets
5. Recognize any resulting difference in profit or loss

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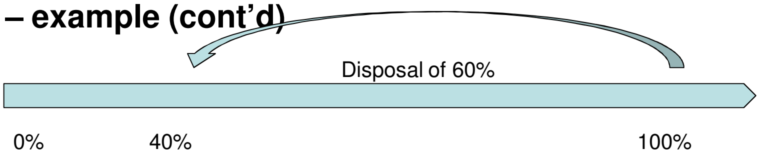
Disposal of ownership interest with loss of control – example (cont'd)



Entity F disposed of 60% of Entity G for $1,800. Carrying amount of Entity G's net assets is $1,000. FV of residual interest (remaining 40% interests) at that date is $1,200.

	HKAS 27
Fair value of consideration transferred (60%)	1,800
Fair value of residual interest (40%)	1,200
	3,000
Net identifiable assets disposed of	1,000
Gain on disposal in P/L	**2,000**

Recognize 100% FV gain (60% disposed interest and 40% retained interest

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Disposal of ownership interest with loss of control – example

Accounting entries

Dr. Interest in an associate (FV of 40% residual interest)	1,200	
Dr. Bank	1,800	
Cr. Assets and liabilities of Entity G (net effect)		1,000
Cr. P/L – gain on disposal		2,000

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Previously held interest Step acquisition

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

Example – Financial asset under HKAS 39 becomes a subsidiary

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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:**

A

75%

B

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

Example – Financial asset under HKAS 39 becomes a subsidiary

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Step acquisition with NCIs

- **In 20x6, 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 20X6, 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

Example – Associate becomes a subsidiary

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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 A controlling B**
- **Key information is as follows:**

A
75%
B

	Step 1	Step 2
Date of acquisition	20X1	20X6
Interest acquired	40%	35%
Total purchase consideration (FV)	40,000	55,000
Fair value of net identifiable assets		110,000
Fair value of the previously-held 40% held 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 – Associate becomes a subsidiary

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Step acquisition with NCIs

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

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

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

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

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Reverse acquisitions

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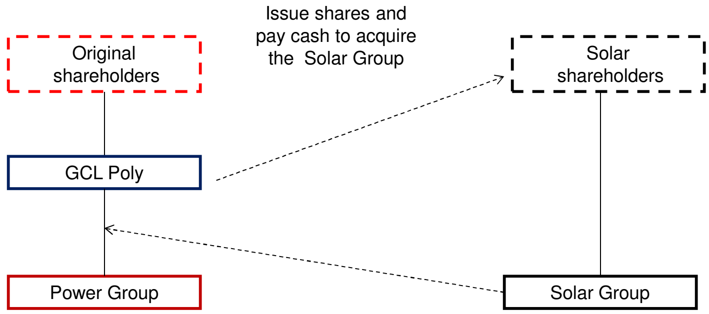
Reverse acquisition – example



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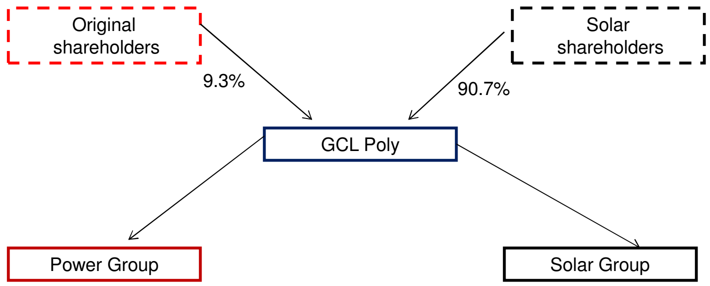
Reverse acquisition – example (cont'd)



- Refer to Annex 6

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Reverse acquisition - Identifying a reverse acquisition

- A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes.

- The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. [HKFRS 3(2008).B19]

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Reverse acquisition - Example

A private entity (Co. B) arranges to have itself 'acquired' by a small public entity (Listco.) as a mean of obtaining a stock exchange listing

- Although legally the issuing public entity is regarded as the parent and the private entity as the subsidiary, the legal subsidiary is the acquirer <u>if it has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities</u>

> Overriding principal of HKFRS 3:
> The entity that obtains control over one or more other entities shall be identified as the acquirer

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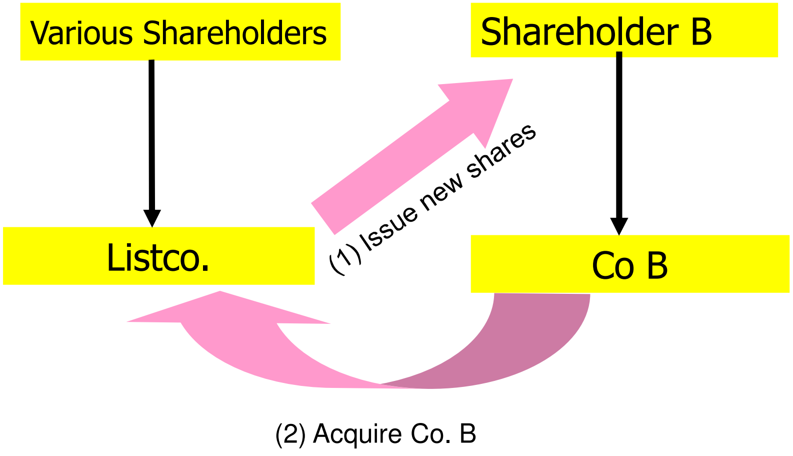
Reverse acquisition - Example



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Reverse acquisition – measuring the consideration transferred [HKFRS 3(2008).B20]

- In a reverse acquisition, the accounting acquirer usually issues no consideration for the acquiree. Instead, **the accounting acquiree usually issues its equity shares to the owners of the accounting acquirer**
- Accordingly, the acquisition-date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is **based on the number of equity interests the legal subsidiary would have had to issue to give the owners of the legal parent the same percentage equity interest in the combined entity** that results from the reverse acquisition
- The **fair value of the number of equity interests calculated in that way can be used as the fair value of consideration transferred** in exchange for the acquiree

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Reverse acquisition – Preparation and presentation of Consolidated financial statements [HKFRS 3(2008).B21]

- Consolidated financial statements prepared following a reverse acquisition are **issued under the name of the legal parent** (accounting acquiree) but **described in the notes as a continuation of the financial statements of the legal subsidiary** (accounting acquirer), with one adjustment, which is **to adjust retroactively the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree**. That adjustment is required to reflect the capital of the legal parent (the accounting acquiree)
- **Comparative information** presented in those consolidated financial statements also **is retroactively adjusted** to reflect the legal capital of the legal parent (accounting acquiree)

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❖ Because the consolidated financial statements represent the combination of the financial statements of the legal subsidiary **except** for its capital structure, the consolidated financial statements reflect:

a) the assets and liabilities of the legal subsidiary (the accounting acquirer) recognised and measured at their pre-combination carrying amounts

b) the assets and liabilities of the legal parent (the accounting acquiree) recognised and measured in accordance with HKFRS 3

c) the retained earnings and other equity balances of the legal subsidiary (accounting acquirer) **before** the business combination

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d) The amount recognised as issued equity interests in the consolidated financial statements determined by **adding the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the business combination to the fair value of the legal parent (accounting acquiree) determined in accordance with HKFRS 3**

However, **the equity structure (i.e., the number and type of equity interest issued) reflects the equity structure of the legal parent** (the accounting acquiree), including the equity interest the legal parent issued to the effect of the combination

Accordingly, **the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement** to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition

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Reverse acquisition – Example [HKFRS 3.IE2]

Balance sheets of Listco and Co B immediately before the business combination

	Listco	Listco's FV	Co B
Current assets	500	500	700
Non-current assets	1,300	1,500	3,000
Total assets	**1,800**		**3,700**
Current liabilities	300	300	600
Non-current liabilities	400	400	1,100
Total liabilities	**700**		**1,700**
Net assets	**1,100**		**2,000**
Retained earnings	800		1,400
Issued equity			
100 ordinary shares	300		
60 ordinary shares			600
Total equity	**1,100**		**2,000**

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Reverse acquisition – Example [HKFRS 3.IE3]

Background

- On 30/9/2010, Listco issued 2.5 shares in exchange for each ordinary share of Co B
- Resulting Listco issues 150 shares for all 60 ordinary shares of Co B (60*2.5)

Assumption:

- FV of each ordinary share of Co B at 30/09/2010 is $40
- Quoted market price of Listco at 30/09/2010 is $12

Acquisition by exchange of shares:

- Before business combination: Listco has 100 issued shares
- After business combination: Listco has 250 issued shares, in which shareholder B own 60% (ie 150 out of 250 enlarged shares)
- The remaining 40% are owned by Listco's original shareholders

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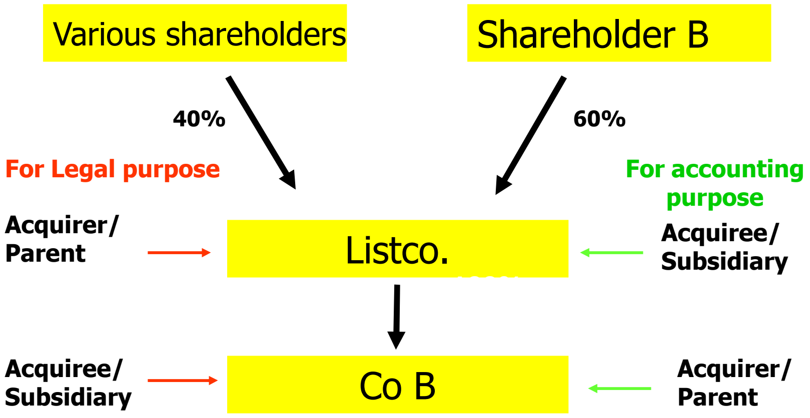
Reverse acquisition - Example



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Reverse acquisition – Example

Calculating the cost of business combination

- To calculate the cost of business combination, shall consider the business combination had taken place in the form of Co B issuing additional ordinary shares to Listco's shareholders in exchange for their ordinary shares in Listco
- Under this, Co B has to issue 40 shares for the ratio of ownership interest in the combined entity to be the same (ie 40 out of 100 enlarged shares)
- Co B's shareholders → own 60 out of 100 enlarged shares (ie 60%) of combined entity

Reverse acquisition - Example

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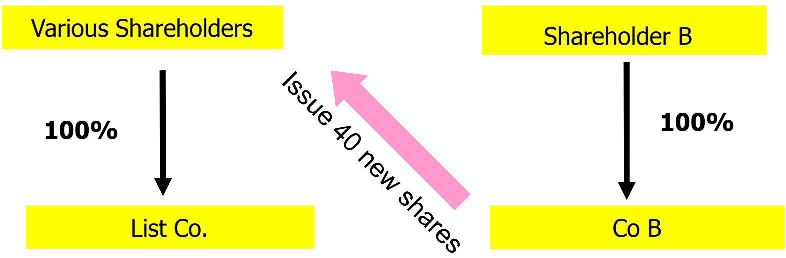
Reverse acquisition – Example

Measuring goodwill

- If the business combination had taken place in the form of Co B issuing additional ordinary shares to Listco's shareholders in exchange for Listco's ordinary shares



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Reverse acquisition – Example [HKFRS 3.IE6]

	HK$	HK$
Cost of the business combination (40 shares x $40 per share)		1,600
Net fair value of Listco's identifiable assets and liabilities:		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	1,300
Goodwill		300

Reverse acquisition – Example [HKFRS 3.IE7]

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Consolidated Balance sheet at 30/9/2010

	Listco's FV	Co B	Consolidated
Current assets	500	700	1,200
Non-current assets	1,500	3,000	4,500
Goodwill	-	-	300
Total assets	**2,000**	**3,700**	**6,000**
Current liabilities	300	600	900
Non-current liabilities	400	1,100	1,500
Total liabilities	**700**	**1,700**	**2,400**
Net assets	**1,300**	**2,000**	**3,600**
Retained earnings			1,400
Issued equity			
250 ordinary shares [$600+$1,600]			2,200
Total equity			**3,600**

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Reverse acquisition – Non-controlling interest [HKFRS 3(2008).B23-24]

- Further example in HKFRS 3.IE11-15 on reverse acquisition

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Presentation and Disclosure

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Key Disclosures

For EACH business combination effected during the period, disclose:

- Name and description of the combining entities / business
- Acquisition date
- Percentage of voting interest acquired
- Cost of business combination and the components of cost (FV and number of equity instrument issued)
- The amount of each class of assets, liabilities and contingent liabilities, immediately before the combination recognised under IFRS
- The amount of goodwill / discount (a description of factors that contribute to recognition of goodwill / discount)
- Amount of acquiree's profit or loss included in the acquirer's F/S for the period
- Disclose in aggregate if each business combination is individually immaterial

(Note: The above requirements are also applicable for business combination effected after the balance sheet date but before the financial statements are authorised for issue)

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Initial accounting determined only provisionally

- Disclose this fact
- The amounts and explanations of the adjustments to provisional values

Adjust values assigned to acquiree's assets, liabilities and contingent liabilities after initial accounting period

- Disclosure required under HKAS 8, either as changes in estimates or accounting error

Reconciliation of goodwill, showing

- Gross amount
- Impairment losses
- Subsequent adjustment due to recognition of deferred tax assets
- Other changes
- Comparative information required

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Proforma financial information

- REVENUE of the combined entity (i.e. the Group) for the period AS IF the all business combinations effected during the period HAD BEEN AT THE BEGINNING OF THAT PERIOD
- PROFIT OR LOSS of the combined entity (i.e. the Group) for the period AS IF the all business combinations effected during the period HAD BEEN AT THE BEGINNING OF THAT PERIOD

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Acquisition of a subsidiary – illustration

[X]. Acquisition of a subsidiary

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

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

Pro Forma Group's Revenue and Results

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

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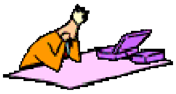
Some key judgement areas/implementation issues

- Acquisition date, ie, date of obtaining control
- Fair value of consideration
  - Esp. shares, convertible instruments
- Acquisition of business or asset
- Identifying intangible assets
- Valuation of underlying assets, liabilities and contingent liabilities
- Lack of guidance on certain transactions



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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

YOUR HOSTS

Winnie Chan
HKICPA Associate Director
Technical Training & Support

Eky Liu
HKICPA Manager
Technical Training & Support

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Consolidated Financial Statements

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Agenda

Part 1: Background

Part 2: What is "Control"?

Part 3: Accounting requirements

Part 4: Transitional requirements

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Background

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Background – issuance of IFRS 10, 11 and 12

Why is there a need for issuance?

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

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

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Background – issuance of IFRS 10, 11 and 12

Why is there a need for issuance?

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

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Background – issuance of IFRS 10, 11 and 12

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

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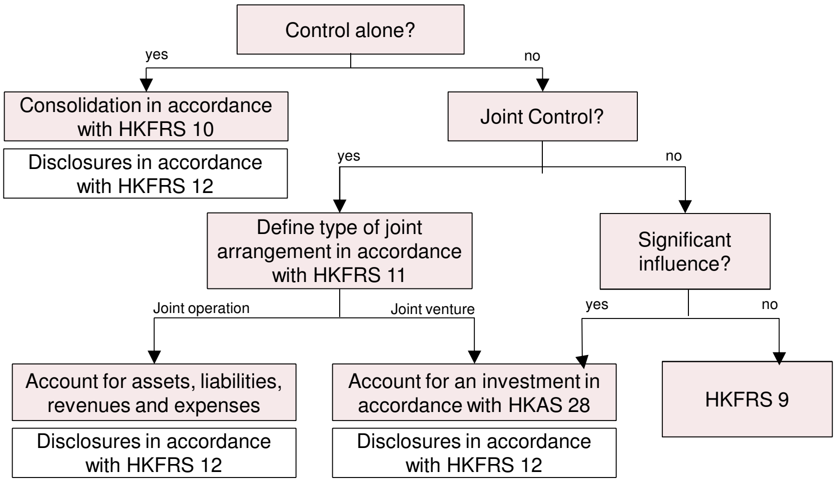
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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What is "Control"?

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Overview of HKFRS 10

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

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

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Scope of HKFRS 10

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

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

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

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Exemption from presenting consolidated FS

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

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

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Statutory requirements

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

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

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Statutory requirements

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

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Applying the new control model

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

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.
- Control vs collective control

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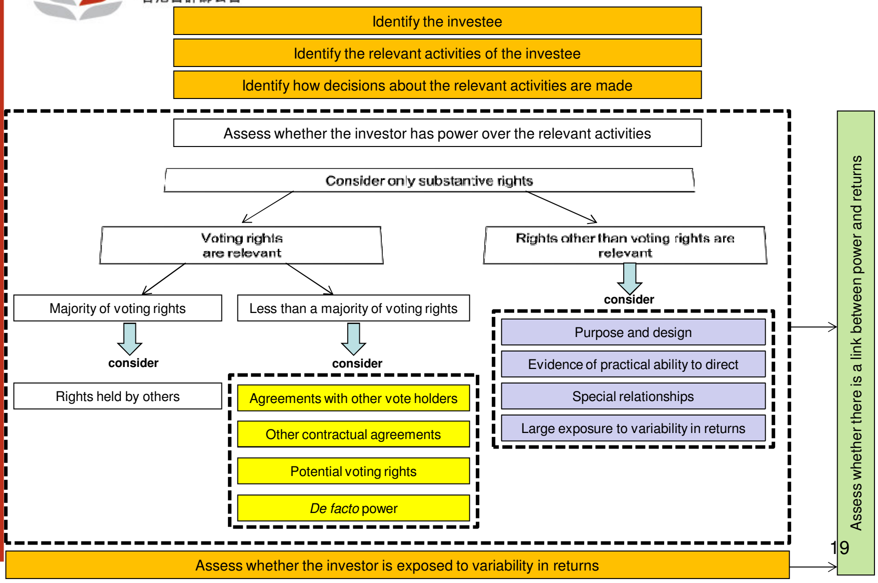
The new model at a glance



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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 consolidated that silo.
- Other parties should exclude the assets and liabilities of the silo when assessing control and consolidation of the entity.

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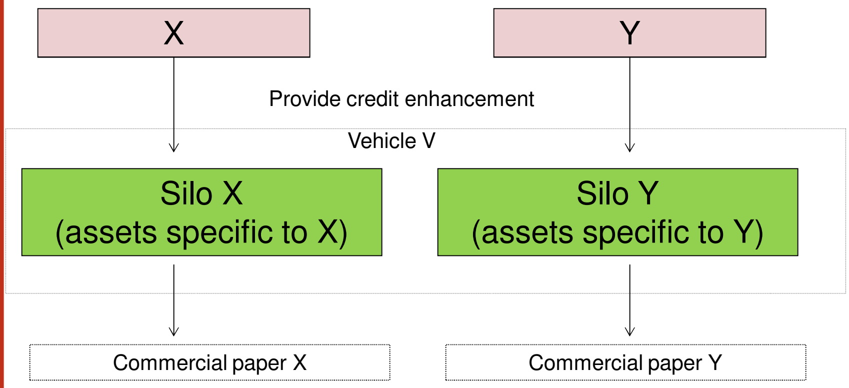
Example: Silo structure

Source: First impressions: consolidated financial statements

This 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 plans to manufacture and market the product after the development. The respective responsibilities to the relevant activities are as follows:

A's responsibility	B's responsibility	
Development	Manufacturing	Marketing

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II. Identify the relevant activities of the investee

- Example (cont'd)

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

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

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II. Identify the relevant activities of the investee

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

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

Example

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

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III. Identify how decisions about the relevant activities are made

To determine whether:

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

A. Controlled by means of voting rights

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

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III. Identify how decisions about the relevant activities are made

B. More complex cases

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

Power

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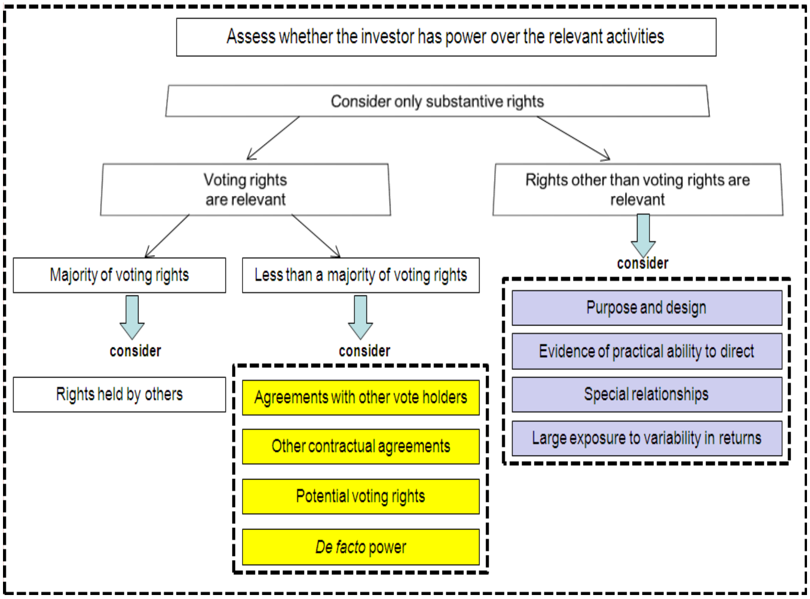
IV. Assess whether the investor has power over the relevant activities

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

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



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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. Franchises

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

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D. Voting rights

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

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

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

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D. Voting rights

Power with a majority of the voting rights

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

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D. Voting rights

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

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

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

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D. Voting rights

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

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

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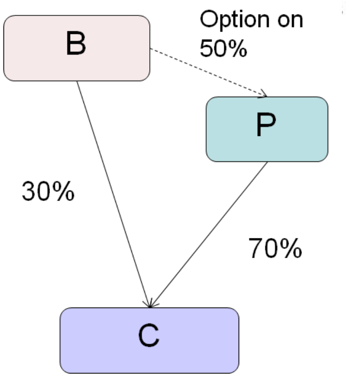
D. Voting rights

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

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

Example 1



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

Does B or P has substantive rights?

Under HKFRS 10
- P has power because it has the currently ability to direct the relevant activities.
- The potential voting rights held by B are not considered substantive. However a significant change in the "moneyness" of the options during the 2 years could lead to a conclusion that the options are substantive, which P loses control at that point.

How about under HKAS 27 (2008)?

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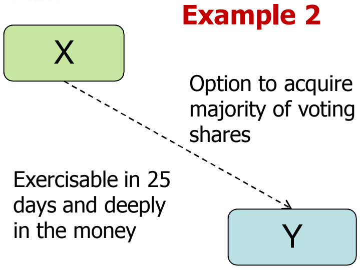
Example 2



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

Does X has substantive rights?

Under HKFRS 10
- X has rights that are essentially equivalent to those of the ordinary shareholders in Y.
- The potential voting rights held by X are substantive and considered when assessing whether X control Y.

How about under HKAS 27 (2008)?

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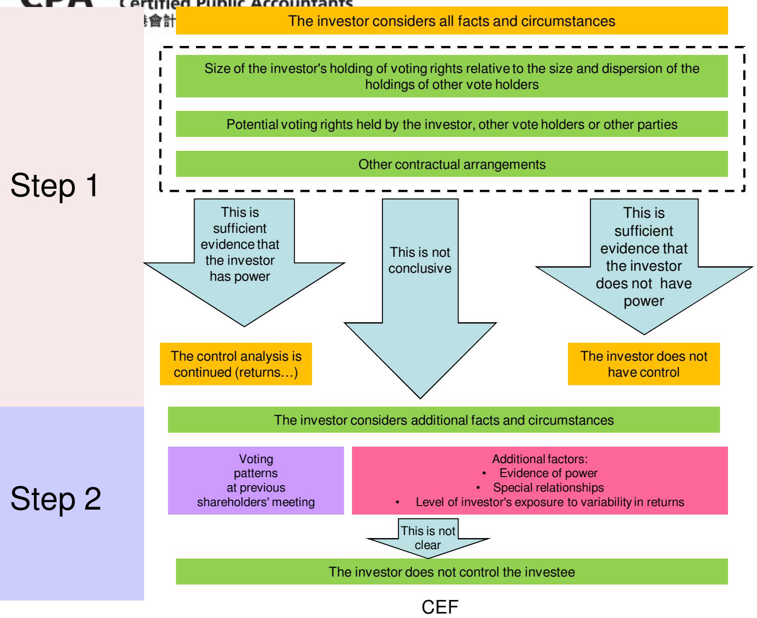
D. Voting rights

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

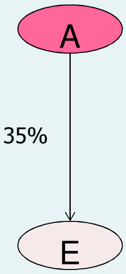
- De facto circumstances are explicitly taken into account when assessing power under HKFRS 10
- An investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally
- When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

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



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

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 • Additional facts and circumstances shall be considered

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

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Exposure to variability in returns

V. Exposure, or rights, to variable returns

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

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Example of returns

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

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Link between power and returns

VI. Link between power and returns

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

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

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

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

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

Rights held by other parties
- Removal rights
- Approval rights

Principal vs agent

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

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

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

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

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Example:

Fact pattern

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

	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

	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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Relationships with other parties

- Consider also (1) nature of relationship with other parties and (2) whether those other parties act on the investor's behalf
- Investor treat the decision-making rights delegated to its agent as held by the investor directly
- A contractual arrangement is not required in a principal-agent relationship. A party is a de facto agent if the investor or those who control the investor have the ability to direct that party to act on the investor's behalf, examples include:
  - ✓related parties of the investor
  - ✓a party that cannot finance its operations without subordinated support from the investor
  - ✓a party for which majority of members of the governing body or key management personnel is the same as that of the investor
  - ✓ a party that has a close business relationship with the investor

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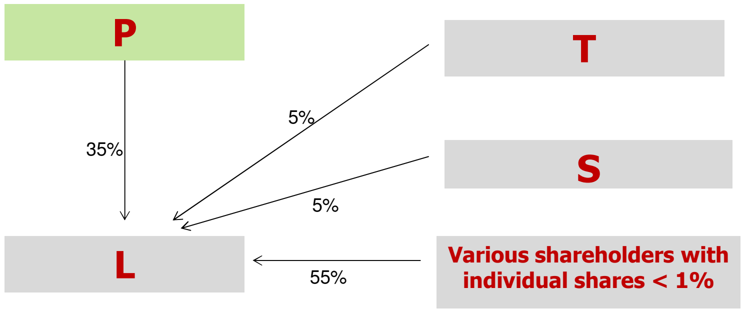
Source: KPMG – First impressions

Example – de facto agents



There is no contractual agreement between P, T and S on how to vote when decisions relating to L are taken. However, T and S have always voted in the same way as P in the past. T and S both have significant business relationships with P.

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Any control by P?

Under HKFRS 10

- P should consider whether T and S are de facto agents of P
- If yes, P should consider whether it has de facto control over L as if P held 45% voting interest in L
- If no, P still need to assess whether it has de facto control over L based on P's 35% voting rights

Under HKAS 27 (2008)

- The voting rights held by T and S are not taken into account

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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	1,100	Not yet sold
Net profit prior to elimination	15,000	8,000
Net assets prior to elimination	125,000	65,000

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Source: Insights into IFRS 2011/12

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

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

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

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Source: Insights into IFRS 2011/12

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

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

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Source: Insights into IFRS 2011/12

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

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

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

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D. Reporting period

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

Source: Deloitte – iGAAP 2012

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Question:

Parent's (P) reporting date: 31 Mar

Subsidiary's (S) reporting date: 31 Dec

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

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

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

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E. Potential voting rights

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

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

•In some circumstances an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the returns associated with an ownership interest.

•In this case, the proportion allocated to the parent and NCI is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns.

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

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

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Source: Insights into IFRS 2011/12

Example

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

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

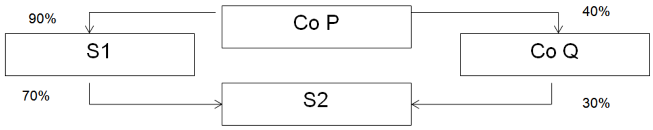
Source: Insights into IFRS 2011/12

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

Source: Insights into IFRS 2011/12

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

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

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

Source: Insights into IFRS 2011/12

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

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

- The decrease in NCI is calculated as follows:

(1) 110 = 10% x 1,100 (total net assets including goodwill) when NCI are initially measured at FV
(2) 108 = 10% x 1080 (total net assets including goodwill) under approach 1
(3) 100 = (10%/20%) x 200 (NCI) under approach 2
(4) 100 = 10% x 1000 (total identifiable net assets) under approach 3

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Source: Insights into IFRS 2011/12

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

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

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

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Source: Insights into IFRS 2011/12

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

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

- The increase in NCI is calculated as follows:

(1) 220 = 20% x 1,100 (total net assets including goodwill) when NCI are initially measured at FV

(2) 216 = 20% x 1080 (total net assets including goodwill) under approach 1

(3) 220 = (20%/80%) x 880 (NCI) under approach 2

(4) 200 = 20% x 1000 (total identifiable net assets) under approach 3

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

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

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Source: Insights into IFRS 2011/12

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

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

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

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G. Loss of control

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

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

a) Derecognise:

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

b) Recognise:

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

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

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

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

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

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

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

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

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Source: Insights into IFRS 2011/12

Example – Loss of control

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

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

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

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

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Source: Insights into IFRS 2011/12

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

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

To recognise loss of control of S

Note:

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

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Linkage of transactions

A parent might lose control of a subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all the terms and conditions of the arrangements and their economic effects.

One or more of the following indicate that the parent should account for the multiple arrangements as a single transaction:

- They are entered into at the same time or in contemplation of each other.
- They form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when a disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

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Source: Insights into IFRS 2011/12

Example – Loss of control: linkage of transactions

- P owns 70% of the shares in S. P intends to sell all of its 70% interest in S and is considering the following structure to effect the sale:

1) sell all of its 70% interest in one transaction; or
2) initially sell 19% of its interest in S without loss of control and then afterwards sell the remaining 51% and lose control

Analysis

- In the first case, the full amount of the gain or loss on the sale of the 70% interest would be recognised in profit or loss
- In the second case, if the transactions are determined not to be linked, then the gain or loss on the sale of the 19% interest would be recognised in equity, whereas the gain or loss from the sale of the remaining 51% interest would be recognised in profit or loss.
- If they are determined to be linked, then the treatment would be the same as the first case.

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Transitional requirements

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General requirements

- The new requirements are applied retrospectively except as described below in the table for which specific transitional requirements are provided; and except for the amendments to HKAS 27 (2008) that were applied prospectively when HKAS 27 (2008) became effective

	The investee was consolidated under HKAS 27 (2008)/HK(SIC)-Int 12	The investee was not consolidated under HKAS 27 (2008)/HK(SIC)-Int 12
The investee is consolidated under HKFRS 10	Generally, the entity would not adjust historical figures upon adoption of HKFRS 10	Specific requirements
The investee is not consolidated under HKFRS 10	Specific requirements	Generally, the entity would not adjust historical figures upon adoption of HKFRS 10

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Consolidation conclusion unchanged

- When there is no change to the consolidation conclusion between HKAS 27 (2008)/HK(SIC)-Int 12 and HKFRS 10 for an investee, the investor is not required to make adjustments to the accounting for its involvement with the investee.

Consolidation upon initial adoption of HKFRS 10

i) The investee is a business

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

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

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

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Consolidation upon initial adoption of HKFRS 10

ii) The investee is not a business

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

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

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

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

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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.

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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Summary – HKFRS 10

- The objective of HKFRS 10 is to have a single basis for consolidation for all entities, regardless of the nature of the investee
- The definition of control includes three elements: power, exposure to variable returns and ability to use power over the investee to affect the investor's returns
- HKFRS 10 provides guidance on how to apply the control principle in a number of situations, including agency relationships and holdings of potential voting rights
- An investor would reassess whether it controls an investee if there is a change in facts and circumstances
- HKFRS 10 replaces parts of HKAS 27 (Revised) and replaces HK(SIC) – Int 12
- Effective on 1 January 2013

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Separate financial statements

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Background

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

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

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Scope

Accounting for investments in subsidiaries, joint ventures and associates when

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

to present separate financial statements

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

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Definition

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

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

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Questions

Are these separate financial statements?

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

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

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

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Measurement

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

  (a) at cost, or

  (b) in accordance with HKFRS 9.

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

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Measurement

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

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Treatment of dividend income

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

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Treatment of dividend income

Dividend from a subsidiary, jointly controlled entity or associate

HKAS 36.12

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

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

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

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Disclosures

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

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

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

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

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Disclosures

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

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

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

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

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

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A Refresher Course on Current Financial Reporting Standards

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HKAS 24

Related party disclosures

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Background:

- The disclosure of related party relationships and transactions with related parties is dealt with in HKAS 24 *Related Party Disclosures*
- The Standard was revised by the IASB in November 2009 **to simplify the definition of a related party** and **to provide partial exemption from disclosure requirements for government-related entities**
- The HKICPA issued the revised version of HKAS 24, which is identical to the revised version of IAS 24 issued by the IASB in November 2009

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Effective date and transitional provisions:

- HKAS 24(2009) supersedes the previous version of HKAS 24 (as revised in 2003) with effect for annual periods beginning on or after **1 January 2011**
- In the year of initial application, disclosure for the comparative period will need to be restated

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Purpose of related party disclosures

- The **objective** of HKAS 24 is to ensure that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by transactions and outstanding balances with related parties
- The Standard concludes that knowledge of **related party transactions, outstanding balances and relationships** may affect assessments of an entity's operations by users of financial statements, including assessments of the risks and opportunities facing the entity

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Scope

- **Related party disclosure** requirements **apply to all entities**, including parent entities, investors and joint venturers, in their consolidated, separate and individual financial statements

- HKAS 24 contains no specific exemptions for intragroup transactions in consolidated financial statements. Such intragroup transactions and outstanding balances are, however, eliminated on consolidation. Therefore, because they do not form part of the consolidated financial statements, **related party transactions and outstanding balances between group members are not disclosed under HKAS 24**

- **No exemptions from the disclosure of intra-group transactions in the separate financial statements of a parent or of its subsidiaries**

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Scope

- **A state-controlled entity that applies HKFRS is not exempt from providing related party disclosures**. Therefore, a state-controlled entity discloses, as related party transactions, its transactions with the state and also with other state-controlled entities, as the parties are under common control and therefore meet the definition of related parties

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Requirements under HKAS 24(2009)

- Instead of a state-controlled entity, HKAS 24 (2009) uses the term "government-related entities" and modifies the related party disclosure requirements for government-related entities

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Recognition and measurement

- HKAS 24 does not establish any recognition or measurement requirements for related party transactions. **Related party transactions are accounted for in accordance with the requirements of relevant HKFRSs**

- Consistent with the identification of related party relationships, **the accounting for related party transactions should take into account their substance in addition to their legal form**

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Identification of related parties

- The definition of related parties **includes relationships involving direct and indirect control, including common control, joint control and significant influence**
- The definition is not restricted to entities; it also **includes individuals, key management personnel and post-employment benefit plans**
- The definition of related parties **also includes close members of the family of an individual who is a related party**

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Identification of related parties (cont'd)

- If a branch of an entity prepares separate financial statements, it should **disclose related party transactions and relationships, including those with its head office**
- The determination of whether an entity or an individual is a related party should be made **considering their relationship during the reporting period and not just the relationship at the reporting date**

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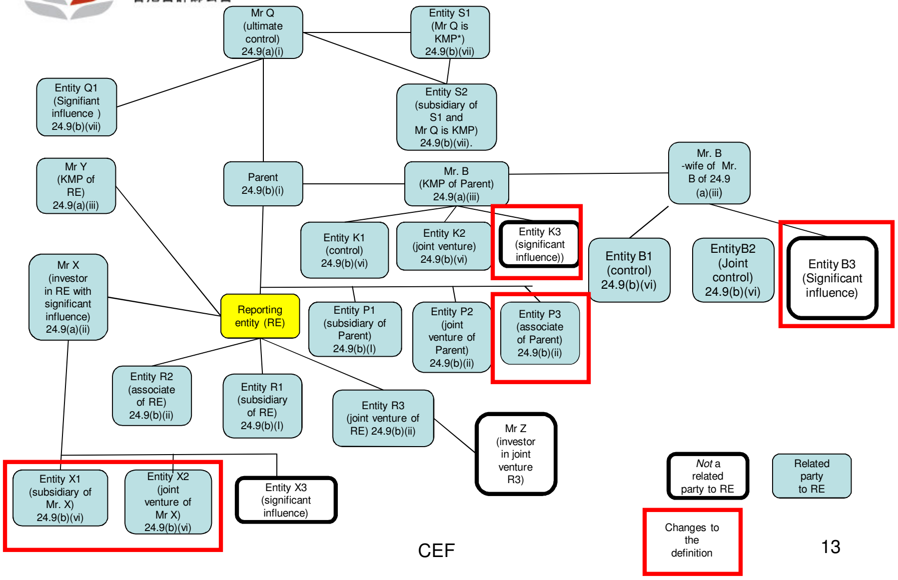
Examples of related party relationships [HKAS 24(2009)]:



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Requirement under HKAS 24(2009)

- HKAS 24 (2009) introduces symmetry in the definition of a related party, i.e. if B is a related party of C for the purposes of C's financial statements, then C is a related party of B for the purposes of B's financial statement
- In addition, certain aspects of the definition were clarified and therefore the new definition includes certain relationships that previously were excluded and vice versa

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Key management personnel

- Key management personnel are those **persons that have authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly**
- Key management personnel includes **directors** (both executive and non-executive) of an entity
- May also includes **directors of any of the entity's parents** to the extent that they have authority and responsibility for planning, directing and controlling the activities of the entity
- An entity's parent may **include the immediate, intermediate or ultimate parent**

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Key management personnel (cont'd)

- **An individual may be key management personnel of an entity even if that entity does not pay for the services received**
- **An entity may have more than one level of management.** For example, there may be a supervisory board whose members have responsibilities similar to those non-executive directors, a board of directors that sets the overall strategy under which an entity operates, and a management team that implements those strategies within the authority delegated to it by the board. In many cases any member of either board, including non-executive directors, will be considered to be key management

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Key management personnel (cont'd)

- **Key management is not limited to directors**. Other members of the management team also may be key management
- **In the consolidated financial statements of a group, key management personnel is not limited to the key management personnel of the parent entity**, but may include key management personnel of entities of the group, such as of subsidiaries.

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Key management personnel (cont'd)

- **Entities under control, joint control or significant influence of key management personnel** (or their close family members) **are related parties of the entity**

Mrs. Z is a director of Company G and a key management personnel of G

Mrs. Z has joint control over Joint Venture H

Company G

Joint venture H is a related party of Company G

Joint Venture H

- **Two entities are not related parties simply because they have a director, or other member of key management, in common**

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Key management personnel (cont'd)

- Related parties include post-employment benefit plans that benefit an entity's employees or the employees of any entity that is a related party of the entity.

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Requirements under HKAS 24(2009)

- Consistent with the previous definition of a related party, the revised definition of a related party includes post-employment benefit plans for the benefit of employees of either the reporting entity or an entity related to the reporting entity. Therefore any changes to an entity's list of related parties as a result of the application of HKAS 24 (2009), would require a consequential reassessment of the post-employment benefit plans that may be related parties of the entity

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Economic dependence

- An entity may be dependent, economically or operationally, on another party, e.g. a major customer or supplier. **This dependency does not itself create a related party relationship**. However, additional information about these relationships and transactions may be relevant to the reader of the financial statements

- **Providers of finance and similar entities are not related parties by virtue of their normal dealings with an entity,** even though these parties may limit the actions of an entity or participate in its decision-making process. However, transactions in the ordinary course of business between related parties are disclosed

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State-controlled entities

- **For entities operating in an environment in which state control is pervasive, many counterparties also are state-controlled, and therefore are related parties**. For example, a state-controlled utility may buy most of its fuel from a state-controlled coal mine

- Any entity in which the state has a controlling interest should be considered to be state-controlled, **even if the state does not participate actively in the management of the entity**

- **All entities that the state can control, whether or not the state exercises that control, are related parties**

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Requirement under HKAS 24(2009)

- HKAS 24 (2009) introduces the term **"government-related entities"** and modifies the disclosure requirements for such entities to enable them to limit the extent of disclosures about related party transactions with the government or other government-related entities

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Disclosure: Control relationships

- An entity is required to **disclose the name of its parent and, if different, the ultimate controlling party**

- The ultimate controlling party may or may not be a corporate entity. The requirement to disclose the entity's ultimate controlling party means that, **where such control is exercised by an individual, or by a group of individuals acting in concert, their identity must be disclosed**

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Disclosure: Control relationships (cont'd)

- If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, then **an entity discloses the name of the next most senior parent that produces financial statements available for public use**

- **Parent and subsidiary relationships are disclosed regardless of whether there have been any transactions between the parties.** The separate financial statements of a parent entity include disclosures of relationships with all subsidiaries, including sub-subsidiaries, except those that are immaterial on both a quantitative and qualitative basis

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Disclosure: Control relationships (cont'd)

- While parent and subsidiary relationships are disclosed regardless of whether transactions between the parties occurred, **an entity is not required to disclose related party relationships with other entities in a group**

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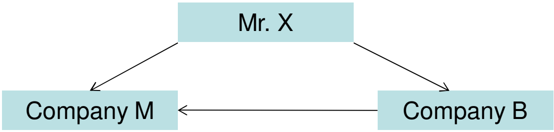
Disclosure: Control relationships (cont'd)

- **For example:** Co M and Co B are **owned and controlled** by Mr. X and have the same directors. Both M and B have numerous subsidiaries. B holds shares in M, but not enough to give B control over M; M does not hold any shares in B. In M's separate financial statements, it discloses only its relationships with X and with M's own subsidiaries. M is not required to describe its relationship with B or any of B's subsidiaries if there have been no transactions with these entities. However, any *transactions* with B or its subsidiaries are disclosed as related party transactions.



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Disclosures: Transactions and balances

- Related party transactions is defined as **a transfer of resources, services or obligations between related parties, regardless of whether a price is charged**. Therefore, disclosure is required in respect of guarantees, gifts or other non-reciprocal transfers of assets or services, asset swaps or other similar transactions between related parties

- **For example:** Co E and Co F are related parties. F's business activities include providing fund raising and promotional activities and F makes use of E's employees to arrange these events. E does not charge F for these services. Accordingly, in both E's and F's financial statements, the nature and the extent of the use of E's employees by F should be disclosed as a related party transaction

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Disclosure: Key management personnel compensation

- **The total compensation paid to key management personnel must be disclosed and analysed between:**

❑ short-term employee benefits;
❑ post-employment benefits;
❑ other long-term benefits;
❑ termination benefits; and
❑ share-based payment

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Disclosure: Key management personnel compensation (cont'd)

- Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. **Compensation amounts should relate to services rendered to the entity**

- Where key management personnel are paid a single salary in respect of services to more than one entity within the group, it will be necessary to **allocate the amounts paid between the services provided to the different group entities for the purposes of the separate financial statements of each individual group entity**

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Disclosure: Key management personnel compensation (cont'd)

- **Disclosure of key management personnel compensation generally is aggregated** rather than presented separately for each individual unless it is otherwise required, for example by local statutory or regulatory requirements

- Materiality considerations cannot be used to override the explicit requirements for the disclosure of elements of key management personnel compensation. The nature of the key management personnel compensation always makes it material qualitatively.

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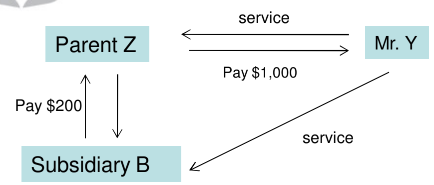
Disclosure: Key management personnel compensation (cont'd)



- Mr. Y is a director of Parent Z.
- Mr. Y provides services to both Parent Z and Sub. B
- Mr. Y is compensated by Z for the services performed for Z ($800) as well as those performed by B ($200)
- B reimburse Z for the amounts paid to Mr. Y on its behalf

- B should disclose in its own financial statements the amount of $200 paid to Z in respect of the services provided by Mr. Y to B as key management personnel compensation even though B pays this compensation to Z and not directly to Mr. Y.

- In Z's separate financial statements, disclosure of key management compensation should include only the amount paid to Mr. Y for services provided to Z, i.e. $800($1000 - $200).

- Z also discloses the reimbursement received from B for Mr. Y's services as a related party transaction.

Disclosure: Key management personnel compensation (cont'd)

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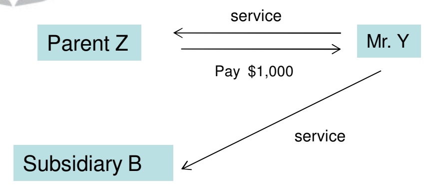

- Mr. Y is a director of Parent Z.
- Mr. Y provides services to both Parent Z and Sub. B
- Mr. Y is compensated by Z for the services performed for Z ($800) as well as those performed by B ($200)
- B **did not** reimburse Z for the amounts paid to Mr. Y on its behalf

- B discloses in its own financial statements the apportioned amount of the compensation paid by Z for the service received by B from Mr. Y (i.e. $200) and that the amount paid by B for these services was zero.
- In Z's separate financial statements, disclosure of key management personnel compensation should include only the amount paid to Mr. Y for service provided to Z (i.e. $800).
- Z also discloses the amount of the compensation paid for the services provided by Mr. Y to B and that no consideration was received, as a related party transaction.

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Disclosure: Key management personnel compensation (cont'd)

- In the consolidated financial statements, Mr. Y is considered to be key management personnel for both Z and for the group as a whole
- The compensation paid by Z therefore relates to the services performed for the group, and therefore, Mr. Y's total compensation for services to both B and Z, i.e. $1000 is disclosed

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Disclosure: Key management personnel compensation (cont'd)

Co X (the reporting entity) ← Mrs. B

Mrs. B is director of Co X & a partner of legal firm that provides legal services to X

Mrs. B is acting in two capacities in relation to X, as
- A director; and
- A partner of a legal firm providing services to X

- Co X should include within its disclosure of key management personnel compensation only the benefits provide to Mrs. B in her capacity as director
- If Mrs. B is involved closely in providing the legal services to X, by providing the services directly on behalf of the legal firm or by supervising the service provided, then Mrs. B is acting not only in the capacity as partner in the legal firm; in substance, it may appears that Mrs. B is providing the legal services directly to X. The fees paid for legal services rendered would be disclosed as "other related party transactions"
- Conversely, if Mrs. B did not provide legal services directly on behalf of the legal firm, did not supervise the services and did not have the power to influence the services provided to X, then the service is not a related party transaction

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Disclosure: Other related party transactions

- In addition to the compensation of key management personnel, an entity is required to disclose details of any other transactions with its related parties
- Where such transactions have occurred, the Standard requires disclosure of:

- [ ] the nature of the related party relationship; and
- [ ] information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements

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Disclosure: Other related party transactions (cont'd)

- The following examples are cited in the Standard of related party transactions that require disclosure:

❑ purchases or sales of goods (finished or unfinished);
❑ purchases or sales of properties or other assets;
❑ rendering or receiving of services;
❑ leases;
❑ transfers of research and development;
❑ transfers under license agreements;
❑ transfer under finance arrangements;
❑ provisions of guarantees or collateral; and
❑ settlement of liabilities on behalf of the entity or by the entity on behalf of another party

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Disclosure: Details to be disclosed

The following **minimum** disclosures are required:

❑ The amount of the transactions;
❑ The amount of outstanding balances 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 the outstanding balances; and
❑ The expense recognised during the period in respect of bad or doubtful debts due from related parties

The above details listed in HKAS 24 are not exhaustive, and other significant aspects of the transactions will be required to be disclosed, if such disclosure is necessary for an understanding of the financial statements

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Disclosure: Details to be disclosed (cont'd)

- The disclosures are required to be made separately for each of the following categorize:
  - The parent
  - Entities with joint control or significant influence over the entity
  - Subsidiaries;
  - Associates;
  - Joint ventures in which the entity is a venturer;
  - Key management personnel of the entity or its parent; and
  - Other related parties

An entity cannot avoid disclosure simply because the transaction is on normal market terms

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Disclosure: Aggregation

- HKAS 24 provides that **items of a similar nature may be disclosed in aggregate**, except where separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements

- **For example:** in the separate financial statements of a subsidiary, regular purchases or sales with other fellow subsidiaries may be aggregated. However, details of a significant disposal of property, plant and equipment to a subsidiary should not be included in an aggregate disclosure of regular sales of goods to subsidiaries as they are not similar in nature

The principal objective of HKAS 24 is to provide useful information to the users while avoiding excessive disclosure

Disclosure: Reference to transactions carried out at arm's length

- Related party transactions are required to be disclosed regardless of whether they are entered into on terms equivalent to those in an arm's length transaction
- An entity may include in its financial statements a statement that related party transactions were made on terms equivalent to those that prevail in an arm's length transaction **only if that statement can be substantiated**

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Disclosure: Comparative amounts

Transactions with party related in the current year, but not in the prior year

- **Scenario:** Sales were made to A Limited in both the current and prior years. If A Limited is a related party in the current year, but was not a related party in the prior year, should comparatives be disclosed?

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Disclosure: Comparative amounts

Transactions with party related in the current year, but not in the prior year (cont'd)

- **Comparatives should not be disclosed,** as there was no related party relationship that may have affected the comparative period's results. Where the absence of comparatives may create confusion, an additional explanation might be provided, stating that, while similar transactions were entered into the prior period, they were not related party transactions, as the related party relationship did not exist in that period

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Disclosure: Comparative amounts (cont'd)

Transactions with party related in the prior year, but not in the current year

- **Scenario:** Sales were made to B Limited in both the current and prior years. If B Limited was a related party in the prior year, but is not a related party in the current year, should the prior year's sales be disclosed as a related party transactions again in the current year's financial statements? If so, should the current year's sales also be disclosed even though B Limited is no longer related?

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Disclosure: Comparative amounts (cont'd)

Transactions with party related in the prior year, but not in the current year (cont'd)

- **The prior year's sales should be disclosed again,** since the related party transactions may have impacted the comparative figures in the financial statements. The current year's sales should not be disclosed, since B Limited is no longer related. Where the inclusion of comparatives but not current period figures may create confusion, then an additional explanation might be provided, stating that, while similar transactions occurred in the current period, they are not related party transactions, as the related party relationship did not exist in that period

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Disclosure: Other

- In the consolidated financial statements, intra-group transactions and the profit on transactions with associates or joint ventures to the extent of the investor's interest are eliminated.

- **An entity still is required to disclose the portions of transactions with joint ventures or associates that are not eliminated on proportionate consolidation or equity accounting**

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Requirements under HKAS 24(2009)

- HKAS 24 (2009) includes a reference to **"commitments"** whenever it refers to transactions and balances

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Partial exemption of government entities under HKAS 24(2009)

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Government-related entities

- HKAS 24 (2009) allows **a reporting entity to reduce the level of disclosures** about 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
- In this context, government refers to government, government agencies and similar bodies whether local, national or international

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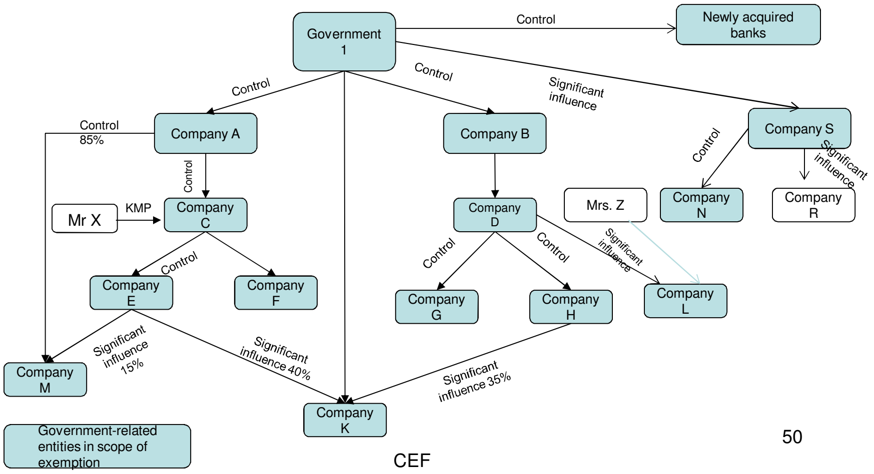
- The following diagram highlights the government-related entities, which might be in the scope of the exemption:



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Partial exemption of government-related entities

- Where a reporting entity is exempted from the general requirements in accordance with HKAS 24(2009).25, the revised Standard requires the reporting entity to disclose the following information about the transactions and related outstanding balances: [HKAS 24(2009).26]

(a) The **name of the government** and the **nature of its relationship** with the reporting entity (i.e. control, joint control or significant influence);

(b) The following information in sufficient detail about:

- the nature and amount of each individually significant transaction; and
- for other transactions that are collectively, but not individually significant, a qualitative or quantitative indication of their extent

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Partial exemption of government-related entities

- Regarding the level of detail to be disclosed in relation to transactions that are collectively (but not individually) significant, the revised Standard states that the closeness of the related party relationship and other factors relevant in establishing the level of significance of the transaction should be considered. **Examples of factors** to be considered are whether the transaction: [HKAS 24(2009).27]

  - is significant in terms of size;
  - is carried out on non-market terms;
  - is beyond normal day-to-day business operations (e.g. such as the purchase and sale of businesses);
  - has been disclosed to regulatory or supervisory authorities;
  - has been reported to senior management;
  - requires shareholder's approval.

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Disclosure for individually significant transaction carried out on non-market terms [HKAS 24(2009).IE3]

Example:

On 15 January 20X1, Entity A, an utility company in which Government G indirectly owns 75% of outstanding shares, sold a 10 hectare piece of land to another government-related utility company for $5M. On 31 December 20X0, a plot of land in a similar location, of similar size and with similar characteristics, was sold for $3M. There had not been any appreciation or depreciation of the land in the intervening period. See note X of the financial statements for disclosure of government assistance as required by HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and note Y and Z of of the financial statements for compliance with other relevant HKFRSs

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Disclosure for individually significant transaction because of size of transaction [HKAS 24(2009).IE3]

Example:

In the year ended December 20X1, Government G provided Entity A, a utility company in which Government G indirectly owns 75% of outstanding shares, with a loan equivalent to 50% of its funding requirements, repayable in quarterly instalments over the next five years. Interest is charged on the loan at a rate of 3%, which is comparable to that charged on Entity A's bank loan*. See notes Y and Z of the financial statements for compliance with other relevant HKFRSs.

* If the reporting entity had concluded that this transaction constituted government assistance it would have needed to consider the dislosure requirements in HKAS 20

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Disclosure of collectively significant transactions [HKAS 24(2009).IE3]

Example:

Government G, indirectly, owns 75% of Entity A's outstanding shares. Entity A's significant transactions with Government G and other entities controlled, jointly controlled or significantly influenced by Government G are [a large portion of its sales of goods and purchases of raw materials] or [about 50% of its sales of goods and about 35% of its purchases of raw materials].

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Overview of major changes – HKAS 24 (2009)

- Modified requirements for entities under control, joint control or significant influence of a government (“government-related entities”) in respect of certain related party disclosures.
- Related party relationships made symmetrical between each of the related parties, i.e., if A is related to B for the purpose of B’s financial statements, then B also is related to A in A’s financial statements.

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Overview of major changes

- New relationships included in the definition of a related party (which are illustrated in detail in later slides):
    1. In the individual and/or separate financial statements of a subsidiary, any associate of the controlling shareholder (slides 57 & 58)
    2. In the financial statements of an entity controlled or jointly controlled by a member of another entity's key management personnel (KMP), the entity managed by that KMP (slides 59 & 60)
    3. In the financial statements of an entity jointly controlled or significantly influenced by a close family member of an individual investor, any entity jointly controlled by that individual investor.
    4. In the financial statements of an entity significantly influenced by an individual investor, another entity controlled or jointly controlled by the same person and vice versa (slides 62 & 63).

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Overview of major changes

- Two entities are no longer related if one of them is under significant influence of a person and the other is:
    1. Under significant influence of that person's close family member (slide).
    2. Managed by that person in his capacity as KMP.
- Clarification that references to associates and joint ventures include the subsidiaries of those associates and joint ventures.
- Relationships between a reporting entity and a corporate investor and between a reporting entity and an individual investor are treated in the same manner.
- The reference to "significant voting power" was removed from the definition.
- More detailed disclosures are required in relation to commitments.
- HKFRS 8 *Operating Segments* no longer regards all government-related entities as a single customer by default.
- The effective date is annual periods beginning on or after 1 January 2011.

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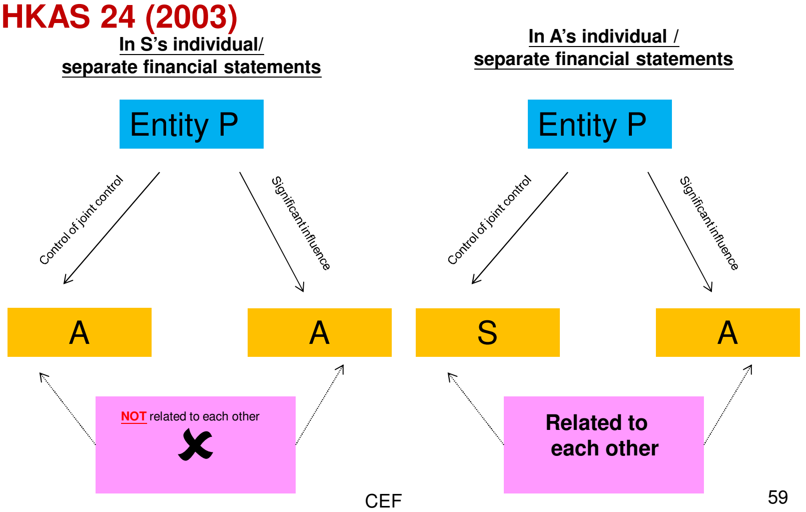
Case 1

An associate and a subsidiary of an investor
HKAS 24 (2003)



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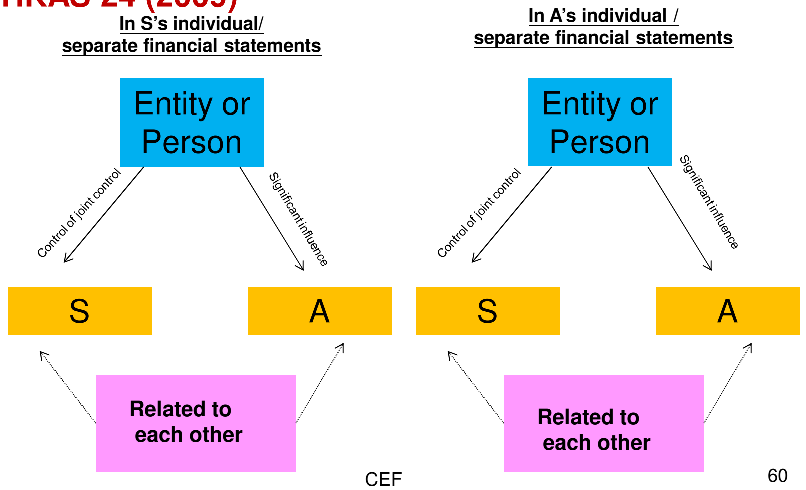
Case 1 (cont'd)

An associate and a subsidiary of an investor
HKAS 24 (2009)



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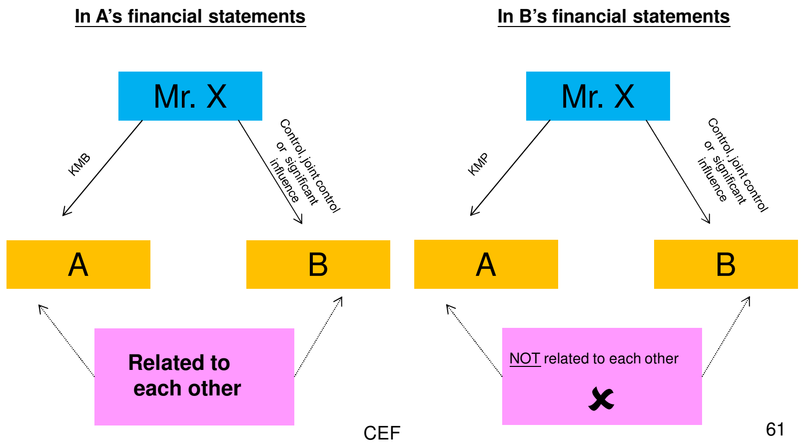
Case 2

Investments of key management personnel (KMP) HKAS 24 (2003)



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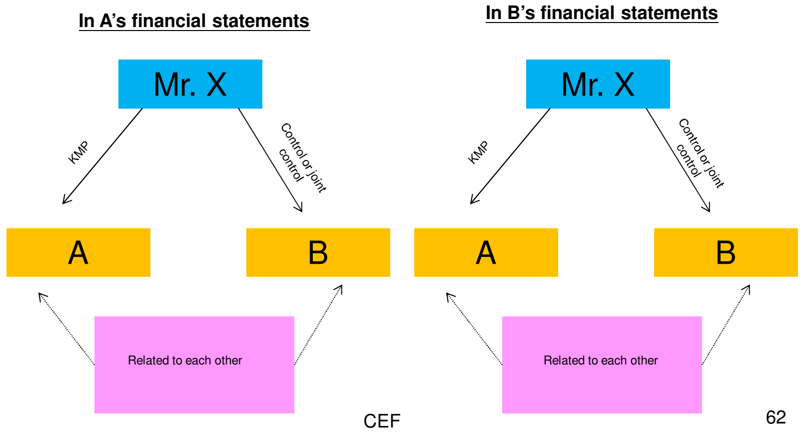
Case 2 (cont'd)

Investments of key management personnel (KMP) HKAS 24 (2009)

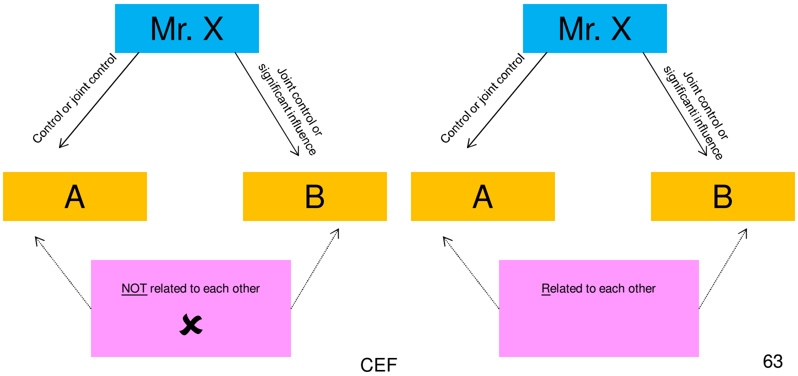


Case 3

Other investments of an individual investor in a reporting entity

HKAS 24 (2003)
In both A's and B's financial statements

HKAS 24 (2009)
In both A's and B's financial statements

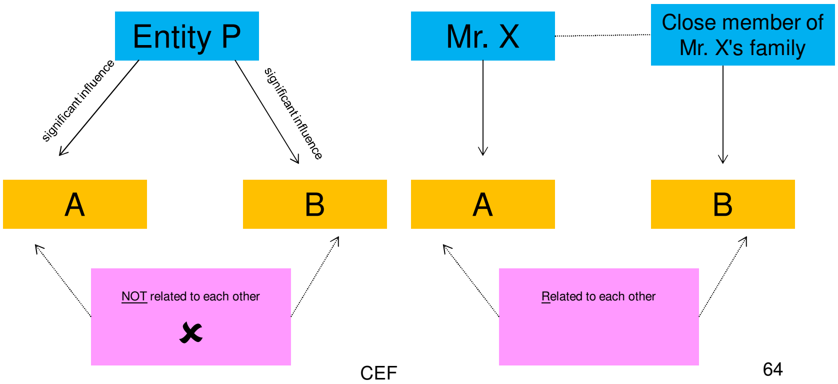


Case 4

Two associates HKAS 24 (2003)

Corporate investor

Individual investor



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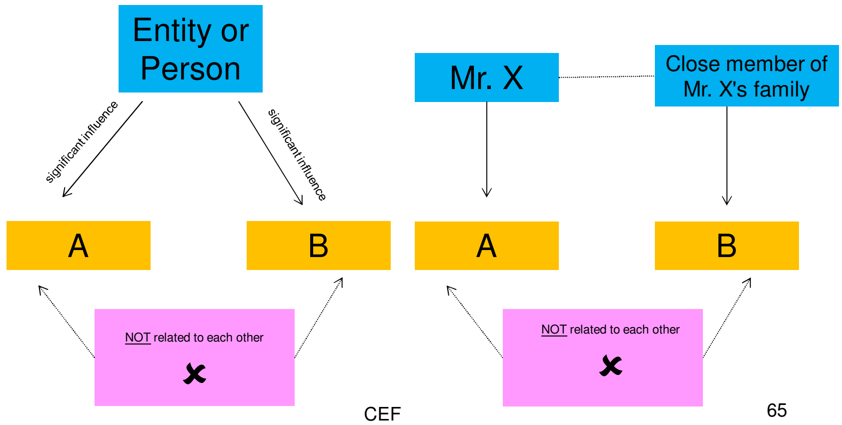
Case 4 (cont'd)

Two associates HKAS 24 (2009)



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Practical Applications

Direct relationships

Principles to remember

- Related party relationships under HKAS 24 (2009) are symmetrical, i.e., if A is related to B for the purpose of B's financial statements, then B also is related to A in A's financial statements.
- All direct relationships involving control, joint control or significant influence are related party relationships.
- Significant influence and KMP relationships are treated as the same level of "closeness". These relationships are not as close as a relationship of control or joint control.
- Relationships between a reporting entity and a corporate investor and between a reporting entity and an individual investor are treated in the same manner.
- An individual and close members of that individual's family are treated as one party in analysing related party relationships.

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Practical Applications

Direct relationships

Principles to remember (cont'd)

- Members of the same group (i.e., parent and all subsidiaries) are treated as one party in respect of the reporting entity in analysing related party relationships.
- A post-employment benefit plan for employees of the reporting entity or any entity that is a related party of the reporting entity is considered to be a related party of the reporting entity.
- Whenever a list of related parties changes as a result of the application of IAS 24 (2009), entities need to re-assess their qualifying insurance policies for the purposes of IAS 19 *Employee Benefits, as the definition in IAS 19 is impacted by the definition of a related party.*

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Practical Applications

Indirect relationships

Principles to remember

- Presence of control or joint control in one leg of an indirect relationship leads to a related party relationship – see illustration below.
- Significant influence and KMP relationships are treated as the same level of "closeness". These relationships are not as close as a relationship of control or joint control.
- An individual and close members of that individual's family are treated as one party in analysing related party relationships.
- Whenever a list of related parties changes as a result of the application of IAS 24 (2009), entities need to re-assess their qualifying insurance policies for the purposes of IAS 19 as the definition in IAS 19 is impacted by the definition of a related party.

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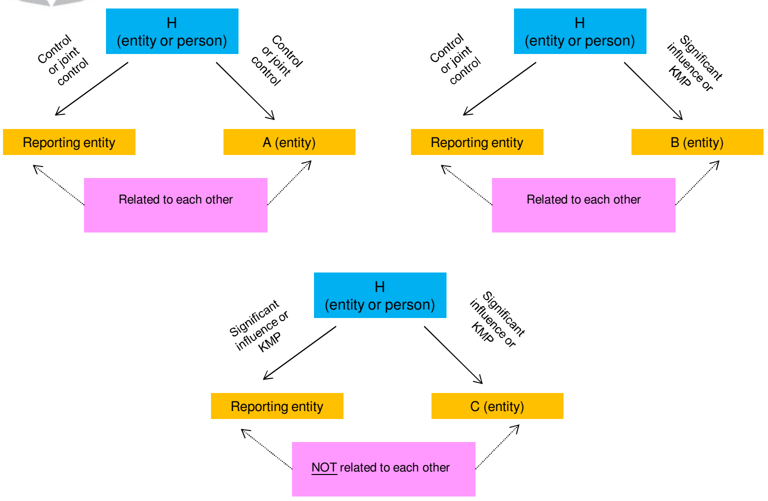
Practical Applications

Indirect relationships



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Related party disclosure requirements for government-related entities

Required to disclose under HKAS 24 (2003)	Required to disclose under HKAS 24 (2009)

• Nature of relationship
• Amount of transaction, for example
  • Sales and purchases of goods or services
  • Sales and purchases of assets
  • Leases
  • Transfers of research and development
  • Transfers under licence arrangements or finance agreements
  • Guarantee or collateral
• Outstanding balances, including their terms and conditions and details of guarantees given or received
• Provision for doubtful debts and related expenses, including bad debts, for the period
	• Name of government and nature of relationship
	• Nature and amount of each individually significant transaction
	• A qualitative or quantitative indication of the extent of other transactions that are collectively, but not individually, significant

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Thank you for your attention

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

Annex 1

Acquisition of Asset – Example

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

收購事項已列作收購資產及負債。收購事項之影響概述如下：

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

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

Annex 2

Acquisition of Asset – Example

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

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

Asset acquired in the transaction is as follows:

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

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

Acquisition of Asset – Example

Annex 3

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

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

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

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

Extract from the 2010 financial statements of China Gold International Resources Corp. Ltd

Issue of shares as consideration – Example

On August 30, 2010, the Company entered into the Purchase Agreement with the Vendors to acquire a 100% interest in the Jiama Mine through the purchase of 100% interest in Skyland and the assumption of shareholders' loan and accrued interests from the Vendors by issuing 170,252,294 common shares of the Company (the "Consideration Shares"), subject to the working capital adjustment mechanism (the "Purchase Price Adjustment") as mentioned below, to the Vendors at the closing date, i.e. December 1, 2010 (the "Closing Date"). This acquisition has been accounted for using the acquisition method. Skyland Group are principally engaged in the exploration, development and mining of mineral properties in the PRC. Skyland Group was acquired to continue the expansion of the Group's mining operations.

Consideration transferred

Common shares issued, without par value	170,252,294
Fair value at the Closing Date	US$4.76
Total consideration (provisional)	US$810,926,039

The fair value of the Consideration Shares was determined using the published price available at the Closing Date, adjusted by applying a discount rate of 17.1% after taking into account the lack of marketability of the Consideration Shares over the 6-month lock-up period. The valuation of the Consideration Shares was conducted by an independent qualified professional valuer using the Black-Scholes option pricing model, with 0.38% risk free interest rate and 61.50% expected volatility over the lock-up period.

Provisional value – Example

Extract from the 2010/11 financial statements of TCC International Holdings Limited

Assets and liabilities recognised at the date of acquisition (determined on a provisional basis):

於收購日期確認之資產及負債如下（按臨時基準釐定）：

		HK$'000 千港元
Non-current assets	***非流動資產***	
Property, plant and equipment	物業、廠房及設備	136,703
Prepaid lease payments	預付租賃款項	12,257
Mining rights	採礦權	1,785
Deposits paid for the acquisition of property, plant and equipment and other assets	收購物業、廠房及設備及其他資產之已付訂金	43,143
		193,888
Current assets	***流動資產***	
Prepaid lease payments	預付租賃款項	257
Prepayments, deposits and other receivables	預付款項、按金及其他應收款項	30,815
Pledged bank deposits	已抵押銀行存款	5,994
Cash and bank balances	現金及銀行結餘	6,558
		43,624
Current liabilities	***流動負債***	
Other payables and accrued liabilities	其他應付款項及應計負債	21,123
Bank loans	銀行貸款	1,794
Loan payable (Note)	應付貸款（附註）	23,400
Amount due to the then shareholder	應付當時股東款項	35,367
Amount due to a related company	應付一間關連公司款項	36,481
		118,165
Non-current liabilities	***非流動負債***	
Bank loans	銀行貸款	16,146
Deferred tax liabilities	遞延稅項負債	378
		16,524
		102,823

		HK$'000 千港元
Goodwill arising on acquisition	***收購事項產生之商譽***	
Consideration transferred	已轉讓代價	90,734
Plus: Non-controlling interests	加：非控股權益	35,988
Less: Provisional fair value of identifiable net assets acquired	減：已收購可識別資產淨值之臨時公平值	(102,823)
Goodwill arising on acquisition	收購時產生之商譽	23,899

Goodwill arose on the acquisition of Kong On because the acquisition included the assembled workforce of Kong On and some potential contracts which are still under negotiation with prospective new customers as at the date of acquisition. These assets could not be separately recognised from goodwill because they are not capable of being separable from the Group and sole, transferred, licensed, rented or exchanged, either individually or together with any related contacts.

由於收購包括港安之集結勞動力及於收購日期仍與潛在客戶磋商中之若干潛在合約，故收購港安產生商譽。該等資產不可獨立於商譽確認，原因為該等並不可獨立於本集團，及不可獨立存在、轉讓、許可、租賃或兌換，無論個別或連同任何相關合約。

Note

The business combination is determined on a provisional basis as the Group is in the process of identifying and obtaining independent valuation to assess the fair value of the identifiable assets acquired. The goodwill, prepaid lease payments and the related deferred tax liabilities may be adjusted upon completion of the initial accounting.

附註：

由於本集團正識別及獲取獨立估值以評估已收購之可識別資產之公平值，故業務合併按臨時基準釐定。商譽、預付租賃款項及相關遞延稅項負債或會於首次會計處理完成時予以調整。

Reverse Acquisition – Example

Annex 6

Extract from the 2009 financial statements of GCL Poly Energy Holding Limited

2. BASIS OF PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

Upon completion of the acquisition agreements (the "Acquisition"), the selling shareholders of GCL Solar, Sun Wave and Greatest Joy (together with their subsidiaries collectively the "Solar Group") received 10,039,772,727 ordinary shares of the Company as part of the consideration of the disposals, representing 90.7% of the enlarged share capital of the Company. As a result, the selling shareholders of the Solar Group received and owned the largest portion of the voting rights of the Company.

Under International Financial Reporting Standard ("IFRS") 3, Business Combinations, the Acquisition is accounted for as a reverse acquisition. For accounting purpose, the Solar Group is the accounting acquirer and the Company (the accounting acquiree) is deemed to have been acquired by the Solar Group. In applying the purchase method of accounting to effect a "reverse acquisition", the goodwill as of the acquisition date is measured as the excess of the deemed cost of the business combination (deemed consideration) over the fair value of the identifiable assets, liabilities and contingent liabilities of the Company and its subsidiaries immediately prior to the Acquisition (the "Power Group").

The consolidated financial statements have been prepared as a continuation of the Solar Group, with adjustments to the equity structure of the Company using the exchange ratio established in the acquisition to reflect the number of shares of the Company issued under the acquisition agreements. Comparative information presented in the consolidated financial statements have been restated to present those of the Solar Group but adjusted to reflect the legal capital of the Company.

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

YOUR HOSTS

Winnie Chan
HKICPA Associate Director
Technical Training & Support

Eky Liu
HKICPA Manager
Technical Training & Support

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Financial Instruments

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Hong Kong Financial Reporting Standards

❖ HKFRS - Our focus in this session

Financial Instruments

HKAS 32 *Financial Instruments: Presentation*

HKAS 39 *Financial Instruments: Recognition and Measurement*

HKFRS 9 *Financial Instruments*

HKFRS 7 *Financial Instruments: Disclosures*

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HKAS 32
Financial Instruments: Presentation

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Agenda – HKAS 32

- Definitions
- Principles of liability/equity classification
- Compound financial instruments

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❖ Definition of a financial instrument and applicability of HKAS 32

- A financial instrument is any contract that gives rise to a financial asset of a company and a financial liability or equity instrument of another company
- HKAS 32 applies to all financial instruments except for:
- interests in subsidiaries, associates and joint ventures
- employers' rights and obligations under employee benefit plans
- rights and obligations arising under insurance contracts
- financial instruments, contracts and obligations under share-based payment arrangements
- HKAS 39 also scopes out these instruments, but has some additional scope exemptions

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Definition of a financial asset [HKAS 32.11]

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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Question:

Financial assets

❖ **Are gold bullion, prepaid expenses and tax receivables financial assets and measured under HKAS 39?**

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

ii. **Prepaid expense** is not a financial asset. The anticipated future economic benefit of the prepaid expense is the receipt of goods or services

iii. **Tax receivables** are not financial assets. They arise from statutory requirements

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Definition of a financial liability [HKAS 32.11]

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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Exemptions from liability classification

- The following two categories of financial instruments issued by an entity are exempt from liability classification even if they contain an obligation for the entity to deliver cash or another financial asset:
  - puttable financial instruments that meets certain conditions; and
  - an instrument, or a component of an instrument, that contains an obligation for the issuing entity to deliver to the holder a pro rata share of the net assets of the issuing entity only on its liquidation
  - refer to HKAS 32.16, 16A-16D

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Equity Instrument [HKAS 32.11 & 16]

- An equity instrument is any contract that evidence a residual interest in the assets of the entity after deducting all of its liabilities
- In classifying a financial instrument as liability or equity, equity classification is appropriate only if the instrument fails the definition of a financial liability
- To determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions as follows are met

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 liability/equity classification

a. *Contractual obligation to settle in cash or another financial asset*

b. *Fixed for fixed requirement*

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Principles of liability/equity classification

Contractual obligation to settle in cash or another financial asset

- Classification of a financial instrument at initial recognition should be:
  - according to the substance of the contractual arrangement, not its legal form, and
  - the definitions of a financial asset, financial liability and an equity instrument
- Key features to determine whether a financial instrument is a liability:
  - existence of a contractual obligation of one party (the issuer) to deliver cash or another financial asset to another party (the holder), or
  - to exchange financial assets or liabilities under conditions that are potentially unfavourable

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Principles of liability/equity classification

Fixed for fixed requirement

- A **contract** is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments

- Classification of contracts that may/will be settled in the entity's own equity instruments is dependent on:
  - whether there is variability in either the number of own equity delivered and/or variability in the amount of cash or other financial assets received, or whether both are fixed

- A contract that will be settled by the **entity receiving (or delivering) a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument** ('fixed for fixed' requirement)

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Principles of liability/equity classification

Fixed for fixed requirement (cont'd)

- **Questions?**
  - A contract to deliver as many of the entity's own equity instruments as are equal in value of $100.
  - A contract to deliver as many of the entity's own equity instruments as are equal in value of the value of 100 ounces of gold.

Are these contracts an equity or a financial liability?

- Such a contract is **a financial liability** even though the entity must or can settle it by delivering its own equity instruments.
- It is **not an equity instrument** because the entity uses a variable number of its own equity instrument as a means to settle the contract.
- The contract **does not evidence a residual interest** in the entity's assets after deducting all of its liabilities.

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Further illustration:

- An entity receives HK$1m in exchange for its promise that it will deliver its own equity shares in an amount sufficient to equal a value of HK$1m at a future date. If the share price at the date on delivery of the contract is HK$5, the entity would be required to issue 200,000 shares (that is, a total value of HK$1m)
- On the day the issuer delivers its own equity, the holder would be indifferent whether it received cash of HK$1m or shares to the value of HK$1m which it could sell and receive HK$1m in cash
- Therefore, the entity is using its own equity as currency and as such the holder does not get a full residual interest
- Hence the financial instrument is a liability

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Principles of liability/equity classification

Classification of Rights Issues

- A financial instrument that gives the holder the right to acquire a fixed number of the entity's own equity instruments for a fixed amount of **any currency** is an equity instrument if, and only if, the entity offers the financial instrument pro rata to all of its existing owners of the same class of its own non-derivative equity instruments, **such rights issues are classified as equity regardless of the currency in which the exercise price is denominated**

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Principles of liability/equity classification
Compound financial instruments

- The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and equity component
- Such components shall be classified separately as financial liabilities, financial assets or equity instruments

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Principles of liability/equity classification
Compound financial instruments (cont'd)

- **Example:** Bonds with conversion features which comprises two components:
  - financial liability (a contractual arrangement to deliver cash or another financial asset), and
  - an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity)

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Separating the liability and equity components

- Separation of the instrument into its liability and equity components is made upon **initial recognition** and is **not subsequently revised**

- **Method** for separating a convertible bond:
  - (a) The fair value of the liability component is calculated, and this fair value establishes the initial carrying amount of the liability component; and
  - (b) The fair value of the liability component is deducted from the fair value of the instrument as a whole, with the residual amount being the equity component.

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Example – Separation of a convertible bond (HKAS 32 IE34 – IE36)

An entity issues 2,000 convertible bonds at the start of year 1:

(a) 3-year term

(b) Issued at par

(c) Face value of HK$1,000 per bond
(Total proceeds of HK$2,000,000)

(d) Interest payable annually in arrears at a nominal interest rate of 6%

(e) Convertible at any time into 250 ordinary shares for each bond

(f) Market interest rate for similar debt without conversion option of 9%

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Example – Separation of a convertible bond (HKAS 32 IE34 – IE36) - Cont'd

	HK$
Present value of the principal – HK$2,000,000 payable at the end of three years $\dfrac{2{,}000{,}000}{(1.09)^3}$	1,544,367
Present value of the interest – HK$120,000 payable annually in arrears for three years $\dfrac{120{,}000}{(1.09)} + \dfrac{120{,}000}{(1.09)^2} + \dfrac{120{,}000}{(1.09)^3}$	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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Question:

Written call over equity of a subsidiary

- **Scenario:** Group Z — Parent X — Subsidiary Y
- **Subsidiary Y writes a call option to a company outside the group over a fixed number of its own equity**
- **The equity shares is exclusively physically settled in all cases**
- **The strike price of the option is a fixed amount of cash**

How should Subsidiary Y and Group Z classified this written call option?

i. **Subsidiary Y's F/S:** the written call option is an equity item

ii. **Group Z's consolidated F/S:** the written call option is within the scope of HKAS 32 because it is a derivative over an interest in a subsidiary.
It is outside the scope of HKAS 39 and HKFRS 7. The instrument meets the definition of equity in the F/S of Subsidiary Y in accordance with HKAS 32 and is presented within non-controlling interests in the consolidated F/S of Group Z

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Question:

Written call over equity of a subsidiary

❖ **Scenario:** Group Z — Parent X — Subsidiary Y

❖ **Parent X writes the call option over a fixed number of shares in Subsidiary Y for a fixed amount of cash**

How should Parent X and Group Z classified this written call option?

i. **Parent X's separate F/S:** the written call option is a derivative that is in the scope of HKAS 39 and HKFRS 7. It does not meet the definition of equity in Parent X's financial statements because the derivative does not relate to Parent X's equity

ii. **Group Z's consolidated F/S:** the written call option is a derivative over an interest in a subsidiary which is presented within non-controlling interests. It is within the scope of HKAS 32. It is outside the scope of HKAS 39 and HKFRS 7 because the instrument meets the definition of equity

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Financial Instrument: Measurement and Recognition

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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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Classification of financial assets

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

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Classification of financial liabilities

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

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

Held for trading financial assets/liabilities

- Acquired or incurred principally for the purpose of sale or settled in the near term OR
- On initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking OR
- It is a derivative (except for a derivative that is a designated and effective hedging instrument)

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

Fair Value Option (FVO)

- A financial asset or a financial liability may upon initial recognition be designated as at FVTPL only if it meets one of the following conditions:
  - it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (commonly referred to as an "accounting mismatch")
  - a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel

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

Fair Value Option (FVO)

- In the case of a hybrid contract containing one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability as FVTPL unless:
  - the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
  - it is clear that separation of the embedded derivative is prohibited

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Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than those the entity intends to sell immediately or in the short-term, and those that the entity on initial recognition designates as either FVTPL or available-for-sale

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Held-to-maturity investments (HTM)

- HTM investments are non-derivative financial instruments with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity, other than those that the entity, upon initial recognition, elects to designate as at FVTPL or available-for-sale or that meet the definition of loans and receivables

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Available-for-sale financial assets (AFS)

AFS financial assets are those non-derivative financial assets that are designated as AFS, or are not classified as loans and receivables or HTM investments, are not held for trading and are not designated as at FVTPL on initial recognition

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Derivatives

- Stand-alone derivatives
  - Held for trading
  - Hedge accounting
    - a fair value hedge
    - a cash flow hedge; and
    - a hedge of a net investment in a foreign operation ("net investment hedge")
- Embedded derivatives

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Financial guarantee contracts

Definition

- Contracts that require the issuer to make specified payments to reimburse the holder for **a loss** it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument

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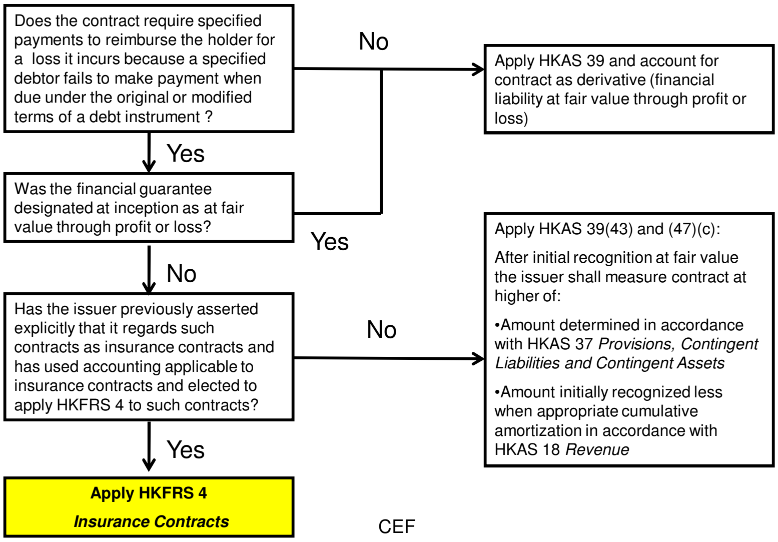
Decision tree: The treatment of issued financial guarantees



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Question:

Financial Guarantee Contracts (Issuer Accounting)

- **Scenario:** Holding Co A — Subsidiary B
- **Subsidiary B enters into a third-party bank loan**
- **Holding Co A writes a financial guarantee contract to the bank over the loan**

How should Holding Co A recognise the financial guarantee contract in its separate financial statements and consolidated financial statements?

i. **Separate financial statements of Holding Co A:** Initially recognise the financial guarantee contract at fair value and subsequently measure it at the higher of (a) the amount determined in accordance with HAKS 37 *Provisions, Contingent Liabilities and Contingent Assets;* and (b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with HKAS 18 *Revenue* [HKAS 39:47(c)]

ii. **Consolidated financial statements of Holding Co A:** the financial guarantee contract is not separately recognised. The group as a single entity simply borrowed money from a 3rd party

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Question:

Financial Guarantee Contracts (Issuer Accounting)

- **In accordance with the requirement of HKAS 39 , financial guarantee contract shall initially be recognised at fair value. How should the fair value be determined?**

i. Theoretically, the initial value of the financial guarantee contract is the difference between the present value of interest to be charged with and without that guarantee

ii. It can also be the price to be paid to a guarantor/insurance company for that kind of guarantee

iii. In the case of Holding company writing a financial guarantee contract to the bank for a loan granted to its subsidiary, the guarantee is recognised as a contribution to the subsidiary and a financial liability at initial recognition

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Question:

Financial Guarantee Contracts (Issuer Accounting)

❖ **Is there exception but to follow the recognition and measurement rules for financial guarantee contract under HKAS 39.47(c)?**

The initial recognition and subsequent measurement rules apply to financial guarantee contracts with the following exceptions:

i.If the financial guarantee contract was entered into or retained on a transfer of a financial asset that does not result in derecognition of the financial asset or resulted in continuing involvement, follow HKAS 39.29 and HKAS 39.31 for measurement basis

ii.If the financial guarantee contract was designated as at fair value through profit or loss at inception . Subsequently measured at fair value

iii.The issuer has previously asserted explicitly that it regards the financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either HKAS 39 or HKFRS 4 *Insurance Contracts.* This election may be made on a contract-by-contract basis, but once made it is irrevocable [HKAS 39:2(e)] *[**note:** refer to HKFRS 4.15-17 for the liability determination for insurance contracts]*

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Question:

Financial Guarantee Contracts

How would the subsidiary account for the financial guarantee contracts issued by the parent company?

i. HKAS 39 does not address the accounting for financial guarantees by the beneficiary

ii. There is no requirement in HKAS 24 to fair value non-arm's length related party transaction

iii. An accounting policy choice as to whether a capital contribution is recognised in equity

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Question:

Financial Guarantee Contracts (Issuer Accounting)

❖ **What about if a parent company provides a comfort letter/guarantee to a subsidiary which says that if the subsidiary fails to repay the loan to the bank when due, the parent will pay on its behalf instead of providing the guarantee to the bank. Any differences in accounting?**

i. **Separate financial statements of parent company:** the guarantee is not recognised separately

ii. Holding Co A agreed to contribute more money to its subsidiary which will be accounted for as a capital contribution as and when it is contributed. The promise by the parent to inject money at a future date is not recognised up-front

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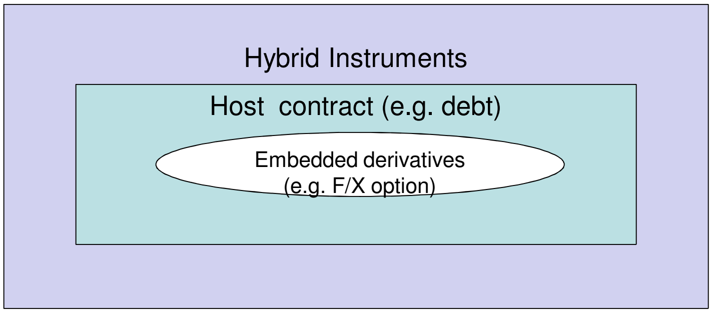
Embedded derivative



❖ A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument

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Embedded derivatives

Separation conditions

- An embedded derivative is separated from its host contract and accounted for separately as a stand-alone derivative when:

a) the economic characteristics and risks of the embedded derivative are not closely related to the economic risks and characteristics of the host contract;
b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
c) the hybrid instrument is not measured at fair value with changes in fair value recognised in profit or loss

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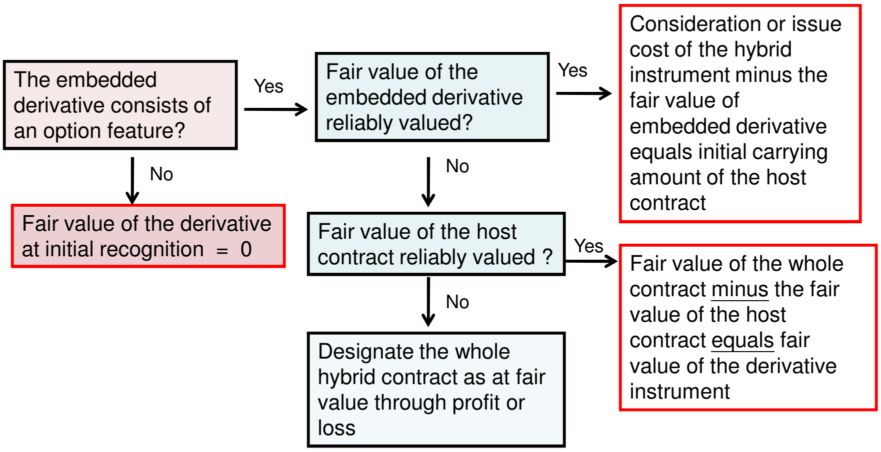
Price allocation between embedded derivative and host contract



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Initial recognition and subsequent measurements

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Initial measurement of financial assets and liabilities

- HKAS 39 requires that financial assets and liabilities are measured initially at "fair value"
- For a financial asset or liability that is not classified as "at fair value through profit or loss" (FVTPL), transaction costs that are directly attributable to the acquisition or issue of the asset or liability should be added to or deducted from the fair value on initial recognition

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Subsequent measurement of financial instruments

- Financial assets falling within the FVTPL category, which includes those classified as held for trading and derivative assets that are not designated as effective hedging instruments, are measured at fair value (transaction costs that might be incurred upon future disposal are not deducted from fair value in determining the carrying amount), but the following financial assets should not valued at fair value……..
- Financial liabilities are measured at amortised cost using the effective interest method, with the following exceptions……..

