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HKICPA QP Module A

Module Preparation Seminar
(for Jun 2018 Exam)

APP:
"HKCA Exam"
Demo Lectures
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Lecturer: Fanny Lam

Agenda

1. • Introduction on HKCA
2. • About the Lecturer
3. • Income taxes
   • Financial assets and liabilities
4. • How to pass!

MASTER GUIDE

Module A: FINANCIAL REPORTING

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2018

Contents

Chapter 8 Expenses and Charges to Financial Statements: Share-Based Payment, Employee Benefits and Income Taxes (HKFRS 2, HKAS 12)

This chapter deals with certain specific expenses and charges to the F/S (despite some items are charged to equity/OCI). The standards covered in this chapter are generally regarded as the complex ones and should be learnt by heart. In particular, for income taxes, some knowledge on Module D *Taxation* may be an advantage but is not required.

In this chapter, we will cover the following Learning Outcomes:

Learning Outcomes	LP
Share-based payment:	
Identify and recognise share-based payment transactions with accordance with HKFRS 2	12
Account for equity-settled and cash-settled share-based payment transactions	12
Account for share-based payment transactions with cash alternatives	12
Account for unidentified goods or services in a share-based payment transaction	12
Account for group and treasury share transactions	12
Disclose requirement of share option	12
Employee benefits:	
Identify short-term employee benefits in accordance with HKAS 19 and apply the recognition and measurement principles in respect of short-term employee benefits	15
Distinguish between defined contribution plans and defined benefit plans	15
Account for defined contribution plans	15
Identify termination benefits in accordance with HKAS 19 and apply the recognition and measurement principles in respect of termination benefits	15
Income taxes:	
Account for current tax liabilities in accordance with HKAS 12	14
Record entries relating to income tax in the according records	14
Identify temporary differences (both inside and outside difference) and calculate deferred tax amounts	14
Account for tax losses and tax credits	14
Identify initial recognition exemption for assets and liabilities	14
Account for deferred tax relating to investments in subsidiaries, associates and joint ventures	14
Determine when tax assets and liabilities can be offset	14
Disclose relevant information with regard to income taxes	14

8.3 Basics of Income Taxes

Reference: HKAS 12 *Income Taxes* (Revised April 2012)

- applicable for annual periods beginning on or after 1 January 2005
- earlier application is encouraged

HKAS 12 is widely regarded as one of the most complex financial reporting standards. It covers:

- current tax (i.e. the tax payable to the tax authority based on tax law)
- deferred tax (arguably, this is an artificial accounting item)

8.3.1 Current Tax

Definitions:

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

The treatment of current tax is relatively straightforward:

Aspects	**Remarks**
Current Tax Expenses	Current tax charge forms part of the tax expense (the other part is the movement of deferred tax liabilities or assets). There are 2 components of current tax charge: 1. Over/under provision in respect of prior year (i.e. the difference between estimated profits tax of prior year and the actual amount paid during current year) 2. Estimated profits tax of current year (i.e. calculated by tax computation: taxable profit x tax rate) (Note: The tax computation is covered by Module D Taxation. In simple terms, tax computation begins with the accounting profit and adjusts for any non-taxable or non-deductible items as required by tax rules to arrive at the taxable profit.)
Current Tax Liabilities or Assets	***Current tax liabilities:*** ▪ Current tax for current and prior periods should (to the extent unpaid) be recognised as a liability.

[HKAS 12 para 12]	***Current tax assets:*** ▪ 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.

In practice - Reconciliation of Tax Payable:

	HK$	Remarks
Tax Payable - Opening Balance	x	*per L/Y F/S*
Payment of L/Y Tax	(x)	*Cash paid*
(Over)/Under Provision in respect of L/Y	(x)/x	*Estimatation Difference*
Provisional Tax paid in respect of C/Y	(x)	*Cash paid*
Current Tax Expense for the year	x	*per C/Y P/L*
Tax Payable - Closing Balance	x	
L/Y = Last Year		
CY = Current Year		

Presentation - Offsetting:

Current tax assets and current tax liabilities may be offset if <u>both</u> of the following conditions are met:

- 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.

[HKAS 12 para 71]

Changes in Tax Status:

This is addressed by HK(SIC)-Int 25 *Income Taxes – Changes in the Tax Status of an Enterprise or its shareholders*.

A change in the tax status of an entity or of its shareholders may have consequences for an entity by increasing or decreasing its tax liabilities or assets. For example, This may, for example, occur upon the public listing of an entity's equity instruments or upon the restructuring of an entity's equity.

Such change may affect the entity's tax current and deferred liabilities or assets.

	HK(SIC)-Int 25 provides that: ▪ The tax consequences due to such change should be included in profit or loss for the period. ▪ In other cases, the consequence should be reflected following the driver amount.