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Subsequent measurement of financial instruments

Classifications	Measurement basis	Fair value changes
Financial assets/liabilities at fair value through profit or loss (FVTPL)	Fair Value	Recognised in profit or loss
Held-to-maturity investments	Amortised cost	-
Loans and receivables	Amortised cost	-
Available-for-sale financial assets	Fair value	Recognised in OCI
Financial assets carried at cost	Cost (*note)*	

(note) Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured, are measured at cost.

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Monetary financial assets/liabilities

- Monetary items are defined in HKAS 21 *The Effects of Changes in Foreign Exchange Rates* as units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency
- Where a financial asset or financial liability is a monetary item under HKAS 21, foreign exchange gains and losses should be recognised in profit or loss in accordance with HKAS 21
- For AFS financial assets that are not monetary items under HKAS 21 (e.g. equity instruments), the gain or loss that is recognised in OCI includes any related foreign currency component

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Summary of how foreign currency is treated for the various financial assets/liabilities classifications:

Classifications	Monetary or non-monetary item	Foreign currency gains and losses from re-measurement (prior to its disposal)*
Available-for-sale	Monetary item (e.g. debt security)	Profit or loss
Available-for-sale	Non-monetary item (e.g. equity security)	Equity
Loans and receivables	Always a monetary item	Profit or loss
Held-to-maturity	Always a monetary item	Profit or loss
Fair value through profit or loss	Not applicable	Profit or loss
Liability carried at amortised cost	Always a monetary item	Profit or loss

** Assumes that the item is not being hedged for foreign currency, or is not a hedging instrument in a foreign currency hedge*

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Derivatives

	Classifications	Measurement basis	Fair value changes
	Non-hedging	Fair value	Profit and loss
	Hedging		
	▪ Fair value hedge	Fair value	Profit and loss
	▪ Cash flow hedge	Fair value	- **Effective portion:** Recognised in other comprehensive income - Subsequently reclassified from equity to profit or loss in the same periods which the hedged item affects profit or loss **- Ineffective portion:** Recognised immediately in profit or loss
	▪ Net investment hedge	Fair value	- **Effective portion:** Recognised in other comprehensive income - Reclassified from equity to profit or loss when the net investment affect profit or loss - **Ineffective portion:** Recognised immediately in profit or loss

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Question:

Presentation of disposal of financial assets

❖ **Regarding the presentation of the disposal of financial assets in the ordinary course of business in the statement of comprehensive income, it is noted that some preparers show sales proceeds from the sale of financial assets as revenue (gross), while others present the gains and losses on disposal net. What guidance is available in this respect?**

i. Revenue arising from disposal of financial assets and financial liabilities is scoped out from HKAS 18 *Revenue*

ii. Disposals of financial assets are addressed in HKAS 39 *Financial Instruments: Recognition and Measurement* and HKFRS 7 *Financial Instruments: Disclosures*

iii. Gains and losses arising from disposal of financial assets should be presented net

iv. However, the company is not precluded from disclosing additional information in the financial statements related to gross sales proceeds provided that they are not described as 'revenue'

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Question:

Reclassification

❖ **Are there any restrictions on the reclassification requirements for financial assets?**

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	Yes
Held-to-maturity	No	No	No		Yes
Available-for-sale	No	No	Yes	Yes	

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Question:

Reclassification

❖ **What are the new "amortised cost" and the "effective interest rate" when a financial asset is reclassified from AFS to loans and receivables?**

i. The fair value at the date of reclassification becomes the amortised cost. This new "amortised cost" is used as the basis for assessing impairment in the future

ii. Any gains or losses already recognised in profit or loss are not reversed

iii. The effective interest rate is recalculated using the fair value at the date of reclassification. This new effective interest rate will be used to calculate interest income in future periods and considered as the original effective interest rate when measuring impairment

iv. For a financial asset denominated in a foreign currency, the amortised cost of the financial asset at the date of reclassification is calculated in the foreign currency and then translated at the spot rate to the functional currency at the date of reclassification.

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Question:

Reclassification

❖ **How should we treat the cumulative gain or loss that has been recognised directly in other comprehensive income when a financial asset with fixed maturity is reclassified from AFS to loans and receivables?**

i. Any previous gain or loss on that asset that has been recognised directly in other comprehensive income is amortised to profit and loss over the investment's remaining life using the effective interest method.

ii. Any difference between the new amortised cost and the amount payable on maturity is also amortised in a similar manner, akin to the amortisation of a premium or a discount.

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Question:

Reclassification

i. On 1 Jan 2009, an entity reclassifies a $9M bond from AFS to loans and receivables. On the date of reclassification, the bond's amortised cost is $9,198,571 and the original effective interest rate is 8.75%. The bond's fair value is $9,488,165, which becomes its new amortised cost.

ii. The excess of the new carrying amount over the amount receivable at maturity on 31 Dec 2010 (i.e. $488,165) is amortised to profit or loss over the remaining term to give a new effective rate of 7%.

iii. The cumulative gain of $289,594 in other comprehensive income as at 31 Dec 2008 (i.e. $9,488,165 - $9,198,571) is also amortised to profit or loss during the remaining two years to maturity.

($)	Cash received	Interest income @7%	New amortised cost
1 Jan 2009	-	-	9,488,165
31 Dec 2009	900,000	664,172	9,252,337
31 Dec 2010	9,900,000	647,663	-
		1,311,835	
Amortisation of gain in OCI in 2009 and 2010		289,594	
Total amount recognised in profit or loss		1,601,429	

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Question:

The tainting rules

- **An entity's held-to-maturity ("HTM") portfolio consists of a mixture of sterling corporate bonds, treasury bonds and eurodollar bonds. The entity prepares its financial statements to 31 Dec 2011. During Sep 2011, the entity sold a certain eurodollar bond (not considered insignificant in relation to the total HTM portfolio) to realise a large gain. Can the entity reclassify only the eurodollar bonds to available-for-sale ("AFS") category?**

i. An entity shall not classify any financial assets as HTM if the entity, has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of HTM before maturity.

ii. The standard does not define what an insignificant amount means, except that it should be measured by reference to the total amount of HTM investments.

iii. Furthermore, all the entity's HTM investment, not just investment s of a similar type, should be reclassified into AFS category and measured at fair value.

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Question:

The tainting rules

iv. The reclassification is recorded in the reporting period in which the sales occurred (i.e. 31 Dec 2011). The HTM are re-measured to fair value, with any difference recognised in other comprehensive income.

v. As tainting occurs in the year 31 Dec 2011, the HTM classification for the comparative period to 31 Dec 2010 is not affected.

vi. Any fixed interest securities acquired during 2012 and 2013, which could qualify for HTM classification, cannot be classified as such in those years.

Tainting occurs	HTM classification prohibited	HTM classification prohibited	HTM classification permitted
31 Dec 2011	31 Dec 2012	31 Dec 2013	31 Dec 2014

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HKAS 39 Financial Instruments: Recognition and Measurement

The tainting rules

vii. A sale or reclassification would not taint the rest of the portfolio if it was:

- so close to maturity or the financial asset's call date that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- made after the entity has collected substantially all of the financial asset's original principal through scheduled payments or pre-payments; or
- due to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

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Question:

The tainting rules

- **Assuming the same situation except that the sale of the Eurodollar bonds are sold as a result of a significant deterioration in the issuer's creditworthiness (evident by a downgrade in the issuer's credit rating), how would that differs ?**

i. A sale due to a significant deterioration in the issuer's creditworthiness might not raise a question about the entity's intention to hold HTM. However, the following should be considered:

ii. What is meant by "significant deterioration"?

- as compared to the credit rating at initial recognition
- must not have been reasonably anticipated when the entity classified the investment as HTM
- is NOT a credit downgrade of a notch within a class or from one rating class to the immediately lower rating class
- other supporting information, e.g. principal and interest due will not be collected

iii. The sale should normally take place as soon as the entity becomes aware of the credit downgrade and not left until a later date

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Question:

The tainting rules

- **Can an entity apply the tainting rules separately to HTM held by different entities in the consolidated financial statements, for example, if the group entities are in different countries with different legal or economic environments?**

i. No. If an entity has sold or reclassified more than an insignificant amount of investments classified as HTM in the consolidated financial statements, it cannot classify any financial assets as HTM in the consolidated financial statements unless the exception conditions are met.

ii. Sales between group entities generally would not taint the HTM classification at the group level, but may do so at the individual entity level.

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Impairment

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Impairment of financial assets

- HKAS 39 requires an assessment, at the end of each reporting period, of whether there is any objective evidence that a financial asset or group of financial assets is impaired. An asset is impaired, and an impairment loss recognised, if and only if, such evidence exists

- Impairment losses are incurred on a financial asset or a group of financial assets if, and only if, there is objective evidence of an impairment that results from one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated

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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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Impairment assessment

➢ Fair value through profit or loss financial assets ❑ Held for trading financial assets ❑ Financial assets designated as FVTPL	✗
➢ Held-to-maturity investment	✔
➢ Loans and receivables	✔
➢ Available-for-sale financial assets	✔

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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

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Examples of loss events (continued)

- **Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:**

i. 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 amount); or

ii. National or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group)

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Impairment of equity investments

- **Information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates may constitute objective evidence of an impairment**

- **A significant <u>or</u> prolonged decline in fair value (below cost) is objective evidence of impairment**

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Impairment of equity investments – significant or prolonged decline in fair value

- The standard cannot be read to require the decline in value to be both significant and prolonged
- Either a significant or a prolonged decline is sufficient to require the recognition of an impairment loss
- A 'significant or prolonged' decline in the fair value of an instrument is not just an indicator of possible impairment, and the IFRS Interpretations Committee (formerly the IFRIC) concluded that when such a decline exists, recognition of an impairment loss is required
- The fact that the decline in the value of an investment is in line with the overall level of decline in the relevant market does not mean that an entity can conclude the investment is not impaired

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Impairment of equity investments – significant or prolonged decline in fair value (continued)

- The existence of a significant or prolonged decline cannot be overcome by forecasts of an expected recovery of market values, regardless of their expected timing (that is, an anticipated market recovery is not relevant to the assessment of 'significant or prolonged')
- The assessment of whether a decline is 'significant or prolonged' must be made in the functional currency of the entity holding the instrument

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Impairment of available-for-sale financial assets

- If a decline in the fair value of an available-for-sale financial asset has been recognised in other comprehensive income and there is objective evidence of an impairment, the cumulative loss that had been recognised in other comprehensive income is reclassified from equity to profit or loss
- The amount of cumulative loss is the difference between the acquisition cost (net of principal repayments and amortisation) and the current fair value, less any impairment loss previously recognised in profit or loss
- Any portion of the cumulative net loss that is attributable to foreign currency movements that had been recognised in other comprehensive income in the case of a non-monetary item (e.g. for equity instruments), is also reclassified from equity to profit or loss

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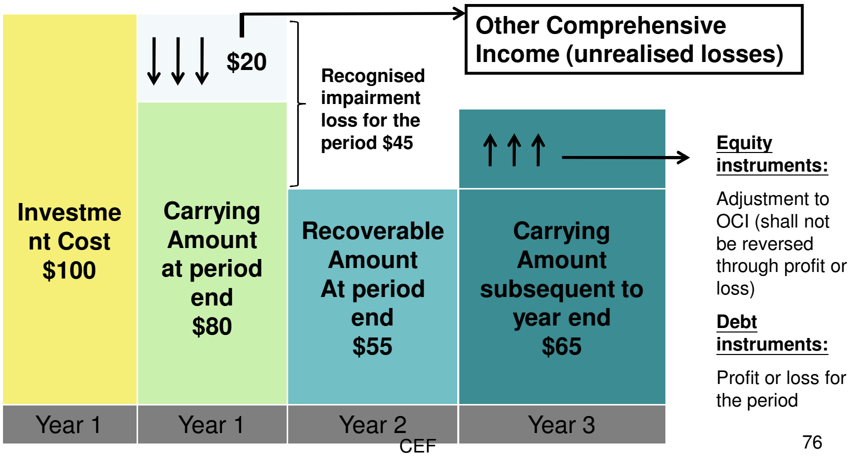
Impairment loss/reversals: available-for-sale financial assets



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Debt instrument

Impairment loss of assets carried at amortised cost

- Once an impairment loss has been identified, its amount 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)
- For a variable rate asset, impairment should be measured using the current effective interest rate determined under the contract
- 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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Debt instrument

Reversals of Impairment loss of assets carried at amortised cost

- If the amount of a past impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, then the impairment is reversed through profit or loss
- However, the carrying amount should not be increased to an amount that exceeds what the amortised cost would have been (at the date of the reversal) had the impairment not been recognised
- The reversal is recognised in profit or loss

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Question:

Impairment of financial assets: discount rate

❖ What is the appropriate discount rate for assessing impairment of financial asset carried at amortised cost?

i. Impairment of a financial asset carried at amortised cost is measured by discounting the expected future cash flows using the financial instrument's original effective interest rate .

ii. However, there are three specific 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
Fixed rate loan that is designated as a hedged item in a fair value hedge of interest rate risk	New effective interest rate recalculated using the loan's adjusted carrying amount (the loan's carrying amount is adjusted for any changes in its fair value attributable to interest rate movements)

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Question:

Impairment of financial assets: discount rate

For example:

31 Dec 2010	• Fixed rate loan's amortised carrying value: $583,435 • Original effective rate: 6.7322%	
	• Impairment indicators noted • Loan is restructured with revised payment schedule • New effective rate: 6.3071% • Present value of revised payment schedule discounted at the original effective rate of 6.7322% amounts to $432,402	• Impairment loss of $151,033 ($583,435 – 432,402) is recognised in the profit or loss.
31 Dec 2011	• Interest income is recognised at the rate of discount used to measure the impairment	• Interest income of $29,110 ($432,402 x 6.7322%) is recognised.

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Hedge Accounting

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Objective of Hedge Accounting

- The objective of hedge accounting is to 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
- Applying hedge accounting results in the "matched" timing of recognition of gains or losses in profit or loss
- Where an entity is perfectly hedged, the gains or losses on the hedging instrument and the hedged item perfectly offset in profit or loss in the same period

HKAS 39 does not mandate the use of hedge accounting. Hedge accounting is voluntary

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Types of hedge accounting

Fair value hedge

- A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or a liability or an unrecognised firm commitment or an identified portion of such an asset, a liability or a firm commitment that is attributable to a particular risk and could affect profit or loss (e.g. a hedge of exposure to changes in the fair value of fixed rate debt as a result of changes in market interest rates)

Cash flow hedge

- A cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and could affect profit or loss (e.g. a hedge of variable rate debt with a floating to fixed interest rate swap)

Net investment hedge

- A hedge of a net investment in a foreign operation is a hedge of the foreign currency exposure to changes in the reporting entity's share in the net assets of that foreign operation

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Criteria for hedge accounting (HKAS 39.88)

- At the inception of the hedge there must be formal designation and documentation of the hedging relationship; and the entity's risk management objective and strategy for undertaking for hedge
- The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk
- For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss
- The effectiveness of the hedge can be reliably measured
- The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated (80 - 125%)

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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
    - ▪The separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
    - • the cumulative gain or loss on the hedging instrument from inception of the hedge; and
    - • the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from 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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Background

- A phased project which aims to replace the existing standard on financial instruments, IAS 39 *Financial Instruments: Recognition and Measurement*
- The objectives of the project is to simplify the classifications and measurement requirements for financial instruments
- Driven in part by the G20 leaders to achieve a single set of high-quality global accounting standards
- IFRS 9 *Financial Instruments* was issued in November 2009, with additions issued in October 2010
- HKFRS 9 was issued to maintain international convergence with the issuance of IFRS 9

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Main phases and Timeline

	2009 Jan-Sep	2009 Oct-Dec	2010 Jan-Jun	2010 Jul-Dec	2011	2015
Classification and Measurement (C&M)	Exposure Draft (ED) on C&M of financial assets & liabilities issued in July 2009	IFRS 9 *Financial* Instrument is issued in Nov 2009	ED on C&M of financial liabilities issued in May 2010	Addition to IFRS 9 Financial Liabilities issued in October 2010		Mandatory effective Date: 1 January 2015
Impairment		ED published in Nov 2009			Supplement to ED issued in Jan 2011 Re-exposure: Impairment expected in the second half of 2012	
Hedge accounting				ED issued in Dec 2010	Final standard: expected second half of 2012 Exposure draft on portfolio (macro) hedge accounting expected the third/fourth of 2012	

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Scope

- An entity shall apply this HKFRS to all items within the scope of HKAS 39 *Financial Instrument: Recognition and Measurement*
- The revised Standard (issued in November 2010 by the HKICPA) retains the requirements for classification and measurement of financial assets that were published in November 2009 but adds guidance on the classification and measurement of financial liabilities

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Structure of HKFRS 9

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Structure of HKFRS 9

Chapters

1 Objective

2 Scope

3 Recognition and Derecognition

4 Classification

5 Measurement

6 Hedge Accounting *(not used yet)*

7 Effective Date and Transition

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Chapter 1 Objective and Chapter 2 Scope

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Chapters 1 and 2

Objective

- The objective of HKFRS 9 is to establish principles for the financial reporting of *financial assets* and *financial liabilities* that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows

Scope

- An entity shall apply HKFRS 9 to *all items* within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement*

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Chapter 3
Recognition & Derecognition

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Chapter 3
Recognition and Derecognition

- **When?** An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument

- **Initial recognition of financial assets:** at fair value, plus, in the case of a financial asset that is not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset (consistent with HKAS 39)

- **Initial recognition of financial liabilities:** at fair value, minus, in the case of a financial liabilitiy that is not at fair value through profit or loss, transaction costs that are directly attributable to issuing the financial liability (consistent with HKAS 39)

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Chapter 3

Recognition and Derecognition (cont'd)

- **Derecognition of financial instruments** – same as HKAS 39
  (but with increased disclosure for transactions involving transfers of financial assets – contained in amendments to HKFRS 7 issued in October 2010)

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Chapters 4 & 5
Classification and Measurement

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Classification Guidance – Financial assets

- **Types:** Under HKFRS 9, a financial asset is classified into a measurement category at inception. Two primary measurement categories:
  - **amortised cost**; and
  - **fair value**

- The existing categories under HKAS 39 of "held-to maturity", "loans and receivables" and "available-for-sale" are eliminated

- HKFRS 9 eliminates the previous exception under HKAS 39 to measure certain investments in unquoted equity instruments at cost if fair value cannot be measured reliably (but provides guidance on when cost may be an appropriate estimate of fair value)

- Similarly, the exemption for derivative assets that are linked to and settled by delivery of such unquoted equity instruments was eliminated

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Classification Guidance (cont'd)

- **How?** Classification under HKFRS 9 is driven by the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets

- A financial asset is measured at **amortised cost** if two criteria are met:
  - The objective of the business model is to hold the financial asset for the collection of the contractual cash flows ('Business Model' test)
  - The contractual asset's cash flows solely represent payments of principal and interest ('Characteristics of the financial asset' test)

- If a financial asset does not meet both of these conditions, then it is measured at fair value

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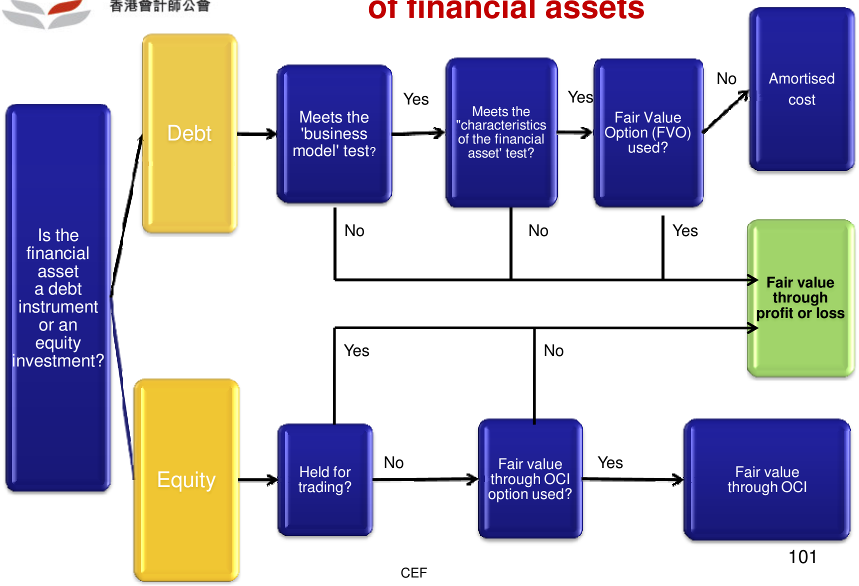
Classification and measurement of financial assets



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Business Model

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"Business Model" test

- Financial assets are subsequently measured at amortised cost or fair value based on the entity's business model as determined by the entity's key management personnel

- The objective of the entity's business model is to hold instruments to collect contractual cash flows rather than to sell instruments prior to contractual maturity to realise fair value changes

- Management will need to apply judgement to determine at what level the business model condition is applied
  - provide a faithful representation of how business activities are actually managed
  - not made at the level of an individual asset
  - the entity's business model is not a choice
  - it is a matter of fact and does not depend on management intent for individual instruments

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"Business Model" test

- **Question:** Can a single entity have more than one business model for managing its financial instruments?
  - Apply judgment to determine at what level the business model condition is applied
  - An entity may hold a portfolio of investments that manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes
  - **A single entity may have more than one business model for managing its financial instruments**
  - **Classification need not be determined at the reporting entity level**

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"Business Model" test

Example 1

- An entity holds investments to collect contractual cash flows but would sell an investment in particular circumstances, e.g.
  - a financial asset no longer meets the entity's investment policy (e.g., the credit rating of the asset declines below that required by the investment policy)
  - an insurer adjusts its investment portfolio to reflect a change in expected duration (i.e., the expected timing of payouts); or
  - an entity needs to fund capital expenditures

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"Business Model" test

Example 1 (cont'd)

Analysis:

- Although the entity may consider the financial assets' fair value from a liquidity perspective, the entity's objective is to hold the financial assets and collect contractual cash flows
- Some sales would not contradict that objective
- If more than an infrequent number of sales are made out of the portfolio, the entity needs to assess whether and how those sales are consistent with the collecting contractual cash flows objective

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"Business Model" test
Example 2

- An entity's business model is to purchase portfolios of financial assets such as loans. Those portfolios may or may not include financial assets with incurred credit losses

- If payment on the loans is not made on a timely basis, the entity attempts to extract the contractual cash flows through various means, e.g. by making contact with the debtor by mail, telephone or other methods

- In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate

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"Business Model" test
Example 2 (cont'd)

Analysis:

- The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows

- The entity does not purchase the portfolio to make a profit by selling them

- The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (e.g., some of the financial assets have incurred credit losses)

- The fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model

- If the portfolio is not managed on a fair value basis, the objective of the business model could be to hold the assets to collect the contractual cash flows

"Business Model" test

Example 3

- An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle (SPV). The SPV issues instruments to investors
- The originating entity controls the securitisation vehicle and thus consolidates it
- The SPV collects the contractual cash flows from the loans and passes them on to its investors
- Assume the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the SPV

Business Model" test

Example 3 (cont'd)

Analysis:

- On the sale of the loans to the vehicle, the loans continue to be recognised in the consolidated financial statements, but are derecognised in the separate financial statements of the originating entity
- In the consolidated financial statements, the loans may be part of a portfolio managed in order to collect the contractual cash flows since they are not derecognised (that is, are not considered 'sold' for accounting purposes)
- In the separate financial statements of the originating entity, where they will be derecognised, they cannot be considered part of a portfolio that is 'held to collect'

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"Business Model" test

Example 4

- **Factoring:** An entity has a past practice of factoring its receivables

Analysis:

- If significant risks and rewards have transferred from the entity, resulting in the original receivable being derecognised from the balance sheet, the entity is not holding these receivables to collect its cash flows, but intends to sell them. Hence, classify such receivable as fair value through profit or loss

- If the significant risks and rewards are not transferred from the entity, and the receivables do not, qualify for derecognition, the client's business objective may still be to hold the assets in order to collect the contractual cash flows

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"Business Model" test

Example 5

- An entity actively manages a portfolio of assets in order to realise fair value changes arising from changes in credit spreads and yield curves

- The entity's objective results in active buying and selling

Analysis:

- The entity is managing its portfolio to realise fair value gains rather than to collect contractual cash flows

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Cash Flow Characteristics

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"Characteristics of the financial asset" test

- To qualify for amortised cost measurement, the cash flows from a financial asset should represent, on specified dates, **solely payments of principal and interest on the principal amount outstanding**
- Interest is defined as "consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time"

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"Characteristics of the financial asset" test

- **Leverage is not consistent with the sole payment of principal and interest criterion**
- Leverage which increases the variability of the contractual cash flows such that they do not have the economic characteristics of interest
- The standard lists stand-alone option, forward and swap contracts as instruments that include leverage
- An instrument that is subordinated to other instruments (e.g., to general creditors) may still have contractual cash flows that are principal and interest

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"Characteristics of the financial asset" test

- A financial asset with contractual terms that permit the issuer to **prepay before maturity** or the holder **to put the financial asset back** to the issuer before maturity or either party **to extend the term** of a financial asset may meet the sole payment of principal and interest criterion only if:
  - the provision is not contingent on future events, other than terms that protect:

    i. the holder against credit deterioration of the issuer (e.g. defaults, credit downgrades, loan covenant violations), or

    ii. a change in control of the issuer; or

    iii. the holder or issuer against changes in relevant taxation or law

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"Characteristics of the financial asset" test

- in the case of prepayment, the prepayment amount substantially represents unpaid principal and interest, but may include reasonable additional compensation for early termination; or
- in the case of an extension option, it results only in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding

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"Characteristics of the financial asset" test

Examples:

Instruments that **will qualify**	Analysis
• **A bond with a stated maturity**. Payments of principal and interest are linked to an unleveraged inflation index	• This linkage resets the time value of money to the current level and therefore the bond's cash flows may be solely payment of principal and interest on the principal outstanding
• **An instrument with a stated maturity and variable interest** for which the borrower can choose a market interest rate that corresponds to the reset period on an ongoing basis	• The fact that the interest rate is reset during the life of the instrument does not disqualify the instrument from meeting the solely payment of principal and interest criterion

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"Characteristics of the financial asset" test

Examples:	
Instruments that **will qualify**	Analysis
• A bond with a stated maturity date and pays a **variable interest rate which is capped**	• This is like a combination of a fixed and floating rate bond, as the cap reduces the variability of cash flows
• A **full recourse loan** secured by collateral	• The fact that a full recourse loan is secured by collateral does not affect the analysis

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"Characteristics of the financial asset" test

Examples:	
Instruments that **will not qualify**	Analysis
• A **convertible bond** that is convertible into equity instruments of the issuer	• The criterion is not met as the return on the bond is not just consideration for the time value of money and credit risk but also reflects the value of the issuer's equity
• A loan that pays **an inverse floating rate**, i.e., the interest rate has an inverse relationship to the market interest rate	• The criterion is not met as interest has an inverse relationship to market rates and so does not represent consideration for the time value of money and credit risk

"Characteristics of the financial asset" test

Examples:

Instruments that **will not qualify**	Analysis
• A loan with **interest payments indexed to the debtor's performance** (e.g. debtor's net income) or an equity index	• The criterion is not met as a return linked to performance or an equity index is not consideration for the time value of money and credit risk
• A **perpetual instrument that is callable at any time by the issuer at par plus accrued interest**, but for which interest is only payable if the issuer remains solvent after payment and **any deferred interest does not accrue additional interest**	• The criterion is not met as the issuer may defer payments and additional interest does not accrue on the amounts deferred. As a result the holder is not entitled to the consideration for the time value of money and credit risk

Contractually Linked Instruments

- The standard requires a look through approach to determine whether the contractually linked instruments (e.g. asset backed securities and other securitised debt) meet the solely payment of principal and interest criterion
- An entity must look through until it can identify the underlying pool of instruments that are creating, rather than passing through, the cash flows
- If it is impracticable for the holder to look through to the underlying assets, all tranches will be at FVTPL

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Non-recourse Loans

- When debt instruments are non-recourse, i.e. the lender's claim is limited to specific assets of the borrower
- It will be necessary to consider whether the loan only represents contractual cash flows that are payments of principal and interest
- HKFRS 9 requires an entity to look through to the underlying assets or cash flows to make this determination
- If the terms of the loan give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the loan cannot be measured at amortised cost

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Non-recourse Assets

Example:

Scenario

- A bank has provided a loan to a borrower with a fixed rate of interest and fixed maturity date
- The loan is secured on non-recourse basis on a portfolio of equity shares.
- At the maturity of the loan, the borrower intends to sell the shares and use the proceeds to repay the loan
- The borrower would keep any upside in the share price, but the bank would suffer the loss
- Does this non-recourse loan meet the condition to be classified at amortised cost?

Analysis

- This loan would fail the 'solely payments of principal and interest' test as the amount of cash to be repaid varies with the performance of the equity instruments

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Option to Designate Financial Assets at Fair Value Through Profit or Loss

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Fair value option (FVO) for financial assets

Fair value option available, if…

Accounting mismatch

~~Manage on fair value basis~~

Not managed to collect contractual cash flows → FV

~~Embedded derivative(s)~~

Hybrid contracts with financial host classified in entirety

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Embedded Derivatives

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Embedded Derivatives

- Embedded derivatives that would have been separately accounted for under HKAS 39 because they were not closely related to the financial asset host **will no longer be separated**
- The contractual cash flows of the financial asset are assessed in their entirely and the asset as a whole is measured at fair value through profit and loss if any of its cash flows do not represent payments of principal and interest

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Embedded Derivatives

Example:

- An entity has an investment in a conventional convertible bond
- Under the terms of the bond, the holder has the option to convert it into fixed number of equity shares of the issuer
- Under current HKAS 39, unless the bond is held for trading or designated as FVTPL, the bond is bifurcated into the conversion option (an embedded derivative) and the host debt instrument because the economic characteristics and risks of the conversion option (primarily equity price risk) are not closely related to those of the host debt instrument
- The conversion option is separately accounted for at FVTPL while the host debt instrument may be classified as a loan and receivable or as available-for-sale
- **Under HKFRS 9, the convertible bond is analysed for classification in its entirely**
- The presence of the conversion option causes the instrument to fail the test on solely payment of principal and interest. **The convertible bond in its entirety would be accounted for at FVTPL**

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Investments in equity instruments

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Equity Instruments

- All equity investments held must be **measured at fair value** under HKFRS 9
- **No cost exemption** for unquoted equity instruments
- In limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if **insufficient more recent information is available to determine fair value**, or if there is a **wide range of possible fair value measurements** and cost represents the best estimate of fair value within that range
- The standard also gives examples of when cost will not be representative of fair value

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Equity Instruments

- Examples of indicators of the circumstances in which cost **may not** be the best estimate of fair value:
  - a significant change in the performance of the investee compared with budgets, plans or milestones;
  - changes in expectation that the investee's technical product milestones will be achieved
  - a significant change in the market for the investee's equity or its products or potential products
  - a significant change in the global economy or the economic environment in which the investee operates
  - a significant change in the performance of comparable entities, or in the valuations implied by the overall market
  - internal matters of the investee such as fraud, commercial disputes, litigation, changes in management

Given the indicators, it is not expected that cost will be representative of fair value for an extended period of time

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Equity Instruments

- **Gains and losses** arising on equity investments are **recognised in profit or loss** unless the entity irrevocably designates at initial recognition that they should be recognised in other comprehensive income
- Presentation of fair value changes in other comprehensive income:
  - Available for all equity instruments that are not held for trading
  - Can be made on an instrument-by-instrument basis
  - Irrevocable for that holding, i.e. no reclassification
- Dividends income is recognised in profit or loss in accordance with HKAS 18 *Revenue*

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Equity Instruments

- **No** amount recognised in OCI is ever **reclassified to profit or loss** at a later date
- **No impairment testing** is required
- Additional disclosures

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Impact of HKFRS 9

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Impact of HKFRS 9

Changes in the requirement to test financial assets for impairment

Financial Asset	HKAS 39 Classification	Impairment testing required?	HKFRS 9 Classification	Impairment testing required?
Debt instruments	Available for sale	Yes	Amortised cost	Yes
	Loan and receivable	Yes	FVTPL	No
	Held to maturity	Yes		
	FVTPL	No		
Equity investments	Available for sale	Yes	FVTOCI	No
	Cost less impairment	Yes	FVTPL	No
	FVTPL	No		

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Impairment – Equity instrument and AFS instrument

- Although HKFRS 9 currently does not address accounting for impairment directly, the changes in classification and measurement requirements for financial assets will impact whether and how impairment is measured for many assets. In particular, impairment of AFS assets is measured currently by reference to the fair value of the investment
- As HKFRS 9 eliminates AFS category, it also eliminates the AFS impairment rules
- The requirement contained in HKAS 39 'A significant or prolonged decline in the fair value of an investment in equity instrument below its cost is also objective evidence of impairment' is **not carried forward to HKFRS 9**

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Reclassifications

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Reclassifications

- Classification of financial instruments is determined on initial recognition. Subsequent reclassification between categories generally is prohibited
- When an entity changes its business model that is significant to its operations, a reassessment is required
- **The standard states that changes to the business models are expected to be "very infrequent"**
- Determined by the senior management of the entity as a result of internal or external changes and are "demonstrable" to external parties

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Reclassification: Examples from application guidance

Reclassifications required
• An entity has a portfolio of commercial loans that it held to sell in the short term. However, the entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows
• A financial services firm decides to shut down its retail mortgage business, and is no longer accepting new business. The firm actively market its mortgage loan portfolio for sale

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Reclassification: Examples from application guidance

Reclassifications prohibited
• A change in intention related to specific financial assets (even in circumstances of significant changes in market conditions)
• A temporary disappearance of a particular market for financial assets
• A transfer of financial assets between parts of the entity with different business models

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Reclassifications

- Reclassification is to be **accounted for prospectively** from the reclassification date, which is the first day of the first reporting period following the change in business model
  - **reclassification from amortised cost to fair value:** measure instrument at fair value on that date; recognise difference between previous carrying amount and fair value in profit or loss
  - **reclassification from fair value to amortised cost:** fair value of the instrument on the date of reclassification becomes its new carrying amount

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Classification Guidance – Financial liabilities

- **Requirements** contained in HKAS 39 regarding the classification and measurement of financial liabilities have been **retained**

- Continue to be **two measurement categories** for financial liabilities:
  a. fair value through profit or loss
  b. amortised cost

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Classification Guidance – Financial liabilities

- Financial liabilities generally are measured subsequently at amortised cost **except** for the following instruments:

  a. financial liabilities that are held for trading (including derivatives)

  b. financial liabilities that upon initial recognition are designated as at fair value through profit or loss;

  c. financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies

  d. financial guarantee contracts; and

  e. commitments to provide a loan at a below-market interest rate

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Classification Guidance – Financial liabilities

- **Retains the eligibility conditions in HKAS 39 for irrevocably designating**, at initial recognition, a financial liability as measured at fair value through profit or loss (the fair value option)

- **Still required to separate derivatives embedded** in financial liabilities where they are not closely related to the host contract (that is, separated embedded derivative continues to be measured at FVTPL, and the residual debt host continues to be measured at amortised cost)

- **No reclassification**: An entity shall not reclassify any financial liability

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New Measurement Guidance – Financial liabilities

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

i. 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
ii. The remaining amount of change in the fair value of the liability shall be presented in profit or loss

unless presentation of the fair value change in respect of the liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss

- The determination of whether there will be a mismatch is made at initial recognition and is not reassessed

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New Measurement Guidance – Financial liabilities

- Amounts presented in OCI shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity

- The only other substantive change from HKAS 39 is to eliminate the exception from fair value measurement contained in HKAS 39 for derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured. Under HKAS 39, such derivatives are measured at cost

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HKFRS 9 Classification and measurement
Financial Liabilities – FVO and own credit

- **What is 'own credit"?**
  - Fair value changes in liability arising from changes in the issuer's credit quality
- **How is it measured?**
  - Often measured as change in margin over a benchmark interest rate
- **What is the concern?**
  - Gain when credit quality deteriorates, loss when credit quality improves
  - Reporting such gains and losses is not useful

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HKFRS 9 Classification and measurement
Financial Liabilities – FVO and own credit

To address 'own credit risk':
- Retain HKAS 39 measurement requirements for financial liabilities:
  - held for trading => fair value through P & L
  - hybrid liabilities => bifurcation requirements in HKAS 39
  - 'vanilla' liabilities => amortised cost
  - maintain FVO (with current eligibility conditions)

BUT
- Separate out 'own credit risk' for FVO
- 'Own credit risk' portion would be separated in a manner similar to that previously used in HKFRS 7 for disclosure (HKFRS 7 B4)

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Financial liability at FVO
on statement of financial position at (full) fair value

Change in FV attributable to all factors except 'own credit risk'

Change in FV attributable to 'own credit' (not recycled)

Profit or Loss		**Statement of Comprehensive Income**	
Profit	XXX	Other comprehensive Income	XXX

Mandatory for all liabilities at FVO unless this would create or enlarge an accounting mis-match

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Effective Date, Comparative Information and Transition

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Effective date, comparative information and transition

- Mandatory effective date of **1 January 2015**, early adoption permitted
- If an entity applies HKFRS 9 in its financial statements for a period before 1 January 2015, it shall disclose that fact
- HKFRS 9 (2010) supersedes HKFRS 9 (2009) and HK(IFRIC) – Int 9 *Reassessment of Embedded Derivatives*, which is incorporated into the standard
- If an entity chooses to apply HKFRS 9 (2010) early and has not already applied HKFRS 9 (2009), it is required to apply all of the requirements in HKFRS 9 (2010) at the same time
- Retrospective application but contains certain transition reliefs
- Entities that early adopt for reporting periods prior to 1 January 2012 are not required to restate comparatives

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Examples:

Annex 1: Deloitte's Illustrative Annual Financial Statements 2010

Annex 2: HKEx Annual Report 2010

Annex 3: Accounting for AFS sovereign debt and ESMA Public Statement

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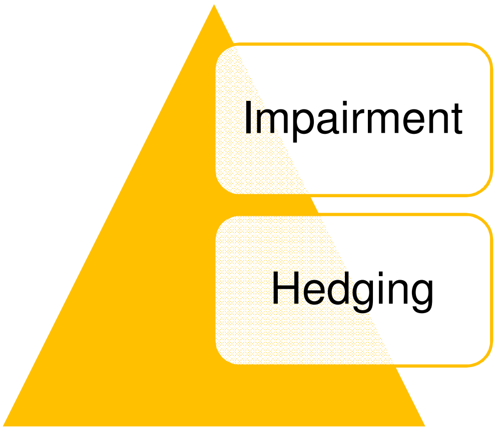
IFRS 9 - Work-in-progress



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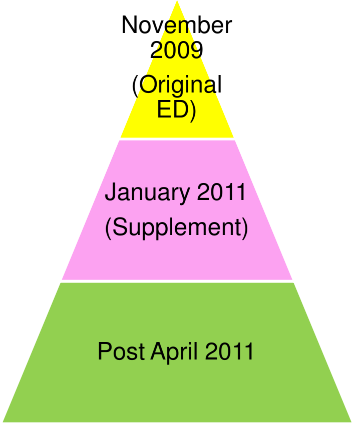
IMPAIRMENT



• second stage of the 3-phase project to replace IAS 39

- Request for Information on expected loss model published 18 June 2009
- ED issued 5 November 2009
- Comment deadline on ED 30 June 2010
- Expert Advisory Panel formed November 2009
- Supplement to ED issued 31 January 2011
- Comment deadline on supplement 1 April 2011
- Re-exposure expected in the second half of 2012

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Impairment

❖ **November 2009: Original Exposure Draft (ED)**
- proposed replacing the incurred loss model with the **expected loss model**

Incurred loss model	Expected loss model
• loans may be written down (impaired) only when evidence (known as a trigger event) is available that a loan or portfolio of loans will not be repaid in full	• Initial carrying amount on the basis of the present value of the future expected cash flows from the asset, taking into consideration expectations about future credit losses
• it does not permit credit losses to be recognised until a trigger event has occurred, even when those losses are expected	• Subsequent to initial recognition, revise its estimates of expected cash flows at each measurement date. Any resulting adjustments to the carrying amount of the financial instrument would be recognised in profit or loss
• The incurred loss model led to complaints that loan losses were recognised 'too little, too late'	

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Impairment

❖ The proposed 'expected loss' approach

- Designed to result in earlier loss recognition by taking into account future credit losses expected over the life of the financial asset measured at amortised cost
- The initial estimate of expected future losses is gradually recognised over the life of the instrument as it is incorporated into the effective interest rate (integrated effective interest rate)
- Applies to all financial instruments that are carried at amortised cost

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Impairment

❖ Latest development – Three-bucket approach

Bucket 1 Assets not affected by observable events	Bucket 2 Assets affected by observable events	Bucket 3 Individual assets expected to default
Allowance	**Allowance**	**Allowance**
Twelve months of expected credit losses based on initial expectations plus full lifetime effect of any change in expected credit losses calculated at a portfolio level	Full lifetime expected credit losses calculated at a portfolio level	Full lifetime expected credit losses calculated at an individual asset level because asset-specific default information is available

Deterioration of credit quality

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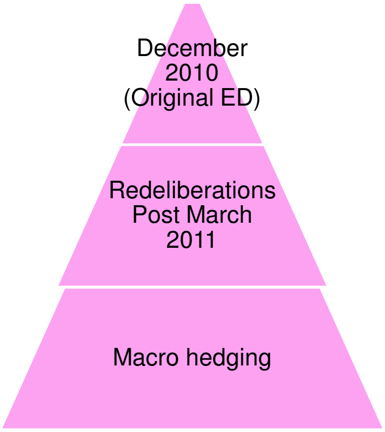
HEDGING



- **third stage of the 3-phase project to replace IAS 39**
- ED published 9 December 2010
- Comment deadline on ED 9 March 2011
- Review draft of proposed 'Hedge Accounting' chapter of IFRS 9 expected second quarter of 2012, finalised second half of 2012
- Separate ED or DP on portfolio (macro) hedging expected in the third or fourth quarter of 2012

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IASB Exposure Drafts

Visit this link for all HKICPA Submissions to IASB
http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/financial-reporting-submissions/2011/

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Recent developments

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HKAS 32 (Amendments): *Offsetting Financial Assets and Financial liabilities*

❖ Background

- Joint project of IASB and US FASB to eliminate the material differences between the two GAAPs in offsetting of financial assets and financial liabilities
- ED was published in January 2011
- At June 2011's meeting, the Boards decided to retain different approaches
- As a consequence, the convergence is limited to disclosures only

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HKAS 32 (Amendments): *Offsetting Financial Assets and Financial liabilities*

❖ **Amendments address the inconsistencies in the application of current HKAS 32**

- **Basic offsetting principles:** Financial assets and financial liabilities would be required to be offset in the statement of financial position only if **all** the following criteria are met:

- There is an unconditional right of set-off
- There is a legally enforceable right to set-off
- The company intends to settle the asset and liability on a net basis, or the company will settle them simultaneously

- A company that meets the criteria must offset the related assets and liabilities in its statement of financial position

- It is not a choice to show the amounts gross or net

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HKAS 32 (Amendments): *Offsetting Financial Assets and Financial liabilities*

❖ **Meaning of 'currently has a legally enforceable right to set-off'**

- No guidance on what was meant by 'currently has a legally enforceable right to set off' under the previous HKAS 32

- Inconsistencies in the application of this criterion and consequently, the IASB included application guidance in IAS 32

- The IASB clarified that to meet this criterion, the right of set-off is required to be legally enforceable in the normal course of business, in the event of default and in the event of insolvency or bankruptcy of the company and all the counterparties

- "currently" means that the right of set-off cannot be contingent on a future event

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HKAS 32 (Amendments): *Offsetting Financial Assets and Financial liabilities*

❖ Reminder

- Reconsider existing arrangements to determine whether items being currently offset would qualify for such presentation under the amended guidance because:
- Companies may not have considered events of default, insolvency or bankruptcy in their assessment of the offsetting rules previously
- Companies may have only considered the counterparty rather than all parties to the arrangement
- Reconsiderations may include new or revised legal opinions

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HKAS 32 (Amendments): *Offsetting Financial Assets and Financial liabilities*

❖ Meaning of 'simultaneous realisation and settlement'

- Clarified that gross settlement mechanisms with features that both eliminate credit and liquidity risk and process receivables and payables in a single settlement process are effectively equivalent to net settlement
- Application guidance include an example of a gross settlement system with characteristics that would satisfy the IAS 32 criterion for net settlement

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HKAS 32 (Amendments): *Offsetting Financial Assets and Financial liabilities*

❖ **Effective date**

- The clarifying amendments to HKAS 32 are not effective until annual periods beginning on or after 1 January 2014, with retrospective application required

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IFRS/HKFRS 9

What do you need to think about when applying the new rules?

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IFRS/HKFRS 9: Financial Assets

Process and Systems

- Complete reassessment of all financial assets
- Assessing business models and contractual terms
- Fair value methodologies

Financial statements/key financial ratios

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IFRS/HKFRS 9: Financial Liabilities

Fair value change of 'own credit risk' in OCI. Reduce volatility in profit or loss

- All changes in fair value presented in profit or loss if accounting mismatch
- Disclosure of 'own credit' for liabilities designated at fair value through profit or loss

Consider carefully on the planned timing of adoption. Cannot revoke or designate FVO for liabilities on transition.

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HKFRS 7

Financial Instruments: Disclosures

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HKFRS 7 *Financial Instruments: Disclosures*

❖ Background

- HKFRS was originally issued in 2005
- Significant amendments subsequently include:
- *Improving Disclosures about Financial Instruments (2009)* amended the required disclosures for fair value measurement and liquidity risk
- *Improvements to HKFRS (2010)* clarified and refined certain disclosure requirements
- *Transfer of Financial Assets* issued in October 2010 (effective for annual accounting periods beginning on or after 1 July 2011) amended the required disclosure for transfers of financial assets that resulted in continued recognition or derecognition

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HKFRS 7 *Financial Instruments: Disclosures*

❖ Background

- Significant amendments subsequently include (cont'd):
- *HKFRS 13 Fair Value Measurement* issued in May 2011 (effective for annual periods beginning on or after 1 January 2013) removed the fair value disclosures from HKFRS 7 and included them, with limited amendment, in HKFRS 13

❖ **All of the amendments listed, if not currently effective, permit application in advance of their effective dates**

❖ **Required to disclose that fact if early applied**

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HKFRS 7 *Financial Instruments: Disclosures*

❖ Scope

- Applicable to **all entities** and to **all risks** arising from **all financial instruments,** whether recognised or unrecognised
- Recognised financial instruments: financial assets and financial liabilities that are within the scope of HKAS 39
- Unrecognised financial instruments: financial instruments, that although outside the scope of HKAS 39, are within the scope of HKFRS 7

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HKFRS 7 *Financial Instruments: Disclosures*

Scope application

❖Are leases within the scope of HKFRS 7?

- HKFRS includes within its scope any lease which meets the definition of a financial instrument
- Finance leases are financial instruments, whereas operating leases are not

Financial Instrument	Within scope of HKAS 32?	Within scope of HKFRS 7?	Within scope of HKAS 39?
Finance lease receivables of a lessor	Yes	Yes	No (i)
Finance lease obligations of a lessee	Yes	Yes	No (ii)

(i) Except for the requirements on derecognition, impairment and embedded derivatives
(ii) Except for the requirements on derecognition and embedded derivatives

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HKFRS 7 *Financial Instruments: Disclosures*

Scope application

❖Does HKFRS 7 applies to financial statements of subsidiaries?

- There is no exemption even if full disclosures are provided in the consolidated financial statements in which the subsidiary is included
- When a company prepares any financial statements in accordance with HKFRSs, users of those financial statements should receive information of the same quality as users of general purpose financial statements prepared in accordance with HKFRSs

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HKFRS 7 *Financial Instruments: Disclosures*

Scope application

❖ **Are all financial instruments of subsidiaries in the consolidated financial statements within the scope of HKFRS 7?**

- Consolidated financial statements include all financial instruments of subsidiaries except those intragroup financial instruments that are fully eliminated on consolidation
- Only if the financial instrument is fully eliminated on consolidation is it excluded from the scope of HKFRS 7 in the consolidated financial statements

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Disclosures relating to the statement of financial position**

- Carrying amounts of each of the following categories:

a. Financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39
b. Held-to-maturity investments
c. Loans and receivables
d. Available-for-sale financial assets
e. Financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with HKAS 39
f. Financial liabilities measured at amortised cost

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HKFRS 7 *Financial Instruments: Disclosures*

Financial assets at fair value through profit and loss (FVTPL)

❖What are the minimum disclosures if a company designates a loan or receivable as at FVTPL?

- HKFRS 7 requires disclosures of :

a. the maximum exposure to *credit risk* of the loan or receivable at the end of the reporting period

b. the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk

c. the amount of change, during the period and cumulatively, in the fair value of the loan or receivable that is attributable to changes in the credit risk (not market risk) of the financial asset

d. the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated

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HKFRS 7 *Financial Instruments: Disclosures*

Financial assets at fair value through profit and loss (FVTPL)

❖What is the maximum exposure to credit risk for loans and receivables? Cash loss or carrying amount?

- Credit risk is defined as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation" [HKFRS 7: Appendix A]

- If the fair value of the debt is $70. The amount of the debt is $100

- Two views:

i. the maximum exposure to credit risk is viewed as a cash loss, then the amount to be disclosed would be the amount owed

ii. the maximum exposure to credit risk is viewed as a loss that will be recognised in the statement of comprehensive income, then the fair value would be disclosed

❖ Either approach is supportable. Must apply a consistent policy.

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ **How about financial liabilities designated as at FVTPL? Any minimum disclosure requirements? Why?**

- HKFRS 7 requires disclosures of :

a. the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability

b. the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation

c. The methods used to comply with the requirements

d. To alleviate concerns that users may misinterpret the profit or loss effects of changes in issuer's credit risk

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ **How do we determine the amount of changes in the fair value of the financial liability that is attributable to changes in the liability's credit risk?**

- Determine the amount of change as the change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ What exactly does it mean? A working example?

- A company issued a 5-year bond which trades on a recognised bond exchange.
- Maturity date: 31 December 20X5
- Nominal value: $500M
- Coupon: 9%, payable annually on 31 December in arrears
- Issue price (1 Jan 20X1): $450M
- Fair value (31 Dec 20X1): $400M
- 5-year LIBOR (1 Jan 20X1): 10.5%
- 4-year LIBOR (31 Dec 20X1): 12.75%

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ Step 1: Determine the liability's internal rate of return (IRR) using the observed market price of the liability and the liability's contractual cash flows at the beginning of the period

- Issue price: 450,000,000
- Coupon: 9%, payable annually on 31 December in arrears
- Nominal value: $500M

Year 0	**(450,000,000)**
Year 1	**45,000,000**
Year 2	**45,000,000**
Year 3	**45,000,000**
Year 4	**45,000,000**
Year 5	**545,000,000**

Date of issue: IRR = effective interest rate = 11.76%

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ **Step 2: Deduct the observed/benchmark interest rate at the beginning of the period from the IRR to arrive at the instrument-specific component of the IRR**

- IRR: 11.76%
- 5-year LIBOR: 10.5%

11.76% - 10.5% = 1.26%	**Instrument specific component of the IRR**

The portion of the effective interest rate relating to credit risk of the bond: 1.26%

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ **Step 3: Compute the present value of the cash flows of the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of the observed benchmark interest rate at the end of the period and the instrument-specific component of the IRR**

- 4- year LIBOR (31 December 20X1): 12.75%
- Instrument specific component of IRR: 1.26%

Remaining cash flow discounted at IRR of 14.01%	
Year 2	**45,000,000**
Year 3	**45,000,000**
Year 4	**45,000,000**
Year 5	**545,000,000**

PV = $427,059,828 at end of the reporting period

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HKFRS 7 *Financial Instruments: Disclosures*

Financial liabilities designated as at FVTPL

❖ **Step 4: Compute the change in the fair value of the liability not attributable to changes in the observed (benchmark) interest rate**

- Observed market price: $400,000,000
- PV of remaining contractual cash flows using the benchmark interest plus the instrument-specific component of IRR: $427,059,828

Changes in fair value due to changes in credit risk of the bond:	**$427,059,828 - $400,000,000 = $27,059,828**

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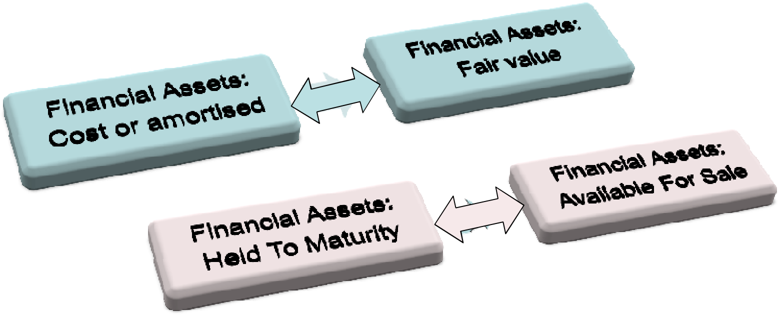
HKFRS 7 *Financial Instruments: Disclosures*

❖ **Reclassifications**



❖ **Disclose the amount that has been reclassified into and out of each category**

❖ **Disclose the reason for the reclassifications**

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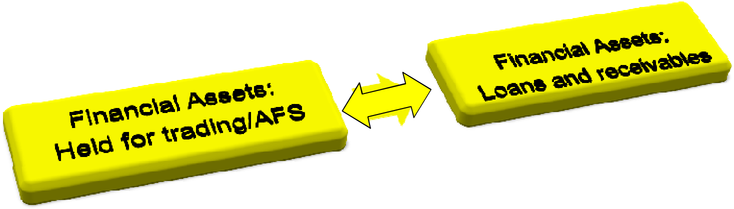
HKFRS 7 *Financial Instruments: Disclosures*

❖**Reclassifications**



❖ **Significant effects**

❖**Extensive disclosures for reclassification out of FVTPL and out of AFS to loans and receivables**

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HKFRS 7 *Financial Instruments: Disclosures*

Reclassifications of financial instruments

❖**What are the required disclosures for reclassifications out of FVTPL or AFS to loans and receivables?**

a. the amount reclassified into and out of each category
b. for each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods
c. if a financial asset was reclassified under rare situation, the facts and circumstances indicating that the situation was rare
d. for the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognised in profit or loss or other comprehensive income (OCI) in that reporting period and in the prevoius reporting period
e. for the reporting period following the reclassification, the fair gain or loss that would have been recognised in profit or loss or OCI if the financial asset had not been reclassified
f. the effective interest rate and the estimated amounts of cash flows the company expected to recover, as at the date of reclassification of the FA

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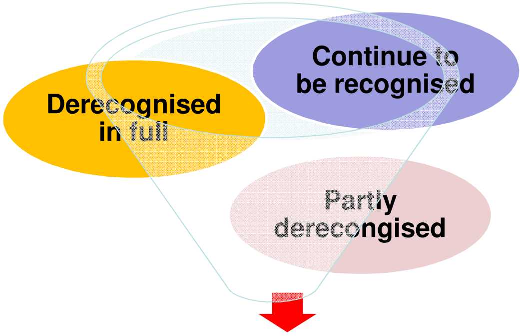
HKFRS 7 *Financial Instruments: Disclosures*

❖ **Transfers of financial assets**



Significant? Risks retained? Nature of risks and rewards the company continues to be exposed? Extent of its continuing involvement with the transferred asset?

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Transfers of financial assets**

Companies not applying the October 2010 amendments to HKFRS 7	October 2010 Amendments to HKFRS 7
* Continue to recognise the assets: the carrying value (CV) of the assets and the associated liabilities	Effective for annual periods beginning on or after 1 July 2011.
* Continue to recognise the assets to the extent of its continuing involvement: CV of the original assets, amount of assets the company continues to recognise and CV of associated liabilities	More extensive disclosures for (i) transferred asset not derecognised in its entirety, or (ii) transferred asset derecognised in its entirety but has some continuing involvement in the asset (refer to HKFRS 7.42A-42H)

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HKFRS 7 *Financial Instruments: Disclosures*

Transfers of financial assets

❖ **Under what circumstances would the transferred asset will not be derecognised in full?**

Two criteria:

a) the transferor retains substantially all the risks and rewards of ownership of the transferred asset; or

b) the transferor neither transfers nor retains substantially all the risks and rewards of ownership of the transferred asset but continues to control the transferred asset

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HKFRS 7 *Financial Instruments: Disclosures*

Transfers of financial assets

❖ **What types of arrangements would meet the requirements for non-derecognition in full and therefore, be subject to the disclosure requirements of HKFRS 7?**

- A transfer of a financial asset with an obligation to repurchase the transferred asset in the future at a fixed price
- A transfer of a financial asset where the transferor has an option to buy (or the transferee has the right to require the transferor to repurchase) the transferred asset back at a fixed price and, at the date of transfer, the option strike price is deeply in the money
- A transfer of a financial asset where the transferor has an option to buy (or the transferee has the right to require the transferor to repurchase) the transferred asset back at a fixed price and, at the date of transfer, the option strike price is neither deeply in nor deeply out of the money and the asset is not readily obtainable in the market

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HKFRS 7 *Financial Instruments: Disclosures*

Transfers of financial assets

❖ **Under the new amendment to HKFRS 7, when the transferor derecognises the transferred asset in its entirety but has some continuing involvement in the asset, minimum disclosures are required for each type of continuing involvement at each reporting date. Would the following constitute continuing involvement?**

a) Normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of a legal action

b) Forward, option and other contracts to reacquire the transferred financial asset for which the contract price (or exercise price) is the fair value of the transferred financial asset

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Collaterals**

- A company is required to disclose (i) the carrying amount of financial assets it has pledged as collateral (non-cash financial assets) for liabilities or contingent liabilities and (ii) the terms and conditions relating to the pledge

- When the company holds collateral (both financial and non-financial assets) as security for financial assets loaned to another company and the company is permitted to sell or repledge in the absence of default by the owner of the collateral, the company is required to disclose (i) the fair value of the collateral held; (ii) the fair value of any such collateral that has been sold or repledged and whether the company has an obligation to return it; and (iii) the terms and conditions associated with its use of the collateral

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HKFRS 7 *Financial Instruments: Disclosures*

Collaterals

❖ **If the company does not have the right to sell or pledge the collateral in the absence of default by the borrower, are there any specific disclosure requirement then?**

a) Included in the credit risk disclosures note

b) Generally, a description of collateral held as security and their financial effect to which the collateral mitigate the credit risk

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Allowance account for credit losses**

- When financial assets are impaired by credit losses, and the company recognises the impairment in a separate allowance account rather than by directly reducing the carrying amount of the assets, the company is required to present a reconciliation of changes in that allowance account during the period
- This disclosure is required by class of financial asset

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HKFRS 7 *Financial Instruments: Disclosures*

Allowance account for credit losses

❖ **Which components of the reconciliation are required to be separately presented?**

a) HKFRS 7 does not specify the components of reconciliation to be separately presented

For Illustration:	**$**
Opening balance	XX
Plus: impairment losses recognised	XX
Less: reversals of impairment losses	XX
Less: amounts written off during the year	XX
Plus/less: exchange gains and losses on foreign denominated items	XX
Less: unwind of discount	XX
Closing balance	XX

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Defaults and breaches**

- For loans payable recognised at the end of the reporting period, required to disclose any defaults during the period of principal, interest, sinking fund, or redemption terms
- Disclose the carrying amount of any such loans that are in default at the end of the reporting period and whether the default was remedied or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue

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HKFRS 7 *Financial Instruments: Disclosures*

Defaults and breaches

❖ **If the defaults were rectified by the end of the reporting period, are the disclosures regarding defaults during the period still required?**

a) Disclosure regarding defaults is required even when those defaults were rectified by the end of the reporting period

b) To provide the users with relevant information about the company's creditworthiness and its prospects for obtaining future loans

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Disclosures relating to the statement of comprehensive income**

- HKFRS 7 requires disclosure of specified income, expense, gains or loss items either in the statement of comprehensive income or in the notes to the financial statements

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HKFRS 7 *Financial Instruments: Disclosures*

Net gains or net losses

❖ **Can the company disclose net gains or losses for all financial assets or financial liabilities in one lump sum? If not, what are the required disclosed components?**

a) The Company is required to disclose the net gains or net losses for each class of financial assets and financial liabilities

b) To assist user understand the extent to which accounting policies affect the performance of the company and the nature of the gains and losses

c) To allow users to appraise management in how the financial instruments are classified and, ultimately, its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities

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HKFRS 7 *Financial Instruments: Disclosures*

Interest income and interest expense

❖ **Can the company only disclose the net of interest income and interest expense for financial assets and financial liabilities in the statement of comprehensive income or in the notes?**

a) Disclose total interest income and total interest expense, determined using the effective interest method, for financial assets or financial liabilities that are not classified as at FVTPL

b) Total interest expense is a component of the finance costs that are required to be disclosed as a line item

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HKFRS 7 *Financial Instruments: Disclosures*

❖ Fair Value

- For assets and liabilities measured at fair value on a recurring or non-recurring basis, disclose the valuation techniques and inputs used to develop those measurements
- For recurring fair value measurements using significant unobservable inputs (Level 3), disclose the effect of the measurements on profit or loss or other comprehensive income for the period

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HKFRS 7 *Financial Instruments: Disclosures*

Fair Value

❖ What are the level of details, how much emphasis and how much aggregation or disaggregation to satisfy the disclosure requirements?

Extent of disclosure

- Recurring fair value measurement
  - HKFRSs require or permit in the statement of financial position the asset or liability to be subsequently measured at fair value at the end of each reporting period
  - The greatest amount of disclosure
- Non-recurring fair value measurement
  - HKFRSs require or permit in the statement of financial position the asset or liability to be subsequently measured at fair value on particular circumstances
  - Most, but not all, of the disclosures

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HKFRS 7 *Financial Instruments: Disclosures*

Fair Value

❖ Are there any exceptions from fair value disclosure for financial instruments?

HKFRS 7 does not require disclosure of fair value:

a) When the carrying amount is a reasonable approximation of fair value, e.g. for financial instruments such as short-term trade receivables and payables

b) For an investment in equity instruments that do not have a quoted price in an active market for an identified instrument (i.e. a Level 1 input), or derivatives linked to such equity instruments, that is measured at cost in accordance with HKAS 39 because its fair value cannot otherwise be measured reliably

c) For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably

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HKFRS 7 *Financial Instruments: Disclosures*

Fair Value

❖ If the fair value of the financial instruments cannot be reliably measured, any required additional disclosures to assist users in making their own judgments about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value?

HKFRS 7 required additional disclosures:

a) A statement that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably
b) A description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably
c) Information about the market for the instruments
d) Information about whether and how the company intends to dispose of the financial instruments
e) If such instruments are subsequently derecognised, the carrying amount at the date of disposal, the fact that fair value could not be reliably measured, and the gain or loss that results

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HKFRS 7 *Financial Instruments: Disclosures*

Fair Value

❖ **HKFRS 7 requires the company to disclose the fair value at the end of the reporting period and level within the fair value hierarchy within which the fair value measurement is categorised. Any illustrative example?**

At 31 December 20X1	Quoted market price (Level 1)	Using observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets			
Trading assets	xx	xx	xx
Financial assets designated at fair value	xx	xx	xx
Available for sale financial assets	xx	xx	xx
Liabilities			
Trading liabilities	xx	xx	xx
Financial liabilities designated at fair value	xx	xx	xx

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HKFRS 7 *Financial Instruments: Disclosures*

Fair Value

❖ **What are the disclosures regarding fair value for a compound financial instrument?**

- A compound financial instrument include a financial liability and equity component
- Disclosures regarding fair value will relate only to the financial liability component of the compound instrument
- The equity component is scoped out of HKFRS 7
- The fair value of the financial liability component incorporates interest rate risk and the company's own credit risk but excludes any consideration of equity price risk

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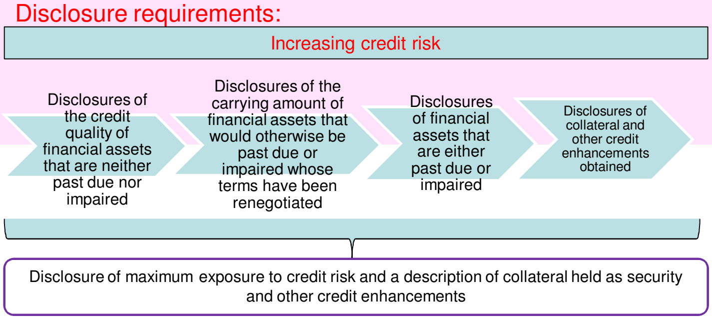
HKFRS 7 *Financial Instruments: Disclosures*

❖ Risk from financial instrument: Credit risk

- Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation
- Disclosure requirements:



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HKFRS 7 *Financial Instruments: Disclosures*

Maximum exposure to credit risk: loan commitment

❖ If Bank A issues a loan commitment to Company B for $100M. (i) What will be disclosed in Bank A's financial statements with respect to the loan commitment? (ii) If Company C issues a financial guarantee to Bank A relating to Bank A's loan commitment to Company B. Will the disclosed amount be different?

i. The maximum exposure to credit risk to be disclosed in Bank A's financial statements with respect to the loan commitment equals the full amount of the loan that has been offered , i.e. $100

ii. The maximum exposure to credit risk for Bank A is $100M, being the maximum potential loss under the loan ignoring the guarantee it has acquired to reduce the potential loss

iii. The maximum exposure to credit risk for Company C is also $100M because this is the maximum amount Company C could have to pay to Bank A if the guarantee is called upon

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HKFRS 7 *Financial Instruments: Disclosures*

Maximum exposure to credit risk: receivables

❖ **Customers purchase goods from Company A under the company standard credit terms. Company A also purchases goods from some of its major customers. Outstanding amounts at end of year are as follows:**

Gross trade receivables	$ 365,000
Impairment loss	(14,000)
Net carrying amount	$ 351,000
Amounts owed to customers	(75,000)

What is the maximum exposure to credit risk at the end of the reporting period for Company A?

i. The maximum exposure to credit risk at the end of each reporting period is the gross amount due from its customers less the allowances recognised for impairment losses

ii. The payables are excluded from the analysis because they are not offset in the statement of financial position

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HKFRS 7 *Financial Instruments: Disclosures*

Maximum exposure to credit risk: financial guarantee contracts

Group A
- Group A directly and indirectly wholly-owned Company A and Company B, respectively

Company A
- Company A has issued a variety of guarantees on behalf of Company B and in favour of the banks
- Short-term banking facilities drawn down at year end: $100M
- Guarantees issued by Company A to various banks: $250M

Company B
- Company B has short-term banking facilities of $300M with various banks

What is the maximum exposure to credit risk in Co B's F/S, Co A's separate F/S and Group A's consolidated F/S?

i. **Company B: Nil**. Company B is the borrower, it does not have an exposure to credit risk

ii. **Company A: $250M**. The full amount of the guarantee that would be required to be paid if the guarantee is called upon

iii. **Group A: Nil.** From the group's perspective , the group is the borrower. It does not have exposure to credit risk. The amount repayable is the same irrespective of whether Company B repays the debt or Company A repays the debt on Company B's behalf

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosure of collateral held as security and other credit enhancement

❖ If a company holds collateral as security against its financial assets, what are the requirements in terms of disclosures that best represents the maximum exposure to credit risk of the company?

i. Provide a description of collateral held e.g. types
ii. The policies and processes for valuing and managing collaterals
iii. The main types of counterparties to collateral and their credit worthiness
iv. Information about risk concentrations within the collateral

20X1	Personal customers	Commercial customers	Financial customers	Governments	Total
Credit exposure	**870**	**880**	**441**	**162**	**2353**
Collateral value	**(707)**	(472)	(392)	(42)	(1613)
Total unsecured credit exposure	163	408	49	120	740
Real property	200	130	170	10	510
Bank accounts	**180**	272	142	20	614
Guarantees	327	70	80	12	489
Total	707	472	392	42	1613

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosure of collateral and other credit enhancements obtained

❖ A bank lends $100K to a homeowner with property specified as collateral for the loan. During the period, the homeowner defaults under the loan and the property meets the criteria for recognition in the statement of financial position before being disposed of. Is the bank required to disclose the collaterals foreclosed?

i. When a company obtains financial or non-financial assets by taking possession of collateral or calling on other credit enhancements (e.g. financial guarantee contracts) at foreclosure, and such assets are required to be recognised at the reporting date in accordance with HKAS 39 or other Standards, disclose nature and carrying amounts of those assets

ii. Disclose the company's policies for disposing of the assets or using them in the operations when the assets are not readily convertible into cash

These disclosures provide information about the frequency of such events and the company's ability to obtain and realise the value of the collaterals

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosure regarding financial assets that are either past due or impaired

Receivables, past due and not impaired	Gross amt at 31.12.2011	Receivables past due, impaired	Receivables not impaired, past due by:				
			Up to 30 days	31 to 60 days	61 to 90 days	91 to 120 days	Over 120 days
Financial receivables	4065	53	-	-	-	-	5
Trade receivables	9829	1160	785	94	53	39	120
Other receivables and other assets	9731	5	-	-	-	1	3
	23.625	1.218	785	94	53	40	128

What are the specific requirements under HKFRS 7 for 'past due' or 'impaired' financial assets?

i. Past due versus Impaired: Subtle distinction
ii. Past due or impaired information should be provided by **class of financial assets**
iii. An analysis of the age of the financial assets that are past due but not impaired at the end of the reporting period
iv. Use judgment to determine an appropriate number of time bands, generally based on internal reporting to management

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HKFRS 7 *Financial Instruments: Disclosures*

❖Risk from financial instrument: Liquidity risk

- Liquidity risk is the risk that a company will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset

Quantitative liquidity risk disclosures

- A maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities
- A maturity analysis for derivative financial liabilities, including the remaining contractual maturities for understanding of the timing of cash flows
- A description of how the company manages the liquidity risk

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis

❖ If the company recognised a financial liability which is exclusively settled in the issuer's own equity instruments, would that financial liability be included in the maturity analysis?

i. If a financial liability is exclusively settled in the issuer's own equity instruments (e.g. a variable number of equity shares equal to a fixed monetary amount) , the financial liability will not be included in the liquidity risk disclosures

ii. If the issuer has the right to deliver its own equity instruments instead of cash or another financial asset, the financial liability is deemed not to have liquidity risk

iii. If the issuer cannot avoid settlement in cash or other financial asset, the financial asset, even if there is an equity-settled alternative, the financial liability must be included in the liquidity risk disclosures

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: amount to include in the time band

❖ Are interest charges computed for the disclosure of contractual maturities of financial liabilities such as bank loans? If interest charges of bank loans within the contractual period are computed for the disclosure of contractual maturities, how about the future rental payments of the contractual leased period of a tenancy agreement? Should that be included for the disclosure of contractual maturities of financial liabilities?

i. Present contractual, undiscounted cash flows

ii. Amounts differ from the amounts disclosed in the statement of financial position for financial liabilities, which are typically discounted amounts

iii. Operating leases are primarily uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. A finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: amount to include in the time band

❖ **How do we compute the interest charges for the disclosure of contractual maturities of financial liabilities for foreign currency denominated fixed- or floating-rate debt instruments?**

i. Foreign currency denominated fixed- or floating-rate debt instruments: Disclose principal and interest in the appropriate time bands based on the interest rates curves in the foreign currency interest rate environment

ii. May be disclosed in the foreign currency

iii. May disclose in the functional currency when preparing entity-only financial statements

iv. May disclose in the group presentation currency when preparing consolidated financial statements

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: amount to include in the time band

❖ **When the amount payable is not fixed, as is the case for issued debt that has a variable interest rate, how should the interest charges for the disclosure of contractual maturities of financial liabilities be determined?**

i. The amount disclosed should be determined by reference to the conditions existing at the end of the reporting period

ii. "Conditions existing at the end of the reporting period" refer to:
(a) absolute level of the index at the end of the reporting period (e.g. LIBOR rate at the end of the reporting period , i.e., five interest payments of the same amount ?, OR

(b) future LIBOR that exist at the end of the reporting period (e.g. for a five-year LIBOR-based debt having five interest payments based on the prevailing forward curve at the end of the reporting period, i.e., based on expectation of future LIBOR)?

The latter appears more appropriate. It recognises the conditions at the period end relating to the company's expected payments of cash or another financial asset

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: determining which time band

❖ **Which time band should a demand deposit be disclosed under the maturity analysis? How about the American-style written option or the European-style option?**

Disclose the liability in the time band on the basis of the earliest date on which the company can be required to pay when the counterparty has a choice regarding when an amount is required to be paid

Demand deposits: included in the earliest time band because the deposit holder can require repayment on demand

American-style written option: disclose in the earliest time band in which the holder can exercise because the holder can exercise anytime

European-style option: included in the time period equivalent to its maturity because it is only exercisable by the holder at maturity

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Maturity analysis: determining which time band

❖ **What about if the company is committed to make amounts available in instalments? What about undrawn loan facilities? What about if a company has written a financial guarantee contracts?**

i. **Commitment to make amounts available in instalments:** disclose each instalment amount to the earliest period in which the company can be required to pay

ii. **Undrawn loan commitment:** included in the time band containing the earliest date it can be drawn down. If the holder can drawn down the loan at any time, included in the earliest time period

iii. **Financial guarantee contracts:** the maximum amount that the writer could be required to pay to the holder of the guarantee included in the time band that reflects the earliest period in which the guarantee could be called

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HKFRS 7 *Financial Instruments: Disclosures*

Maturity analysis: determining which time band

❖ **Does the company have to disclose the maturity analysis of the financial assets in all cases as HKAS 1.65 states that HKFRS 7 requires disclosure of the maturity dates of financial assets and financial liabilities?**

i. HKFRS 7 requires disclosure of a liquidity analysis for all financial liabilities

ii. A company is not required to disclose a maturity analysis for financial assets in all cases

iii. Minimum required disclosure is for a maturity analysis for financial liabilities only

iv. A maturity analysis should be disclosed for financial assets if the company holds financial assets for managing liquidity risk and that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk

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HKFRS 7 *Financial Instruments: Disclosures*

❖ **Risk from financial instrument: Market risk**

- Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices

Currency Risk	Interest Rate Risk	Other Price Risk
• Risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates • Arises on financial instruments that are denominated in a different currency to the company's functional currency	• Risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates • Arises on interest-bearing financial instruments that are recognised in the statement of financial position and some financial instruments that are not recognised in the statement of financial position	• Risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk

❖ **What are the requirements under HKFRS 7 on disclosures of market risks?**

i. Market risk sensitivity analysis is required for each type of market risk to which the company is exposed at the end of the reporting period

ii. Show how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at the end of the reporting period

iii. Disclose methods and assumptions used in preparing the sensitivity analysis

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

❖ **How should we disclose the sensitivity analysis for currency risk?**

i. Identify the functional currency of the company

ii. Identify those financial instruments denominated in foreign currencies held as at the end of the reporting date

iii. Determine the reasonably possible change in foreign currency rates. Expected change in foreign currency rates may be different for each foreign currency.

iv. According to HKFRS 7, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

For example:

i. The company's functional currency is RMB

ii. The carrying amount of the company's foreign currency denominated monetary assets and liabilities are as follows:

	2011 RMB'000	**2010 RMB'000**
Assets		
USD	70	1,000
HKD	280	2,100
Liabilities		
USD	1,600	800

iii. 5% is the sensitivity rate used when reporting foreign currency risk internally to key management personnel and represents management's assessment of the reasonably possible change in foreign exchange rates. A positive /(negative) number indicates an increase/(decrease) in profit for the year where RMB strengthens against the relevant currencies.

	2011 RMB'000	**2010 RMB'000**
USD	77	(10)
HKD	(14)	(105)

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

Other considerations:

i. How should we prepare the sensitivity analysis for consolidated financial statements with foreign subsidiaries?
- Prepare the maturity analysis of each foreign subsidiary and then aggregate them all at group level? (i.e. consider the functional currency of each foreign subsidiary)
- Prepare the maturity analysis altogether at the group level by referring only to the functional currency of the holding company?

ii. How to present the results of the analysis if the presentation currency is different from the functional currency?
- Using the average rate to translate?
- Using the rate as at the reporting date to translate?

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

❖ **HKFRS 7 states that sensitivity analysis is prepared to show the risk to which the company is exposed at the end of the reporting period. What does it mean by at the end of the reporting period? If I hold an overnight time deposit / demand deposit, would it be appropriate if I calculate the impact on the P&L for 1 day to represent "the end of the reporting period"?**

i. HKFRS 7 paragraph 40(b) states that unless the company complies with paragraph 41 (that is, the entity should disclose the methods and assumptions used in preparing the sensitivity analysis unless it prepares a sensitivity analysis that reflects interdependencies between risk variables and uses it to manage financial risks), it shall disclose the methods and assumptions used in preparing the sensitivity analysis.

ii. For example, as extracted from Deloittle illustrative financial statements
"the analysis is prepared assuming the amount of the liability outstanding at the end of the reporting period was outstanding for the whole year".

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HKFRS 7 *Financial Instruments: Disclosures*

Disclosures required for market risk: sensitivity analysis

iii. As extracted from KPMG's illustrated financial statements,
"the impact on the group's profit after tax (and retained profits) and other components of consolidated equity is estimated as an annualized impact on interest expense or income of such a change in interest rates"

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HKFRS 7 *Financial Instruments: Disclosures*

Important:

For detailed disclosures requirements under HKFRS 7, refer to the following link:

http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/hkfrs9.pdf

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Hong Kong Financial Reporting Standards

❖Financial Instruments: Way forward

- **Financial Instruments**
  - **HKAS 39 will be replaced by a new Standard: HKFRS 9 *Financial Instruments***
  - **HKFRS 7 will be consequentially amended to reflect the requirements of HKFRS 9; and**
  - **HKAS 32 will be unchanged except for some anticipated amendments to offset requirements**

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

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Statement of Cash Flows

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Introduction

- HKAS 7 *Statement of Cash Flows* 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
- 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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Form of statement of cash flows

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

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

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Form of statement of cash flows (cont'd)

- **When an entity prepares only individual financial statements,** the statement of cash flows will be for the individual entity

- **When consolidated financial statements are prepared,** a consolidated statement of cash flows will be prepared

- **When an entity produces both separate and consolidated financial statements,** a statement of cash flows will be required for each

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

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Cash and cash equivalents

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

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Cash and cash equivalents (Cont'd)

❑ **Cash equivalents:**

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

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Cash and cash equivalents (Cont'd)

❑ **Bank overdrafts repayable on demand**

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

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

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Cash flows should be classified by
operating, investing or financing activities

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Classification of cash flows

- **Operating activities**
  - principal revenue-producing activities of the entity and other activities that are not investing or financing activities
- **Investing activities**
  - acquisition and disposal of long-term assets and other investments not included in cash equivalents
- **Financing activities**
  - relate to shareholders' equity and borrowings of the entity

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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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Direct method

	20X1	20X1
	$'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 (alt.1)

	20X1	20X1
	$'000	$'000
Cash flows from operating activities		
Profit before taxation	19,696	
Adjustments for :		
Depreciation	6,174	
Foreign exchange loss	829	
Interest expense*	7,305	
Profit before working capital changes	34,004	
Increase in trade and other receivables	(7,601)	
Increase in trade payables	5,224	
Decrease in inventories	3,652	
Cash generated from operations	**35,279**	
Interest paid	(5,933)	
Income taxes paid	(13,447)	
Net cash from operating activities		15,899

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

	20X1	20X1
	$'000	$'000
Cash flows from operating activities		
Revenue	259,376	
Operating expenses excluding depreciation	(225,372)	
Profit before working capital changes	34,004	
Increase in trade and other receivables	(7,601)	
Increase in trade payables	5,224	
Decrease in inventories	3,652	
Cash generated from operations	35,279	
Interest paid	5,993	
Income taxes paid	13447	
Net cash from operating activities		15899

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Indirect method (cont'd)

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

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Classification Issues

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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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Interest and dividends

- Cash flows from interest and dividends **paid:**
  - Operating or financing
- Cash flows from interest and dividends **received:**
  - Operating or investing
- Must disclose separately and consistently in a manner that is most appropriate for the business or industry

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Interest and dividends (cont'd)

- Split the cost of acquisition of qualifying assets and the capitalised borrowing costs in the statement of cash flows
- **For example**:
  - Total cost of a property: $1000 (including $50 of capitalised interest)
  - <u>$50 will be included in operating or financing activities</u> (depending on the entity's accounting policy for presenting interest paid in the statement of cash flows), and <u>the remaining $950 will be included in investing activities</u>

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Debt securities issued at a discount or premium

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

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

- **Example:**
  - Proceeds from a zero coupon bond upon issuance: $100,000 on 1 January 2007
  - On 31 December 2011, the company redeems the bond by paying cash of $140,255 to the bondholder
  - Statement of comprehensive income for the five years ended 31 December 2011, classify $40,255 as interest expense
  - Statement of cash flows for the year ended 31 December 2011: $100,000 is classified as a financing cash flow and $40,255 is classified according to the entity's general classification for interest

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Shares classified as liabilities

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

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Treasury shares

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

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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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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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Investments in subsidiaries, associates and joint ventures

- Consolidated statement of cash flows **includes** the cash flows of consolidated subsidiaries, but **excludes** any that are intragroup

- When a consolidated subsidiary is only **partly owned** by the group, the dividends paid to the non-controlling interests (but not the dividends paid to group entities) are classified as either financing or operating cash outflows, consistently with the classification of dividends paid by the parent

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Investments in subsidiaries, associates and joint ventures (cont'd)

- 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

- When an entity has an interest in a joint venture that is accounted for using proportionate consolidation, the consolidated statement of cash flows includes the investor's proportionate share of the cash flows of the joint venture

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Changes in ownership interests involving a change in control

- When an entity has **obtained or lost control** of subsidiaries or other businesses during the reporting period, the aggregate cash flows arising should be presented separately and classified as **investing activities**
- The **single-line entry** in the statement of cash flows comprises the amount of cash paid or received as consideration for obtaining or losing control, net of the cash and cash equivalents in the subsidiaries or businesses at the date of the transaction, event or change in circumstances

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Changes in ownership interests involving a change in control (cont'd)

- The cash flow effects of losing control are not to be deducted from those of obtaining control. **Each is to be shown separately**

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Changes in ownership interests involving a change in control (cont'd)

- Each of the following should be disclosed, in aggregate, in respect of obtaining control of subsidiaries or other businesses during the period:
  - The total consideration paid;
  - 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; 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, summarised by each major category

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Changes in ownership interests not resulting in a loss of control

- 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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Foreign currency cash flows

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

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

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Example: Cash held in a foreign currency

	Fx	Rate	Functional currency
Balance of cash held in foreign currency at 1 January 2011	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 2011	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 2011		Functional currency 2010
Share capital	100		100
Retained earnings	200	(150-80+130)	0
	300		100
Cash	300		100

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Statement of cash flows extract – direct method

	2011
Statement of cash flows extract – direct method	
Receipts from customers (all receivables collected by the end of the reporting period)	150
Payments to suppliers (all invoices paid by the end of the reporting period)	(80)
Net increase in cash	70
Cash and cash equivalents at 1 January 2011	100
Effect of exchange rate fluctuations on cash held	130
Cash and cash equivalents at 31 December 2011	300

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Statement of cash flows extract – indirect method

	2010
Statement of cash flows extract – indirect method	
Net profit	200
Unrealised foreign currency gain	(130)
Net increase in cash	70
Cash and cash equivalents at 1 January 2011	100
Effect of exchange rate fluctuations on cash held	130
Cash and cash equivalents at 31 December 2011	300

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Example: Other foreign currency differences

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

	Fx	**Rate**	**Functional currency**
Loan received during 2010 (converted to AC immediately)	250	1.5:1	375
Translate at the end of the reporting period	250	2:1	500

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Example: Other foreign currency differences (cont'd)

	2011		**2010**
Statement of financial position (in AC)			
Share capital	100		100
Retained earnings	75	(200-125)	200
	175		300
Cash	675		300
Loan	(500)		-
	175		300
Statement of cash flows extract – indirect method	**2011**		
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 2011	300		
Cash at 31 January 2011	675		
Notes			
Cash on balance at the end of 2009 is held in its own functional currency (FC)			

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Offsetting

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

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Taxes collected on behalf of third parties

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

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Example: Taxes collected on behalf of third parties

Services rendered for cash during 2010 (excluding GST)	100	
GST paid to tax authorities	10	
GST payable to tax authorities (GST collected from customers is 20 of which 10 is paid and 10 remains outstanding to tax authorities)	10	
Statement of financial position	**2011**	**2010**
Share capital	100	100
Retain earnings	100	-
	200	100
Cash	210	100
GST payable	(10)	-
	200	100

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

	2011
Statement of cash flows extract – direct method option 1	
Receipts from customers (all receivables collected by the end of the reporting period)	100
Indirect taxes collected	20
Indirect taxes paid	(10)
Net cash increase	110
Cash at 1 January 2011	100
Cash at 31 December 2011	210

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

	2011
Statement of cash flows extract – direct method option 2	
Receipts from customers (all receivables collected by the end of the reporting period)	120
Payments to tax authorities (all invoices paid by the reporting period)	(10)
Net cash increase	110
Cash at 1 January 2011	100
Cash at 31 December 2011	210

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

	2010
Statement of cash flows extract – indirect method	
Net profit	100
Increase in accounts payable	10
Net cash increase	110
Cash at 1 January 2011	100
Cash at 31 December 2011	210

Consolidated Statement of Cash Flows

	$'000	$'000
Operating activities		
Profit before tax	X	
Adjustments for:		
Depreciation	X	
Allowance for bad debts	X	
Loss on disposal of property, plant and equipment	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

Consolidated Statement of Cash Flows (cont'd)

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

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The net cash outflow arising on the acquisition and the fair value of the assets acquired and liabilities assumed were as follows:

	$'000	$'000
Total consideration paid		X
Fair value of non-controlling interests		X
Property, plant and equipment	X	
Trade and other receivables	X	
Cash and cash equivalents	X	
Trade and other payables	X	
Taxation payable	X	
Less: Fair value of identifiable net assets		(X)
Goodwill		X
Total consideration paid		X
Non-cash consideration – fair value of share issued		(X)
Cash consideration paid		X
Less: Cash and cash equivalent of subsidiaries		(X)
Cash outflow on acquisition, net of cash acquired		X

The amount of the assets and liabilities other then cash for cash equivalents in the subsidiary over which control is obtained, summarised by each major category.

The total consideration paid

The portion of the consideration consisting of cash and cash equivalents

The amount of cash and cash equivalents in the subsidiary over which control is obtained

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Additional disclosure requirements

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Non-cash transactions

- When an entity enters into an investing or financing transaction that does not involve the use of cash or cash equivalents, the transaction is excluded from the statement of cash flows
- The entity should disclose sufficient information in the financial statements to give a user all the relevant information about the transaction

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Components of cash and cash equivalents

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

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Balances not available for use by the group

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

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Additional recommended disclosures

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

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Borrowing costs

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Overview

- **Capitalise borrowing costs** that are **directly attributable** to the acquisition, construction, or production of a **qualifying asset**

  Exceptions: (i) qualifying assets measured at fair value
  (ii) inventories that are manufactured or produced in large quantities on a repetitive basis

- Other borrowing costs are recognised as an expense

- Borrowing costs are **reduced by interest income** from the **temporary investment of borrowings**

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Qualifying assets

- A qualifying asset is one that **necessarily** takes a **substantial period of time** to be made ready for its **intended use or sale**. Qualifying asset generally are those that are subject to major development or construction project
- An asset that is ready for its intended use or sale when acquired is **not** a qualifying asset, even if expenditure subsequently is incurred on the asset

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Qualifying assets (cont'd)

- There is **no specific guidance** on how long a **"substantial period of time"** is. Judgment required.
- Inventories that take a long time to produce (e.g. whisky or property) can be qualifying assets.
- The term **"necessarily"** is included in the definition of a qualifying asset to indicate that the nature of the asset should be such that it takes a long time to get it ready for its intended use or sale. Therefore, an asset that takes a long time to prepare for use or sale only because of inefficiencies in the development process is not a qualifying asset.

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Examples of qualifying assets

Assets that may be qualifying assets	Non-qualifying assets
➢ inventories;	➢ assets that are ready for their intended use or sale when acquired;
➢ intangible assets;	➢ financial assets; and
➢ investment properties;	➢ inventories that are manufactured, or otherwise produced, over a short period of time
➢ manufacturing plants; and	
➢ power generation facilities	

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Example: whether an equity-accounted investment can be a qualifying asset

Background

Company X invests in construction contracts via participating interests in single-purpose entities. The entities are generally either associates or jointly controlled entities of Company X, which accounts for all such investments using the equity method of accounting. Where Company X borrows funds for the purpose of funding its investments, should it capitalise borrowing costs as part of the carrying amount of the equity-accounted investments?

Answer

Borrowing costs should not be capitalised in these circumstances. HKAS 23.7 states that financial assets are not qualifying assets.

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Example: Whether an asset being refurbished can be a qualifying asset?

Background

An entity owns and manages a hotel. The hotel is closed down for a major refurbishment. The refurbishment costs will be capitalised and the refurbishment will take 18 months.

Answer

There is no guidance in HKFRSs regarding whether an asset that is being refurbished can be a qualifying asset. An asset being refurbished can be a qualifying asset if the refurbishment costs qualify for capitalisation, and the refurbishment will take a substantial period of time.

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Borrowing costs eligible for capitalisation

- Borrowing costs eligible for capitalisation may include:
  - **Interest expense** calculated using the effective interest method, include:
    - Interest on specific borrowings to obtain the qualifying asset
    - Interest on general borrowings
  - **Finance charges** in respect of finance leases
  - The amount of borrowing costs to be capitalised is **calculated on a pre-tax basis**. Borrowing costs that are capitalised may give rise to deferred tax.

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Borrowing costs eligible for capitalisation (cont'd)

- **Exchange differences** to the extent that they are regarded as an adjustment to interest costs
- No further guidance on the conditions under which foreign exchange differences may be capitalised
- The foreign exchange differences to be capitalised should be **limited** to the difference between interest accrued at the contractual rate and the interest that would apply to a borrowing with identical terms in the entity's functional currency.

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Example: Exchange differences to be included in borrowing costs

➢ An entity which prepares its financial statements in **Thai Baht** (the entity's **functional currency**) enters into a borrowing arrangement, with the following terms and conditions:

Drawdown amount (in the foreign currency)	**US $100M**
Drawdown date	1 January 20X1
Exchange rate at drawdown	Baht 25: US$1
Interest rate on foreign borrowings (fixed)	6% per annum
Interest rate on similar borrowing in Thailand as at the drawdown date (fixed)	12% per annum
Average exchange rate for 20X2	Baht 36: US$1
Closing exchange rate for 20X2	Baht 47: US$1

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Example: Exchange differences to be included in borrowing costs (cont'd)

➢ The following interest payments were made in 20X2:

Interest payments (6% X US$100M)	US$6M
Translated at average rate	**Baht 216 million**

➢ The borrowing costs that would have been incurred in the 20X2 reporting period if the funds had been borrowed in Baht:

Baht equivalent of US$100M at 1 January 20X1	Baht 2,500 million
Annual interest expense based on Thai interest rates (12%)	**Baht 300 million**

➢ **Baht 84 million is the limit on the amount to be classified as borrowing costs.**

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Example: Exchange differences to be included in borrowing costs (cont'd)

➢ The foreign exchange loss incurred on the retranslation of the principal amount of the US$100 million borrowings during 20X2 is calculated as follows:

Baht equivalent at opening rate of Baht 25: US$1	Baht 2,500 million
Baht equivalent at closing rate of Baht 47: US$1	Baht 4.700 million
Foreign exchange loss	**Baht 2,200 million**

➢ **The amount of borrowing costs included in the cost of assets under construction for 20X2 = Baht 300 million** (the Baht equivalent of the US$ interest paid of Baht 216 million **plus Baht 84 million** of the exchange loss arising on the principal amount). This is equal to the interest expense that would have been incurred if the funds had been borrowed in Thailand based on commercial interest rate at that time

➢ The remaining exchange loss on the principal **(Baht 2,116 million)** is recognised in profit or loss in the year

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Calculating the amount of borrowing costs to capitalise

- **Specific borrowings**

Actual borrowing costs incurred on funds borrowed specifically for the purpose of acquiring or constructing a qualifying asset

−

Any investment income earned on the temporary investment of the funds borrowed, pending their expenditure on the qualifying asset

=

The amount of borrowing costs eligible for capitalisation [HKAS 23.12 &13]

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Calculating the amount of borrowing costs to capitalise (cont'd)

- **General borrowing costs**

Expenditure on the qualifying assets

×

Capitalisation rate [HKAS 23.14]

=

Amount of borrowing costs eligible for capitalisation

- should be reduced by any pre-sale deposits, progress payments or grants received in connection with the qualifying asset
- The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period

- Total general borrowing cost for the period (i.e. other than specific borrowings relating to qualifying assets) ÷ Weighted average total general borrowings (i.e. other than those specific borrowings)

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Example: Qualifying asset funded from a general borrowing pool

Background

- An entity centrally co-ordinates its financing activities through a treasury function, with borrowings being raised to finance general requirements, including the acquisition and development of qualifying assets
- During the year ended 31 December 20X1, the entity commenced a property development project and incurred the following expenditure:

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

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Example: Qualifying asset funded from a general borrowing pool (cont'd)

Background (cont'd)

- The entity had total borrowings outstanding during the period, and incurred interest on those borrowings, as follows:

		Balance outstanding	**Interest**
Long term loans		HK$'000	HK$'000
	10 years at 10%	35,000	3,500
	5 years at 8%	10,000	800
Short-term loans*		12,000	1,600
Bank overdraft*		5,000	500
		62,000	6,400

* The amounts disclosed for short-term loans and the bank overdraft represent the average amounts outstanding during the period and the interest incurred at variable rates

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Example: Qualifying asset funded from a general borrowing pool (cont'd)

Question

How much should Entity A capitalise its borrowing cost?

Answer

Capitalisation rate:

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

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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Limits on borrowing costs capitalised

The capitalisation of general borrowing costs calculated using the capitalisation rate is subject to the condition that the amount of borrowing costs capitalised should not exceed the actual borrowing costs incurred during that same period [HKAS 23.14]

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Calculation in the consolidated financial statements

- **No specific guidance** in HKFRSs related to the calculation in consolidated financial statements. Judgment is required.
- Where the treasury function is managed within the group - may include all borrowings of a parent and its subsidiaries when calculating the weighted average borrowing costs
- Where each subsidiary is responsible for managing its own treasury, may be appropriate for each subsidiary to calculate the weighted average applicable to its own borrowings
- **Only external borrowings should be considered in calculating a weighted average group borrowing rate**

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Calculation in separate financial statements

- Only borrowings costs incurred by the group entity that has incurred expenditures on a qualifying asset are eligible for capitalization in the entity's separate financial statement.

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Example: Limits on borrowing cost capitalised

Background

- A group consists of the parent and two subsidiaries. Sub 1 is engaged in the construction of a power plant that is wholly financed by fellow subsidiary 2, which obtains the necessary funds through bank borrowings. No intra group interest is charged by Subsidiary 2 to subsidiary 1

Question

- Can interest be capitalised?

Answer

- No interest should be capitalised in either of the individual financial statements of subsidiary 1 and subsidiary 2 under these circumstances. Subsidiary 1 has incurred no borrowing costs, and subsidiary 2 has no qualifying asset
- Interest will be capitalised in the consolidated financial statements of the parent, provided that the amount capitalised fairly reflect the interest cost to the group of borrowings from third parties which could have been avoided if the expenditure on the qualifying asset had not been made

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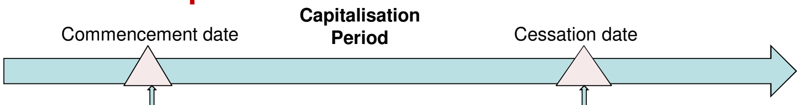
Period of capitalisation

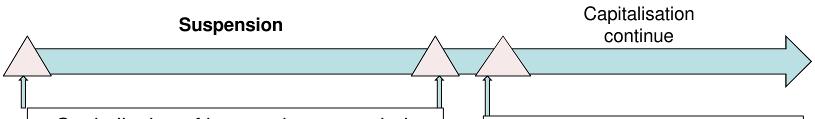


The commencement date for capitalisation is the date when the following **three conditions** are first met:
- expenditures for the asset are being incurred
- borrowing costs are being incurred; and
- activities that are necessary to prepare the asset for its intended use or sale are being undertaken

Capitalisation should cease when substantially all of the activities necessary to prepare the qualifying asset for its intended use or sale are complete

- Such activities include initial technical and administrative work, such as activities associated with obtaining permits, prior to the commencement of the physical construction of the asset [HKAS 23.19]
- The mere holding of an asset without any assoiciated development activities does not entitle an entity to capitalise related borrowing costs [HKAS 23.19] e.g. holding land banks

Suspension of capitalisation



- Capitalisaion of interest is suspended during extended periods in which active development is interrupted e.g. waiting for parts to arrive, cash flow difficulties, desire to hold back development due to economic downturn
- No guidance on what length of time is considered "extended delay"

- 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

Qualifying assets – construction in stages

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

- Capitalisation of the borrowing costs related to that part should cease when substantially all of the activities necessary to prepare that part for its intended use or sale are completed [HKAS 23.24]
- e.g. a development comprising several buildings or units, each of which can be used or sold individually

- Borrowing costs should be capitalised until all of the activities necessary to prepare the entire asset for its intended use or sale are substantially complete
- E.g. a manufacturing facility involving a sequence of processes, where production cannot begin until all the processes are in place

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

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Recognition of an impairment loss or write-down

- When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other HKFRSs. [HKAS 23.16]

  - **Capitalised the interest cost** as part of the gross carrying amount of the asset, and then **recognise an impairment loss** for any excess over the estimated recoverable amount or net realisable value in accordance with the requirements of HKAS 36 "Impairment of Assets" or HKAS 12 "Inventories", as appropriate

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Disclosure

- Entities are required to disclose: [HKAS 23.26]
  - the amount of borrowing costs capitalised during the period; and
  - the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

YOUR HOSTS

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Technical Training & Support

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Associates

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Agenda

Part 1: Background

Part 2: What is "Associate"?

Part 3: Accounting requirements

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Background

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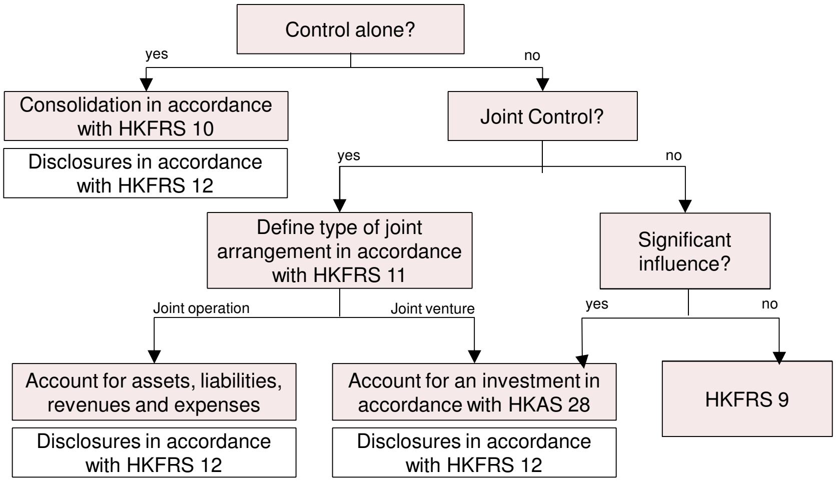
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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Background

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

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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
- A substantial or majority ownership by another investor does not preclude an investor from having significant influence

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Significant influence

Potential voting rights

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

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Significant influence

Potential voting rights

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

Example - Potential voting rights

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

Does A have significant influence over B?

No, because the call option is not currently exercisable.

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Significant influence

Ceasing to have significant influence

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

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Accounting requirements

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Equity method

(a) Basic principle

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

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

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Equity method

(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 on the basis of its proportionate ownership interest.

Aggregation of group interests

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

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Source: Deloitte iGAAP 2012

Example - aggregation of group interests

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

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Source: Deloitte iGAAP 2012

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

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Equity method

(c) Potential voting rights

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

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

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

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

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Equity method

(d) Implicit goodwill and fair value adjustments

- On acquisition of the investment in an associate or a joint venture, any difference between the cost of acquisition and the entity's share of the fair values of the net identifiable assets of the associate is accounted for as follows:

  (a) goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.

  (b) any excess of the investor's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.
- Appropriate adjustments to the entity's share of the profits or losses after acquisition are made to account for additional depreciation of the depreciable assets based on their fair values at the acquisition date.

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Equity method

(e) Subsequent accounting for goodwill

- 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) Reporting periods of associate and joint ventures

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

(g) Reporting periods of associate and joint ventures

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

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Equity method

(h) Upstream and downstream transactions

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

Source: PwC IFRS Student Manual 2010

a. Upstream transaction:

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

b. Downstream transaction:

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

What will be the eliminations for each case?

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Equity method

(i) Non-monetary contributions by investors

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

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Equity method

(j) Losses in excess of investment

- If an investor's share of losses of an associate or joint venture equals or exceeds its "interest in the associate or joint venture", the investor discontinues recognising its share of further losses.
- The "interest in an associate or joint venture" is the carrying amount of the investment in the associate under the equity method together with any long-term interests that, in substance, form part of the investor's net investment in the associate, e.g. preference shares, long-term receivables or loans
- 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.
- Assume that 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, the investor should recognise a loss of HK$5 million in respect of its equity stake.

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

- 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, less HK$10 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 (HK$2.5 million) equals the amount of the unrecognized loss in the previous period. For any profits made in excess of HK$10 million, the investor recognises its proportionate share.

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Equity method

(k) 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

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

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

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

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Equity method

(l) Change in ownership interest

Associate ⟷ **Joint venture**

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

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

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Exemption from applying equity method

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

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

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

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

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

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Exemption from applying equity method (cont'd)

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

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Classification as held for sale

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

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Joint Arrangements

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Agenda

Part 1: Background

Part 2: Identifying joint arrangements

Part 3: Accounting requirements

Part 4: Transitional requirements

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Background

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Background

- IASB issued *IFRS 11 Joint Arrangements* in May 2011
- IFRS 11 supersedes *IAS 31 Interest in Joint Ventures*
- IFRS 11 establishes principles for the financial reporting by parties to a joint arrangement
- IFRS 11 is effective from 1 January 2013. Early application is permitted.

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Background – Why IASB undertook the project?

IASB were mainly concerned with remedying two aspects of IAS 31 that are considered impediments to high quality reporting of joint arrangements.

- The structure of the arrangement was the only driver for the accounting
  – the accounting requirements in IAS 31 may not have always reflected the rights and obligations of the parties arising from the arrangements
- Accounting options for jointly controlled entities (JCEs)

→ These resulted in inconsistencies in the accounting.

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Background – overview of HKFRS 11

HKFRS 11 improves the accounting for joint arrangements by introducing a principle-based approach that requires a party to a joint arrangement to recognise its rights and obligations arising from the arrangement.

What are new in HKFRS 11?

- It carves out, from HKAS 31, those cases in which, although there is a separate vehicle, that separate is ineffective in certain ways. These arrangements are treated similarly to jointly controlled assets/operations under HKAS 31, and are now called joint operations.
- No free choice of using equity method or proportionate consolidation for the remainder of HKAS 31 jointly controlled entities, now called joint ventures

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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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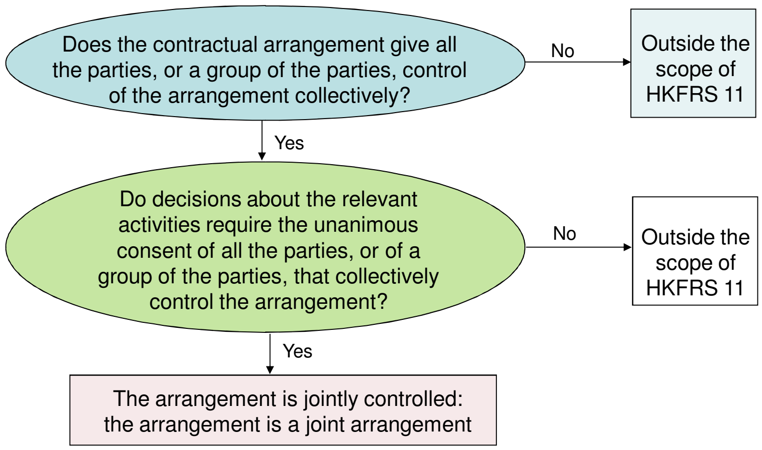
Assessing joint control



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What is control?

- *HKFRS 10 Consolidated financial statements*, an investor controls an investee when it is exposed, or has rights to variable returns from its involvement with that investee and has the ability to affect those returns through its power over the investee.

Is the control joint?

- **Joint control** is the contractually agreed sharing of control of an arrangement.
- Joint control exists only when decisions about the relevant activities, i.e. those that significantly affect the returns of the arrangement, require the unanimous consent of the parties sharing the control of the arrangement.

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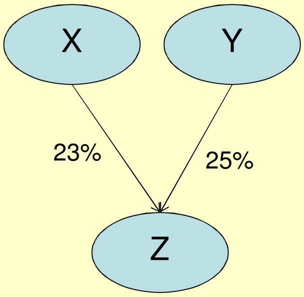
Is the control joint?

- 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

Structure of the joint arrangement

- Not structured through a separate vehicle → Joint operation
- Structured through a separate vehicle →
  An entity shall consider:
  (i) The legal form of the separate vehicle;
  (ii) The term of the contractual arrangement; and
  (iii) When relevant, other facts and circumstances.
  → Joint operation
  → Joint venture

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Classification of a joint arrangement structured through a separate vehicle

Legal form of the separate vehicle	Does the legal form of the separate vehicle give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement?	Yes	Joint operation
	No ↓		
Terms of the contractual arrangement	Do the terms of the contractual arrangement specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement?	Yes	Joint operation
	No ↓		
Other facts and circumstances	Have the parties designed the arrangement so that: (a) its activities primarily aim to provide the parties with an output (ie the parties have rights to substantially all the economic benefits of the assets held in the separate vehicle) and (b) it depends on the parties on a continuous basis for setting the liabilities relating to the activity conducted through the arrangement?	Yes	Joint operation
	No ↓		
	Joint venture		

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

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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 a joint venture or a joint operation.
- If there is a separate vehicle, the remaining tests are applied.

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II. Legal form of the arrangement

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

Example – Assessing the legal form

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

Is it a joint operation or joint venture?

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II. Legal form of the arrangement

Example – Assessing the legal form (cont'd)

Is it a joint operation or joint venture?

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

Please note that

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

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II. Legal form of the arrangement

- In some cases, the assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle indicates that the arrangement is a joint venture. However, the terms agreed by the parties in their contractual arrangement and, when relevant, other facts and circumstances can override the assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle.

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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 – The effect of guarantees
(assessing the terms of the contractual arrangement)

- X and Y set up a separate vehicle (entity C)
- The main feature of C's legal form is that the assets and liabilities of the separate vehicle are considered to be its own and not those of the parties
- The board of entity C decides to enter into a financing arrangement with a syndicate of lenders
- The arrangement specifies that the syndicate has recourse to companies X and Y only if entity C defaults on the loan arrangement

Is the structure a joint venture or joint operation?

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Example – The effect of guarantees (continued)

- As the arrangement is conducted through a separate vehicle whose legal form confers separation between the parties and the separate vehicle
- An initial indication that the arrangement is a joint venture
- The contractual arrangement does not specify that the parties have rights to assets and obligations for the liabilities
- The arrangement is a joint venture
- The recourse nature of the financing arrangement does not, in itself, impose on the parties an obligation for the liabilities of C, but rather it is a separate obligation

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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.

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Example 3(b) – Other facts and circumstances

Background

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

Analysis

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

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IV. Other facts and circumstances

- Each joint arrangement is analysed individually and separately to determine its type, even though the joint arrangements are governed by a single framework agreement. This could result in one arrangement being classified as a joint venture and the other being classified as a joint operation.

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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
(Major impact to companies that now uses proportionate consolidation)

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A. Joint operators

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

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

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

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A. Joint operators

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

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

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A. Joint operators - Upstream and downstream transactions

Accounting for sales or contributions of assets to a joint operation

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

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A. Joint operators - Upstream and downstream transactions

Accounting for purchases of assets from a joint operation

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

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Financial statements of other parties to a joint arrangement

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

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

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Transitional requirements

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Effective date and transitional requirements

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

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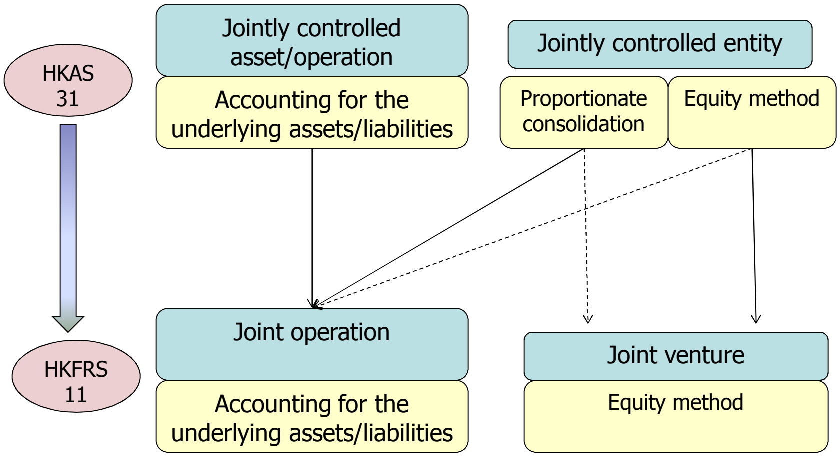
Consolidated financial statements



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I. Transition from proportionate consolidation to the equity method

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

- 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

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 nest 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:

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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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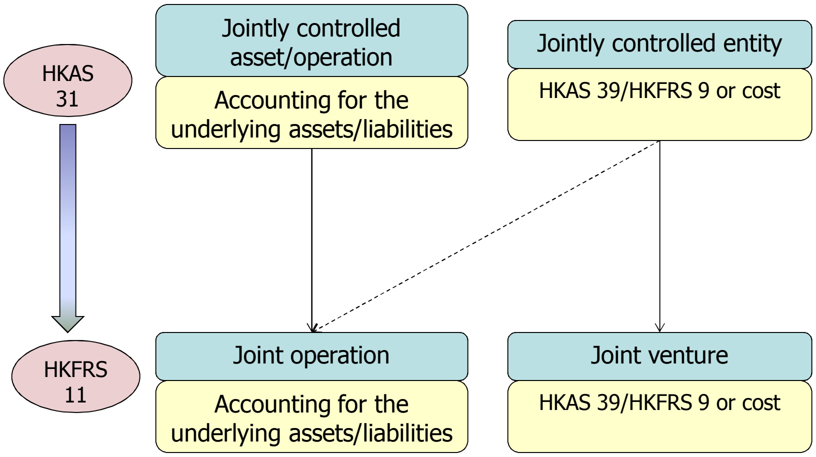
III. No transitional requirements

- 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

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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Summary – HKFRS 11

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

Source	International GAAP Holdings Limited

Notes to the consolidated financial statements for the year ended 31 December 2010 – continued

IAS 8.28(a)

IFRS 9 *Financial Instruments*

IAS 8.28(c),(d)
IFRS 9.8.2.3
IFRS 9.8.2.12

In the current year, the Group has applied IFRS 9 *Financial Instruments* (IFRS 9) (as issued in November 2009 and revised in October 2010) and the related consequential amendments in advance of its effective date. The Group has chosen 31 December 2010 as its date of initial application (i.e. the date on which the Group has assessed its existing financial assets and financial liabilities) because the Group decided to apply IFRS 9 in the current year and 31 December 2010 is the year end date of the current year. The Group has applied IFRS 9 retrospectively and comparative amounts have been restated, where appropriate.

Financial assets

IFRS 9 introduces new classification and measurement requirements for financial assets that are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. Specifically, IFRS 9 requires all financial assets to be classified and subsequently measured at either amortised cost or fair value on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.

As required by IFRS 9, debt instruments are measured at amortised cost only if (i) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows and (ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. If either of the two criteria is not met, the debt instruments are classified as at fair value through profit or loss (FVTPL).

However, the Group may choose at initial recognition to designate a debt instrument that meets the amortised cost criteria as at FVTPL if doing so eliminates or significantly reduces an accounting mismatch. In the current year, the Group has not elected to designate any debt instruments that meet the amortised cost criteria as at FVTPL.

Debt instruments that are subsequently measured at amortised cost are subject to impairment.

Investments in equity instruments are classified and measured as at FVTPL except when the equity investment is not held for trading and is designated by the Group as at fair value through other comprehensive income (FVTOCI). If the equity investment is designated as at FVTOCI, all gains and losses, except for dividend income that is generally recognised in profit or loss in accordance with IAS 18 *Revenue*, are recognised in other comprehensive income and are not subsequently reclassified to profit or loss.

As at 31 December 2010, the directors have reviewed and assessed the Group's existing financial assets. The initial application of IFRS 9 has had an impact on the following financial assets of the Group:

- the Group's redeemable notes that were classified as available-for-sale financial assets under IAS 39 have been classified as financial assets at fair value through profit or loss because they do not meet the criteria to be classified as amortised cost; and
- the Group's investments in equity instruments (not held for trading) that were previously classified as available-for-sale financial assets and were measured at fair value at each reporting date under IAS 39 have been designated as at fair value through other comprehensive income.

The impact of the application of IFRS 9 is that the cumulative fair value gains in relation to the Group's redeemable notes as at 1 January 2009 of CU130,000 (along with the cumulative deferred tax charge of CU39,000) have been reclassified from the investments revaluation reserve to retained earnings.

In 2009, the fair value gains in relation to the Group's redeemable notes of CU30,000 (along with the deferred tax charge of CU9,000) have been reclassified from other comprehensive income to profit or loss. Therefore, the profit reported for 2009 has been increased by CU21,000 as a result of the change in accounting policy. As at 31 December 2009, the Group's investments revaluation reserve has been decreased by CU112,000 and the Group's retained earnings has been increased by the same amount.

Source	International GAAP Holdings Limited

Notes to the consolidated financial statements
for the year ended 31 December 2010 – continued

In 2010, the fair value gains in relation to the Group's redeemable notes of CU20,000 (along with the deferred tax charge of CU6,000) have been reclassified from other comprehensive income to profit or loss. Therefore, the profit reported for 2010 has been increased by CU14,000 as a result of the change in accounting policy. As at 31 December 2010, the Group's investments revaluation reserve has been decreased by CU126,000 and the Group's retained earnings has been increased by the same amount.

The reclassification of the Group's investments in equity instruments that are not held for trading (see above) has had no impact on the Group's profit or loss for both years.

Please refer to note 22 for the Group's financial assets in more detail.

Financial liabilities

IFRS 9 also contains requirements for the classification and measurement of financial liabilities. One major change in the classification and measurement of financial liabilities relates to the accounting for changes in fair value of a financial liability (designated as at fair value through profit or loss) attributable to changes in the credit risk of that liability.

Specifically, under IFRS 9, for financial liabilities that are designated as at fair value through profit or loss, the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability is recognised in other comprehensive income, unless the recognition of the effects of changes in the liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. Changes in fair value attributable to a financial liability's credit risk are not subsequently reclassified to profit or loss. Previously, under IAS 39, the entire amount of the change in the fair value of the financial liability designated as at fair value through profit or loss was recognised in profit or loss.

This change in accounting policy has affected the Group's accounting for changes in the fair value of redeemable cumulative preference shares issued by the Group in the current year that were designated by the Group as financial liabilities at fair value through profit or loss on initial recognition. Specifically, the gain arising on change in the fair value of the redeemable cumulative preference shares attributable to changes in the credit risk of the liabilities of CU20,000 has been recognised in other comprehensive income in the current year. The remaining amount of change in the fair value of the liabilities (including changes in fair value of the embedded derivatives) of CU105,000 has been recognised in profit or loss.

Therefore, the application of IFRS 9 has resulted in the profit reported for 2010 being decreased by CU20,000. Profit and other comprehensive income reported for 2009 have not been affected as the Group did not have financial liabilities designated as at fair value through profit or loss in the prior year.

Please refer to note 34 for the Group's financial liabilities in more detail.

Source	International GAAP Holdings Limited

Notes to the consolidated financial statements for the year ended 31 December 2010 – continued

Source	22. Other financial assets	31/12/10 CU'000	31/12/09 CU'000	01/01/09 CU'000
IFRS 7.7	***Derivatives designated and effective as hedging instruments carried at fair value***			
	Foreign currency forward contracts	244	220	308
	Interest rate swaps	284	177	128
		528	397	436
	Financial assets designated as at fair value through profit or loss (FVTPL)			
	[Describe details]	-	-	-
		-	-	-
IFRS 7.8(a)	***Financial assets mandatorily measured at fair value through profit or loss (FVTPL)***			
	Redeemable notes (i)	2,200	2,180	2,150
	Held for trading derivatives that are not designated in hedge accounting relationships	-	-	-
	Held for trading non-derivative financial assets	1,539	1,639	1,137
		3,739	3,819	3,287
IFRS 7.8(f)	***Financial assets measured at amortised cost***			
	Bills of exchange (ii)	5,405	4,015	4,066
	Debentures (iii)	500	-	-
	Loans to related parties (iv)	3,637	3,088	355
	Loans to other entities	-	-	-
		9,542	7,103	4,421
IFRS 7.8(h)	***Financial assets designated and measured at fair value through other comprehensive income (FVTOCI)***			
IFRS 7.11A(c)	Shares (v)	5,719	5,285	5,234
		5,719	5,285	5,234
		19,528	16,604	13,378
	Current	8,757	6,949	5,528
	Non-current	10,771	9,655	7,850
		19,528	16,604	13,378

Source	International GAAP Holdings Limited

Notes to the consolidated financial statements
for the year ended 31 December 2010 – continued

IFRS 7.7

(i) The Group holds listed redeemable notes that carry interest at 7% per annum. The notes are redeemable at par value in 2012. The notes are held with a single counterparty with an AA credit rating. The Group holds no collateral over this balance. The Group does not have an objective to hold the redeemable notes and receive the contractual cash flows over the entire life of the instrument and hence the redeemable notes are measured at FVTPL.

(ii) The Group holds bills of exchange that carry interest at variable rate. The weighted average interest rate on these securities is 7.10% per annum (2009: 7.0% per annum). The bills have maturity dates ranging between 3 to 18 months from the end of the reporting period. The counterparties have a minimum A credit rating. None of these assets had been past due or impaired at the end of the reporting period.

(iii) The debentures carry interest at 6% per annum payable monthly, and mature in March 2011. The counterparties have a minimum B credit rating. None of these assets had been past due or impaired at the end of the reporting period.

IAS 24.17(b)

(iv) The Group has provided several of its key management personnel with short-term loans at rates comparable to the commercial rates of interest. Further information about these loans is set out in note 43.

IAS 28.37(d)
IFRS 7.11A(a), (b)
IFRS 7.11A(c)

(v) The Group holds 20% of the ordinary share capital of Rocket Corp Limited, a company involved in the refining and distribution of fuel products. The directors of the Group do not consider that the Group is able to exercise significant influence over Rocket Corp Limited as the other 80% of the ordinary share capital is controlled by one shareholder, who also manages the day-to-day operations of that company. The fair value of the investment in Rocket Corp Limited as at 31 December 2010 amounts to CU5.359 million (31 December 2009: CU5.285 million and 1 January 2009: CU5.234 million).

At 31 December 2010, the Group also continues to hold a 10% interest in E Plus Limited, a former associate (see note 20). The fair value of the investment in E Plus Limited as at 31 December 2010 amounts to CU360,000.

These investments in equity instruments are not held for trading. Instead, they are held for medium or long-term strategic purpose. Upon the application of IFRS 9, the Group has chosen to designate these investments in equity instruments as at FVTOCI as the directors believe that this provides a more meaningful presentation for medium or long-term strategic investments, than reflecting changes in fair value immediately in profit or loss.

Source	International GAAP Holdings Limited

Notes to the consolidated financial statements for the year ended 31 December 2010 – continued

IFRS 7.44I
IFRS 7.44J

The table below illustrates the classification and measurement of financial assets under IFRS 9 and IAS 39 at the date of initial application, 31 December 2010.

	Original measurement category under IAS 39	New measurement category under IFRS 9	Original carrying amount under IAS 39	New carrying amount under IFRS 9
			CU'000	CU'000
Foreign currency forward contracts	Derivatives designated as hedging instruments	Derivatives designated as hedging instruments	244	244
Interest rate swaps	Derivatives designated as hedging instruments	Derivatives designated as hedging instruments	284	284
Financial assets designated as at FVTPL	Financial assets at FVTPL	Financial assets at FVTPL	-	-
Held for trading non-derivative financial assets	Financial assets at FVTPL	Financial assets at FVTPL	1,539	1,539
Bills of exchange	Held-to-maturity investments	Financial assets at amortised cost	5,405	5,405
Debentures	Held-to-maturity investments	Financial assets at amortised cost	500	500
Redeemable notes (see note (i) above)	Available-for-sale investments	Financial assets at FVTPL	2,200	2,200
Investments in equity instruments (unlisted shares) (see note (v) above)	Available-for-sale investments	Financial assets at FVTOCI	5,719	5,719
Loans to related parties	Loans and receivables	Financial assets at amortised cost	3,637	3,637
Loans to other entities	Loans and receivables	Financial assets at amortised cost	-	-
Trade and other receivables (see note 25)	Loans and receivables	Financial assets at amortised cost	19,249	19,249
Cash and bank balances (including cash and bank balances in a disposal group held for sale) (see note 46)	Loans and receivables	Financial assets at amortised cost	23,621	23,621

IFRS 7.44I(c)

There were no financial assets that the Group previously had designated as at FVTPL under IAS 39 that were subject to reclassification upon the application of IFRS 9.

Source	International GAAP Holdings Limited

Notes to the consolidated financial statements for the year ended 31 December 2010 – continued

34. Other financial liabilities

Source		31/12/10 CU'000	31/12/09 CU'000	01/01/09 CU'000
	Financial guarantee contracts	24	18	-
	Derivatives that are designated and effective as hedging instruments carried at fair value			
	Foreign currency forward contracts	87	-	-
	Interest rate swaps	5	-	-
	Currency swaps	-	-	-
	Other [describe]	-	-	-
		92	-	-
IFRS 7.8(e)	***Financial liabilities carried at fair value through profit or loss (FVTPL)***			
	Non-derivative financial liabilities designated as at FVTPL on initial recognition (i)	14,875	-	-
	Held for trading derivatives not designated in hedge accounting relationships (ii)	51	-	-
	Held for trading non-derivative financial liabilities	-	-	-
		14,926	-	-
	Other (contingent consideration) (iii)	75	-	-
		15,117	18	-
	Current	116	18	-
	Non-current	15,001	-	-
		15,117	18	-

(i) 3,000,000 7% redeemable cumulative preference shares were issued on 1 June 2010 at an issue price of CU5 per share. The shares are redeemable on 31 May 2012 at CU5 per share. The shares are unsecured borrowings of the Group and are designated as at FVTPL (see below).

The Group has designated its redeemable cumulative preference shares as financial liabilities at FVTPL as permitted by IFRS 9 *Financial Instruments*. The preference shares have fixed interest payments and mature on 31 May 2012. To reduce the fair value risk of changing interest rates, the Group has entered into a pay-floating receive-fixed interest rate swap. The swap's notional principal is CU15 million and matches the principal of the cumulative redeemable preference shares. The swap matures on 31 May 2012. The designation of preference shares as at FVTPL eliminates the accounting mismatch arising on measuring the liability at amortised cost and measuring the derivative at FVTPL.

The fair value of the redeemable cumulative preference shares has decreased by CU125,000 since their issuance. The change in fair value includes a gain of CU20,000 attributable to the change in credit risk of the liabilities and is recognised in other comprehensive income.

Dividends of CU613,000 (2009: nil) were paid on redeemable cumulative preference shares and are included in the "other gains and losses" line item in the consolidated [statement of comprehensive income/income statement].

(ii) A pay-floating receive-fixed interest rate swap economically hedges fair value interest rate risk of redeemable cumulative preference shares.

(iii) Other financial liabilities include CU75,000 representing the estimated fair value of the contingent consideration relating to the acquisition of Subsix Limited (see note 44.2).

2. Principal Accounting Policies (continued)

(b) Basis of preparation (continued)

Early adoption of new/revised HKFRSs (continued)

HKFRS 9 (as amended in 2010) has been expanded to include the requirements with respect to derecognition of financial assets and financial liabilities (which have been taken from HKAS 39 without amendment) and classification and measurement of financial liabilities. The early adoption of the amended HKFRS 9 did not have any financial impact to the Group as the Group did not have any financial liabilities that were affected by the changes in classification and measurement requirements and there were no changes in the derecognition of financial assets and financial liabilities.

The Improvements to HKFRSs (2010) comprise a number of minor and non-urgent amendments to a range of HKFRSs. Of these, only the amendments to HKFRS 7: Financial Instruments: Disclosures are pertinent to the Group's operations.

HKFRS 7 is amended to clarify the required level of disclosures about credit risk and collateral held and provide relief from disclosures previously required regarding renegotiated loans. The early adoption of the amendment did not have any financial impact to the Group as it only affects certain disclosure of financial instruments held by the Group. The amendments have been applied retrospectively.

Change in accounting policy for cash and cash equivalents of cash collateral

For the purpose of the consolidated statement of cash flows, cash and cash equivalents comprise cash and cash equivalents available for the disposition of the Group and exclude cash and cash equivalents held for specific purposes such as those held for the purpose of the Margin Funds, Clearing House Funds and cash collateral received from Clearing Participants of Hong Kong Securities Clearing Company Limited (HKSCC). In prior years, cash collateral received from HKSCC Participants was included as part of the cash and cash equivalents of the Group for the purpose of the consolidated statement of cash flows. The comparative figures have been restated to conform with the revised presentation.

Change in accounting policy for HKEx Employees' Share Award Scheme

In prior years, contributions made to The HKEx Employees' Share Award Scheme (HKEx Employee Share Trust), a controlled special purpose entity, were carried as an asset and disclosed as Contributions to HKEx Employee Share Trust in HKEx's statement of financial position. During the year, the Group has reassessed the relationship between HKEx and the HKEx Employee Share Trust. As the HKEx Employee Share Trust is set up solely for the purpose of purchasing, administrating and holding HKEx shares for the Share Award Scheme (note 33(c)), HKEx has the power to govern the financial and operating policies of the HKEx Employee Share Trust and it can derive benefits from the services of the employees who have been awarded the Awarded Shares through their continued employment with the Group. Accordingly, the Group considers that it is appropriate to include the assets and liabilities of HKEx Employee Share Trust in HKEx's statement of financial position from 2010 onwards, and to present as a deduction in equity the HKEx shares held by the HKEx Employee Share Trust as Shares held for Share Award Scheme. This change has been applied retrospectively and comparative figures have been restated to reflect such change.

2. Principal Accounting Policies (continued)

(p) Financial assets

(i) Classification

For financial assets held on or after 31 December 2009

Following the adoption of HKFRS 9 on 31 December 2009, investments and other financial assets of the Group held on or after 31 December 2009 are classified under the following categories:

Financial assets measured at amortised cost

Investments are classified under this category if they satisfy both of the following conditions:

the assets are held within a business model whose objective is to hold assets in order to collect contractual cash flows for managing liquidity and generating income on the investments, but not for the purpose of realising fair value gains; and

the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, with interest being the consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time and are unleveraged.

Bank deposits, trade and accounts receivable and other deposits are also classified under this category.

Financial assets measured at fair value through profit or loss

Investments and other financial assets are classified under this category if they do not meet the conditions to be measured at amortised cost.

Securities or bank deposits with embedded derivatives are classified in their entirety as measured at fair value through profit or loss where the economic characteristics and risks of the embedded derivatives are dissimilar to those of the host contracts and modify the contractual cash flows, such that they are not solely payments of principal and interest on the principal amount outstanding or the interest rate does not reflect only consideration for the time value of money and credit risk.

The Group will reclassify all affected investments when and only when its business model for managing these assets changes.

Financial assets of Clearing House Funds, Margin Funds and cash collateral are classified as current assets as they will be liquidated whenever liquid funds are required.

Financial assets of Corporate Funds, which include those held for trading purpose, are classified as current assets unless they are non-trading assets that are expected to mature after twelve months at the end of the reporting period and, in which case, they are included in non-current assets. For equities and mutual funds, which have no maturity date, they are included in current assets as they are held for trading.

2. Principal Accounting Policies (continued)

(p) Financial assets (continued)

(i) Classification (continued)

For financial assets held on 1 January 2009 or financial assets derecognised prior to 31 December 2009

Investments and other financial assets of the Group which were held on 1 January 2009 or derecognised prior to 31 December 2009 were classified under the following categories:

Financial assets at fair value through profit or loss

This category comprised financial assets held for trading and financial assets designated as fair value through profit or loss at inception if the designation related to financial instruments containing one or more embedded derivatives that significantly modified the cash flows arising from those financial instruments.

Securities or bank deposits with embedded derivatives whose economic characteristics and risks were not closely related to the host investments were designated as financial assets at fair value through profit or loss.

Available-for-sale financial assets

This category comprised financial assets which were non-derivatives and were designated as available-for-sale financial assets or not classified under other investment categories.

Loans and receivables

Loans and receivables, which comprised bank deposits, trade and accounts receivable, deposits and other assets, were non-derivative financial assets with fixed or determinable payments that were not quoted in an active market and the Group had no intention of trading the loans or receivables.

Financial assets were classified as current assets unless the investments were expected to mature after twelve months at the end of the reporting period and, in which case, they were included in non-current assets. For equities or mutual funds, which had no maturity date, they were included in current assets as they were held for trading.

(ii) Recognition and initial measurement

Purchases and sales of financial assets are recognised on trade-date. Assets classified as financial assets measured at fair value through profit or loss and financial assets at fair value through profit or loss are initially recognised at fair value with transaction costs recognised as expenses in profit or loss. Financial assets not carried at fair value through profit or loss are initially recognised at fair value plus transaction costs.

2. Principal Accounting Policies (continued)

(p) Financial assets (continued)

(iii) Derecognition

Financial assets are derecognised when the rights to receive cash flows from the assets have expired or the Group has transferred substantially all the risks and rewards of ownership of the assets.

(iv) Gains or losses on subsequent measurement and disposal, interest income and dividend income

<u>For financial assets held on or after 31 December 2009</u>

<u>Financial assets measured at fair value through profit or loss</u>

Financial assets under this category are investments carried at fair value. Gains and losses arising from changes in fair value are included in profit or loss in the period in which they arise. Upon disposal, the differences between the net sale proceeds and the carrying values are included in profit or loss.

Interest income is recognised in profit or loss using the effective interest method and included in net fair value gains/(losses) and interest income from these financial assets.

Dividend income is recognised when the right to receive a dividend is established and is disclosed separately as dividend income.

<u>Financial assets measured at amortised cost</u>

Financial assets under this category are carried at amortised cost using the effective interest method less provision for impairment. Gains and losses arising from disposal, being the differences between the net sale proceeds and the carrying values, are recognised in profit or loss.

Interest income is recognised in profit or loss using the effective interest method and disclosed as interest income.

2. Principal Accounting Policies (continued)

(p) Financial assets (continued)

(iv) Gains or losses on subsequent measurement and disposal, interest income and dividend income (continued)

For financial assets held on 1 January 2009 or financial assets derecognised prior to 31 December 2009

Financial assets at fair value through profit or loss

Same as financial assets measured at fair value through profit or loss held on or after 31 December 2009.

Available-for-sale financial assets

Available-for-sale financial assets were investments carried at fair value. Gains and losses (including transaction costs on acquisition) arising from changes in fair value were recognised in other comprehensive income and transferred to investment revaluation reserve. When an asset was sold, the difference between the net sale proceeds and the carrying value, and the accumulated fair value adjustments recognised in other comprehensive income and retained in the investment revaluation reserve were reclassified from investment revaluation reserve to profit or loss as a reclassification adjustment.

Interest income was recognised in profit or loss using the effective interest method and disclosed as interest income.

Loans and receivables

Same as financial assets measured at amortised cost held on or after 31 December 2009.

(v) Fair value measurement principles

Fair values of quoted investments are based on bid prices. For unlisted securities or financial assets without an active market, the Group establishes the fair value by using valuation techniques including the use of recent arm's length transactions, reference to other instruments that are substantially the same and discounted cash flow analysis.

(vi) Impairment

The Group assesses at the end of each reporting period whether there is objective evidence that a financial asset or a group of financial assets is impaired. Impairment losses are incurred if and only if there is objective evidence of impairment as a result of one or more loss events that have occurred after the initial recognition of the financial assets and have an impact on their estimated future cash flows that can be reliably estimated. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the Group about the following loss events:

2. Principal Accounting Policies (continued)

(p) Financial assets (continued)

(vi) Impairment (continued)

significant financial difficulty of the debtor or obligor;

fees receivable that have been outstanding for over 180 days;

it is becoming probable that the debtor or obligor will enter into bankruptcy or other financial reorganisation;

the disappearance of an active market for that financial asset because of financial difficulties; or

observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the Group.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics relevant to the estimation of future cash flows. These financial assets are collectively assessed based on historical loss experience on each type of assets and management judgement of the current economic and credit environment.

<u>For financial assets held on or after 31 December 2009</u>

<u>Financial assets measured at amortised cost</u>

If there is objective evidence that an impairment loss has been incurred, the loss is measured as the difference between the assets' carrying amounts and the present values of estimated future cash flows discounted at the financial assets' original effective interest rates. The carrying amounts of the assets are reduced through the use of a doubtful debt allowance account and the amount of the loss is recognised in profit or loss.

If, in a subsequent period, the amount of impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed by adjusting the doubtful debt allowance account. The amount of reversal is recognised in profit or loss.

As soon as a receivable becomes impaired, the Group may continue to allow the debtor or obligor concerned to participate in its markets but no further accounts receivable is recognised on the consolidated statement of financial position as economic benefits may not flow to the Group. The revenue concerned is not recognised but tracked as doubtful deferred revenue and will only be recognised as income when cash is received.

2. Principal Accounting Policies (continued)

(p) Financial assets (continued)

(vi) Impairment (continued)

For financial assets held on 1 January 2009 or financial assets derecognised prior to 31 December 2009

Available-for-sale financial assets

If there was objective evidence that an impairment loss on available-for-sale financial assets had been incurred, the cumulative loss (measured as the difference between the acquisition cost and the current fair value, less any impairment loss on the financial asset previously recognised in profit or loss) was reclassified from investment revaluation reserve to profit or loss.

Loans and receivables

Same as financial assets measured at amortised cost held on or after 31 December 2009.

(q) Financial liabilities

(i) Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss are financial liabilities held for trading.

Liabilities under this category are initially recognised at fair value on trade-date and subsequently remeasured at their fair values. Changes in fair value of the liabilities are recognised in profit or loss.

(ii) Financial guarantee contracts

A financial guarantee contract is a contract that requires the Group to make specified payments to reimburse the holder for a loss it incurs because a specified entity or person fails to make payment when due in accordance with the original or modified terms of an undertaking.

Financial guarantee contracts are initially recognised at fair value. Subsequently, such contracts are measured at the higher of the amount determined in accordance with HKAS 37 and the amount initially recognised less, where appropriate, cumulative amortisation over the life of the guarantee on a straight-line basis.

Financial guarantee contracts issued by HKEx to guarantee borrowings of subsidiaries are eliminated on consolidation.

(iii) Other financial liabilities

Financial liabilities, other than financial liabilities at fair value through profit or loss and financial guarantee contracts, are initially recognised at fair value and subsequently carried at amortised cost using the effective interest method.

International Accounting Standards Board (IASB)

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4 August 2011

Steven Maijoor, Chair
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Sent via email

Dear Mr Maijoor,

Accounting for available-for sale (AFS) sovereign debt

There have been indications in the market that some European companies are applying the accounting requirements for fair value measurement and impairment losses in a way that seems to differ from the objective of IAS 39 *Financial Instruments: Recognition and Measurement*. This is evident particularly in their accounting for distressed sovereign debt, including Greek government bonds. Those indications have now been confirmed by recently published financial reports, which show inconsistent application of IAS 39 across Europe. This is a matter of great concern to us.

We are aware that, as an accounting standard-setter, the IASB does not have the authority to ensure compliance with International Financial Reporting Standards (IFRSs). However, the IASB and ESMA have a mutual interest in ensuring the highest quality in the application of IFRSs. Although we do not usually comment on how our standards are applied, because this case demonstrates visibly inconsistent application, we believe that it is appropriate for us to bring this matter to your attention.

I thought it would be helpful to provide you with some information about the objective of fair value measurement in IAS 39 and the use of models when the market for a particular financial instrument is not active. This letter does not address financial assets classified as held-to-maturity or loans and receivables.

In October 2008 the IASB staff published a report summarising the discussions of our Fair Value Expert Advisory Panel, which was set up in response to the recommendations made by the Financial Stability Board to address the measurement and disclosure of financial instruments when markets are no longer active. That report was well-received and was found to be helpful in the last financial crisis. Many respondents to our exposure draft on fair value measurement indicated that they found it consistent with the fair value measurement concepts in IAS 39 (as well as in US generally accepted accounting principles, or GAAP), which are described in this letter. That guidance is now in IFRS 13 *Fair Value Measurement*, which we issued in May.

<u>Fair value of AFS financial assets</u>

AFS financial assets are measured at fair value with changes in fair value measurement presented in other comprehensive income. However, as you know, IAS 39 requires a company to recognise any impairment loss in profit or loss when there is objective evidence that those financial assets are impaired. If it is determined that those assets are not impaired, the company continues to recognise the decline in fair value in other comprehensive income. If it is determined that those assets are impaired, the company recognises the accumulated decline in fair value in profit or loss. In other words, the impairment calculation for AFS financial assets is based on the fair value of the assets.

It appears that some companies are not following IAS 39 when determining whether the Greek government bonds that they classify as AFS are impaired. They are using the assessed impact on the present value of future cash flows arising from the proposed restructure of those bonds, rather than using the amount reflected by current market prices as required in IAS 39.

In addition, some companies holding Greek government bonds classified as AFS have stated that they are relying on internal valuation methodologies, rather than on market prices, to measure the fair value of the assets as at 30 June 2011. The reason generally given for using models rather than market prices is that the market for Greek government bonds is currently inactive (and therefore, in their view, does not provide reliable pricing information).

Determining whether a market is active

In measuring fair value, IAS 39 prioritises the use of quoted prices in active markets over the use of valuation models developed using internal assumptions.

IAS 39 describes an active market for a financial instrument as one in which 'quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis'. It is important to note that the description of an active market does not focus solely on trading activity. That is because when measuring fair value, the issue is not about the level of market activity *per se*, but about whether an observed transaction price represents fair value.

Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices varying significantly over time or among market participants, or the prices not being current. However, those factors alone do not necessarily mean that a market is no longer active. A company cannot ignore observable transaction prices when it is clear that market participants are regularly entering into transactions for the same or similar financial assets, even if they are doing so less frequently than they have in the past.

Although the level of trading activity in Greek government bonds has decreased, transactions are still taking place. IAS 39 is clear that unless there is evidence that the prices in those transactions do not represent fair value (for example, because those transactions are forced or because they require significant adjustment because of timing differences between the transaction date and the measurement date, which are matters of judgement and depend on the facts and circumstances), the observed transactions prices should be used to measure fair value.

Using models when measuring fair value

The objective of a fair value measurement, whether using an observed market price or a valuation model, is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date. In other words, the goal is to arrive at a current market price. This can be done by using an observed price, or by replicating a market price using a valuation model. In addition, the objective of the measurement is the same *irrespective* of current market conditions.

Even when a model is used to measure fair value, that model must reflect current market conditions (including those as evidenced by observable transaction prices) and it should include appropriate adjustments that market participants would make for credit and liquidity risks. Furthermore, the model must maximise the use of relevant observable inputs (eg market data) and minimise the use of unobservable inputs (eg the company's own assumptions). A company cannot ignore relevant market data (including observable transaction prices) when it is clear that market participants would use that data in determining the price at which they would be willing to enter into a transaction for the financial asset.

It would therefore not be in accordance with either the requirements in, or the intent of, IAS 39 to measure a loss on government bonds classified as AFS financial assets solely by assessing the present value of the future cash flows arising from a proposed restructure of those bonds. It is hard to imagine that there are buyers willing to buy those bonds at the prices indicated by the valuation models being used. In my view it is therefore difficult to justify that those models would meet the objective of a fair value measurement.

Yours sincerely

Hans Hoogervorst, Chair

European Securities and Markets Authority

Date: 25 November 2011
ESMA/2011/397

PUBLIC STATEMENT

Sovereign Debt in IFRS Financial Statements

As a result of recent sovereign debt[1] developments and the increased market interest in this area, there has been a lot of focus on the accounting practices of listed companies, and financial institutions in particular, with respect to their exposures to sovereign debt.

On 28 July 2011 ESMA issued a Statement[2] stressing the need for enhanced transparency and the importance of applying the relevant International Financial Reporting Standards (IFRS). ESMA also encouraged issuers to provide information on their exposures to sovereign debt on a country-by-country basis in their financial statements.

Since then ESMA conducted together with national competent authorities a fact-finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements based on a sample of financial institutions listed in EU regulated markets.

The consistent application of IFRS, which covers standards for recognition, measurement and disclosure, is important for the proper functioning of financial markets. ESMA publishes this Statement to promote consistent application of European securities and markets legislation, and notably of IFRS. It contains two Sections:

— Section 1 discusses accounting issues related to sovereign debt in IFRS annual financial statements ending 31 of December 2011. The Section highlights elements that should be considered by issuers and their auditors in relation to exposure to sovereign debt when preparing their financial statements for the upcoming year-end.

— Section 2 is an ESMA Opinion "*Accounting for Exposure to Greek Sovereign Debt – Considerations with respect to IFRS Interim Financial Statements for Accounting Periods ended on 30 June 2011.* The Opinion provides a summary of the outcome of the fact-finding exercise together with elements that should have been considered by issuers and their auditors as part of the IFRS interim financial statements for periods ended 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

[1] Sovereign debt, for the purpose of this statement, refers to bonds issued by and loans given to central and local government and governmental bodies.
[2] http://www.esma.europa.eu/popup2.php?id=7685

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Section 1: Sovereign Debt in Annual IFRS Financial Statements

ESMA would like to stress the need for transparency and the importance of appropriate and consistent application of the recognition, measurement and disclosure principles provided for in IFRS. This Section should not be understood as constituting guidance or recommendations on how to apply IFRS, but rather as assisting issuers in preparing their annual financial statements.

Issuers having securities traded on an EU regulated market and that have material exposure to sovereign debt should consider the following elements as part of the preparation of their year-end IFRS financial statements:

Existence of impairment for sovereign debt related financial assets

The assessment of objective evidence that a financial asset is impaired should be based on the criteria in paragraph 59 of IAS 39 – *Financial instruments: Recognition and Measurement* such as: financial difficulty of the obligor, breach of contract, concession granted to the borrower, disappearance of an active market or decrease in the estimated future cash flows. IAS 39 paragraph 60 specifically notes that a credit downgrade is not, of itself, evidence of impairment, nor is a decline in the instrument's fair value, although it may be evidence of impairment when considered with other available information. In addition, when assessing the existence of a loss event, consideration should also be given to the fact that default risk is related to the obligor and not to a specific financial instrument issued by that party.

Therefore, ESMA emphasises that issuers should carefully analyse facts and circumstances at the reporting date. They should provide in the IFRS financial statements all relevant disclosures related to the criteria used in assessing the existence of objective evidence of impairment for financial assets and present all the assumptions and uncertainties regarding the impact on future estimated cash-flows.

Measurement of financial assets related to sovereign debt exposure

ESMA reminds issuers of the following IAS 39 measurement principles regarding the different accounting categories of financial assets:

— For financial assets classified as held to maturity or loans and receivables:

  Sovereign debt classified as held to maturity or loans and receivables are measured at amortized cost using the effective interest rate method[3]. If there is objective evidence that assets are impaired, an estimate of impairment losses should be determined based on appropriate reassessment of expected future cash-flows using the original effective interest rate. In cases where a restructuring plan is in place, such estimation should be based using details from the plan, unless a derecognition of the original asset has taken place and a new financial asset is recognised. Where a restructuring plan exists (see also below the paragraph on *Greek sovereign debt – specific accounting matters*), but it is not yet in place and/or the details are still unknown, issuers should ensure that a best estimate is determined based on all the information available, including any further indications of material losses in addition to those induced by the plan.

[3] In case the bonds have been reclassified out of the fair value through profit or loss category or the available for sale category the effective interest rate calculated at the moment of the transfer should be used.

- For financial assets classified as available-for-sale or held-for-trading

  Sovereign debt classified as available-for-sale or held for trading is recognized in the statement of financial position at fair value. If there is objective evidence that assets are impaired, an impairment loss has to be recognised in the profit or loss account for the assets classified at available-for-sale. In order to determine the fair value, issuers should analyse whether a financial instrument is regarded as quoted in an active market or not at the reporting date by analysing whether quoted prices are readily and regularly available for each instrument (by issuance) and whether those prices represent actual transactions between willing parties on an arm's length basis. In this context we believe that the literature provided by the IASB Expert Advisory Panel – *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*[4] constitutes relevant guidance. Though IFRS 13 (*IFRS 13 – Fair Value Measurement*) is not endorsed in the European Union it could be relevant as part of that analysis.

  When a market for a financial instrument is active, issuers should use the quoted prices, which are defined as level 1 fair value measurements under IFRS 7 – *Financial Instruments: Disclosures*. For those instruments for which the market is not active, level 2 measurements should be applied by using models which make maximum use of market inputs, such as inputs from observable similar or linked instruments, such as other bonds, preferably issued by the same sovereign state, with similar maturities.

Disclosures in the year-end IFRS financial statements

ESMA would like to stress the importance for issuers to provide all relevant disclosures related to exposure to sovereign debt in order to comply with the requirements of IFRS 7. ESMA would also like to underline that in order to achieve a fair presentation, as stated under IAS 1 – *Presentation of Financial Statements*, issuers are required to provide any additional disclosures when compliance with IFRS 7 does not suffice to enable users to understand the impact of sovereign debt to the financial position and performance of the issuer. This is particularly important for areas in which management judgement is applied, as allowed by IFRSs.

In addition, ESMA believes that in the case where a market is not active for a specific instrument, the issuer should provide supplementary disclosures explaining the underlying rationale, assumptions and the sources used as inputs to the valuation.

Moreover, ESMA would encourage providing quantitative and qualitative information on sovereign debt related instruments such as credit default swaps (CDS) and other instruments, directly referencing to sovereign debt such as financial guarantees, forward contracts, options and other derivatives. This could include the level and the risks to which the issuer is exposed, as well as the estimated level of protection in case a CDS was acquired by an issuer.

Greek sovereign debt - specific accounting matters

As a result of significant financial and economic difficulties experienced by Greece, a particular focus is given to Greek sovereign debt. European leaders proposed in July 2011 a financial assistance package for Greece in which private bondholders would be asked to contribute towards the relief of Greece's debt burden via a voluntary bond exchange (known as the Private Sector Involvement). That proposal would have resulted in a 21% net present value loss for private bondholders based on an assumed discount rate of 9% and a significant extension in the overall maturity profile of the country's debts.

[4] http://www.iasb.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf

The economic situation in Greece has continued to deteriorate and on 26 October 2011 European leaders proposed changes to the plan for Private Sector Involvement. At the date of this release the specific terms of the participation to the plan are unknown and negotiations are still ongoing, but based on the Euro Summit Statement we understand that the plan would request private bondholders to accept a 50% reduction in the nominal value of the bonds.

ESMA together with national competent authorities conducted a fact finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements of a wide sample of financial institutions listed in EU regulated markets. Based on this review, there is evidence that accounting practices of financial institutions with regard to sovereign debt exposures varied, in particular with respect to the extent of debt exposures subject to impairment losses, the methods for calculation of impairment losses and methodologies used for fair value measurement. Therefore, the second Section of this Statement contains an Opinion regarding accounting for exposure to Greek Sovereign debt in the IFRS interim financial statements for accounting periods ended on 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

Future actions

ESMA will, together with national competent authorities, continue to strictly monitor the application of IFRS and consider whether further actions are needed in order to ensure the appropriate accounting treatment of exposure to sovereign debt by European issuers.

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Section 2: Opinion – Accounting for Greek Sovereign Debt – Considerations with respect to IFRS interim financial statements for accounting periods that ended on 30 June 2011

I. Introduction and legal basis

1. As a result of recent developments in the area of sovereign debt and the increased market interest in this area, ESMA issues an opinion to promote the effective and consistent application of European securities and markets legislation and notably of International Financial Reporting Standards and relevant sectoral legislation.

2. ESMA's competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EC) No 1095/2010 (the "Regulation"). In accordance with Article 44(1) of the Regulation the Board of Supervisors has adopted this opinion.

II. General observations

3. As part of its objective to coordinate European enforcement activities, ESMA has collected information from National Competent Authorities (NCAs) with respect to IFRS half-year financial statements ended on 30 June 2011, published by listed European financial institutions. On this basis, there is evidence that some accounting practices of issuers with regard to Greek sovereign debt exposures varied across the European Economic Area.

4. The main identified divergences for the 53 financial institutions included in our fact-finding exercise relate to the following:

   — It has been observed that there are differences regarding recognition or non-recognition of impairment losses. Data collected show that for example two financial institutions which had decided not to participate in the July International Institute of Finance plan (the "July IIF plan") did not recognise any impairment. Another difference relates to bonds with maturities after July 2020, for which some financial institutions indicated recognition of impairment losses and some did not.

   — Regarding bonds classified as held to maturity, 10 out of 23 financial institutions with investments in this category used the estimation of the 21% "haircut" on the face value of the bonds provided in the July IIF plan as the estimation for the impairment loss. Some banks used the original effective interest rate resulting in impairment losses between 17% and 23% while others used the new discount rate indicated in the July IIF plan for calculating the impact on the estimated future cash-flows.

   — Other differences appeared with respect to financial assets classified as available for sale (AFS), for which different valuation methods have been used by issuers. Out of 34 financial institutions with AFS instruments, 20 used fair values based on market data corresponding to level 1 valuation as defined by IFRS 7. Other financial institutions judged that the markets for the investments in their portfolio were not active and therefore used level 2 (3 financial institutions) presumably because they thought either that there were no transactions taking place or because the transactions that were taking place were not orderly transactions. Four issuers used level 3 measurements. For another 4 issuers it was not possible to identify the measurement method used. Finally 3 issuers did not recognise any impairment losses, but only a decrease in value accounted for in other comprehensive income.

— It appeared that there were some cases in which the consequences of different accounting practices could be assessed as non-material.

III. Description of accounting considerations

5. While ESMA acknowledges that the supervision of financial reporting and necessary potential enforcement actions that may arise rests with NCAs, it is important that consistent application of IFRS is achieved in the European Union. To achieve that goal, the existing European IFRS Enforcement Coordination Mechanism (EECS) provides ESMA with a very valuable tool.

6. The present opinion is based on discussions that took place between ESMA and NCAs within EECS in order to coordinate the enforcement activities in the particular area of accounting for exposures to Greek sovereign debt. EECS has been specifically mandated to consider all technical issues related to this matter, including but not limited to: the arguments used by issuers relating to triggering events when recognising an impairment loss, measurement methods used in compliance with the fair value hierarchy, and determination of criteria for assessing whether markets are active or inactive. This Opinion forms an element for NCA's when considering an enforcement decision.

7. ESMA acknowledges that materiality plays an important role in identifying the appropriate type of enforcement action to be considered by NCAs where a misstatement is identified in the IFRS financial statements. When a material misstatement in the financial information is detected enforcers should take appropriate action to achieve appropriate disclosure of such a misstatement and, where relevant, public correction of the misstatement.

8. In ESMA's opinion, the following elements should have been considered by issuers and their auditors when preparing their IFRS interim financial statements published for periods that ended on 30 June 2011. Some of these elements might also be relevant for issuers and their auditors when preparing or auditing future financial statements.

9. Regarding the existence of objective evidence of impairment and determination of an asset being impaired, it is ESMA's opinion that:

— There was objective evidence of impairment of Greek sovereign bonds as of 30 June 2011, based on at least two of the criteria to be considered according to paragraph 59 of IAS 39 – *Financial Instruments: Recognition and Measurement*: significant financial difficulty of the debtor and decrease in the fair value of the investment. The European Council's decision on 21 July 2011 with respect to the private sector initiative is indicative of a concession granted by private investors and confirms the significant financial difficulty of the debtor as of 30 June 2011 and raises concerns about whether the bonds would be paid in full. Issuers should have provided indications on the facts and circumstances and the conditions that existed at that date in their reports.

— The conditions existing as of 30 June 2011 had an impact on the estimated future cash-flows that could be reliably estimated. Indicators of the possible impact on contractual cash flows were available as part of the haircut indicated in the July IIF plan, in which a number of financial institutions confirmed their participation. In some circumstances, transactions observed in the market were also indicative of the fact that future estimated cash flows will be impacted, even if other scenarios than the implementation of the July IIF plan were taken into account by market participants. Consequently financial assets related to exposure to Greek sovereign bonds with maturities before July 2020 were impaired.

— Regarding Greek bonds with maturities after July 2020, which were not included in the July IIF plan, the facts considered above should have been analysed as indicating that the contractual cash-flows were at risk of being impacted by the financial difficulties. Default risk is related to the debt issuer and not to a financial instrument issued by the debt issuer. The estimation of the size of such an impact on the future cash flows is a matter of judgement.

10. With regards to the measurement of exposure to Greek Sovereign bonds, it is ESMA's opinion that:

— For their interim financial statements issuers should have determined impairment losses on the Greek sovereign bonds classified as held-to-maturity using the original effective interest rate[3], notwithstanding whether they expressed their participation in the plan put forward by the IIF or not. According to IAS 34 paragraph 41, the preparation of interim financial reports generally requires a greater use of estimation methods than annual reports. Taking into consideration the uncertainties that existed at the time the interim financial statements were prepared, the 21% haircut could be accepted in some circumstances as being a possible estimate based on reasonable judgement for measuring impairment losses for financial assets measured at amortised cost. It could be regarded as a practical expedient, assuming that the assessment of expected cash flows at the original effective interest rate would have resulted in materially the same level of impairment.

— Greek sovereign bonds classified as available for sale or held for trading should have been reported at fair value using the fair value hierarchy as outlined in paragraph 27A of IFRS 7 – *Financial Instruments: Disclosures*. In order to determine the fair value, issuers should analyse whether a market is active or not at the reporting date. This means analysing whether quoted prices are readily and regularly available for each instrument (by maturity, and where relevant by issuance) and whether those prices represent actual and regularly occurring market transactions on an arm's length basis (paragraph 71 of Appendix A to IAS 39). Based on trading data obtained from the Bank of Greece, it is ESMA's opinion that, as of 30 June 2011, the market was active for some Greek sovereign bonds but could be judged inactive for some others. Issuers should consequently have used level 1 fair value measurement as defined under IFRS 7 for instruments with active markets. For those instruments for which the market was not active, a level 2 measurement method should have been applied (using models which include observable market data from similar instruments, such as Greek bonds with close maturities or prices for credit default swaps, if relevant). The same fair value measurement considerations also apply when assets are reclassified from available for sale to loans and receivables.

11. Regarding disclosures of exposure to Greek Sovereign bonds, in line with the statement published by ESMA on 28 July 2011 it is ESMA's opinion that issuers should have included all information required under IAS 34 – *Interim Financial Reporting*. This means that, as a minimum, the issuer should have provided: the level of exposure to Greek Sovereign debt as of 30 June (including details

about maturities), the accounting treatment applied for the debt and its impairment losses together with a description of key judgments used in the assessment of whether the asset was impaired or not and key assumptions underpinning the assessment of the impairment losses for each class of instruments (IAS 34 paragraph 15B).

12. This opinion will be published on ESMA's website.

Done at Paris, 24 November 2011

Steven Maijoor

ESMA Chair

For the Board of Supervisors

Notes to editors

1. ESMA is an independent EU Authority that was established on 1 January 2011 according to EU Regulation No. 1095/2010 as published on December 15, 2010, in the Official Journal of the European Union (L 331/84). The Authority contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA).

2. ESMA's work on securities legislation contributes to the development of a single rule book in Europe. This serves two purposes; firstly, it ensures the consistent treatment of investors across the Union, enabling an adequate level of protection of investors through effective regulation and supervision. Secondly, it promotes equal conditions of competition for financial service providers, as well as ensuring the effectiveness and cost efficiency of supervision for supervised companies. As part of its role in standard setting and reducing the scope of regulatory arbitrage, ESMA strengthens international supervisory co-operation. Where requested in European law, ESMA undertakes the supervision of certain entities with pan European reach.

3. ESMA also contributes to the financial stability of the European Union, in the short, medium and long-term, through its contribution to the work of the European Systemic Risk Board, which identifies potential risks to the financial system and provides advice to diminish possible threats to the financial stability of the Union. ESMA is also responsible for coordinating actions of securities supervisors or adopting emergency measures when a crisis situation arises.

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Annex 4

Stephen Cooper: Reforming hedge accounting

17 January 2011

As part of our project to improve accounting for financial instruments, we, the International Accounting Standards Board (IASB), recently issued an exposure draft (ED) on proposals to replace the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement.* Hedge accounting is a complex and controversial topic in financial reporting and has long been an area of difficulty both for companies seeking to inform investors about what they are doing and for standard-setters in trying to regulate it appropriately.

Essentially, hedge accounting concerns the reporting of derivative instruments that companies hold to hedge various exposures to risk that affect their business. The general accounting treatment of a derivative instrument is that it should be measured at fair value with changes being reported as gains and losses in the income statement. This was the approach in IAS 39 and has been carried forward to IFRS 9 *Financial Instruments*. While some commentators have suggested a cost basis for derivatives, most consider that cost measurement would be completely inappropriate, because the cost is often zero and changes in value can be significant.

The main problem, though, is that most derivatives are held in order to hedge more than one risk. If such an exposure arises from an asset and liability that are recognised in the balance sheet, and it is measured at fair value with changes in value reported in the income statement, then there is no problem if that exposure is hedged against fair value changes. Gains and losses on both the hedged exposure and the hedging instrument are reported together and the hedging activity is correctly reported. This simple state of affairs might arise where, for example, an entity uses a forward contract to hedge an investment in an equity instrument, because both instruments are reported at fair value through profit and loss. However, matters are not so simple for many other hedges, which present a greater accounting challenge.

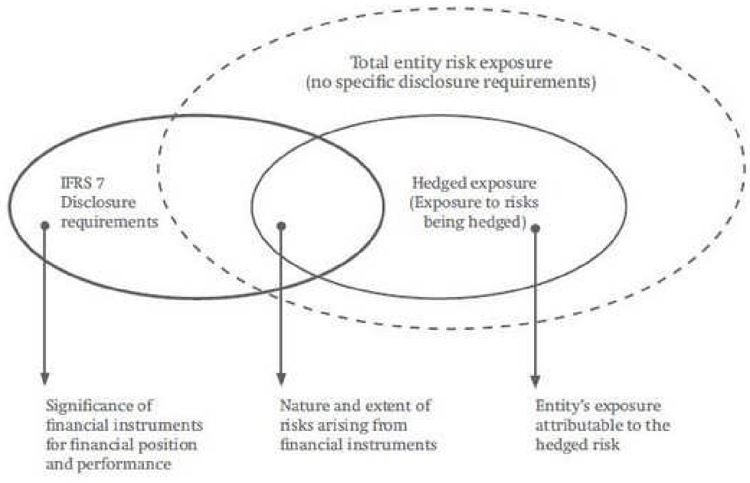
Gains and losses on a hedged risk exposure may not be reported in profit or loss for two main reasons. Firstly, the asset or liability may be measured at cost or amortised cost and secondly, there may be no asset or liability at all, because the risk exposure relates to, for example, a transaction that has not yet actually happened. In these circumstances some modification to the accounting for the derivative or to the hedged item is necessary to faithfully represent the activity. This is where hedge accounting is needed.

Hedging and hedge accounting has been an area of business activity and financial reporting where investors often struggle to understand what is going on. This has not been helped by the restrictions in IAS 39 which, arguably, limit the practical ability of companies to faithfully report their risk management activity. Some companies, because of these restrictions, choose not to apply hedge accounting at all and, instead, provide supplementary non-GAAP disclosures reflecting their own version of hedge accounting. Others use IAS 39 hedge accounting for some risks, but present similar supplementary non-GAAP information. The resulting lack of comparability, together with the use of sometimes confusing unaudited supplementary disclosures, creates problems for investors. Hedge accounting that is applied in accordance with IAS 39 can be confusing, because of the different methods available (cash flow and fair value hedges) and the lack of clear disclosure requirements. In addition, many companies feel that the accounting creates artificial restrictions on how they may hedge, which has negatively affected the way in which the business was managed. It is for all these reasons that the IASB has proposed significant changes to the hedge accounting model.

The main proposal in the hedge accounting exposure draft is to adopt a principle-based approach that will align hedge accounting more closely with risk management activities undertaken by companies when hedging their financial and non-financial risk exposures. The proposals also include enhanced presentation and new disclosure requirements. Investors should find the application of the new hedge accounting model more logical, and they should also find that its effects are more transparent and easier to understand.

Here are some of our key proposals:

- Presentation of all hedges in Other Comprehensive Income (OCI): IAS 39 requirements permit only cash flow hedges to be reflected in OCI. We now propose that all gains and losses from hedges, including fair value hedges, should be initially reported in OCI. The extent to which a hedge is ineffective will now be more transparent because there will be a separate transfer from OCI to profit and loss in respect of ineffectiveness.
- Separate presentation of the effects of fair value hedges: in IAS 39, a hedge of a component of the fair value change resulted in the remeasurement of the hedged item to a value that was neither cost nor fair value. The proposals will require such hedged value changes to be reported separately in the balance sheet with the hedged item itself remaining at amortised cost.
- Hedges of risk components of non-financial items: IAS 39 severely restricts the ability to hedge part of a risk exposure. This is a common problem for non-financial companies where the available hedging instrument often does not exactly match the hedged item. This can be the case, for example, for an airline that is hedging its exposure to changes in the future cost of jet fuel. Because jet fuel derivatives are not particularly liquid, a strategy of hedging the crude oil component of jet fuel is often adopted. In effect, this hedges only part of the overall cost. The proposals explicitly permit this, provided that the component can be separately identified.
- Aggregated exposures of derivatives and non-derivatives: IAS 39 does not allow derivatives to be part of the hedged item. This causes problems for many common risk management approaches that hedge different risks using different strategies. For example, an entity first hedges commodity price risk by converting it into a fixed amount in US dollars. In a second step, the entity includes that US dollar amount in its foreign currency hedging strategy. IAS 39 does not allow an entity to choose that fixed US dollar amount as a hedged item for foreign currency hedging because it results from a commodity derivative. We propose that entities should be able to look at both the commodity purchase and the commodity derivative and hedge the resulting US dollar exposure.
- Removing the artificial qualification criteria: at present, a hedge needs to be demonstrated to be highly effective (both expected and observed). A limit as a percentage range was imposed such that price changes for the hedging instrument needed to be within a 80–125 per cent band of those for the hedged item. We propose to remove this artificial bright line and, instead, specify that hedges should be determined in an unbiased manner that minimises ineffectiveness and that is in accordance with the risk management policy. Any ineffectiveness that then arises will continue to be reported in profit or loss.
- Changes to the treatment of option premiums: one of the current ‘rules’ that has frustrated investors is the artificial volatility that can arise where an option strategy is used to effectively provide insurance against an adverse price change, such as a change in the purchase price of a raw material. In IAS 39 the intrinsic value of the option is treated as the hedging instrument, with changes in the time value of the option being reported each period in profit or loss. However, in practice, changes in the time value are often irrelevant because the option runs to maturity and so the time value is lost. In effect it is a cost of the hedge. We propose to align the accounting more closely with the underlying economic reality thus avoiding these artificial gains and losses.
- Enhanced disclosures: we propose a comprehensive set of new disclosures that focus on the risks being hedged and on how the use of hedge accounting affects the financial statements. These proposed disclosures have been developed after extensive discussions with a range of investors and analysts. If you would like to read more or to see examples of how the disclosures will work then **click here**. The diagram below illustrates how we have developed the disclosure package.



We have some proposed some further changes to those outlined above, all of which have the objective of making hedge accounting more usable and transparent. If you would like to learn more please go the **hedge accounting pages** on the IASB website where you will find the full exposure draft, webcasts, podcasts and other supporting material.

We would particularly like to hear from investors regarding hedge accounting. Comments on the ED would be greatly appreciated by 9 March 2011. Additionally, we would welcome any thoughts you may have regarding difficulties that you have in understanding hedging activities and the related hedge accounting. We will do our best to ensure that these problems are addressed as part of the final standard.

Respond to the author

__Stephen Cooper__ is a Board member of the IASB. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB/IFRS Foundation. The IASB/IFRS Foundation disclaims any and all responsibility.

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Appendix 1

Assessing the terms of the contractual arrangement

	Joint operation	Joint venture
The terms of the contractual arrangement	The contractual arrangement provides the parties to the joint arrangement with rights to the assets, and obligations for the liabilities, relating to the arrangement.	The contractual arrangement provides the parties to the joint arrangement with rights to the net assets of the arrangement (ie it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities, relating to the arrangement).
Rights to assets	The contractual arrangement establishes that the parties to the joint arrangement share all interests (eg rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The contractual arrangement establishes that the assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie no rights, title or ownership) in the assets of the arrangement.
Obligations for liabilities	The contractual arrangement establishes that the parties to the joint arrangement share all liabilities, obligations, costs and expenses in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The contractual arrangement establishes that the joint arrangement is liable for the debts and obligations of the arrangement. The contractual arrangement establishes that the parties to the joint arrangement are liable to the arrangement only to the extent of their respective investments in the arrangement or to their respective obligations to contribute any unpaid or additional capital to the arrangement, or both.

Assessing the terms of the contractual arrangement		
	Joint operation	**Joint venture**
	The contractual arrangement establishes that the parties to the joint arrangement are liable for claims raised by third parties.	The contractual arrangement states that creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.
Revenues, expenses, profit or loss	The contractual arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly, which could differ from their ownership interest in the joint arrangement. In other instances, the parties might have agreed to share the profit or loss relating to the arrangement on the basis of a specified proportion such as the parties' ownership interest in the arrangement. This would not prevent the arrangement from being a joint operation if the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.
Guarantees	The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation. The feature that determines whether the joint arrangement is a joint operation or a joint venture is whether the parties have obligations for the liabilities relating to the arrangement (for some of which the parties might or might not have provided a guarantee).	

HKFRS 11 IE
Issued June 2011

Illustrative Examples
Hong Kong Financial Reporting Standard 11

Joint Arrangements

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CONTENTS

IFRS 11 *Joint Arrangements*
Illustrative examples

Illustrative examples
IFRS 11 *Joint Arrangements*

These examples accompany, but are not part of, IFRS 11. They illustrate aspects of IFRS 11 but are not intended to provide interpretative guidance.

IE1 These examples portray hypothetical situations illustrating the judgements that might be used when applying IFRS 11 in different situations. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying IFRS 11.