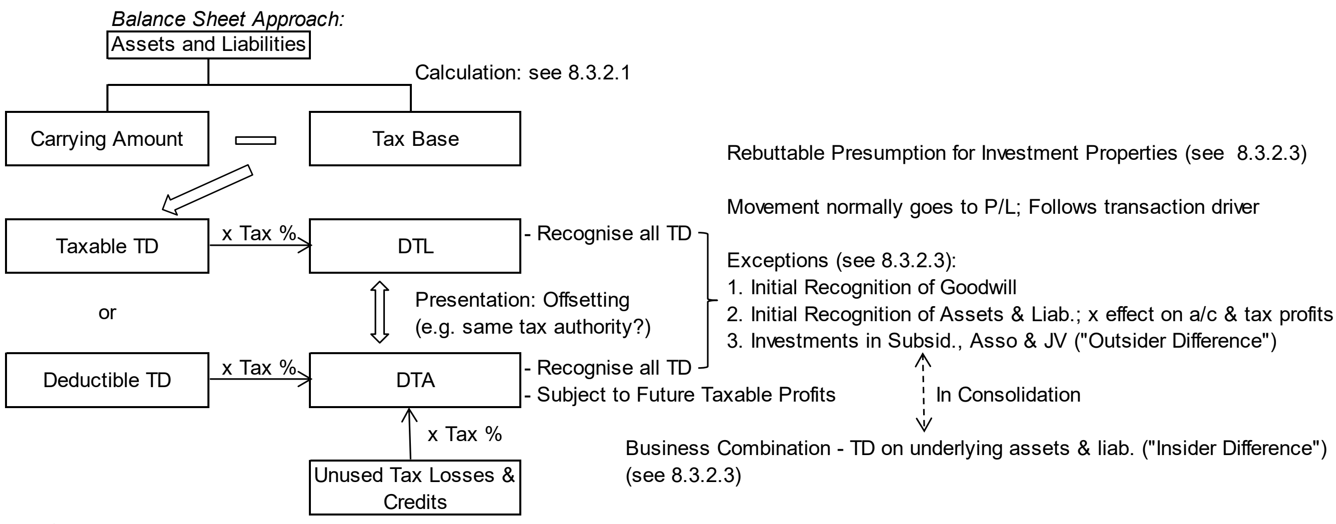
8.3.2 Deferred Tax

HKAS 12 adopts a balance sheet liability method to account for deferred tax.

In simple terms, it can be reasoned that the concept of deferred tax is to align the balance sheet per accounting book and tax book. For example, the useful life permitted by the tax rules may be different from the actual useful life adopted by the entity for depreciation purpose. Such difference may be temporary (i.e. timing difference which will be eventually flatted out) but some differences may be permanent. Before we touch on the mechanics of deferred tax calculation, there are a few definitions to note.

The mindmap of deferred tax is as follows:

Mindmap of HKAS 12 - Deferred Tax



Definitions:

Deferred tax liabilities ("DTL") are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets ("DTA") are the amounts of income taxes recoverable in future periods in respect of:

- deductible temporary differences;
- the carryforward of unused tax losses; and
- the carryforward of unused tax credits.

Temporary differences ("TD") are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. TD may be either:

Taxable TD	TD that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
Deductible TD	TD that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

In nutshell:

From future tax consequences (DTL or DTA):

Carrying Amounts of Assets or Liabilities	-	Tax Bases of Assets or Liabilities	=	Taxable or Deductible Temporary Differences
Taxable or Deductible Temporary Differences	x	Tax Rates	=	Deferred Tax Liabilities or Assets

From Tax Losses (DTA only):

Unused Tax Losses	x	Tax Rates	=	Deferred Tax Assets

According to HKAS 1 [para 56], DTL and DTA should not be classified as current in the balance sheet.

8.3.2.1 Calculation of Deferred Tax

Deferred tax can be calculated by the following steps:

1. Identify the items (assets or liabilities) in the balance sheet
2. Note the carrying amount in the balance sheet
3. (Depending on asset or liability) Take note of the tax rule and calculate the tax base.
4. Calculate the TD.
5. (Depending on asset or liability) Determine whether it is taxable or deductible TD.
6. Multiply the TD with applicable tax rate to arrive at DTL or DTA.

Relationship	Assets	Liabilities
Tax Base [HKAS 12 para 7 & 8]	Amount that will be **deductible for tax purpose** against any **taxable economic benefits** when the entity recovers the carrying amount of asset = Carrying amount – Future Taxable Amount + Future Deductible Amounts (i.e. Carrying Amount at tax book, e.g. Tax Written Down Value for PPE)	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. = Carrying amount – Future Deductible Amount + Future Taxable Amounts
Carrying Amount	As stated in the Balance Sheet	
Temporary Difference	= Carrying Amount – Tax Base Whether it is Taxable or Deductible TD depends on: ▪ It is an asset or a liability ▪ the net figure calculated (see next table)	

Relationship	Assets	Liabilities
Carrying Amount > Tax Base	**Taxable TD (i.e. DTL)**	**Deductible TD (i.e. DTA)**
Carrying Amount < Tax Base	**Deductible TD (i.e. DTA)**	**Taxable TD (i.e. DTL)**
Carrying Amount = Tax Base	None	None

Example: Asset (PPE with depreciation)

Accounting Book: Cost HK$1,000; Accumulated Depreciation HK$200 (i.e. Carrying Amount = HK$800)

Tax Book: Cost HK$1,000, Accumulated Depreciation Allowance HK$300 (i.e. TWD = HK$700)

Tax Base = Carrying amount – Future Taxable Amount + Future Deductible Amounts
= HK$800 – HK$800 + HK$700
= HK$700

Taxable Temporary Difference = HK$800 – HK$700 = HK$100
Deferred Tax Liability = HK$100 x 16.5% = HK$16.5

Example: Liability (Bank Loan)

A bank loan has carrying amount of HK$2,000. The repayment of loan will have no tax consequences.

Tax Base = Carrying amount – Future Deductible Amount + Future Taxable Amounts
= HK$2,000 – Nil + Nil
= HK$2,000

Temporary Difference = HK$2,000 – HK$2,000 = Nil
No deferred tax.

Example: Liability (Foreign Currency Loan Payable)

A foreign currency loan payable has a carrying amount of HK$950 after recognising an exchange gain of HK$50 in profit or loss. Exchange gains are taxable only when realised.

When the loan is repaid at its carrying amount, the amount that would be included in future taxable amount is HK$50 and no part of the carrying amount would be deductible.

Tax Base = Carrying amount – Future Deductible Amount + Future Taxable Amounts
= HK$950 – Nil + HK$50
= HK$1,000

Taxable Temporary Difference = HK$950 – HK$1,000 = HK$50
Deferred tax liability = HK$50 x 16.5% = HK$8.25

8.3.2.2 Treatment of Deferred Tax

HKAS 12 sets out the below requirements:

Aspects	Remarks
Recognition of DTL [HKAS 12 para 15]	DTL should be recognised for all taxable TD. (Note: there are some exceptions, see below box)
Recognition of DTA [HKAS 12 para 24 & 37]	DTA should be recognised for all deductible TD to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. (Note: there are some exceptions, see below box) ***Reassessment of Unrecognised DTA:*** ▪ Unrecognised DTA should be reassessed at the end of each reporting period ▪ A previously unrecognised DTA is recognised to the extent that it has become probable that future taxable profit will allow the DTA to be recovered.
Unused Tax Losses and Unused Tax Credits [HKAS 12 para 34 – 36]	DTA should be recognised for the carryforward 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. (e.g. if the entity is not a going concern, DTA should not be recognised.) The entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised: ▪ whether the entity has sufficient taxable TD relating to the same taxation authority and the same taxable entity ▪ whether it is probable that the entity will have taxable profits before expiry of the unused tax losses or unused tax credits ▪ whether the unused tax losses result from identifiable causes which are unlikely to recur ▪ whether tax planning opportunities are available to the entity that will create taxable profit

Exceptions to Recognition Rules [HKAS 12 para 15 & 24]	As noted above, DTL and DTA (subject to availability of future taxable profits) should be recognised for all TD. However, there are a few exceptions [see next section for further details]: ▪ initial recognition of goodwill arising in a business combination (for DTL only) ▪ initial recognition of an asset or liability in a transaction that is not a business combination and that affects neither accounting profit nor taxable profit ▪ investments in subsidiaries, associates and joint ventures, but only where certain criteria apply
Applicable Tax Rate [HKAS 12 para 46 & 47]	Tax rates that have been <u>enacted</u> or substantively enacted by the end of the reporting period.
Where should movement of DTL and DTA go? [HKAS 12 para 58 & 61A]	Movement of DTL and DTA should be recognised in profit or loss, except to the extent that the tax arises from: ▪ a transaction or event which is recognised either in OCI or directly in equity (i.e. "outside profit or loss"); or ▪ a business combination. "Outside Profit or Loss": ▪ For example, PPE revalution gain goes to revaluation reserve ▪ The movement of DTA or DTA follows the transaction driver.
Presentation - Offsetting [HKAS 12 para 74]	DTA and DTL may be offset if <u>both</u> of the following conditions are met: ▪ the entity has a legally enforceable right to set off current tax assets against current tax liabilities; **and** ▪ the DTA and DTL relate to income taxes levied by the same taxation authority on either: (i) the same taxable entity; or (ii) 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 DTL or DTA are expected to be settled or recovered.
No Discounting [HKAS 12 para 53]	Deferred tax assets and liabilities should <u>not</u> be discounted.

8.3.2.3 Specific Application of Deferred Tax

The following table summarises the (more advanced) requirements of deferred tax under specific circumstance.

Aspects	**Remarks**
Investment Properties [HKAS 12 para 51C]	If a deferred tax liability or asset arises from investment property that is measured using the fair value model in HKAS 40, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset shall reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. This presumption is 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.
Exception for Goodwill in Business Combinations [HKAS 12 para 21]	Goodwill arising from business combination is not amortised but is test for impairment annually or when impairment indicators exist. ***How Taxable TD may arise in Goodwill*** ▪ Many taxation authorities do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. ▪ In such case, goodwill has a tax base of nil. ▪ Any difference between the carrying amount of goodwill and its tax base of nil is a taxable TD. ***Recognition Exception for Goodwill*** ▪ HKAS 12 does not permit the recognition of DTL arising from taxable TD in the above circumstance. ▪ Note, however, that this exception applies to taxable TD (i.e. DTL) only
Exception for Initial Recognition of Asset or Liability	This exception applies when the initial recognition of assets and liabilities: ▪ Not from a business combination; **and** ▪ Affect neither accounting profit nor taxable profit

[HKAS 12 para 22c]	***How TD may arise on Initial Recognition of Asset or Liability*** ▪ TD may arise on initial recognition of an asset or liability, for example, if part or all of the cost of an asset will not be deductible for tax purposes. ▪ In such case, the tax base of such asset would be nil. ▪ This would give rise to a taxable TD. ***Recognition Exception for Initial Recognition of Asset or Liability*** ▪ HKAS 12 does not permit the recognition of DTL and DTA arising from TD in the above circumstance.
Exception for DT relating to Investments in Subsidiaries, Associates and Joint Ventures	In the consolidated F/S, investment in subsidiary is recorded by line-by-line consolidation and investment in associates and joint venture are accounted for using equity accounting method. TD may arise between the investment's carrying amount in the consolidated F/S and its tax base. Such TD is sometimes referred to as "outside basis" difference. This is additional to the TD relating to the investee's underlying assets and liabilities (sometimes referred to as "inside basis" difference"). Such "outside basis" difference may arise due to, for example: ▪ the existence of undistributed profits of subsidiaries, branches, associates and joint ventures ▪ changes in foreign exchange rates when a parent and its subsidiary are based in different countries ▪ a reduction in the carrying amount of an investment in an associate to its recoverable amount [HKAS 12 para 38] ***DTL for "Outside Basis" Difference*** The entity should recognise a <u>DTL for all taxable TD</u> associated with investments in subsidiaries, branches and associates, and interests in joint ventures, <u>except to the extent that both of the following conditions are satisfied</u>: ▪ the parent, investor or venturer is able to control the timing of the reversal of the TD; and ▪ it is probable that the TD will not reverse in the foreseeable future. [HKAS 12 para 39]

	As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of TD associated with that investment. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a DTL. An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a DTL arising from taxable TD associated with its investment in the associate. The arrangement between the parties to a joint venture usually deals with the sharing of the profits and identifies whether decisions on such matters require the consent of all the venturers or a specified majority of the venturers. When the venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a DTL is not recognised. ***DTA for "Outside Basis" Difference*** The entity should recognise a DTA for all deductible TD arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that: ▪ the TD will reverse in the foreseeable future; and ▪ taxable profit will be available against which the TD can be utilised. [HKAS 12 para 44]
Business Combinations HKAS 12 para 19 & 66]	With limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their FV at the acquisition date. TDs arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to FV but the tax base of the asset remains at cost to the previous owner, a taxable TD arises which results in DTL.