Example 1 – Construction services

IE2 A and B (the parties) are two companies whose businesses are the provision of many types of public and private construction services. They set up a contractual arrangement to work together for the purpose of fulfilling a contract with a government for the design and construction of a road between two cities. The contractual arrangement determines the participation shares of A and B and establishes joint control of the arrangement, the subject matter of which is the delivery of the road.

IE3 The parties set up a separate vehicle (entity Z) through which to conduct the arrangement. Entity Z, on behalf of A and B, enters into the contract with the government. In addition, the assets and liabilities relating to the arrangement are held in entity Z. The main feature of entity Z's legal form is that the parties, not entity Z, have rights to the assets, and obligations for the liabilities, of the entity.

IE4 The contractual arrangement between A and B additionally establishes that:

(a) the rights to all the assets needed to undertake the activities of the arrangement are shared by the parties on the basis of their participation shares in the arrangement;

(b) the parties have several and joint responsibility for all operating and financial obligations relating to the activities of the arrangement on the basis of their participation shares in the arrangement; and

(c) the profit or loss resulting from the activities of the arrangement is shared by A and B on the basis of their participation shares in the arrangement.

IE5 For the purposes of co-ordinating and overseeing the activities, A and B appoint an operator, who will be an employee of one of the parties. After a specified time, the role of the operator will rotate to an employee of the other party. A and B agree that the activities will be executed by the operator's employees on a 'no gain or loss' basis.

IE6 In accordance with the terms specified in the contract with the government, entity Z invoices the construction services to the government on behalf of the parties.

Analysis

IE7 The joint arrangement is carried out through a separate vehicle whose legal form does not confer separation between the parties and the separate vehicle (ie the assets and liabilities held in entity Z are the parties' assets and liabilities). This is reinforced by the terms agreed by the parties in their contractual arrangement, which state that A and B have rights to the assets, and obligations for the liabilities, relating to the arrangement that is conducted through entity Z. The joint arrangement is a joint operation.

IE8 A and B each recognise in their financial statements their share of the assets (eg property, plant and equipment, accounts receivable) and their share of any liabilities resulting from the arrangement (eg accounts payable to third parties) on the basis of their agreed participation share. Each also recognises its share of the revenue and expenses resulting from the construction services provided to the government through entity Z.

Example 2 – Shopping centre operated jointly

IE9 Two real estate companies (the parties) set up a separate vehicle (entity X) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in entity X. The main feature of entity X's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

IE10 The terms of the contractual arrangement are such that:

(a) entity X owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.

(b) the parties are not liable in respect of the debts, liabilities or obligations of entity X. If entity X is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.

(c) the parties have the right to sell or pledge their interests in entity X.

(d) each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in entity X.

Analysis

IE11 The joint arrangement is carried out through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). In addition, the terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, relating to the arrangement. Instead, the terms of the contractual arrangement establish that the parties have rights to the net assets of entity X.

IE12 On the basis of the description above, there are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to the arrangement, and that the parties have an obligation for the liabilities relating to the arrangement. The joint arrangement is a joint venture.

IE13 The parties recognise their rights to the net assets of entity X as investments and account for them using the equity method.

Example 3 – Joint manufacturing and distribution of a product

IE14 Companies A and B (the parties) have set up a strategic and operating agreement (the framework agreement) in which they have agreed the terms according to which they will conduct the manufacturing and distribution of a product (product P) in different markets.

IE15 The parties have agreed to conduct manufacturing and distribution activities by establishing joint arrangements, as described below:

(a) Manufacturing activity: the parties have agreed to undertake the manufacturing activity through a joint arrangement (the manufacturing arrangement). The manufacturing arrangement is structured in a separate vehicle (entity M) whose legal form causes it to be considered in its own right (ie the assets and liabilities held in entity M are the assets and liabilities of entity M and not the assets and liabilities of the parties). In accordance with the framework agreement, the parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement in accordance with their ownership interests in entity M. The parties subsequently sell product P to another arrangement, jointly controlled by the two parties themselves, that has been established exclusively for the distribution of product P as described below. Neither the framework agreement nor the contractual arrangement between A and B dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity.

(b) Distribution activity: the parties have agreed to undertake the distribution activity through a joint arrangement (the distribution arrangement). The parties have structured the distribution arrangement in a separate vehicle (entity D) whose legal form causes it to be considered in its own right (ie the assets and liabilities held in entity D are the assets and liabilities of entity D and not the assets and liabilities of the parties). In accordance with the framework agreement, the distribution arrangement orders its requirements for product P from the parties according to the needs of the different markets where the distribution arrangement sells the product. Neither the framework agreement nor the contractual arrangement between A and B dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.

IE16 In addition, the framework agreement establishes:

(a) that the manufacturing arrangement will produce product P to meet the requirements for product P that the distribution arrangement places on the parties;

(b) the commercial terms relating to the sale of product P by the manufacturing arrangement to the parties. The manufacturing arrangement will sell product P to the parties at a price agreed by A and B that covers all production costs incurred. Subsequently, the parties sell the product to the distribution arrangement at a price agreed by A and B.

(c) that any cash shortages that the manufacturing arrangement may incur will be financed by the parties in accordance with their ownership interests in entity M.

Analysis

IE17 The framework agreement sets up the terms under which parties A and B conduct the manufacturing and distribution of product P. These activities are undertaken through joint arrangements whose purpose is either the manufacturing or the distribution of product P.

IE18 The parties carry out the manufacturing arrangement through entity M whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the contractual arrangement dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, when considering the following facts and circumstances the parties have concluded that the manufacturing arrangement is a joint operation:

(a) The parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement. Consequently, A and B have rights to substantially all the economic benefits of the assets of the manufacturing arrangement.

(b) The manufacturing arrangement manufactures product P to meet the quantity and quality needs of the parties so that they can fulfil the demand for product P of the distribution arrangement. The exclusive dependence of the manufacturing arrangement upon the parties for the generation of cash flows and the parties' commitments to provide funds when the manufacturing arrangement incurs any cash shortages indicate that the parties have an obligation for the liabilities of the manufacturing arrangement, because those liabilities will be settled through the parties' purchases of product P or by the parties' direct provision of funds.

IE19 The parties carry out the distribution activities through entity D, whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the contractual arrangement dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.

IE20 There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to the distribution arrangement or that the parties have an obligation for the liabilities relating to that arrangement. The distribution arrangement is a joint venture.

IE21 A and B each recognise in their financial statements their share of the assets (eg property, plant and equipment, cash) and their share of any liabilities resulting from the manufacturing arrangement (eg accounts payable to third parties) on the basis of their ownership interest in entity M. Each party also recognises its share of the expenses resulting from the manufacture of product P incurred by the manufacturing arrangement and its share of the revenues relating to the sales of product P to the distribution arrangement.

IE22 The parties recognise their rights to the net assets of the distribution arrangement as investments and account for them using the equity method.

Variation

IE23 Assume that the parties agree that the manufacturing arrangement described above is responsible not only for manufacturing product P, but also for its distribution to third-party customers.

IE24 The parties also agree to set up a distribution arrangement like the one described above to distribute product P exclusively to assist in widening the distribution of product P in additional specific markets.

IE25 The manufacturing arrangement also sells product P directly to the distribution arrangement. No fixed proportion of the production of the manufacturing arrangement is committed to be purchased by, or to be reserved to, the distribution arrangement.

Analysis

IE26 The variation has affected neither the legal form of the separate vehicle in which the manufacturing activity is conducted nor the contractual terms relating to the parties' rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, it causes the manufacturing arrangement to be a self-financed arrangement because it is able to undertake trade on its own behalf, distributing product P to third-party customers and, consequently, assuming demand, inventory and credit risks. Even though the manufacturing arrangement might also sell product P to the distribution arrangement, in this scenario the manufacturing arrangement is not dependent on the parties to be able to carry out its activities on a continuous basis. In this case, the manufacturing arrangement is a joint venture.

IE27 The variation has no effect on the classification of the distribution arrangement as a joint venture.

IE28 The parties recognise their rights to the net assets of the manufacturing arrangement and their rights to the net assets of the distribution arrangement as investments and account for them using the equity method.

Example 4 – Bank operated jointly

IE29 Banks A and B (the parties) agreed to combine their corporate, investment banking, asset management and services activities by establishing a separate vehicle (bank C). Both parties expect the arrangement to benefit them in different ways. Bank A believes that the arrangement could enable it to achieve its strategic plans to increase its size, offering an opportunity to exploit its full potential for organic growth through an enlarged offering of products and services. Bank B expects the arrangement to reinforce its offering in financial savings and market products.

IE30 The main feature of bank C's legal form is that it causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). Banks A and B each have a 40 per cent ownership interest in bank C, with the remaining 20 per cent being listed and widely held. The shareholders' agreement between bank A and bank B establishes joint control of the activities of bank C.

IE31 In addition, bank A and bank B entered into an irrevocable agreement under which, even in the event of a dispute, both banks agree to provide the necessary funds in equal amount and, if required, jointly and severally, to ensure that bank C complies with the applicable legislation and banking regulations, and honours any commitments made to the banking authorities. This commitment represents the assumption by each party of 50 per cent of any funds needed to ensure that bank C complies with legislation and banking regulations.

Analysis

IE32 The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of bank C, but it establishes that the parties have rights to the net assets of bank C. The commitment by the parties to provide support if bank C is not able to comply with the applicable legislation and banking regulations is not by itself a determinant that the parties have an obligation for the liabilities of bank C. There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of bank C and that the parties have an obligation for the liabilities of bank C. The joint arrangement is a joint venture.

IE33 Both banks A and B recognise their rights to the net assets of bank C as investments and account for them using the equity method.

Example 5 – Oil and gas exploration, development and production activities

IE34 Companies A and B (the parties) set up a separate vehicle (entity H) and a Joint Operating Agreement (JOA) to undertake oil and gas exploration, development and production activities in country O. The main feature of entity H's legal form is that it causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).

IE35 Country O has granted entity H permits for the oil and gas exploration, development and production activities to be undertaken in a specific assigned block of land (fields).

IE36 The shareholders' agreement and JOA agreed by the parties establish their rights and obligations relating to those activities. The main terms of those agreements are summarised below.

Shareholders' agreement

IE37 The board of entity H consists of a director from each party. Each party has a 50 per cent shareholding in entity H. The unanimous consent of the directors is required for any resolution to be passed.

Joint Operating Agreement (JOA)

IE38 The JOA establishes an Operating Committee. This Committee consists of one representative from each party. Each party has a 50 per cent participating interest in the Operating Committee.

IE39 The Operating Committee approves the budgets and work programmes relating to the activities, which also require the unanimous consent of the representatives of each party. One of the parties is appointed as operator and is responsible for managing and conducting the approved work programmes.

IE40 The JOA specifies that the rights and obligations arising from the exploration, development and production activities shall be shared among the parties in proportion to each party's shareholding in entity H. In particular, the JOA establishes that the parties share:

(a) the rights and the obligations arising from the exploration and development permits granted to entity H (eg the permits, rehabilitation liabilities, any royalties and taxes payable);

(b) the production obtained; and

(c) all costs associated with all work programmes.

IE41 The costs incurred in relation to all the work programmes are covered by cash calls on the parties. If either party fails to satisfy its monetary obligations, the other is required to contribute to entity H the amount in default. The amount in default is regarded as a debt owed by the defaulting party to the other party.

Analysis

IE42 The parties carry out the joint arrangement through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The parties have been able to reverse the initial assessment of their rights and obligations arising from the legal form of the separate vehicle in which the arrangement is conducted. They have done this by agreeing terms in the JOA that entitle them to rights to the assets (eg exploration and development permits, production, and any other assets arising from the activities) and obligations for the liabilities (eg all costs and obligations arising from the work programmes) that are held in entity H. The joint arrangement is a joint operation.

IE43 Both company A and company B recognise in their financial statements their own share of the assets and of any liabilities resulting from the arrangement on the basis of their agreed participating interest. On that basis, each party also recognises its share of the revenue (from the sale of their share of the production) and its share of the expenses.

Example 6 – Liquefied natural gas arrangement

IE44 Company A owns an undeveloped gas field that contains substantial gas resources. Company A determines that the gas field will be economically viable only if the gas is sold to customers in overseas markets. To do so, a liquefied natural gas (LNG) facility must be built to liquefy the gas so that it can be transported by ship to the overseas markets.

IE45 Company A enters into a joint arrangement with company B in order to develop and operate the gas field and the LNG facility. Under that arrangement, companies A and B (the parties) agree to contribute the gas field and cash, respectively, to a new separate vehicle, entity C. In exchange for those contributions, the parties each take a 50 per cent ownership interest in entity C. The main feature of entity C's legal form is that it causes the separate vehicle to be considered in its own right (ie the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).

IE46 The contractual arrangement between the parties specifies that:

(a) companies A and B must each appoint two members to the board of entity C. The board of directors must unanimously agree the strategy and investments made by entity C.

(b) day-to-day management of the gas field and LNG facility, including development and construction activities, will be undertaken by the staff of company B in accordance with the directions jointly agreed by the parties. Entity C will reimburse B for the costs it incurs in managing the gas field and LNG facility.

(c) entity C is liable for taxes and royalties on the production and sale of LNG as well as for other liabilities incurred in the ordinary course of business, such as accounts payable, site restoration and decommissioning liabilities.

(d) companies A and B have equal shares in the profit from the activities carried out in the arrangement and, as such, are entitled to equal shares of any dividends distributed by entity C.

IE47 The contractual arrangement does not specify that either party has rights to the assets, or obligations for the liabilities, of entity C.

IE48 The board of entity C decides to enter into a financing arrangement with a syndicate of lenders to help fund the development of the gas field and construction of the LNG facility. The estimated total cost of the development and construction is CU1,000 million.*

IE49 The lending syndicate provides entity C with a CU700 million loan. The arrangement specifies that the syndicate has recourse to companies A and B only if entity C defaults on the loan arrangement during the development of the field and construction of the LNG facility. The lending syndicate agrees that it will not have recourse to companies A and B once the LNG facility is in production because it has assessed that the cash inflows that entity C should generate from LNG sales will be sufficient to meet the loan repayments. Although at this time the lenders have no recourse to companies A and B, the syndicate maintains protection against default by entity C by taking a lien on the LNG facility.

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* In this example monetary amounts are denominated in 'currency units (CU)'.

Analysis

IE50 The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of entity C, but they establish that the parties have rights to the net assets of entity C. The recourse nature of the financing arrangement during the development of the gas field and construction of the LNG facility (ie companies A and B providing separate guarantees during this phase) does not, by itself, impose on the parties an obligation for the liabilities of entity C (ie the loan is a liability of entity C). Companies A and B have separate liabilities, which are their guarantees to repay that loan if entity C defaults during the development and construction phase.

IE51 There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of entity C and that the parties have an obligation for the liabilities of entity C. The joint arrangement is a joint venture.

IE52 The parties recognise their rights to the net assets of entity C as investments and account for them using the equity method.

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HKAS 37
Provisions, contingent assets and liabilities

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Objective of HKAS 37

- HKAS 37 's recognition and disclosure requirements are designed to prohibit:
  - The creation of provisions where there is no liability
  - The use of old provisions created for one purpose to meet new expenditure for a different purpose; and
  - The undisclosed release of provisions into profit or loss
- HKAS 37 was introduced to restrict an entity's ability to make large "general" provisions

The objective of HKAS 37 is to ensure that provisions, contingent liabilities and contingent assets are measured, recognised and presented appropriately in the financial statements

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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: [HKAS 37.1]

  - Resulting from **executory contracts**, **except where the contract is onerous**; and
  - Covered by another Standard

- Financial Guarantee contracts are within the scope of HKAS 39

- The acquirer's treatment of contingent liabilities assumed in a business combination is addressed by HKFRS 3

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What is an executory Contracts

- ❑ Executory contracts are contracts under which neither party has performed any of its obligations, or both parties have partially performed their obligations to an equal extent [HKAS 37.3]

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

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Illustration of executory contract

- On 1 January 2010, Co A enters into a contract with Co B for the manufacture and delivery of 100 units of component Q at five different dates in the future, i.e. 500 units are to be delivered in total. Payment is due on delivery of the units.
- On **1 January 2010**, the **contract** between Co A and Co B is **executory because neither party has performed any of its obligations**: Co B has neither manufactured nor delivered any of the units, nor has Co A paid for any of them.
- By **1 March 2010**, **Co B has produced and delivered 200 of the units and Co A has paid in full for those 200 units**. At this date, the contract between Co A and Co B continues to be **executory** because both parties have **partially performed their obligations to an equal extent**.
- By **1 June 2010**, **Co B has produced and delivered the full 500 units, but Co A has only paid for 400 units in total**. The contract between Co A and Co B no longer meets the definition of an executory contract because the two parties have not performed under the terms of the contract to an equal extent. Co A is required to **recognise a liability** for the final 100 units of component Q for which it has not yet paid.

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Principles of recognising provisions under HKAS 37

- ❑ Summary of principals in HKAS 37 for an entity to make provisions:
  - The entity must have a **present obligation (legal or constructive) that is more likely than not (probable) to arise**
  - The obligation must arise from an **obligating event** (i.e., a past event)
  - The obligation must **not relate to costs that will be incurred in the future** as part of the entity's future operations
  - The entity must be **more likely than not** that the obligation will result in an **outflow of economic benefits**
  - The entity must be possible to make a **reliable estimate** of the obligation

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Illustration of the recognition criteria

Situation	Provision?	Action
Past event has occurred, resulting in a ***possible*** **obligation** for which a transfer of benefits is possible but **not probable**	X	**Unless** the possibility of a transfer of benefits is **remote**, **disclose a contingent liability**
Past event has occurred, resulting in a **present obligation** for which there may ***possibly*** **be a transfer of benefits**, but for which there **probably will not**	X	**Unless** the possibility of a transfer of benefits is **remote**, **disclose a contingent liability**
Past event has occurred, resulting in a **present obligation** for which it is likely there will be a transfer of benefits, but a ***reliably estimate cannot be made*** of the amount of the obligation	X	**Disclose a contingent liability** (note: this situation is likely to be very rare)

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Illustration of the recognition criteria (cont'd)

Situation	Provision?	Action
Past event has occurred, resulting in a ***present*** **obligation** for which it is **likely** there will be a transfer of benefits, a **reliable estimate** can be made of the amount of the obligation	✔	**Recognise provision** and make necessary disclosure
An ***obligating event has not taken place by the end of the reporting period***, but it takes place after the reporting period, resulting in an obligation for which it is likely there will be a transfer of benefits; a reliable estimate can be made of the amount of the obligation	X	Consider whether the requirements of **HKAS 10 *Events after the Reporting Period*** require the disclosure of the non-adjusting event that has arisen

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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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Distinguishing provisions versus other liabilities

- Provisions can be distinguished from other types of liability, including those that involve uncertain amounts, by considering the events that give rise to the obligation and also the degree of uncertainty as to the amount of the liability

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 approximately authorised before the period end		✔	Recognise as a current financial liability

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Provisions versus Other liabilities

- ***Accruals are often presented as part of trade and other payables, whereas provisions are reported separately* [HKAS 37.11]**
- ***Provisions are subject to disclosure requirements that do not apply to other payables***
  - ***For each class of provision an entity should provide a reconciliation of the carrying amount of the provision at the beginning and end of the period showing***

    (a) Additional provisions made in the period, including increases to existing provisions
    (b) Amounts used, i.e. incurred and charged against the provision, during the period
    (c) Unused amounts reversed during the period; and
    (d) The increase during the period in the discontinued 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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Present obligations and past events and future actions

- Only those obligations arising from past events that exist independently of the reporting entity's future actions that are recognised as provisions
- If the existence of an obligation depends on future actions of the entity, then a provision is not recognised until the obligation is unavoidable
- When the entity can avoid future expenditure by its future actions, it has no present obligations for that future expenditure and no provision is recognised

CEF 13

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Example: Present obligations, past events and future actions

- A new regulation is passed that imposes an obligation on motor vehicle manufacturers to pay a scrapping levy to the government. The scrapping levy in respect of vehicles sold before 2011 will be based on vehicle manufacturers' market share in 2011 regardless of their actual sales in the previous period. V could avoid the obligation, for example by selling vehicle in a different market. Therefore, the obligating event occurs only in 2011 as V makes sales that establish its market sales.
- Conversely, a provision for clean-up costs relating to environmental damage is recognised because even if the entity changes its future business activities, it will still incur the expenses relating to cleaning up because of its past activities.

CEF 14

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Specific application guidance

TUE 120

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Obligating event

- **Key:**
  - An integral part of an obligation is that it arises from a past event [HKAS 37.17]
  - **Expected future operating losses, even if probable, are not provided** for unless they relate to an onerous contract [HKAS 37.18, 63,66]

- **Example:**
  - Co A announced to the public a business plan to enter into a new overseas market
  - The new overseas market expose Co A to significant increases in currency risk and legal and political uncertainties
  - Although the plan has been made public, and may be virtually certain of being implemented
  - Co A does not recognise a provision because there is no obligating event

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Uncertainty about whether an obligation exists

- **Key:**
  - In some cases it may not be clear whether an obligation exists, particularly in the case of a legal claim, an entity may dispute whether there is an obligation even if it is clear that there is a past event
  - A past event gives rise to a present obligation if it is more likely than not that a present obligation exists at the reporting date

- **Example:**
  - Co F is a fish-canning company.
  - A group is claiming that certain people suffered food poisoning from tuna canned by Co F
  - Co F disputes the claim
  - If it is more likely than not that Co F's tuna caused the food poisoning, Co F is considered to have a present obligation, even if Co F is planning to defend its position

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Counterparty

- **Key:**
  - An obligation involves another party
  - However, an entity is not required to be able to identify the counterparty to the obligation before a provision is recognised [HKAS 37.20]

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Contingent liabilities

- **Key:**
  - **Contingent liabilities are not recognised in the statement of financial position** unless they were assumed in a business combination [HKFRS 3.23, HKAS 37.27]
  - **Contingent liabilities are reviewed continuously to assess whether an outflow of resources has become probable**. If the recognition criteria are met, then a liability is recognised in the statement of financial position in which the change in probability occurs [HKAS 37.30]
  - **If a present obligation relates to a past event, the possibility of an outflow is probable and reliable estimate can be made**, then the obligation is not a contingent liability, but is a liability for which a **provision is required** [HKAS 37.14]

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Contingent liabilities (cont'd)

- **Key:**
  - The **expectation that an outflow related to an obligation will be reimbursed**, e.g. an environmental obligation will be covered by an insurance policy, does not affect the assessment of the probability of an outflow for the obligation [HKAS 37.53]
  - Financial guarantee contract are within the scope of HKAS 39 unless the issuer of the contract has previously asserted explicitly that it regards such contracts as insurance contracts. **Generally, when a financial guarantee recgonised under HKAS 39 or HKFRS 4 becomes probable of being exercised, the provision is measured in accordance with HKAS 37** [HKAS 39.2(e), 47(c)]

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Contingent assets

- **Key:**
  - **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 [HKAS 37.31, 33]

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Measurement

- The amount recognised for a provision is the **best estimate** of the expenditure to be incurred. No option to have an accounting policy of measuring the provision based on the lowest or the highest anticipated outcome [HKAS 37.36]

HKAS 37.26 concludes that the circumstances in which the entity will not be possible to reach a reliable estimate will be extremely rare. That liability will instead be disclosed as a contingent liability

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Estimation techniques – large population

- If the provision is being made for a large population of items, then the provision is measured at its expected value
- Examples: product warranties

Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used

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Examples: Estimation techniques – large population

- Scenario:
  - An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent with the first six months after purchase
  - If minor defects were detected in all products sold, repair costs of $1M would result
  - If major defects were detected in all products sold, repair costs of $4M would result
  - The entity's past experience and future expectations indicate that, for the last six month's sales, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects
  - The entity assesses the probability of an outflow for the warranty obligations as a whole

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Examples: Estimation techniques – large population

❑ Analysis:

- The expected value of the cost of repairs is:

(75% x $nil) + (20% x $1M) + (5% of $4M) = $400,000

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Estimation techniques – Single obligations

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

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Examples: Estimation techniques – Single obligations

- Scenario:
  - An entity faces a single legal claim, with a 40% likelihood of success with no cost and a 60% likelihood of failure with a cost of HK$1M

- Analysis:
  - Expected value is not valid
  - It is more likely that the cost of HK$1M will result
  - Therefore, a provision for HK$1M will be recognised

Where the provision relates to a single event, or a smaller number of events, expected value is not a valid technique

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Estimation techniques – Single obligations

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 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

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Estimation techniques – Single obligations

Where the most likely outcome and the expected value <u>are not close together,</u> it will often be appropriate to provide for whichever possible outcome is nearest to the expected value

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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% change 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

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Estimation techniques – Single obligations

Irrespective of the method applied, in relation to very material items, entities may wish to consider whether it would be appropriate to provide any further information, e.g. the range of possible outcomes

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Discounting

- HKAS 37 requires that where **the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation**

- For the majority of provisions that will reverse in the short-term, the effects of discounting may be immaterial and are not then required to be made

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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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
- ❑ **Basis of recognition:** Reimbursements are recognsied as a separate asset when recovery is virtually certain. The amount recognised is limited to the amount of the related provision

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Reimbursements (cont'd)

- ❑ It is the existence of the reimbursement asset that must be virtually certain, rather than its amount
- ❑ The appropriate presentation of a reimbursement is:
  - in the balance sheet, a separate asset is recognised (which must not exceed the amount of the provision)
  - in the income statement, a net amount may be presented, being the anticipated cost of the obligation less the reimbursement
- ❑ Offset of a provision and the related reimbursement is never appropriate

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Example: Reimbursement

- Scenario:
  - A customer sue Co A for $300 for a defective products purchased from Co A
  - Co 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 Co A as soon as Co A paid the customer
- Analysis:
  - Co 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
  - Co A discloses the unrecognised reimbursement of $36 in the notes to the financial statements

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Joint and several liability

- Where an entity is jointly and severally liable for an obligation, the entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable
- The remainder, expected to be paid by other parties, is a contingent liability

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Review and revision of provisions

- ❑ Provisions should be reviewed at each balance sheet date and adjusted to reflect current best estimates
- ❑ 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 a provision is no longer required, the provision should be reversed

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Review and revision of provisions

- ❑ In the balance sheets for years following the intitial measurement of a provision at a present value, the present value will be restated to reflect estimated cash flows being closer to the measurement date
- ❑ This unwinding of the discount relating to the passage of time should be recognised as a 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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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 2009 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 2010
  - No other steps were taken to implement the decision until that date
  - The current financial year of the entity ends at 31 December 2009
  - 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 2009

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Examples: Restructuring

- Scenario:
  - In a monthly meeting held on 12 December 2009 the board of an entity resolved to close down a division
  - In a special meeting on 20 December 2009 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 2009
  - 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 2009 for the best estimate of the costs of closing the division

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Restructuring (cont'd)

- An obligation related to the **sale of an operation** arises only when there is a **binding sale agreement**. Even though the decision to sell an operation has been announced, no provision is recognised for obligations arising as a result of the sale until there is a binding sale agreement

- There is no specific requirements for the contents of the announcement. However, the announcement should be **sufficiently explicit to create a valid expectation in those affected that the plan will be implemented.**

- **An entity is not required to know the identity of the counterparty to the obligation before a provision is recognised**. Therefore, it is not necessary to notify individual counterparties (e.g. each employee or vendor) before a provision is recognised.

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Restructuring (cont'd)

- For a plan to create a constructive obligation, implementation should begin as soon as possible and it should be completed in a timeframe that would not allow for significant changes to the plan

- Restructuring provisions **include only incremental costs associated directly with the restructuring.** Amounts to be recognised in a restructuring provision include:
  - employee termination benefits that relate directly to the restructuring
  - contract termination costs e.g. lease termination penalties
  - onerous contract provisions
  - consulting fee that relate directly to the restructuring
  - expected costs from when operations cease until final disposal

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Restructuring (cont'd)

- The Standard prohibits recognition of provision for costs associated with ongoing activities. Therefore restructuring provisions are not recognised for:
  - costs of retaining or relocating continuing staff
  - marketing and administrative costs
  - investment in new systems and distribution networks
  - loyalty bonuses or amounts paid to staff as an incentive to stay

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Warranties

- An entity that has an **established practice** of repairing or replacing faulty or defective goods that are returned, even if legally it is not obliged to do so, generally has a **constructive obligation** to repair or replace products. The obligating event is the sale of goods that turn out to be defective or faulty

- A warranty provision is **measured based on the probability of the goods requiring repair or replacement and the best estimate of the costs to be incurred** in respect of defective products sold on or before the reporting date

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Example: Warranties

- Scenario:
  - A manufacturer gives warranties at the time of sale to purchasers of its product
  - Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that becomes apparent within three years from the date of sale
- Analysis:
  - The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation such that an entity has no realistic alternative but to settle a claim under the warranty
  - If it is probable there will be some claims under the warranties, a provision should be recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period

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Examples: Refunds

- Scenario:
  - A retail store has a policy of refunding any return by dissatisfied customers within 7 days
  - Even though there is no legal obligation to do so, its policy of making refunds is generally known
- Analysis:
  - The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund any return within 7 days
  - Since it is probable that a proportion of goods will be returned for refund, a provision for sales return is recognised for the best estimate of the amount of refunds

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Future operating costs

- HKAS 37 seeks to stop artificial "smoothing" of results
- Entities will no longer be able to provide on an annual basis for items such as future repairs, so as to produce a reasonably level charge each year
- Such costs will instead generally be charged to profit or loss when they are actually incurred, i.e. when the work is done

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Determining whether a contract is onerous

- An onerous contract is one in which the unavoidable cost of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract

- In assessing whether a contract is onerous, it is necessary to consider:
  - the unavoidable costs of meeting the contractual obligations, which is the lower of the net costs fulfilling the contract and cost of terminating it; and
  - the economic benefits expected to be received.

HKAS 37 requires that if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision

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Examples: Onerous contracts

- Scenario 1:
  - An entity operates profitably in a factory that it has leased under an operating lease
  - During the year ended 31 December 2009 the entity relocates its operations to a new factory
  - The lease on the old factory continues for the next four years
  - It cannot be cancelled and it is unlikely that the entity can sub-let the factory to another user

- Scenario 2:
  - Same facts as above except that the factory can be let to the Cultural Development Department as an exhibition centre for artists, generating a low level of income

Should provision be made?

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Examples: Onerous contracts

- Analysis:

Scenario 1:

- The obligating event is the signing of the lease contract which gives rise to a legal obligation
- The lease becomes onerous since it is almost certain that the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it
- A provision is recognised for the best estimate of the unavoidable lease payments

Scenario 2:

- Similar to Scenario 1 that the lease becomes onerous
- A provision is recognised for the best estimate of the net amount of the unavoidable lease costs
- i.e. the gross unavoidable lease costs less the probable net revenue expected from the sub-letting

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Examples: Onerous contracts

- Example: Determination of costs for an onerous contract

- Company F leases office space for an annual rental of $20. The remaining lease term is 5 years, although after 2 years, F has an option to cancel the lease and pay a penalty of $25.
- The cost of fulfilling the contract is $75 (the present value of $20 X 5).
- The cost of terminating the contract is $60 (the present value of ($20 x 2 + $25).
- The cost used to determine whether the contract is onerous should be $60.

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Presentation and Disclosure

Reminders:

- ***Provisions are disclosed as a separate line item in the statement of position***
- ***Movements in each class of provisions during the reporting period are disclosed***
- ***Comparative period information is not required***
- ***Provisions that will be utilised within one year are classified as current liabilities***

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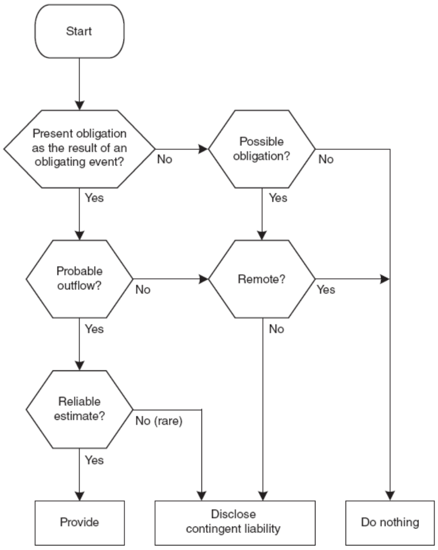
Final Recap



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Thank you for your attention

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HKAS 18 Revenue

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Introduction

- **Revenue may be generated by:**
  - **sale of goods**, including goods produced or purchased by the entity for resale
  - **construction contracts**, which are specifically negotiated contracts for the construction of an asset or a combination of assets if those assets are closely interrelated or interdependent in terms of their design, technology and function or ultimate purpose or use
  - **Rendering of services**, typically involving the performance of a contractually agreed task; and
  - Use of an entity's assets that generates fees such as **royalties, dividends and interest**

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Scope of HKAS 18

Revenue from sale of goods	• Including goods produced for sale and goods purchased for sale, such as merchandise purchased by a retailer or land and other property held for resale
Revenue from services rendered	• Including rendering of services in accordance with contract terms
Revenue from use by others of assets belonging to the entity	• Including interest, dividend and royalties

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Exclusion from HKAS 18

HKAS 18 excludes from its scope revenue arising from:	
X	Lease agreement (dealt with by HKAS 17 "Leases"
X	Dividends from equity-accounted investments (dealt with by HKAS 28 "Investments in associate"
X	Insurance contracts within the scope of HKFRS 4 "Insurance contracts"
X	Changes in the fair value of financial assets and liabilities or their disposal (dealt with by HKAS 39 "Financial Instruments: Recognition and measurement)
X	Changes in the fair value of other current assets
X	Initial recognition and changes in the fair value of biological assets related to agricultural activity (dealt with by HKAS 41 "Agriculture")
X	Initial recognition of agricultural produce (also dealt with by HKAS 41)
X	The extraction of mineral ores

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Definition of revenue

- **General definition**
- Gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows results in increases in equity, other than increases relating to contributions from equity

- **Items not within definition of revenue**
- Contributions from equity participants
- Amounts collected on behalf of the principal and which do not result in increases in equity for the equity

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Gross or net presentation

- Revenue includes only **gross inflows** of economic benefits that are received or receivable by the entity **on its own account**

- Amounts **collected on behalf of third parties** (e.g. sales taxes collected on behalf of custom authority) are not economic benefits which flow to the entity and do not result in increases in equity

- The amount of revenue recognised for a transaction is **net of any trade discounts or volume rebates given,** since these discounts and rebates are not received as consideration by the seller

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Agency relationship

- Gross amounts collected by the agent on behalf of the principal are not benefits that flow to the agent and therefore, they are not revenue. **The agent's revenue is the amount of commission**
- The **principal** in an agency relationship recognises the **gross amount** charged to the ultimate customer as revenue. Commission paid to the agent is accounted for as an expense by the principal.
- Determining whether an entity is acting as an agent or principal is based on an **evaluation of the risks and responsibilities** taken by the entity, including inventory risk and responsibility for the delivery of goods or services.
- Judgment is required and all relevant facts and circumstances must be considered

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Agency relationship (cont'd)

- **Example:** A travel agents sell airline tickets to the public generally at a price determined by reference to the market rate, but often pay the airline a discounted amount. The travel agent does not bear any general inventory risk because it does not carry tickets in inventory and only purchases tickets when it receives orders or bookings from customers.
- In this case, the travel agent does not bear any inventory risk nor is it responsible for carrying out the services related to the ticket itself, as this is the responsibility of the airlines.
- The travel agent's revenue should reflect only the fee and not the gross amount billed to the customer

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Measurement of revenue

- Revenue is measured at the **fair value** of the consideration received or receivable.
- The nominal amount of the consideration received or receivable will not vary materially from its fair value because most trade receivables are due within a relatively short time-frame
- When consideration is to be received outside such a short time-frame, the fair value of the consideration to be received will not be the same as the nominal amount of the consideration due to the time value of money. Such an arrangement effectively includes a **financing transaction**. Therefore, to calculate the fair value of the consideration receivable, **future receipts are discounted using an imputed interest rate**

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Measurement of revenue (cont'd)

- To calculate the fair value of the consideration receivable, future receipts are discounted using an imputed interest rate which is the more clearly determinable of :
- the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
- a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services*

* where the second approach is taken, the resulting interest rate should be assessed for reasonableness. If the rate appears unrealistically low, this may indicate that the current cash sales price that would be appropriate for this particular customer has not been correctly identified

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Example: Deferred consideration

- An entity sells an item of equipment for $100,000 under a financing agreement which has no stated interest rate
- Annual instalments of $20,000 are due each year for five years from the date of purchase
- **Scenario 1:** The seller believes that the buyer would be able to obtain financing from other sources at an interest rate of 10%
- **Scenario 2:** If the buyer had paid cash for the equipment, the sales price would have been $80,000

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Example: Deferred consideration: discounting based on interest rate (scenario 1)

Analysis:

- Assuming no down payment, five annual instalments of $20,000, and an interest rate of 10%, the fair value of the stream of payments forming the considerations is $75,816
- The amount of interest earned each year as follows:

	{A}	{A x 10%=B}	{C-B}	{C}
1st year end	75,816	7,581	12,419	20,000
2nd year end	63,397	6,340	13,660	20,000
3rd year end	49,737	4,974	15,026	20,000
4th year end	34,711	3,471	16,529	20,000
5th year end	18,182	1,818	18,182	20,000
Total		24,184	75,816	100,000

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Example: Deferred consideration: discounting based on interest rate (scenario 1) – cont'd

Initial recognition at date of sale:

	DR	CR
Trade receivables	75,816	
Sales revenue		75,816

Yearly income

	Year end	1st	2nd	3rd	4th	5th
DR	Cash	20,000	20,000	20,000	20,000	20,000
CR	Trade receivables	12,419	13,660	15,026	16,529	18,182
CR	Interest income	7,581	6,340	4,974	3,471	1,818

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Example: Deferred consideration: discounting to current cash sales price (scenario 2)

Analysis:

- Since the cash price offered is $80,000, it is necessary to determine the interest rate which discount $100,000 to $80,000 over a five year period, assuming no down payment and five annual instalments of $20,000. This interest rate is 7.93%
- The amount of interest earned each year as follows:

	{A}	{A x 7.93%=B}	{C-B}	{C}
1st year end	80,000	6,345	13,655	20,000
2nd year end	66,345	5,262	14,738	20,000
3rd year end	51,607	4,093	15,907	20,000
4th year end	35,700	2,931	17,169	20,000
5th year end	18,531	1,469	18,531	20,000
Total		20,000	80,000	100,000

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Example: Deferred consideration: discounting based on interest rate (scenario 2) – cont'd

Initial recognition at date of sale:

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

Yearly income

	Year end	1st	2nd	3rd	4th	5th
DR	Cash	20,000	20,000	20,000	20,000	20,000
CR	Trade receivables	13,655	14,738	15,907	17,169	18,531
CR	Interest income	6,345	5,267	4,093	2,931	1,469

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Measurement of revenue: Exchange of goods or services

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

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Example: Transfer of inventories for an entity's own shares

- Entity A has produced inventory at a cost of $80 that is normally sold to unrelated third parties at a price of $100
- Entity A enters into a transaction to buy $100 of its ordinary shares from a shareholder in return for $100 of its inventory
- How should Entity A account for this transaction?

Analysis:

- Entity A should record revenue for the sale of its inventory for $100 and treasury shares for $100. The form of consideration should not have an impact on whether revenue is recognised
- Entity A would then recognise cost of sales and reduce inventories by $80

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Recognition – Identifying components

- The first step in recognising revenue is to determine whether a single arrangement **comprises separately identifiable components.** In an arrangement that comprises more than one activity, it may be appropriate to identify the separable components within the contract and **allocate revenue to each separately identified component.**
- If no separable components are identified, then it may not be appropriate to recognise any revenue until completion of the final deliverables if the transaction is accounted for under HKAS 18
- In some cases, a contract may identify separate components, but it may be appropriate to account for them as a single transaction

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Recognition – identifying components (cont'd)

- **Example:** a contract to sell software may include an element related to after-sales servicing over a period of time. In such circumstances, it is appropriate to split the transaction into two components, a sale element and a servicing element, and to apply the revenue recognition criteria to each component individually
- **Example:** a seller may enter into a contract to sell goods but agree in a separate contract to repurchase the goods at a later date. In such circumstances, the revenue recognition criteria are applied to both transactions together to determine if revenue is recognised

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Recognition criteria: sales of goods

All of the following criteria have to be met [HKAS 18.14]

- Significant risks and rewards of ownership of the goods transferred
- Retains neither continuing managerial involvement nor effective control over the goods sold
- The amount of revenue can be measured reliably
- 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: sales of goods (cont'd)

HKAS 18.14(a) : Risks and rewards of ownership

- The circumstances of the transaction must be examined to assess when a seller has transferred the significant risks and rewards of ownership to the buyer
- Generally, the transfer of the risks and rewards of ownership **coincides** with the transfer of the legal title or the passing of possession to the buyer

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(a) : Risks and rewards of ownership

If significant risks of ownership are retained by the seller, the transaction is not a sale and revenue is not recognised

Examples:

▪ when the seller retains an obligation for unsatisfactory performance not covered by normal warranty provisions	▪ when receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods	▪ when goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity	▪ when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the seller is uncertain about the probability of return

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(a) : Risks and rewards of ownership

If only an insignificant risk of ownership is retained by the seller, the transaction is a sale and revenue is recognised

Examples:

- A seller may retain the legal title to goods solely to protect the collectibility of the amount due

- an insignificant risk of ownership may be retained by the seller in a retail sale when a refund is offered if the customer is not satisfied.
- Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability and corresponding reduction for returns based on previous experience and other relevant factors

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Example: Warranty

- An entity manufactures an item of customised machinery and gives a three-month warranty covering the cost of any adjustments or repair subsequent to delivery
- The product is likely to have some serious problems that will need to be remedied after the delivery, due to the need to suit the particular customer's environment
- It is not possible to estimate with reliability the cost to the seller of carrying out any such adjustments or repair
- Under the terms of the sales contract, title passes on delivery
- **Can the seller recognise revenue immediately**?

Analysis:

The risks and rewards of ownership do not pass until the three-month period has expired, since it is not possible to estimate, and therefore accrue, any costs of repairs or adjustments, which could be material

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Example: Equipment sold subject to right of return

- A heavy equipment manufacturer sells an item of machinery to a customer who is anticipating being awarded a particular road-building contract from the Government
- In the sales contract, the seller gives the customer the right to return the machinery if the customer does not win the contract
- There is no way to estimate reliably whether the customer will return the machinery

Analysis:

The risks and rewards of ownership do not pass until the customer has been granted the road-building contract from the Government

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Example: Retail guarantee

- A retail shop offers a lifetime guarantee on its products
- A customer may return any item for any reason at any time and have its money refunded
- Based on reliable, historical data, .95 per cent of sales are returned under this policy

Analysis:

Based on historical data (.95%), the shop retains only insignificant risks and rewards of ownership by offering this guarantee. Provided that the other revenue recognition criteria are met, revenue should be recognised at the time of sale and a corresponding provision of 0.95% of the amount of the sale should be recognised to cover the cost of expected sales returns

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Example: Retention of title

- As a matter of policy, a manufacturer writes its sales contracts in such a way that legal title does not pass on delivery but when consideration for the goods is received
- A sale is made and related goods are delivered to a customer who is not a particular credit risk policy

Analysis:

- The risks and rewards of ownership have passed even though title has not
- Transfer of title may be an indicator that the risks and rewards of ownership have passed to the buyer, but it is not a required condition
- Therefore, provided that the other revenue recognition criteria are met, revenue can be recognised if the only rights that a seller retains with the title are those enabling recovery of the goods in the event of customer default on payment

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Example: Sale of products with a time restriction on resale or use

- Co A, a manufacturer of designer clothing, ships clothing for the spring season to customers (clothing retailers) in Dec 2009
- While the customers take title to the goods when they receive them, the terms of the sales prohibit the customers from displaying or selling the clothing until Feb 2010
- The terms of the arrangement are such that payment generally is not due until the restriction is lifted.
- When is revenue recognised - when the goods are delivered (2009) or when the restriction on resale expires 2010?

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Example: Sale of products with a time restriction on resale or use (cont'd)

Analysis:

- The limitation on when the product can be sold would not, of itself, preclude revenue recognition in 2009.
- HKAS 18.14(a) prohibits revenue recognition when goods are sold, until the seller has transferred to the buyer the significant risks and rewards of ownership of the goods
- In the above situation , the timing is short compared to the life cycle of the inventory and the timing of the restriction does not affect the value of the inventory to be sold
- If the timing was longer, however, for example until the summer season, a review of whether the significant rewards of ownership had been transferred should be performed

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(b) :
Continuing managerial involvement and effective control

- This criterion generally goes hand-in-hand with the risks and rewards of ownership. It would be unusual for an entity to retain effective control over goods without retaining the risks and rewards of ownership
- Each situation should be considered individually

Examples:

- a software consultancy firm may install a software system for a client and then oversee and manage the computer department that uses the software
- This outsourcing of managerial control over the computer department does not necessarily prohibit revenue recognition for the provision of the software
- It will be necessary to consider the terms of the agreement to determine whether the risk and rewards stemming from the software have been transferred to the client

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(c) : Reliable measurement of revenue

- Until the amount of revenue to be received can be measured reliably, revenue cannot be recognised
- This does not imply that the consideration must have been received in all cases for revenue to be recognised
- Generally, consideration will be agreed in advance and the revenue from a sale will be recognised when all of the other recognition criteria are met

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(d) : Probability of receipt of economic benefits

- Revenue cannot be recognised unless it is probable that the economic benefits or consideration associated with the transaction will flow to the entity
- If revenue has been recognised and it later emerges that the related consideration will not be collectible, an expense for bad debts is reconised rather than reversing the related revenue (HKAS 18.18)

Example:

- When it is not probable that consideration will be received from a particular customer due to exchange controls in the country in which the customer operates which limit the amount of currency that can be remitted from that country, revenue is not recognised until the consideration is received

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Recognition criteria: sales of goods (cont'd)

HKAS 18.14(e) : Measurement of costs incurred related to the transaction

When the costs incurred or to be incurred in a transaction cannot be measured reliably, revenue is not recognised

- This criterion flows from the matching principle. Under this principle, when revenue is recognised, the related expenses are also recognised
- If such costs cannot be estimated reliably, revenue is deferred until the amount of such expenses can be more reliably estimated or have been incurred
- In these circumstances, any consideration already received from the sale of goods is recognised as a liability

Example:

❖ Warranty costs

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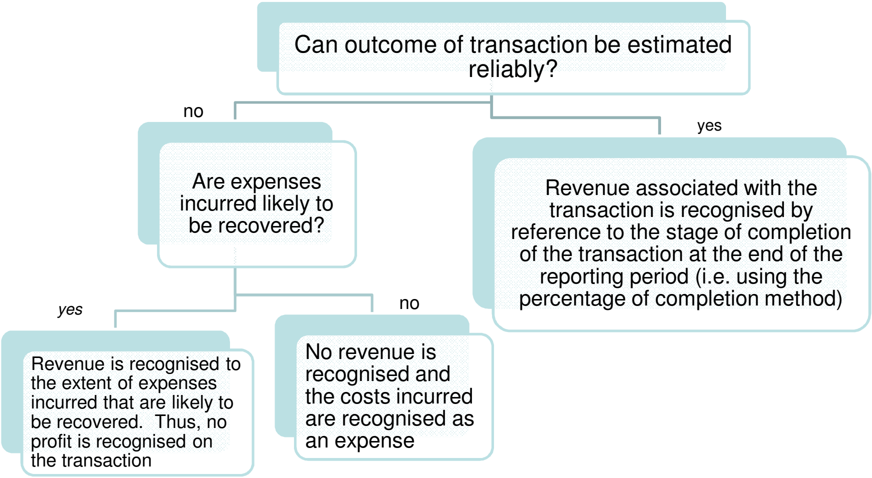
Recognition criteria – rendering of services



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Recognition criteria: rendering of services

Conditions for the outcome of a transaction to be estimated reliably (HKAS 18.20)

- Amount of revenue can be measured reliably
- Probable that the economic benefits associated with the transaction will flow to the entity
- Stage of completion can be measured reliably
- The cost incurred and to complete can be measured reliably

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Recognition criteria – rendering of services

HKAS 18.20 (a): Amount of revenue can be measured reliably

- An entity is usually able to make reliable estimate after it has agreed the following with the other parties to the transaction:
  - each party's enforceable rights regarding the service to be provided and received by the parties
  - the consideration to be exchanged; and
  - the manner and terms of settlement

Examples:

- membership fees
- performance-based fee part way through the performance period

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Example: Performance-based fee part way through the performance period

- Co A, an investment manager, will earn a bonus $1 million if a managed fund's performance exceeds the performance of the S&P 500 by 20% for the calendar year 2009
- Co A's financial year ends 30 June 2009. At that time, the fund is outperforming the S&P 500 by 25%
- Should the investment manager recognise revenue (bonus) at 30 June 2009 and if so, $500,000 (one-half year's worth) or $1M (the expected total hours)?

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Example: Performance-based fee part way through the performance period (cont'd)

Analysis:

- HKAS 18.20 states that revenue can be recognised when the amount of revenue can be measured reliably and it is probable that the economic benefits will flow to the entity
- The investment manager has not earned the bonus until the annual return exceeds the performance of the S&P 500 by 20%.As the markets are very volatile, the annual performance of the S&P 500 cannot be estimated reliably before the end of the year
- Consequently no amount of the bonus can be determined reliably before the bonus measurement date
- The fund manager should not recognise any of the bonus at 30 June 2009

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Recognition criteria – rendering of services

HKAS 18.20 (c): Stage of completion of the transaction at the end of the reporting period can be measured reliably

- The stage of completion of a transaction at the end of the reporting period can be determined in a number of ways
- Progress payments and advances received from customers are generally not reliable indicators of the stage of completion
- Depending on the nature of the transaction, methods for determining the stage of completion may include:
  - surveys of work performed
  - services performed to date as a percentage of total services to be performed; or
  - the proportion that costs incurred to date bear to the estimated total costs of the transaction

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Recognition criteria: Interest revenue

Interest revenue should be recognised using the effective interest method when:

It is probable that the economic benefits associated with the transaction will flow to the entity

and

The amount of the revenue can be measured reliably

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Recognition criteria: Interest revenue

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: Interest revenue

- An entity purchases $1M face value bonds for $1.03M on 1 April 2009. The bonds pay interest at 12% per annum on 31 December and 30 June each year
- The investor will receive $60,000 as interest for the period from 1 January 2009 to 30 June 2009, but only $30,000 of this is to be treated as interest revenue
- The entries to record the acquisition of the bond and the receipt of interest on 30 June 2009 will be as follows:

<u>On acquisition</u>			
DR	Investment	1000000	
DR	Interest receivable	30000	
CR	Cash		1030000
<u>Interest payment date</u>			
DR	Cash	60000	
CR	Interest		30000
CR	Interest receivable		30000

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Recognition criteria: Royalty income

Royalty revenue should be recognised on an accrual basis in accordance with the substance of the relevant agreement when (HKAS 18.29 & 30(b)):

It is probable that the economic benefits associated with the transaction will flow to the entity

and

The amount of the revenue can be measured reliably

Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regards to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis (HKAS 18.33)

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Example: Recognition of royalty income

- Purpose of most royalty agreements is to sell a right to use an entity's assets, such as trademarks, patents, and software, for a certain period of time

- Under royalty agreements, should revenue recognition be up front upon signing the agreement or should it be deferred and spread over the duration of the agreement?

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Example: Recognition of royalty income (cont'd)

Analysis:

- Appendix to HKAS 18 states that recognition of revenue under royalty agreements should be recognised in accordance with the substance of the arrangements
- It further clarifies that the overriding factor in determining the accounting treatment for such arrangement should be whether the licensor has any remaining obligation to perform
- The outcome of each arrangement depends on the circumstances
- **Typical examples: License to use a trademark**
  - revenue recognition should be deferred and spread over the license term by the seller if required the seller continue to ensure the quality of the trademark (ie, imposes a genuine performance obligation). Otherwise, revenue shall be recognised immediately

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Example: Recognition of royalty income (cont'd)

Analysis:

- **Typical examples: Software licensing arrangement**
  - Software licensing arrangements allow the licensee (customer) to use intellectual property
  - In the absence of any requirement that the licensor provide technical support, software upgrades or enhancements, a sale has occurred and revenue from the sale can be fully recognised upon delivery of the software license
  - If the licensor sells technical support or software upgrades together with the license, the arrangement should be analysed if it is a multiple-element arrangement. Revenue shall be recognised separately for each of the identified components

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Recognition criteria: Dividend revenue

Revenue should be recognised when:

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

In May 2008, the IASB issued amendments to HKFRS 1 *First-time Adoption of Hong Hong Financial Reporting Standards* and HKAS 27 *Consolidated and Separate Financial Statements* in respect of the cost of an investment in a subsidiary, jointly controlled entity or associate. For annual periods beginning on or after 1 January 2009, dividend revenue is recognised in profit or loss irrespective of whether it is declared from pre- or post-acquisition profits and separately, in some cases, it is necessary to consider whether the equity investment may be impaired

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Improvements to HKFRS 2009 relating to HKAS 18

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Improvements to HKFRS 2009 - Overview

HKFRS	Subject of Amendment	Amendments
HKAS 18	Determining whether an entity is acting as a principal or as an agent	• Additional guidance added to the appendix to HKAS 18 regarding the determination as to whether an entity is acting as a principal or an agent • Features include: primary responsibility for providing the goods and services, inventory risk, price determination and credit risk
HKAS 36	Unit of accounting for goodwill impairment test	• Clarify that the largest unit permitted for allocating goodwill acquired in a business combination is the operating segment as defined in HKFRS 8 before aggregation for reporting purposes

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HK(IFRIC) - Int 13

Customer Loyalty Programmes

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Scope of HK(IFRIC)- Int 13

- Customers buying goods or services are granted customer award credits (often described as "points") by the entity, which can be redeemed for awards such as free or discounted goods or services
- HK(IFRIC) – Int 13 "Customer Loyalty Programmes" addresses the accounting by the entity that grants award credits. It applies to customer loyalty award credit that:
  - entities grant to their customers as part of a HKAS 18 sale transaction; and
  - the customers can redeem in future for free or discounted goods or services, subject to meeting any further qualifying conditions

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Types of Customer Loyalty Programmes

- **Customers permit to redeem award credits when they have accumulated a specified minimum number or value**

For examples:
- Air mileage programme
- Credit card bonus points
- Family mart bonus point

- **Award credits may be linked to individual purchases or groups of purchases, or to continued custom over a specified period**

For examples:
- Discount vouchers granted for future spending with initial purchases

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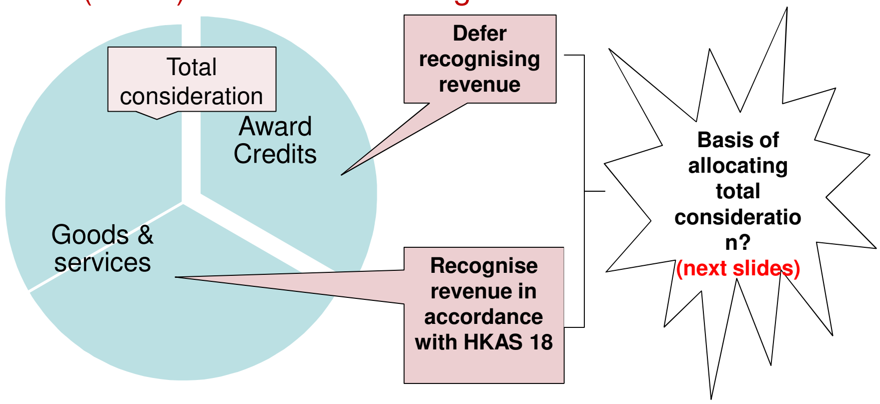
Items outside the scope of HK(IFRIC) – Int 13

Items	Within scope of HK(IFRIC) - Int 13?
• "money off" vouchers that are distributed free of charge	✕
• any sort of promotion that is not connected to sales of an entity's goods or services	✕
• the accounting for the award credits in the books of the customers	✕

HK(IFRIC) - Int13 : Accounting treatment



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HK(IFRIC) - Int 13 Accounting treatment

Customer award credit granted on sales of goods and services

↓

Can the consideration allocated to the award credits be measured by reference to their fair value, being the amount for which the award credits could be sold separately?

Yes ↓

Allocate some of the consideration from the sale transaction to the award credits by reference to its fair value and defer the recognition of that revenue

No →

- Can make reference to the fair value of the awards for which they could be redeemed
- That fair value is adjusted to take into account the fair value of awards that would be offered to customers who have not earned award credits from an initial sale transaction and the proportion of the award credits not expected to be redeemed
- Allocate the consideration by reference to the estimated fair value and defer recognition

↓

Recognise its share of revenue allocated to the award credits when it has fulfilled its obligations in respect of the award credits

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Example: Measuring the fair value of award credits

- Visitors to Supermarket B can pickup a voucher entitling them to a reduction of $1 off the price of Product X, irrespective of whether they make any purchases
- Customers who make a purchase receive a voucher entitling them to a reduction of $5 off the price of Product X
- Only one voucher can be used for any purchase of Product X

Analysis

- The $1 vouchers are outside the scope of HK(IFRIC)- Int 13 because they are distributed free of charge
- In assessing the fair value of the $5 vouchers for the purposes of HK(IFRIC)- Int 13, Supermarket B will take into account both the number of vouchers not expected to be redeemed and $1 voucher
- Although the $5 vouchers are not sold separately, logically no customer would pay more than $4 for such a voucher because it would be cheaper to buy Product X using one of the free $1 vouchers
- Thus, the fair value of the $5 vouchers would not exceed $4 and may be considerably lower depending on the proportion of vouchers expected to be redeemed

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Example: Measuring the fair value of award credits

If there is a range of awards that customers may choose from, how should be fair value be measured?

Analysis

If there is a range of awards that customers may choose from, the fair value of the award credits will reflect the fair value of the range of available awards, weighted in proportion to the frequency with which each award is expected to be selected (HK(IFRIC) – Int 13.AG2)

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Method for fair value allocation to award credits

Obtain the fair value of (i) goods and services and (ii) credit awards

↓

Management must apply judgement in deciding to select one or other method

↓

- The amount allocated to the award credits should be equal to their fair value (irrespective of the fair values of the other components)
- A proportion of the total consideration based on the relative fair value of the award credits to the fair values of the other components of the sale

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Example: Valuing award credits

- Customers buying Product A from Company X for $100 receive an award credit. This award credit can be used to:
  1) obtain Product B free of charge (regular price $5)
  2) purchase Product C at a discounted price of $10 (regular price $17)
- Company X estimated that 60% of customers will select Product B, and 40% will select Product C
- The normal selling price of Product A is $95
- **How should Company X allocate its credit award revenue?**

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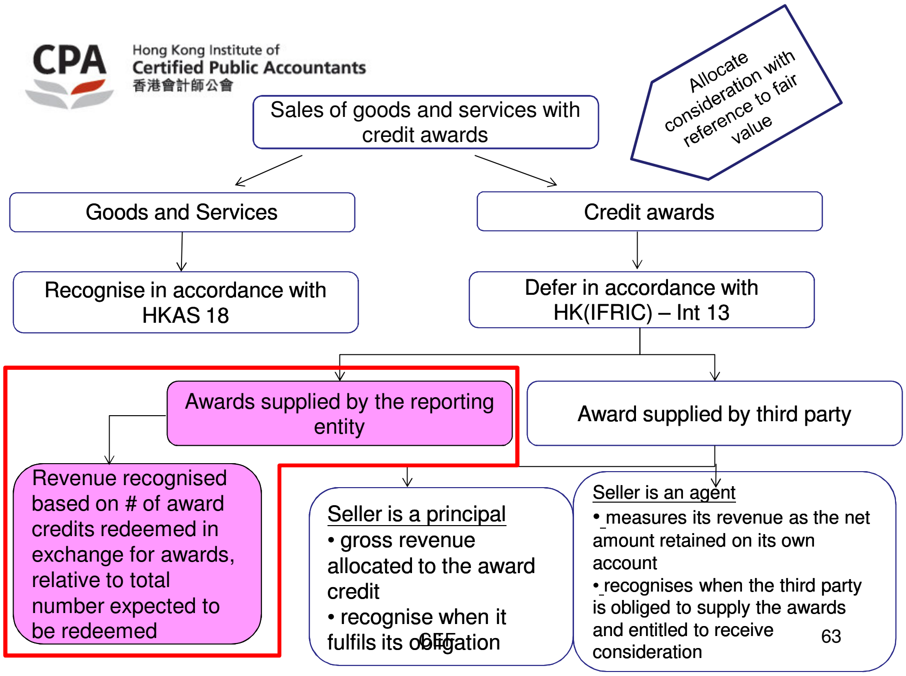
Example: valuing award credits

Valuing award credits by reference to goods and services that may be selected

- The fair value of the award credit may be estimated as:
(60% x $5) + (40% x [$ 17 - $ 10]) = $ 5.80
- Revenue recognised for Product A is = $ 100.00 - $ 5.80 = $ 94.20 。

Valuing award credit by reference to relative fair values

❑ The total revenue of $100 is allocated between Product A and the award credit by reference to their relative fair values of $95 and $5.8 respectively. Accordingly:
- Revenue for Product A = $100 x ($95 ÷[$ 95 + $ 5.80]) = $94.25
- Revenue for award credit = $100 x ($ 5.80 ÷[$ 95 + $ 5.80]) = $5.75



Award supplied by the reporting entity

- When the entity will supply the awards itself, it recognises the consideration allocated to award credits as revenue when award credits are redeemed and it fulfils its obligations to supply awards
- The amount of revenue recognised is based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed
  - The entity may revise its expectation about the proportion that the award credits will be redeemed and is accounted for as a change in estimation in the period of change and future periods, in accordance with HKAS 8.36
  - If there are changes in expectations regarding redemption rates or revised cost expectations, for the unavoidable costs of meeting award obligations to exceed the consideration received and receivable for them, the entity has onerous contracts and a liability will be needed for the excess in accordance with HKAS 37

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Examples: Awards supplied by the reporting entity

- A grocery retailer operates a customer loyalty programme
- It grants programme members loyalty points when they spend a specified amount on groceries
- Programme members can redeem the points for further groceries. The points have no expiry date.
- In one period, the entity grants 100 points
- Management expects 80 of these points to be redeemed
- Management estimates the fair value of each loyalty point to be $1 and defers revenue of $1
- In the 2nd and 3rd year, management expects 90 points to be redeemed
- Points redeemed by the customers in 1st, 2nd & 3rd years are 40 points, 41 points and 9 points
- **How much deferred credit should be recognised as revenue each year?**

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Analysis

Year 1

Revenue recognised = (40 points/ 80 points) x $100 = $50

Year 2

Cumulative revenue recognised = (81points/90points) x $100 = $90
Revenue recognised in year 2 = $90 - $50 = $40

Year 3

Management continues to expect that only 90 points will be redeemed, i.e., no more points will be redeemed after the third year. Therefore:
Cumulative revenue recognised = (90 points/90 points)x $100 = $100
Revenue recognised in the 3rd year = $100 - $90 = $10

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Sales of goods and services with credit awards

Allocate consideration with reference to fair value

Goods and Services

Recognise in accordance with HKAS 18

Credit awards

Defer in accordance with HK(IFRIC) – Int 13

Awards supplied by the reporting entity

Revenue recognised based on # of award credits redeemed in exchange for awards, relative to total number expected to be redeemed

Award supplied by third party

Seller is a principal
- gross revenue allocated to the award credit
- recognise when it fulfils its obligation

Seller is an agent
- measures its revenue as the net amount retained on its own account
- recognises when the third party is obliged to supply the awards and entitled to receive consideration

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Awards supplied by third party

If a third party supplies the award, the entity required to assess whether

it is collecting the consideration on its own accounts

- Measures its revenue as the gross consideration allocated to the award credits and recognises the revenue when it fulfils its obligations in respect of the awards

it is collecting the consideration on behalf of 3rd party

- Measures its revenue as the net amount retained on its own account, ie, the difference between the consideration allocated to the award credit and the amount payable to the third party for supplying the awards; and
- Recognises this net amount as revenue when the third party is obliged to supply the awards and entitled to receive consideration for doing so

Example: Awards supplied by a third party

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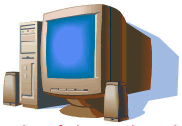


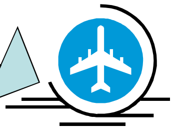
A retailer of electrical goods participates in a CLP operated by an airline

The retailer grants programme members one air travel point with $1 they spend on electrical goods. Programme members can redeem the points for air travel with the airline

Customers

Programme members redeem the points for air miles

The retailer pays the airline $0.009 for each point



- The retailer sells electrical goods for consideration totally $1M. It grants 1M points
- The retailer estimates the fair value is $0.01 and allocate to the points 1 million X $0.01 = $10,000 of the consideration it has received from the sales of its electrical goods
- **How should the retailer recognised revenue?**

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Example: Awards supplied by a third party (cont'd)

- Having granted the points, the retailer has fulfilled its obligations to the customer.
- The airline is obliged to supply the awards and entitled to receive consideration for doing so.
- Therefore the retailer recognises revenue from the points when it sells the electrical goods.

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Example: Awards supplied by a third party (cont'd)

- If the retailer has collected the consideration allocated to the points **on its own account**, it measures its revenue as the **gross** $10,000 allocated to them.
- It separately recognises the $9,000 paid or payable to the airline as an expense.
- If the retailer has collected the consideration **on behalf of the airline, i.e. as an agent for the airline, it measures** its revenue as the **net** amount it retains on its own account.
- This amount of revenue is the difference between the CU10,000 consideration allocated to the points and the CU9,000 passed on to the airline.

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Thank you for your attention

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

YOUR HOSTS

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HKFRS 8
Operating Segments

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Replacement of HKAS 14 by HKFRS 8 *Operating Segments*

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Objective

- HKFRS 8 defines segments base on the structure of the entity's internal organisation with an aim to allow the financial statements users be able **to see the entity "through the eyes of management"**
- HKFRS 8 requires segment disclosure based on the components of the entity that management monitors in making decisions about operating matters – the **"management approach"**

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Agenda

- Core principle
- Scope
- Chief operating decision maker
- Operating segments
- Reportable segments
- Segment information
- Disclosure
- Measurement of segment information

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]

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.BC23]

- 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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Five Steps Approach

Step 1	Identification of the CODM
Step 2	Identification of operating segment
Step 3	Aggregation of operating segment
Step 4	Determination of reportable segment
Step 5	Segment disclosure information

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Step 1: Identification of chief operating decision maker

- **"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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Step 2: Identification of operating Segments

- Operating segments are identified based on the way in which financial information is organised and reported to the CODM

- 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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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** [HKFRS 8]

- 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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Step 3: Aggregation of operating segments

- **Two or more operating segments may be aggregated** into a single operating segments when they are similar in the following respects:

  (i) it 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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Step 4: 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 per cent** 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 percent 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

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Reportable Segments (cont'd)

Quantitative Thresholds (cont'd)

- The segment's **assets** are **10 per cent or more** of the **combined assets of all operating segments**

- 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 percent 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 percent 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 per cent revenue threshold

- Company J has determined its reportable segments in accordance with HKFRS 8 and has noted that the reportable segments constitute 68 per cent of consolidated revenue. All remained operating segments are of similar size. How should Company J determine which operating segments to report separately?

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Reportable Segments (cont'd)

Example: Identification of additional segments to reach 75 per cent revenue threshold (cont'd)

- HKFRS 8 does not specify which of the remaining operating segments should be selected to achieve the 75 per cent 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 per cent 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 [HKFRS 8.16]
- The sources of the revenue included in the "all other segments" category shall be described [HKFRS 8.16]

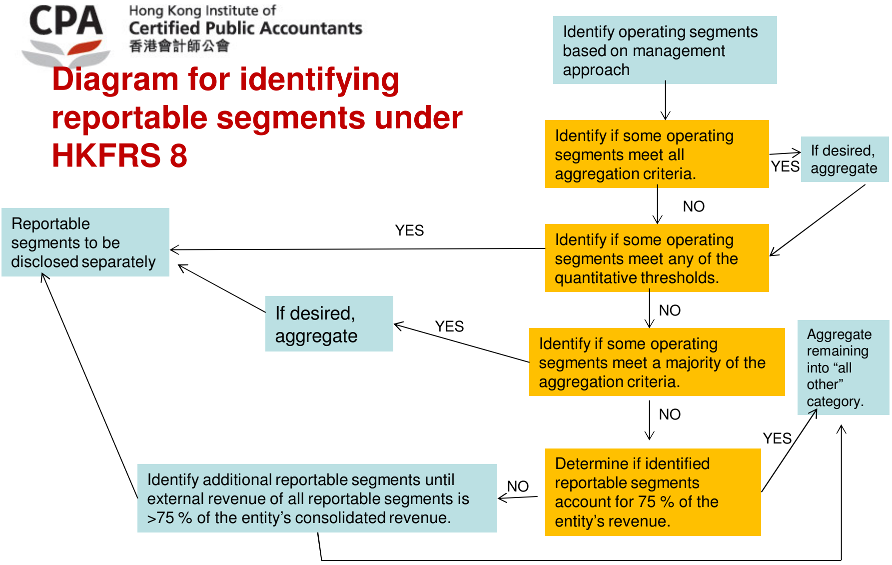
Reportable Segments (cont'd)

Practical limit of number of reportable segment

- There may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed

- Although no precise limit has been determined, as the number of segments that are reportable increases above ten, the entity should consider whether a practical limit has been reached [HKFRS 8.19]

Diagram for identifying reportable segments under HKFRS 8



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Disclosures

Annual disclosures

- Disclose for each period in the statement of comprehensive income as follows:
  - **General information e.g. how to identify the entity's reportable segments;**
  - **Information about profit or loss, assets and liabilities; and**
  - **Reconciliation disclosures**

- **HKFRS 8 does not provide any exemptions from the required disclosures du to "competitive harm"**

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Disclosures

General information

- An entity shall disclose the following **general information** on the reportable segments: [HKFRS 8.22]

  a) **factors used to identify the entity's reportable segments**, including the basis of organisation (e.g., whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated), **and**

  b) **types of products and services from which each reportable segment derives its revenues**

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Disclosures (Cont'd)

Profit or loss, assets and liabilities

- **For each reportable segment, entities are required to report a measure of profit or loss** [HKFRS 8.23]
- Entities are required to report a measure of **total assets and liabilities for each reportable segment** if such an amount is regularly provided to the chief operating decision maker [HKFRS 8.23]

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Disclosures (cont'd)

Profit or loss, assets and liabilities (cont'd)

- An entity shall also disclose …{amounts specified in HKFRS 8.23(a) to (i), see next slide….}about each reportable segment **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** [HKFRS 8.23]

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Disclosures (cont'd)

Profit or loss, assets and liabilities (cont'd)

[HKFRS 8.23]

- revenues from external customers;
- revenues from transactions with other operating segments of the same entity;
- interest revenue;
- interest expense;
- 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 (cont'd)

Interest revenue and interest expense

[HKFRS 8.23]

- 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 (Cont'd)

Segment assets

[HKFRS 8.23, 25]

- 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**
- Total segment assets or total identifiable assets by segment are not necessarily measures used by the CODM to assess performance and to make resource allocation decisions
- **Only those assets that are included in the measure of the segment's assets that is used by the CODM should be reported for that segment**

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Disclosures (cont'd)

Segment assets (cont'd)

[HKFRS 8.24]

- ❑ The following information should be disclosed by each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the CODM, or are otherwise provided regularly to the CODM even if not included in the determination of segment assets:
  - **Equity accounted investees; and**
  - **Additions to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets; and rights arising under insurance contracts**

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Disclosures (cont'd)

Segment assets (cont'd)

[HKFRS 8.27(f)]

- It is possible that a component of an entity could qualify as an operating segment and have no asset information about it reported to the CODM. Disclose that fact and reason if no asset information is provided for a reportable segment

- **HKFRS 8 requires disclosure of the nature and effect of any asymmetrical allocation**

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Disclosures (cont'd)

Segment assets (cont'd)

[HKFRS 8.23, 24, 28]

- **Jointly controlled entities and associates**
  - The segment information to be disclosed for an investee that is a reportable segment should be consistent with the concept of the management approach and the core principle of HKFRS 8
  - The segment information that is disclosed should be determined on the same basis as it is reported to the CODM

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Disclosures (cont'd)

Segment assets (cont'd)

[HKFRS 8.23, 24, 28]

- **Jointly controlled entities and associates (cont'd)**
  - 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 (cont'd)

Segment assets (cont'd)

[HKFRS 8.23, 24, 28]

- **Jointly controlled entities and associates (cont'd)**
  - In situations in which the CODM only receives information about the investee that represents the entity's proportionate share in the investee's revenue, profits or loss, assets and other information
  - In those instances, the entity may disclose the segment information of the investee using the proportionate amounts

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Measurement

General principles

[HKFRS 8.25]

- The amount of each segment item reported shall be **the measure reported to the chief operating decision maker** for the purposes of making decisions about allocating resources to the segment and assessing its performance

- Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses shall be included in determining reported segment profit or loss **only if** they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker

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Measurement (cont'd)

General principles (cont'd)

[HKFRS 8.25]

- Similarly, only those assets and liabilities that are included in the measures of the segment's assets and segment's liabilities that are used by the chief operating decision maker shall be reported for that segment

- **If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts shall be allocated on a reasonable basis**

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Measurement (cont'd)

Explanation of measurement basis

[HKFRS 8.27]

- An entity shall provide **an explanation of the measurements** of segment profit or loss, segment assets and segment liabilities for each reportable segment
- At a minimum, an entity shall disclose:
  - the **basis of accounting for any transactions** between reportable segments;
  - the **nature of any differences, if not apparent from the reconciliations,** between the measurements of
    - (i) the reportable segments' profits or losses and the entity's profit or loss before income tax;
    - (ii) the reportable segments' assets and the entity's assets;
    - (iii) the reportable segments' liabilities and the entity's liabilities;

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Measurement (cont'd)

Explanation of measurement basis (cont'd)

[HKFRS 8.27]

- the **nature of any changes from prior periods** in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss;
- the nature and effect of any asymmetrical allocations to reportable segments. (For example, an entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.)

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Measurement (cont'd)

Example: Performance measure when different inventory valuation methods

- An entity that operates a chain of grocery stores uses the weighted average cost formula method of assigning costs to inventory and cost of goods sold for financial reporting purposes, but the reports provided to the chief operating decision maker use last-in, first-out (LIFO) for evaluating the performance of segment operations

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Measurement (cont'd)

Example: Performance measure when different inventory valuation methods (cont'd)

- 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 chief operating decision maker determines which measure is used for the HKFRS 8 operating segment note

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Measurement (cont'd)

Reconciliations

[HKFRS 8.28]

- An entity shall provide **reconciliations of all of the following**:
  - the total of the reportable segments' revenues to the entity's revenue
  - the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations
  - the total of the reportable segments' assets to the entity's assets.
  - the total of the reportable segments' liabilities to the entity's liabilities, if segment liabilities are reported
  - the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity

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Measurement (cont'd)

Reconciliations (cont'd)

[HKFRS 8.28]

- All material reconciling items shall be separately identified and described
- **Example:** the amount of each material adjustment needed to reconcile total reportable segment profit or loss to the entity's profit or loss arising from different accounting policies shall be separately identified and described

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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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Entity-wide disclosure

- **Entity-wide disclosures related to the following items are required, regardless of whether the information is used by the CODM in assessing segment performance [HKFRS 8.31-34]**
  - Revenue from external customers for products and services
  - Revenue from external customers by geographical areas
  - Geographical information about non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising from insurance contracts

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Entity-wide disclosure

Information about products and services
[HKFRS 8.32]

- An entity shall **report the 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

- 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)

Information about geographical areas [HKFRS 8.33]

- Unless the necessary information is not available and the cost to develop it would be excessive, an entity shall **report geographical information on revenues from external customers attributed to:**
  - **the entity's country of domicile; and**
  - **all foreign countries in total from which the entity derives revenues**
- If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately
- An entity shall **disclose the basis for attributing revenues** from external customers to individual countries

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Entity-wide disclosure (cont'd)

Information about geographical areas (cont'd)
[HKFRS 8.33(b)]

- Unless the necessary information is not available and the cost to develop it would be excessive, an entity shall **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 in which the entity holds assets**
- If assets in an individual foreign country are material, those assets shall be disclosed separately

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Entity-wide disclosure (cont'd)

Information about major customers
[HKFRS 8.34]

- **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 per cent or more** of an entity's revenues, the entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues

- The entity **need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer**

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Entity-wide disclosure (cont'd)

Information about major customers (cont'd)
[HKFRS 8.34]

- For the purposes of HKFRS 8, a group of entities known to a **reporting entity to be under common control** shall be considered a single customer, and **a government** (national, state, provincial, territorial, local or foreign) and **entities known to the reporting entity to be under the control of that government** shall be considered a single customer

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Entity-wide disclosure (cont'd)

Information about major customers (cont'd)
[HKFRS 8.34]

- For the purposes of HKFRS 8, a group of entities known to a **reporting entity to be under common control** shall be considered a single customer, and **a government** (national, state, provincial, territorial, local or foreign) and **entities known to the reporting entity to be under the control of that government** shall be considered a single customer

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Major differences between HKFRS 8 and SFAS 131

Difference	HKFRS 8	SFAS 131
Non-current assets versus long-lived assets	Non-current assets under IFRSs include intangible assets, therefore they are required to be disclosed if regularly provided to and/or considered by the CODM.	Long-lived assets implies hard assets that cannot be readily removed, which would appear not to include intangible assets; therefore there is no explicit requirement to disclose intangible assets.
Segment liabilities	Segment liabilities are disclosed if regularly provided to and/or considered by the CODM.	No requirement to disclose segment liabilities.

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Major differences between HKFRS 8 and SFAS 131 (cont'd)

Difference	HKFRS 8	SFAS 131
Entities with a matrix form of organization	Operating segments are determined based on the core principle of HKFRS 8.	Operating segments are determined based on products and services.
Extraordinary items	The concept of extraordinary items was eliminated from IFRSs in 2003	Extraordinary items are required to be disclosed, if regularly provided to and/or considered by the CODM.

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

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Accounting for properties

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Different types of properties

How to account for a property under applicable HKFRS?

- Depends on the purpose and management's intention of holding the property
- Normally, all self-owned properties will be classified as follows:
  - Own use property
  - Property held to earn rental or capital appreciation
  - Property held for sale
  - Hotel property

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Different types of properties

How to account for a property under applicable HKFRS?

- Depending on the types of properties, the appropriate accounting standards that apply are as follows:

Types of properties	Accounting standards
Own use property	HKAS 16 PPE
Property held to earn rental or capital appreciation	HKAS 40 Investment property
Property held for sale	HKAS 2 Inventories
Hotel property	Depends

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Part 1 : Own use properties

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HKAS 16 - Scope

In-scope	Out of scope
• are held for use in production or supply of goods or services, or for administrative purposes; and • are expected to be used during more than one period	• Assets held under leases (HKAS 17 "Leases") • Property, plant and equipment classified as held for sale (HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations") • Biological assets related to agricultural activity (HKAS 41 "Agriculture") • Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources • property being constructed or developed for future use as investment property

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General Recognition Criteria

The recognition criteria are:

- ❐ **Derived from the general principles for asset recognition established by the "Framework for the Preparation and Presentation of Financial Statements"**
- ❐ **An item of property, plant and equipment is to be recognised as an asset if, and only if:**

It is probable that future economic benefits associated with the asset will flow to the entity

The cost of the asset to the entity can be measured reliably

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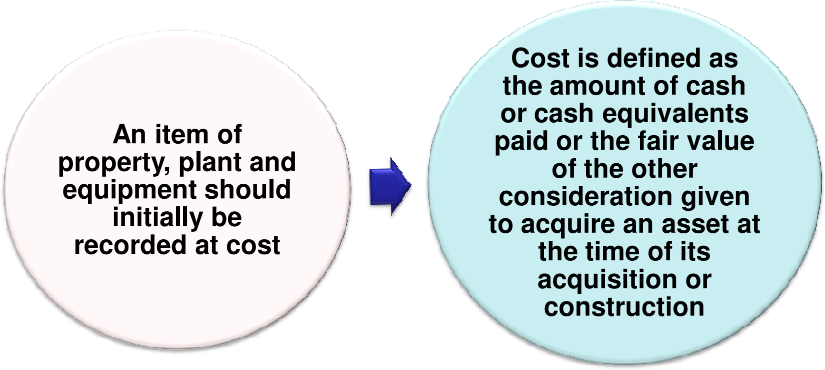
Measurement at recognition



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Elements of cost

In the case of an acquired asset, cost comprises:

- The purchase price, including import duties and non-refundable purchase taxes after deducting trade discounts and rebates;
- Any directly attributable costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, and
- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located (this element will be included only when, and to the extent that, the entity has an obligation to dismantle and remove the asset, and has therefore set a provision in accordance with HKAS 37 *Provisions, Contingent liabilities and Contingent Assets*)

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Recognition – Subsequent costs

- **General recognition criteria (i.e., inflow of future economic benefits probable and cost of entity measured reliably)**
  If the recognition criteria are met → the expenditure will be added to the carrying amount of the PPE
  If the recognition criteria are not met → the expenditure will be expensed when incurred

Questions:

- Repair and maintenances, e.g. repair of heating and electrical system?
- Replacement parts, e.g. replacement of elevators or water system?
- Major inspection ?

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Measurement of cost – Payments deferred beyond normal credit terms

- When payment for an item of property, plant and equipment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payments: [HKAS 16.23]
  → Recognised as an interest expense over the period of credit, unless it can be capitalised in accordance with HKAS 23 "Borrowing Costs"

- **Normal credit terms:**
  The "normal credit terms" provision is intended to recognise that settlement of cash purchases often takes a few days, weeks, or even months (depending on the industry and national laws), and imputation of interest is not required in those circumstances

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Measurement of cost – Exchange of assets

- Where an item of property, plant and equipment is acquired in exchange for a non-monetary asset, or a combination of monetary and non-monetary assets, the cost of that item is measured at fair value (even if the entity cannot immediately derecognise the asset given up) unless

  [HKAS 16.24]
  - the exchange transaction lacks commercial substance; or
  - the fair value of neither the asset received nor the asset given up is reliably measurable
- If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up

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Measurement basis of asset exchanged

Can fair value be reliably measured?		Basis of measurement
Assets given up	**Assets received**	
Yes	No	Measured at the fair value of assets given up
No	Yes	Measured at the fair value of the assets received
Yes	Yes	Fair value of the asset given up is used to measure the cost of the asset received, unless the fair value of the asset received is more clearly evident
No	No	Measured at the carrying cost of the assets given up

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Determine whether an exchange transaction has commercial substance?

- Consider the extent to which its future cash flows are expected to change as a result of the transaction
- An exchange transaction has commercial substance if either: [HKAS 16.25]
  - ✓ The configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; **or**

    the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange (post-tax cash flows are used); **and**
  - ✓ the difference arising in either of the two circumstances outlined above is significant relative to the fair value of the assets exchanged

Note: Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability [HKAS 16.6]

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Fair value reliably measurable?

- The fair value of an asset for which comparable market transactions do not exist is reliably measurable if: [HKAS 16.26]
  - ➢ the variability in the range of reasonable fair value estimates is not significant for that asset; or
  - ➢ the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value

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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.

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]

Refer to HKFRS 13 for the definition of fair value upon the adoption of HKFRS 13

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Frequency of revaluations

- Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet
- Where items of property, plant and equipment have only insignificant changes in fair value, the Standard indicates that it may be necessary to revalue them only every three or five years [HKAS 16.34]

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Question：Accumulated depreciation at the date of revaluation

- A property has a carrying amount of HK$10M, represented by cost of HK$12M and accumulated depreciation of HK$2M. It is revalued to its fair value of HK$13M.
  - How would you adjust the cost and the accumulated depreciation of the property?

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Accumulated depreciation at the date of revaluation

HKAS 16.35 allows that any depreciation accumulated on an asset at the date of revaluation can be dealt with in one of two ways, i.e. either:

- **Method A (often used when an asset is revalued to its depreciated replacement cost by means of an index)**
  — restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. The carrying amount is increased to the revalued amount by restating the cost and depreciation proportionately
- **Method B (often used for buildings, and most commonly used in practice)**
  —eliminated against the gross carrying amount of the asset and the resulting net amount restated to the revalued amount of the asset. The accumulated depreciation is eliminated, and any remaining surplus is used to increase cost

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Example：Accumulated depreciation at the date of revaluation

A property has a carrying amount of HK$10M, represented by cost of HK$12M and accumulated depreciation of HK$2M. It is revalued to its fair value of HK$13M.