	In accordance with HKFRS 3 [para 24], the entity recognises any resulting DTA (to the extent that they meet the recognition criteria) or DTL as identifiable assets and liabilities at the acquisition date. (Note, however, as explained above, the entity does not recognise DTL arising from the initial recognition of goodwill.)
Assets at FV [HKAS 12 para 20]	The difference between the carrying amount of a revalued asset and its tax base is a TD and gives rise to a DTL or DTA. This is true even if: ▪ the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or ▪ tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.
Foreign Currency Translation [HKAS 21 para 41 & 62(c)]	***How TD may or may not arise in Foreign Currency Translation*** **(1) Foreign Currency Assets and Liabilities** HKAS 21 requires foreign currency monetary assets and liabilities to be translated at the end of the reporting period, with the resulting gain or loss is recognised in profit or loss. Such exchange gain or loss may be taxable or deductible, but the tax base of the asset or liability is not changed as a result of change in exchange rate. The difference between the translated carrying amount and its tax base (i.e. original carrying amount) may give rise to taxable or deductible TD. Alternatively, for non-monetary assets and liabilities, their carrying amounts are typically translated at historical rate. However, when the assets are recovered or when the liabilities are settled, they may give rise to tax consequences in foreign countries such that the tax base will change while the carrying amount remains the same. This may also give rise to taxable or deductible TD.

	(2) Foreign Subsidiaries, Associates and Joint Ventures HKAS 21 requires the results and financial position of foreign operation to be translated into presentation currency of the reporting entity in the consolidated F/S. Exchange differences may arise because income statement is translated at average rate while balance sheet is translated at closing rate. Exchange difference may also arise when the opening and closing net assets are translated at different closing rates in time. All these exchange differences are recognised in OCI. However, as far as deferred tax is concerned, there should be no TD at the consolidation level because the carrying amounts and tax bases are measured at the foreign entity's functional currency such that any TD would have already accounted for in the foreign entity's own F/S. Nevertheless, TD may still arise on consolidation because of the difference between the reporting entity's investment in foreign entity and the tax base of the investment itself in the reporting entity.

8.3.3 Disclosure of HKAS 12

The below table outlines the key disclosure requirements of HKAS 12 (important ones are highlighted in bold):

Aspects	Remarks
Major Components of Tax Expense [HKAS 12 para 78 & 80]	The major components of tax expense (income) should be disclosed separately. Components of tax expense (income) may include: · **current tax expense (income)** · **any adjustments recognised in the period for current tax of prior periods** · **the amount of deferred tax expense (income) relating to the origination and reversal of TD** · the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes

	· the amount of the benefit arising from a previously unrecognised tax loss, tax credit or TD of a prior period that is used to reduce current tax expense · the amount of the benefit from a previously unrecognised tax loss, tax credit or TD of a prior period that is used to reduce deferred tax expense · deferred tax expense arising from the write-down, or reversal of a previous write-down, of DTA
Information about Deferred Tax recognised and not recognised [HKAS 12 para 81]	The following shall also be disclosed separately: · the **aggregate current and deferred tax** relating to items that are **charged or credited directly to equity** · the amount of income tax relating to each component of **OCI** · an explanation of **changes in the applicable tax rate(s)** compared to the previous accounting period · the **amount** (and expiry date, if any) **of deductible TD, unused tax losses, and unused tax credits** for which **no DTA** is recognised · the aggregate amount of **TD associated with investments in subsidiaries, branches and associates and interests in joint ventures**, for which **DTL have not been recognised** · in respect of each type of TD and each type of unused tax losses and unused tax credits: (i) the **amount of the DTA and DTL recognised** in the statement of financial position for each period presented; (ii) the **amount of the 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
Tax Reconciliation [HKAS 12 para 81]	The entity should disclose an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms: (i) a **numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s)**, disclosing also the basis on which the applicable tax rate(s) is (are) computed; or (ii) a numerical reconciliation between the average **effective tax rate** and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

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<tr><td><u>Tax Reconciliation</u></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>Profit before Tax</td><td>x</td><td>per P/L</td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>Tax thereon</td><td>x</td><td>= Profit x Tax Rate</td></tr>
<tr><td>Tax effect of non-taxable income</td><td>x</td><td>= Total from Tax Comp.</td></tr>
<tr><td>Tax effect of non-deductible expenses</td><td>(x)</td><td>= Total from Tax Comp.</td></tr>
<tr><td>Deferred tax recognised at different tax rate</td><td>x</td><td>If any</td></tr>
<tr><td>(Over)/Under Provision in respect of L/Y</td><td>(x)/x</td><td>= Actual Figure</td></tr>
<tr><td>Tax charge for the year</td><td>x</td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>L/Y = Last Year</td><td></td><td></td></tr>
<tr><td>Tax Comp = Tax Computation</td><td></td><td></td></tr>
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<tr>
<td>DTA recognised on Unused Tax Losses and Unused Tax Credits

[HKAS 12 para 82]</td>
<td>Disclose the amount of DTA and the nature of the evidence supporting its recognition, when:
▪ the utilisation of DTA is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable DTA; and
▪ the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.</td>
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Extract from QP MA Feb 08 Q3 **(12 marks – approximately 22 minutes)**

Bestpoint Printing Limited ("BP"), established in the People's Republic of China ("PRC"), is a wholly-owned subsidiary of Glory Publishing Group ("GP"). BP is entitled to a two-year exemption from foreign enterprise income tax ("FEIT") from its first profit-making year, as computed under PRC accounting standards ("PRC GAAP") and tax regulations. For the following three years, it enjoyed a 50% reduction in the rate of FEIT. 2003 was BP's first profit-making year. The standard tax rate for BP was 24% for the periods up to 31 December 2007. With the enactment of the new tax law during 2007, BP will be subject to FEIT at 25% for the year beginning 1 January 2008. GP is subject to Hong Kong Profits Tax at 17.5%.

BP acquired a printing machine on 1 July 2003 at a cost of HK$20 million. For the purpose of FEIT calculations, the machine is depreciated over 10 years with a residual value of 10% of the cost from the corresponding date of acquisition, which is the same for the preparation of BP's PRC GAAP financial statements. In the preparation of GP's consolidated financial statements, the machine is depreciated over 16 years with nil residual value.

Required:

(a) **Calculate the deferred tax asset or liability position in relation to the machine at 31 December 2007 accounted for in GP's consolidated financial statements.**

(5 marks)

(b) **Prepare the journal entry(ies) to record the deferred income taxes at 31 December 2008 for GP's consolidated financial statements with calculation supporting the balances recorded.**

(5 marks)

(c) **Assuming GP has a deferred tax asset of HK$500,000 in respect of its own plant and equipment at 31 December 2008, explain how the deferred taxes will appear on the consolidated balance sheet at that date.**

(2 marks)

Answer to QP MA Feb 08 Q3

Answer 3a

Deferred tax position at 31 December 2007 accounted for in GP's consolidated financial statements:

Carrying amount of the printing machine at 31 December 2007:

HK$20,000,000 * [1 – (4.5 years / 16 years)]
= HK$14,375,000

Tax base at 31 December 2007:

HK$20,000,000 * [1 – (1 – 0.1) * (4.5 years / 10 years)]
= HK$11,900,000

Taxable temporary difference:

Carrying amount – Tax base
= HK$14,375,000 – HK$11,900,000
= HK$2,475,000

Deferred tax liability:
HK$2,475,000 * 25% (1)
= HK$618,750

(1) Deferred tax 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) that have been enacted or substantively enacted by the balance sheet date. 2003 is the first profit-making year for GP, the company will have full tax exemption for 2003 and 2004, and then be subject to 50% reduction for 2005 to 2007 (i.e. 12%). Afterward, the tax rate is 25%. As the taxable temporary difference will be reversed after 2007, the tax rate applied for deferred tax computation is 25%.

Answer 3(b)

Journal entries to record the deferred income taxes at 31 December 2008 for GP's consolidated financial statements:

		HK$	HK$
DR	Deferred tax – Income statement	137,500	
	CR Deferred tax liability		137,500

Carrying amount of the printing machine at 31 December 2008:

HK$20,000,000 * [1 – (5.5 years / 16 years)]
= HK$13,125,000

Tax base at 31 December 2008:

HK$20,000,000 * [1 – (1 – 0.1) * (5.5 years / 10 years)]
= HK$10,100,000

Taxable temporary difference:

Carrying amount – Tax base
= HK$13,125,000 – HK$10,100,000
= HK$3,025,000

Deferred tax liability:

HK$3,025,000 * 25%
= HK$756,250

Increase in deferred tax liability in 2008:
= HK$756,250 – HK$618,750
=HK$137,500

Answer 3(c)

Amount of deferred taxes to be shown on GP's consolidated balance sheet at 31 December 2008:

Deferred tax asset	HK$500,000
Deferred tax liability	HK$756,250

GP's deferred tax asset cannot be offset against the deferred tax liability of BP as the two entities' income taxes are NOT levied by the same taxation authority.

Extract from QP MA Dec 13 Q2a (6 marks – approximately 11 minutes)

Rider Games Inc. (RGI) acquired a patented technology that expires in 10 years and a licence to use a custom made software for 5 years at consideration of HKD4.5 million and HKD2.4 million respectively on 1 October 2009. Amortisation is calculated on an annual basis over a 5-year estimated useful life for both intangible assets. For tax purposes, the cost of a patent is a non-deductible expenditure and the software licence is fully deductible in the year of acquisition. Tax rate applicable to RGI is 30%.

Required:

(a) **Calculate the temporary differences and deferred tax asset / liability of RGI at the year end date of 30 September 2013.**

(6 marks)

Answer to QP MA Dec 13 Q2a

Answer 2(a)

Temporary differences at 30 September 2013 = Carrying amount less tax base

Where tax base of asset = Carrying amount – taxable amount + deductible amount

Patent:

Carrying amount = HKD4.5 million x 1/5 = HKD0.9 million

Tax base = HKD(0.9 – 0.9 + 0) = 0

Temporary difference is HKD0.9 million.

Deferred tax at 30 September 2013:

Patent being a non-tax deductible expenditure and the initial recognition is not part of a business combination and does not affect either accounting profit or taxable profit, therefore no deferred tax liability should be recognised.

Software licence:

Carrying amount = HKD2.4 million x 1/5 = HKD0.48 million

Tax base = HKD(0.48 – 0.48 + 0) = 0

Temporary difference is HKD0.48 million.

Deferred tax at 30 September 2013:

Deferred tax liability: HKD0.48 million x 30% = HKD144,000

Chapter 10 Financial Instruments (HKFRS 9, HKAS 32, HKFRS 7)

Topic List

(LP17)

In this chapter, we will cover the following Learning Outcomes:

Learning Outcomes	**LP**
Discuss and apply the criteria for the recognition and de-recognition of a financial asset or financial liability	17
Discuss and apply the rules for the classification of a financial asset, financial liability and equity, and their measurement (including compound instrument)	17
Discuss and apply the treatment of gains and losses arising on financial assets or financial liabilities	17
Discuss the circumstances that give rise to and apply the appropriate treatment for the impairment of financial assets	17
Account for derivative financial instruments and simple embedded derivatives, including the application of own-use exemption	17
Disclose relevant information with regard to financial assets, financial liabilities and equity instruments	17
Identify fair value hedges, cash flow hedges and hedges for net investment in accordance with HKFRS 9	17
Account for fair value hedges, cash flow hedges and hedges for net investment10	17

10.1 Basics of Financial Instruments

Reference:

- HKAS 32 Financial Instruments: Presentation
- HKFRS 7 Financial Instruments: Disclosures
- HKFRS 9 Financial Instruments

The issue of which topic are examinable under which standard(s) is summarise in the table below.

✓ = fully examinable. Blank = not applicable.