	Method A	Method B
	'000	'000
Cost or valuation		
Before revaluation	12,000	12,000
Revaluation adjustment	3,600*	1,000
After revaluation	15,600	13,000
Depreciation		
Before revaluation	2,000	2,000
Revaluation adjustment	600*	(2,000)
After revaluation	2,600	0
Revalued amount	13,000	13,000

*allocated in the ratio 12:2

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Revaluation to be made for entire class of assets

- When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belong is required to be revalued [HKAS 16.36]

  Reasons:
  1. to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and valuations at different dates [HKAS 16.38]
  2. to prevent the distortions caused by the selective use of revaluation (i.e., cherry-picking), so as to take credit for gains without acknowledging falls in the value of similar assets

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Revaluation Model – Surplus or Deficit arising from revaluation

Surplus [HKAS 16.39]

- When an asset's carrying amount is increased as a result of a revaluation, the increase (being the difference between the fair value at the date of revaluation and the carrying amount at that date) should generally be recognised in OCI and accumulated in equity under the heading of revaluation surplus [HKAS 16.39]
- A revaluation increase should be recognised as income, to the extent that it reverses a revaluation decrease of the same asset previously recognised as an expense [HKAS 16.39]
- When a revaluation surplus is recognised, no amendment is made to profit or loss to reverse depreciation previously charged

Deficit [HKAS 16.40]

- When an asset's carrying amount is decreased as a result of a revaluation, the decrease should generally be recognised as an expense [HKAS 16.40]
- A revaluation decrease should be recognised in OCI, to the extent of any credit balance existing in the revaluation surplus in respect of that same asset [HKAS 16.40]

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Example：Treatment of revaluation movement

- An entity purchased a property on 1 July 20X1 for HK$140M. At 31 December 20X1, the property was valued at HK$125M. At 31 December 20X2, the fair value of the property had increased to HK$150M
  - **How should the entity account for these changes?**

20X1.12.31： Revaluation deficit of HK$15M (HK$140M – HK$125M) is charged to the profit or loss

20X2.12.31： Revaluation surplus (HK$150M – HK$125M) is treated as follows:
- HK$15M is credited to the profit or loss (i.e. reversal of the previous deficit)
- HK$10M is credited to OCI and accumulated in the revaluation reserve in equity

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Example : Treatment of revaluation movement

- An entity purchased a property on 1 July 20X1 for HK$60M. At 31 December 2008, 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?**

20X1.12.31: Revaluation surplus of HK$10M is credited to OCI and accumulated in the property revaluation reserve within equity

20X2.12.31: Revaluation deficit is treated as follows:
- HK$10M is debited to the OCI and reduce the property revaluation reserve within equity (i.e. reversal of the previous surplus)
- HK$5M is charged to the profit or loss (i.e. excess of deficit over available surplus attributable to the same property)

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Utilisation of revaluation reserve

- The entity had a choice of utilisation of revaluation reserve
  - Opt to utilise ➔directly transferred to retained earnings (should not made through the profit or loss):
    - When the asset is derecognised (on retirement or disposal); OR
    - Transferred over the period for which the asset is used by the entity (the amount of the reserve transferred is the difference between the depreciation charge based on the revalued carrying amount of the asset and the depreciation charged based on the asset's original cost)
  - Opt not to utilise ➔ the revaluation surplus may be left in equity under the heading revaluation surplus

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Depreciation

- The depreciation charge for each period should be recognised in profit or loss, unless it qualifies to be capitalised in the carrying amount of another asset [HKAS 16.48]
- In order to comply with HKAS 16 relating to depreciation, it is necessary to identify:
  - the parts (components) of each item of PPE that are depreciated separately;
  - the cost or valuation of each separately depreciable component;
  - the estimated residual value of each separately depreciable component;
  - the length of time during which the component will be commercially useful to the entity; and
  - the most appropriate depreciation method for each separately depreciable component

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Each significant component to be depreciated separately

- **Significant components/parts:** an item of PPE or those separately identifiable components of the item with a cost that is significant to the total cost of the item should be depreciated separately [HKAS 16.43-44]

  What can be the significant components/parts of a property?
  - ✓ Structural design
  - ✓ Membrane
  - ✓ Exterior doors and windows
  - ✓ Interior walls, doors, windows
  - ✓ Heating and other technical systems
  - ✓ Sanitary facilities etc.

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Each significant component to be depreciated separately

- **Group of components:** There may be a number of significant parts which, although separately identifiable, have the same useful life and which are appropriately depreciated using the same depreciation method. Such items will generally be grouped together for the purposes of calculating the depreciation charge [HKAS 16.45]

- **Insignificant components:** The Standard allows the individually insignificant parts can be depreciated as a group, provided that the depreciation rate and method selected result in a faithful representation of the pattern of consumption of benefits [HKAS 16.46]

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Residual Value

Definitions:

The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life **[HKAS 16.6]**

- The residual value of an asset is required to be reviewed at least at each financial year end [HKAS 16.51]
- The revised estimate should be based on market conditions current at the financial reporting date
- Where the revised estimate differs significantly from previous estimates of residual value, the effect is accounted for prospectively as a change in estimate
- The depreciation charge over the remaining useful life of the asset is adjusted to take account of the revised estimate of residual value
- Where the revised estimate of residual value is equal to or greater than the asset's carrying amount (whether due to inflation or otherwise), then the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount [HKAS 16.54]

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Depreciation - Others

Estimates of useful lives

- The useful life of an asset is defined as: [HKAS 16.6]
  - the period over which an asset is expected to be available for use by an entity; or
  - the number of production or similar units expected to be obtained from the asset by an entity

- Factors impacting the useful life of an asset:
  - the expected usage of the asset
  - the expected wear and tear
  - technical or commercial obsolescence
  - legal or similar limits on the use of the asset

- Estimate of the useful life of an item of property, plan and equipment should be reviewed at each financial year-end
  - If expectations differ from previous estimates, the change is accounted for as a change in accounting estimates [HKAS 16.51]
  - A significant reduction in the estimated useful life of an asset may indicate that the asset has been impaired

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Depreciation - Others

Commencement of depreciation

- Depreciation of an asset commences when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management [HKAS 16.55]

- This is the same point in time at which the entity is required to cease capitalising costs within the carrying amount of the asset

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Depreciation - Others

Cessation of depreciation

- Depreciation of an asset ceases at the earlier of:
  - the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations"; and
  - the date that the asset is derecognised
- Unless the asset is fully depreciated, depreciation of an asset does not cease when an asset becomes idle or is retired from active use
  - where the depreciation charge is calculated by reference to the usage of the asset, while there is no production ➔ depreciation charge may be zero [HKAS 16.55]
  - when an asset becomes idle, or is retired from active use, this may trigger an impairment loss which may reduce the carrying amount to estimated recoverable amount

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Method of depreciation

Principal:
The depreciation method used should be that which reflects most closely the pattern in which the asset's economic benefits are expected to be consumed by the entity [HKAS 16.60]

- **Method:**
  - most commonly used: straight-line method & the reducing balance method
  - more accurately matches costs with revenue: unit of production method (commonly used in the oil, gas and other extractive industries)

- The depreciation method applied to an item of property, plant and equipment should be reviewed at least at each financial year-end
  - Except where there is a change in the expected of consumption of economic benefits embodied in the asset, the depreciation method adopted should be applied consistently from period to period
  - If there has been a significant change in the expected pattern of consumption of benefits, the depreciation method is changed to reflect the changed pattern

- A change of depreciation method constitutes a change in accounting estimate
  - the carrying amount of the asset is written off using the new method over the remaining useful life, commencing with the period in which the change takes place
  - Separate disclosure of the impact of the change will be required if the change has a material effect in the current period or is expected to have a material effect in subsequent periods

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Depreciation of particular classes of asset

Freehold Land

- Freehold land that is not subject to depletion (e.g. by the extraction of minerals) does not have a limited useful life and, therefore, should not be depreciated
- Where freehold land is purchased, it is necessary to allocate the purchase consideration between the value of the land and the building
- Any revaluations of freehold property should distinguish between land and building

- Where the cost of site dismantlement, removal and restoration is included in the cost of land, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs
- In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it [HKAS 16.59]

- Where the value of freehold land is adversely affected by long-term environmental factors, an impairment loss should be recognised to reflect any decline in its estimated recoverable amount below its carrying amount

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Depreciation of particular classes of asset (cont'd)

- The estimated useful lives are usually significantly longer than other items of PPE
- Depreciation method: generally using straight-line method
- HKAS 16 emphasises that an increase in the value of the land on which a building stands does not affect the determination of the useful life of the building [HKAS 16.58]

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Derecognition

- The carrying amount of an item of PPE should be derecognised:
  - On disposal; or
  - When no future economic benefits are expected from its use or disposal
- The gain or loss arising on the derecognition of an item of PPE must be included in profit or loss when the amount is derecognised (prohibits classification as revenue)
  - The standard requires the date of disposal of an item of PPE be determined using the criteria for recognising revenue from the sale of goods, as set out in HKAS 18 "Revenue"
  - Except for sales and leaseback where HKAS 17 would apply
- Where a revalued asset is disposed of, any credit balance on the revaluation reserve attributable to that asset may be transferred directly to retained earnings (such transfer is not mandatory), but must not be reflected in profit or loss

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Disclosures

For each class of PPE, should disclose

- Measurement bases (i.e. cost or valuation) to determine the gross carrying amount;
- Depreciation methods used;
- Useful lives or the depreciation rate used
- Gross carrying amount and the accumulated depreciation at the beginning and end of the period; and
- Reconciliation of the carrying amount at the beginning and end of the period
- Existence and amounts of restrictions on title & PPE pledged as security for liabilities;
- Amount of expenditures recognised in the carrying amount of an item of PPE in the course of construction;
- Amount of contractual commitments for acquisition of PPE; and
- If not disclosed separately in the statement of comprehensive income, the amount of compensation from third parties for items of PPE that were impaired, lost or given up that is included in profit or loss

Reconciliation

- Additions;
- Assets classified as held for sale or included as a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals'
- Acquisitions through business combinations;
- Increases or decreases resulting from revaluations and from impairment losses recognised or reversed in other comprehensive income;
- Impairment losses recognised/reversed in P/L during the period
- Depreciation;
- Net exchange differences arising on the translation of the F/S from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and
- Other changes

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Deleted and refer to HKFRS 13 upon the adoption of HKFRS 13

Disclosure (cont'd)

- For items of PPE stated at revalued amounts, the entity is required to disclose [HKAS 16.77]
  - The effective date of the revaluation;
  - Whether an independent valuer was involved
  - The methods and significant assumptions applied in estimating the items' fair values;
  - The extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques;
  - For each revalued class of PPE, the carrying amount that would have been recognised had the assets been carried under the cost model; and
  - The revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders

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Additional recommended disclosures

- HKAS 16.79 also encourages but does not require the disclosure of the following information:
  - the carrying amount of temporarily idle property, plant and equipment;
  - the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;
  - the carrying amount of property, plant and equipment retired from active use and not classified as held for sale in accordance with HKFRS 5 "Non-current Assets Held for Sale and Discontinued Operations"; and
  - when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount

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Part 2: Investment Property

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Definition of Investment Property

- Investment property is property (land or a building or part of a building or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both. [HKAS 40.5]

Examples of investment property: [HKAS 40.8]

- land held for long-term capital appreciation
- land held for undetermined future use
- building owned by the entity and leased out under one or more operating leases
- vacant building held to be leased out under an operating lease
- property that is being constructed or developed for future use as investment property

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Definition of Investment Property

- The following are not investment property and, therefore, are outside the scope of HKAS 40: [HKAS 40.5 and 40.9]
  - property held for use in the production or supply of goods or services or for administrative purposes
  - property held for sale in the ordinary course of business or in the process of construction of development for such sale (HKAS 2 *Inventories*)
  - property being constructed or developed on behalf of third parties (HKAS 11 *Construction Contracts*)
  - owner-occupied property (HKAS 16 *Property, Plant and Equipment*), including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees and owner-occupied property awaiting disposal
  - property leased to another entity under a finance lease

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Other Classification Issues

Questions:

How should we classify the following properties?

1. Part of the property unit is for own use as office and part of the property unit is leased out to a third party.

2. The property is leased to a fellow subsidiary of the group.

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Other Classification Issues

- **Partial own use.** If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. Therefore the part that is rented out is investment property. If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant. [HAS 40.10]

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Other Classification Issues

- **Intracompany rentals.** Property rented to a parent, subsidiary, or fellow subsidiary is not investment property in consolidated financial statements that include both the lessor and the lessee, because the property is owner-occupied from the perspective of the group. However, such property could qualify as investment property in the separate financial statements of the lessor, if the definition of investment property is otherwise met. [HKAS 40.15]

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Recognition

- Investment property should be recognised as an asset when it is probable that the future economic benefits that are associated with the property will flow to the entity, and the cost of the property can be reliably measured. [HKAS 40.16]

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Initial measurement

- Investment property is initially measured at cost, including transaction costs. Such cost should not include start-up costs, abnormal waste, or initial operating losses incurred before the investment property achieves the planned level of occupancy. [HKAS 40.20 and 40.23]

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Measurement subsequent to initial recognition

- HKAS 40 permits entities to choose between: [HKAS 40.30]
  - a fair value model, and
  - a cost model
- One method must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation.

HKAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model

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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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Fair value model

Refer to the definition of fair value under HKFRS 13 upon the adoption of HKFRS 13

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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Improvements to HKAS 40

- HKAS 40 was amended by *Improvements to HKFRSs* issued in October 2008 regarding property under construction or development for future use as an investment property ("investment property under construction")
- Before the amendment, investment properties under construction were within the scope of HKAS 16 *Property, Plant and Equipment* and were measured at cost less impairment
- The amendments to HKAS 40 arising from *Improvements to HKFRSs* effective for annual periods beginning on or after 1 January 2009 and to be applied prospectively [HKAS 40.85B]

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Improvements to HKAS 40 (Cont'd)

- Therefore, where an entity has previously accounted for property under construction or development for future use as an investment property under HKAS 16, prior period amounts are not restated and the reclassification is presented as a movement in the asset categories in the period of first application

- Accordingly, the revised requirements will apply to investment property that is already under construction at the start of first application and to all investment property constructed after that date

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- Under HKAS 40, entities are given a choice as to how to measure their investment properties; entities can measure their investment properties using the fair value model or the cost model.
- Once the decision is taken, entities should apply the chosen policy **consistently** to all of their investment properties including investment properties under construction.
- Therefore, if an entity has chosen to account for its completed investment properties using the fair value model, it should also account for its investment properties under construction using the fair value model. Alternatively, if an entity has decided to account for its completed investment properties using the cost model, it should also account for its investment properties under construction using the cost model.

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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

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

- ❑ HKAS 2 defines inventories as assets: [HKAS 2.6]
  - ❖ held for sale in the ordinary course of business (finished goods)
  - ❖ in the production process for sale in the ordinary course of business (work in progress); and
  - ❖ materials and supplies that are consumed in production (raw materials)

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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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Refer to HKFRS 13 for definition of fair value upon the adoption of HKFRS 13

Subsequent measurement

- Inventories shall be measured at the lower of cost and net realisable value.
- Net realisable value (NRV) vs fair value

NRV	Fair value
the estimated selling price in the **ordinary course of business** less the estimated costs of completion and the estimated costs necessary to make the sale.	amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction
Entity specific	Not entity specific

NRV may NOT = fair value less costs to sell

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Subsequent measurement

Consideration of NRV

- the most reliable evidence available at the time the estimates are made, of the amount the inventories are **expected to realise**.
- These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period
- Consider if there are any sales contracts that have been entered into

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Question: For write-down to net realisable value, how should "the costs necessary to make the sale" be determined to arrive at the net realisable value of the inventories?

Analysis:

- Should determine in a manner consistent with the definition of "costs of disposal" in HKAS 36 *Impairment of Assets* which states that these costs are "incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense"
- An incremental cost is one which would not be incurred if the activity was not undertaken
- General overheads may not be allocated for the purposes of determining costs to sell, but direct transaction costs must be allocated

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Subsequent measurement

When the cost of properties held for sale may not be recoverable?

- Damaged
- Wholly or partially obsolete
- Selling prices have declined
- estimated costs of completion or the estimated costs to be incurred to make the sale have increased

→ write inventories down below cost to net realisable value

How to assess the recoverability of properties under development?

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Question: A property held for sale which cost $10M has a sale price of $11M, but subsequently were sold at $8M. Assume the cost to make the sale is immaterial, what is the accounting treatment?

Analysis:

- Sale at the lower price will generally provide evidence of the net realisable value of the inventory at the end of the reporting period and the closing inventories will therefore be carried at $8M less any cost to sell
- However, if on further investigation, it indicates that the cause of the loss in value did not reflect conditions existing at the end of the reporting period, such loss should not be accounted for until the next period

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Subsequent measurement

- Inventories are usually written down to net realisable value item by item.
- In some circumstances, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line.

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Comparison basis (example)

Type of products	Cost	Net realisable value	Lower of cost & NRV: Individual items	Lower of cost & NRV: Classified items
Classification A: 1	$800	$980	$800	
2	1,500	1,000	1,000	
3	900	1,100	900	
Subtotal	3,200	3,080		3,080
Classification B: 4	$3,000	$4,800	3,000	
5	4,500	5,000	4,500	
6	2,000	1,750	1,750	
Subtotal	9,500	11,550		9,500
Total	$12,700	$14,630	$11,950	$12,580

	Comparison basis	NRV	Loss
Prohibited		14,630	0
May allowed	Grouped by similar nature	12,580	120
Mandatory	Individual items	11,950	750

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Subsequent measurement

- A new assessment is made of net realisable value in each subsequent period

Subsequent increase in NRV

- The amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realisable value.
- This occurs, for example, when an item of inventory that is carried at net realisable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

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Recognition as an expense

The following items are recognised in the profit or loss in relation to properties held for sale:

- ❖ Properties are sold (match with the period when revenue is recognised)

Be careful with the cost allocation among different inventories

- ❖ Write-down of inventories to NRV
- ❖ Reversal of write-down of inventories (recognise as a reduction of cost of inventories)
- ❖ Expenses incurred that cannot be capitalised

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Disclosure

Required disclosures: [HKAS 2.36]

- accounting policy
- the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity
- carrying amount of any inventories carried at net realisable value
- amount of any write-down of inventories recognised as an expense in the period
- amount of any reversal of a write-down to NRV and the circumstances that led to such reversal
- carrying amount of inventories pledged as security for liabilities

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Disclosure (Con't)

- cost of inventories recognised as expense (cost of goods sold).

HKAS 2 acknowledges that some enterprises classify income statement expenses by nature (materials, labour, and so on) rather than by function (cost of goods sold, selling expense, and so on). Accordingly, as an alternative to disclosing cost of goods sold, HKAS 2 allows an entity to disclose operating costs recognised during the period by nature of the cost (construction costs, labour costs, other operating costs) and the amount of the net change in inventories for the period). [HKAS 2.39] This is consistent with HKAS 1 *Presentation of Financial Statements*, which allows presentation of expenses by function or nature.

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Part 4: Hotel property

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Hotel Property

- Classifications may vary depending on the arrangement that may exist

- The owner of a hotel property may transfer some responsibilities to third parties under a management contract. Terms of such contracts may vary widely. The owner's role may be restricted to that of a passive investor, in which case the property would be more likely to qualify as investment property
- For example, if the owner's primary source of income from the property comes from longer-term leases, the hotel is likely to be an investment property and hence HKAS 40 applies.

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Hotel Property

- At the other extreme, the contract may simply result in the outsourcing of some day-to-day responsibilities, while the owner retains significant exposure to variations in the cash flows generated by the operation of the hotel.
- For example, if the property owner's primary source of income from the property depends on day-to-day or week-by-week occupancy of hotel rooms and usage of restaurants and other facilities, and the property owner is providing services directly to hotel guests and diners, the hotel is likely to be property held by the entity for use in the production of services.
- In this case, the contract has little effect on the substance of the owner's interest and property is likely to be classified as owner-managed and hence HKAS 16 applies

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HKAS 17 Amendment – Leases

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Previous issues

Previous HKAS 17.14 *"… a characteristic of land…. if title is not expected to pass to the lessee…. the lessee normally does not receive substantially all of the risks and rewards…… the lease of land will be an operating lease."*

Therefore…

- land element of a leasehold property, no matter the lease term is 10 years or 999 years → operating lease
- This is based on the notion that the life of land is infinite and therefore the lessee could not possibly enjoy the majority of risks and rewards during a finite lease term

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Amendment - overview

- HKAS 17 Para 15A

  "When a lease includes both land and buildings elements, an entity assesses the classification of each element as a finance or an operating lease separately in accordance with paragraphs 7–13. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life."
- Lease classified as finance lease if it transfers all the risk and rewards incidental to ownership
- Even when there is no transfer of title at the end of lease

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Amendment - overview

Example

999 – year lease of land	Reason
• Lease of land with no title transfer at end of lease	• Significant risks and rewards have been transferred to lessee even no transfer title • Economically similar to entity purchased the land and buildings • Present value of the residual value of property in lease of several decades was negligible. • Account for land element as finance lease consistent with economic position of lessee **Classified as: Finance Lease**

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Amendment - overview

- Effective for annual periods beginning on or after 1 January 2010
- Apply retrospectively based on the information that existed at the inception of the lease
- If impractical, assess the land element of the property leases using information available at the time of applying the amendment

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Application

<u>Land interest in an own-use property</u>

✓ Apply HKAS 16 Property, plant and equipment

✓ Account for land interest using either cost model or revaluation model, depending on the lessee's accounting policy

✓ Depreciate the land interest over the period of expected use on a systematic basis that is consistent with the depreciation policy adopted for the building owned

✓ Reclassify the unexpired leasehold land to PPE

Properties under development

- No amortisation of leasehold land until ready for use
- Follow existing asset treatment

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Application

Land interest in an investment property

- ✓ Apply HKAS 40 Investment property
- ✓ Account for land interest using either fair value model or cost model, depending on the lessee's accounting policy
- ✓ For most entities selecting the fair value model, they need to periodically re-measure the property (including the land) to fair value
- ✓ Record changes in fair value in the profit or loss

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Application

Land interest in an inventory

Previous accounting treatment

- Leasehold land classified as prepaid operating lease or leasehold land and land use rights
- Amortised on a straight line basis over the period of the lease.
- Amortisation capitalized during the construction stage but charged to profit or loss following completion of development.

New accounting treatment

- ✓ Apply HKAS 2 Inventories
- ✓ No amortisation on leasehold land
- ✓ Measured at the lower of cost and net realisable value
- ✓ Classification into "Current" / "non-current" based on the normal operating cycle for property inventories

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Considerations

- ✓ Classification of lease depend on the judgement to decide whether the lease transfers the significant risks and rewards of ownership of the land
- ✓ Land leases with a term as short as "several decades" might be regarded as finance leases if the lessee is economically in the same position as a purchaser
- ✓ For property market where the reversionary interest is small or that the lease term specified in the land lease will be capable of extension for a nominal amount, this may imply land interest as finance lease

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Disclosures

- ✓ Apply HKAS 8 “Accounting policies, change in accounting estimates and errors” for change in accounting policy

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A Refresher Course on Current Financial Reporting Standards

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HKAS 36 – Impairment of Assets

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Agenda

A. Scope
B. Key definition
C. Indications of impairment
D. Determining recoverable amount
E. Recognition of impairment loss
F. Cash generating unit
G. Impairment of goodwill
H. Reversal of impairment loss
I. Disclosures

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Objective

- To ensure that assets are carried at no more than their recoverable amount, and to define how recoverable amount is determined.

carrying amount > recoverable amount??

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A. Scope

HKAS 36 applies to all assets except: [HKAS 36.2]

- inventories (see HKAS 2)
- assets arising from construction contracts (see HKAS 11)
- deferred tax assets (see HKAS 12)
- assets arising from employee benefits (see HKAS 19)
- financial assets (see HKAS 39)
- investment property carried at fair value (see HKAS 40)
- agricultural assets carried at fair value less costs to sell (see HKAS 41)
- insurance contract assets (see HKFRS 4)
- non-current assets held for sale (see HKFRS 5)

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A. Scope

Therefore, IAS 36 applies to (among other assets):

- land
- buildings
- machinery and equipment
- investment property carried at cost
- Biological assets carried at cost
- intangible assets
- goodwill
- investments in subsidiaries, associates, and joint ventures carried at cost
- assets carried at revalued amounts under HKAS 16 and HKAS 38

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B. Key Definitions

- Impairment loss: the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.
- Carrying amount: the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses
- Recoverable amount: the higher of an asset's fair value less costs to sell and its value in use
- Fair value less costs to sell: the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
- Value in use: the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

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C. Identifying an asset that may be impaired

Timing of assessment – general requirements

- At the end of each reporting period, review all assets to look for any indication that an asset may be impaired
- HKAS 36 para 12 – 14 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, an entity is required to make a formal estimate of recoverable amount. [HKAS 36.9]
- The standard does not require an entity to make a formal estimate of recoverable amount if no indication of an impairment loss is present.

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C. Identifying an asset that may be impaired (Con't)

Timing of assessment - exception

- The recoverable amounts of the following types of **intangible assets** should be **tested for impairment annually** whether or not there is any indication that it may be impaired [HKAS 36.10]
  - an intangible asset with an indefinite useful life (e.g. Acquired trademark for a market-leading consumer product with a remaining legal life of five years, but renewable every 10 years at little cost. Management intends to renew indefinitely and market indicators support cash inflows for an indefinite period.)
  - an intangible asset not yet available for use
  - goodwill acquired in a business combination

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D. Indications of Impairment [HKAS 36.12]

External sources:

- Asset's value declines
- negative changes in technology, markets, economy, or laws
- increases in market interest rates
- company stock price is below book value

Internal sources:

- obsolescence or physical damage
- asset is part of a restructuring or held for disposal
- Internal report indicates worse economic performance of the asset than expected

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D. Indications of Impairment [HKAS 36.12]

Such internal reporting may show:

- 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

Dividend from a subsidiary, JCE/JV or associate

Dividend is recognised when:

- Carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated FS of the investee's net assets, including associated goodwill; or
- Dividend exceeds the total comprehensive income of the subsidiary, JCE/JV or associate in the period the dividend is declared.

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D. Indications of Impairment [HKAS 36.12]

These lists are not intended to be exhaustive. [HKAS 36.13] Further, an indication that an asset may be impaired may indicate that the asset's useful life, depreciation method, or residual value may need to be reviewed and adjusted. [HKAS 36.17]

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E. Determining Recoverable Amount

Recoverable amount→ higher of fair value less costs to sell and value in use (VIU)

Fair value in less costs to sell or VIU?

- If fair value less costs to sell or value in use is more than carrying amount, it is not necessary to calculate the other amount. The asset is not impaired.
- If fair value less costs to sell cannot be determined, then recoverable amount is value in use.
- For assets to be disposed of, recoverable amount is fair value less costs to sell.

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Fair Value Less Costs to Sell

- If there is a **binding sale agreement** in an arm‘s length transaction, use the price under that agreement less costs of disposal. [HKAS 36.25]
- If there is an **active market** for that type of asset, use market price less costs of disposal. Market price means **current bid price** if available, otherwise the price in the most recent transaction. [HKAS 36.26]
- If there is no active market, use the **best estimate of the asset's selling price** less costs of disposal. [HKAS 36.27]
- Costs of disposal are the direct added costs only (not existing costs or overhead). [HKAS 36.28]

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Value in Use

The calculation of value in use should reflect the following elements: [HKAS 36.30]

- an **estimate of the future cash flows** the entity expects to derive from the asset
- expectations about **possible variations** in the amount or timing of those future cash flows
- the **time value of money**, represented by the current market risk-free rate of interest
- the price for bearing the **uncertainty inherent** in the asset
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset

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Estimate of future cash flows

Projected cash inflows from continuing use of asset	+	Projected cash outflows for continuing use of asset (directly attributed or allocated reasonably and consistently)	+	Net cash flows for disposal of asset at the end of its useful life

When estimating future cash flows…

- Cash flow projections should be based on reasonable and supportable assumptions that represent **management's best estimate** of the range of economic conditions that will exist over the **remaining useful life of the asset**.
- HKAS 36 presumes that **budgets and forecasts** should **not go beyond five years**, unless justified.
- For periods after five years, **extrapolate** from the earlier budgets using a **steady or declining growth rate**. The growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used.

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Estimate of future cash flows

When estimating future cash flows…

✓factors relate to the asset in its current condition

✓net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's fair value less costs to sell

✓ using appropriate discount rate appropriate for the currency in which the future cash flow will be generated. Translates the present value using the spot exchange rate at the date of the value in use calculation

✓Management should assess the reasonableness of its assumptions by examining the causes of differences between past cash flow projections and actual cash flows.

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Estimate of future cash flows

Cash flow projections do **NOT** include:

- ✗ future restructurings to which the entity is not committed and expenditures to improve or enhance the asset's performance
- ✗ cash inflows or outflows from financing activities, or income tax receipts or payments.
- ✗ cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, receivable)
- ✗ cash outflows that relate to obligations that have been recognised as liabilities (for example, pensions or provisions)

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Discount Rate

Discount rate is…

- ✓ **pre-tax rate** that reflects current market assessments of the time value of money and the risks specific to the asset
- ✓ reflect risks for which future cash flows have been adjusted and should equal **the rate of return** that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset.
- ✓ For impairment of an individual asset or portfolio of assets, it is the rate the entity would pay in a **current market transaction to borrow money to buy** that specific asset or portfolio.

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Discount Rate

Be aware…

- If the discount rate includes the effect of price increases attributable to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases attributable to general inflation, future cash flows are estimated in real terms
- If a market-determined asset-specific rate is not available, a surrogate must be used that reflects the time value of money over the asset's life as well as country risk, currency risk, price risk, and cash flow risk. The following would normally be considered:
  - the entity's own weighted average cost of capital;
  - the entity's incremental borrowing rate; and
  - other market borrowing rates.

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E. Recognition of an Impairment Loss

- An impairment loss should be recognised whenever recoverable amount is below carrying amount.
- The impairment loss is recognised in profit or loss (unless it relates to a revalued asset. Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.).
- Adjust depreciation for future periods.
- Adjust any deferred taxation recognised based on the revised carrying amount and its tax base.

Example – deferred tax effect of an impairment loss

At the beginning of 20X2, the tax base of the identifiable assets of the Country A cash-generating unit is CU900. Impairment losses are not deductible for tax purposes. The tax rate is 40 per cent.

Beginning of 20X2	*Identifiable assets before impairment loss*	*Impairment loss*	*Identifiable assets after impairment loss*
	CU	CU	CU
Carrying amount (Example 2)	1,833	(473)	1,360
Tax base	900	-	900
Taxable temporary difference	933	(473)	460
Deferred tax liability at 40%	373	(189)	184

The recognition of an impairment loss on the assets of the Country A cash-generating unit reduces the taxable temporary difference related to those assets. The deferred tax liability is reduced accordingly.

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F. Cash-Generating Units

- Recoverable amount should be determined for the individual asset, if possible. If it is not possible to determine the recoverable amount (fair value less cost to sell and value in use) for the individual asset, then determine recoverable amount for cash-generating unit (CGU) to which the asset belongs.
- The CGU is the **smallest identifiable group of assets** that generates cash inflows that are largely **independent** of the cash inflows from **other assets or groups of assets**.

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Example 1: Identification of cash-generating units

A. Retail store chain

Background

- Store X belongs to a retail store chain M
- M also owns five other stores in the same province as X and 20 other stores in other provinces
- X makes all its retail purchases through M's purchasing centre
- Pricing, marketing, advertising and human resources policies etc are decided by M
- X and four other stores were purchased five years ago and goodwill was recognised

Question: What is the cash-generating unit for X?

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Example 1: Identification of cash-generating units

A. Retail store chain (cont'd)

Answers

- In identifying X's cash generating unit, consider:
  - how was the internal management reporting organised?
  - how was the business run? Store-by-store basis or by region/provinces?
- The stores are in different regions and probably have different customer bases. Hence, generation of cash inflow may be independent for each store
- In conclusion, although X is managed at a corporate level, it generates cash inflows that are largely independent of those of M stores. Therefore, it is likely that X is a cash generating unit

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Example 1: Identification of cash-generating units

B. Plant for an intermediate step in a production process

Background

- A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same entity
- X's products are sold to Y at a transfer price that passes all margins to X
- 80% of plant Y's final production is sold to customers outside the entity
- 60% of X's final production is sold to Y and the remaining 40% is sold to customers outside the entity

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Example1: Identification of cash-generating units

B. Plant for an intermediate step in a production process (cont'd)

Questions:

Case 1: What are the cash generating units for plant X and plant Y if X could sell the products it sells to Y in an active market. Internal transfer prices are higher than the market prices?

Case 2: What are the cash generating units of plant X and plant Y if there is no active market for X's products?

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Example 1: Identification of cash-generating units

B. Plant for an intermediate step in a production process (cont'd)

Answers

Case 1

- X could sell its products in an active market and so, generate cash inflows that would be largely independent of the cash inflows from Y
- Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y (HKAS 36.70)
- It is likely that Y is also a separate cash-generating unit. Y sells 80% of its products to customers outside of the entity. Therefore, its cash inflows can be regarded as largely independent.

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Example 1: Identification of cash-generating units

B. Plant for an intermediate step in a production process (cont'd)

Answers

Case 2

- The majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y
- The two plants are managed together
- As a consequence, it is likely that plant X and plant Y together are the smallest group of assets that generates cash inflows that are largely independent

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Example 1: Identification of cash-generating units

C. Single product entity

Background

- Entity M produces a single product and owns plants A, B and C
- Each plant is located in a different continent
- A produces a component that is assembled in either B & C
- The combined capacity of B & C is not fully utilised
- M's products are sold worldwide from either B or C, i.e., B's production can be sold in C's continent if the products can be delivered faster from B than from C
- Utilisation levels of B & C depend on the allocation of sales between the two sites

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Example 1: Identification of cash-generating units

C. Single product entity (cont'd)

Questions

Case 1: What are the cash generating units of A, B and C assuming there is an active market for A's products?

Case 2: What are the cash generating units of A, B and C assuming there is no active market for A's products?

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Example 1: Identification of cash-generating units

C. Single product entity (cont'd)

Answers

Case 1

- Active market for A's product: Likely that A is a separate cash-generating unit
- Cash flows for B and C depend on the allocation of production across the two sites: Unlikely that the future cash inflows for B and C can be determined individually although there is an active market for the products assembled by B and C
- It is likely that B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independent

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Example 1: Identification of cash-generating units

C. Single product entity (cont'd)

Answers

Case 2

- It is likely that the recoverable amount of each plant cannot be assessed independently because:
  a. There is no active market for A's products. Therefore, A's cash inflows depend on sales of the final product by B and C
  b. Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites
  - As a consequence, it is likely that A, B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independently

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Example 1: Identification of cash-generating units

D. Building half-rented to others and half-occupied for own use

Background

- M is a manufacturing company
- It owns a headquarters building that used to be fully occupied for internal use
- After down-sizing, half of the building is now used internally and half rented to third parties
- The lease agreement with the tenant is for five years

Question: What is the cash-generating unit of the building?

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Example 1: Identification of cash-generating units

D. Building half-rented to others and half-occupied for own use (cont'd)

Answers

- Primary purpose of the building: to serve as a corporate asset supporting M's manufacturing activities
- Therefore, the building as a whole cannot be considered to generate cash inflows that are largely independent of the cash inflows from the entity as a whole
- The building is not held as an investment
- Therefore, it would not be appropriate to determine the value in use of the building based on projections of future market related rents
- Cash-generating unit for the building is M as a whole

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G. Impairment of Goodwill

- Goodwill should be tested for impairment annually.
- To test for impairment, goodwill must be allocated to each of the acquirer's CGU, or groups of CGU, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.
- Each unit or group of units to which the goodwill is so allocated shall:
  - represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
  - not be larger than an operating segment determined in accordance with HKFRS 8 Operating Segments before aggregation

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G. Impairment of Goodwill (Con't)

- A cash-generating unit to which goodwill has been allocated shall be tested for impairment at least annually by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit:
  - If the recoverable amount of the unit > the carrying amount of the unit, the unit and the goodwill allocated to that unit is Not impaired.
  - If the carrying amount of the unit > the recoverable amount of the unit, the entity must recognise an impairment loss.

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G. Impairment of Goodwill (Con't)

Allocation of impairment loss

- The impairment loss is allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:
  - first, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
  - then, reduce the carrying amounts of the other assets of the unit (group of units) on pro rata basis.

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G. Impairment of Goodwill (Con't)

Allocation of impairment loss

- The carrying amount of an asset should not be reduced below the highest of:
  - its fair value less costs to sell (if determinable),
  - its value in use (if determinable), and
  - zero.

- If the preceding rule is applied, further allocation of the impairment loss is made pro rata to the other assets of the unit (group of units).

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Example 2: Calculation of value in use and recognition of an impairment loss

Background and calculation of value in use

- At the end of 20X0, entity T acquires entity M for CU10,000. M has manufacturing plants in three countries.

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Example 2: Calculation of value in use and recognition of an impairment loss

Schedule 1. Data at the end of 20X0

End of 20X0	*Allocation of purchase price* CU	*Fair value of identifiable assets* CU	*Goodwill* CU[(a)]
Activities in Country A	3,000	2,000	1,000
Activities in Country B	2,000	1,500	500
Activities in Country C	5,000	3,500	1,500
Total	10,000	7,000	3,000

(a) Activities in each country represent the lowest level at which the goodwill is monitored for internal management purposes (determined as the difference between the purchase price of the activities in each country, as specified in the purchase agreement, and the fair value of the identifiable assets).

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Example 2: Calculation of value in use and recognition of an impairment loss

- Goodwill has been allocated to the activities in each country: each activity must be tested for impairment annually or more frequently if there is any indication that it may be impaired (HKAS 36.90)
- Recoverable amounts of the cash-generating units are determined on the basis of value in use calculations
- At end of 20X0 and 20X1, the value in use of each cash-generating unit exceeds its carrying amount. Therefore the activities in each country and the goodwill allocated to those activities are regarded as not impaired.

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Example 2: Calculation of value in use and recognition of an impairment loss

- At the beginning of 20X2, a new legislation was passed in Country A which significantly restrict exports of T's main product. As a result, and for the foreseeable future, T's production in Country A will be cut by 40%
- The significant export restriction and the resulting production decrease require T to estimate the recoverable amount of Country A's operations at the beginning of 20X2
- T uses straight-line depreciation over a 12-year life for Country A's identifiable assets and anticipates no residual value

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Example 2: Calculation of value in use and recognition of an impairment loss

- To determine the value in use for the Country A cash-generating unit (see Schedule 2), T:
  - (a) prepares cash flow forecasts derived from the most recent financial budgets/forecasts for the next five years (years 20X2–20X6) approved by management
  - (b) estimates subsequent cash flows (years 20X7–20Y2) based on declining growth rates. The growth rate for 20X7 is estimated to be 3 per cent. This rate is lower than the average long-term growth rate for the market in Country A
  - (c) selects a 15 per cent discount rate, which represents a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the Country A cash-generating unit.

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Schedule 2. Calculation of the value in use of the Country A cash-generating unit at the beginning of 20X2

Year	*Long-term growth rates*	*Future cash flows*	*Present value factor at 15% discount rate*[3]	*Discounted future cash flows*
		CU		CU
20X2 (n=1)		230[1]	0.86957	200
20X3		253[1]	0.75614	191
20X4		273[1]	0.65752	180
20X5		290[1]	0.57175	166
20X6		304[1]	0.49718	151
20X7	3%	313[2]	0.43233	135
20X8	(2)%	307[2]	0.37594	115
20X9	(6)%	289[2]	0.32690	94
20Y0	(15)%	245[2]	0.28426	70
20Y1	(25)%	184[2]	0.24719	45
20Y2	(67)%	61[2]	0.21494	13
Value in use				1,360

1 Based on management's best estimate of net cash flow projections (after the 40% cut).

2 Based on an extrapolation from preceding year cash flow using declining growth rates.

3 The present value factor is calculated as $k = 1/(1+a)^n$, where a = discount rate and n = period of discount.

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Schedule 3. Calculation and allocation of the impairment loss for the Country A cash-generating unit at the beginning of 20X2

Beginning of 20X2	*Goodwill*	*Identifiable assets*	*Total*
	CU	CU	CU
Historical cost	1,000	2,000	3,000
Accumulated depreciation (20X1)	–	(167)	(167)
Carrying amount	1,000	1,833	2,833
Impairment loss	(1,000)	(473)	(1,473)
Carrying amount after impairment loss	–	1,360	1,360

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Example 2: Calculation of value in use and recognition of an impairment loss

Recognition and measurement of impairment loss

- The recoverable amount of the Country A cash-generating unit is CU1,360 (Schedule 2)
- T compares the recoverable amount of the Country A cash-generating unit with its carrying amount (Schedule 3)
- Carrying amount exceeds recoverable amount by CU1,473. T recognises an impairment loss of CU1,473 immediately in profit or loss
- Carrying amount of the goodwill that relates to Country A's operations is reduced to zero before reducing the carrying amount of other identifiable assets within Country A's cash-generating unit (HKAS 36.104)

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H. Reversal of an Impairment Loss

- Same approach as for the identification of impaired assets: assess at each balance sheet date whether there is an indication that an impairment loss may have decreased. If so, calculate recoverable amount.
- No reversal for unwinding of discount.
- The increased carrying amount due to reversal should not be more than what the depreciated historical cost would have been if the impairment had not been recognised.
- Reversal of an impairment loss is recognised as income in the profit or loss, unless it is a revalued asset.
- Adjust depreciation for future periods.
- **Reversal of an impairment loss for goodwill is prohibited.**

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Example 3: Reversal of an impairment loss

Background

- Use the data for entity T as presented in Example 2, with supplementary information as provided in this example. In this example, tax effects are ignored
- In 20X3, the business situation is improving. The effects of the export laws on T's production are proving to be less drastic than initially expected by management. As a result, management estimates that production will increase by 30%
- This favourable change requires T to re-estimate the recoverable amount of the net assets of the Country A operations
- The cash-generating unit for the net assets of the Country A operations is still the Country A operations. Calculations similar to those in Example 2 show that the recoverable amount of the Country A cash-generating unit is now CU1,910

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Example 3: Reversal of impairment loss

Schedule 1. Calculation of the carrying amount of the Country A cash-generating unit at the end of 20X3

	Goodwill	*Identifiable assets*	*Total*
	CU	CU	CU
Beginning of 20X2 (Example 2)			
Historical cost	1,000	2,000	3,000
Accumulated depreciation	–	(167)	(167)
Impairment loss	(1,000)	(473)	(1,473)
Carrying amount after impairment loss	–	1,360	1,360
End of 20X3			
Additional depreciation (2 years)[(a)]	–	(247)	(247)
Carrying amount	–	1,113	1,113
Recoverable amount			1,910
Excess of recoverable amount over carrying amount			797

(a) After recognition of the impairment loss at the beginning of 20X2, T revised the depreciation charge for the Country A identifiable assets (from CU166.7 per year to CU123.6 per year), based on the revised carrying amount and remaining useful life (11 years).

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Example 3: Reversal of impairment loss

Schedule 2. Determination of the depreciated historical cost of the Country A identifiable assets at the end of 20X3

End of 20X3	*Identifiable assets*
	CU
Historical cost	2,000
Accumulated depreciation *(166.7 × 3 years)*	(500)
Depreciated historical cost	1,500
Carrying amount (Schedule 1)	1,113
Difference	387

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Example 3: Reversal of impairment loss

Schedule 3. Carrying amount of the Country A assets at the end of 20X3

End of 20X3	*Goodwill*	*Identifiable assets*	*Total*
	CU	CU	CU
Gross carrying amount	1,000	2,000	3,000
Accumulated amortisation	–	(414)	(414)
Accumulated impairment loss	(1,000)	(473)	(1,473)
Carrying amount	–	1,113	1,113
Reversal of impairment loss	0	387	387
Carrying amount after reversal of impairment loss	–	1,500	1,500

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Example 3: Reversal of impairment loss

- Favorable change in estimates used to determine the recoverable amount of the Country A's net assets since the last impairment loss was recognised. Therefore, T recognises a reversal of the impairment loss recognised in 20X2
- T increases the carrying amount of the Country A's identifiable assets by CU387 (Schedule 3), i.e. up to the lower of recoverable amount (CU1,910) and the identifiable assets' depreciated historical cost (CU1,500) (Schedule 2)
- This increase is recognised immediately in profit or loss.
- Impairment loss on goodwill is not reversed.

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Example 4: Treatment of future costs

Background

- At the end of 20X0, entity F tests a machine for impairment. The machine is a cash-generating unit. It is carried at depreciated historical cost and its carrying amount is CU150,000. It has an estimated remaining useful life of 10 years
- The machine's recoverable amount (i.e. higher of value in use and fair value less costs to sell) is determined on the basis of a value in use calculation. Value in use is calculated using a pre-tax discount rate of 14%

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Example 4: Treatment of future costs

- Management approved budgets reflect:
  - (a) estimated costs necessary to maintain the level of economic benefit expected to arise from the machine in its current condition; and
  - (b) that in 20X4, costs of CU25,000 will be incurred to enhance the machine's performance by increasing its productive capacity
- At the end of 20X4, costs to enhance the machine's performance are incurred. The machine's estimated future cash flows reflected in the most recent management approved budgets are given in Schedule 3 and a current discount rate is the same as at the end of 20X0.

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At the end of 20X0

Schedule 1. Calculation of the machine's value in use at the end of 20X0

Year	*Future cash flows*	*Discounted at 14%*
	CU	CU
20X1	22,165[1]	19,443
20X2	21,450[1]	16,505
20X3	20,550[1]	13,871
20X4	24,725[1,2]	14,639
20X5	25,325[1,3]	13,153
20X6	24,825[1,3]	11,310
20X7	24,123[1,3]	9,640
20X8	25,533[1,3]	8,951
20X9	24,234[1,3]	7,452
20X10	22,850[1,3]	6,164
Value in use		121,128

[1] Includes estimated costs necessary to maintain the level of economic benefit expected to arise from the machine in its current condition.

[2] Excludes estimated costs to enhance the machine's performance reflected in management budgets.

[3] Excludes estimated benefits expected from enhancing the machine's performance reflected in management budgets.

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Example 4: Treatment of future costs

- The machine's recoverable amount (value in use) is less than its carrying amount. Therefore, F recognises an impairment loss for the machine

Schedule 2. Calculation of the impairment loss at the end of 20X0

	Machine
	CU
Carrying amount before impairment loss	150,000
Recoverable amount (Schedule 1)	121,128
Impairment loss	(28,872)
Carrying amount after impairment loss	121,128

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Example 4: Treatment of future costs

Years 20X1–20X3

- No event occurs that requires the machine's recoverable amount to be re-estimated. Therefore, no calculation of recoverable amount is required to be performed

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Example 4: Treatment of future costs

At the end of 20X4

- The costs to enhance the machine's performance are incurred. Therefore, in determining the machine's value in use, the future benefits expected from enhancing the machine's performance are considered in forecasting cash flows
- This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. As a consequence, in accordance with paragraphs HKAS 36.110-111, the recoverable amount of the machine is recalculated at the end of 20X4

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Example 4: Treatment of future costs

At the end of 20X4

Schedule 3. Calculation of the machine's value in use at the end of 20X4

Year	*Future cash flows*[a]	*Discounted at 14%*
	CU	CU
20X5	30,321	26,597
20X6	32,750	25,200
20X7	31,721	21,411
20X8	31,950	18,917
20X9	33,100	17,191
20X10	27,999	12,756
Value in use		122,072

(a) Includes estimated benefits expected from enhancing the machine's performance reflected in management budgets.

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Example 4: Treatment of future costs

At the end of 20X4

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X4

	Machine
	CU
Carrying amount at the end of 20X0 (Schedule 2)	121,128
End of 20X4	
Depreciation charge (20X1 to 20X4 – Schedule 5)	(48,452)
Costs to enhance the asset's performance	25,000
Carrying amount before reversal	97,676
Recoverable amount (Schedule 3)	122,072
Reversal of the impairment loss	17,324
Carrying amount after reversal	115,000
Carrying amount: depreciated historical cost (Schedule 5)	115,000 [a]

(a) The value in use of the machine exceeds what its carrying amount would have been at depreciated historical cost. Therefore, the reversal is limited to an amount that does not result in the carrying amount of the machine exceeding depreciated historical cost.

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Example 4: Treatment of future costs

At the end of 20X4

Schedule 5. Summary of the carrying amount of the machine

Year	*Depreciated historical cost*	*Recoverable amount*	*Adjusted depreciated charge*	*Impairment loss*	*Carrying amount after impairment*
	CU	CU	CU	CU	CU
20X0	150,000	121,128	0	(28,872)	121,128
20X1	135,000	nc	(12,113)	0	109,015
20X2	120,000	nc	(12,113)	0	96,902
20X3	105,000	nc	(12,113)	0	84,789
20X4	90,000		(12,113)		
enhancement	25,000		–		
	115,000	122,072	(12,113)	17,324	115,000
20X5	95,833	nc	(19,167)	0	95,833

nc = not calculated as there is no indication that the impairment loss may have increased/decreased.

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Example 4: Treatment of future costs

At the end of 20X4

- The machine's recoverable amount (i.e. value in use) is higher than the machine's carrying amount and depreciated historical cost (Schedule 4)
- Therefore, K reverses the impairment loss recognised for the machine at the end of 20X0 so that the machine is carried at depreciated historical cost

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

I. Other Disclosure (Con't)

- If an individual impairment loss (reversal) is material disclose:
  - events and circumstances resulting in the impairment loss
  - amount of the loss
  - individual asset: nature and segment to which it relates
  - cash generating unit: description, amount of impairment loss (reversal) by class of assets and segment
  - if recoverable amount is fair value less costs to sell, disclose the basis for determining fair value
  - if recoverable amount is value in use, disclose the discount rate

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I. Other Disclosure (Con't)

- If impairment losses recognised (reversed) are material in aggregate to the financial statements as a whole, disclose:
  - main classes of assets affected
  - main events and circumstances
- Disclose detailed information about the estimates used to measure recoverable amounts of cash generating units containing goodwill or intangible assets with indefinite useful lives.
- For details of disclosures, please refer to HKAS 36.126 - 137
- Refer to Appendix 1 for an extract of annual report for impairment disclosure

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Main amendments following the issuance of HKFRS 13

- All references to "fair value less costs to sell" are replaced with "fair value less costs of disposal"
- 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 differs from value in use. Fair value reflects the assumptions market participants would use when pricing the asset. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in general.
- Please refer to HKFRS 13 Fair value measurements for details of amendments.

CONSOLIDATED PROFIT AND LOSS STATEMENT

For the year ended 31 December 2008

	Notes	2008 HK$'000	2007 HK$'000
Revenue	7	**10,496,657**	13,035,439
Cost of sales	8a	**(9,447,353)**	(11,383,472)
Gross profit		**1,049,304**	1,651,967
Other income	8b	**279,643**	415,732
Impairment of gaming licence	18	**(12,330,305)**	—
Administrative expenses		**(1,073,619)**	(928,304)
Other operating expenses		**(1,114,522)**	(1,058,113)
Operating (loss)/profit	8c	**(13,189,499)**	81,282
Finance income/(costs), net	10	**79,290**	(557,395)
Share of profits less losses of jointly controlled entities		**51,885**	52
Loss before taxation		**(13,058,324)**	(476,061)
Taxation credit/(charge)	11	**1,503,093**	(26,172)
Loss for the year		**(11,555,231)**	(502,233)
Attributable to:			
Shareholders	31	**(11,390,368)**	(466,200)
Minority interests		**(164,863)**	(36,033)
		(11,555,231)	(502,233)
		HK cents	HK cents
Loss per share	13		
Basic		**(289.3)**	(13.8)
Diluted		**(289.3)**	(13.8)

5. Critical Accounting Estimates and Judgements

Estimates and judgements used in preparing the consolidated financial statements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk causing a material adjustment to the carrying amounts of assets and liabilities within the next financial period are discussed below:

(a) Impairment of non-financial assets other than goodwill

When there is indication for impairment, the Group tests whether the assets within a cash generating unit has suffered any impairment. The recoverable amount has been determined based on the higher of fair value less cost to sell and value-in-use. The methodologies are based upon estimates of future results, assumptions as to income and expenses of the business, future economic conditions on growth rates and estimation of the future returns.

An impairment charge of HK$12.3 billion arose in the gaming and entertainment division cash generating unit during 2008, resulting in the carrying amount of the gaming licence being written down to its recoverable amount. If the annual growth rate for each of all the coming years used in the fair value calculation had been 1% lower or higher than management's estimates at 31 December 2008, the impairment of gaming licence would have increased or decreased by approximately HK$500 million, details of which are disclosed in note 18. If the discount rate is increased or decreased by 1%, the impairment of gaming licence would have increased or decreased by approximately HK$600 million.

(b) Impairment of goodwill

The Group tests annually whether goodwill has suffered any impairment, in accordance with the accounting policy stated in note 3.6. The recoverable amounts of cash generating units in the construction materials division have been determined based on value-in-use calculations. These calculations require the use of estimates, details of which are disclosed in note 18.

(c) Useful lives of property, plant and equipment

The management determines the estimated useful lives and residual values for its property, plant and equipment. Management will revise the depreciation charge where useful lives are different from previous estimates, or it will write-off or write-down obsolete or non-strategic assets that have been abandoned or sold.

(d) Impairment of available-for-sale financial assets

The fair value of financial instruments that are not traded in an active market is determined by using valuation techniques. The Group uses its judgement to select a variety of methods and make assumptions that are mainly based on market conditions existing at each balance sheet date. The fair value also reflects the discounted cash flows that could be expected from the ultimate sale after deducting the estimated expenses directly associated with the sale. The Group determines whether an investment is impaired by evaluating the duration and extent to which the fair value of an investment is less than its cost.

(e) Fair value of derivative financial instruments

The fair value of derivative financial instruments is with reference to the valuation performed by an independent valuer by reference to the Binomial model. In making the judgement, consideration has been given to assumptions that are mainly based on market conditions existing at the balance sheet date.

18. Intangible Assets

Group

	Goodwill (note a) HK$'000	Gaming licence (note b) HK$'000	Computer software HK$'000	Total HK$'000
Cost				
At 31 December 2006	33,014	16,887,329	18,201	16,938,544
Additions	—	—	4,268	4,268
Disposals	—	—	(2)	(2)
At 31 December 2007	33,014	16,887,329	22,467	16,942,810
Additions	—	—	12,633	12,633
Disposals	—	—	(456)	(456)
At 31 December 2008	33,014	16,887,329	34,644	16,954,987
Accumulated amortisation and impairment				
At 31 December 2006	—	1,416,851	1,207	1,418,058
Charge for the year	—	998,360	5,728	1,004,088
Disposals	—	—	(1)	(1)
At 31 December 2007	—	2,415,211	6,934	2,422,145
Charge for the year	—	706,987	7,494	714,481
Disposals	—	—	17	17
Impairment charge	—	12,330,305	—	12,330,305
At 31 December 2008	—	15,452,503	14,445	15,466,948
Net book value				
At 31 December 2008	**33,014**	**1,434,826**	**20,199**	**1,488,039**
At 31 December 2007	33,014	14,472,118	15,533	14,520,665

(a) Goodwill is allocated to the Group's cash-generating units identified according to country of operation and business segment. Goodwill with carrying amount of HK$28,524,000 (2007: HK$28,524,000) and HK$4,490,000 (2007: HK$4,490,000) is allocated to the construction materials segment in Macau and Hong Kong respectively. The recoverable amount of the business unit is determined based on value-in-use calculations. The key assumptions used in the value-in-use calculations are based on the best estimates of growth rates and discount rates of the respective segments.

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18. Intangible Assets (Continued)

(b) Gaming licence represents the fair value of licence acquired on the acquisition of Galaxy Casino, S.A. in 2005 and has been amortised on a straight line basis over the remaining term of the gaming licence which will expire in June 2022.

In the face of a weakening global economy and the tightening of Mainland China's policy on visa issuance to the PRC nationals to visit Macau, visitor growth in Macau has slowed down which also adversely affected the Macau gaming market. Keen competition from the other five concession/sub-concession holders together with the rising labour and operating costs in Macau has exerted pressure on the Group's gaming operation net margin. Taking into account the presently available indicators, the Group performed an impairment assessment on the net assets of the gaming business which is regarded as a cash-generating unit. This assessment indicated an impairment on the gaming licence as at 31 December 2008.

With reference to a valuation carried out by an independent professional valuer, American Appraisal China Limited, the carrying value of the gaming licence is written down by approximately HK$12.3 billion to the recoverable amount of HK$1.4 billion at 31 December 2008. The recoverable amount of the gaming licence has been determined based on its fair value less cost to sell which the Group considers to be higher than the value-in-use. It is calculated using the cash flow projections derived from the financial forecasts for the remaining concession tenure in respect of a normal market participant.

Key assumptions adopted in the valuation are as follows:

Market growth rate in 2009, 2010, 2011 and 2012	–9%, 9%, 18%, –1%
Market share	16.67%
Customer mix (VIP : Mass)	
2009	64% : 36%
2010	62% : 38%
2011	66% : 34%
2012	65% : 35%
Discount rate	16%

The market growth rate projections beyond four years are extrapolated at a rate of 3% per annum. Other key assumptions for the fair value calculation relating to the estimated cash flows include gross margin which is estimated based on the gaming division's past performance, management's expectations for the market development, and industry information. The average growth rates used are consistent with the forecasts included in industry reports. The discount rate used reflects specific risks relating to the gaming and entertainment segments.

Taking into account the corresponding release of approximately HK$1.3 billion in deferred taxation liability, the net amount of write-down is approximately HK$11.0 billion.

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CONSOLIDATED BALANCE SHEET

As at 31 December 2011

	Note	As at 31 December 2011 RMB'000	2010 RMB'000
ASSETS			
Non-current assets			
Property and equipment	6	**8,325,789**	6,553,628
Investment properties	7	**20,566,979**	11,854,995
Land use rights	8	**2,475,068**	2,572,389
Intangible assets	9	**2,264,027**	2,280,462
Associated companies	11	**1,308,281**	412,442
Jointly controlled entities	12	**4,307,877**	3,908,554
Available-for-sale financial assets	13	**267,362**	347,823
Deferred income tax assets	25	**1,313,909**	1,193,780
Other non-current assets	14	**3,205,665**	11,750,131
		44,034,957	40,874,204
Current assets			
Properties under development	15	**37,324,085**	29,013,883
Completed properties held for sale	16	**7,382,116**	4,761,453
Trade and other receivables and prepayments	17	**4,472,085**	5,124,272
Prepayment for acquisition of land use rights	18	**7,634,561**	—
Prepaid income taxes		**949,184**	640,567
Amounts due from related companies	19	**1,451,591**	1,526,306
Restricted cash	20	**1,681,222**	1,589,081
Cash and cash equivalents	20	**12,312,740**	12,139,549
		73,207,584	54,795,111
Total assets		**117,242,541**	95,669,315
EQUITY			
Equity attributable to the equity holders of the Company			
Share capital	21	**355,737**	362,384
Reserves			
– Proposed final dividend	22	**505,772**	754,623
– Others	22	**29,730,171**	25,581,827
		30,591,680	26,698,834
Non-controlling interests		**4,426,397**	3,255,150
Total equity		**35,018,077**	29,953,984

CONSOLIDATED BALANCE SHEET

As at 31 December 2011

	Note	As at 31 December 2011 RMB'000	2010 RMB'000
LIABILITIES			
Non-current liabilities			
Borrowings	23	**27,577,834**	24,695,507
Deferred income tax liabilities	25	**3,172,815**	2,370,209
		30,750,649	27,065,716
Current liabilities			
Trade and other payables	26	**17,317,407**	11,512,930
Advanced proceeds received from customers		**11,828,902**	11,932,050
Income tax payable		**7,159,326**	5,693,970
Borrowings	23	**14,983,419**	9,376,655
Derivative financial instruments	24	**52,115**	—
Amounts due to related parties	27	**30,831**	30,831
Deferred income		**101,815**	103,179
		51,473,815	38,649,615
Total liabilities		**82,224,464**	65,715,331
Total equity and liabilities		**117,242,541**	95,669,315
Net current assets		**21,733,769**	16,145,496
Total assets less current liabilities		**65,768,726**	57,019,700

Hui Wing Mau	**Hui Sai Tan, Jason**
Director	*Director*

The notes on pages 87 to 174 are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2011

	Note	Year ended 31 December 2011 RMB'000	2010 RMB'000
Revenue	5	**26,031,426**	21,789,433
Cost of sales	29	**(16,031,376)**	(13,812,137)
Gross profit		**10,000,050**	7,977,296
Fair value gains on investment properties	7	**2,527,013**	2,339,562
Other income/other gains – net	28	**794,320**	796,826
Selling and marketing costs	29	**(769,889)**	(563,900)
Administrative expenses	29	**(1,349,272)**	(1,083,122)
Other operating expenses	29	**(192,173)**	(176,703)
Operating profit		**11,010,049**	9,289,959
Finance income		**100,074**	66,247
Finance costs		**(480,420)**	(737,800)
Finance costs – net	30	**(380,346)**	(671,553)
Share of results of			
– Associated companies	11	**97,653**	(48,110)
– Jointly controlled entities	12	**24,213**	14
		121,866	(48,096)
Profit before income tax		**10,751,569**	8,570,310
Income tax expense	32	**(4,302,640)**	(3,079,368)
Profit for the year		**6,448,929**	5,490,942
Other comprehensive income:			
Fair value losses on available-for-sale financial assets, net of tax		**(60,346)**	(258,432)
Total comprehensive income for the year		**6,388,583**	5,232,510

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2011

	Note	Year ended 31 December 2011 RMB'000	2010 RMB'000
Profit for the year attributable to:			
Equity holders of the Company		**5,722,775**	4,671,536
Non-controlling interests		**726,154**	819,406
		6,448,929	5,490,942
Total comprehensive income for the year attributable to:			
Equity holders of the Company		**5,684,021**	4,505,571
Non-controlling interests		**704,562**	726,939
		6,388,583	5,232,510
Dividends	33	**1,145,545**	1,218,424
Earnings per share for profit attributable to the equity holders of the Company			
– Basic (RMB cents)	34	**162.2**	131.8
– Diluted (RMB cents)	34	**162.1**	131.6

The notes on pages 87 to 174 are an integral part of these consolidated financial statements.

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.6 Property and equipment

Property and equipment are stated at historical cost less accumulated depreciation and accumulated impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items. Buildings comprise hotel buildings and self-use buildings.

Assets under construction are stated at historical cost less impairment losses. Historical cost includes expenditure that is directly attributable to the development of the assets which comprises construction costs, borrowing costs and professional fees incurred during the development period. On completion, the assets are transferred to buildings within property and equipment.

No depreciation is provided for assets under construction. The carrying amount of an asset under construction is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognised. All other repairs and maintenance costs are charged to the income statement during the financial period in which they are incurred.

Depreciation on property and equipment is calculated using the straight-line method to allocate their costs less their residual values and impairment loss over their estimated useful lives, as follows:

Buildings	50 years or the remaining lease period of the land use rights, whichever is shorter
Building improvements	10 to 20 years
Furniture and equipment	5 years
Jet plane and motor vehicles	10 to 20 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount (Note 2.9).

Gains and losses on disposals are determined by comparing proceeds with the carrying amount and are recognised within "Other income/other gains – net" in the income statement.

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.7 Investment property

Investment property, principally comprising leasehold land and buildings, is held for long-term rental yields or for capital appreciation or both, and that is not occupied by the Group. It also includes properties that are being constructed or developed for future use as investment properties. Land held under operating leases are accounted for as investment properties when the rest of the definition of an investment property is met. In such cases, the operating leases concerned are accounted for as if they were finance leases. Investment property is initially measured at cost, including related transaction costs and where applicable borrowing costs. After initial recognition, investment properties are carried at fair value, representing open market value determined at each reporting date by external valuers. Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific asset. If the information is not available, the Group uses alternative valuation methods such as recent prices on less active markets or discounted cash flow projections. Changes in fair values are recorded in the income statement as 'fair value gains/losses on investment properties'.

If an entity determines that the fair value of an investment property under construction is not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, it shall measure that investment property under construction at cost until either its fair value becomes reliably determinable or construction is completed (whichever is earlier).

If an investment property becomes owner-occupied or commences development with a view to sale, it is reclassified as property and equipment or as properties under development or completed properties held for sale, and the property's deemed cost for subsequent accounting is its fair value at the date of change in use.

If an item of property and equipment becomes an investment property because its use has changed, any difference resulting between the carrying amount and the fair value of this item at the date of transfer is recognised as a revaluation of property and equipment in equity under HKAS 16. If a property commences an operating lease to another party, it is transferred from properties under development or completed properties held for sale to investment property, and any difference between the fair value of the property at that date and its previous carrying amount shall be recognised in profit or loss.

2.8 Intangible assets – goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiaries/associated companies/jointly controlled entities at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of associated companies/jointly controlled entities is included in investments in associated companies/jointly controlled entities. Goodwill is tested at least annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose identified according to operating segment.

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.12 Properties under development

Properties under development are stated at the lower of cost and net realisable value. Net realisable value takes into account the price ultimately expected to be realised, less applicable variable selling expenses and the anticipated costs to completion.

Development cost of properties comprises cost of land use rights, construction costs, borrowing costs and professional fees incurred during the development period. On completion, the properties are transferred to completed properties held for sale.

Properties under development are classified as current assets unless the construction period of the relevant property development project is expected to complete beyond normal operating cycle.

2.13 Completed properties held for sale

Completed properties held for sale are stated at the lower of cost and net realisable value.

Cost comprises development costs attributable to the unsold properties.

Net realisable value is determined by reference to the sale proceeds of properties sold in the ordinary course of business, less applicable variable selling expenses, or by management estimates based on prevailing marketing conditions.

2.14 Trade and other receivables

Trade receivables are amounts due from customers for properties sold or services performed in the ordinary course of business. If collection of trade and other receivables is expected in one year or less (or in the normal operating cycle of the business if longer), they are classified as current assets. If not, they are presented as non-current assets.

Trade and other receivables are recognized initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment.

2.15 Cash and cash equivalents

Cash and cash equivalents include cash in hand and at banks and deposits held at call with banks.

2.16 Share capital

Ordinary shares are classified as equity.

Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds.

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

2.22 Provisions and contingent liabilities *(continued)*

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. It can also be a present obligation arising from past events that is not recognised because it is not probable that outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognised but is disclosed in the notes to the financial statements. When a change in the probability of an outflow occurs so that outflow is probable, it will then be recognised as a provision.

2.23 Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sales of properties and services in the ordinary course of the Group's activities. Revenue is shown, net of discounts and after eliminating sales with the Group companies. Revenue is recognised as follows:

(i) Sales of properties

Revenue from sales of properties is recognised when the risks and rewards of the properties are transferred to the purchasers, which is when the construction of relevant properties has been completed and the properties have been delivered to the purchasers pursuant to the sales agreement and collectibility of related receivables is reasonably assured. Deposits and instalments received on properties sold prior to the date of revenue recognition are included in the consolidated balance sheet under current liabilities.

(ii) Property management services

Revenue arising from property management services is recognised in the accounting period in which the services are rendered.

(iii) Interest income

Interest income is recognised on a time-proportion basis using the effective interest method.

(iv) Rental income

Rental income from properties letting under operating leases is recognised on a straight line basis over the lease terms.

(v) Hotel operation income

Hotel operation income which includes rooms rental, food and beverage sales and other ancillary services is recognised when the services are rendered.

(vi) Sales of goods

The Group operates certain retail department stores. Sales of goods are recognized when the Group sells goods to the customers.

(vii) Dividend income

Dividend income is recognised when the right to receive payment is established.

4 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS *(CONTINUED)*

4.1 Critical accounting estimates and assumptions *(continued)*

(d) Estimated fair value of investment properties

The best evidence of fair value is current prices in an active market for the properties with similar lease and other contracts. In the absence of such information, the Group determines the amount within a range of reasonable fair value estimates. In making its judgement, the Group considers information from a variety of sources including:

(i) current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;

(ii) recent prices of similar properties in less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and

(iii) discounted cash flow projections based on reliable estimates of future cash flows, derived from the terms of any existing lease and other contracts and (where possible) from external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

The Group assesses the fair value of its investment properties based on valuations determined by independent professional qualified valuers.

(e) Provision for properties under development and completed properties held for sale

The Group assesses the carrying amounts of properties under development and completed properties held for sale according to their net realisable value based on the realisability of these properties, taking into account costs to completion based on past experience and net sales value based on prevailing market conditions. Provision is made when events or changes in circumstances indicate that the carrying amounts may not be realised. The assessment requires the use of judgement and estimates.

(f) Fair value of derivatives financial instruments

The Group's derivative financial instruments are interest rate swap contracts entered into with commercial bank, the fair value of which is determined using valuation models for which not all inputs are market observable prices or rates.

(g) Estimated impairment of trade receivable

When there is objective evidence of impairment loss, the Group takes into consideration the estimation of future cash flows to determine impairment loss. The amount of the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective increase rate (i.e. the effective interest rate computed at initial recognition). Where the actual future cash flows are less than expected, a material impairment loss may arise.

4 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS *(CONTINUED)*

4.2 Critical judgements in applying the Group's accounting policy

(a) Classification between investment properties and owner-occupied properties

The Group determines whether a property qualifies as an investment property, and has developed criteria in making that judgement.

Investment property is a property held to earn rentals or for capital appreciation or both. Therefore, the Group considers whether a property generates cash flows largely independently of the other assets held by the Group. Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), the Group accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

(b) Impairment of available-for-sale equity investments

The Group follows the guidance of HKAS 39 to determine when an available-for-sale equity investment is impaired. This determination requires significant judgment. In making this judgment, 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 net loss of RMB182,391,000 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.

6 PROPERTY AND EQUIPMENT – GROUP

	Assets under construction RMB'000	Hotel buildings and improvements RMB'000	Furniture and equipment RMB'000	Jet plane and motor vehicles RMB'000	Self-use buildings RMB'000	Total RMB'000
Cost						
At 1 January 2011	2,069,136	4,488,086	114,488	446,901	404,873	7,523,484
Additions	1,870,311	29,815	103,396	25,914	19,665	2,049,101
Amortisation of land use rights	31,977	–	–	–	–	31,977
Disposals	–	(3,804)	(9,353)	(13,320)	(12,746)	(39,223)
Transfer upon completion	(906,741)	880,978	25,763	–	–	–
At 31 December 2011	3,064,683	5,395,075	234,294	459,495	411,792	9,565,339
Accumulated depreciation						
At 1 January 2011	–	835,250	47,208	39,692	47,706	969,856
Charge for the year	–	230,192	26,398	30,415	11,009	298,014
Disposals	–	(1,342)	(7,226)	(9,653)	(10,099)	(28,320)
At 31 December 2011	–	1,064,100	66,380	60,454	48,616	1,239,550
Net book value						
At 31 December 2011	3,064,683	4,330,975	167,914	399,041	363,176	8,325,789

6 PROPERTY AND EQUIPMENT – GROUP *(CONTINUED)*

	Assets under construction RMB'000	Hotel buildings and improvements RMB'000	Furniture and equipment RMB'000	Jet plane and motor vehicles RMB'000	Self-use buildings RMB'000	Total RMB'000
Cost						
At 1 January 2010	1,519,336	4,170,756	59,783	352,574	501,786	6,604,235
Acquisition of subsidiaries	—	—	753	2,935	—	3,688
Additions	879,071	56,146	56,391	96,505	64,782	1,152,895
Amortisation of land use rights	17,128	—	—	—	—	17,128
Disposals	—	(80)	(2,439)	(5,113)	—	(7,632)
Transfer to cost of sales	—	—	—	—	(161,695)	(161,695)
Transfer to properties under development	(85,135)	—	—	—	—	(85,135)
Transfer upon completion	(261,264)	261,264	—	—	—	—
At 31 December 2010	2,069,136	4,488,086	114,488	446,901	404,873	7,523,484
Accumulated depreciation						
At 1 January 2010	—	617,948	29,699	18,489	46,497	712,633
Acquisition of subsidiaries	—	—	67	83	—	150
Charge for the year	—	217,364	19,306	24,338	11,635	272,643
Disposals	—	(62)	(1,864)	(3,218)	—	(5,144)
Transfer to cost of sales	—	—	—	—	(10,426)	(10,426)
At 31 December 2010	—	835,250	47,208	39,692	47,706	969,856
Net book value						
At 31 December 2010	2,069,136	3,652,836	67,280	407,209	357,167	6,553,628

Depreciation charge of RMB298,014,000 for the year ended 31 December 2011 (2010: RMB272,643,000) has been recorded in cost of sales and administrative expenses in the consolidated income statement (Note 29).

As at 31 December 2011, assets under construction and buildings of the Group with a total carrying amount of RMB6,955,413,000 (2010: RMB5,354,156,000) were pledged as collateral for certain bank borrowings of the Group (Note 23).

As at 31 December 2011, interest capitalised in assets under construction amounted to RMB169,950,000 (2010: RMB36,898,000).

The capitalisation rate of borrowings was 7.89% for the year ended 31 December 2011 (2010: 5.52%).

7 INVESTMENT PROPERTIES – GROUP

	Year ended 31 December 2011 RMB'000	2010 RMB'000
Opening balance	**11,854,995**	6,372,600
Additions		
– Transfer from properties under development	**3,477,519**	3,139,870
– Other additions	**2,707,452**	2,963
Fair value gains	**2,527,013**	2,339,562
Ending balance	**20,566,979**	11,854,995

(a) Amounts recognised in profit and loss for investment properties

	Year ended 31 December 2011 RMB'000	2010 RMB'000
Rental income	**440,559**	324,106
Direct operating expenses from properties that generated rental income	**31,789**	10,339
Direct operating expenses from properties that did not generate rental income	**4,914**	1,598

(b) Valuation basis

The fair values of the Group's investment properties were assessed as at 31 December 2011 by Vigers Appraisal & Consulting Limited ("Vigers") and Shanghai Zhonghua Assets Appraisal Co., Ltd. ("Shanghai Zhonghua"), two independent professional qualified valuers. Valuations were performed using either: (i) income capitalisation approach based on existing and current market rents for similar properties, using capitalisation rates that reflect current market assessments of the uncertainty in the market; or (ii) direct comparison approach assuming sales of these properties in its existing state by making reference to comparable sales transactions as available in the relevant market. Shanghai Zhonghua assessed the fair values of investment properties held by Shanghai Shimao, a subsidiary of the Group listed in Shanghai Stock Exchange. The management has evaluated the standards and assumptions used, as well as the results valued by Shanghai Zhonghua, and concluded the valuations are acceptable for preparation of these consolidation financial statements.

(c) Pledge

As at 31 December 2011, the Group's investment properties were held in the PRC on leases of between 10 to 50 years. Investment properties with a carrying amount of RMB14,423,730,000 (2010: RMB11,392,995,000) were pledged as collateral for the Group's borrowings (Note 23).

7 INVESTMENT PROPERTIES – GROUP *(CONTINUED)*

(d) Leasing arrangements

Some of the investment properties are leased to tenants under long term operating leases with rentals receivable monthly. Minimum lease rental receivable under non cancellable operating leases of investment properties not recognised in the financial statements are as follows:

	As at 31 December	
	2011	2010
	RMB'000	RMB'000
Within one year	**451,152**	358,008
Later than one year but no later than 5 years	**1,067,904**	810,663
Later than 5 years	**831,485**	854,981
	2,350,541	2,023,652

(e) Investment properties under construction

As at 31 December 2011, RMB6,680,698,000 of the investment properties are under construction (2010: Nil).

8 LAND USE RIGHTS – GROUP

	Year ended 31 December	
	2011	2010
	RMB'000	RMB'000
Land use rights relating to property and equipment under non-current assets		
Opening balance	**2,572,389**	3,060,382
Additions	**148,117**	297,617
Amortisation		
– Capitalised in property and equipment (Note 6)	**(31,977)**	(17,128)
– Recognised as expenses (Note 29)	**(40,058)**	(32,047)
Transfer to properties under development	**(173,403)**	(731,262)
Transfer to completed properties held for sale	**—**	(5,173)
Ending balance	**2,475,068**	2,572,389
Outside Hong Kong, held on leases of:		
Over 50 years	**79,098**	99,078
Between 10 to 50 years	**2,395,970**	2,473,311
	2,475,068	2,572,389

8 LAND USE RIGHTS – GROUP *(CONTINUED)*

Land use rights comprise cost of acquiring rights to use certain land, which are all located in the PRC, for assets under construction, hotel buildings and self-use buildings over fixed periods.

As at 31 December 2011, land use rights of RMB1,892,220,000 (2010: RMB2,132,254,000) were pledged as collateral for the Group's bank borrowings (Note 23).

9 INTANGIBLE ASSETS – GROUP

Intangible assets comprise goodwill arising from acquisitions:

	Year ended 31 December	
	2011	2010
	RMB'000	RMB'000
Opening balance	**2,280,462**	2,348,261
Write-off of goodwill recognised as expenses (Note 29)	**(16,435)**	(67,799)
Ending balance	**2,264,027**	2,280,462

Impairment tests for goodwill

Goodwill is allocated to the Group's cash-generating units (CGUs) identified according to business segment. A segment level summary of the goodwill is presented below:

	As at 31 December	
	2011	2010
	RMB'000	RMB'000
Property development and investment – Shanghai Shimao	**1,709,730**	1,709,730
Property development and investment – Others	**423,369**	439,804
Hotel operation	**130,928**	130,928
	2,264,027	2,280,462

The recoverable amounts of CGUs are determined based on their fair values (less cost to sell). The fair value of CGU – Property development and investment – Shanghai Shimao is determined according to the quoted price of Shanghai Shimao's equity shares in the PRC share capital market. The fair values of other CGUs are determined according to the value of the underlying properties and decrease along with the sales of underlying properties, and the attributable goodwill is impaired accordingly.

The goodwill impairment was included in other operating expenses in the consolidated income statement.

13 AVAILABLE-FOR-SALE FINANCIAL ASSETS – GROUP

	Year ended 31 December 2011 RMB'000	2010 RMB'000
Opening balance	**347,823**	692,399
Fair value losses recognised in other comprehensive income	**(80,461)**	(344,576)
Ending balance	**267,362**	347,823

Available-for-sale financial assets represented investment in listed equity securities in the PRC which were stated at market value based on the quoted price.

As at 31 December 2011, available-for-sale financial assets with a carrying amount of RMB207,480,000 (2010: RMB269,920,000) were pledged as collateral for the Group's borrowings (Note 23).

14 OTHER NON-CURRENT ASSETS – GROUP

As at 31 December 2011, the Group has made prepayments of RMB2,875,665,000 (2010: RMB11,255,096,000) for certain land use rights for the purpose to develop hotel buildings, self-used buildings and investment properties, the ownership certificates of which have not been obtained.

As at 31 December 2011, the Group made prepayments of RMB330,000,000 for acquisition of additional interests in a subsidiary (2010: Nil).

As at 31 December 2010, RMB495,035,000 have been advanced to certain local government authorities for land resettlement and site formation.

15 PROPERTIES UNDER DEVELOPMENT – GROUP

	As at 31 December 2011 RMB'000	2010 RMB'000
Properties under development comprise:		
Land use rights	**20,424,315**	19,466,113
Construction costs and capitalised expenditures	**14,702,487**	8,726,084
Interests capitalised	**2,197,283**	821,686
	37,324,085	29,013,883

15 PROPERTIES UNDER DEVELOPMENT – GROUP *(CONTINUED)*

	As at 31 December 2011 RMB'000	2010 RMB'000
Land use rights		
Outside Hong Kong, held on leases of:		
Over 50 years	**14,772,368**	12,740,173
Between 10 to 50 years	**5,651,947**	6,725,940
	20,424,315	19,466,113

The properties under development are all located in the PRC. The relevant land use rights are on leases of 40 to 70 years.

As at 31 December 2011, properties under development of approximately RMB17,502,613,000 (2010: RMB12,596,883,000) were pledged as collateral for the Group's bank borrowings (Note 23).

The capitalisation rate of borrowings was 7.89% for the year ended 31 December 2011 (2010: 6.16%).

	As at 31 December 2011 RMB'000	2010 RMB'000
Properties under development:		
Expected to be completed and available for sale after more than 12 months	**18,233,372**	17,002,416
Expected to be completed and available for sale within 12 months	**19,090,713**	12,011,467
	37,324,085	29,013,883

16 COMPLETED PROPERTIES HELD FOR SALE – GROUP

All completed properties held for sale are located in the PRC. Included in completed properties held for sale, there are land use rights as follows:

	As at 31 December 2011 RMB'000	2010 RMB'000
Outside Hong Kong, held on leases of:		
Over 50 years	**1,125,561**	508,815
Between 10 to 50 years	**247,374**	365,380
	1,372,935	874,195

16 COMPLETED PROPERTIES HELD FOR SALE – GROUP *(CONTINUED)*

As at 31 December 2011, completed properties held for sale of RMB1,049,536,000 (2010: RMB681,061,000) were pledged as collateral for the Group's bank borrowings (Note 23).

For the year ended 31 December 2011, the Group recognised impairment losses of RMB15,398,000 (2010: net write back of impairment losses of RMB152,480,000) on completed properties held for sale.

17 TRADE AND OTHER RECEIVABLES AND PREPAYMENTS – GROUP

	As at 31 December	
	2011	2010
	RMB'000	RMB'000
Bidding deposits for land use rights (note (a))	**1,177,617**	1,450,656
Trade receivables (note (b))	**1,549,466**	2,022,178
Prepaid business tax on pre-sale proceeds	**676,215**	606,901
Prepayments for construction costs	**326,812**	557,119
Other receivables	**741,975**	487,418
	4,472,085	5,124,272

(a) Bidding deposits for land use rights mainly represented deposits of the Group placed with various municipal governments for the participation in miscellaneous land auctions. These deposits will be deducted against the total land costs to be paid if the Group wins the bid at the auction. If the Group's bid did not win, the amount will be fully refunded.

(b) Trade receivables are mainly arisen from sales of properties. Consideration in respect of properties sold is paid in accordance with the terms of the related sales and purchase agreements. The ageing analysis of trade receivables at respective balance sheet dates is as follows:

	As at 31 December	
	2011	2010
	RMB'000	RMB'000
Within 90 days	**1,220,336**	1,710,853
Over 90 days and within 365 days	**289,375**	297,947
Over 365 days	**39,755**	13,378
	1,549,466	2,022,178

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Income Taxes

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Agenda

Part 1 - HKAS 12 *Income Taxes*

Part 2 - Amendments to HKAS 12 *Income Taxes*

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Part 1

HKAS 12 *Income Taxes*

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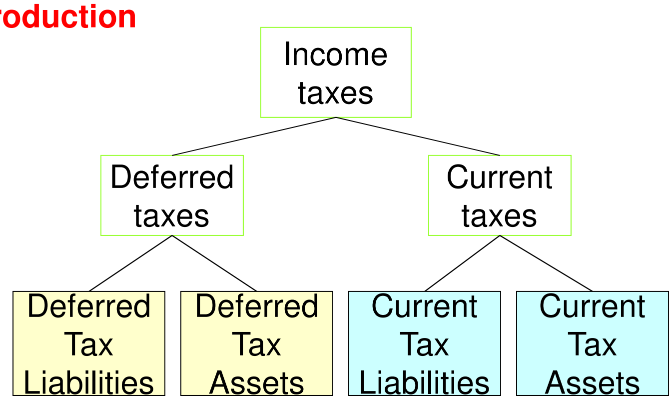
Introduction



Tax expense (tax income)

- is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

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Scope

- **HKAS 12 shall be applied in accounting for income tax**
  - HKAS 12.2 defines these as all domestic and foreign taxes that are based on taxable profits
  - Income taxes also include taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint venture on distributions to the reporting entity

"Taxable profit" = Taxable income minus deductible amounts (a net rather than a gross basis)

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Scoped Out

Sales taxes – Transactional taxes based on sales value	Scoped out from HKAS 12
Interest and penalties assessed on under-payment or late payment of income tax	Scoped out from HKAS 12
Tonnage tax paid on basis of tonnage transported, tonnage capacity or a notional profit	Scoped out from HKAS 12

Such taxes should be presented based on its nature, either as finance cost (e.g. interest) or operating expense (e.g. penalty)

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Current tax

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Definitions

- **Current tax:**
  - Current tax is defined as the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. [HKAS 12.5]
  - It is the tax that the entity expects to pay (recover) in respect of the financial period

- **Taxable profit (tax loss)**
  - Taxable profit (tax loss) is defined as the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable). [HKAS 12.5]

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Current Tax – Recognition

- **Basic requirements:** [HKAS 12.12-13]
  - Current tax for current and prior periods shall, to the extent unpaid, be recognised as a **liability**
  - If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an **asset**
  - The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an **asset**.

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Current Tax – Recognition (cont'd)

- Generally, current tax is **recognised in profit or los**s
- **Exceptions**: [HKAS 12.58]
  - ❑ where the current tax arises as a result of a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity **or**
  - ❑ where the current tax arises from a business combination

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Current Tax – Measurement

- Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, **using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period**

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Current Tax – Presentation

- An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:
  a) has a legally enforceable right to set off the recognised amounts; and
  b) intends either
    - to settle on a net basis, or
    - to realise the asset and settle the liability simultaneously
- The tax expense (income) related to profit or loss from ordinary activities
  - shall be presented on the face of the income statement.
- Other disclosures (to be discussed with deferred tax)

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Deferred tax

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Deferred Tax – Overview

❖ **HKAS 12 *Income Taxes* adopts:**

- Balance sheet liability method
  - Largely focuses on the statement of financial position by recognising the tax effects of <u>temporary differences between the carrying amount of an asset or a liability and its tax base</u>
- Full provision approach
  - Recognised all differences, except for some limited cases

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Deferred Tax - Definitions

- **Deferred tax liabilities:**
  - Deferred tax liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences. [HKAS 12.5]

- **Deferred tax assets:**
  - Deferred tax assets are defined as the amounts of income taxes recoverable in future periods in respect of : [HKAS 12.5]
    - ❑ Deductible temporary differences;
    - ❑ the carryforward of unused tax losses; and
    - ❑ the carryforward of unused tax credits.

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Principal steps in arriving at deferred tax assets/liabilities

Step 1: Calculate the tax base of each asset and liability in the statement of financial position

Step 2: Calculate the temporary difference (if any) for each of the above items

Step 3: Identify those temporary differences that will give rise to deferred tax assets or liabilities taking into account the recognition criteria and initial exemption laid down in the Standard

Step 4: Calculate the deferred tax attributable to those temporary differences by multiplying each temporary difference by the tax rate that is expected to apply when the temporary difference reverses based on enacted or substantively enacted tax rates

Step 5: Recognise the movement between the deferred tax balances in the opening and closing statements of financial position in profit or loss, in other comprehensive income, in equity, or as part of the initial accounting for a business combination

Step 1: Deferred tax – Tax bases

- **Definition of tax base:**
  - The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes. [HKAS 12.5]

- **Assets:**
  - The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. [HKAS 12.7]

Tax base of an asset = Carrying amount – Future taxable amount + Future deductible amount

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Step 1: Deferred tax – tax bases (cont'd)

- **Liabilities:**
  - The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods

Tax base of an liability = Carrying amount – Future deductible amount + Future taxable amount

  - In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods [HKAS 12.8]

Tax base of revenue received in advance = Carrying amount – The amount of the revenue that will not be taxable in future periods

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Step 1: Deferred tax – tax bases (cont'd)

❖ **Tax bases without an associated carrying amount**

- Where a transaction does not give rise to, or affect the carrying amount of an asset or liability, but does affect the taxable income of future operating periods, <u>the tax base is calculated as the amount of the effect on taxable income in future reporting period</u>
- In this case, the carrying amount of the asset or liability associated with the tax base is zero for the purpose of calculating temporary differences [HKAS 12.9]

❖ **Examples:**

- Goodwill or other intangible assets recognised for local tax purposes, but not meeting the recognition criteria under HKFRSs
- Research and development costs or other costs recognised as an expense under HKFRSs, but for which local tax law requires capitalisation

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Step 2: Deferred tax - temporary differences

❖ **Key concepts**

- HKAS 12 introduces the concept of temporary differences, where under the previous standard focused on timing differences
- Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods
- All timing differences are temporary differences. But there are some temporary differences that are not timing differences

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Step 2: Deferred tax - temporary differences (cont'd)

- Focus on the statement of financial position where deferred tax balances arise when there are differences between the amounts at which assets or liabilities are carried in the statement of financial position and the amounts that are attributed to those assets and liabilities for tax purposes

- HKAS 12 does not have an equivalent for 'permanent differences', i.e. items of income and expense that are never taxable or tax deductible. However, HKAS 12 states that when the recovery of an asset or settlement of a liability has no tax consequences, then the tax base is equal to the carrying amount, and no deferred tax arises

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Step 2: Deferred tax - temporary differences (cont'd)

❖ **Definition of temporary difference**

- HKAS 12 defines a temporary difference as the difference between the carrying amount of an asset or liability in the statement of financial position and its tax base. [HKAS 12.5]

- Temporary differences are determined by reference to the carrying amount of an asset or liability. [HKAS 12.55]

The carrying amounts used in the calculation of temporary differences are determined from the accounting records. Where applicable, carrying amounts are calculated net of any allowances or impairment losses

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Step 2: Deferred tax - temporary differences (cont'd)

- **Types of temporary differences**

1) Taxable temporary differences:
   - Temporary differences that will result in taxable amounts in determining the taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [HKAS 12.5]

2) Deductible temporary differences:
   - Temporary differences that will result in amounts that are deductible in determining the taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [HKAS 12.5]

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Step 2: Deferred tax - temporary differences (cont'd)

	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 2: Deferred tax - temporary differences *(cont'd)*

- In consolidated financial statements, temporary differences are determined by comparing
  - the carrying amounts of assets and liabilities in the consolidated financial statements with
  - the appropriate tax base.
- The tax base is determined by reference to
  - a consolidated tax return in those jurisdictions in which such a return is filed, or
  - in other jurisdictions, the tax returns of each entity in the group.