Topic	HKAS 32	HKRS 7	HKFRS 9
Classification	✓		
Offsetting	✓		
Interest, dividends, losses and gains	✓		
Disclosure		✓	
Recognition			✓
Derecognition			✓
Measurement			✓
Reclassification			✓
Embedded derivatives			✓
Impalrment of financial			✓
Hedging			✓

10.1.1 Definitions:

Financial instrument - Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset - Any asset that is:	1. Cash;
	2. An equity instrument of another entity;
	3. A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity; or
	4. A contract that will or may be settled in the entity's own equity instruments and is a: a. Non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments b. 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

Financial liability - Any liability that is a:	1. Contractual obligation to: a. Deliver cash or another financial asset to another entity b. Exchange financial instruments with another entity under conditions that are potentially unfavourable
	2. Contract that will or may be settled in the entity's own equity instruments and is a: a. Non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments b. 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

Equity instrument - Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value - the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Derivative - A financial instrument or other contract with all three of the following characteristics:

1. Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying')
2. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
3. It is settled at a future date

10.1.2 Financial assets and liabilities

Examples of financial assets: Trade receivables, an investment in shares, a loan made to another party
Examples of NOT financial assets: Physical assets, prepaid assets, Income taxes, operating leases (transfer of a financial asset)
Examples of financial liabilities: Trade payables, loans payable, redeemable preference shares

Contingent rights and obligations meet the definition of financial assets and financial liabilities respectively, even though many do not qualify for recognition in financial statements -> because the contractual rights and obligations exist due to a past transaction or event

10.1.3 Primary and derivative instruments

Primary instruments – financial assets and liabilities listed above

A derivative - a financial instrument that derives its value from the price or rate of an underlying item.

Common examples of derivatives include the following:

1. Forward contracts which are agreements to buy or sell an asset at a fixed price at a fixed future date.
2. Futures contracts, which are similar to forward contracts except that contracts are standardised and traded on an exchange.
3. Options, which are rights (but not obligations) for the option holder to exercise at a pre- determined price; the option writer loses out if the option is exercised.
4. Swaps, which are agreements to swap one set of cash flows for another (normally interest rate or currency swaps).

10.3 HKFRS 9: Recognition of financial instruments

Entities that early adopt HKFRS 9 are required to apply it to all types of financial instruments with the exception of the following:

(a) Investments in subsidiaries, associates, and joint ventures (HKFRS 10, HKAS 27 or HKAS 28)

(b) Leases (HKAS 17)

(c) Employee benefit plans (HKAS 19)

(d) Equity instruments issued by the entity e.g. ordinary shares issued, or options and warrants.

(e) Insurance contracts (HKFRS 4)

(f) Forward contracts between an acquirer and a seller in a business combination (HKFRS 3)

(g) Loan commitments that cannot be settled net in cash or another financial instrument

(h) Financial instruments, contracts and obligations under share-based payment transactions (HKFRS 2)

(i) Provisions (HKAS 37)

(j) Rights and obligations under Revenue from Contracts with Customers (HKFRS 15)

10.3.1 *Initial recognition*

HKFRS 9 requires that financial instruments are recognised in the statement of financial position when the entity becomes a party to the contractual provisions of the instrument.

Classification of financial assets

10.3.2 Amortised cost

(a) The objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and

(b) 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 outstanding.

10.3.3 Fair value through other comprehensive income (FVTOCI)

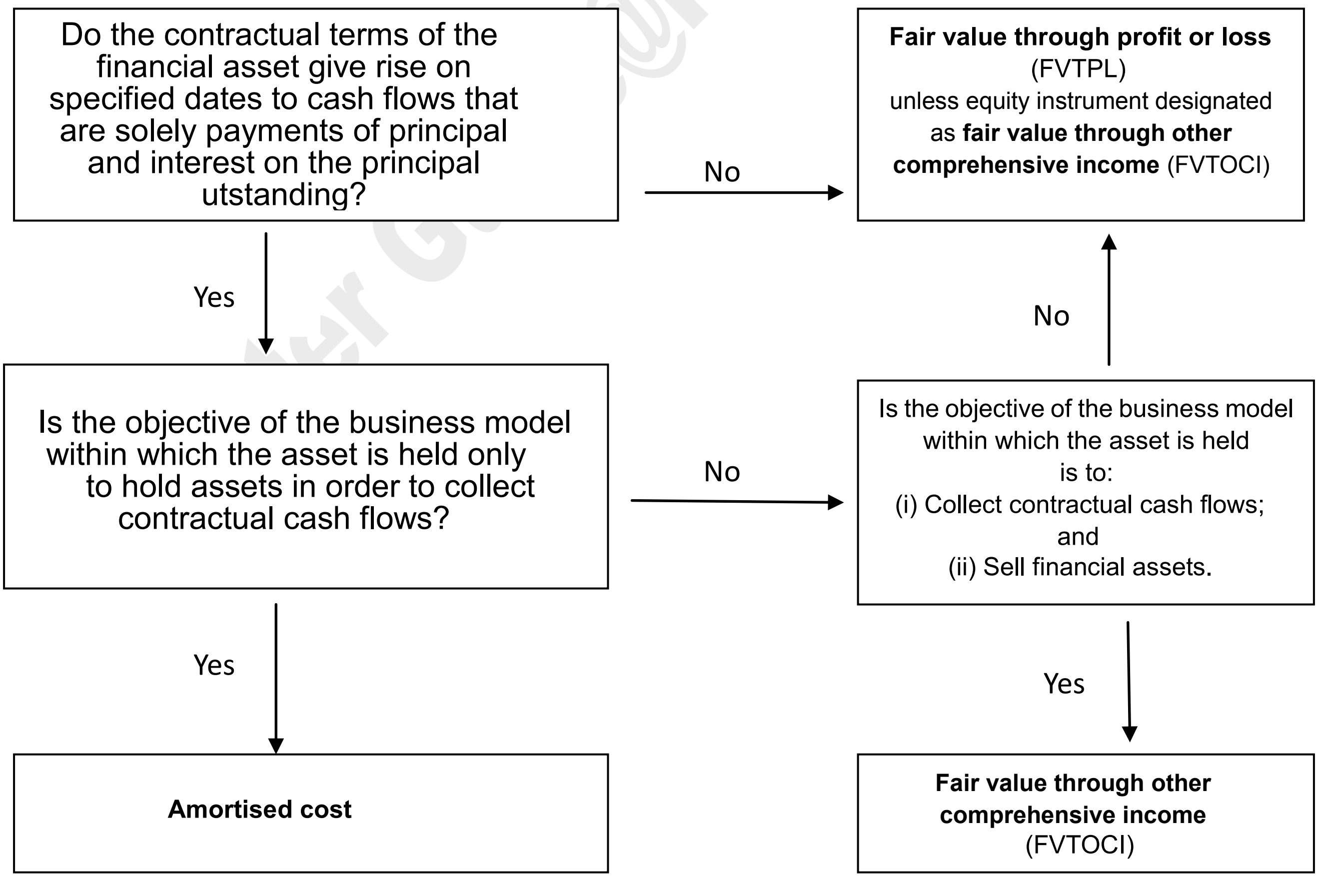
(a) The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, and