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Step 2: Deferred tax - temporary differences *(cont'd)*

- **Example**

  CEF Ltd. sold goods at a price $8 million to its parent, DEF Ltd, and made a profit of $3 million on the transaction.

  The inventory of these goods recorded in DEF's balance sheet at the year end of 31 March 2011 was $4 million.

  The entities file income tax return individually.

Answers

To the group, the carrying amount of the inventory, excluding unrealised profit, is $2.5 million ($4 million x 5/8) while the tax base is $4 million (the unrealised profit taxed in the seller, CEF Ltd.).

A deferred tax asset is resulted from a deductible temporary difference (whether to be recognised or not subject to certain limitations under HKAS 12, to be discussed later).

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Step 2: Deferred tax - temporary differences *(cont'd)*

Example

- CEF Ltd purchased an item of plant for $4,000,000 on 1 April 2008
- The plant had an estimated life of 9 years and an estimated residual value of $400,000
- The plant is depreciated on a straight-line basis
- The tax authorities do not allow depreciation as a deductible expense
- Instead, a tax expense of 40% of the cost of this type of asset can be claimed against income tax in the year of purchase and 20% per annum (on a reducing balance basis) of its tax base thereafter
- The rate of income tax can be taken as 25%
- Calculate the deferred tax impact for years up to 31 March 2011

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Answers

On 1 April 2008, CEF Ltd purchased a plant:

• Purchase cost	$4,000,000	$3,600,000
• Estimated residual value	$400,000	9 years
• Estimated useful life	9 years	$ 400,000
• Depreciation basis	Straight-line	

The tax authority does not allow depreciation as a deductible expense but grants:

• Initial allowance	40% on cost	$ 1,600,000
• Annual allowance	20% p.a. on tax base	
• Income tax rate	25%	

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Answers (cont'd)

Temporary difference

($' 000)	Carrying amount	Tax base
Addition	4,000	4,000
Depreciation	(400)	(1,600)
2009 year end	**3,600**	**2,400**

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Answers (cont'd)

Temporary difference

($' 000)	Carrying amount	Tax base	Temporary difference	Deferred tax liabilities	Deferred tax charge/ (credit)
Addition	4,000	4,000			
Depreciation	(400)	(1,600)			
2009 year end	**3,600**	**2,400** ⇒	**1,200** ⇒	**300** ⇒	**300**

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Answer (cont'd)

Temporary difference

($' 000)	Carrying amount	Tax base	Temporary difference	Deferred tax liabilities	Deferred tax charge/ (credit)
Addition	4,000	4,000			
Depreciation	(400)	(1,600)			
2009 year end	**3,600**	**2,400**	**1,200**	**300**	**300**
Depreciation	(400)	(480)			
2010 year end	**3,200**	**1,920**	**1,280**	**320**	**20**
Depreciation	(400)	(384)			
2011year end	**2,800**	**1,536**	**1,264**	**316**	**(4)**

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Temporary difference

Examples of circumstances resulting in taxable temporary differences:

1. Depreciation of an asset is accelerated for tax purposes.
2. Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.
3. Development costs have been capitalised and will be amortised to the income statement but were deducted in determining taxable profit in the period in which they were incurred.
4. Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.
5. Financial assets or investment property are carried at fair value which exceeds cost but no equivalent adjustment is made for tax purposes.
6. An entity revalues property, plant and equipment (under HKAS 16) but no equivalent adjustment is made for tax purposes.

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Temporary difference

Examples of circumstances resulting in deductible temporary differences:

1. Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the balance sheet date for tax purposes.
2. The net realisable value of an item of inventory, or the recoverable amount of an item of property, plant or equipment, is less than the previous carrying amount and an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.
3. Research costs are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.
4. Income is deferred in the balance sheet but has already been included in taxable profit in current or prior periods.
5. Financial assets or investment property are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

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Step 3: Deferred tax – Balance Sheet recognition

- **Balance sheet liability method - full provision approach**

Taxable temporary difference → Deferred tax liability

Deductible temporary difference → Deferred tax asset

Unused tax losses or credits → Deferred tax asset

All recognised?

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Step 3: Deferred tax – Balance Sheet recognition (cont'd)

❖ **Requirements for recognition – taxable temporary differences**

- A deferred tax liability should be recognised for **all** taxable temporary differences, **except to the extent that** the deferred tax liability arises from:
  a) the initial recognition of goodwill; or
  b) the initial recognition of an asset or liability in a transaction which
    - is not a business combination; and
    - at the time of the transaction affects neither accounting profit nor taxable profit (tax loss)

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Requirements for recognition – taxable temporary differences** (cont'd)

c) an investment in a subsidiary, branch or an interest in a joint venture, where
  - The parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
  - It is probable that the temporary difference will not reverse in the foreseeable future

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Requirements for recognition – deductible temporary differences**

- A deferred tax asset should 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:
  a) the initial recognition of an asset or liability in a transaction which:
     - is not a business combination; and
     - at the time of the transaction affects neither accounting profit nor taxable profit (tax loss)

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Requirements for recognition – deductible temporary differences** (cont'd)

b) an investment in a subsidiary, branch or an interest in a joint venture, and it is probable that the temporary difference will not reverse in the foreseeable future

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Step 3: Deferred tax – Balance Sheet Recognition *(cont'd)*

❖ **Recognition exceptions – the initial recognition of goodwill**

- The tax deductibility of impairments in the carrying amount of goodwill varies by jurisdiction according to tax laws
- Where a reduction of goodwill is not deductible against taxable income, the tax base of the goodwill is nil, and a taxable temporary difference arises equal to the carrying amount of the goodwill
- Although a taxable temporary difference exists at initial recognition, HKAS 12 prohibits the recognition of the resulting deferred tax liability

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Step 3: Deferred tax – Balance Sheet Recognition *(cont'd)*

- The underlying rationale for this exception is that, if a deferred tax liability were set up in respect of the goodwill at the time of the business combination, this would decrease the total for the net assets recognised. Because goodwill is a residual, this would further increase goodwill and the increase would also need to be tax-effected. [HKAS 12.21 & 21A]

- Subsequent reductions in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and, therefore, they are not recognised. [HKAS 12.21A]

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- Deferred tax liabilities for taxable temporary differences relating to goodwill are, however, recognised to the extent they do not arise from the initial recognition of goodwill. [HKAS 12.21B]

❑ **Never recognise a temporary difference in respect of goodwill at initial recognition**

❑ **By contrast, deferred tax liabilities associated with goodwill are recognised to the extent that they do not arise from the initial recognition of that goodwill**

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Example – Goodwill Exemption

Deferred tax implications for the CEF Group of companies

- CEF Ltd acquired DEF Ltd on 1 January 2010 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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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- HKAS 12 was previously silent on the recognition of deferred tax assets from the initial recognition of goodwill

- HKFRS 3(2008) amended HKAS 12 to insert HKAS 12.32A which states that if the carrying amount of goodwill arising in a business combination is less than its tax base, the difference gives rise to a deferred tax asset that will be recognised as part of the accounting for the business combination to the extent that it is probable that taxable profit will be available against which the deductible temporary difference could be utilised

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Recognition exceptions – initial recognition of an asset or liability**

- HKAS 12 requires the recognition of deferred tax in respect of temporary differences arising where an asset or liability results from any of the following:

  - ❑ a transaction that affects the income statement (e.g. anticipation of income receivable (asset), or accrual of costs payable (liability); or
  - ❑ a transaction that affects taxable income (e.g. expenditure on assets such as computer equipment allowed for tax purposes when paid (asset), or deferral of income recognition in respect of funds that are taxable when received (liability); or
  - ❑ a business combination

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- Temporary differences are **not** permitted to be recognised where the difference arise in respect of the initial recognition of an asset or liability in a transaction that: [HKAS 12.24]

  - ❑ 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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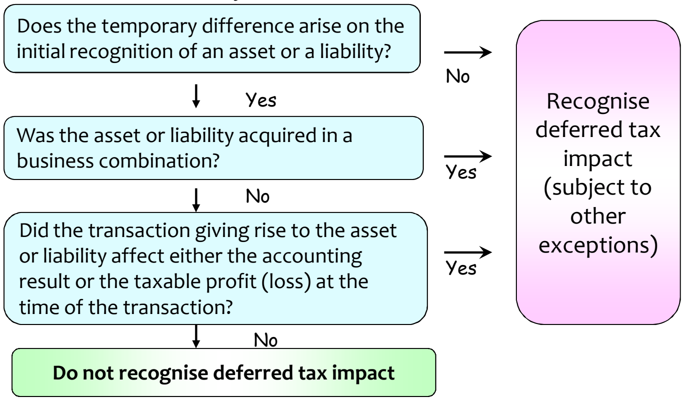
Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- Temporary difference arising on the initial recognition of an asset or liability – Flowchart illustration:



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Example 1: Deferred tax liability arising on the recognition of an asset – asset depreciated at the same rate for tax and accounting purposes

Company A purchases an asset for $100,000. Only $60,000 is qualifying expenditure for tax purposes. The carrying amount of the asset will be recovered through use in taxable manufacturing operations. The asset is depreciated on a straight-line basis at 25% for **both** tax and accounting purposes.

	Carrying amount	Tax base	Temporary difference	Deferred tax
Year	**$**	**$**	**$**	**$**
20X0	100,000	60,000	40,000	-
20X1	75,000	45,000	30,000	-
20X2	50,000	30,000	20,000	-
20X3	25,000	15,000	10,000	-
20X4	0	0	-	-

No deferred tax is ever recognized in respect of the original temporary difference.

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Example 2: Deferred tax liability arising on the recognition of an asset – different depreciation rates for tax and accounting purposes

Facts same as above, but the asset is depreciated at 25% for accounting purposes and 33 1/3% for tax purposes. The tax rate is 17.5%.

	Carrying amount	Tax base	Temporary difference	Un-recognized temporary difference	Recognized temporary difference	Deferred tax liability
Year	**$**	**$**	**$**	**$**	**$**	**$**
	A	B	A-B=C	D*	C-D=E	EX17.5%
20X0	100,000	60,000	40,000	40,000	-	-
20X1	75,000	40,000	35,000	30,000	5,000	875
20X2	50,000	20,000	30,000	20,000	10,000	1,750
20X3	25,000	0	25,000	10,000	15,000	2,625
20X4	0	0	-	-	-	-

* As per Example 1

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Example 3: Deferred tax liability arising on the recognition of an asset – asset subsequently revalued

Fact as per example 1 (i.e. depreciation at 25% or both tax and accounting purposes), but assume that the asset is revalued for accounting purposes to $120,000 at the end of the first year.

	Carrying amount	Tax base	Temporary difference	Un-recognized temporary difference	Recognized temporary difference	Deferred tax liability
Year	**$**	**$**	**$**	**$**	**$**	**$**
	A	B	A-B=C	D*	C-D=E**	EX17.5%
20X0	100,000	60,000	40,000	40,000	-	-
20X1	120,000	45,000	75,000	30,000	45,000	7,875
20X2	80,000	30,000	50,000	20,000	30,000	5,250
20X3	40,000	15,000	25,000	10,000	15,000	2,625
20X4	0	0	-	-	-	-

* As per example 1

** The recognized temporary difference is the amount by which the asset has been revalued upwards in comparison with the depreciated original cost (i.e. the difference between $120,000 and $75,000, being the carrying amount of the asset at the time of the revaluation).

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Example 4: Business combination – adjustments on acquisition of a subsidiary

Background

- On 1 January 20X1, H Company acquired 100% of S Company for $3,500
- At the date of acquisition, S Company 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 asst 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 4: Business combination – adjustments on acquisition of a subsidiary (cont'd)

Net assets at carrying amount	2,500
Fair value adjustment of property	400
Fair value of intangible assets	200
Provision for onerous contract	(300)
Deferred tax on:	
- fair value adjustment of property (20% X 400)	(80)
- fair value of intangible assets (20% X 200)	(40)
- provision for onerous contract (20% X 300)	60
Fair value of net assets acquired	2,740
Goodwill	760
Consideration paid	3,500

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Example 5: Business combination - Elimination of unrealised profits on consolidation

Fact pattern:

- H Limited sold inventory costing $100 to its overseas subsidiary, S Limited, for $160.
- H Limited's tax rate: 30%
- S Limited's tax rate: 25%

The inventory remains on hand at year-end and unrealised profit of $60 to be eliminated on consolidation

No change in tax base

What is the deferred tax balance?

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Example 5: Business combination - Elimination of unrealised profits on consolidation (cont'd)

Analysis:

- H Limited recognises a current tax liability of $18 ($60 profit at 30%) but does not recognise any deferred tax balances as there is no future tax consequences from H Limited's point of view
- S Limited is entitled to a future deduction for $160 paid for the inventory. $160 is the tax base from S Limited's perspective. In S Limited's individual financial statements, the tax base is equal to the carrying amount, and no temporary difference arises
- However, 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: Business combination - Elimination of unrealised profits on consolidation (cont'd)

- A deferred tax asset is calculated by multiplying the temporary difference of $60 by 25%, as the deduction is available to S Limited 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

The tax rate to be used when recognising a deferred tax balance arising from the elimination of unrealised profits on intercompany transactions is determined by reference to the tax jurisdiction where the temporary difference will reverse

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Recognition exceptions – investments in subsidiaries/ branches and associates/joint ventures**

- Temporary difference may arise between the carrying amount of the investment (share of net assets) and the tax base (historical cost) in the consolidated financial statements
- For example, under the equity method, the investment is originally recorded at cost and the carrying amount is then increased by the investor's share of profits of the investee.
- The tax arising in respect of profits earned by the investee will already have been recognised in its financial statements and reflected in the net result accounted for by the investor

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- The tax arising on any dividends paid will also be reflected in the investor's own financial statements
- However, there might be additional tax implications if the investor were to realise the investment – whether through distribution or through disposal
- Example:
  - A Ltd. has an associate, B Ltd., which operates in the PRC. At 31 December 2010, A Ltd. had accounted for $20,000 profits of B Ltd., using the equity method of accounting

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- During the period, B Ltd. had paid dividends of $5,000 to B Ltd. No tax arises in A Ltd.'s country of operation on receipt of dividends. However, under the PRC, tax is withheld at 25% of dividends paid, and is not recoverable
- Assuming that it is anticipated that the investment in B Ltd. will be recovered through distributions, in accounting for the incremental profits of $15,000 in its consolidated financial statements, A Ltd. should also recognise the tax consequences if those profits were remitted as dividends
- A deferred tax liability of $3,750 ($15,000 x 25%) should therefore be recognised in the financial statements to 31 December 2010

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- Taxable temporary differences required to be recognised as deferred tax liability, except for taxable temporary differences where: [HKAS 12.39]
  - ❑ the investor is able to control the timing of the reversal; and
  - ❑ it is probable that the difference will not reverse in the foreseeable future

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

- Conversely, an entity should recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent, and only to the extent that, it is probable that: [HKAS 12.44]

  - ❑ the temporary difference will reverse in the foreseeable future; **and**
  - ❑ taxable profit will be available against which the temporary difference can be utilised

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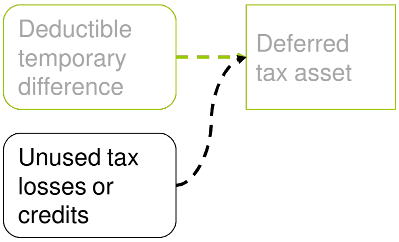
Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Recognition exceptions – Unused Tax Loss/Credit**

- A deferred tax asset shall be recognised for the carry-forward of
  - unused tax losses and
  - unused tax credits
    - to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised



- To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised,
  - the deferred tax asset is not recognised.

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Availability of future profits**

- A deferred tax asset represents a future tax deduction
- It is valuable only if the entity will have future taxable profits against which the deduction can be offset

Important question to answer is when can it be considered probable that an entity will have sufficient taxable profits available in the future to enable the deferred tax asset to be recovered ?

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Examples criteria in assessing available taxable profit:**

a) whether there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity
b) whether it is probable to have taxable profits before the unused tax losses or unused tax credits expire;
c) Whether the unused tax losses result from identifiable causes which are unlikely to recur; and
d) whether tax planning opportunities are available

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Step 3: Deferred tax – Balance Sheet Recognition (cont'd)

❖ **Recognition – Unrecognised D.T. 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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Step 4: Deferred tax – Measurement

❖ **Computation of deferred tax assets and liabilities**

- To calculate the amount of a deferred tax asset or liability, HKAS 12 contains the following formula:

Deferred tax liabilities or assets = Taxable or deductible temporary difference × Tax rate

- A deferred tax asset can also arise from tax losses that have been carried forward. These deferred tax assets are calculated as follows:

Deferred tax asset = Unused tax losses and / or tax credit × Tax rate

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Step 4: Deferred tax – Measurement (cont'd)

❖ **Applicable tax rates and laws**

- Deferred assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates and tax laws enacted or substantively enacted at the end of the reporting period. [HKAS 12.47]

Where the tax rates that will apply to the entity are expected to vary in coming years (e.g., in start-up situations where tax concessions are granted in the early years), it is necessary to anticipate the year in which the temporary difference will reverse, so that the deferred tax asset or liability can be calculated at the appropriate rate.

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Step 4: Deferred tax – Measurement (cont'd)

- Example:
  - A PRC joint venture is entitled to tax concessions during its initial years of operation. The standard income tax rate is 30%. However, the joint venture is fully exempted from PRC income tax for 2 years starting from its first profit-making year (i.e. the first year in which there is a taxable profit after deducting all losses brought forward), followed by a 50% reduction in the PRC income tax rate for the next 3 years.
  - The joint venture has an item of equipment that cost RMB 12,000, which is depreciated over 6 years for accounting purposes and 3 years for PRC income tax purposes, using the straight-line method. The first year that the joint venture has taxable profit is 20X1

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Step 4: Deferred tax – Measurement (cont'd)

- The temporary differences arising as a result of the accelerated tax depreciation will reverse during years 20X4, 20X5 and 20X6 as follows:

	Carrying amount	Tax base	Temporary difference	Reversal of temporary difference	Tax rate	Deferred tax liability
	RMB	RMB	RMB	RMB		RMB
20X1	10,000	8,000	2,000	N/A	0%	300 (2,000x15%)
20X2	8,000	4,000	4,000	N/A	0%	600 (4,000x15%)
20X3	6,000	0	6,000	N/A	15%	1,200 (4,000x15%) +(2,000x30%)
20X4	4,000	0	4,000	2,000	15%	900 (2,000x15%) +(2,000x30%)
	2,000	0	2,000	2,000	15%	600 (2,000x30%)
	0	0	-	2,000	30%	-

❖ **The above table illustrates that, where tax rates vary, it is necessary to estimate the tax rate that willl apply when the temporary difference reverses. In the example, it is predictable that the temporary difference arising in 20X1 will reverse in 20X4 and, therefore, the appropriate tax rate for deferred tax purposes is 15% rather than 0%. Similarly, the temporary differences arising in 20X2 and 20X3 will reverse in 20X5 and 20X6, and tax rates of 15% and 30% should therefore be applied for the temporary differences arising in 20X2 and 20X3 respectively.**

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Step 4: Deferred tax – Measurement (cont'd)

❖ **Progressive or graduated tax rates**

- When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse. [HKAS 12.49]

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Step 4: Deferred tax – Measurement *(cont'd)*

❖ **Substantively enacted tax rates**

- Current and deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, in some jurisdictions, announcements of tax rates and tax laws by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate and tax laws.
  [HKAS 12.48]

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Step 4: Deferred tax – Measurement *(cont'd)*

❖ **Changes in tax rates after the reporting period**

- Where there is a change in tax rates or laws after the reporting period, no adjustment is made to the carrying amounts of deferred tax assets and liabilities
- However, where the effect of the change is such that "non-disclosure could influence the economic decisions of users taken on basis of the financial statements", disclosure will be required in accordance with HKAS 10 *Event after the Reporting Period .* [HKAS 10.21]

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Step 4: Deferred tax – Measurement (cont'd)

❖ **Discounting**

- HKAS 12 explicitly prohibits the use of discounting for the measurement of deferred tax assets and liabilities. [HKAS 12.53]

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Step 5: Deferred tax - Recognition of movement between opening and closing balance sheets

❖ 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 tax arises from: [HKAS 12.58, 61 & 66]

- ❑ a transaction or event which is recognised, in the same or a different period, directly in **equity,** in which case the movement in deferred tax should be accounted for directly in equity; or
- ❑ a **business combination**, in which case the deferred taxes arising at the date of the business combination are taken into account in the initial accounting for the combination, and so affect the amount of goodwill arising on acquisition.

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Step 5: Deferred tax - Recognition of movement between opening and closing balance sheets (cont'd)

- In general, deferred tax arising in a reporting period is debited or credited directly to equity if it relates to an amount that is or was directly debited or credited to equity in the current or a previous reporting period
- The most common example of deferred tax debited to equity is on the revaluation of an asset
- However, where the original debit for the deferred tax liability arising on a revaluation was against the revaluation reserve, the subsequent release of that deferred tax liability is not credited to the revaluation reserve. It is credited to income.

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Step 5: Deferred tax - Recognition of movement between opening and closing balance sheets (cont'd)

- Other circumstances where deferred tax will be dealt with directly in equity include:
- An adjustment to the opening balance of retained earnings resulting from a change in accounting policy that is applied retrospectively or the correction of an error
- Exchange differences arising on the transaction of the financial statements of a foreign operation, and
- Amounts arising on initial recognition of the equity component of a compound financial instrument or revaluation of an asset

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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

❖ Classification:

- Tax assets and liabilities may not be combined with other assets and liabilities, but must be shown separately on the statement of financial position
- Deferred tax assets and liabilities must be presented separately from current tax assets and liabilities; and
- Deferred tax assets and liabilities must be classified as non-current

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Presentation *(cont'd)*

❖ Offset of current tax

- An entity should offset current tax assets and current tax liabilities if, and only if, the entity: [HKAS 12.71]
  - ❑ has a legally enforceable right to set off the recognised amounts; and
  - ❑ intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.
- An entity normally has a legally enforceable right to set off current tax assets against current tax liabilities when they relate to taxes levied by the same taxation authority, and that authority permits the entity to make or receive a single net payment. [HKAS 12.72]

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Presentation (cont'd)

❖ Offset of current tax (cont'd)

- Where a company is preparing consolidated financial statements, current tax assets and liabilities arising from different group companies should not be offset unless: [HKAS 12(73)]
  - ❑ the companies concerned have a legally enforceable right to make or receive a single net payment; and
  - ❑ the companies intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

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Presentation (cont'd)

❖ Offset of deferred tax assets and liabilities

- An entity should offset deferred tax assets and deferred tax liabilities if, and only if: [HKAS 12.74]
  - ❑ the entity has a legally enforceable right to set off current tax assets against current tax liabilities; **and**
  - ❑ the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
    - ➢ the same taxable entity; or
    - ➢ different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

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Disclosure

❖ **HKAS 12 has extensive disclosure requirements on income tax**

❖ Statement of comprehensive income
- Major components of the tax charge or credit in the statement of comprehensive income are required to be separately identified, including:
  - Current tax expense or income;
  - Adjustments to current tax of prior periods
  - Deferred tax expense (income) relating to:
    - Origination and reversing of temporary differences
    - Changes in tax rates or new taxes

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Disclosure *(cont'd)*

- Tax expense relating to changes in accounting policies or errors
- Adjustments to deferred tax expense arising from a change in the tax status of the entity or its shareholders
- Deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes
- The amount of benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense or deferred tax expense

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Disclosure (cont'd)

❖ Reconciliation of tax expense or income:

- HKAS 12 requires the presentation of an explanation of the relationship between the tax expense (income) and accounting profit in either or both of the following forms:
  - A numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rates disclosing also the basis on which the applicable tax rates are computed; or
  - A numerical reconciliation between the average effective tax rate (being the tax expense (income) divided by the accounting profit) and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed
- An explanation is required of changes in the applicable tax rates compared to the previous accounting period

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Disclosure: Reconciliation of tax charge

(i) Reconciliation in absolute terms	20X1	20X0
	$'000	$'000
Accounting profit	8,740	8,775
Tax at the applicable rate of 35% (20X0:40%)	3,059	3,510
Tax effect of expenses that are not deductible in determining taxable profit	122	480
Reduction in opening deferred tax liability resulting from reduction in tax rate	(1,127)	-
Tax expense	2,054	3,990

(ii) Reconciliation in percentage terms	20X1	20X0
	%	%
Applicable tax rate	35.0	40.0
Tax effect of expenses that are not deductible in determining taxable profit	1.4	5.5
Effect on opening deferred tax liability of reduction in tax rate	(12.9)	-
Average effective tax rate (tax expense divided by profit before tax	23.5	45.5

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Disclosure

- ❖ Other disclosures:
  - For each type of temporary difference and unused tax loss and tax credit:
    - Amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented
    - Amount of deferred tax income or expense recognised in profit or loss if this is not apparent from the changes in the amounts recognised in the statement of financial position
  - The amount and expiry date of temporary differences and unused tax losses and tax credits for which no deferred tax asset is recognised in the statement of financial position and
  - The aggregate 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.

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Disclosure (cont'd)

- ❖ Other disclosures (cont'd):
  - Current and deferred tax relating to items that are charged or credited directly to equity
  - Amount of income tax relating to each component of other comprehensive income
  - The amount of income tax consequence of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements
  - Explanation of changes in the applicable tax rates compared with the previous reporting period
  - Changes in tax rates

and many others……(please refer to the standard itself for a comprehensive list)

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Amendments to HKAS 12
Income Taxes

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Issues in Hong Kong

Current principle in HKAS 12

Measurement of deferred tax assets or liabilities which reflect the tax consequences that would follow the manner in which management expects to recover or settle the carrying amount of the entity's assets or liabilities

> Management may expect to recover the investment property by using it, by selling it, or by a combination of use and sale.
>
> Such expectation can affect the measurement of deferred taxes when different tax rates or tax bases apply to the profits generated from using and selling the investment property.

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Issues in Hong Kong (cont.)

Adoption of HK (SIC) – Int 21

- Deals with cases where a non-depreciable asset (such as freehold land) carried at revaluation under HKAS 16
- Deferred tax arises from the revaluation of such asset must be measured based on the tax consequences that would follow from the sale of the asset rather through use
- Unfortunately, all land in Hong Kong are leasehold land and therefore "depreciable" because they have a limited useful life

Investment properties in Hong Kong are therefore, NOT included within the scope of HK (SIC) – Int 21
⇨ temporary differences are provided based on expected manner of recover

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Issues in Hong Kong (cont.)

Concern arises when it is required to recognise deferred tax liabilities arising from revaluation of investment properties that are not subject to any form of taxes upon disposal.

The Institute had lobbied with the IASB on the issue since 2005.

In response to our concern, the IASB issued the "Deferred Tax: Recovery of Underlying Assets (amendments to HKAS 12)" on 20 December 2010.

The Institute, based on the IASB version, issued the relevant HKFRS on 21 December 2010.

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Highlights of amendments to HKAS 12

Limited scope amendments to HKAS 12 (principally paragraphs 51A – 51E)

Provides a practical solution when it is difficult and subjective to determine the expected manner of recovery for investment property measured at fair value under HKAS 40

Basic principle in HKAS 12 remains unchanged

- Measurement of deferred tax reflects the expected manner of recovery or settlement of the underlying asset or liability

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Highlights of amendments to HKAS 12

HKAS 12 has been updated to include:

- A rebuttable presumption that deferred tax on investment property measured using the fair value model in HKAS 40 should be determined on the basis that its carrying amount will be recovered through sale;

and

- A requirement that deferred tax on non-depreciable assets, measured using the revaluation model in HKAS 16, should always be measured on a sale basis.

- HK(SIC) Int 21 *"Income taxes – Recovery of Revalued Non-Depreciable Assets"*, withdrawn.

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Impact

Who will be affected ?

For entities holding investment property measured at fair value in territories where

a) the capital gains tax rate is different from the income tax rate, and/or;

b) the tax base from sale is different from tax base from use

Example :

For investment properties in Hong Kong, movement in the fair value will not be tax-affected as there is no capital gains tax in Hong Kong. Deferred tax liabilities will be reduced significantly.

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Further considerations

The presumption can be rebutted…

- if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.

The presumption cannot be rebutted for an investment property or portion of an investment property that is non-depreciable (that is, freehold land).

- this is not a policy choice.
- it also applies when a deferred tax arises from measuring investment property in a business combination if the entity will use the fair value model for subsequent measurement

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Further considerations (cont.)

For entities subject to Hong Kong tax, recovery of investment property through sale does not necessarily mean that the deferred tax liability on fair value gains is nil.

- Need to consider the possible claw back of previously granted tax allowances in respect of the property.
- If the IRD considers the investment property is held for trading purposes (i.e., disposal would not be deemed to be a capital transaction), the zero rate applicable to capital gains will not apply.

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Further considerations (cont.)

Impact on deferred tax assets

- Applying the presumption does not change the principles to be adopted when recognising and measuring deferred tax assets
- The amendment is likely to reduce significantly deferred tax liabilities.
- The entity might need to reconsider the recoverability of the entity's deferred tax assets due to the changes in the nature and amount of deferred tax liabilities.

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Illustrations

Example 1

Background

On 1 Jan 2007, B Co Ltd purchased an investment property for $100K. The investment property does not have a freehold land component and is measured at fair value subsequently. At 31 Dec 2009, the fair value of the investment property is $120K.

Tax depreciation of 4% of the cost per annum is claimed for investment properties. Income tax rate is 30%. The cumulative tax depreciation claimed previously will be included in the taxable income if the investment property is sold for more than the tax written-down value. Sale proceeds in excess of the cost are not taxed. The tax written down value is $88K at 31 Dec 2009.

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Scenario – B's management does not have any plan to sell the investment property but to hold it for rental income and capital appreciation. The investment property may be sold in the future.

Existing HKAS 12		**Amendment to HKAS 12**	
At 31 December 2009		At 31 December 2009	
	$'K		$'K
Fair value	120	Fair value in excess of cost ($20K x 0%)	0
Tax base	(88)	Claw back of depreciation	
Taxable temporary difference	32	allowance claimed ($12K x 30%)	3.6
Deferred tax liabilities at 30%	9.6	Total deferred tax liabilities	3.6
The lack of a plan to sell the investment property in the future may result in measuring the deferred tax on the basis of use.		As the presumption of recovery through sale is not rebutted, deferred tax is measured based on the tax consequences of sale.	

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Illustrations

Example 2 – extract from the amendments to HKAS 12

Background
An entity holds an investment property with the following details:

	Cost	Fair value	Cumulative tax depreciation
Land (unlimited useful life)	40	60	N/A
Buildings	60	90	30
Total	100	150	
	tax rate		
If sales > cost	20%		
Claw back of tax depreciation claimed if sales > cost	30%		

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Illustrations

Example 2 – if the presumption is NOT rebutted…

	Taxable temporary difference	Tax rate	Deferred tax liabilities
Claw back of depreciation allowance claimed	30	30%	9
Fair value in excess of cost (150-100)	50	20%	10
	80		19

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Illustrations

Example 2 – if the presumption is rebutted…

	Taxable temporary difference	Tax rate	Deferred tax liabilities
Buildings			
Fair value in excess of tax base (90 -30)	60	30%	18
Land (with unlimited useful life)			
Fair value in excess of tax base (60-40)	20	20%	4
	80		22

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Illustrations

Example 3

Background

P Co Ltd acquired the entire shares of S Co Ltd for $500K on 31 Dec 2010. The identifiable assets acquired included an investment property of fair value $250K and other net assets (excluding deferred tax on property) with a fair value of $100K.

S Co Ltd purchased the investment property for $180K. The cumulative tax depreciation at 31 Dec 2010 is $45K.

Income tax rate is 30%. The cumulative tax depreciation claimed previously will be included in the taxable income if the investment property is sold for more than the tax written-down value. Sale proceeds in excess of the cost are not taxed.

Existing HKAS 12		Amendments to HKAS 12	Amendments to HKAS 12	
At 31 December 2010		Cost Model		Fair value
	$'K	$'K		$'K
Fair value	250	250	Fair value in excess of cost ($70K x 0%)	0
Tax base (180 – 45)	(135)	(135)	Claw back of depreciation	
Taxable temporary difference	115	115	allowance claimed ($45K x 30%)	13.5
Deferred tax liabilities at 30%	34.5	34.5	Total deferred tax liabilities	13.5
The deferred tax on acquisition is the same regardless of which model (cost or fair model) is applied for subsequent measurement.		P Co Ltd applies cost model and assumes recovery of the investment property through use.	Assuming the presumption of recovery through sale is not rebutted, deferred tax is measured based on the tax consequences of sale.	

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	Existing HKAS 12	Amendments to HKAS 12	
		Cost model	Fair value model
	$'K	$'K	$'K
Purchase consideration	500	500	500
Fair value of investment property	(250)	(250)	(250)
Fair value of other identifiable net assets	(100)	(100)	(100)
Deferred tax liability on the investment property	34.5	34.5	13.5
Goodwill	184.5	184.5	163.5

The choice of the accounting polices for subsequent measurement of investment properties acquired in a business combination might affect the goodwill.

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Effective date

An entity shall apply these amendments for annual periods beginning on or after 1 January 2012.

Earlier application is permitted.

The amendments do not contain any transitional provisions, which means that they need to be applied retrospectively in accordance with HKAS 8, except if retrospective application is impracticable.

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Same scenario in example 1
If B's management intends to early adopt the amendments to HKAS 12 on 1 Jan 2010, the retrospective adjustment at 31 Dec 2009 will be:

	31-Dec-08 $'K	31-Dec-09 $'K
Existing HKAS 12		
Fair value	110	120
Tax base	(92)	(88)
Taxable temporary difference	18	32
Deferred tax liability at 30%	**5.4**	**9.6**
Amendment to HKAS 12		
Tax depreciation claimed	8	12
Deferred tax liability at 30%	**2.4**	**3.6**

If early adoption on 1 Jan 2010, cumulative entries at 31 Dec 2009 are as follows:

Dr. Deferred tax liability – 31 Dec 2009	6	
Cr. Retained earnings – 1 Jan 2009		3
Cr. Income tax expenses – Y.E. 31 Dec 2009		3

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Disclosures

HKAS 8

Disclose the impact of retrospective application, including:

- Nature and description
- Impact in current and prior periods presented for each line item affected
- Impact on earnings per share (basic and diluted) (HKAS 8.28)

Disclose judgments made by management that have had the most significant effect on the financial statements (HKAS 1.122)

CEF 109

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Disclosure (cont.)

Present a statement of financial position as at the beginning of the earliest comparative period for a change in accounting policy adopted retrospectively or retrospective restatements / reclassifications (HKAS 1.10(f))

e.g., if the amendments are adopted early for a December year end entity. Present a statement of financial position as at

<u>31 December 2010</u> <u>31 December 2009</u> <u>1 January 2009</u>

Refer to Annex 1 and 2 for the extracts of the annual reports 2010 which has early adopted the amendments to HKAs 12.

CEF 110

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Disclosure (cont.)

(for a listed entity) Adjust the 5 year financial summary included in the annual report presented under para 19 of Appendix 16 / GEM 18.33.

When an entity has not applied the amendments (because they have been issued but are not yet effective), disclose:

- This fact
- Known or reasonably estimable information relevant to assessing the possible impact in the period of initial application (HKAS 8.30)
- Refer to Annex 3 and 4 for the extracts of the annual report 2010 which has not early adopted the amendments.

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Disclosure (cont.)

- When it is impracticable to adjust comparative information, disclosure such circumstances and a description of how and from when the change in accounting policy has been applied. (HKAS 8.28(h))

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Action plan

- As a result of the amendments to HKAS 12, deferred tax assets or liabilities arising from investment property carried at fair value are like to be affected.
- Management is therefore advised to consider the implication of the amendments, in particular:
  - Whether the amendments should be early adopted?
  - Whether there is sufficient information to determine the retrospective application?

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Annex I – Amendment to HKAS 12 early adopted: Extract from the Annual Report of Hysan 2010

Annex II – Amendment to HKAS 12 early adopted: Extract from the Annual Report of Hong Kong Land 2010

Annex III – Amendment to HKAS 12 not early adopted: Extract from the Annual Report of Hutchison Whampoa Limited 2010

Annex IV - Amendment to HKAS 12 not early adopted: Extract from the Annual Report of Cheung Kong (Holdings) Limited 2010

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Thank you for your attention

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

YOUR HOSTS

Winnie Chan
HKICPA Associate Director
Technical Training & Support

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Presentation of financial statements

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AGENDA

- Introduction
- General Requirements
- Statement of Financial Position
- Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Cash Flow (HKAS 7)
- Notes to Financial Statements
- Accounting Policies, Estimates and Errors (HKAS 8)
- Event After the Reporting Period (HKAS 10)

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INTRODUCTION

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HKAS 1(Revised) Title Changes to the Financial Statements

Items	New Title
Balance Sheet	Statement of Financial Position
Statement of Comprehensive Income	• If opt to adopt a single statement approach to present income & expense, that statement is called "Statement of Comprehensive income" • If opt to adopt two statements - Income statement and Statement of Comprehensive Income
Statement of Changes in Equity	Statement of Changes in Equity
Cash Flow Statement	Statement of Cash Flows

An entity may use titles for the statements other than those used in HKAS 1

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Main changes between HKAS 1 (Revised) & HKAS 1 (2004)

Items	Differences	Effects
Statement of Financial Position	Present a statement of financial position as at the beginning of the earliest comparative period in a complete set of financial statements when the entity applies an accounting policy retrospectively or makes a retrospective restatement	For 31 December 2009 year end reporting: ▪ 3 statements of financial positions will be presented -31 December 2009 -31 December 2008 (comparatives) -1 January 2008 (the beginning of the earliest comparative period)
Statement of Comprehensive income	Present all non-owner changes in equity (i.e., comprehensive income) either in one statement of comprehensive income or in two statements (i.e., a separate income statement and a statement of comprehensive income). Components of comprehensive income may not be presented in the statement of changes in equity	Components of other comprehensive income (i.e., non-owner changes in equity) presented separately in the Statement of Changes in Equity previously are no longer allowed to be presented in that Statement

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Main changes between HKAS 1 (Revised) & HKAS 1 (2004)

Items	Differences	Effects
Statement of Changes in Equity	Non-owner transactions are no longer allowed to be separately presented in the Statement of Changes in Equity	Changes in equity due to non-owner transactions have to be presented in the Statement of Comprehensive Income with the total balance presented in the Statement of Changes in Equity
Holders of instruments classified as equity	Adopt the term "owners" which was defined to mean holders of instruments classified as equity	Holders of the instruments classified as equity are named from "shareholders" to "owners"
Disclosure of income tax	Disclose income tax relating to each component of other comprehensive income, either in (a) the statement of comprehensive income or (b) in the notes	Components of total comprehensive income can be presented either: (i) net of related tax effects, or (ii) before related tax effects with one amount shown for the aggregate amount of income tax relating to those components

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Main changes between HKAS 1 (Revised) & HKAS 1 (2004)

Items	Differences	Effects
Reclassification adjustments	Disclose reclassification adjustments relating to components of other comprehensive income	Other comprehensive income also comprises "reclassification adjustments". Reclassification adjustments are defined as amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or previous periods

The key changes are to present all non-owner changes in equity either in (1) one statement of comprehensive income; or (2) in two statements (a separate income statement and a statement of comprehensive income)

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BASIC CONCEPTS

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Basic Requirements

- Fundamentals of financial statements presentation:
  - **Consistency** — Presentation and classification of items in the financial statements should be retained from one period to the next
  - **Comparable** — Comparative information should be given for the previous period for all amounts reported in the financial statements

- Scope: The scope of the Standard is all general purpose financial statements prepared and presented in accordance with HKFRSs

- General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs

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Basic Requirements

- The Standard applies equally to all entities that present consolidated financial statements and separate financial statements, but does not apply to condensed interim financial statements prepared in accordance with HKAS 34 *Interim Financial Reporting*

- Except for cash flow information, HKAS 1 requires financial statements to be prepared using the accruals basis of accounting

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Contents of Financial Statements

- ❖ Financial statements should provide the following information:
  - Assets
  - Liabilities
  - Equity
  - Income and expenses (including gains & losses)
  - Contributions by and distributions to owners in their capacity as owners
  - Cash flows

- ❖ This information, together with other information in the notes, assists users of financial statements in predicting the entity's future cash flows, including their timing and certainty

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Components of a Complete Set of Financial Statements

- ❖ A complete set of financial statements should include:
  - A statement of financial position at the end of each period
  - A statement of comprehensive income for a period
  - A statement of changes in equity for the period
  - A statement of cash flows for the period
  - Notes, comprising a summary of significant accounting policies and other explanatory information

- ❖ Reports and statements presented outside the financial statements are outside the scope of HKFRSs

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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

CEF 15

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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

CEF 16

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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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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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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

Is the error material?

❖ Before its 20X0 FS approved for issue, the entity discovered depreciation expense for 20X0 was overstated by $150. Ignored the error, reported profit for 20X0 is $600,000.

❖ Same as above, except had the error been corrected, the entity would have breached a borrowing covenant on a significant long-term liability.

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Offsetting

- Assets and liabilities, and income and expenses, are not offset unless required or permitted by a HKFRS
- Measuring assets net of valuation allowances (e.g. inventories or debtors) is not regarded as offsetting for the purposes of applying HKAS 1

Source: Deloitte iGAAP 2012

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Example – Withholding tax

Background: Co A pays a dividend to Co B. Co B receives a net amount as Co A is required to deduct withholding tax on dividends that it pays to the tax authorities on Co B's behalf.

Question: Should Co B present the dividends received net of tax or gross?

Answer: Dividends from investments should be presented on a gross basis. Co B should recognise the incoming dividend at an amount gross of the withholding tax and the tax should be shown as part of the tax charge. HKAS 1 requires a specific line item for tax expense. This line item should include all tax expenses, including withholding taxes suffered.

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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, it is required to present, as a minimum:
  - three statements of financial position for
    - the end of the current period (e.g.12.31.2010)
    - the end of the previous period which is the same as the beginning of the current period (i.e. 12.31.2009)
    - the beginning of the earliest comparative period (1.1.2009)
  - two of each of the other statements and related notes

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Comparative Information

- When the presentation and classification of items in the financial statements is amended, comparative amounts are reclassified unless this is impracticable. When comparative amounts are reclassified, disclosure is required of:
  - ✓ nature of the reclassification
  - ✓ the amount of each item or class of items that is reclassified; and
  - ✓ the reason for the reclassification
- When it is impracticable to reclassify comparative amounts, disclosure is required of:
  - ✓ the reason for not reclassifying the amounts; and
  - ✓ the nature of the adjustments that would have been made if the amounts had been reclassified

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Identification of financial statements

- ❖ Clearly identify each of the financial statements and notes and distinguish them from other information in the same document

- ❖ Display prominently (and repeat when necessary):
  - name of the reporting entity; and any change from the end of the preceding reporting period
  - individual or group financial statements
  - presentation currency and level of rounding
  - reporting date or the period covered

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Frequency of reporting

- ❖ HKAS 1 states that a complete set of financial statements, including comparative information, should be presented at least "annually"

- ❖ The financial statements may cover a period longer or shorter than twelve months, but requires the following disclosures:
  - the period covered by the financial statements
  - the reason for using a longer or shorter period; and
  - the fact that the amounts presented in the financial statements are not entirely comparable

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Statutory requirements

- ❖ Please also note the Hong Kong Companies Ordinance requires the following:
  - ✓ the preparation of a profit and loss account and balance sheet; and the accounts must give a true and fair view of the profit or loss and of the state of affairs of the company, and comply with the requirements of the Schedule
  - ✓ Where a company has a subsidiary at the end of the financial year, the group accounts should be prepared unless the company is, at the end of the financial year, a wholly-owned subsidiary of another body corporate.
  - ✓ A directors' report to be attached to every balance sheet laid before a company in general meeting.
  - ✓ a company's accounts, together with the director's report and auditor's reports should be laid before the company at its AGM and the accounts shall be made up to a date falling not more than 6 months or in the case of a private company and a company limited by guarantee not more than 9 months, before the date of the meeting.

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Compliance with HKFRSs

- ❖ Financial statements must not be described as complying with HKFRSs unless they comply with all of the requirements of HKFRSs
- ❖ An entity whose financial statements comply with HKFRSs must make an explicit and unreserved statement of such compliance in the notes
- ❖ For example:

3.1 Statement of compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards.

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Compliance with HKFRSs

For compliance with HKFRSs, the financial statements must:

- ❖ Comply with HKAS and HKFRS
- ❖ Comply with HK(IFRIC) and HK(SIC)
- ❖ In the absence of specific guidance in HKFRSs (in descending order)
  - Apply the requirements in HKFRSs dealing with similar and related issues
  - Apply the IASB *Framework;* or
  - Apply pronouncements of national standard setters to the extent that these are consistent with other HKFRSs, other HK(IFRICs) and the IASB *Framework*

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True and Fair Presentation

- ❖ Financial statements should present a true and fair view of the financial position, financial performance and cash flows of an entity

- ❖ True and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses

- ❖ The application of the HKFRS is presumed to result in presentation of the financial position, financial performance and cash flows of an entity that achieve a true and fair view

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Statement of Financial Position

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Scope

- The statement of financial position (SOFP) (or the balance sheet) presents an entity's assets, liabilities and equity as of a specific date – the end of the reporting period
- HKAS 1 sets out the information to be presented in a statement of financial position and how to present it

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Information to be presented in the SOFP

❖ The statement of financial position should include, at a minimum, line items that present the following amounts:

- Property, plant and equipment
- Investment property
- Intangible assets
- Financial assets (other than investments accounted for using the equity method, trade and other receivables and cash and cash equivalents, which are presented separately)
- Investments accounted for using the equity method
- Biological assets
- Inventories
- Trade and other receivables
- Cash and cash equivalents

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Information to be presented in the SOFP (Cont'd)

- The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with HKFRS 5
- Trade and other payables
- Provisions
- Financial liabilities (other than trade and other payables, and provisions, which are presented separately)
- Liabilities and assets for current tax
- Deferred tax liabilities and deferred tax assets
- Liabilities included in disposal groups classified as held for sale
- Non-controlling interests, presented within equity; and
- Issued capital and reserves attributable to owners of the parent.

Additional line items, headings and subtotals are presented in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position

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Current/non-current distinction

- Make current/non-current distinction unless liquidity presentation is reliable and more relevant
- In liquidity presentation, present assets & liabilities in order of liquidity
- Refer to Appendix 1 for an example of SOFP presented in order of liquidity
- Whichever method of presentation is adopted, for each asset or liability line item that combines amounts expected to be recovered or settled:
  - ✓ No more than 12 months after the reporting period; and
  - ✓ More than 12 months after the reporting period,

  The amount expected to be recovered or settled after more than 12 months should be disclosed. [HKAS 1.61]

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Current Assets

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

Current assets include assets, e.g. inventories and trade receivables that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets primarily held for the purpose of trading e.g. financial assets classified as held for trading in accordance with HKAS 39 and the current portion of non-current financial assets

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Current Liabilities

❖ Current liability if:

- Expect to settle in entity's normal operating cycle
- Held for trading
- Due to be settled within twelve month after the reporting period
- Entity does not have an unconditional right to defer settlement for at least twelve months after the reporting period

❖ All other liabilities are classified as non-current

Source: Deloitte iGAAP 2012

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Current Liabilities – example

Background: A primary school requires a deposit to be paid upon enrolment into the school. Should the student leave the school, this deposit is refundable with one school-term's notice (four months). The majority of students enrol into just one primary school and, having completed the six year study period, receive the deposit back at the end of that six year period.

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

Answer: Despite the historical evidence that indicates that the majority of the deposits are only repaid after the six-year period, the deposit are payable on four months notice. HKAS 1 states that a liability should be classified as current when the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Therefore, the deposits should be classified as current liabilities.

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Source: Deloitte iGAAP 2012

Example – Breaches of covenants

- At December 31, 2010 Co A was in breach of a covenant in a loan that is otherwise repayable 3 years later. The breach entitles (but not obliged) the bank to require immediate repayment
  - At December 31, 2010 the loan is a current liability – at December 31, 2010 Company A does not have an unconditional right to defer settlement for at least twelve months

- Same as above, except after the end of the reporting period (December 31, 2010) but before the financial statements were approved for issue, the bank formally agreed not to demand early repayment of the loan
  - At December 31, 2010 the loan is a current liability – at December 31, 2010 Co A does not have an unconditional right to defer settlement for at least twelve months

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Example – Breaches of covenants

- When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach.

An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.

- However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

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Recap: Classifications of Financial Liabilities

- ❖ Financial liabilities are classified as current when they are due to be settled within twelve months after the reporting period even if:
  - The original term was for a period longer than twelve months; and
  - An agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.
- ❖ If an entity expects and has the discretion to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current. But when refinancing or rolling over the obligation is not at the discretion of the entity, the potential to refinance is not considered.

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Recap: Classifications of Financial Liabilities

- ❖ For loans classified as current liabilities, HKAS 1 states that if the following events occur between the end of the reporting period and the date the financial statements are authorised for issue, those events are disclosed as non-adjusting events.
  - ✓ refinancing on a long-term basis
  - ✓ Rectification of a breach of a long-term loan arrangement; and
  - ✓ The granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least 12 months after the reporting period.

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HK Int 5 Presentation of Financial Statements – classification by the borrower of a term loan that contains a repayment on demand clause

- Term loans – loans which are repayable on a specific date or in instalments over a period of time, usually in excess of one year.
- Loan facility agreements for such loans will set out the basic terms and may also include specific clauses which define default events which would give the lender the right to accelerate the repayment terms if those events occur.
- Some even include an overriding repayment on demand clause, which gives the lender the right to demand repayment at any time at their sole discretion and irrespective of whether a default event has occurred.

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HK Int 5 Presentation of Financial Statements – classification by the borrower of a term loan that contains a repayment on demand clause

- The classification of a term loan is
  - ✓ determined by reference to the **rights and obligations** of the lender and the borrower, as **contractually agreed** between the two parties and in force as of the reporting date.
  - ✓ subject to loan agreements which include a clause which gives the lender the **unconditional right to call the loan** at any time. Under such case, the term loan is classified as **current** in its statements of financial position.
  - ✓ Not determined by the probability of the lender choosing to exercise its rights within the next 12 months after the reporting date.

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Example of "Repayment on demand" clause

"By signing this letter, you [the Obligor] expressly acknowledge that we [the Lender] may suspend, withdraw or make demand for repayment of the whole or any part of the Facilities at any time notwithstanding the fact that the following covenants/undertakings are included in this letter and whether or not the Guarantor is in breach of any such covenants/undertakings."

"As a general banking practice and notwithstanding any terms and conditions specified above, the Lender reserves its overriding right to cancel or to modify the Facility, or to demand immediate repayment of all outstanding balances whether due or owing, actual or contingent under the Facility without prior notice."

"Notwithstanding anything contained in this letter, the Facilities are subject to the Bank's overriding right of repayment on demand, to review, amend, and/or cancel any or all of the Facilities at its sole discretion."

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Comfort letters

- A letter indicating by the lender that loan will not be called within the next 12 months
- Reminders:
  - Letter has to be legally enforceable
  - Wording needs to be clear that the bank provides an undertaking that it will not exercise the "repayment on demand clause" in the period covered by the letter, or it will only have the right to exercise the clause if some specified trigger default event occurs during that future period.
  - No sufficient if the letter only refers to the lender's current intentions or expectations about the future

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Other matters to consider

Breach of covenants on bank loans and other facilities

Disclosure of price sensitive information

Effect of reproduction of issued financial statements

Net current liabilities - going concern uncertainties ??

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Effective date and transitional arrangements

- Immediate effect
- Initial application of the HK Int 5 constitutes a change in accounting policy, it should be accounted for retrospectively in accordance with HKAS 8.
- HK Int 5 also applies to companies using HKFRS for Private Entities and SME – FRS

Presentation and disclosures

- Refer to Appendix 2 for the illustrative disclosures released by the Institute.

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Share Capital and Reserves

- HKAS 1 requires several disclosures as follows:
  - The number of shares authorised
  - The number of shares issued and fully paid
  - The number of shares issued but not fully paid
  - The par value per share, or the fact that the shares have no par value
  - A reconciliation of the number of shares outstanding at the beginning and at the end of the period
  - The rights, preferences and restrictions attaching to that class including restriction on dividends and the repayment of capital
  - Shares in the entity held by its subsidiaries or associates
  - Shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts
  - A description of the nature and purpose of each reserve within equity has to be given, either in the statement of financial position or in the notes.

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Statement of Comprehensive Income

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Scope

- ❖ The statement of comprehensive income presents an entity's financial performance (i.e., its income and expenses) for the period
  - HKAS 1 requires financial performance be presented in a single statement or two statements (an accounting choice)
  - Sets out the information to be presented in those statements

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Minimum Requirements

- ❖ As a minimum, the statement of comprehensive income includes line items that present the following amounts for the period:
  - revenue
  - finance costs
  - share of profit or loss of associates and joint ventures
  - tax expense
  - a single amount comprising the total of:
    - the post-tax profit or loss of discontinued operations; and
    - the post-tax gain or loss recognised on the measurement to fair value costs to sell, or on the disposal of the assets or disposal groups constituting the discontinued operation
  - profit or loss
  - each component of other comprehensive income, classified by nature
  - share of other comprehensive income of associates and joint ventures accounted for using the equity method; and
  - total comprehensive income

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Disclose allocations

- Profit or loss and total comprehensive income are before allocating those amounts to non-controlling interests and owners of the parent

- Disclose the allocations of those amounts to
  - the non-controlling interests
  - the owners of the parent

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Presentation alternatives

- Accounting policy choice – one performance statement or two
- Single statement of comprehensive income
  - includes all income and expenses
  - separate line items include, among others,
    - profit or loss (unless no items of OCI)
    - each item of other comprehensive income displayed below profit or loss
    - total comprehensive income

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Two statements

- Two statements
  - income statements
  - statement of comprehensive income
- Income statement
  - ends with profit or loss
- Statement of comprehensive income
  - starts with profit or loss
  - present each item of other comprehensive income separately
  - ends with total comprehensive income

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Other Comprehensive Income

- Comprehensive income for a period includes profit or loss for that period plus other comprehensive income recognised in that period
- Other comprehensive income comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other HKFRSs

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Components of Other Comprehensive Income

- The components of other comprehensive income include
  - Changes in revaluation surplus (HKAS 16 and HKAS 38)
  - Actuarial gains and losses on defined benefit plans recognised in accordance with paragraph 93A of HKAS 19
  - Gains and losses arising from translating the financial statements of a foreign operation or from functional to presentation currency (HKAS 21)
  - Gains and losses on remeasuring available-for-sale financial assets (HKAS 39)
  - The effective portion of gains and losses on hedging instruments in a cash flow hedge (HKAS 39)

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Example : One statement of comprehensive income (components presented in gross)

XYZ Group – Statement of Comprehensive Income for the year ended 12.31.20Y0	20Y0	20X9
Revenue	390,000	355,000
Expenses	(250,000)	(275,000)
Net profit before tax	140,000	80,000
Profits tax expense	(25,000)	(15,000)
Profit for the year from continuing operations	115,000	65,000
Loss for the year from discontinued operations	(30,500)	-
Profit for the year	84,500	65,000
Other comprehensive income:		
Exchange differences on translating of foreign operations	5,000	10,000
Available for sale financial assets	2,400	3,500
Cash flow hedges	1,200	2,200
Gain on property valuation	8,000	7,000
Actuarial gains(loss) on defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to components of other comprehensive income	(4,000)	(3,900)
Other comprehensive income for the year, net of tax	12,333	19,433
Total comprehensive income for year	96,833	84,433

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Example : One statement of comprehensive income (components presented in gross) – Cont'd

XYZ Group -Statement of Comprehensive Income for the year ended 12.31.20Y0		
	20Y0	20X9
Profit attributable to:		
Owners of the parent	76,271	58,890
Non-controlling interest	8,229	6,110
	84,500	65,000
Total comprehensive income attributable to :		
Owners of the parent	86,604	75,123
Non-controlling interest	10,229	9,310
	96,833	84,433

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Example: Two statements - a separate income statement - a statement of comprehensive income

XYZ Group – Income Statement for the year ended 12.31.20Y0		
	20Y0	20X9
Revenue	390,000	355,000
Expenses	(250,000)	(275,000)
Net profit before tax	140,000	80,000
Profits tax expense	(25,000)	(15,000)
Profit for the year from continuing operations	115,000	65,000
Loss for the year from discontinued operations	(30,500)	-
Profit for the year	84,500	65,000
Profit attributable to:		
Owners of the parent	76,271	58,890
Non-controlling interest	8,229	6,110
	84,500	65,000

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Example: Two statements approach - a separate income statement - a statement of comprehensive income

XYZ Group – Statement of Comprehensive Income for the year ended 12.31.20Y0	20Y0	20X9
Profit for the year	84,500	65,000
Other comprehensive income:		
Exchange differences on translating of foreign operations	5,000	10,000
Available for sale financial assets	2,400	3,500
Cash flow hedges	1,200	2,200
Gain on property valuation	8,000	7,000
Actuarial gains(loss) on defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to components of other comprehensive income	(4,000)	(3,900)
Other comprehensive income for the year, net of tax	12,333	19,433
Total comprehensive income for year	96,833	84,433
Total comprehensive income attributable to:		
Owners of the parent	86,604	75,123
Non-controlling interest	10,229	9,310
	96,833	84,433

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Other Comprehensive Income – Income Tax

- The components of other comprehensive income may be presented either:
  - Net of related tax effects; or
  - Before related tax effects with one amount shown for the aggregate amount of income tax relating to those components
- Where the income tax effects are aggregated into a single item in the statement, it is still necessary to disclose in the notes the amount of tax attributable to each item of other comprehensive income as required by HKAS 1.90

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Example: Other Comprehensive Income (components presented in net)

Other comprehensive income for the year after tax:	20X7	20X7
Exchange differences on translating foreign operations	4,000	8,000
Available-for-sale financial assets	(18,000)	20,000
Cash flow hedges	(500)	(3,000)
Gains on property revaluation	600	2,700
Actuarial gains (losses) on defined benefit pension plans	(500)	1,000
Share of other comprehensive income of associates	400	(700)
Other comprehensive income for the year, net of tax	(14,000)	28,000

Ref.: IAS 1(2007).IG 6

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Example – Disclosure of income tax relating to each component of other comprehensive income

Disclosure of tax effects relating to each component of other comprehensive income

Notes

Year ended 31 December 20X7

(in thousands of currency units)

	20X7			20X6		
	Before-tax amount	Tax (expense) benefit	Net-of-tax amount	Before-tax amount	Tax (expense) benefit	Net-of-tax amount
Exchange differences on translating foreign operations	5,334	(1,334)	4,000	10,667	(2,667)	8,000
Available-for-sale financial assets	(24,000)	6,000	(18,000)	26,667	(6,667)	20,000
Cash flow hedges	(667)	167	(500)	(4,000)	1,000	(3,000)
Gains on property revaluation	933	(333)	600	3,367	(667)	2,700
Actuarial gains (losses) on defined benefit pension plans	(667)	167	(500)	1,333	(333)	1,000
Share of other comprehensive income of associates	400	–	400	(700)	–	(700)
Other comprehensive income	(18,667)	4,667	(14,000)	37,334	(9,334)	28,000

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Reclassification Adjustments

- Reclassification adjustments are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income (OCI) in the current or previous period.
- Requires disclosure relating to components of OCI either in the statement of comprehensive income or in the notes.

Transfer of a "reserve" to "reserve, e.g. transfer of property, plant and equipment revaluation surplus to retained earnings on disposal is not a reclassification adjustments. Instead, such transfer should be presented in the Statement of Changes in Equity

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Reclassifications Adjustment – Examples

XYZ Group
Disclosure of components of other comprehensive income[h]
Notes
Year ended 31 December 20X7
(in thousands of currency units)

		20X7		20X6
Other comprehensive income:				
Exchange differences on translating foreign operations[i]		5,334		10,667
Available-for-sale financial assets:				
Gains arising during the year	1,333		30,667	
Less: Reclassification adjustments for gains included in profit or loss	(25,333)	(24,000)	(4,000)	26,667
Cash flow hedges:				
Gains (losses) arising during the year	(4,667)		(4,000)	
Less: Reclassification adjustments for gains (losses) included in profit or loss	3,333		–	
Less: Adjustments for amounts transferred to initial carrying amount of hedged items	667	(667)	–	(4,000)
Gains on property revaluation		933		3,367
Actuarial gains (losses) on defined benefit pension plans		(667)		1,333
Share of other comprehensive income of associates		400		(700)
Other comprehensive income		(18,667)		37,334
Income tax relating to components of other comprehensive income[j]		4,667		(9,334)
Other comprehensive income for the year		(14,000)		28,000

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Statement of Changes in Equity

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Scope

- ❖ The statement of changes in equity presents all changes in equity in the reporting period, detailing those arising from transactions with owners in their capacity as owners

- HKAS 1 sets out requirements for presenting the changes in an entity's equity for a period

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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 profit or loss; each item of OCI; transactions with owners in their capacity as owners; and changes in ownership interests in subsidiaries that do not result in a loss of control

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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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Scope

- Notes provide additional information – narrative descriptions or disaggregations of items presented in the statements of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows and information about items that do not qualify for recognition in those statements

- HKAS 1 sets out the principles for presenting note disclosures

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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}: summary of 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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Source: PwC illustrative HKFRS corporate consolidated financial statements 2011

Judgement In Applying Accounting Policies

- Example:

4.2 Critical judgements in applying the entity's accounting policies

(a) Revenue recognition

The group has recognised revenue amounting to HK$950,000 for sales of goods to L&Co in the UK during 2011. The buyer has the right to return the goods if their customers are dissatisfied. The group believes that, based on past experience with similar sales, the dissatisfaction rate will not exceed 3%. The group has, therefore, recognised revenue on this transaction with a corresponding provision against revenue for estimated returns. If the estimate changes by x%, revenue will be reduced/increased by HK$10,000.

(b) Impairment of available-for-sale equity investments

The group follows the guidance of IAS/HKAS 39 to determine when an available-for-sale equity investment is impaired. This determination requires significant judgement. In making this judgement, the group evaluates, among other factors, the duration and extent to which the fair value of an investment is less than its cost; and the financial health of and short-term business outlook for the investee, including factors such as industry and sector performance, changes in technology and operational and financing cash flow.

If all of the declines in fair value below cost were considered significant or prolonged, the group would suffer an additional loss of HK$1,300,000 in its 2011 financial statements, being the transfer of the accumulated fair value adjustments recognised in equity on the impaired available-for-sale financial assets to the income statement.

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Key Sources of Estimation Uncertainty

- When there are uncertainties that have a significant risk of causing material adjustment to the carrying amount of assets and liabilities within the next financial year, the notes should disclose:
  - ✓ information about the assumptions concerning the future; and
  - ✓ other major sources of estimation uncertainty at the end of the reporting period
  - ✓ Include details of the nature of assets and liabilities and their carrying amount at the end of the reporting period

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Key Sources of Estimation Uncertainty

- Some examples include:
  - ✓ recoverable amount of classes of PPE
  - ✓ effect of technological obsolescence on inventories
  - ✓ provisions subject of the future outcome of litigation in progress; and
  - ✓ long-term employee benefit liabilities such as pension obligations

Some other HKFRSs include specific requirements for disclosures that would otherwise be required by HKAS 1, for example:

- HKAS 37 – major assumptions concerning future events affect classes of provisions
- HKFRS 7 – significant assumptions used in estimating fair values of financial assets and liabilities carried at fair values
- HKAS 16 – significant assumptions used in estimating fair values of revalued items of PPE

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Key Sources of Estimation Uncertainty - Example

(a) Estimated impairment of goodwill

The group tests annually whether goodwill has suffered any impairment, in accordance with the accounting policy stated in note 2.6. The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates (note 7).

An impairment charge of HK$4,650,000 arose in the wholesale CGU in Step-land (included in the Russian operating segment) during the course of the 2010 year, resulting in the carrying amount of the CGU being written down to its recoverable amount. If the budgeted gross margin used in the value-in-use calculation for the wholesale CGU in Step-land had been x% lower than management's estimates at 31 December 2010 (for example, 46% instead of 56%), the group would have recognised a further impairment of goodwill by HK$100,000 and would need to reduce the carrying value of property, plant and equipment by HK$300,000.

If the estimated cost of capital used in determining the pre-tax discount rate for the wholesale CGU in Step-land had been x% higher than management's estimates (for example, 13.8% instead of 12.8%), the group would have recognised a further impairment against goodwill of HK$300,000.

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Key Sources of Estimation Uncertainty - Example

Example:

4.2 Key sources of estimation uncertainty

The following are the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

4.2.3 Useful lives of property, plant and equipment

As described at 3.18 above, the Group reviews the estimated useful lives of property, plant and equipment at the end of each annual reporting period. During the financial year, the directors determined that the useful life of certain items of equipment should be shortened, due to developments in technology.

The financial effect of this reassessment, assuming the assets are held until the end of their estimated useful lives, is to increase the consolidated depreciation expense in the current financial year and for the next 3 years, by the following amounts:

	CU'000
2007	9
2008	7
2009	4
2010	2

Capital Disclosures

- HKAS 1 (revised) requires entities to disclose information which enables users of FS to evaluate the entity's objectives, policies and processes for managing capital. Therefore, the following disclosures are required:
  - Qualitative information about its objectives, policies and processes for managing capital;
  - Summary quantitative data about what it manages as capital;
  - Any changes in the foregoing from the previous period;
  - Whether the entity has complied with any externally imposed capital requirements to which it is subject; and
  - The consequence of non-compliance when the entity has not complied with the externally imposed capital requirements
- The Standard requires these disclosures to be based on the information provided internally to the entity's key management personnel

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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Disclosure of Details of Entity - Example

1. General

The Company is incorporated in Bermuda as an exempted company with limited liability and its shares are listed on The Stock Exchange of Hong Kong Limited. Its parent and ultimate holding company is Group Holdings Limited (incorporated in the British Virgin Islands). The addresses of the registered office and principal place of business of the Company are disclosed in the corporate information section of the annual report.

The consolidated financial statements are presented in Hong Kong dollars, which is the same as the functional currency of the Company.

The principal activities of the Company and its subsidiaries (the “Group”) are the manufacture and sale of widgets and toys. The Group was also engaged in the manufacture of bicycles and construction businesses, which were discontinued in the current year (see note 11).

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Improvements to HKAS 1 (revised)

Improvements in 2010 – effective on or after 1 January 2011

Para	Main changes
106	An entity shall present a statement of changes in equity as required by paragraph 10. The statement of changes in equity includes the following information: (d) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from: (i) profit or loss; (ii) ~~each item of~~ other comprehensive income; and (iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control. Information to be presented in the statement of changes in equity or in the notes
106A	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 (see paragraph 106(d)(ii)).

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Improvements to HKAS 1 (revised)

Improvements in 2011 – effective on or after 1 July 2012

Para	Main changes
Relevant para	From "Statement of comprehensive income" to " Statement of profit or loss and other comprehensive income"
10A	An entity may present a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section. An entity may present the profit or loss section in a separate statement of profit or loss. If so, the separate statement of profit or loss shall immediately precede the statement presenting comprehensive income, which shall begin with profit or loss.
82A	The other comprehensive income section shall present line items for amounts of other comprehensive income in the period, classified by nature (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method) and grouped into those that, in accordance with other HKFRSs: (a) will not be reclassified subsequently to profit or loss; and (b) will be reclassified subsequently to profit or loss when specific conditions are met. See Appendix 3 for illustrative disclosures.

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Accounting Policies, Estimates and Errors

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Scope

- HKAS 8 prescribes the criteria for selecting and changing accounting policies
- The Standard specifies accounting for
  - changes in account estimates
  - corrections of errors in prior period financial statements

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Consistency of Accounting Policies

❖ Select and apply its accounting policies consistently for similar transactions, other events and conditions

❖ Change accounting policy only if

- is required by change to HKFRSs (compulsory)
- results in reliable and more relevant information (voluntary)
- corrections of errors in prior period financial statements

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Consistency of Accounting Policies

❖ **Background:** An entity owns an office building that has been classified as PPE and accounted for under HKAS 16 using the cost model. During the current year, management vacated the property and leased it out to a third party. The entity's accounting policy for its investment property under HKAS 40 is to use the fair value model.

❖ **Question:** Is this a change in accounting policy?

Answer: This change in use of the building does not result in a change of accounting policy. The entity's policies for each type of property remain unchanged but the property in question is accounted for as an investment property from the date when its use changed. No retrospective restatement is required.

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Retrospective Application

- **Background:** In 20Y0, there is a voluntarily change in accounting policy. The cumulative effect of the change is a decrease of $100,000 in retained earnings at 1/1/20Y0 (ie. $25,000 less profit for each of the past four years). The entity presents two years of comparative information.

- **Question:** How should this change be accounted for?

- **Answer:** Presented as a restatement of :
  - retained earnings at 1/1/20X8 – reduced by $50,000
  - profit for 20X8 and 20X9 – reduced by $25,000 each

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Impracticability Exemption

- **Background:** In 20Y0, there is a voluntarily change in accounting policy. The cumulative effect of the change is a decrease of $100,000 in retained earnings at 1/1/20Y0 (ie. $25,000 less profit for each of the past four years). The entity presents two years of comparative information. It is impracticable to determine the individual period effects of the change of policy.

- **Question:** How should this change be accounted?

- **Answer:** Presented as a restatement of :
  - retained earnings at 1/1/20Y0
  - reduced by $100,000 (no adjustment to 20X8 and 20X9)
  - additional disclosures

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Accounting Estimate

- ❖ The use of reasonable estimates is an essential part of accounting
- ❖ Changes in accounting estimates result from new information or new developments and, accordingly, are not correction of errors
- ❖ Account for changes in accounting estimates prospectively
- ❖ Disclose:
  - nature of change and the effect of the change on assets, liabilities, income and expense for the current period
  - if practicable, estimates of the effect of the change in one or more future periods

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Errors

- ❖ Prior period errors are omissions from, and misstatements in, financial statements for prior periods arising from a failure to use, or misuse of, reliable information that:
  - was available when financial statements for those periods were authorised for issue, and
  - could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements

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Correcting Errors

- ❖ 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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Example - Change in Estimates

- ❖ 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

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Example - Change in Estimates (cont'd)

❖ The reassessment of the yacht's useful life and its residual value are changes in accounting estimates. The revised assessments are appropriately made on the basis of new information that arose from research performed in the current reporting period – 2009.

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Example – Prior Period Error

❖ 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.

❖ Co A's 2005 – 2008 financial statements include errors. The comparative figures in its 2009 financial statements must be restated to correct the effects of the prior period errors (if materials).

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Disclosures

- Where an entity has applied an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or when it reclassifies items in its financial statements, it shall present, as a minimum, three statements of financial position, two of each of the other statements and related notes. An entity presents SOFP as at:

  (i) the end of the current period,

  (ii) the end of the previous period

  (iii) the beginning of the earliest comparative period

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Disclosures

- For initial application of a HKFRS that have an effect on current or prior periods, or that may have an effect on future periods, the following information should be disclosed:
  - title of HKFRS
  - change in accounting policy is made in accordance with its transitional provisions, a description of the such provisions and whether there is any effect on future periods, if applicable
  - nature of change in accounting policy
  - the amount of adjustment for each line item affected and the basic and diluted EPS for the current and prior period presented
  - Amount of adjustments relating to periods prior to the earliest period presented in the F/S
  - If retrospective application has not been practicable for a prior period presented, or for earlier periods, circumstances why impractical and a description of how and from when the change in policy has been applied

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Disclosures

- For voluntary changes in accounting policy that have an effect on current or prior periods, or that may have an effect on future periods, the following information should be disclosed:
  - Nature of the change in policy
  - Reason why the new policy give more reliable and relevant information
  - Amount of the adjustments for the current period & each prior period
  - Effects of changes in accounting policies for each component of equity
  - Amount of adjustments relating to periods prior to the earliest period presented in the F/S
  - If retrospective application has not been practicable for a prior period presented, or for earlier periods, circumstances why impractical and a description of how and from when the change in policy has been applied
  - Such disclosures need not be repeated in subsequent years' F/S

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Disclosures

- For changes in accounting estimates, disclose:
  - Nature and amount of change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods
  - The fact that if the amount of effect in future periods is impracticable to estimate
- For correction of period errors, disclose:
  - the nature of the prior period error
  - the amount of the correction for each line item affected; and basic and diluted EPS if HKAS 33 applies
  - the amount of correction at the beginning of the earliest prior period presented; and
  - If retrospective restatement is impracticable for a prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected

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HKFRS in issue but not yet effective

- Entities should make certain disclosures on new standard or interpretation published (but has not yet come into effect) after the balance sheet date, but before date of authorisation of F/S,
  - ✓ title of the new HKFRS
  - ✓ nature of future change in policy
  - ✓ date the standard/interpretation should be applied
  - ✓ a discussion of the impact or if that impact is not known or reasonably estimable, a statement to that effect
- For pronouncements where there is an option that would impact the entity, the management expectation on whether the entity will use the option should be disclosed

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Events After the Reporting Period

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Scope

- ❖ Events after the end of the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue

- ❖ Two types of events:
  - Adjusting events – those that provide evidence of conditions that existed at the end of the reporting period
  - Non-adjusting events – those that are indicative of conditions that arose after the end of the reporting period

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Accounting and Reporting

- ❖ Adjusting events – adjust the amounts recognised (and update disclosures made) in its financial statements

- ❖ Non-adjustment events – do not adjust the amounts recognised in its financial statements. However, disclose:
  - The nature of the event, and
  - An estimate of its financial effect, or a statement that estimate cannot be made

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Example Adjusting Event

- On 31/12/2010 Co A assessed its warranty obligation as $100,000. Before its 2010 financial statements were authorised for issue, Co A discovered a latent defect in one of its lines of products. It reassessed its warranty obligation at 31/12/2010 at $150,000

- Adjusting events – latent defect existed at 31/12/2010. Measure warranty provision at $150,000 at 31/12/2010.

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Example Non-adjusting Event

- On 28/2/2011 Co A's 2010 FS authorised for issue. Fair value of A's investment in B's publicly traded shares on 31/12/2010 = $20,000. On 28/2/2011 fair value of shares = $15,000.

- Non-adjusting event – the change in fair value results from conditions that arose after 2010

- Co A does not adjust the amounts recognised in its financial statements. However, it must give additional disclosure given the impact is significant.

Effect of post balance sheet events on classifications

- For loans classified as current liabilities, HKAS 1 states that if the following events occur between the end of the reporting period and the date the financial statements are authorised for issue, those events are disclosed as non-adjusting in accordance with HKAS 10:

  - Refinancing on a long-term basis
  - Rectification of a breach of a long-term loan arrangement
  - The granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least twelve months after the reporting period

Disclosure Non-adjusting

- On 1/3/2011, Co A's 31/12/2010 FS authorised for issue when spot ex rate = $2.5 to FCU 1. At 31/12/2010 spot ex rate = $2 to FCU 1. Co A measured its FCU $2,000,000 unhedged non-current liability at $4,000,000 in the statement of financial position.

- Notes 20 Events after the end of the reporting period

  The financial statements were authorised for issue on 1 March 2011 when the exchange rate was $2.5: FCU 1. The deterioration of the exchange rate from $2: FCU 1 at 31 December 2010 has increased the expected settlement amount of the FCU-denominated liability by $1,000,000

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Thank you for your attention

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

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Winnie Chan
HKICPA Associate Director
Technical Training & Support

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HKAS 21 – The effects of changes in foreign exchange rates

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Agenda

- Scope
- Definitions
- Functional currency
- Net investment in a foreign operation
- Reporting foreign currency transactions in the functional currency
- Change in functional currency
- Presentation currency
- Translation of a foreign operation
- Disposal or partial disposal of a foreign operation
- Tax effects of all exchange differences
- Disclosures

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Scope

No more proportionate consolidation under HKFRS 11

- ✓ accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement;*
- ✓ translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation, proportionate consolidation or the equity method; and
- ✓ translating an entity's results and financial position into a presentation currency.
- X hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation.
- X presentation in a statement of cash flows of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation

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Scope

Example: Hedging in a net investment in a foreign operation

Background

X, a HK entity with HK$ as functional currency, has a foreign subsidiary with a different functional currency. X's investment in the subsidiary is US$ 2 million. X has a third party long-term debt agreement of US$ 4 million. X designates US$ 2 million of the debt at the beginning of the year as a hedge of its net investment in the foreign subsidiary.

Analysis

- US$ 2 million debt qualifying as a hedging instrument is outside the scope of HKAS 21 and is dealt with by HKAS 39.
- Remaining US$ 2 million not designated in the hedging relationship is still within the scope of HKAS 21.

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Definitions

Terms	Definitions
Foreign operation	A subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity
Functional currency	Currency of the primary economic environment in which the entity operates
Presentation currency	Currency in which the financial statements are presented
Net investment in a foreign operation	Amount of the reporting entity's interest in the net assets of that operation
Monetary items	Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency

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Definitions

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

** For prepayments – if it is refundable, it is more akin to a deposit and hence, is a monetary items. Conversely, where it is not refundable, it is non-monetary.

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Functional currency

- Each entity is required to determine its functional currency in accordance with HKAS 21
- This applies whether the entity is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch)
- There is NO concept of a "group functional currency" in HKFRSs
- Judgment is required in assessing the functional currency
- Function currency will change ONLY if there is a change in the primary economic environment in which the entity operates

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Primary indicators of a functional currency

- the currency that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and the currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
- the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Further indicators:

- currency in which funds from financing activities are generated; and
- currency in which receipts from operating activities are usually retained.

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Functional currency of a foreign operation

Whether the functional currency of the foreign operation is the same as that of a reporting entity to which it is related?

- Whether the activities of a foreign operation are carried out as an extension of that reporting entity, rather than being carried out with a significant degree of autonomy;
- Whether the transactions with that reporting entity are a high or low proportion of the foreign operation's activities;
- Whether cash flows from the activities of the foreign operation directly affect the cash flows of that reporting entity and are readily available for remittance to it; and
- Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by that reporting entity.

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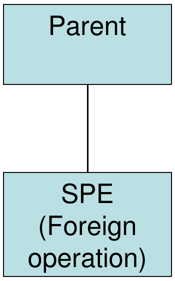
Functional currency of a foreign operation

Example 1:



- The special purpose entity (SPE) is set up to conduct on behalf of the parent entity (e.g. leasing vehicles) and the SPE is an extension of the reporting entity.
- What is the functional currency of the SPE?

✓ same functional currency of the reporting entity

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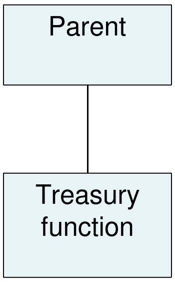
Functional currency of a foreign operation

Example 2:



- What is the functional currency of the entity that carries out treasury function?
  - ✓ If it exists to serve the funding and cash management needs of the group as a whole (i.e. constitute an extension of the parent), the functional currency is the same as the parent.
  - ✓ If it exist solely to service a specific sub-group, the functional currency may be different to that of the parent.

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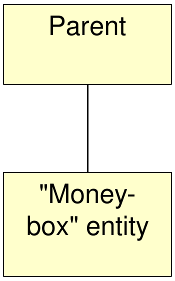
Functional currency of a foreign operation

Example 3:



- A "money-box" entity is an entity that holds cash for the group only.
- What is the functional currency of the "money-box" entity?
  - ✓ The currency of the cash will not be the determining factor.
  - ✓ Consider whose benefit the "money-box" entity exists, which will determine its functional currency.

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Example 4: What are the functional currencies of Co P and Co Q ?

(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

Example 4:

Accounting Treatment:

- **Co Q:** functional currency is Sterling 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 (eg the Cayman Islands and Bermuda) with its shares listed on the Hong Kong Stock Exchange;
  - The ordinary share capital and the borrowings of the investment holding company are all denominated in Hong Kong dollars (HKD);
  - The investment holding company incurs some administrative and local expenses, comprising mainly directors' emoluments, limited staff costs and office rental payments, which are settled in HKD;

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- The principal assets of the holding company are its investments in subsidiaries. All of the operating subsidiaries of the holding company operate in Mainland China and their functional currency is Renminbi (RMB). Any dividend income received from the subsidiaries is either received in HKD or converted into HKD on receipt as the holding company does not have any RMB liabilities and, due to currency restrictions over the RMB, has very limited ability to hold RMB cash deposits

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View 1

- One view would be that the functional currency of the holding companies is to be determined as HKD
- The proponents of this view note that there is no scope within paragraphs 9 to 14 of IAS 21 for an investment holding company to be viewed as an extension of its subsidiary (i.e. the attribution of a functional currency from one group entity to another in accordance with paragraph 11 only applies in a downwards direction i.e. from parent to subsidiary (or other investee) and not vice versa)
- HKD is the currency in which all its operating expenses (small though they may be) are denominated and the currency of its sources of financing. The currency of Mainland China, the RMB, is not considered to be the functional currency of the investment holding company as it does not itself operate in Mainland China and carries its investments in the operating subsidiaries at cost

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- the operating subsidiaries are regarded as foreign operations of the investment holding company as these subsidiaries accumulate cash and other monetary items, incur expenses, generate income and arrange borrowings all substantially in their own local currency of the RMB with a significant degree of autonomy
- The supporters of this approach also note that such investment holding companies frequently exist to hold investments within jurisdictions with restricted currencies, such as the RMB
- In their view it would seem inappropriate to identify a restricted currency, such as the RMB, as the functional currency of an entity, when that entity is itself legally unable to hold the currency and would incur operational costs if settling transactions denominated in that currency due to the need to enter into foreign exchange trades

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View 2

- An alternate view would be that the RMB is a more appropriate functional currency for such an investment holding company given that its primary source of income (being dividend income from its operating subsidiaries) is from Mainland China and its ability to service debts and make distributions to its owners are heavily dependent on the economy of Mainland China
- This approach is considered by its supporters to be consistent with the provision in paragraph 12 which states that the entity needs to consider the primary factors stated in paragraph 9 of IAS 21, before going down to the indicators stated in other paragraphs of IAS 21. In the context of an investment holding company the assessment of income, as required by paragraph 9(a), would be the dividend income to be received from its operating subsidiaries

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- Furthermore, the currency in which dividends from subsidiaries are denominated of itself is not a conclusive factor in determining the functional currency of an investment holding company
- Paragraph IN7 in the introduction to IAS 21 makes clear that the Standard gives greater emphasis to the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated
- Investment holding companies control their subsidiaries and thus may ask for dividends to be paid in whatever currency they like. The currency in which dividend income is denominated is therefore not relevant in determining the functional currency of an investment holding company, as the amount of the dividend income is determined by the currency of the income of subsidiaries (eg the RMB) and retranslated into the settlement currency
- Likewise, management should not determine the functional currency of an investment holding company solely based on the currency in which funds are invested in the subsidiaries

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Functional currency – investment holding co

- IAS 21 paragraphs 9—11 provide factors to be considered in determining the functional currency of an entity. Paragraph 12 states that when the 'indicators are mixed and the functional currency is not obvious, management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions'
- In addition, paragraph 17 of IAS 21 requires that an entity determine its functional currency in accordance with paragraphs 9—14 of the standard. Therefore, paragraph 9 should not be considered in isolation when determining the functional currency of an entity

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Example: Functional currency

- **HSBC Holdings PLC:**

  Annual report for ye 31 December 2010:

➢ 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 2010:

➢ Functional and presentation currency

  Items included in the financial statements of each of the group entities 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 presentation currency.

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Monetary item that forms part of a net investment in a foreign operation

- Receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation.
- Such monetary items may include long-term receivables or loans. They do NOT include trade receivables or trade payables.
- HKSA 21 does not specify a time period that might qualify as the "foreseeable future".
- The entity that has a monetary item receivable from or payable to the foreign operation may be the parent or any subsidiary in the group, including another foreign operation.
- For example, an entity has two subsidiaries, A and B. B is a foreign operation. A grants a loan to B. A's loan receivable from B would be part of the entity's net investment in B if settlement of the loan is neither planned nor likely to occur in the foreseeable future.

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Monetary item that forms part of a net investment in a foreign operation

- Can the following monetary items form part of the net investment in a foreign operation?
  - Rolling balance intragroup accounts
  - Parent guarantee of foreign subsidiary's debt
  - Foreign-currency denominated intragroup payables arising in the normal course of business with no fixed repayment terms
  - Short-term intragroup debt with parent's representation each year that it will not demand repayment in that year
- A monetary item that meets the requirements for accounting as "net investment in a foreign operation" can be denominated in a currency other than the functional currency of either the reporting entity or the foreign operation.

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Reporting foreign currency transactions in the functional currency

Initial recognition: recorded, in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction

Subsequent reporting periods	Monetary items	Non-monetary items at historical costs	Non-monetary items at fair value
	translated using the closing rate	translated using the exchange rate at the date of the transaction	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)?

<u>HKAS 21.25</u>

the carrying amount is determined by comparing:

(a) the cost or carrying amount, as appropriate, <u>translated at the exchange rate at the date when that amount was determined</u> (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, <u>translated at the exchange rate at the date when that value was determined</u> (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 <u>profit or loss in the separate financial statements</u> 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 <u>consolidated financial statements</u> that include the foreign operation, in <u>other comprehensive income</u>; they will be <u>reclassified from equity to profit or loss on disposal of the net investment</u>. [HKAS 21.32]
- No →
  - Exchange differences arising when <u>monetary items are settled</u> or when monetary items are <u>translated at rates different</u> from those at which they were translated when initially recognised or in previous financial statements are reported <u>in profit or loss in the period</u> [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)

1 Nov 20X1:

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)

31 Dec 20X1:

Dr. Property, plant and equipment	US$5,325,814
Cr. Revaluation gain (via OCI)	US$5,325,814

(The building is a non-monetary item and held at fair value. It is retranslated at the rate of SGD 1.71: US$1.)

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Exchange rates – other considerations

- Several exchange rates available

  the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. [HKAS 21.26]
- Lack of exchangeability between two currencies

  If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made. [HKAS 21.26]
- Exchange rate movements after the end of the reporting period

  If there is significant volatility in exchange rates, the effect on foreign currency monetary items of a change in exchange rates after the year end should be disclosed if the change is of significance to the users of financial statements
- Accounting records in a currency other than the functional currency

  At the time the entity prepares its financial statements, all amounts are translated into the functional currency in accordance with paragraphs 20-26. This produces the same amounts in the functional currency as would have occurred had the items been recorded initially in the functional currency. [HKAS 21.36]

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Change in functional currency

- Reason for the change in functional currency:

  Once determined, the functional currency can be changed ONLY if there is a change to those underlying transactions, events and conditions.

  For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in en entity's functional currency.
- Accounting treatment:
  - ✓ The entity applies the translation procedures applicable to the new functional currency prospectively from the date of the change.
  - ✓ In other words, an entity translates all items into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost.
  - ✓ Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation.
- Disclosure:

  The fact that there has been a change in functional currency and the reasons for the change

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Presentation currency

The presentation currency is defined as the currency in which the financial statements are presented.

- It can be any currency of choice
- Presenting the financial statements in a currency other than the functional currency does not change the way in which the underlying items are measured.
- For example:
  - ✓ When a group contains entities with different functional currencies, the results and financial position of each entity must be expressed in a common currency in order to produce the consolidated accounts. Such presentation currency is often, but not always, the functional currency of the parent.
  - ✓ Entities may also choose to present their accounts in a currency other than their functional currency in order to:
    - provide information to overseas shareholders; or
    - comply with the regulation in certain jurisdictions where entities are required to present the accounts in local currency.

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Presentation currency

Translation to the presentation currency

(a) assets and liabilities for each statement of financial position presented (ie including comparatives) shall be translated at the closing rate at the date of that statement of financial position;

(b) income and expenses for each statement of comprehensive income or separate income statement presented (i.e. including comparatives) shall be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences shall be recognised in other comprehensive income.

How about translation of share capital or other equity reserves?

- The 'foreign currency translation reserve' should not include any amounts for the retranslation of share capital or other equity reserves.
- It is, therefore, appropriate to translate share capital and other components of equity using the historical rates.
- There may be circumstances where more than one historical rate will apply when share capital is issued at different times.

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Presentation currency

Notes:

- Cash flows are translated on a basis similar to that required for income and expenses, i.e. using the exchange rates at the transaction dates.
- Equity transactions (e.g. contributions to equity share capital, distributions to owners of equity) are also translated at the exchange rates at the transaction dates.
- A rate approximates the exchange rates at the dates of the transactions is often used to translate income and expenses. If the exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

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Translation of a foreign operation

- Generally follow that of the principles of translating the functional currency to the presentation currency
- Other factors to considers:
  - ✓ Not wholly-owned foreign operations
  - ✓ Exchange differences on intragroup transactions
  - ✓ Financial statements of foreign operations prepared to a different date
  - ✓ Goodwill and fair value adjustments

(I) Not wholly-owned foreign operations

- The cumulative amount of the exchange differences is presented in a separate component of equity until disposal of the foreign operation.
- When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognised as part of, non-controlling interests in the consolidated statement of financial position

CEF

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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 jointly controlled entities and in applying proportionate consolidation to jointly controlled entities. [joint ventures under HKFRS 11]

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Translation of a foreign operation

(IV) Goodwill and fair value adjustments

- Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be:
  - treated as assets and liabilities of the foreign operation, and therefore expressed in the functional currency of the foreign operation; and
  - translated at the closing rate

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Disposal or partial disposal of a foreign operation

Disposals

- On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognised in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised.
- The following events, transactions or changes in circumstances are accounted for as disposals:
  - ✓ Disposal of entire interest in a foreign operation
  - ✓ Loss of control of a subsidiary that includes a foreign operation
  - ✓ Loss of significant influence over an associate that includes a foreign operation
  - ✓ Loss of joint control over a jointly controlled entity that includes a foreign operation [joint arrangement under HKFRS 11]

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Disposal or partial disposal of a foreign operation

Differences attributable to non-controlling interests

- On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be derecognised, but shall not be reclassified to profit or loss.
- For example:
  - ✓ P has held an 80% interest in a foreign operation, S. Exchange differences of HK$2.5 million relating to S have been recognised in other comprehensive income. 80% of the exchange differences (i.e. HK$ 2 million) have been accumulated in P's foreign currency translation reserve in equity and the remainder have been attributed to non-controlling interests.
  - ✓ On loss of control, the HK$2 million in P's reserve are reclassified from reserve to profit or loss and included in the calculation of profit or loss on disposal.
  - ✓ HK$0.5 million were already reflected as part of the non-controlling interest in the consolidated accounts and are derecognised upon loss of control.

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Disposal or partial disposal of a foreign operation

Partial disposals

- A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except those reductions in paragraph 48A that are accounted for as disposals.
- Partial disposal of a subsidiary that includes a foreign operation:
  - Re-attribute the proportionate share of the cumulative amount of the exchange differences in other comprehensive income to the non-controlling interest in the foreign operation.
  - Such transfer will be recognised in equity.
  - For example, P held 100% interest in a foreign subsidiary S. Exchange differences of HK$2.5 million recognised in OCI and accumulated in a separate component of equity.

P disposes of 20% interests in S but retains control of S. 20% of the cumulative exchange differences (i.e. HK$0.5 million) are transferred within equity from the foreign currency translation reserve to non-controlling interests.

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Disposal or partial disposal of a foreign operation

Partial disposals

- Other partial disposal of a foreign operation:
  - Reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.
  - For example, I held a 40% interest in an associate, A. Exchange differences of HK$8 million relating to A have been recognised in OCI and accumulated in a separate component of equity.
    I disposes of 15% interest in A, but retains significant influence. The proportionate share of accumulated exchange differences (i.e. 3 million) is derecognised and is recognised in profit or loss as a reclassification adjustment.

Write-downs

- A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

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Tax effects of all exchange differences

- Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects. HKAS 12 *Income Taxes applies to these tax effects.*

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Disclosure

- The amount of exchange differences recognised in profit or loss (excluding differences arising on financial instruments measured at fair value through profit or loss in accordance with HKAS 39) [HKAS 21.52(a)]
- Net exchange differences recognised in other comprehensive income and accumulated in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period [HKAS 21.52(b)]
- When the presentation currency is different from the functional currency, disclose that fact together with the functional currency and the reason for using a different presentation currency [HKAS 21.53]

  Refer to Appendix 5 for an extract of annual report for disclosures.
- A change in the functional currency of either the reporting entity or a significant foreign operation and the reason. [HKAS 21.54]
- When an entity presents its financial statements in a currency that is different from its functional currency, it may describe those financial statements as complying with HKFRS only if they comply with all the requirements of each applicable Standard (including HKAS 21) and each applicable Interpretation. [HKAS 21.55]

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Thank you for your attention

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

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

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Agenda

A. Scope of HKFRS 5
B. Measurement of assets held for sale
C. Presentation & disclosures
D. Held for sale criteria no longer met
E. Discontinued operations
F. Presentation & disclosures
G. Distributions of non-cash assets to owners

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A. Scope of HKFRS 5

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

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

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"Scoped-out" non-current assets

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

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

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Disposal Group

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

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

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

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Classifications as non-current assets held for sale

Principle – carrying amounts recovered <u>principally through a sale transaction rather than through continuing use</u>

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

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 expected within 12 months
- Actively marketed at a reasonable price
- Requirements to complete indicate plan won't alter

Held for Sale Classification Criteria

Available for sale - Example:

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

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

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

Do they meet the criteria of available for sale?

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Held for Sale Classification Criteria

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 4 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

Newly acquired assets or disposal groups

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

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Non-current asset/disposal group to be abandoned

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

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

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Disposal and partial disposal

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

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Disposals and partial disposals (cont'd)

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

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

B. Measurement of assets held for sale

Initial Measurement

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

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Subsequent Measurement

- Remeasured in accordance with applicable HKFRSs:

  For disposal group,
  - scoped out non-current assets
  - all current assets and all liabilities
- No depreciation or amortisation for "*scoped in non-current assets*".

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

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Increases and Decreases in Fair Value Less Costs to Sell

❑ **Impairment loss (subsequent reversal) recognised (reversed) for a disposal group shall be allocated**:

- only between the "*scoped in non-current assets"*
- in the order set out in HKAS 36.104(a)&(b) and HKAS 36.122

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Increases and Decreases in Fair Value Less Costs to Sell

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

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

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

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

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

- Subsequent increase in fair value less costs to sell

A gain is recognised

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

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Extracted from PwC Manual of Accounting 2010

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	250	520
Current liabilities	(850)	(870)
Non-current liabilities - provisions	(300)	(250)
	1,900	2,160

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Extracted from PwC Manual of Accounting 2010

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 2010

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 2010

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 2010

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 2010

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 2010

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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Interests in associates and joint ventures held for sale

- The associate or joint venture must meet the conditions to be classified as held for sale.
- Shares of profits and re-measurement of carrying amounts should be done in accordance with normal associate and joint venture under HKAS 28 and HKAS 31 respectively up to the point of classification as held for sale.
- The associate or joint venture must then be measured in accordance with HKFRS 5, i.e. at the lower of carrying amount and fair value less costs to sell.

Note on adoption of HKAS 28 (2011), HKFRS 5 applies to the investment in an associate or a joint venture, or a portion of the investment when the criteria to be classified as held for sale met according to HKFRS 5.

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C. Presentation & Disclosure

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

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C. Presentation & Disclosure (cont'd)

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

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C. Presentation & Disclosure (cont'd)

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

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D. Held for Sale Criteria No Longer Met

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

Example:

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

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

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D. Held for Sale Criteria No Longer Met

Measurement on de-classification as held for sale

- **measure at the lower of**

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

and

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

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D. Held for Sale Criteria No Longer Met

Presentation of adjustments to carrying amount on de-classification

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

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D. Held for Sale Criteria No Longer Met

Question:

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

Answer:

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

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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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E. Discontinued Operations (Con't)

Measuring discontinued operations

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

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F. Presentation & disclosures

- **Statement of comprehensive income**

  A single amount comprises of:

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

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

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

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F. Presentation & disclosures

- an analysis of the single amount into:

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

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

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

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

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

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F. Presentation & disclosures

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

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F. Presentation & disclosures

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

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F. Presentation & disclosures

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

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

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F. Presentation & Disclosures

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

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G. Distributions of non-cash assets to owners

- Non-cash assets held for distribution to owners are now specifically scoped into HKFRS 5 and should be treated in accordance with HKFRS 5's classification, presentation and measurement
- Whether or not a non-cash asset is classified as 'held for distribution to owners' is determined using HKFRS 5's general principles regarding whether the transaction is highly probable
- When the non-cash asset is classified as held for distribution to owners, it is re-measured at the lower of its carrying amount and fair value less costs to distribute, with any adjustment to carrying amount recognised in accordance with the general principles of HKFRS 5
- Where the fair value less costs to distribute of an asset accounted for using the cost model is less than its carrying amount, an impairment loss should be recognised in profit or loss. Where the fair value less costs to distribute is higher than the carrying amount, no adjustment is made until the distribution is made

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Thank you for your attention

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

At 31 December 2010

		At 31 Dec 2010			As restated At 31 Dec 2009			As restated At 1 Jan 2009		
	Note	Current $m	Non-current $m	Total $m	Current $m	Non-current $m	Total $m	Current $m	Non-current $m	Total $m
ASSETS										
Cash and cash equivalents	18	19,361	-	19,361	14,738	-	14,738	27,784	-	27,784
Financial assets at fair value through profit or loss		-	-	-	-	-	-	3,020	-	3,020
Financial assets measured at fair value through profit or loss	19	9,949	1,241	11,190	12,466	1,559	14,025	-	-	-
Available-for-sale financial assets		-	-	-	-	-	-	19,394	-	19,394
Financial assets at amortised cost		-	-	-	-	-	-	3,664	47	3,711
Financial assets measured at amortised cost	20(a)	7,021	783	7,804	4,157	768	4,925	-	-	-
Accounts receivable, prepayments and deposits	21	9,203	3	9,206	11,334	3	11,337	8,535	3	8,538
Fixed assets	22(a)	-	295	295	-	303	303	-	370	370
Lease premium for land	23	-	25	25	-	-	-	-	-	-
Deferred tax assets	30(e)	-	3	3	-	4	4	-	5	5
Total assets		45,534	2,350	47,884	42,695	2,637	45,332	62,397	425	62,822
LIABILITIES AND EQUITY										
Liabilities										
Margin deposits from Clearing Participants on derivatives contracts	24	22,702	-	22,702	20,243	-	20,243	41,840	-	41,840
Cash collateral from HKSCC Clearing Participants	25	3,594	-	3,594	3,432	-	3,432	3,600	-	3,600
Accounts payable, accruals and other liabilities	26	9,946	-	9,946	11,827	-	11,827	8,894	-	8,894
Deferred revenue		473	-	473	424	-	424	393	-	393
Taxation payable		320	-	320	261	-	261	141	-	141
Other financial liabilities	27	58	-	58	42	-	42	118	-	118
Participants' contributions to Clearing House Funds	28	2,039	-	2,039	723	276	999	198	252	450
Provisions	29(a)	28	29	57	33	26	59	36	25	61
Deferred tax liabilities	30(e)	-	18	18	-	18	18	-	31	31
Total liabilities		39,160	47	39,207	36,985	320	37,305	55,220	308	55,528
Equity										
Share capital	32			1,078			1,076			1,075
Share premium	32			416			376			347
Shares held for Share Award Scheme	32			(219)			(52)			(65)
Employee share-based compensation reserve	33			56			43			47
Investment revaluation reserve	34			-			-			97
Designated reserves	28, 35			580			563			552
Retained earnings	37			6,766			6,021			5,241
Shareholders' funds				8,677			8,027			7,294
Total liabilities and equity				47,884			45,332			62,822
Net current assets				6,374			5,710			7,177
Total assets less current liabilities				8,724			8,347			7,602

Approved by the Board of Directors on 2 March 2011

Ronald Joseph ARCULLI
Director

LI Xiaojia, Charles
Director

2. Principal Accounting Policies (continued)

(b) Basis of preparation (continued)

Change in presentation of statements of financial position

In previous years, the Group and HKEx presented current and non-current assets, and current and non-current liabilities, as separate classifications in the statements of financial position. From 2010 onwards, the Group and HKEx decided to present their assets and liabilities in order of liquidity in the statements of financial position as it provides information that better reflects the manner in which the assets and liabilities are managed in the business operations of the Group, particularly following the changes made on adopting HKFRS 9, and is thus more relevant.

The comparative figures have been restated to conform with the revised presentation. There is no financial impact to the Group and HKEx.

Change in units of presentation of accounts

In previous years, the consolidated accounts were presented in Hong Kong dollars (HKD), rounded to the nearest thousand. From 2010 onwards, the Group and HKEx decided to present the consolidated accounts in HKD, rounded to the nearest million, as it simplifies the accounts and provides a better view on material items.

Effects of HKFRSs issued after 31 December 2010 and up to the date of approval of the consolidated accounts

Subsequent to 31 December 2010 and up to the date of approval of these consolidated accounts, the HKICPA has issued certain revised HKFRSs but they are not applicable to the Group's operations.

(c) Consolidation

The consolidated accounts include the accounts of HKEx and all of its subsidiaries made up to 31 December.

Subsidiaries and controlled special purpose entities are entities over which HKEx, directly or indirectly, has the power to govern the financial and operating policies generally accompanying a holding of more than one half of the voting rights or issued share capital.

The accounts of subsidiaries and controlled special purpose entities are included in the consolidated accounts from the date on which control commences until the date that control ceases. The assets and liabilities of the controlled special purpose entity, HKEx Employee Share Trust, are included in HKEx's statement of financial position and the HKEx shares held by the HKEx Employee Share Trust are presented as a deduction in equity as Shares held for Share Award Scheme. All material intra-group transactions and balances have been eliminated on consolidation.

In HKEx's statement of financial position, investments in subsidiaries are stated at cost less provision for any impairment, if necessary. The results of subsidiaries are accounted for by HKEx on the basis of dividends received and receivable.

Appendix 2

Illustrative disclosures in respect of

Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*

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Illustrative disclosures in respect of the application of Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*

The following sets out extracts from a set of financial statements for the year ended 31 December 2010 prepared by a fictitious company, XYZ Limited, incorporated in Hong Kong applying Hong Kong Interpretation 5 for the first time and as a result, certain bank borrowings have been reclassified as current liabilities.

[Note: The disclosures are only for illustrative purposes. They should not be considered the only acceptable form of presentation and do not attempt to cater for all entity-specific facts and circumstances. Alternative presentations to those proposed in this publication may also be acceptable.]

XYZ Limited

Statement of financial position at 31 December 2010 (Expressed in Hong Kong dollars)

	Note	**As at 31 December 2010**	**As at 31 December 2009**	**As at 1 January 2009**
		$'000	**$'000**	**$'000**
			(restated)	(restated)
ASSETS				
Non-current assets				
Etc.		[•]	[•]	[•]
		[•]	[•]	[•]
Current assets				
Etc.		[•]	[•]	[•]
		[•]	[•]	[•]
Total assets		[•]	[•]	[•]
LIABILITIES AND EQUITY				
Current liabilities				
Trade and other payables		[•]	[•]	[•]
Bank borrowings	20	18,000	13,000	12,000
Current taxation		[•]	[•]	[•]
Provisions		[•]	[•]	[•]
		[•]	[•]	[•]
Non-current liabilities				
Bank borrowings	20	34,000	32,000	29,000
Deferred tax liabilities		[•]	[•]	[•]
Provisions		[•]	[•]	[•]
		[•]	[•]	[•]
Total liabilities		[•]	[•]	[•]
Equity				
Share capital		[•]	[•]	[•]
Reserves		[•]	[•]	[•]
		[•]	[•]	[•]
Total liabilities and equity		[•]	[•]	[•]

Approved and authorized for issue by the Board of Directors on [Date] and are signed on its behalf by:

(Name, Director) (Name, Director)

The notes on pages [X] to [Y] form part of these financial statements.

Note : As required by HKAS 1.10(f), a statement of financial position is presented at the beginning of the earliest comparative period when the entity has applied new accounting policies retrospectively in the year.

Notes to the financial statements
For the year ended 31 December 2010 - continued

Changes in accounting policies

HKAS 8.28

In November 2010 the HKICPA issued Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*. The Interpretation is effective immediately and is a clarification of an existing standard, HKAS 1 *Presentation of Financial Statements*. It sets out the conclusion reached by the HKICPA that a term loan which contains a clause which gives the lender the unconditional right to demand repayment at any time shall be classified as a current liability in accordance with paragraph 69(d) of HKAS 1 irrespective of the probability that the lender will invoke the clause without cause.

In order to comply with the requirements of Hong Kong Interpretation 5, the Company has changed its accounting policy on the classification of term loans that contain a repayment on demand clause. Under the new policy, term loans with clauses which give the lender the unconditional right to call the loan at any time are classified as current liabilities in the statement of financial position. Previously such term loans were classified in accordance with the agreed repayment schedule unless the Company had breached any of the loan covenants set out in the agreement as of the reporting date or otherwise had reason to believe that the lender would invoke its rights under the immediate repayment clause within the foreseeable future.

The new accounting policy has been applied retrospectively by re-presenting the opening balances at 1 January 2009, with consequential reclassification adjustments to comparatives for the year ended 31 December 2009. The reclassification has had no effect on reported profit or loss, total comprehensive income or equity for any period presented.

Effect of adoption of Hong Kong Interpretation 5 on the statement of financial position

	At 31 December 2010	*At 31 December 2009*	*At 1 January 2009*
	$'000	$'000	$'000
Increase/(decrease) in			
Current liabilities			
Bank borrowings	3,500	4,000	5,000
Non-current liabilities			
Bank borrowings	(3,500)	(4,000)	(5,000)

Notes to the financial statements
For the year ended 31 December 2010 – continued

9. Finance costs

		2010	2009
		$'000	$'000
10th Sch (13(1)(b))	Interest on bank borrowings		
	- Wholly repayable within five years	3,352	2,788
	- Not wholly repayable within five years	184	137
		-----------	-----------
	Total finance costs	3,536	2,925
		======	======

The analysis shows the finance costs of bank borrowings, including term loans which contain a repayment on demand clause, in accordance with the agreed scheduled repayments dates set out in the loan agreements. For the years ended 31 December 2010 and 2009, the interest on bank borrowings which contain a repayment on demand clause amounted to HK$184,000 and HK$137,000 respectively.

[Note: It is acceptable to classify the interest on the bank loans with instalments which fall due after more than five years, but are subject to a repayment on demand clause, either as "wholly repayable within five years" or "not wholly repayable within five years", provided that the approach adopted is applied in a consistent manner and it is clear from the note which approach has been taken.]

Notes to the financial statements
For the year ended 31 December 2010 – continued

20. Bank borrowings

HKFRS 7.7

The analysis of the carrying amount of bank borrowings is as follows:

	2010 $'000	*2009* $'000 (restated)	*1 January 2009* $'000 (restated)
Current liabilities			
Bank overdrafts	1,300	700	800
Portion of term loans from banks due for repayment within one year	8,000	8,200	5,800
Portion of term loans from banks due for repayment after one year which contain a repayment on demand clause	8,700	4,100	5,400
	18,000	13,000	12,000
Non-current liabilities			
Bank loans	34,000	32,000	29,000

HKFRS 7.31

Bank borrowings bear average coupons of [x]% annually (2009:[y]% annually)

HKFRS 7.8(f) & HKAS 1.61

The interest-bearing bank borrowings, including the term loans repayable on demand, are carried at amortised cost. None of the portion of term loans due for repayment after one year which contain a repayment on demand clause and that is classified as a current liability is expected to be settled within one year.

Notes to the financial statements
For the year ended 31 December 2010 – continued

HKFRS 7.7 & 31

20. Bank borrowings (continued)

A16(22)(1)

At 31 December 2010, interest-bearing bank loans and overdrafts were due for repayment as follows:

	2010 $'000	*2009* $'000
Overdrafts repayable on demand	1,300	700
Portion of term loans due for repayment within one year	8,000	8,200
	9,300	8,900
Term loans due for repayment after one year (Note 1):		
After 1 year but within 2 years	10,000	9,000
After 2 years but within 5 years	30,000	25,000
After 5 years	2,700	2,100
	42,700	36,100
	52,000	45,000

Note 1 - The amounts due are based on the scheduled repayment dates set out in the loan agreements and ignore the effect of any repayment on demand clause.

10th Sch (10)

At 31 December 2010, the bank loans and overdrafts were secured as follows:

	2010 $'000	*2009* $'000
Unsecured bank overdrafts	1,300	700
Bank loans		
- secured	17,000	15,000
- unsecured	33,700	29,300
	52,000	45,000

10th Sch (12(4))
HKAS 16.74(a)

[*details of security given*]

HKFRS 7.25

[*details of fair value of current and non-current bank borrowings*]

All of the banking facilities are subject to the fulfilment of covenants relating to certain of the Company's balance sheet ratios, as are commonly found in lending arrangements with financial institutions. If the company was to breach the covenants the drawn down facilities would become repayable on demand. In addition, certain of the Company's term loan agreements contain clauses which give the lender the right at its sole discretion to demand immediate repayment at any time irrespective of whether the Company has complied with the covenants and met the scheduled repayment obligations.

The Company regularly monitors its compliance with these covenants, is up to date with the scheduled repayments of the term loans and does not consider it probable that the bank will exercise its discretion to demand repayment for so long as the Company continues to meet these requirements. Further details of the Company's management of liquidity risk are set out in note 35(b). As at 31 December 2010 none of the covenants relating to drawn down facilities had been breached (2009: $nil).

Notes to the financial statements
For the year ended 31 December 2010 – continued

35. Financial risk management

(a) Credit risk

Etc.

(b) Liquidity risk

HKFRS 7.31-35 & 39(c)

The Company's policy is to regularly monitor its liquidity requirements, its compliance with lending covenants and its relationship with its bankers to ensure that it maintains sufficient reserves of cash and readily realisable marketable securities and adequate committed lines of funding from major financial institutions to meet its liquidity requirements in the short and longer term.

HKFRS 7.39(a)

The following tables show the remaining contractual maturities at the end of the reporting period of the Company's bank borrowings, based on undiscounted cash flows (including interest payments computed using contractual rates or, if floating, based on rates current at the balance sheet date) and the earliest date the Company can be required to pay.

Specifically, for term loans which contain a repayment on demand clause which can be exercised at the bank's sole discretion, the analysis shows the cash outflow based on the earliest period in which the entity can be required to pay, that is if the lenders were to invoke their unconditional rights to call the loans with immediate effect. The maturity analysis for other bank borrowings is prepared based on the scheduled repayment dates.

2010
Maturity Analysis - Undiscounted cash outflows

	On demand	*Within 1 year*	*More than 1 year but less than 2 years*	*More than 2 years but less than 5 years*	*More than 5 years*	***Total undiscounted cash outflows***
	$'000	$'000	$'000	$'000	$'000	$'000
Bank overdrafts	1,300	-	-	-	-	1,300
Term loans subject to a repayment on demand clause (*HKFRS 7.B11C(a)*)	9,920	-	-	-	-	9,920
Other bank loans	-	7,300	9,259	29,885	-	46,444
	11,220	7,300	9,259	29,885	-	57,664

2009 (restated)
Maturity Analysis - Undiscounted cash outflows

	On demand	*Within 1 year*	*More than 1 year but less than 2 years*	*More than 2 years but less than 5 years*	*More than 5 years*	***Total undiscounted cash outflows***
	$'000	$'000	$'000	$'000	$'000	$'000
Bank overdrafts	700	-	-	-	-	700
Term loans subject to a repayment on demand clause	4,715	-	-	-	-	4,715
Other bank loans	-	8,241	8,865	27,610	-	44,716
	5,415	8,241	8,865	27,610	-	50,131

Notes to the financial statements
For the year ended 31 December 2010 – continued

35. Financial risk management (continued)

(b) Liquidity risk (continued)

The table that follows summarises the maturity analysis of term loans with a repayment on demand clause based on agreed scheduled repayments set out in the loan agreements. The amounts include interest payments computed using contractual rates. As a result, these amounts were greater than the amounts disclosed in the "on demand" time band in the maturity analysis contained in page 6. Taking into account the Company's financial position, the directors do not consider that it is probable that the bank will exercise its discretion to demand immediate repayment. The directors believe that such term loans will be repaid in accordance with the scheduled repayment dates set out in the loan agreements.

Maturity Analysis - Term loans subject to a repayment on demand clause based on scheduled repayments

	On demand $'000	*Within 1 year* $'000	*More than 1 year but less than 2 years* $'000	*More than 2 years but less than 5 years* $'000	*More than 5 years* $'000	***Total undiscounted cash outflows*** $'000
31 December 2010	-	1,275	1,594	4,970	3,687	11,526
31 December 2009	-	642	754	2,291	2,643	6,330

Part I: Illustrative presentation of financial statements

Examples of statement of profit or loss and other comprehensive income when IAS 39 *Financial Instruments: Recognition and Measurement* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates[a]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[c]	400	(700)
Income tax relating to items that will not be reclassified[d]	(166)	(1,000)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations[b]	5,334	10,667
Available-for-sale financial assets[b]	(24,000)	26,667
Cash flow hedges[b]	(667)	(4,000)
Income tax relating to items that may be reclassified[d]	4,833	(8,334)
	(14,500)	25,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500

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Examples of statement of profit or loss and other comprehensive income when IAS 39 *Financial Instruments: Recognition and Measurement* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

Other comprehensive income for the year, after tax:	**20X7**	**20X6**
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	600	2,700
Actuarial gains (losses) on defined benefit pension plans	(500)	1,000
Share of gain (loss) on property revaluation of associates	400	(700)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	4,000	8,000
Available-for-sale financial assets	(18,000)	20,000
Cash flow hedges	(500)	(3,000)
	(14,500)	25,000
Other comprehensive income for the year, net of tax[(d)]	(14,000)	28,000

(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(b) This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

(c) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(d) The income tax relating to each item of other comprehensive income is disclosed in the notes.

XYZ Group – Statement of profit or loss for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements and the classification of expenses within profit or loss by nature)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Other income	20,667	11,300
Changes in inventories of finished goods and work in progress	(115,100)	(107,900)
Work performed by the entity and capitalised	16,000	15,000
Raw material and consumables used	(96,000)	(92,000)
Employee benefits expense	(45,000)	(43,000)
Depreciation and amortisation expense	(19,000)	(17,000)
Impairment of property, plant and equipment	(4,000)	–
Other expenses	(6,000)	(5,500)
Finance costs	(15,000)	(18,000)
Share of profit of associates[(e)]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

(e) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements)

(in thousands of currency units)

	20X7	20X6
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[f]	400	(700)
Income tax relating to items that will not be reclassified[g]	(166)	(1,000)
	500	3,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	5,334	10,667
Available-for-sale financial assets	(24,000)	26,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified[g]	4,833	(8,334)
	(14,500)	25,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500

Alternatively, items of other comprehensive income could be presented, net of tax. Refer to the statement of profit or loss and other comprehensive income illustrating the presentation of income and expenses in one statement.

(f) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(g) The income tax relating to each item of other comprehensive income is disclosed in the notes.

Examples of statement of profit or loss and other comprehensive income when IFRS 9 *Financial Instruments* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
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Other expenses	(2,100)	(1,200)
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Share of profit of associates[(a)]	35,100	30,100
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Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
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Investments in equity instruments[(b)]	(24,000)	26,667
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[(c)]	400	(700)
Income tax relating to items that will not be reclassified[(d)]	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations[(b)]	5,334	10,667
Cash flow hedges[(b)]	(667)	(4,000)
Income tax relating to items that may be reclassified[(d)]	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500

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Examples of statement of profit or loss and other comprehensive income when IFRS 9 *Financial Instruments* is applied

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function)

(in thousands of currency units)

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Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

Alternatively, items of other comprehensive income could be presented in the statement of profit or loss and other comprehensive income net of tax.

Other comprehensive income for the year, after tax:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	600	2,700
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Actuarial gains (losses) on defined benefit pension plans	(500)	1,000
Share of gain (loss) on property revaluation of associates	400	(700)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	4,000	8,000
Cash flow hedges	(500)	(3,000)
	3,500	5,000
Other comprehensive income for the year, net of tax[(d)]	(14,000)	28,000

(a) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(b) This illustrates the aggregated presentation, with disclosure of the current year gain or loss and reclassification adjustment presented in the notes. Alternatively, a gross presentation can be used.

(c) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(d) The income tax relating to each item of other comprehensive income is disclosed in the notes.

XYZ Group – Statement of profit or loss for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements and the classification of expenses within profit or loss by nature)

(in thousands of currency units)

	20X7	20X6
Revenue	390,000	355,000
Other income	20,667	11,300
Changes in inventories of finished goods and work in progress	(115,100)	(107,900)
Work performed by the entity and capitalised	16,000	15,000
Raw material and consumables used	(96,000)	(92,000)
Employee benefits expense	(45,000)	(43,000)
Depreciation and amortisation expense	(19,000)	(17,000)
Impairment of property, plant and equipment	(4,000)	–
Other expenses	(6,000)	(5,500)
Finance costs	(15,000)	(18,000)
Share of profit of associates[(e)]	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Earnings per share (in currency units):		
Basic and diluted	0.46	0.30

(e) This means the share of associates' profit attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

(illustrating the presentation of profit or loss and other comprehensive income in two statements)

(in thousands of currency units)

	20X7	20X6
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain (loss) on property revaluation of associates[f]	400	(700)
Income tax relating to items that will not be reclassified[g]	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss:		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified[g]	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500

Alternatively, items of other comprehensive income could be presented, net of tax. Refer to the statement of profit or loss and other comprehensive income illustrating the presentation of income and expenses in one statement.

(f) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, ie it is after tax and non-controlling interests in the associates.

(g) The income tax relating to each item of other comprehensive income is disclosed in the notes.

Appendix B
Application supplement

This appendix is an integral part of the HKFRS.

Extension of the period required to complete a sale

B1 As noted in paragraph 9, an extension of the period required to complete a sale does not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group). An exception to the one-year requirement in paragraph 8 shall therefore apply in the following situations in which such events or circumstances arise:

(a) at the date an entity commits itself to a plan to sell a non-current asset (or disposal group) it reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (or disposal group) that will extend the period required to complete the sale, and:

(i) actions necessary to respond to those conditions cannot be initiated until after a *firm purchase commitment* is obtained, and

(ii) a firm purchase commitment is highly probable within one year.

(b) an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a non-current asset (or disposal group) previously classified as held for sale that will extend the period required to complete the sale, and:

(i) timely actions necessary to respond to the conditions have been taken, and

(ii) a favourable resolution of the delaying factors is expected.

(c) during the initial one-year period, circumstances arise that were previously considered unlikely and, as a result, a non-current asset (or disposal group) previously classified as held for sale is not sold by the end of that period, and:

(i) during the initial one-year period the entity took action necessary to respond to the change in circumstances,

(ii) the non-current asset (or disposal group) is being actively marketed at a price that is reasonable, given the change in circumstances, and

(iii) the criteria in paragraphs 7 and 8 are met.

(iv) Share-based compensation

The fair value of the employee services received in exchange for the grant of the options is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted at the date of grant, excluding the impact of any non-market vesting conditions. At the end of each reporting period, the Group revises its estimates of the number of options that are expected to vest. It recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity.

The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised.

On lapse of share option according to the plan, corresponding amount recognised in share option reserve is transferred to retained profits.

(x) Foreign currencies

(i) Functional and presentation currency

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The Company's functional currency is Renminbi. The consolidated financial statements are presented in Hong Kong dollars to facilitate analysis of financial information by the holding company.

(ii) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies at the exchange rates ruling at the end of the reporting period are recognised in the income statement.

Translation differences on financial assets held at fair value through profit or loss is reported as part of the fair value gain or loss. Translation differences on non-monetary available-for-sale financial assets are included in equity.

Notes to the Financial Statements

3. Principal Accounting Policies *(Continued)*

(x) Foreign currencies *(Continued)*

(iii) Group companies

The results and financial position of all the Group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

(1) assets and liabilities for each statement of financial position presented are translated at the closing rate at the date of the end of that reporting period;

(2) income and expenses for each income statement are translated at average exchange rates; and

(3) all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. When a foreign operation is sold, exchange differences that were recorded in equity are recognised in the consolidated income statement as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

(y) Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the executive committee that makes strategic decisions.

(z) Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sale of goods and services rendered in the ordinary course of the Group's activities. Revenue is shown net of sales tax, returns, rebates and discounts, allowances for credit and other revenue reducing factors.

Revenue is recognised when the amount can be reliably measured, it is probable that future economic benefits will flow to the Group and specific criteria for each of the activities have been met. Estimates are based on historical results, taking into consideration the type of customers, the type of transactions and the specifics of each arrangement.

(i) Property sales

Revenue from sale of properties is recognised when the risks and rewards of the properties are passed to the purchasers. Deposits and instalments received on properties sold prior to their completion are included under current liabilities.

Annex I – Amendment to HKAS 12 early adopted:

Extract from the Annual Report of Hysan 2010

Consolidated Income Statement

For the year ended 31 December 2010

	Notes	2010 HK$ million	As restated 2009 HK$ million
Turnover	4	1,764	1,680
Property expenses		(250)	(235)
Gross profit		1,514	1,445
Investment income	6	49	38
Other gains and losses	7	(42)	(3)
Administrative expenses		(140)	(133)
Finance costs	8	(117)	(131)
Change in fair value of investment properties		2,594	1,249
Share of results of associates		394	768
Profit before taxation		4,252	3,233
Taxation	9	(201)	(189)
Profit for the year	10	4,051	3,044
Profit for the year attributable to:			
Owners of the Company		3,844	2,914
Non-controlling interests		207	130
		4,051	3,044
Earnings per share (expressed in HK cents)	15		
Basic		365.47	278.52
Diluted		365.16	278.42

Consolidated Statement of Comprehensive Income

For the year ended 31 December 2010

	Note	2010 HK$ million	As restated 2009 HK$ million
Profit for the year		4,051	3,044
Other comprehensive income:	11		
Fair value gains on available-for-sale investments		150	37
Net (losses) gains on cash flow hedges		(22)	5
Gain on revaluation of properties held for own use		29	9
Share of translation reserve of an associate		103	(1)
Other comprehensive income for the year (net of tax)		260	50
Total comprehensive income for the year		4,311	3,094
Total comprehensive income attributable to:			
Owners of the Company		4,104	2,964
Non-controlling interests		207	130
		4,311	3,094

Consolidated Statement of Financial Position

At 31 December 2010

	Notes	At 31 Dec 2010 HK$ million	As restated At 31 Dec 2009 HK$ million	As restated At 1 Jan 2009 HK$ million
Non-current assets				
Investment properties	16	40,833	37,363	35,850
Property, plant and equipment	17	429	396	387
Investments in associates	19	3,014	2,517	1,750
Principal-protected investments	20	378	82	85
Term notes	21	168	–	–
Available-for-sale investments	22	1,152	1,002	1,022
Other financial assets	23	90	95	157
Other receivables		79	31	29
		46,143	41,486	39,280
Current assets				
Accounts receivable and other receivables	24	98	83	94
Amount due from an associate	26	139	369	590
Principal-protected investments	20	84	118	40
Term notes	21	95	–	700
Other financial assets	23	2	2	1
Time deposits	27	1,930	1,945	964
Cash and bank balances	27	63	39	51
		2,411	2,556	2,440
Current liabilities				
Accounts payable and accruals	28	433	314	320
Rental deposits from tenants		175	127	158
Amounts due to non-controlling interests	29	327	327	327
Borrowings	30	650	400	550
Taxation payable		50	45	351
		1,635	1,213	1,706
Net current assets		776	1,343	734
Total assets less current liabilities		46,919	42,829	40,014
Non-current liabilities				
Borrowings	30	3,937	3,491	3,201
Other financial liabilities	23	52	36	41
Rental deposits from tenants		276	273	230
Deferred taxation	31	337	297	269
		4,602	4,097	3,741
Net assets		42,317	38,732	36,273
Capital and reserves				
Share capital	32	5,267	5,253	5,206
Reserves		35,410	31,963	29,605
Equity attributable to owners of the Company		40,677	37,216	34,811
Non-controlling interests		1,640	1,516	1,462
Total equity		42,317	38,732	36,273

The consolidated financial statements on pages 86 to 154 were approved and authorised for issue by the Board of Directors on 9 March 2011 and are signed on its behalf by:

David AKERS-JONES
Director

Gerry L.F. YIM
Director

Consolidated Statement of Changes in Equity

For the year ended 31 December 2010

	Attributable to owners of the Company			
	Share capital HK$ million	Share premium HK$ million	Share options reserve HK$ million	Capital redemption reserve HK$ million
At 1 January 2009, as originally stated	5,206	1,606	9	276
Effect of changes in accounting policies *(note 2)*	–	–	–	–
At 1 January 2009, as restated	5,206	1,606	9	276
Profit for the year	–	–	–	–
Change in fair value of available-for-sale investments	–	–	–	–
Transfer to profit and loss on disposal of available-for-sale investments	–	–	–	–
Change in fair value of derivatives designated as cash flow hedges	–	–	–	–
Transfer to profit and loss for cash flow hedges	–	–	–	–
Gain on revaluation of properties held for own use	–	–	–	–
Deferred taxation arising on revaluation of properties held for own use	–	–	–	–
Share of other comprehensive income of an associate	–	–	–	–
Total comprehensive income (expenses) for the year	–	–	–	–
Issue of shares pursuant to scrip dividend schemes	47	96	–	–
Issue of shares under share option schemes	–	1	–	–
Recognition of equity-settled share-based payments	–	–	6	–
Forfeiture of share options	–	–	(5)	–
Dividends paid during the year *(note 14)*	–	–	–	–
At 31 December 2009, as restated	5,253	1,703	10	276
Profit for the year	–	–	–	–
Change in fair value of available-for-sale investments	–	–	–	–
Change in fair value of derivatives designated as cash flow hedges	–	–	–	–
Transfer to profit and loss for cash flow hedges	–	–	–	–
Gain on revaluation of properties held for own use	–	–	–	–
Deferred taxation arising on revaluation of properties held for own use	–	–	–	–
Share of other comprehensive income of an associate	–	–	–	–
Total comprehensive income (expenses) for the year	–	–	–	–
Issue of shares pursuant to scrip dividend schemes	14	50	–	–
Issue of shares under share option schemes	–	1	–	–
Recognition of equity-settled share-based payments	–	–	6	–
Dividends paid during the year *(note 14)*	–	–	–	–
At 31 December 2010	5,267	1,754	16	276

12. Retirement Benefit Costs

Payments to the Mandatory Provident Fund Scheme are charged as an expense when employees have rendered service entitling them to the contributions.

13. Taxation

Income tax expense represents the sum of the tax currently payable and deferred tax.

(a) Current tax

The tax currently payable is based on taxable profit for the year. Taxable profit differs from profit as reported in the consolidated income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's or the Company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the end of the reporting period.

(b) Deferred tax

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are generally recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences associated with investments in subsidiaries and associates, except where the Group or the Company is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax assets arising from deductible temporary differences associated with such investments and interests are only recognised to the extent that it is probable that there will be sufficient taxable profits against which to utilise the benefits of the temporary differences and they are expected to reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at the end of the reporting period and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

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

The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Group or the Company expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities. For the purposes of measuring deferred tax liabilities and deferred tax assets for investment properties that are measured using the fair value model in accordance with HKAS 40 "Investment Properties", such properties' value are presumed to be recovered through sale. Such a presumption is rebutted when the investment property is depreciable and is held within a business model of the Group or the Company whose business objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. If the presumption is rebutted, deferred tax liabilities and deferred tax assets for such investment properties are measured in accordance with the above general principles set out in HKAS 12 (i.e based on the expected manner as to how the properties will be recovered).

Deferred tax is recognised in profit or loss, except when it relates to items that are recognised in other comprehensive income or directly in equity, in which case the deferred tax is also recognised in other comprehensive income or directly in equity respectively.

Notes to the Financial Statements
For the year ended 31 December 2010

1. General
The Company is a public listed company incorporated in Hong Kong and its shares are listed on The Stock Exchange of Hong Kong Limited (the "Stock Exchange"). The addresses of the registered office and principal place of business of the Company are disclosed in the "Shareholder Information" section of the annual report.

The principal activities of the Company and its subsidiaries (collectively referred to as the "Group") are property investment, management and development.

These financial statements are presented in Hong Kong dollars ("HKD"), which is the same as the functional currency of the Company.

2. Application of New and Revised Hong Kong Financial Reporting Standards ("HKFRSs")
In the current year, the Group and the Company have applied all of the new and revised Standards, Amendments to Standards and Interpretations ("new and revised HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") that are relevant to their operations and effective for the financial year beginning on 1 January 2010. In addition, the Group and the Company have early adopted the amendments to HKAS 12 "Income Taxes", in respect of the recognition of deferred tax on investment properties carried at fair value under HKAS 40 "Investment Property".

Except as described below, the adoption of these new and revised HKFRSs had no material effect on the financial statements of the Group or the Company for the current and/or prior accounting years. Accordingly, no prior year adjustment has been required.

Amendments to HKAS 17 "Leases"
As part of Improvements to HKFRSs issued in 2009, HKAS 17 "Leases" has been amended in relation to the classification of leasehold land. Before the amendments to HKAS 17, lessees were required to classify leasehold land as operating leases and presented leasehold land as prepaid lease payments in the consolidated statement of financial position. The amendments have removed such a requirement. The amendments to HKAS 17 require that the classification of leasehold land should be based on the general principles set out in HKAS 17, that is, whether or not risks and rewards incidental to ownership of a leased asset have been transferred substantially to the lessee.

In accordance with the transitional provisions set out in the amendments to HKAS 17, the Group reassessed the classification of unexpired leasehold land as at 1 January 2010 based on information that existed at the inception of these leases. Leasehold land that qualifies for finance lease classification has been reclassified from prepaid lease payments to property, plant and equipment and has been measured using the revaluation model on a retrospective basis. The application of the amendments has had no significant financial impact to the Group's consolidated income statements for the current and prior periods.

Amendments to HKAS 12 "Income Taxes"
Amendments to HKAS 12 titled "Deferred Tax: Recovery of Underlying Assets" have been applied in advance of their effective date (annual periods beginning on or after 1 January 2012). Under the amendments, investment properties that are measured using the fair value model in accordance with HKAS 40 "Investment Property" are presumed to be recovered through sale, unless the presumption is rebutted in certain circumstances.

As a result, the Group's investment properties that are measured using the fair value model have been presumed to be recovered through sale for the purpose of measuring deferred tax liabilities and deferred tax assets in respect of such properties. This resulted in deferred tax liabilities being decreased by HK$3,409 million and HK$3,616 million as at 1 January 2009 and 31 December 2009 respectively, with the corresponding adjustment being recognised in retained profits.

In the current year, no deferred tax has been provided for in respect of changes in fair value of such investment properties, whereas previously deferred tax liabilities were provided for in relation to the changes in fair value of such investment properties. The application of the amendments has resulted in profit for the year being increased by HK$426 million.

2. Application of New and Revised Hong Kong Financial Reporting Standards ("HKFRSs") continued

Summary of the effects of the above changes in accounting policies

(a) The effects of changes in accounting policies described above on the results for the current and prior years by line items are as follows:

	2010 HK$ million	2009 HK$ million
Decrease in taxation and increase in profit for the year	426	207
Increase in profit for the year attributable to owners of the Company	406	198

(b) The effects of the above changes in accounting policies on the financial positions of the Group as at 1 January 2009 and 31 December 2009 are as follows:

	At 31 Dec 2009				At 1 Jan 2009			
	Originally stated HK$ million	Amendments to HKAS 12 HK$ million	Amendments to HKAS 17 HK$ million	Restated HK$ million	Originally stated HK$ million	Amendments to HKAS 12 HK$ million	Amendments to HKAS17 HK$ million	Restated HK$ million
Property, plant and equipment	81	–	315	396	80	–	307	387
Prepaid lease payments	121	–	(121)	–	123	–	(123)	–
Deferred taxation	(3,881)	3,616	(32)	(297)	(3,648)	3,409	(30)	(269)
Non-controlling interests	(1,286)	(230)	–	(1,516)	(1,241)	(221)	–	(1,462)
Properties revaluation reserve	13	–	162	175	12	–	154	166
Retained profits	25,373	3,386	–	28,759	23,361	3,188	–	26,549

(c) The effects of the above changes in accounting policies on the Group's basic and diluted earnings per share for the current and prior years are as follows:

	Impact on basic earnings per share		Impact on diluted earnings per share	
	2010 HK cents	2009 HK cents	2010 HK cents	2009 HK cents
Figures before adjustments	326.87	259.60	326.59	259.50
Adjustments arising from changes in the Group's accounting policies in relation to:				
Deferred tax for investment properties	38.60	18.92	38.57	18.92
Figures after adjustments	365.47	278.52	365.16	278.42

30. Borrowings continued

(d) Zero coupon notes

	The Group		
	At 31 Dec 2010 HK$ million	At 31 Dec 2009 HK$ million	At 1 Jan 2009 HK$ million
Zero coupon notes	268	255	242
Add: Net loss attributable to hedged risk	20	7	36
	288	262	278

In February 2005, 15-year zero coupon notes of nominal amount of HK$430 million were issued at an issue price of around 46.37% of the nominal amount by Hysan (MTN) Limited. The notes are guaranteed as to nominal amount by the Company, bear an effective yield (which is equal to contracted yield) at the rate of 5.19% per annum and are repayable at par in February 2020.

Hysan (MTN) Limited has the option to redeem the notes on 7 February 2015 at a price of about 77.4% of the nominal amount.

The Group has entered into an interest rate swap to hedge against the interest rate risk of the zero coupon notes under fair value hedge (see note 23(b) for details).

The net loss of HK$20 million (2009: HK$7 million) represented changes in fair value attributable to the hedged interest rate risk of the zero coupon notes under fair value hedge.

31. Deferred Taxation

The following are the major deferred tax liabilities (assets) recognised by the Group and movements thereon during the current and prior years:

	Accelerated tax depreciation HK$ million	Revaluation of properties HK$ million	Tax losses HK$ million	Total HK$ million
The Group				
At 1 January 2009, as originally stated	250	3,412	(14)	3,648
Effect of changes in accounting policies *(note 2)*	–	(3,379)	–	(3,379)
At 1 January 2009, as restated	250	33	(14)	269
Charge to profit or loss *(note 9)*	16	–	10	26
Charge to other comprehensive income	–	2	–	2
At 31 December 2009, as restated	266	35	(4)	297
Charge to profit or loss *(note 9)*	31	–	4	35
Charge to other comprehensive income	–	5	–	5
At 31 December 2010	297	40	–	337

At the end of the reporting period, the Group has unused estimated tax losses of HK$570 million (2009: HK$534 million), of which HK$253 million (2009: HK$252 million) has not been agreed by the IRD, available for offset against future profits. As at 31 December 2009, a deferred tax asset has been recognised in respect of HK$24 million of such losses. No deferred tax asset has been recognised in respect of the estimated tax losses of HK$570 million (2009: HK$510 million) as the utilisation of these estimated tax losses is uncertain. These estimated tax losses may be carried forward indefinitely.

The Company does not have any unused tax loss at the end of the reporting period.

Consolidated Profit and Loss Account

for the year ended 31st December 2010

	Note	2010 Underlying business performance US$m	2010 Non-trading items US$m	2010 Total US$m	2009 Underlying business performance US$m (restated)	2009 Non-trading items US$m (restated)	2009 Total US$m (restated)
Revenue	5	1,340.6	–	1,340.6	1,322.6	–	1,322.6
Net operating costs	6	(459.2)	–	(459.2)	(508.1)	–	(508.1)
		881.4	–	881.4	814.5	–	814.5
Change in fair value of investment properties	11	–	3,197.6	3,197.6	–	1,000.6	1,000.6
Asset impairment provisions, reversals and disposals	11	–	0.1	0.1	–	(8.4)	(8.4)
Operating profit		881.4	3,197.7	4,079.1	814.5	992.2	1,806.7
Financing charges		(112.3)	–	(112.3)	(110.0)	–	(110.0)
Financing income		35.2	–	35.2	58.0	–	58.0
Net financing charges	7	(77.1)	–	(77.1)	(52.0)	–	(52.0)
Share of results of associates and joint ventures	8	173.9	731.4	905.3	177.8	47.2	225.0
Profit before tax		978.2	3,929.1	4,907.3	940.3	1,039.4	1,979.7
Tax	9	(122.8)	0.7	(122.1)	(120.3)	0.4	(119.9)
Profit after tax		855.4	3,929.8	4,785.2	820.0	1,039.8	1,859.8
Attributable to:							
Shareholders of the Company		810.2	3,929.2	4,739.4	777.1	1,035.9	1,813.0
Minority interests		45.2	0.6	45.8	42.9	3.9	46.8
		855.4	3,929.8	4,785.2	820.0	1,039.8	1,859.8
				US¢			US¢
Earnings per share	10						
– basic				210.70			80.60
– diluted				202.30			77.92

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Consolidated Statement of Comprehensive Income

for the year ended 31st December 2010

	Note	2010 US$m	2009 US$m (restated)
Profit for the year		**4,785.2**	1,859.8
Revaluation of properties	12	**–**	83.3
Revaluation of other investments		**11.0**	8.5
Net actuarial gain on employee benefit plans		**0.2**	4.0
Net exchange translation differences		**59.1**	15.0
Cash flow hedges			
– net loss arising during the year		**(17.1)**	(7.1)
– transfer to profit and loss		**7.2**	(1.4)
		(9.9)	(8.5)
Share of other comprehensive income of associates and joint ventures		**80.8**	7.6
Tax relating to components of other comprehensive income		**1.1**	(0.8)
Other comprehensive income for the year		**142.3**	109.1
Total comprehensive income for the year		**4,927.5**	1,968.9
Attributable to:			
Shareholders of the Company		**4,870.4**	1,920.4
Minority interests		**57.1**	48.5
		4,927.5	1,968.9

Consolidated Balance Sheet

at 31st December 2010

	Note	At 31st December 2010 US$m	At 31st December 2009 US$m (restated)	At 1st January 2009 US$m (restated)
Net operating assets				
Tangible assets	*12*			
Investment properties		**18,036.0**	14,817.7	13,702.7
Others		**4.2**	3.9	14.8
		18,040.2	14,821.6	13,717.5
Associates and joint ventures	*13*	**3,177.7**	2,352.2	1,840.6
Other investments	*14*	**59.2**	46.4	–
Deferred tax assets	*15*	**7.1**	3.9	4.5
Pension assets	*16*	**10.6**	10.0	6.1
Non-current debtors	*18*	**51.5**	56.7	101.9
Non-current assets		**21,346.3**	17,290.8	15,670.6
Properties for sale	*17*	**1,184.4**	787.1	838.9
Current debtors	*18*	**245.1**	315.3	289.2
Bank balances	*19*	**1,366.7**	1,226.1	1,119.0
Current assets		**2,796.2**	2,328.5	2,247.1
Current creditors	*20*	**(723.4)**	(687.1)	(668.8)
Current borrowings	*21*	**(859.7)**	(245.9)	(95.4)
Current tax liabilities		**(69.2)**	(120.6)	(58.2)
Current liabilities		**(1,652.3)**	(1,053.6)	(822.4)
Net current assets		**1,143.9**	1,274.9	1,424.7
Long-term borrowings	*21*	**(2,864.8)**	(3,397.5)	(3,624.1)
Deferred tax liabilities	*15*	**(54.8)**	(46.2)	(41.2)
Non-current creditors	*20*	**(93.1)**	(50.5)	(26.8)
		19,477.5	15,071.5	13,403.2
Total equity				
Share capital	*22*	**225.1**	224.9	224.9
Revenue and other reserves		**19,231.5**	14,711.2	13,083.2
Shareholders' funds		**19,456.6**	14,936.1	13,308.1
Minority interests		**20.9**	135.4	95.1
		19,477.5	15,071.5	13,403.2

Approved by the Board of Directors on 3rd March 2011

A J L Nightingale

Y K Pang

Directors

Consolidated Statement of Changes in Equity

for the year ended 31st December 2010

	Note	Share capital US$m	Share premium US$m	Revenue reserves US$m	Capital reserves US$m	Hedging reserves US$m	Exchange reserves US$m	Total US$m	Attributable to minority interests US$m	Total equity US$m
		Attributable to shareholders of the Company								
2010										
At 1st January										
– as previously reported		**224.9**	–	**12,332.5**	**63.4**	**(7.4)**	**142.5**	**12,755.9**	**135.4**	**12,891.3**
– change in accounting policy for deferred tax		–	–	**2,172.1**	–	–	**8.1**	**2,180.2**	–	**2,180.2**
– as restated		**224.9**	–	**14,504.6**	**63.4**	**(7.4)**	**150.6**	**14,936.1**	**135.4**	**15,071.5**
Total comprehensive income		–	–	**4,750.6**	–	**(8.8)**	**128.6**	**4,870.4**	**57.1**	**4,927.5**
Dividends paid by the Company	23	–	–	**(359.9)**	–	–	–	**(359.9)**	–	**(359.9)**
Dividends paid to minority shareholders		–	–	–	–	–	–	–	**(8.1)**	**(8.1)**
Issue of shares		**0.2**	**5.3**	–	–	–	–	**5.5**	–	**5.5**
Change in interests in subsidiaries		–	–	**4.5**	–	–	–	**4.5**	**(163.5)**	**(159.0)**
Transfer		–	–	**0.9**	**(0.9)**	–	–	–	–	–
At 31st December		**225.1**	**5.3**	**18,900.7**	**62.5**	**(16.2)**	**279.2**	**19,456.6**	**20.9**	**19,477.5**
2009										
At 1st January										
– as previously reported		224.9	–	10,901.9	63.4	1.2	121.9	11,313.3	95.1	11,408.4
– change in accounting policy for deferred tax		–	–	1,986.7	–	–	8.1	1,994.8	–	1,994.8
– as restated		224.9	–	12,888.6	63.4	1.2	130.0	13,308.1	95.1	13,403.2
Total comprehensive income		–	–	1,908.4	–	(8.6)	20.6	1,920.4	48.5	1,968.9
Dividends paid by the Company	23	–	–	(292.4)	–	–	–	(292.4)	–	(292.4)
Dividends paid to minority shareholders		–	–	–	–	–	–	–	(6.0)	(6.0)
New subsidiary		–	–	–	–	–	–	–	(2.2)	(2.2)
At 31st December		224.9	–	14,504.6	63.4	(7.4)	150.6	14,936.1	135.4	15,071.5

The comprehensive income included in revenue reserves comprises profit attributable to shareholders of US$4,739.4 million (2009: US$1,813.0 million), net fair value gain on other investments of US$11.0 million (2009: US$8.5 million) and net actuarial gain on employee benefit plans of US$0.2 million (2009: US$3.3 million).

1 Principal Accounting Policies continued

Basis of preparation continued

Amended standard early adopted by the Group

Amendments to IAS 12 Deferred Tax: Recovery of Underlying Assets

The amendments to IAS 12 (effective from 1st January 2012) provides that the measurement of deferred tax liabilities and deferred tax assets arising from investment properties which are measured using the fair value model in IAS 40 should reflect a rebuttable presumption that the carrying amount of the underlying asset will be recovered through sale.

The early adoption of the amendments to IAS 12 has resulted in a change in accounting policy on the provision of deferred tax on revaluation of investment properties. Previously, provision for deferred tax was made at the income tax rates on the revaluation of, and the tax bases of, investment properties held under operating leases on the basis that their values would be recovered through use rather than through sale. In accordance with the amendments, deferred tax is provided at the income tax rates on allowances claimed on these properties and at the capital gains tax rates on the valuation in excess of cost. As the Group's long leasehold investment properties are located in Hong Kong and Singapore where sales of a capital nature in excess of cost are not taxable, deferred tax liabilities relating to investment properties have been reduced significantly. This change in accounting policy has been accounted for retrospectively and the comparative financial statements have been restated.

Effects of change in accounting policy on the adoption of amendments to IAS 12:

a) On the consolidated profit and loss account for the year ended 31st December

	2010	2009
	US$m	US$m
Increase in share of results of associates and joint ventures	**110.5**	2.6
Decrease in tax	**528.2**	169.3
Increase in profit after tax	**638.7**	171.9
Attributable to:		
Shareholders of the Company	**638.7**	171.9
	US¢	US¢
Increase in basic earnings per share	**28.39**	7.64
Increase in diluted earnings per share	**27.14**	7.30

b) On the consolidated balance sheet at 31st December

	Increase in assets	(Increase)/decrease in equity/liabilities	
	Associates and joint ventures	Revenue and other reserves	Deferred tax liabilities
	US$m	US$m	US$m
2010	**166.5**	**(2,821.9)**	**2,655.4**
2009	47.0	(2,180.2)	2,133.2
2008	43.1	(1,944.8)	1,951.7

3 Critical Accounting Estimates and Judgements

Estimates and judgements used in preparing the financial statements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant effect on the carrying amounts of assets and liabilities are discussed below.

Acquisition of subsidiary, associates and joint ventures

The initial accounting on the acquisition of subsidiary, associates and joint ventures involves identifying and determining the fair values to be assigned to the identifiable assets, liabilities and contingent liabilities of the acquired entities. The fair values of leasehold land, tangible assets and investment properties are determined by independent valuers by reference to market prices or present value of expected net cash flows from the assets. Any changes in the assumptions used and estimates made in determining the fair values, and management's ability to measure reliably the contingent liabilities of the acquired entity will impact the carrying amount of these assets and liabilities.

Investment properties

The fair values of investment properties are determined by independent valuers on an open market for existing use basis calculated on the discounted net income allowing for reversionary potential.

In making the judgement, considerations have been given to assumptions that are mainly based on market conditions existing at the balance sheet date and appropriate capitalisation rates. These estimates are regularly compared to actual market data and actual transactions entered into by the Group.

Impairment of assets

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset exceeds its recoverable amount. The recoverable amount of an asset or a cash generating unit is determined based on the higher of its fair value less costs to sell and its value-in-use, calculated on the basis of management's assumptions and estimates. Changing the key assumptions, including the discount rates or the growth rate assumptions in the cash flow projections, could materially affect the value-in-use calculations.

In determining when an available-for-sale equity investment is impaired, significant judgement is required. 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 near-term business outlook for the investee, including factors such as industry and sector performance, changes in technology and operational and financial cash flows.

Income taxes

The Group is subject to income taxes in numerous jurisdictions. Significant judgement is required in determining the worldwide provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

Provision of deferred tax follows the way management expects to recover or settle the carrying amount of the related assets or liabilities, which the management may expect to recover through use, sale or combination of both. Accordingly, deferred tax will be calculated at income tax rate, capital gains tax rate or combination of both. There is a rebuttable presumption in International Financial Reporting Standards that investment properties measured at fair value are recovered by sale. Thus, deferred tax on revaluation of investment properties held by the Group are calculated at the capital gains tax rate.

Recognition of deferred tax assets, which principally relate to tax losses, depends on the management's expectation of future taxable profit that will be available against which the tax losses can be utilised. The outcome of their actual utilisation may be different.

14 Other Investments

	2010 US$m	2009 US$m
Listed securities	57.2	46.4
Unlisted securities	2.0	–
	59.2	46.4
Movements for the year:		
At 1st January	46.4	–
Exchange differences	(0.2)	–
Additions	2.0	37.9
Net revaluation surplus	11.0	8.5
At 31st December	59.2	46.4
The fair value measurements of available-for-sale financial assets are based on the following data:		
Quoted prices in active markets	57.2	46.4
Unobservable inputs	2.0	–
	59.2	46.4

15 Deferred Tax Assets and Liabilities

	Tax losses US$m	Accelerated capital allowances US$m	Revaluation surpluses of investment properties US$m	Other temporary differences US$m	Total US$m
2010					
At 1st January					
– as previously reported	0.5	(41.9)	(2,134.9)	0.8	(2,175.5)
– change in accounting policy for deferred tax	–	–	2,133.2	–	2,133.2
– as restated	0.5	(41.9)	(1.7)	0.8	(42.3)
Exchange differences	0.1	0.1	–	–	0.2
(Charged)/credited to profit and loss	0.4	(4.4)	0.7	(3.4)	(6.7)
Credited to other comprehensive income	–	–	–	1.1	1.1
At 31st December	1.0	(46.2)	(1.0)	(1.5)	(47.7)
Deferred tax assets	1.0	–	–	6.1	7.1
Deferred tax liabilities	–	(46.2)	(1.0)	(7.6)	(54.8)
	1.0	(46.2)	(1.0)	(1.5)	(47.7)

15 Deferred Tax Assets and Liabilities continued

	Tax losses US$m	Accelerated capital allowances US$m	Revaluation surpluses of investment properties US$m	Other temporary differences US$m	Total US$m
2009					
At 1st January					
– as previously reported	–	(35.9)	(1,953.8)	1.3	(1,988.4)
– change in accounting policy for deferred tax	–	–	1,951.7	–	1,951.7
– as restated	–	(35.9)	(2.1)	1.3	(36.7)
Exchange differences	–	–	–	0.1	0.1
(Charged)/credited to profit and loss	0.5	(6.0)	0.4	0.2	(4.9)
Charged to other comprehensive income	–	–	–	(0.8)	(0.8)
At 31st December	0.5	(41.9)	(1.7)	0.8	(42.3)
Deferred tax assets	0.5	–	–	3.4	3.9
Deferred tax liabilities	–	(41.9)	(1.7)	(2.6)	(46.2)
	0.5	(41.9)	(1.7)	0.8	(42.3)

Deferred tax balances predominantly comprise non-current items. Deferred tax assets and liabilities are netted when the taxes relate to the same taxation authority and where offsetting is allowed.

Deferred tax assets of US$0.8 million (2009: US$2.9 million) arising from unused tax losses of US$4.7 million (2009: US$17.2 million) have not been recognised in the financial statements. Of the unused tax losses, US$4.4 million (2009: US$17.2 million) have no expiry date and the balance will expire in 2015.

16 Pension Plans

The Group has a number of defined benefit pension plans, covering all the main territories in which it operates with the major plans relating to employees in Hong Kong. Most of the pension plans are final salary defined benefit plans and are funded. The assets of the funded plans are held independently of the Group's assets in separate trustee administered funds. The Group's major plans are valued by independent actuaries annually using the projected unit credit method.

The principal actuarial assumptions used for accounting purposes at 31st December are as follows:

	2010 Weighted average %	2009 Weighted average %
Discount rate applied to pension obligations	**4.85**	5.00
Expected return on plan assets	**7.50**	7.50
Future salary increases	**5.00**	5.00

The expected return on plan assets is determined on the basis of long-term average returns on global equities of 4.3% to 11.4% (2009: 3.8% to 11.3%) per annum and global bonds of 3.6% to 5.2% (2009: 2.8% to 4.4%) per annum, and the long-term benchmark allocation of assets between equities and bonds in the plan.

Consolidated Statement of Financial Position

at 31 December 2010

31 December 2010 US$ millions		Note	31 December 2010 HK$ millions	As restated Note 1 31 December 2009 HK$ millions	As restated Note 1 1 January 2009 HK$ millions
	ASSETS				
	Non-current assets				
21,519	Fixed assets	13	**167,851**	176,192	178,143
5,544	Investment properties	14	**43,240**	42,323	41,282
3,534	Leasehold land	15	**27,561**	29,191	29,848
8,761	Telecommunications licences	16	**68,333**	70,750	72,175
3,504	Goodwill	17	**27,332**	28,858	30,436
1,649	Brand names and other rights	18	**12,865**	7,351	10,486
13,529	Associated companies	19	**105,528**	83,716	76,045
6,927	Interests in joint ventures	20	**54,032**	51,568	45,865
1,808	Deferred tax assets	21	**14,105**	14,657	13,248
1,171	Other non-current assets	22	**9,131**	5,286	8,904
3,152	Liquid funds and other listed investments	23	**24,585**	23,213	30,735
71,098			**554,563**	533,105	537,167
	Current assets				
11,750	Cash and cash equivalents	24	**91,652**	92,521	57,286
7,337	Trade and other receivables	25	**57,229**	48,146	54,767
2,273	Inventories		**17,733**	16,593	18,528
21,360			**166,614**	157,260	130,581
	Current liabilities				
10,370	Trade and other payables	26	**80,889**	73,029	82,599
2,964	Bank and other debts	28	**23,122**	17,589	23,945
372	Current tax liabilities		**2,900**	3,249	1,274
13,706			**106,911**	93,867	107,818
7,654	**Net current assets**		**59,703**	63,393	22,763
78,752	**Total assets less current liabilities**		**614,266**	596,498	559,930
	Non-current liabilities				
29,248	Bank and other debts	28	**228,134**	242,851	234,141
1,730	Interest bearing loans from non-controlling shareholders	29	**13,493**	13,424	13,348
1,832	Deferred tax liabilities	21	**14,290**	13,355	13,616
218	Pension obligations	30	**1,702**	2,436	2,541
506	Other non-current liabilities	31	**3,945**	4,520	4,586
33,534			**261,564**	276,586	268,232
45,218	**Net assets**		**352,702**	319,912	291,698

2 Significant accounting policies (continued)

At the date of authorisation of these accounts, the following standards, amendments and interpretations were in issue but not yet effective and have not been early adopted by the Group:

HKFRSs (Amendments) (1)	Improvements to HKFRSs issued in 2010
HKAS 12 (Amendments) (2)	Deferred Tax: Recovery of Underlying Assets
HKAS 24 (Revised) (1)	Related Party Disclosures
HKAS 32 (Amendment) (1)	Classification of Rights Issues
HKFRS 1 (Amendment) (1)	Limited Exemption from Comparative HKFRS 7 Disclosures for First-time Adopters
HKFRS 1 (Amendments) (2)	Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters
HKFRS 7 (Amendments) (2)	Transfers of Financial Assets
HKFRS 9 (3)	Financial Instruments
Additions to HKFRS 9 (3)	Financial Instruments - Financial Liabilities
Hong Kong (IFRIC) Interpretation 19 (1)	Extinguishing Financial Liabilities with Equity Instruments
Hong Kong (IFRIC) Interpretation 14 (Amendment) (1)	Prepayments of a Minimum Funding Requirement

(1) Effective for the Group for annual periods beginning 1 January 2011
(2) Effective for the Group for annual periods beginning 1 January 2012
(3) Effective for the Group for annual periods beginning 1 January 2013

The adoption of standards, amendments and interpretations listed above, with the exception of HKAS 12 (Amendments), HKFRS 9 and Additions to HKFRS 9, in future periods is not expected to result in substantial changes to the Group's accounting policies.

HKAS 12 (Amendments) Deferred Tax: Recovery of Underlying Assets applies to annual periods beginning 1 January 2012 and is available for early adoption. The current version of HKAS 12 requires an entity to measure the deferred tax relating to an asset depending on whether the entity expects to recover the carrying amount of the asset through use or sale. It can be difficult and subjective to assess whether recovery will be through use or through sale. The amendments introduce a presumption that recovery of the carrying amount of an investment property is through sale. Accordingly, the effect that the adoption of the amendments will have on the results and financial position of the Group will depend on the timing of the adoption and the relevant applicable tax rate. As a result, it is impracticable to quantify the impact of amendments to HKAS 12 as at the date of publication of these accounts.

HKFRS 9 Financial Instruments introduces new requirements for classifying and measuring financial assets. Together with Additions to HKFRS 9 Financial Instruments - Financial Liabilities, these changes represent the first phase in the process to replace HKAS 39 Financial Instruments: Recognition and Measurement. The standard is not effective until 1 January 2013 but is available for early adoption. The second and third phases in the HKICPA's project to replace HKAS 39 will address the impairment of financial assets measured at amortised cost and hedge accounting. Accordingly, the impact of HKFRS 9 may change as a consequence of further development resulting from the HKICPA's project to replace HKAS 39. As a result, it is impracticable to quantify the impact of HKFRS 9 as at the date of publication of these accounts.

Annex IV - Amendment to HKAS 12 not early adopted:
Extract from the Annual Report of Cheung Kong (Holdings) Limited 2010

Consolidated Statement of Financial Position

As at 31st December, 2010

	Note	31/12/2010 $ Million	31/12/2009 (Restated) $ Million	1/1/2009 (Restated) $ Million
Non-current assets				
Fixed assets	(8)	10,399	10,696	11,624
Investment properties	(9)	21,170	19,433	15,670
Associates	(11)	154,117	147,542	144,738
Jointly controlled entities	(12)	39,431	32,591	29,391
Investments available for sale	(13)	9,282	7,026	4,678
Long term loan receivables		357	444	1,093
		234,756	217,732	207,194
Current assets				
Stock of properties	(14)	65,679	62,999	64,273
Debtors, deposits and prepayments	(15)	2,459	2,799	3,904
Investments held for trading	(16)	258	1,927	858
Derivative financial instruments		334	83	22
Bank balances and deposits		25,147	11,423	7,173
		93,877	79,231	76,230
Current liabilities				
Bank and other loans	(17)	13,127	7,210	8,991
Creditors and accruals	(18)	18,298	12,078	6,940
Loan from joint development partner	(19)	2,000	2,000	2,000
Derivative financial instruments		647	460	872
Provision for taxation		633	1,028	768
Net current assets		59,172	56,455	56,659
Total assets less current liabilities		293,928	274,187	263,853
Non-current liabilities				
Bank and other loans	(17)	22,027	25,279	31,258
Loan from joint development partner	(19)	–	–	2,000
Deferred tax liabilities	(20)	2,390	2,011	1,359
		24,417	27,290	34,617
Net assets		269,511	246,897	229,236
Representing:				
Share capital	(21)	1,158	1,158	1,158
Share premium		9,331	9,331	9,331
Reserves		255,207	232,603	214,405
Shareholders' funds		265,696	243,092	224,894
Non-controlling interests		3,815	3,805	4,342
Total equity		269,511	246,897	229,236

Li Ka-shing
Director

Ip Tak Chuen, Edmond
Director

Notes to Financial Statements

1. General Information

The Company is a limited liability company incorporated in Hong Kong and its shares are listed on The Stock Exchange of Hong Kong Limited. The address of the registered office and other corporate information are set out on page 144 of the annual report.

2. Principal Accounting Policies

(a) Basis of preparation

The financial statements have been prepared in accordance with generally accepted accounting principles in Hong Kong and comply with the Hong Kong Financial Reporting Standards ("HKFRSs"). The financial statements are prepared under the historical cost convention except that investments in securities, investment properties and derivative financial instruments, as set out in notes 2(f), 2(h) and 2(l) respectively, are stated at fair values.

The Hong Kong Institute of Certified Public Accountants has issued a number of new and revised HKFRSs. For the HKFRSs which are effective for accounting periods beginning on 1st January, 2010, the adoption has no significant impact on the Group's results and financial position; and for the following HKFRSs which are not yet effective, the Group is in the process of assessing their impact on the Group's results and financial position.

Effective for the year ending 31st December, 2011:

HKAS 24 (Revised)	Related Party Disclosures
HKAS 32 (Amendment)	Classification of Rights Issues
HKFRSs (Amendments)	Improvements to HKFRSs
HK(IFRIC)-Int 14 (Amendment)	Prepayments of a Minimum Funding Requirement
HK(IFRIC)-Int 19	Extinguishing Financial Liabilities with Equity Instruments

Effective for the year ending 31st December, 2012:

HKAS 12 (Amendments)	Deferred Tax: Recovery of Underlying Assets
HKFRS 7 (Amendments)	Disclosures – Transfers of Financial Assets

Effective for the year ending 31st December, 2013:

HKFRS 9	Financial Instruments

Question 1

Which one of the following independent statements about the concept of Control under HKFRS 10 is CORRECT?

A An investor controls an investee when it is exposed or has rights, to benefits from its involvement with the investee and has the ability to affect those benefits through its power over the investee.

B For the purpose of assessing power, only protective rights held by the investor and other parties are considered.

C For potential voting rights to the substantive, it must be currently exercisable.

D When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor's behalf (ie they are 'de facto agents').

E None of the above statements A, B, C and D is correct.

Question 2

Entity M acquired 30% interest in entity N and obtained significance influence at 31 December 20X0. The cost of investment was $250,000 and entity N has net assets of $500,000 at date of acquisition. The fair value of those net assets is $600,000 as the fair value of plant and equipment is $100,000 higher than its book value. The plant and equipment has a remaining useful life of 10 years.
In 20X1, entity N recognised profit after tax of $100,000 and paid a dividend out of these profits of $9,000. It also recognised exchange losses of $20,000 directly in other comprehensive income.

Which one of the following independent statements is CORRECT?

A Share of profit of associate of $30,000 is recognised in the profit or loss of entity M's financial statements.

B Goodwill of $70,000 arising from this transaction is presented separately on the face of statement of financial position

C Entity M's interest in entity N at the end of 20X1 under the equity method is $271,300.

D None of the above statements A, B and C is correct.

E All of the above statements A, B and C are correct.

Question 3

Which of the following independent statements about Joint Arrangement under HKFRS 11 are incorrect?

1. There are two types of joint arrangements under HKFRS 11, namely joint operation and joint venture.
2. If the parties can demonstrate past experience of voting together in the absence of a contractual agreement, this can still satisfy the requirements of "joint control".
3. A joint arrangement structured through a separate vehicle must be a joint venture.
4. A guarantee to third parties provided by the parties to the arrangement, e.g. service provided or financing provided to the arrangement, does not in itself determine that the joint arrangement is a joint operation.
5. A joint venturer accounts for its investment using the equity method or proportionate consolidation unless the entity is exempted from applying the equity method as specified in accordance with HKAS 28 (2011) Investments in Associates and Joint Ventures.

A. (1), (2) & (3)
B. (1), (3) & (4)
C. (2), (3) & (4)
D. (2), (3) & (5)
E. All of the above statements are incorrect

Question 4

Entity A purchased a piece of land on 15 December 20X0 but there was no plan on what the land would be used for. On 10 February 20X1, management approved the plan to develop a 15-storey building which will then be leased out under operating leases to generate rental income. The construction was completed in March 20X2 and was then leased out to third parties.
On 10 May 20X5, the management determined to use this building as the group head office as the lease term for the current office would soon be expired. On 1 April 20X6, after all the tenants had moved out, Entity A and its subsidiaries occupied the building and used it as office. Entity A occupied the first six floors as head office while the remaining floors were leased out to its subsidiaries.
Entity A elects to use fair value model to account for investment properties and cost model for own-use properties. The financial year end is 31 December.

Which one of the following independent statements are CORRECT?

1. Entity A should account for the land under HKAS 16 Property, plant and equipment on 31 December 20X0.
2. Property under construction is stated at its fair value on 31 December 20X1 unless the fair value cannot be determined reliably.
3. The building is accounted for as property, plant and equipment under HKAS 16 on 31 December 20X5.
4. For the transfer from investment property carried at fair value to property, plant and equipment, the fair value at the date of change in use will be the properties' deemed cost for subsequent accounting in accordance with HKAS 16.
5. Entity A should account for the whole building as property, plant and equipment under HKAS 16 in its separate financial statements on 31 December 20X6.

A (1), (2) & (3)
B (2), (3) & (4)
C (2) & (3)
D (2) & (4)
E (2), (4) & (5)

Question 5

Which one of the following independent statement(s) about HKAS 36 impairment of assets is/are CORRECT?

1. Goodwill acquired in a business combination should be tested for impairment only when there is any indication that it may be impaired.
2. When calculating the value in use, since the discount rate is determined on a pre-tax basis, future cash flows are estimated on a pre-tax basis (i.e. excluding income tax payments or receipts).
3. The impairment loss of a cash generating unit is allocated to reduce the carrying amount of goodwill and the other assets of the units pro rata on the basis.
4. The increased carrying amount due to reversal of impairment should not be more than what the depreciated historical cost would have been if no impairment loss had been recognised in prior years

A. (1)
B. (1) & (3)
C. (2) & (3)
D. (2) & (4)
E. (3) & (4)

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

YOUR HOSTS

Winnie Chan
HKICPA Associate Director
Technical Training & Support

Eky Liu
HKICPA Manager
Technical Training & Support

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HKFRS 13 Fair value measurement

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Agenda

Part 1: Background

Part 2: Scope

Part 3: Fair value principles

Part 4: Application issues

Part 5: Valuation techniques

Part 6: Fair value hierarchy

Part 7: Disclosures

Part 8: Application of fair value measurement – Greek government bonds

Part 9: Consequential amendments to other HKFRSs

Part 10: Summary

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Part 1
Background

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Background

- HKFRS 13 define fair value, sets out in a single standard a framework for measuring fair value and requires disclosures about fair value measurement
- Applies when other HKFRSs require or permit fair value measurements
- Does not introduce any new requirements to measure an asset or a liability at fair value, change what is measured at fair value in HKFRSs or address how to present changes in fair value
- Part of the Memorandum of Understanding between IASB and US FASB
- Aligned IFRSs and US GAAP to have the same definition and meaning of fair value and the same disclosure requirements about fair value measurements

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Background

- The goals of the fair value measurement project were:
  - To reduce complexity and improve consistency in the application of fair value measurement principles by having a single set of requirements for all fair value measurements
  - To communicate the measurement objective more clearly by clarifying the definition of fair value
  - To improve transparency by enhancing disclosures about fair value measurements
  - To increase the convergence of IFRSs and US GAAP

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Background

- HKFRS 13 provides clear and consistent guidance for measuring fair value and addressing valuation uncertainty in markets that are no longer active
- It also increases the transparency of fair value measurements by requiring detailed disclosures about fair values derived using models
- Some of those disclosures, including the fair value hierarchy, were already introduced in 2009 through an amendments to HKFRS 7 *Financial Instruments: Disclosures* and are now relocated to HKFRS 13
- Effective for annual periods beginning on or after 1 January 2013. Earlier application permitted
- Applied prospectively from the beginning of the annual period in which it is adopted

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Part 2
Scope

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Scope

Measurement and disclosure requirements of HKFRS 13 do not apply to:

- HKFRS 2 *Share-based Payment*
- HKAS 17 *Leases*
- Measurements that are similar to fair value but that are not fair value
  - Net realisable value (HKAS 2 *Inventories*) or
  - Value in use (HKAS 36 *Impairment of Assets*)

The measurement and disclosure requirements do apply to measurements based on fair value, e.g. fair value less costs to sell in HKFRS 5 Non-current assets held for sale and discontinued operations

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Scope

Disclosure requirements of HKFRS 13 do not apply to:

- Plan assets measured at fair value in accordance with HKAS 19 *Employee Benefits*
- Retirement benefit plan investments measured at fair value in accordance with HKAS 26 *Accounting and Reporting by Retirement Benefit Plans*
- Assets for which recoverable amount is fair vale less costs of disposal in accordance with HKAS 36

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Part 3
Fair value principles

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Definition of fair value

HKFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

- An exit price
- Same as in US GAAP
- Emphasizes fair value as a market-based measurement, not an entity-specific measurement

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- HKFRS 13 stipulates the following factors that should be considered in fair value measurement
  a. the asset or liability
  b. the market
  c. market participants
  d. the price
- In addition, there are considerations that are specific to:
  a. non-financial assets
  b. liabilities
  c. equity
  d. financial assets and financial liabilities with offsetting positions

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The asset or liability

- When measuring fair value, an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date
- Such characteristics include, for example:
  - The condition and location of the asset; and
  - Restrictions, if any, on the sale or use of the asset
- HKFRS 13 generally does not specify the unit of account, e.g. a single asset or liability or a group of assets and/or liabilities, for measuring fair value
- The unit of account for the asset or liability shall be determined in accordance with the particular standard giving rise to the requirement to measure fair value

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Example 1 – Restriction on the sale of an equity instrument

- An entity holds an equity instrument (a financial asset) for which sale is legally or contractually restricted for a specified period (e.g. such a restriction could limit sale to qualifying investors)
- The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants
- In that case, the fair value of the instrument would be measured on the basis of the quoted price for an identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction
- Would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period

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- The adjustment will vary depending on all the following:
  - (a) the nature and duration of the restriction
  - (b) the extent to which buyers are limited by the restriction (e.g. there might be a large number of qualifying investors)
  - (c) qualitative and quantitative factors specific to both the instrument and the issuer

When measuring fair value, an entity shall take into account characteristics of the asset!

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Example 2 – Restriction on the use of an asset

- A donor contributes land in an otherwise developed residential area to a not-for-profit neighbourhood association
- Currently used as a playground
- The donor specifies that the land must continue to be used by the association as a playground in perpetuity
- Upon review of relevant legal and other documentation , the association determines that the fiduciary responsibility to meet the donor's restriction would not be transferred to market participants if the association sold the asset - <u>the donor restriction on the use of the land is specific to the association</u>

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- The association is not restricted from selling the land
- Without the restriction on the use of the land by the association, the land could be used as a site for residential development
- In addition, the land is subject to an easement (i.e. a legal right that enables a utility to run power lines across the land)

Question:

What are the characteristics of the land that should be consider when measuring its fair value?

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Following is an analysis of the effect on the fair value measurement of the land arising from the restriction and the easement:

(a) Donor restriction on use of land

- The donor restriction on the use of the land is specific to the association
- Would not be transferred to market participants
- Fair value of the land would be the higher of the following, regardless of the restriction on the use of the land by the association:
  - i) Fair value used as a playground
  - ii) Fair value as a site for residential development

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(b) Easement for utility lines

- Easement for utility lines is specific to (ie a characteristic of) the land
- Would be transferred to market participants with the land
- Fair value measurement would take into account the effect of the easement, regardless of whether the highest and best use is as a playground or as a site for residential development

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The transaction/the market

- A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions
- A fair value measurement assumes that the transaction to sell the asset or transfer the liability take place either:

  - in the principal market for the asset or liability; or

  - in the absence of a principal market, in the most advantageous market for the asset or liability

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- *Principal market*
  The market with the greatest volume and level of activity for the asset or liability

- *Most advantageous market*
  The market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs

- In many instances, the principal market and the most advantageous market would be the same

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- In either case, the entity must have access to the principal (or most advantageous) market at the measurement date
- The concepts of principal market and most advantageous market are considered from the perspective of the entity
- Because different entities, and different businesses within a single entity, may have access to different markets, the principal or most advantageous market for the same asset or liability may vary from one entity to another, or between businesses within an entity

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Market participants

- An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest
- Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
  a. Independent (not related parties in HKAS 24)
  b. Knowledgeable
  c. Able to enter into a transaction
  d. Willing to enter into a transaction

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The price

- Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique
- Not adjusted for transaction costs – not a characteristic of the asset or liability
- Transactions costs are considered to be a characteristic of the transaction
- Transaction costs are considered when determining the most advantageous market

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Transaction costs is defined in HKFRS 13 as:

- The costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:
  - (a) They result directly from and are essential to that transaction
  - (b) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made
- Transaction costs do not include transport costs
- If location is a characteristic of an asset, e.g. crude oil held in the Arctic circle, the price in the principal (or most advantageous) market is adjusted for the costs that would be incurred to transport the asset to that market
- For example, costs to transport the crude oil from the Arctic circle to the appropriate market

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Example – Principal market

Company M holds an asset that is traded in three different markets as follows:
(Note: Company M buys and sell in Market Z)

	Market X	Market Y	Market Z
Volume (annual)	30,000	12,000	6,000
Trade per month	30	12	10
Price	50	48	53
Transport costs	(3)	(3)	(4)
Possible fair value	47	45	49
Transaction costs	(1)	(2)	(2)
Net proceeds	46	43	47

1. Which one is the principal market ?
2. Which one is the most advantageous market?
3. What is the fair value?

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Example – Principal market

- The principal market for the asset in this example is Market X because it has the highest volume and level of activity.
- The most advantageous market is Market Z because it has the highest net proceeds.
- M bases its fair value on prices in Market X when information about the volume and level of activity of each market is reasonably available and M is able to access Market X. Pricing is taken from this market even though M does not normally transact in that market and it is not the most advantageous market. In this case, fair value would be 47, considering transport costs but not transaction costs, even though M normally transacts in Market Z and could maximise net proceeds in that market.
- If M is unable to access Market X and Y, or information allowing a conclusion on what market has the greatest volume and level of activity is not reasonably available, then M would use Market Z and net proceeds would be 47. In this case, fair value would be 49.