(b) 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.

10.3.4 Fair value through profit or loss (FVTPL)

Those do not meet the above criteria are measured at fair value through profit or loss

Decision tree



Application of classification criteria

1. Equity investments must generally be measured at fair value through profit or loss. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. Where an equity instrument is not held for trading, an entity may make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income.

2. All derivatives are measured at fair value.

3. A debt instrument may be classified as measured at either amortised cost or fair value depending on whether it meets the criteria above. Even where the criteria are met at initial recognition, a debt instrument may be classified as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

Reclassification of financial instruments

HKFRS 9 requires that when an entity changes its business model for managing financial assets, it should reclassify all affected financial assets. This reclassification applies only to debt instruments, as equity instruments must be classified as measured at fair value.

Derecognition

10.3.5 Derecognition of financial assets

A financial asset should be derecognised by an entity when:

(a) The contractual rights to the cash flows from the financial asset expire, or

(b) The entity transfers substantially all the risks and rewards of ownership of the financial asset to another party

The following are examples of the transfer of substantially all risks and rewards of ownership:

ξ An unconditional sale of a financial asset

ξ A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase

The standard also provides examples of situations where the risks and rewards of ownership have not been transferred:

ξ A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return

ξ A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity

ξ A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur

10.3.6 Derecognition of financial liabilities

A financial liability is derecognised when it is extinguished i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Where an existing borrower and lender of debt instruments exchange one financial instrument for another with substantially different terms, this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

Similarly, a substantial modification of the terms of an existing financial liability or a part of it should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

For this purpose, a modification is 'substantial' where the discounted present value of cash flows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the cash flows of the original financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

Partial derecognition

Partial derecognition of a financial asset or liability is possible on condition that the derecognised part comprises only:

(a) Identifiable cash flows

(b) A share of the total cash flows on a fully proportionate (pro rata) basis

Where only part of a financial asset is derecognised, the carrying amount of the asset should be allocated between the part retained and the part transferred based on their relative fair values on the date of transfer. A gain or loss should be recognised based on the proceeds for the portion transferred.

10.5 HKFRS 9: Credit losses

The impairment requirements of HKFRS 9 are applied to:

- Debt instruments measured at amortised cost or FVTOCI
- Lease receivables (HKAS 17)
- Contract assets (HKFRS 15)
- Loan commitments within the scope of HKFRS 9 and not measured at FVTPL
- Financial guarantee commitments not measured at FVTPL

10.5.2 Recognition of credit losses

Impairment losses are recognised in profit or loss with a corresponding credit entry as follows:

Financial assets at amortised cost	An allowance account, which is offset against the carrying amount of the financial asset so that a net position is presented in the statement of financial position
Financial assets at FVTOCI	An 'accumulated impairment amount' in other comprehensive income. The carrying amount remains at fair value in the statement of financial position.
Loan commitments and financial guarantee contracts	A provision account, which is presented as a separate liability

Extract from QP MA Jun 11 Q4 (14 marks – approximately 25 minutes)

Company J, a company engaged in the metal trading business in Hong Kong with functional currency of Hong Kong dollars ("HK$"), has the following investments as at 31 December 2010:

1. A debenture of RMB10 million which carries interest at 3% per annum payable semi-annually and will mature at 30 September 2013.

2. An equity linked deposit of HK$8 million with semi-annual coupon linked to performance of a basket of listed securities listed on The Stock Exchange of Hong Kong Limited and maturity at 30 June 2012.

3. 200,000 ordinary shares of Company Y listed on The Stock Exchange of Hong Kong Limited.

Required:

(a) Assuming the entity has early adopted HKFRS 9 *Financial Instruments*, discuss how Company J shall account for the above investments in the financial statements for the year ended 31 December 2010 in accordance with HKFRS 9 and other applicable standards.

(10 marks)

(b) Explain the difference between a refundable deposit to a supplier for steel purchase and a prepayment for steel supply (with physical delivery) in the context of HKAS 32 *Financial Instruments: Presentation.*

(4 marks)

Answer to QP MA Jun 11 Q4

Answer 4(a)

1. The RMB10 million debenture with the contractual terms gives rise on specified dates to cash flow that are solely, payments of principal (i.e. 30 September 2013) and interest on the principal amount outstanding (i.e. payable semi-annually), (HKFRS 9 para. 4.1.2(a)).

   Providing that the investment is held by Company J within a business model whose objective is to hold the investment in order to collect contractual cash flows (HKFRS 9 para. 4.1.2(b)), the debenture shall be measured at amortised costs under HKFRS 9 para. 4.1.2. Otherwise, the debenture is measured at fair value under HKFRS 9 para. 4.1.4.

   As the debenture is denominated in RMB, which is different to the functional currency of Company J, it is considered as a foreign currency monetary asset, which is reported at the end of each reporting period at closing rate. The exchange difference arising on such translation is recognised in profit or loss.