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Most advantageous market is the market that maximises the amount that would be received to sell the assets after taking into transport and transaction costs.

Fair value of the asset is adjusted for transport cost but not transaction costs.

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Part 4
Application issues

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Highest and best use for non-financial assets

- HKFRS 13 requires the fair value of a non-financial asset to be measured based on its highest and best use from a market participant's perspective
- Does not apply to financial instruments, liabilities or equity
- Highest and best use refers to the use of a non-financial asset by market participants that would maximize the value of the asset or the group of assets and liabilities with which the asset would be used
- A fair value measurement considers a market participant's ability to generate economic benefits by:

  - using a non-financial asset; or

  - selling it to another market participant who will use the asset in its highest and best use

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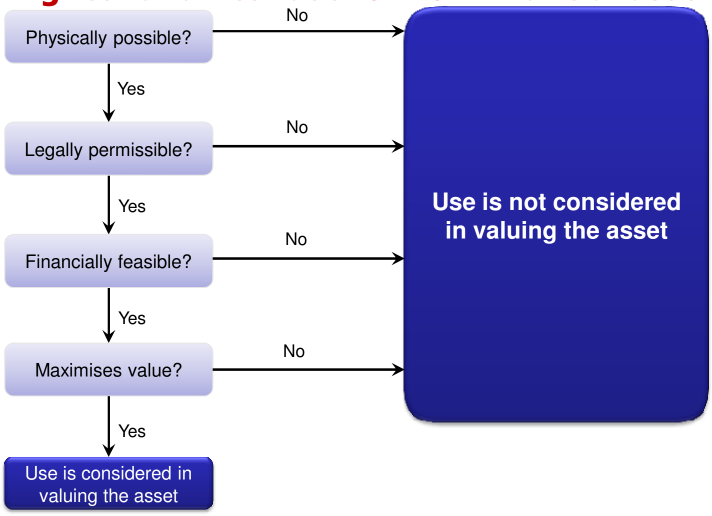
Highest and best use for non-financial assets



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- Highest and best use is determined from the perspective of market participants, even if the entity intends a different use
- However, HKFRS 13 allows management to presume that its current use of an asset is the highest and best use unless market or other factors suggest otherwise

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Example 1 – Highest and best use

- Company A acquires a brand in a business combination
- But decided not to use the brand – assuming that its removal from the market will generate greater incremental value to Company A as a result of increased revenues from its existing brands
- However, a market participant would choose to continue to use the brand
- Therefore, the fair value of the brand would be based on that as the highest and best use to a market participant

	Market participant	Company A
Direct benefits	100	0
Indirect benefits	0	120
Total incremental benefits	100	120
Fair value	100	100

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Example 2 – Highest and best use

- An entity acquires land in a business combination
- Currently developed for industrial use as a site for a factory – presumed to be its highest and best use unless market or other factors suggest a different use
- Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings
- The highest and best use of the land would be determined by comparing both of the following:

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(a) the value of the land as currently developed for industrial use (ie used in combination with other assets, such as factory, or with other assets and liabilities)

(b) the value of the land as a vacant site for residential use (ie on a stand-alone basis), taking into account the following:

- costs of demolishing the factory
- other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site

The highest and best use of the land would be determined on the basis of the higher of those values

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Liabilities and an entity's own equity instruments

- Measured using quoted prices for the transfer of identical or similar instruments, but would remain outstanding
- Not an extinguishment or settlement cost
- Fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation
- Non-performance risk is assumed to be the same before and after the transfer of the liability. It includes, but may not be limited to, an entity's own credit risk
- A separate input or adjustment to reflect a restriction on an entity's ability to transfer a liability or own equity instruments to another party is not applied in fair value measurement of the liability of the entity's own instruments
- Such restriction is assumed to be reflected implicitly or explicitly in the other inputs used by the market participants to price such instruments

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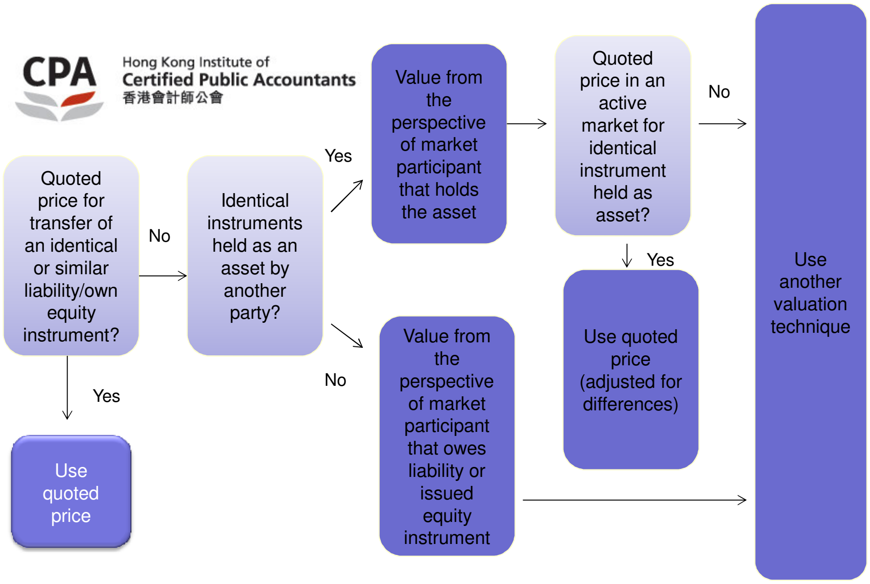

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Financial instruments

Measurement exception – net exposure

- HKFRS 13 allows an exception whereby if an entity manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or counterparty risks
- Permitted to apply an exception to measure the fair value of the group of financial assets and financial liabilities consistently with how market participants would price the net risk exposure at the measurement date
- Exposure to market risks – the market risks net exposure should be substantially the same as regards both their nature and duration

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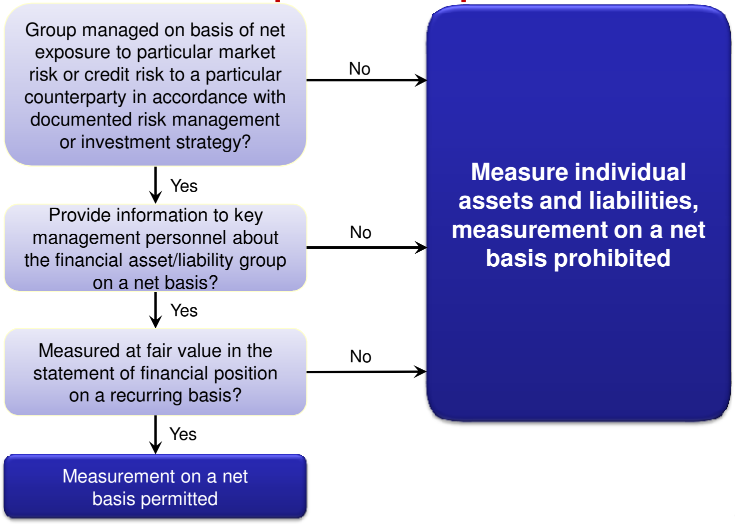
Measurement exception – net exposures



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- The above exception does not change the presentation requirement for financial assets and financial liabilities
- Presentation is dealt with in other HKFRSs (e.g. HKAS 32 *Financial Instruments: Presentation*)
- Where gross presentation is required, the fair value of the group should be allocated to the assets and liabilities within the group on a reasonable and consistent basis

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Fair value at initial recognition

- When an asset is acquired or a liability is assumed, the transaction price is the price paid to acquire the asset or received to assume the liability – An entry price
- In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability – An exit price
- Although conceptually different, in many cases the exit price and entry price are equal and therefore fair value at initial recognition generally equals the transaction price
- A day one gain or loss arises when the transaction price for an asset and / or liability differs from the fair value used to measure it at initial recognition.

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However, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist

- the transaction is between related parties
- the transaction takes place under duress or the seller is forced to accept the price in the transaction (e.g. the seller is experiencing financial difficulty)
- the unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value, e.g. if the transaction price represents the purchase of multiple items
- the market in which the transaction takes place is different from the principal market (or most advantageous market)

HKFRS 13 requires day one gains or losses to be recognised in profit or loss unless another HKFRS specifies otherwise.

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Part 5
Valuation techniques

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General principles

- The valuation technique should be:
  - appropriate in the circumstances
  - sufficient data are available to measure fair value
  - maximising the use of relevant observable inputs
  - minimising the use of unobservable inputs
- Valuation techniques used to measure fair value shall be applied consistently
- Three widely used valuation techniques are:
  - market approach
  - cost approach
  - income approach

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a. Market approach

- Uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business
- Examples are:
  - valuation techniques using market multiples derived from comparable transactions
  - matrix pricing – a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities' relationship to other benchmark quoted securities

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b. Cost approach

- Reflects the amount that would be required currently to replace the service capacity of an asset (ie current replacement cost)
- Assumes that fair value is the cost to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence (including physical deterioration, functional (technological) obsolescence and economic (external) obsolescence)
- Not relevant for financial assets

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c. Income approach

- Converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount
- Examples are
  - Present value techniques
  - Option pricing models, such as Black-Scholes-Merton formula, that incorporates present value techniques and reflect both the time value and the intrinsic value of an option
  - Multi-period excess earnings method (for intangible assets, such as customer relationships or technology)

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Part 6
Fair value hierarchy

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Fair value hierarchy

- Similar to the hierarchy established under HKFRS 7 *Financial Instruments: Disclosures*
- Categorised into three levels
- Highest priority given to unadjusted quoted prices in active market for identical assets or liabilities (Level 1 inputs)
- Lowest priority given to unobservable inputs (Level 3 inputs)
- Based on <u>inputs to valuation techniques</u> used to measure fair value, not the valuation techniques used to measure fair value

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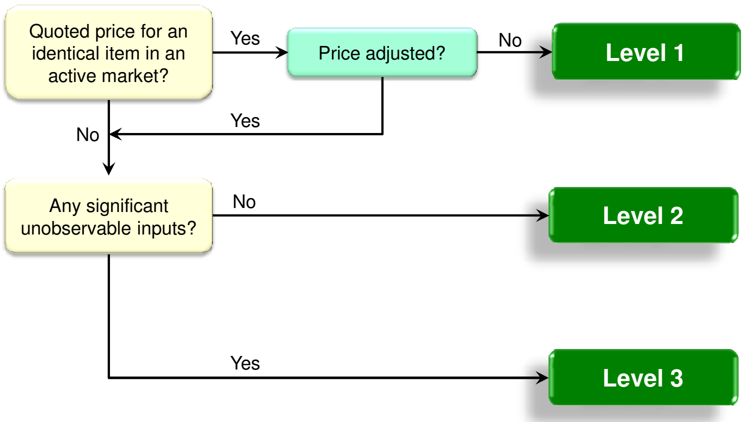
Fair value hierarchy



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- In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised within different levels of the fair value hierarchy
- Fair value measurement is categorised in its entirety in the same level as the lowest level input that is significant to the entire measurement
- For example, a fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on
  - the inputs that are significant to the entire measurement
  - the level of the fair value hierarchy within which those inputs are categorised
- Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, shall not be taken in account when determining the level of fair value hierarchy within which a fair value measurement is catergorised.

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Level 1 inputs

- Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date
- Active market refers to a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis
- A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except:

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- an entity holds a large number of similar (but not identical) assets or liabilities that are measured at fair value
- a quoted price in an active market does not represent fair value at the measurement date
- measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset.

Any adjustment to the quoted price will result in a fair value measurement being categorised into a lower level of the fair value hierarchy.

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Level 2 inputs

- Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly
- Level 2 inputs include:
  - quoted prices for similar assets or liabilities in active markets
  - quoted prices for identical or similar assets or liabilities in markets that are not active
  - inputs other than quoted prices that are observable for the asset or liability, such as interest rates, credit spreads or yield curves

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- If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability.
- Adjustments to Level 2 inputs may be necessary depending on the characteristics of the asset or liability being measured
- An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs

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Examples:

- *Receive-fixed, pay variable interest rate swap based on the LIBOR swap rate*

  A Level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap

- *Building held and used*

  A Level 2 input would be the price per square metre for the building derived from observable market data, e.g. multiples derived from prices in observed transactions involving comparable buildings in similar locations.

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Level 3 inputs

- Unobservable inputs for the asset or liability
- Used only when observable inputs are not available
- Both the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique should be considered
- Level 3 inputs should be developed using the best information available in the circumstances, which might include an entity's own data. However, the entity's own data should be adjusted if reasonably available information indicates that other market participants would use different data

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Examples:

- *Interest rate swap*

  A Level 3 input would be an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data

- *Cash generating unit.*

  A Level 3 input would be a financial forecast (e.g. of cash flows or profit or loss) developed using the entity's own data if there is no reasonably available information that indicates that market participants would use different assumptions.

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Premium, discounts and blockage factors

What valuation adjustments are permitted?

- Only when they reflect a characteristic of an asset or liability

What valuation adjustments are **NOT** permitted?

- Premiums or discounts that reflect size as a characteristic of the entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity)

In all cases, if there is a quoted price in an active market (i.e. a Level 1 input*)*, an entity shall use that price without adjustment when measuring fair value.

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Significant decrease in volume/level of activity

- Fair value of an asset or a liability might be affected when there has been a significant decrease in the volume or level of activity for that item compared to its normal market activity
- Following factors shall be considered
  a. There are few recent transactions
  b. Price quotations are not developed using current information
  c. Price quotations vary substantially either over time or among market-makers
  d. Indices that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability

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e. Significant increase in implied liquidity risk premiums, yields or performance indicators for observed transactions or quoted prices when compared with previous estimates
f. Wide bid-ask spread or significant increase in the bid-ask spread
g. Significant decline in the activity of, or there is an absence of, a market for new issues for the (or similar) asset or liability
h. Little information is publicly available

If there has been a significant decrease in the volume or level of activity,

- The entity needs to perform further analysis.
- Conclusion of the analysis can be:
  a. the transaction or quoted price still represents fair value. A decline in volume/activity, on its own, may not indicate that the quoted price does not represent fair value
  b. the transaction or quoted price does not represent fair value. In such cases, an adjustment will be necessary if:
     – the entity uses those prices as a basis for measuring fair value; and
     – the adjustment may be significant to the fair value measurement in its entirety.
  c. the transaction is not orderly.
- A change in valuation technique or the use of multiple valuation techniques may be appropriate, if the volume or level of activity has significantly decreased

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Identifying transactions that are not orderly

- Not appropriate to conclude that all transactions in a market are not orderly simply due to significant decrease in volume/level of activity
- Indications that transactions are not orderly include:
  a. Not adequate exposure to the market for a period before measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions
  b. Usual and customary marketing period, but the seller marketed the asset or liability to a single market participant
  c. Seller is distressed (in or near bankruptcy or receivership)
  d. Seller was forced to sell to meet regulatory or legal requirements
  e. Transaction price is an outlier when compared with other recent transactions for the same or a similar asset or liability

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If evidence indicates that a transaction is / is not orderly?

a. A transaction is NOT orderly -> place little or no weight on transaction price

b. A transaction is orderly -> take into account the transaction price. The weight placed on such a transaction price depends on the circumstances, e.g. volume and timing of transaction.

c. Cannot determine if transaction is orderly or not -> place less weight on those transactions when compared with transactions that are known to be orderly

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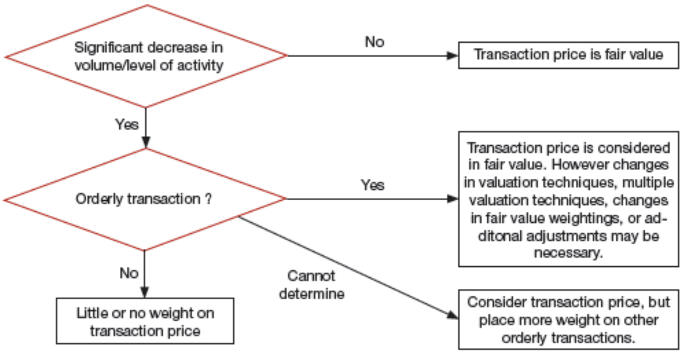
Considerations in determining the level of reliance on market prices



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Part 7
Disclosures

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Objectives

- HKFRS 13 requires disclosure of sufficient information to help financial statement users to assess:
  a. valuation techniques and inputs used to develop both recurring and non-recurring measurements of assets and liabilities carried at fair value after initial recognition
  b. the effect of the measurements on profit or loss or other comprehensive income of recurring Level 3 fair value measurements

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- To meet the above-mentioned objectives, an entity shall consider all the following:
  a. the level of detail necessary to satisfy the disclosure requirements
  b. how much emphasis to place on each of the various requirements
  c. how much aggregation or disaggregation to undertake
  d. whether users of financial statements need additional information to evaluate the quantitative information disclosed
- If the disclosures provided are insufficient to meet the above-mentioned objectives, an entity shall disclose additional information necessary to meet those objectives

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Recurring vs Non-recurring

- Recurring fair value measurements of assets or liabilities
  – those that other HKFRSs require or permit in the statement of financial position at the end of each reporting period (eg financial instruments in HKAS 39 *Financial Instruments: Recognition and Measurement*
- Non-recurring fair value measurements of assets or liabilities
  – those that other HKFRSs require or permit in the statement of financial position in particular circumstances (eg when an entity measures an asset held for sale at fair value less costs to sell in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

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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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	Measured at fair value on a recurring basis	Measured at fair value on a non-recurring basis (after initial recognition)	Not measured at fair value, but fair value is required to be disclosed
For Level 3, reconciliation of opening and closing balance	✓		
For Level 3, unrealised gains/losses from remeasurement	✓		
For Level 3, narrative description of sensitivity to changes in unobservable inputs	✓		
For Level 3, quantitative sensitivity to changes in unobservable inputs (for financial assets and liabilities only)	✓		

Please refer to HKFRS 13 for details of disclosure requirements.

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Part 8
Application of fair value measurement – Greek government bonds
(Annex I & II)

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Background

- There have been significant economic concerns in some European countries that are members of the single currency (the eurozone) as well as potential uncertainty about the single currency itself
- Greece, together Portugal, Italy and Spain continue to experience economic decline
- Austerity programmes aimed at reducing debt levels in these countries have not eliminated the possibility of default on sovereign debt and other governmental obligations.
- The fiscal and economic difficulties may have a significant impact on entities that hold sovereign debt from any of the troubled eurozone economies

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- Any entity that is owed money by the government or a quasi-governmental body from the troubled eurozone economies has sovereign debt risk; management needs to consider whether sovereign debt, trade debtors and other holdings are impaired
- European leaders have recently proposed a financial assistance package for Greece ('the package')
- Private holders of Greek government bonds (GGBs) will be asked to contribute towards the relief of Greece's debt burden
- The proposed financial assistance package is expected to require holders of government bonds to accept a reduction in the nominal value of the bonds of at least 50%

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- Any GGB classified as available for sale (AFS) should be measured at year-end fair value
- Any assertions that investments in GGBs are not impaired should be viewed with scepticism

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Accounting for available-for sale sovereign debt

(Extract from letter from IASB Chairman to ESMA – Annex I)

- AFS financial assets are measured at fair value with changes in fair value measurement presented in other comprehensive income
- However, if it is determined that those assets are impaired, the company recognises the accumulated decline in fair value in profit or loss
- In other words, the impairment calculation for AFS financial assets is based on the fair value of the assets
- It appears that some companies are not following IAS 39 *Financial Instruments: Recognition and Measurement* when determining whether the Greek government bonds that they classify as AFS are impaired

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Issues

- Using the assessed impact on the present value of future cash flows arising from the proposed restructure of those bonds, rather than using the amount reflected by current market prices as required in IAS 39
- Some companies holding Greek government bonds classified as AFS have stated that they are relying on internal valuation methodologies, rather than on market prices, to measure the fair value of the assets as at 30 June 2011
- The reason generally given for using models rather than market prices is that the market for Greek government bonds is currently inactive (and therefore, in their view, does not provide reliable pricing information)

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Accounting treatment

- In measuring fair value, IAS 39 prioritises the use of quoted prices in active markets over the use of valuation models developed using internal assumptions
- IAS 39 describes an active market for a financial instrument as one in which 'quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis'
- It is important to note that the description of an active market does not focus solely on trading activity
- When measuring fair value, the issue is not about the level of market activity per se, but about whether an observed transaction price represents fair value

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- Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices varying significantly over time or among market participants, or the prices not being current
- However, those factors alone do not necessarily mean that a market is no longer active
- A company cannot ignore observable transaction prices when it is clear that market participants are regularly entering into transactions for the same or similar financial assets, even if they are doing so less frequently than they have in the past

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- Although the level of trading activity in Greek government bonds has decreased, transactions are still taking place
- IAS 39 is clear that unless there is evidence that the prices in those transactions do not represent fair value (for example, because those transactions are forced or because they require significant adjustment because of timing differences between the transaction date and the measurement date, which are matters of judgement and depend on the facts and circumstances), the observed transactions prices should be used to measure fair value
- The goal of fair value measurement is to arrive at a current market price. This can be done by using an observed price, or by replicating a market price using a valuation model

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- Even when a model is used to measure fair value, that model must reflect current market conditions (including those as evidenced by observable transaction prices) and it should include appropriate adjustments that market participants would make for credit and liquidity risks
- The model must maximise the use of relevant observable inputs (eg market data) and minimise the use of unobservable inputs (eg the company's own assumptions)
- A company cannot ignore relevant market data (including observable transaction prices) when it is clear that market participants would use that data in determining the price at which they would be willing to enter into a transaction for the financial asset
- It would therefore not be in accordance with either the requirements in, or the intent of, IAS 39 to measure a loss on government bonds classified as AFS financial assets solely by assessing the present value of the future cash flows arising from a proposed restructure of those bonds

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Sovereign debt in IFRS financial statements

(Extract from public statements by ESMA – Annex II)

- As part of its objective to coordinate European enforcement activities, ESMA has collected information with respect to IFRS half-year financial statements ended on 30 June 2011, published by listed European financial institutions
- On this basis, there is evidence that some accounting practices of issuers with regard to Greek sovereign debt exposures varied across the European Economic Area

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- Out of 34 financial institutions with AFS instruments, 20 used fair values based on market data corresponding to level 1 valuation as defined by IFRS 7
- Other financial institutions judged that the markets for the investments in their portfolio were not active and therefore used level 2 (3 financial institutions). Presumably because they thought either that there were no transactions taking place or because the transactions that were taking place were not orderly transactions
- Four issuers used level 3 measurements. For another 4 issuers it was not possible to identify the measurement method used
- Finally 3 issuers did not recognise any impairment losses, but only a decrease in value accounted for in other comprehensive income

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With regards to the measurement of exposure to Greek Sovereign bonds, it is ESMA's opinion that:

- Greek sovereign bonds classified as available for sale or held for trading should have been reported at fair value using the fair value hierarchy as outlined in paragraph 27A of IFRS 7
- To determine the fair value, issuers should analyse whether a market is active or not at the reporting date
- This means analysing whether quoted prices are readily and regularly available for each instrument (by maturity, and where relevant by issuance) and whether those prices represent actual and regularly occurring market transactions on an arm's length basis

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- Based on trading data obtained from the Bank of Greece, it is ESMA's opinion that, as of 30 June 2011, the market was active for some Greek sovereign bonds but could be judged inactive for some others
- Issuers should consequently have used level 1 fair value measurement as defined under IFRS 7 for instruments with active markets
- For those instruments for which the market was not active, a level 2 measurement method should have been applied (using models which include observable market data from similar instruments, such as Greek bonds with close maturities or prices for credit default swaps, if relevant)
- The same fair value measurement considerations also apply when assets are reclassified from available for sale to loans and receivables

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Part 9
Consequential amendments to other HKFRSs

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Consequential amendments to other HKFRSs primarily include:

- Aligning terminology with HKFRS 13, e.g. changing "market value" to "fair value"
- Improving consistency in describing fair value measurement, e.g. "determining" or "estimating" fair values is changed to "measuring" fair value
- Deleting fair value guidance and instead cross-referencing to HKFRS 13
- Adding new disclosures in HKAS 36 to reflect additional fair value measurement disclosures when entities measure recoverable amount using fair value less costs to sell
- Articulating differences between fair value less costs to sell (modified to fair value less costs of disposal by HKFRS 13) and value in use in HKAS 36

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Part 10
Summary

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- 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
- Not a liquidation price or a forced sale
- From the perspective of a market participant
- Not entity-specific measurement
- Under current market conditions
- Assumes a transaction in the entity's principal (or most advantageous) market between market participants
- Price is not adjusted for transaction costs
- Maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs
- Three-level fair value hierarchy is extended to all fair value measurements

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- Non-financial assets – Highest and best use
- Financial assets and liabilities with offsetting positions – allows measurement of net exposures in limited circumstances
- Liabilities and an entity's own equity instruments – quoted prices are used if available; if not, then quoted prices for an identical item held as an asset are used before resorting to other valuation techniques
- HKFRS 13 requires a number of quantitative and qualitative disclosures about fair value measurements. Many of these are related to the three-level fair value hierarchy on the basis of the inputs to the valuation technique
- Some disclosure requirements differ depending on whether the fair value measurement is performed on a recurring or non-recurring basis

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Thank you for your attention

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A Refresher Course on Current Financial Reporting Standards

8, 13, 17, 20 and 28 June 2012

YOUR HOSTS

Winnie Chan
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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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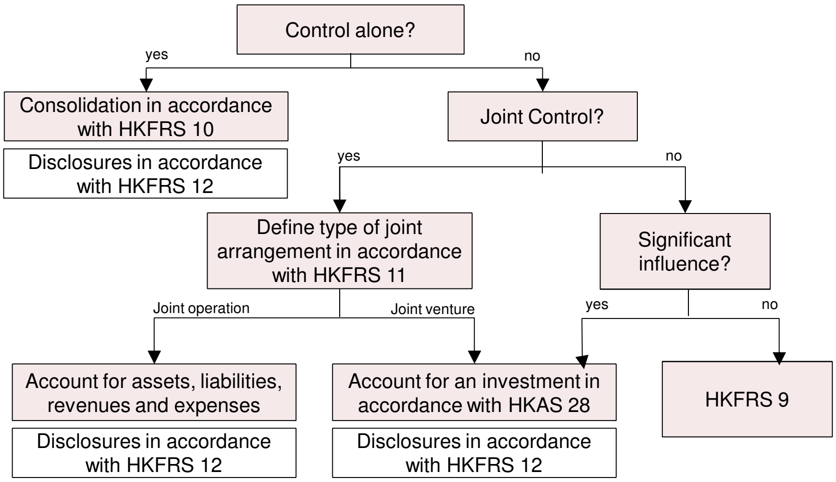
Interaction between HKFRSs 10, 11, 12 and HKAS 28



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Background

- IFRS 12 contains the note disclosures that companies must make about their interest in subsidiaries, joint arrangements, associates and unconsolidated structured entities
- The four broad categories of disclosures include:
  - the significant judgments and assumptions a company has made in deciding whether it has control, joint control or significant influence over another entity
  - a company's interests in subsidiaries
  - a company's interest in joint arrangements and associates, and
  - The nature, extent and risks relating to a company's interest in unconsolidated structured entities
- Effective date: 1 January 2013, early adoption is allowed

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Objective

- To disclose information that enables users of its 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 entities; and
  - the effects of those interests on its financial position, financial performance and cash flows

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Interest in other entities

- contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the other entity
- an interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees
- includes the means by which an entity has control or joint control of, or significant influence over, another entity
- An entity does not necessarily have an interest in another entity solely because of a typical customer supplier relationship.

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Structured entities

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

Features of structured entities:

- Restricted activities
- A narrow and well-defined objective
- Insufficient equity to permit it to finance its activities without subordinated financial support
- Financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks

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Structured entities

Examples of structured entities:

- Securitisation vehicles
- Asset-backed financings
- Some investment funds

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General requirements

- HKFRS 12 specifies minimum disclosures that an entity must provide
- An entity shall disclose whatever additional information which is considered is necessary if the minimum disclosures required by HKFRS 12 and other HKFRSs, taken together, are not sufficient to meet the objective
- HKFRS 12 requires an entity to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the requirements
- An entity shall aggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics

CEF 11

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General requirements

- Disclosure the method of aggregation
- A quantitative and qualitative analysis, taking into account the different risk and return characteristics of each entity, is made in order to determine the aggregation level
- As a minimum, information is given for:
  - (a) subsidiaries;
  - (b) joint ventures;
  - (c) joint operations;
  - (d) associates; and
  - (e) unconsolidated structured entities

CEF 12

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General requirements

- Within the boundaries of the minimum, HKFRS 12 identifies the following examples of further potential sub-aggregation
  (a) nature of activities (e.g. R & D vs revolving credit card securitisation)
  (b) industry classification
  (c) geography (e.g. country or region)

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Significant judgements and assumptions

- Disclose the significant judgements and assumptions made in deciding
  (i) whether it has control, joint control or significant influence over another entity;
  (ii) the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle

(a) it does not control another entity even though it holds more than half of the voting rights of the other entity.
(b) it controls another entity even though it holds less than half of the voting rights of the other entity.
(c) it is an agent or a principal (see paragraphs 58–72 of HKFRS 10).
(d) it does not have significant influence even though it holds 20 per cent or more of the voting rights of another entity.
(e) it has significant influence even though it holds less than 20 per cent of the voting rights of another entity

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Information about a company's interests in subsidiaries

To enable users of the consolidated financial statements to understand and evaluate:

1. the composition of the group
2. the interest that non-controlling interests (NCIs) have in the group's activities and cash flows;

   For each subsidiary with material NCI, refer to Annex III for details
3. the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;

   For example, restriction on transfer cash or other assets, dividend and other capital contributions being paid, or loans and advances being made or paid

The summarised financial information shall be the amounts before intercompany eliminations.

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Information about a company's interests in subsidiaries (cont'd)

To enable users of the consolidated financial statements to understand and evaluate:

4. the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
   – the terms of any contractual arrangements that could require parent or its subsidiaries to provide financial support, including events or circumstances that could expose the reporting entity to loss
   – type of and reasons for the support the group entity has provided if there is no contractual obligation to do so
   – any current intentions to provide financial or other support, including assistance in obtaining financial support

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

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 Annex III 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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References

- Refer to Annex IV for the illustrative disclosures extracted from Deloitte illustrative financial statements 2011
- http://www.iasplus.com/en/publications/hong-kong-publications/models/hong-kong-financial-reporting-standards-2014-illustrative-financial-statements-2011/file

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Thank you for your attention

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4 August 2011

Steven Maijoor, Chair
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Sent via email

Dear Mr Maijoor,

Accounting for available-for sale (AFS) sovereign debt

There have been indications in the market that some European companies are applying the accounting requirements for fair value measurement and impairment losses in a way that seems to differ from the objective of IAS 39 *Financial Instruments: Recognition and Measurement*. This is evident particularly in their accounting for distressed sovereign debt, including Greek government bonds. Those indications have now been confirmed by recently published financial reports, which show inconsistent application of IAS 39 across Europe. This is a matter of great concern to us.

We are aware that, as an accounting standard-setter, the IASB does not have the authority to ensure compliance with International Financial Reporting Standards (IFRSs). However, the IASB and ESMA have a mutual interest in ensuring the highest quality in the application of IFRSs. Although we do not usually comment on how our standards are applied, because this case demonstrates visibly inconsistent application, we believe that it is appropriate for us to bring this matter to your attention.

I thought it would be helpful to provide you with some information about the objective of fair value measurement in IAS 39 and the use of models when the market for a particular financial instrument is not active. This letter does not address financial assets classified as held-to-maturity or loans and receivables.

In October 2008 the IASB staff published a report summarising the discussions of our Fair Value Expert Advisory Panel, which was set up in response to the recommendations made by the Financial Stability Board to address the measurement and disclosure of financial instruments when markets are no longer active. That report was well-received and was found to be helpful in the last financial crisis. Many respondents to our exposure draft on fair value measurement indicated that they found it consistent with the fair value measurement concepts in IAS 39 (as well as in US generally accepted accounting principles, or GAAP), which are described in this letter. That guidance is now in IFRS 13 *Fair Value Measurement*, which we issued in May.

Fair value of AFS financial assets

AFS financial assets are measured at fair value with changes in fair value measurement presented in other comprehensive income. However, as you know, IAS 39 requires a company to recognise any impairment loss in profit or loss when there is objective evidence that those financial assets are impaired. If it is determined that those assets are not impaired, the company continues to recognise the decline in fair value in other comprehensive income. If it is determined that those assets are impaired, the company recognises the accumulated decline in fair value in profit or loss. In other words, the impairment calculation for AFS financial assets is based on the fair value of the assets.

It appears that some companies are not following IAS 39 when determining whether the Greek government bonds that they classify as AFS are impaired. They are using the assessed impact on the present value of future cash flows arising from the proposed restructure of those bonds, rather than using the amount reflected by current market prices as required in IAS 39.

In addition, some companies holding Greek government bonds classified as AFS have stated that they are relying on internal valuation methodologies, rather than on market prices, to measure the fair value of the assets as at 30 June 2011. The reason generally given for using models rather than market prices is that the market for Greek government bonds is currently inactive (and therefore, in their view, does not provide reliable pricing information).

Determining whether a market is active

In measuring fair value, IAS 39 prioritises the use of quoted prices in active markets over the use of valuation models developed using internal assumptions.

IAS 39 describes an active market for a financial instrument as one in which 'quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis'. It is important to note that the description of an active market does not focus solely on trading activity. That is because when measuring fair value, the issue is not about the level of market activity *per se*, but about whether an observed transaction price represents fair value.

Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices varying significantly over time or among market participants, or the prices not being current. However, those factors alone do not necessarily mean that a market is no longer active. A company cannot ignore observable transaction prices when it is clear that market participants are regularly entering into transactions for the same or similar financial assets, even if they are doing so less frequently than they have in the past.

Although the level of trading activity in Greek government bonds has decreased, transactions are still taking place. IAS 39 is clear that unless there is evidence that the prices in those transactions do not represent fair value (for example, because those transactions are forced or because they require significant adjustment because of timing differences between the transaction date and the measurement date, which are matters of judgement and depend on the facts and circumstances), the observed transactions prices should be used to measure fair value.

Using models when measuring fair value

The objective of a fair value measurement, whether using an observed market price or a valuation model, is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date. In other words, the goal is to arrive at a current market price. This can be done by using an observed price, or by replicating a market price using a valuation model. In addition, the objective of the measurement is the same *irrespective* of current market conditions.

Even when a model is used to measure fair value, that model must reflect current market conditions (including those as evidenced by observable transaction prices) and it should include appropriate adjustments that market participants would make for credit and liquidity risks. Furthermore, the model must maximise the use of relevant observable inputs (eg market data) and minimise the use of unobservable inputs (eg the company's own assumptions). A company cannot ignore relevant market data (including observable transaction prices) when it is clear that market participants would use that data in determining the price at which they would be willing to enter into a transaction for the financial asset.

It would therefore not be in accordance with either the requirements in, or the intent of, IAS 39 to measure a loss on government bonds classified as AFS financial assets solely by assessing the present value of the future cash flows arising from a proposed restructure of those bonds. It is hard to imagine that there are buyers willing to buy those bonds at the prices indicated by the valuation models being used. In my view it is therefore difficult to justify that those models would meet the objective of a fair value measurement.

Yours sincerely

Hans Hoogervorst, Chair

European Securities and Markets Authority

Date: 25 November 2011
ESMA/2011/397

PUBLIC STATEMENT

Sovereign Debt in IFRS Financial Statements

As a result of recent sovereign debt[1] developments and the increased market interest in this area, there has been a lot of focus on the accounting practices of listed companies, and financial institutions in particular, with respect to their exposures to sovereign debt.

On 28 July 2011 ESMA issued a Statement[2] stressing the need for enhanced transparency and the importance of applying the relevant International Financial Reporting Standards (IFRS). ESMA also encouraged issuers to provide information on their exposures to sovereign debt on a country-by-country basis in their financial statements.

Since then ESMA conducted together with national competent authorities a fact-finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements based on a sample of financial institutions listed in EU regulated markets.

The consistent application of IFRS, which covers standards for recognition, measurement and disclosure, is important for the proper functioning of financial markets. ESMA publishes this Statement to promote consistent application of European securities and markets legislation, and notably of IFRS. It contains two Sections:

— Section 1 discusses accounting issues related to sovereign debt in IFRS annual financial statements ending 31 of December 2011. The Section highlights elements that should be considered by issuers and their auditors in relation to exposure to sovereign debt when preparing their financial statements for the upcoming year-end.

— Section 2 is an ESMA Opinion "*Accounting for Exposure to Greek Sovereign Debt – Considerations with respect to IFRS Interim Financial Statements for Accounting Periods ended on 30 June 2011.* The Opinion provides a summary of the outcome of the fact-finding exercise together with elements that should have been considered by issuers and their auditors as part of the IFRS interim financial statements for periods ended 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

[1] Sovereign debt, for the purpose of this statement, refers to bonds issued by and loans given to central and local government and governmental bodies.
[2] http://www.esma.europa.eu/popup2.php?id=7685

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Section 1: Sovereign Debt in Annual IFRS Financial Statements

ESMA would like to stress the need for transparency and the importance of appropriate and consistent application of the recognition, measurement and disclosure principles provided for in IFRS. This Section should not be understood as constituting guidance or recommendations on how to apply IFRS, but rather as assisting issuers in preparing their annual financial statements.

Issuers having securities traded on an EU regulated market and that have material exposure to sovereign debt should consider the following elements as part of the preparation of their year-end IFRS financial statements:

Existence of impairment for sovereign debt related financial assets

The assessment of objective evidence that a financial asset is impaired should be based on the criteria in paragraph 59 of IAS 39 – *Financial instruments: Recognition and Measurement* such as: financial difficulty of the obligor, breach of contract, concession granted to the borrower, disappearance of an active market or decrease in the estimated future cash flows. IAS 39 paragraph 60 specifically notes that a credit downgrade is not, of itself, evidence of impairment, nor is a decline in the instrument's fair value, although it may be evidence of impairment when considered with other available information. In addition, when assessing the existence of a loss event, consideration should also be given to the fact that default risk is related to the obligor and not to a specific financial instrument issued by that party.

Therefore, ESMA emphasises that issuers should carefully analyse facts and circumstances at the reporting date. They should provide in the IFRS financial statements all relevant disclosures related to the criteria used in assessing the existence of objective evidence of impairment for financial assets and present all the assumptions and uncertainties regarding the impact on future estimated cash-flows.

Measurement of financial assets related to sovereign debt exposure

ESMA reminds issuers of the following IAS 39 measurement principles regarding the different accounting categories of financial assets:

— For financial assets classified as held to maturity or loans and receivables:

  Sovereign debt classified as held to maturity or loans and receivables are measured at amortized cost using the effective interest rate method[3]. If there is objective evidence that assets are impaired, an estimate of impairment losses should be determined based on appropriate reassessment of expected future cash-flows using the original effective interest rate. In cases where a restructuring plan is in place, such estimation should be based using details from the plan, unless a derecognition of the original asset has taken place and a new financial asset is recognised. Where a restructuring plan exists (see also below the paragraph on *Greek sovereign debt – specific accounting matters*), but it is not yet in place and/or the details are still unknown, issuers should ensure that a best estimate is determined based on all the information available, including any further indications of material losses in addition to those induced by the plan.

[3] In case the bonds have been reclassified out of the fair value through profit or loss category or the available for sale category the effective interest rate calculated at the moment of the transfer should be used.

— For financial assets classified as available-for-sale or held-for-trading

Sovereign debt classified as available-for-sale or held for trading is recognized in the statement of financial position at fair value. If there is objective evidence that assets are impaired, an impairment loss has to be recognised in the profit or loss account for the assets classified at available-for-sale. In order to determine the fair value, issuers should analyse whether a financial instrument is regarded as quoted in an active market or not at the reporting date by analysing whether quoted prices are readily and regularly available for each instrument (by issuance) and whether those prices represent actual transactions between willing parties on an arm's length basis. In this context we believe that the literature provided by the IASB Expert Advisory Panel – *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*[4] constitutes relevant guidance. Though IFRS 13 (*IFRS 13 – Fair Value Measurement*) is not endorsed in the European Union it could be relevant as part of that analysis.

When a market for a financial instrument is active, issuers should use the quoted prices, which are defined as level 1 fair value measurements under IFRS 7 – *Financial Instruments: Disclosures*. For those instruments for which the market is not active, level 2 measurements should be applied by using models which make maximum use of market inputs, such as inputs from observable similar or linked instruments, such as other bonds, preferably issued by the same sovereign state, with similar maturities.

Disclosures in the year-end IFRS financial statements

ESMA would like to stress the importance for issuers to provide all relevant disclosures related to exposure to sovereign debt in order to comply with the requirements of IFRS 7. ESMA would also like to underline that in order to achieve a fair presentation, as stated under IAS 1 – *Presentation of Financial Statements,* issuers are required to provide any additional disclosures when compliance with IFRS 7 does not suffice to enable users to understand the impact of sovereign debt to the financial position and performance of the issuer. This is particularly important for areas in which management judgement is applied, as allowed by IFRSs.

In addition, ESMA believes that in the case where a market is not active for a specific instrument, the issuer should provide supplementary disclosures explaining the underlying rationale, assumptions and the sources used as inputs to the valuation.

Moreover, ESMA would encourage providing quantitative and qualitative information on sovereign debt related instruments such as credit default swaps (CDS) and other instruments, directly referencing to sovereign debt such as financial guarantees, forward contracts, options and other derivatives. This could include the level and the risks to which the issuer is exposed, as well as the estimated level of protection in case a CDS was acquired by an issuer.

Greek sovereign debt - specific accounting matters

As a result of significant financial and economic difficulties experienced by Greece, a particular focus is given to Greek sovereign debt. European leaders proposed in July 2011 a financial assistance package for Greece in which private bondholders would be asked to contribute towards the relief of Greece's debt burden via a voluntary bond exchange (known as the Private Sector Involvement). That proposal would have resulted in a 21% net present value loss for private bondholders based on an assumed discount rate of 9% and a significant extension in the overall maturity profile of the country's debts.

[4] http://www.iasb.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf

The economic situation in Greece has continued to deteriorate and on 26 October 2011 European leaders proposed changes to the plan for Private Sector Involvement. At the date of this release the specific terms of the participation to the plan are unknown and negotiations are still ongoing, but based on the Euro Summit Statement we understand that the plan would request private bondholders to accept a 50% reduction in the nominal value of the bonds.

ESMA together with national competent authorities conducted a fact finding exercise on the accounting treatment of Greek sovereign debt in the half-year financial statements of a wide sample of financial institutions listed in EU regulated markets. Based on this review, there is evidence that accounting practices of financial institutions with regard to sovereign debt exposures varied, in particular with respect to the extent of debt exposures subject to impairment losses, the methods for calculation of impairment losses and methodologies used for fair value measurement. Therefore, the second Section of this Statement contains an Opinion regarding accounting for exposure to Greek Sovereign debt in the IFRS interim financial statements for accounting periods ended on 30 June 2011.

Though ESMA cannot predict market developments and how the facts and circumstances relevant for financial reporting will look at the end of the year, ESMA believes that the Opinion contains elements that are relevant for issuers and their auditors to consider – together with the other elements presented in this Public Statement – when preparing or auditing the financial statements for the upcoming year end.

Future actions

ESMA will, together with national competent authorities, continue to strictly monitor the application of IFRS and consider whether further actions are needed in order to ensure the appropriate accounting treatment of exposure to sovereign debt by European issuers.

Section 2: Opinion – Accounting for Greek Sovereign Debt – Considerations with respect to IFRS interim financial statements for accounting periods that ended on 30 June 2011

I. Introduction and legal basis

1. As a result of recent developments in the area of sovereign debt and the increased market interest in this area, ESMA issues an opinion to promote the effective and consistent application of European securities and markets legislation and notably of International Financial Reporting Standards and relevant sectoral legislation.

2. ESMA's competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EC) No 1095/2010 (the "Regulation"). In accordance with Article 44(1) of the Regulation the Board of Supervisors has adopted this opinion.

II. General observations

3. As part of its objective to coordinate European enforcement activities, ESMA has collected information from National Competent Authorities (NCAs) with respect to IFRS half-year financial statements ended on 30 June 2011, published by listed European financial institutions. On this basis, there is evidence that some accounting practices of issuers with regard to Greek sovereign debt exposures varied across the European Economic Area.

4. The main identified divergences for the 53 financial institutions included in our fact-finding exercise relate to the following:

   — It has been observed that there are differences regarding recognition or non-recognition of impairment losses. Data collected show that for example two financial institutions which had decided not to participate in the July International Institute of Finance plan (the "July IIF plan") did not recognise any impairment. Another difference relates to bonds with maturities after July 2020, for which some financial institutions indicated recognition of impairment losses and some did not.

   — Regarding bonds classified as held to maturity, 10 out of 23 financial institutions with investments in this category used the estimation of the 21% "haircut" on the face value of the bonds provided in the July IIF plan as the estimation for the impairment loss. Some banks used the original effective interest rate resulting in impairment losses between 17% and 23% while others used the new discount rate indicated in the July IIF plan for calculating the impact on the estimated future cash-flows.

   — Other differences appeared with respect to financial assets classified as available for sale (AFS), for which different valuation methods have been used by issuers. Out of 34 financial institutions with AFS instruments, 20 used fair values based on market data corresponding to level 1 valuation as defined by IFRS 7. Other financial institutions judged that the markets for the investments in their portfolio were not active and therefore used level 2 (3 financial institutions). Presumably because they thought either that there were no transactions taking place or because the transactions that were taking place were not orderly transactions, four issuers used level 3 measurements. For another 4 issuers it was not possible to identify the measurement method used. Finally 3 issuers did not recognise any impairment losses, but only a decrease in value accounted for in other comprehensive income.

— It appeared that there were some cases in which the consequences of different accounting practices could be assessed as non-material.

III. Description of accounting considerations

5. While ESMA acknowledges that the supervision of financial reporting and necessary potential enforcement actions that may arise rests with NCAs, it is important that consistent application of IFRS is achieved in the European Union. To achieve that goal, the existing European IFRS Enforcement Coordination Mechanism (EECS) provides ESMA with a very valuable tool.

6. The present opinion is based on discussions that took place between ESMA and NCAs within EECS in order to coordinate the enforcement activities in the particular area of accounting for exposures to Greek sovereign debt. EECS has been specifically mandated to consider all technical issues related to this matter, including but not limited to: the arguments used by issuers relating to triggering events when recognising an impairment loss, measurement methods used in compliance with the fair value hierarchy, and determination of criteria for assessing whether markets are active or inactive. This Opinion forms an element for NCA's when considering an enforcement decision.

7. ESMA acknowledges that materiality plays an important role in identifying the appropriate type of enforcement action to be considered by NCAs where a misstatement is identified in the IFRS financial statements. When a material misstatement in the financial information is detected enforcers should take appropriate action to achieve appropriate disclosure of such a misstatement and, where relevant, public correction of the misstatement.

8. In ESMA's opinion, the following elements should have been considered by issuers and their auditors when preparing their IFRS interim financial statements published for periods that ended on 30 June 2011. Some of these elements might also be relevant for issuers and their auditors when preparing or auditing future financial statements.

9. Regarding the existence of objective evidence of impairment and determination of an asset being impaired, it is ESMA's opinion that:

— There was objective evidence of impairment of Greek sovereign bonds as of 30 June 2011, based on at least two of the criteria to be considered according to paragraph 59 of IAS 39 – *Financial Instruments: Recognition and Measurement*: significant financial difficulty of the debtor and decrease in the fair value of the investment. The European Council's decision on 21 July 2011 with respect to the private sector initiative is indicative of a concession granted by private investors and confirms the significant financial difficulty of the debtor as of 30 June 2011 and raises concerns about whether the bonds would be paid in full. Issuers should have provided indications on the facts and circumstances and the conditions that existed at that date in their reports.

— The conditions existing as of 30 June 2011 had an impact on the estimated future cash-flows that could be reliably estimated. Indicators of the possible impact on contractual cash flows were available as part of the haircut indicated in the July IIF plan, in which a number of financial institutions confirmed their participation. In some circumstances, transactions observed in the market were also indicative of the fact that future estimated cash flows will be impacted, even if other scenarios than the implementation of the July IIF plan were taken into account by market participants. Consequently financial assets related to exposure to Greek sovereign bonds with maturities before July 2020 were impaired.

— Regarding Greek bonds with maturities after July 2020, which were not included in the July IIF plan, the facts considered above should have been analysed as indicating that the contractual cash-flows were at risk of being impacted by the financial difficulties. Default risk is related to the debt issuer and not to a financial instrument issued by the debt issuer. The estimation of the size of such an impact on the future cash flows is a matter of judgement.

10. With regards to the measurement of exposure to Greek Sovereign bonds, it is ESMA's opinion that:

— For their interim financial statements issuers should have determined impairment losses on the Greek sovereign bonds classified as held-to-maturity using the original effective interest rate[3], notwithstanding whether they expressed their participation in the plan put forward by the IIF or not. According to IAS 34 paragraph 41, the preparation of interim financial reports generally requires a greater use of estimation methods than annual reports. Taking into consideration the uncertainties that existed at the time the interim financial statements were prepared, the 21% haircut could be accepted in some circumstances as being a possible estimate based on reasonable judgement for measuring impairment losses for financial assets measured at amortised cost. It could be regarded as a practical expedient, assuming that the assessment of expected cash flows at the original effective interest rate would have resulted in materially the same level of impairment.

— Greek sovereign bonds classified as available for sale or held for trading should have been reported at fair value using the fair value hierarchy as outlined in paragraph 27A of IFRS 7 – *Financial Instruments: Disclosures*. In order to determine the fair value, issuers should analyse whether a market is active or not at the reporting date. This means analysing whether quoted prices are readily and regularly available for each instrument (by maturity, and where relevant by issuance) and whether those prices represent actual and regularly occurring market transactions on an arm's length basis (paragraph 71 of Appendix A to IAS 39). Based on trading data obtained from the Bank of Greece, it is ESMA's opinion that, as of 30 June 2011, the market was active for some Greek sovereign bonds but could be judged inactive for some others. Issuers should consequently have used level 1 fair value measurement as defined under IFRS 7 for instruments with active markets. For those instruments for which the market was not active, a level 2 measurement method should have been applied (using models which include observable market data from similar instruments, such as Greek bonds with close maturities or prices for credit default swaps, if relevant). The same fair value measurement considerations also apply when assets are reclassified from available for sale to loans and receivables.

11. Regarding disclosures of exposure to Greek Sovereign bonds, in line with the statement published by ESMA on 28 July 2011 it is ESMA's opinion that issuers should have included all information required under IAS 34 – *Interim Financial Reporting*. This means that, as a minimum, the issuer should have provided: the level of exposure to Greek Sovereign debt as of 30 June (including details about maturities), the accounting treatment applied for the debt and its impairment losses together with a description of key judgments used in the assessment of whether the asset was impaired or not

about maturities), the accounting treatment applied for the debt and its impairment losses together with a description of key judgments used in the assessment of whether the asset was impaired or not and key assumptions underpinning the assessment of the impairment losses for each class of instruments (IAS 34 paragraph 15B).

12. This opinion will be published on ESMA's website.

Done at Paris, 24 November 2011

Steven Maijoor

ESMA Chair

For the Board of Supervisors

Notes to editors

1. ESMA is an independent EU Authority that was established on 1 January 2011 according to EU Regulation No. 1095/2010 as published on December 15, 2010, in the Official Journal of the European Union (L 331/84). The Authority contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA).

2. ESMA's work on securities legislation contributes to the development of a single rule book in Europe. This serves two purposes; firstly, it ensures the consistent treatment of investors across the Union, enabling an adequate level of protection of investors through effective regulation and supervision. Secondly, it promotes equal conditions of competition for financial service providers, as well as ensuring the effectiveness and cost efficiency of supervision for supervised companies. As part of its role in standard setting and reducing the scope of regulatory arbitrage, ESMA strengthens international supervisory co-operation. Where requested in European law, ESMA undertakes the supervision of certain entities with pan European reach.

3. ESMA also contributes to the financial stability of the European Union, in the short, medium and long-term, through its contribution to the work of the European Systemic Risk Board, which identifies potential risks to the financial system and provides advice to diminish possible threats to the financial stability of the Union. ESMA is also responsible for coordinating actions of securities supervisors or adopting emergency measures when a crisis situation arises.

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IFRS

Annex III

Welcome to the website of the IFRS Foundation and the IASB

Paul Pacter: Improving disclosures about intercompany investments

12 March 2012

In May 2011 the IASB issued IFRS 12 *Disclosure of Interests in Other Entities* as part of a suite of new standards that address intercompany investments. IFRS 12 contains the note disclosures that companies must make about their interests in subsidiaries, joint arrangements (eg joint ventures), associates and unconsolidated structured entities. It takes effect from 1 January 2013, although companies may elect to apply it earlier.

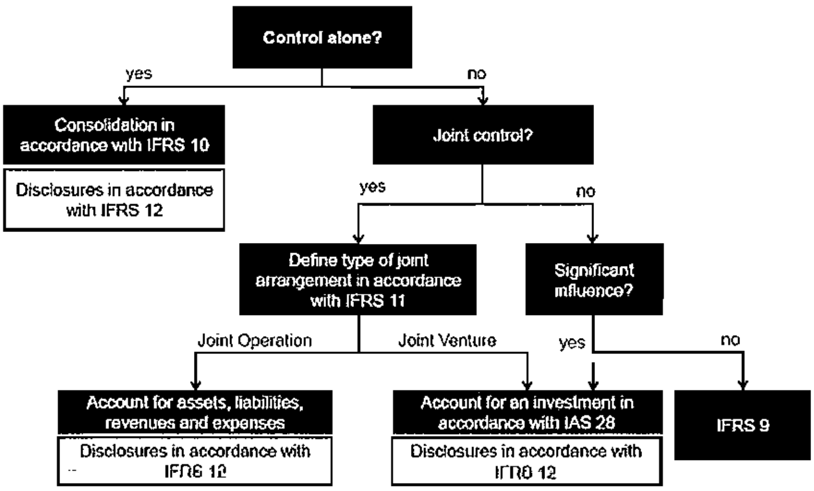
IFRS 12 requires four broad categories of disclosures—namely, information about:

1. **the significant judgements and assumptions** a company has made in deciding whether it has control, joint control or significant influence over another entity;
2. a company's interests in **subsidiaries**;
3. a company's interests in **joint arrangements and associates**; and
4. the nature, extent, and risks relating to a company's interests in **unconsolidated structured entities**.

From an investor's perspective, this fourth category is probably IFRS 12's biggest disclosure enhancement. Information about unconsolidated structured entities was not explicitly required before, and was largely unavailable in financial statements prepared in accordance with earlier IFRSs.

IFRS 12 was part of a suite of three new standards, issued concurrently, that address intercompany investments. The other two were IFRS 10 *Consolidated Financial Statements* and IFRS 11 *Joint Arrangements*. The existing standards that cover the accounting for investments in associates and passive investments of less than 20 per cent were largely unaffected. **Click here** to see more information on those standards.

The following diagram illustrates the interaction between the IFRSs that cover investments in other entities:



Objective of IFRS 12

The objective of IFRS 12 is to require the disclosure of information that enables users of a company's financial statements to evaluate:

- the nature of a company's interests in subsidiaries, joint arrangements, associates, and unconsolidated structured entities;
- the risks associated with those interests; and
- the effects of those interests on its financial position, financial performance and cash flows.

Most often, a company's interest in another entity is evidenced by holding equity or debt instruments. But that is not always the case. Such interests also include other forms of involvement, for example, providing funding, liquidity support, credit enhancements and guarantees. The IFRS 12 disclosures apply to all of those involvements.

Before looking more closely at the specific requirements of IFRS 12, there is an important point to bear in mind. The IFRS 12 disclosures are a **minimum.** Each entity is required to assess whether the disclosures required by IFRS 12 and other IFRSs, taken together, provide sufficient information to evaluate the nature, risks and effects of the company's interests in other entities. If the conclusion from that assessment is that further disclosures are needed, a company must present them to comply with IFRS 12.

Figure 1 below summarises the minimum required descriptive disclosures and **Figure 2** summarises the minimum required financial information.

Significant judgements and assumptions

IFRS 12 requires a company to disclose the significant judgements and assumptions made in deciding whether it has control, joint control or significant influence over another entity.

In deciding whether one entity controls another, IFRS 10 requires the company to assess whether it currently has the power to direct the activities of the other entity for its own benefit. If it does have that power, it must prepare consolidated financial statements, even if the company has less than a 50 per cent voting interest. Similarly, a company must consider any substantive **potential** voting rights that it holds (via options, warrants, contingent issuance agreements and the like) in deciding whether it has 'de facto control' over another entity. Clearly, those assessments involve judgements, and IFRS 12 requires companies to disclose those judgements and related assumptions.

Likewise, disclosure would be required if a company concludes that it should not consolidate another entity because it is acting as an agent of another party rather than on its own behalf (for example, a company that manages an investment fund by contract).

IFRS 12 also covers disclosures about investments in joint arrangements. If a company is a party to a joint arrangement, IFRS 11 requires the company to determine whether the investee is a joint venture (in which case the equity method set out in IAS 28 *Investments in Associates* applies) or a joint operation (in which case IFRS 11 requires the investor to account for its share of the various assets, liabilities, revenue and expenses of the joint operation). IFRS 12 requires companies to explain the basis on which they made the joint venture versus joint operation decision.

Information about a company's interests in subsidiaries

For subsidiaries, the objective is to disclose information that enables users of a company's consolidated financial statements to understand and evaluate:

- the composition of the group;
- the interest that non-controlling interests have in the group's activities and cash flows;
- the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
- the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
- the consequences of changes in its ownership interest in a subsidiary that do not result in loss of control; and
- the consequences of losing control of a subsidiary during the reporting period.

Information about a company's interests in joint arrangements and associates

For joint arrangements and associates, the objective is to disclose information that enables users of a company's financial statements to evaluate:

- the nature, extent, and financial effects of its interests in joint arrangements and associates, including details of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates.
- the risks associated with its interests in joint ventures and associates.

Figure 1 – Required descriptive and other disclosures

	Subsidiary that is wholly owned	Subsidiary that is less than wholly owned	Joint operation	Joint venture	Associate

Name of subsidiary, joint arrangement, or associate		✓	✓	✓	✓
Nature of relationship			✓	✓	✓
Principal place of business and country of incorporation		✓	✓	✓	✓
Proportion of ownership and voting rights held by non-controlling interest (NCI)		✓			
Method of accounting (equity method or fair value)				✓	✓
Fair value, if equity method is used and investee is quoted				✓	✓
Profit or loss allocated to NCI		✓			
Accumulated NCI		✓			
Unrecognised losses for equity method investments				✓	✓
Restrictions on access to a subsidiary's assets	✓	✓			
Risks associated with consolidated structured entities	✓	✓			
Changes in ownership interest that do not result in loss of control	✓	✓			
Consequences of losing control in the period	✓	✓			
Dividends paid to NCI		✓			
Dividends received				✓	✓
Different reporting date of investor and investee	✓	✓		✓	✓
Commitments				✓	✓
Contingent liabilities				✓	✓

Figure 2 – Required summarised financial information

	Subsidiary that is wholly owned	Subsidiary that is less than wholly owned	Joint operation	Joint venture	Associate
Current assets		✓		✓	✓
Cash and cash equivalents included in current assets				✓	
Non-current assets		✓		✓	✓
Current liabilities		✓		✓	✓
Current financial liabilities included in				✓	

current liabilities (excluding payables and provisions)				
Non-current liabilities	✓		✓	✓
Non-current financial liabilities included in non-current liabilities (excluding payables and provisions)			✓	
Revenue	✓		✓	✓
Depreciation and amortisation			✓	
Interest income			✓	
Interest expense			✓	
Income tax expense or income			✓	
Profit or loss from continuing operations			✓	✓
Post-tax profit or loss from discontinued operations			✓	✓
Profit or loss	✓			
Other comprehensive income			✓	✓
Total comprehensive income	✓		✓	✓

Information about a company's interests in unconsolidated structured entities

The disclosures that IFRS 12 requires about unconsolidated (ie off-balance-sheet) structured entities are all new. Our previous standards had nothing similar. The objective here is to ensure that users of financial statements are able to:

- understand the nature and extent of a company's interests in unconsolidated structured entities; and
- evaluate the risks associated with those interests.

To meet the first objective, a company would disclose (among other things) the nature, purpose, size and activities of the structured entity and how those activities are financed. Even if a company no longer has an interest in an unconsolidated structured entity at the reporting date, some disclosures will be required if the company set up and sponsored the structured entity in the first place.

To meet the second objective, a company would present a tabular (or other) summary that includes:

- the carrying amounts (and line items) of the assets and liabilities recognised in its financial statements relating to its interests in unconsolidated structured entities.
- the company's estimate of its maximum exposure to losses from those interests, and how that estimate was made. If the company cannot quantify its maximum exposure to loss from unconsolidated structured entities, it must disclose that fact and the reasons.

If, during the reporting period, a company has voluntarily provided financial or other support to an unconsolidated structured entity in which it previously had, or currently has, an interest (for example, by purchasing assets of or instruments issued by the structured entity), it must disclose the type, amount, and reasons for that support.

Additionally, if a company intends to provide financial or other support to an unconsolidated structured entity, or to assist that structured entity in obtaining financial support, it must disclose that fact.

Related disclosures in other IFRSs

Companies also need to provide other disclosures about interests in other entities. For example, parents and subsidiaries are related parties under IAS 24 *Related Party Disclosures*, as are investors and their associates and joint ventures. IAS 24 requires disclosures about related party transactions and also about relationships between a parent and its subsidiaries, even if there are no transactions between them. In addition, IFRS 7 *Financial Instruments: Disclosures* requires various disclosures about the nature and extent of risks arising from financial instruments.

Respond to the author

Paul Pacter is a member of the IASB and a guest author of *Investor Perspectives*. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB/IFRS Foundation. The IASB/IFRS Foundation disclaims any and all responsibility.

The IASB/IFRS Foundation encourages its staff to express their individual views. This article has been developed by the author as an individual. It is has not been subjected to any due process of the IASB/IFRS Foundation. Official positions of the IASB/IFRS Foundation are determined only after extensive due process.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

4. Critical accounting judgements and key sources of estimation uncertainty

Note: HKFRS 12.7 requires entities to disclose information about significant judgements and assumptions they have made in determining (i) whether they have control of another entity, (ii) whether they have joint control of an arrangement or significant influence over another entity, and (iii) the type of arrangement when the arrangement has been structured through a separate vehicle.

Critical judgements in applying accounting policies

The following are the critical judgements, apart from those involving estimations (see below), that the directors have made in the process of applying the Group's accounting policies and that have the most significant effect on the amounts recognised in the consolidated financial statements.

HKFRS 12.7(a)
HKFRS 12.9(b)

Control over C Plus Limited

Note 59 describes that C Plus Limited is a subsidiary of the Group although the Group has only 45 per cent ownership interest and voting rights in C Plus Limited. C Plus Limited is listed on the stock exchange of C Land. The Group has the 45 per cent ownership since June 2009 and the remaining 55 per cent of shareholdings are owned by thousands of shareholders that are unrelated to the Group. Details of C Plus Limited are set out in note 59.

The directors assessed whether or not the Group has control over C Plus Limited based on whether the Group has the practical ability to direct the relevant activities of C Plus Limited unilaterally. In making their judgement, the directors considered the Group's absolute size of holding in C Plus Limited and the relative size of and dispersion of the shareholdings owned by the other shareholders. After assessment, the directors concluded that the Group has sufficiently dominant voting interest to direct the relevant activities of C Plus Limited and therefore the Group has control over C Plus Limited.

HKFRS 12.7(b)
HKFRS 12.9(e)

Significant influence over A Plus Limited

Note 24 describes that A Plus Limited is an associate of the Group although the Group only owns 17% ownership interest in A Plus Limited. The Group has significant influence over A Plus Limited by virtue of the contractual right to appoint two out of the six directors to the board of directors of that company.

17. Earnings per share

Impact of changes in accounting policies

HKAS 8.28(f)(ii)

Changes in the Group's accounting policies during the year are described in detail in note 2. To the extent that those changes have had an impact on results reported for 2011 and 2010, they have had an impact on the amounts reported for earnings per share.

The following table summarises that effect on both basic and diluted earnings per share.

	Increase (decrease) in profit for the year attributable to the owners of the Company		Increase (decrease) in basic earnings per share		Increase (decrease) in diluted earnings per share	
	Year ended 31/12/11	Year ended 31/12/10	Year ended 31/12/11	Year ended 31/12/10	Year ended 31/12/11	Year ended 31/12/10
	HK$'000	HK$'000	Cents per share	Cents per share	Cents per share	Cents per share
Changes in accounting policies relating to:						
- Application of HKFRS 10 (see note 2)	-	-	-	-	-	-
- Application of HKFRS 11 (see note 2)	-	-	-	-	-	-
- Others (please specify)	-	-	-	-	-	-
	-	-	-	-	-	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

24. Investments in associates

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

	31/12/11	31/12/10
	HK$'000	HK$'000
Cost of investments in associates		
Listed in Hong Kong	-	-
Listed outside Hong Kong	-	-
Unlisted	2,624	2,824
Share of post-acquisition profits and other comprehensive income, net of dividends received	2,695	2,766
	5,319	5,590

HKFRS 12.21(a) Details of each of the Group's material associates at the end of the reporting period are as follow:

Name of entity	Form of entity	Place of incorporation	Principal place of operation	Class of shares held	Proportion of nominal value of issued capital held by the Group	Proportion of voting power held	Principal activities
A Plus Limited	Incorporated	A Land	A Land	Ordinary	17%	17% (Note 1)	Transport
B Plus Limited	Incorporated	B Land	B Land	Ordinary	56%	56% (Note 2)	Finance

Note: To illustrate the disclosure requirements of HKFRS 12, it is assumed that the Group only has two material associates, A Plus Limited and B Plus Limited.

Notes:

HKFRS 12.9(e) 1) The Group is able to exercise significant influence over A Plus Limited because it has the power to appoint two out of the six directors of that company under the Articles of Association of that company.

HKFRS 12.9(d) 2) The Group holds 56% of the issued share capital of B Plus Limited. However, under a shareholders' agreement, the other shareholder controls the composition of the board of directors of B Plus Limited and therefore the Group does not control B Plus Limited. The directors of the Company consider that the Group does have significant influence over B Plus Limited and it is therefore classified as an associate of the Group.

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

24.1 Summarised financial information of material associates

HKFRS 12.B14

Summarised financial information in respect of each of the Group's material associates is set out below. The summarised financial information below represents amounts shown in the associate's financial statements prepared in accordance with HKFRSs [adjusted by the Group for equity accounting purposes].

HKFRS 12.21(b)(i)

All of these associates are accounted for using the equity method in these consolidated financial statements.

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

A Plus Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	19,151	18,442
Non-current assets	18,460	17,221
Current liabilities	(15,981)	(14,220)
Non-current liabilities	(6,206)	(8,290)

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	5,790	5,890
Profit or loss from continuing operations	2,271	2,262
Post-tax profit (loss) from discontinued operations	-	-
Profit (loss) for the year	2,271	2,262
Other comprehensive income for the year	-	-
Total comprehensive income for the year	2,271	2,262
Dividends received from the associate during the year	-	-

HKFRS 12.B14(b)

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

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the associate	15,424	13,153
Proportion of the Group's ownership interest in the associate	17%	17%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the associate	2,622	2,236

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

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

B Plus Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	7,570	7,269
Non-current assets	4,574	3,579
Current liabilities	(3,562)	(3,061)
Non-current liabilities	(4,228)	(4,216)

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	2,554	2,560
Profit or loss from continuing operations	783	833
Post-tax profit (loss) from discontinued operations	-	-
Profit (loss) for the year	783	833
Other comprehensive income for the year	-	-
Total comprehensive income for the year	783	833
Dividends received from the associate during the year	30	22

HKFRS 12.B14(b)

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

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the associate	4,354	3,571
Proportion of the Group's ownership interest in the associate	56%	56%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the associate	2,438	2,000

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

Aggregate information of associates that are not individually material	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The Group's share of profit (loss) from continuing operations	42	358
The Group's share of post-tax profit (loss) from discontinued operations	-	-
The Group's share of other comprehensive income	-	-
The Group's share of total comprehensive income	42	358

HKFRS 12.22(c)

Unrecognised share of losses of an associate	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The unrecognised share of loss of an associate for the year	-	-

	31/12/11 HK$'000	31/12/10 HK$'000
Cumulative share of loss of an associate	-	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

24.2 Change in ownership interest in an associate

HKAS 28.25

In December 2011, the Group disposed of a 30% interest in E Plus Limited to a third party for proceeds of HK$1.245 million (received in January 2012). The Group has retained the remaining 10% interest as an available-for-sale investment whose fair value at the date of disposal was HK$360,000, that is determined using a discounted cash flow model (please describe key factors and assumptions used in determining the fair value). Prior to the disposal, the Group held a 40% interest in E Plus Limited and accounted for the investment as an associate. This transaction has resulted in the recognition of a gain in profit or loss, calculated as follows.

	HK$'000
Proceeds of disposal	1,245
Plus: fair value of investment retained (10%)	360
Less: carrying amount of investment on the date of loss of significant influence	(1,024)
Gain recognised	581

The gain recognised in the current year comprises a realised profit of HK$477,000 (being the proceeds of HK$1.245 million less HK$768,000 carrying amount of the interest disposed of) and an unrealised profit of HK$104,000 (being the fair value less the carrying amount of the 10% interest retained). A current tax expense of HK$143,000 arose on the gain realised in the current year, and a deferred tax expense of HK$32,000 has been recognised in respect of the portion of the profit recognised that is not taxable until the remaining interest is disposed of.

24.3 Significant restriction

HKFRS 12.22(a)

[When there are significant restrictions on the ability of associates to transfer funds to the Group in form of cash dividends, or to repay loans or advances made by the Group, the Group should disclose the nature and extent of significant restrictions in the financial statements. Please see HKFRS 12.22(a) for details.]

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

25. Investments in joint ventures

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

	31/12/11	31/12/10
	HK$'000	HK$'000
Cost of investments in joint ventures		
Listed in Hong Kong	-	-
Listed outside Hong Kong	-	-
Unlisted	1,820	1,820
Share of post-acquisition profits and other comprehensive income, net of dividends received	2,179	1,842
	3,999	3,662

Note: Similar to the disclosures applicable to associates, HKFRS 12 requires the following information to be disclosed for each of the Group's material joint ventures. In this model, the Group only have two joint ventures, A JV Limited and B JV Limited, and for illustrative purposes, both entities are assumed to be material to the Group.

HKFRS 12.21(a) Details of the Group's material joint ventures at the end of the reporting period is as follows:

Name of entity	Form of entity	Place of incorporation	Principal place of operation	Class of shares held	Proportion of nominal value of issued capital held by the Group	Proportion of voting power held	Principal activities
A JV Limited	Incorporated	Hong Kong	Hong Kong	Ordinary	25%	25%	Manufacture of electronic equipment
B JV Limited	Incorporated	Hong Kong	Hong Kong	Ordinary	40%	40%	Manufacture of electronic equipment

25.1 Summarised financial information of material joint ventures

HKFRS 12.B14 Summarised financial information in respect of the Group's material joint ventures is set out below. The summarised financial information below represents amounts shown in the joint ventures' financial statements prepared in accordance with HKFRSs [adjusted by the Group for equity accounting purposes].

HKFRS 12.21(b)(i) The joint ventures are accounted for using the equity method in these consolidated financial statements.

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

A JV Limited	31/12/11	31/12/10
	HK$'000	HK$'000
Current assets	5,454	7,073
Non-current assets	23,887	20,769
Current liabilities	(2,836)	(3,046)
Non-current liabilities	(13,721)	(13,033)

HKFRS 12.B13 The above amounts of assets and liabilities include the following:

Cash and cash equivalents	-	-
Current financial liabilities (excluding trade and other payables and provisions)	-	-
Non-current financial liabilities (excluding trade and other payables and provisions)	(13,721)	(13,033)

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
HKFRS 12.B12	Revenue	6,436	6,076
	Profit or loss from continuing operations	1,021	733
	Post-tax profit (loss) from discontinued operations	-	-
	Profit (loss) for the year	1,021	733
	Other comprehensive income for the year	-	-
	Total comprehensive income for the year	1,021	733
	Dividends received from the joint venture during the year	-	-

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

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Depreciation and amortisation	200	180
Interest income	-	-
Interest expense	56	48
Income tax expense	-	-

HKFRS 12.B14(b) Reconciliation of the above summarised financial information to the carrying amount of the interest in the joint venture recognised in the consolidated financial statements:

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the joint venture	12,784	11,763
Proportion of the Group's ownership interest in the joint venture	25%	25%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the joint venture	3,196	2,941

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

Source	B JV Limited	31/12/11 HK$'000	31/12/10 HK$'000
HKFRS 12.21(b)(ii) HKFRS 12.B12 HKFRS 12.B14	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)

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'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 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Depreciation and amortisation	36	33
Interest income	-	-
Interest expense	5	8
Income tax expense	-	-

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for the year ended 31 December 2011 – continued

HKFRS 12.B14(b)

Reconciliation of the above summarised financial information to the carrying amount of the interest in the joint venture recognised in the consolidated financial statements:

	31/12/11 HK$'000	31/12/10 HK$'000
Net assets of the joint venture	2,006	1,802
Proportion of the Group's ownership interest in the joint venture	40%	40%
Goodwill	-	-
Other adjustments (please specify)	-	-
Carrying amount of the Group's interest in the joint venture	803	721
The Group's share of profit (loss) from continuing operations	-	-
The Group's share of post-tax profit (loss) from discontinued operations	-	-
The Group's share of other comprehensive income	-	-
The Group's share of total comprehensive income	-	-

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

Aggregate information of joint ventures that are not individually material	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The Group's share of profit (loss) from continuing operations	-	-
The Group's share of post-tax profit (loss) from discontinued operations	-	-
The Group's share of other comprehensive income	-	-
The Group's share of total comprehensive income	-	-

HKFRS 12.22(c)

Unrecognised share of losses of a joint venture	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
The unrecognised share of loss of a joint venture for the year	-	-
	31/12/11 HK$'000	**31/12/10 HK$'000**
Cumulative share of loss of a joint venture	-	-

25.2 Significant restriction

HKFRS 12.22(a)

[When there are significant restrictions on the ability of joint ventures to transfer funds to the Group in form of cash dividends, or to repay loans or advances made by the Group, the Group should disclose the nature and extent of significant restrictions in the financial statements. Please see HKFRS 12.22(a) for details.]

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

51. Disposal of a subsidiary

On 30 November 2011, the Group disposed of Subzero Limited which carried out its entire toy manufacturing operations.

Consideration received

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
HKAS 7.40(b)	Consideration received in cash and cash equivalents	7,854	-
	Deferred sales proceeds (note 30)	960	-
HKAS 7.40(a)	Total consideration received	8,814	-

HKAS 7.40(d) ***Analysis of asset and liabilities over which control was lost***

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
<u>Current assets</u>		
Cash and cash equivalents	288	-
Trade receivables	1,034	-
Inventories	2,716	-
<u>Non-current assets</u>		
Property, plant and equipment	5,662	-
Goodwill	3,080	-
<u>Current liabilities</u>		
Payables	(973)	-
<u>Non-current liabilities</u>		
Borrowings	(4,342)	-
Deferred tax liabilities	(471)	-
Net assets disposed of	6,994	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

Gain on disposal of subsidiary

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
	Consideration received	8,814	-
	Net assets disposed of	(6,994)	
	Non-controlling interests	-	-
	Cumulative gain/loss on available-for-sale financial assets reclassified from equity on loss of control of subsidiary	-	-
	Cumulative exchange gain in respect of the net assets of the subsidiary and related hedging instruments reclassified from equity to profit or loss on loss of control of subsidiary	120	-
HKFRS 12.19	Gain on disposal	1,940	-

HKFRS 12.19(b) — The gain on disposal is included in the profit for the year from discontinued operations in the consolidated [statement of comprehensive income/income statement] (see note 11).

Net cash inflow on disposal of subsidiary

Source		Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
	Consideration received in cash and cash equivalents	7,854	-
HKAS 7.40(c)	Less: cash and cash equivalent balances disposed of	(288)	-
		7,566	-

55. Commitments

HKFRS 12.23(a)
HKFRS 12.B18
- B19

The Group's commitments, including its share of commitments made jointly with other joint venturers relating to its joint venture, A JV Limited, is as follows:

	31/12/11 HK$'000	31/12/10 HK$'000
Commitments to contribute funds for the acquisition of property, plant and equipment	983	192
Commitments to provide loans	-	-
Commitments to acquire other venturer's ownership interest when a particular event occurs or does not occur in the future (please specify what the particular event is)	-	-
Others (please specify)	-	-

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

57. Contingent liabilities and contingent assets

Source		31/12/11 HK$'000	31/12/10 HK$'000
	Contingent liabilities		
HKFRS 12.23(b)	Contingent liabilities incurred by the Group arising from its interests in a joint venture (i)	110	116
HKFRS 12.23(b)	Contingent liabilities incurred by the Group arising from its interests in associates (please disclose the details)	-	-
HKFRS 12.23(b)	Group's share of associates' contingent liabilities (ii)	150	14
HKFRS 12.23(b)	Group's share of joint venture's contingent liabilities (please specify the details)	-	-

(i) A number of contingent liabilities have arisen as a result of the Group's interests in joint ventures. The amount disclosed represents the aggregate amount of such contingent liabilities for which the Group as an investor is liable. The extent to which an outflow of funds will be required is dependent on the future operations of the joint ventures being more or less favourable than currently expected. The Group is not contingently liable for the liabilities of other venturers in its joint ventures.

(ii) The amount disclosed represents the Group's share of contingent liabilities of associates. The extent to which an outflow of funds will be required is dependent on the future operations of the associates being more or less favourable than currently expected.

Source	Hong Kong GAAP Limited

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

59. Subsidiaries

59.1 General information of subsidiaries

HKFRS 12.10(a)

Details of the Group's material subsidiaries at the end of the reporting period are set out below.

Name of subsidiary	Place of incorporation / registration / operations	Class of shares held	Paid up registered capital	Proportion ownership interest held by the Company				Proportion of voting power held		Principal activity
				Directly		Indirectly				
				2011	2010	2011	2010	2011	2010	
				%	%	%	%	%	%	
Subzero Limited	Hong Kong	Ordinary	HK$50,000,000	-	-	-	100	-	100	Manufacture of toy
Subone Limited	Hong Kong	Ordinary	HK$1,000	-	-	90	100	90	100	Manufacture of electronic equipment
Subtwo Limited	PRC	Registered	RMB5,000,000	-	-	100	100	100	100	Construction of residential properties
Subthree Limited	Malaysia	Ordinary	RMB10,000,000	-	-	70	70	70	70	Manufacture of leisure good
Subfour Limited	PRC	Registered	USD100	100	100	-	-	100	100	Manufacture of electronic equipment
Subfive Limited	PRC	Registered	USD5,000	100	100	-	-	100	100	Manufacture of electronic equipment
Subsix Limited	Hong Kong	Ordinary	HK$100	-	-	80	-	80	-	Manufacture of electronic equipment
Kowloon Limited	Hong Kong	Ordinary	HK$100	-	-	100	-	100	-	Manufacture of electronic equipment
C Plus Limited	C Land	Ordinary	USD100	45	45	-	-	45	45	Manufacture of electronic equipment

The above table lists the subsidiaries of the Group which, in the opinion of the directors, principally affected the results or assets of the Group. To give details of other subsidiaries would, in the opinion of the directors, result in particulars of excessive length.

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

Notes to the consolidated financial statements
for the year ended 31 December 2011 – continued

HKFRS 12.10(a)
HKFRS 12.4
HKFRS 12.B4(a)
HKFRS 12.B5-B6

At the end of the reporting period, the Company has other subsidiaries that are not material to the Group. A majority of these subsidiaries operate in A Land. The principal activities of these subsidiaries are summarised as follows:

Principal activities	Principal place of business	Number of subsidiaries 31/12/11	31/12/10
Manufacture of electronic equipment	A Land	1	1
	B Land	2	2
		3	3
Manufacture of leisure goods	A Land	2	2
Construction	A Land	1	1
Toys manufacturing	A Land	Nil	1
		6	7

Note: *HKFRS 12.10(a) requires entities to disclose the composition of the group. The list above discloses information about the Group's material subsidiaries (wholly- and non-wholly-owned subsidiaries). The above illustrates one example as to how the requirements set out in HKFRS 12 can be met. When local laws or regulations require the list of investments in subsidiaries to be disclosed, the above disclosures should be modified to comply with the additional local requirements.*

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

HKFRS
12.10(a)(ii)
HKFRS 12.12

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

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

Name of subsidiary	Place of incorporation and principal place of business	Proportion of ownership interests and voting rights held by non-controlling interests		Profit (loss) allocated to non-controlling interests		Accumulated non-controlling interests	
		31/12/11	31/12/10	31/12/11	31/12/10	31/12/11	31/12/10
				HK$'000	HK$'000	HK$'000	HK$'000
Subthree Limited	Malaysia	30%	30%	1,020	980	10,680	9,660
C Plus Limited (i)	C Land	55%	55%	392	464	2,445	2,053

HKFRS 12.9(b)

(i) C Plus Limited is listed on the stock exchange of C Land. Although the Group has only 45 per cent ownership in C Plus Limited, the directors concluded that the Group has a sufficiently dominant voting interest to direct the relevant activities of C Plus Limited on the basis of the Group's absolute size of shareholding and the relative size of and dispersion of the shareholdings owned by other shareholders. The 55 per cent ownership interests in C Plus Limited are owned by thousands of shareholders that are unrelated to the Group, none individually holding more than 2 per cent.

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

HKFRS 12.12(g)
HKFRS 12.B10
HKFRS 12.B11

Summarised financial information in respect of each of the Group's subsidiaries that has material non-controlling interests is set out below. The summarised financial information below represents amounts before intragroup eliminations.

Subthree Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	32,100	31,400
Non-current assets	10,238	10,441
Current liabilities	(1,617)	(4,299)
Non-current liabilities	(5,121)	(5,342)
Equity attributable to owners of the Company	24,920	22,540
Non-controlling interests	10,680	9,660

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	6,200	6,101
Expenses	(2,800)	(2,834)
Profit (loss) for the year	3,400	3,267
Profit (loss) attributable to owners of the Company	2,380	2,287
Profit (loss) attributable to the non-controlling interests	1,020	980
Profit (loss) for the year	3,400	3,267
Other comprehensive income attributable to owners of the Company	-	-
Other comprehensive income attributable to the non-controlling interests	-	-
Other comprehensive income for the year	-	-
Total comprehensive income attributable to owners of the Company	2,380	2,287
Total comprehensive income attributable to the non-controlling interests	1,020	980
Total comprehensive income for the year	3,400	3,267
Dividends paid to non-controlling interests	-	-
Net cash inflow (outflow) from operating activities	4,405	2,050
Net cash inflow (outflow) from investing activities	(330)	1,148
Net cash inflow (outflow) from financing activities	(3,489)	(315)
Net cash inflow (outflow)	586	2,883

Notes to the consolidated financial statements for the year ended 31 December 2011 – continued

C Plus Limited	31/12/11 HK$'000	31/12/10 HK$'000
Current assets	1,530	3,517
Non-current assets	3,625	1,070
Current liabilities	(280)	(266)
Non-current liabilities	(430)	(588)
Equity attributable to owners of the Company	2,000	1,680
Non-controlling interests	2,445	2,053

	Year ended 31/12/11 HK$'000	Year ended 31/12/10 HK$'000
Revenue	2,165	2,285
Expenses	(1,453)	(1,441)
Profit (loss) for the year	712	844
Profit (loss) attributable to owners of the Company	320	380
Profit (loss) attributable to the non-controlling interests	392	464
Profit (loss) for the year	712	844
Other comprehensive income attributable to owners of the Company	-	-
Other comprehensive income attributable to the non-controlling interests	-	-
Other comprehensive income for the year	-	-
Total comprehensive income attributable to owners of the Company	320	380
Total comprehensive income attributable to the non-controlling interests	392	464
Total comprehensive income for the year	712	844
Dividends paid to non-controlling interests	-	-
Net cash inflow (outflow) from operating activities	(263)	(241)
Net cash inflow (outflow) from investing activities	-	-
Net cash inflow (outflow) from financing activities	(160)	(120)
Net cash inflow (outflow)	(423)	(361)

59.3 Change in ownership interest in a subsidiary

HKFRS 12.18

During the year, the Group disposed of 10% of its interest in Subone Limited, reducing its continuing interest to 90%. The proceeds on disposal of HK$213,000 were received in cash. An amount of HK$179,000 (being the proportionate share of the carrying amount of the net assets of Subone Limited) has been transferred to non-controlling interests. The difference of HK$34,000 between the increase in the non-controlling interests and the consideration received has been credited to retained earnings.

59.4 Significant restriction

HKFRS 12.13

[When there are significant restrictions on the Company's or its subsidiaries' ability to access or use the assets and settle the liabilities of the Group, the Group should disclose the nature and extent of significant restrictions. Please see HKFRS 12.13 for details.]

59.5 Financial support

HKFRS 12.14-17

[When the Group gives financial support to a consolidated structured entity, the nature and risks (including the type and amount of support provided) should be disclosed in the financial statements. Please see HKFRS 12.14 – 17 for details.]