2. The semi-annual coupons of the equity linked deposit are indexed to the performance of a basket of listed securities, they are not a consideration for the time value of money and for credit risk associated with the principal amount outstanding.

   Accordingly, the contractual cash flows are not solely payment of principal and interest thereon, the RMB8 million equity linked deposit shall not be measured at amortised cost, but at fair value under HKFRS 9 para. 4.1.4.

   The gain or loss arising from the fair value change shall be recognised in profit or loss.

3. Ordinary shares of Company Y are not a financial asset with contractual terms which give rise on specific dates to cash flows that are solely payments of principal amount and interest on the principal amount outstanding.

   The investment shall be measured at fair value under HKFRS 9 para. 4.1.4.

   The gain or loss arising from the fair value change shall be recognised in profit or loss unless Company J has elected to present gains or losses on that investment in other comprehensive income providing that the investment in the equity instruments is not held for trading in accordance with HKFRS 9 para. 5.7.1(b).

Answer 4(b)

A refundable deposit to a supplier for steel purchase is considered as a financial asset as the holder has the contractual right to obtain a refund of cash under HKAS 32.11(c)(i).

A prepayment for steel supply with physical delivery is not considered as a financial asset as the holder does not have the contractual right to receive cash or other financial assets from the supplier or to exchange financial assets or financial liabilities with another entity under conditions that are potential favourable to the entity.

Extract from QP MA Jun 17 Q7 (12 marks – approximately 22 minutes)

Good Harvest Limited ("GHL") is wholly owned by Mr Chan and GHL has had certain transactions with banks during the year ended 31 December 2015 as below:

On 1 July 2015, GHL provided a guarantee to a bank for a bank borrowing of a related company, which is wholly owned by Mr Chan, amounting to HK$8,000,000 with a tenor of 3 years. No consideration is received for the guarantee. The fair values of the guarantee are HK$180,000 and HK$220,000 as at 1 July 2015 and 31 December 2015 respectively. As at 31 December 2015, it is considered as not probable that the related company will default on the repayment of the bank borrowing.

On 30 October 2015, GHL obtained a new bank loan of HK$10,000,000 from a bank, which is wholly repayable at 31 December 2017 without a repayment on demand clause. Under the terms of such banking facilities, GHL is required to maintain a gearing ratio of less than 1.2 at all times. As at 31 December 2015, the gearing ratio of GHL is 1.5 and the management of GHL is negotiating with the bank in this regard. It is unknown as to whether the bank would grant any waiver to GHL as at 31 December 2015.

Required:

(a) **Prepare the journal entries for providing a guarantee for the bank borrowing of a related company, with detailed calculation, in the preparation of the financial statements of GHL for the year ended 31 December 2015.**

(4 marks)

(b) **Advise the management of GHL, in both the scenarios of (1) granting and (2) not granting a waiver, as to the presentation of the bank loan on the statement of financial position at 31 December 2015 with current/ non-current classification and discuss the relevant disclosures in accordance with the relevant financial reporting standards.**

(8 marks)

Answer to QP MA Jun 17 Q7

Answer 7(a)

Journal entries for the initial recognition of the financial guarantee provided for the bank borrowing of a related company on 1 July 2015:

Dr Equity	HK$180,000	
Cr. Financial guarantee liability		HK$180,000

Journal entries for amortising the financial guarantee liability initially recognised for the period from 1 July 2015 to 31 December 2015:

Amortisation for 2015 = HK$180,000 / 3 years / 12 months x 6 months = HK$30,000

Dr Financial guarantee liability	HK$30,000	
Cr. Profit or loss		HK$30,000

Answer 7(b)

The bank loan should be originally classified as a non-current liability when it is due to be settled after twelve months from 31 December 2015.

However, as GHL has breached the bank covenant (i.e. the gearing ratio) of a long-term loan arrangement at 31 December 2015, it does not have an unconditional right to defer its settlement for at least twelve months after 31 December 2015. 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 authorisation of the issuance of financial statements, not to demand payment as a consequence of the breach.

GHL may continue to classify the liability as non-current if the bank agreed by 31 December 2015 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.

If GHL classifies the bank loan as a current liability, it shall disclose in the financial statements for the year ended 31 December 2015 in respect of the 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 twelve months after the reporting period, if these events occur between 1 January 2016 and the date the financial statements are authorised for issue.

Chapter 12 Key Disclosures: Related Parties, Earnings per Share, Segmental Reporting and Fair Value Measurement (HKAS 24, HKFRS 8, HKAS 33, HKFRS 13)

Topic List

(LP18)

This chapter looks into some important disclosure standards, some of which are mainly for listed companies. Nevertheless, readers are minded to understand the requirements thoroughly and be able to apply to specific case information.

In this chapter, we will cover the following Learning Outcomes:

Learning Outcomes	**LP**
Related party disclosures:	
Identify the parties that may be related to a business entity in accordance with HKAS 24	20
Identify the related party disclosures	20
Explain the importance of being able to identify and disclose related party transactions	20
Operating segments:	
Identify and discuss the nature of segmental information to be disclosed in accordance with HKFRS 8	23
Explain when operating segments should be aggregated and disaggregated	23
Disclose the relevant information for operating segments and appropriate entity-wide information	23
Earnings per Share:	
Explain the meaning and significance of a company's earnings per share	22
Calculate the earnings per share, including the impact of a bonus issue, a rights issue and an issue of shares at full market value in accordance with HKAS 33	22
Explain the relevance of a company's diluted earnings per share	22
Discuss the limitations of using earnings per share as a performance measure	22

12.4 Fair Value Measurement and Disclosure – HKFRS 13

Reference: HKFRS 13 *Fair Value Measurement* (Issued June 2011)
- applicable for annual periods beginning on or after 1 January 2013
- earlier application is encouraged
- prospective application

It can be said that the use of FV is getting increasingly paramount in HKFRS as you may have seen throughout this Masterguide.

However, because the respective HKFRSs were developed over many years, the requirements for measuring FV and for disclosing information about FV measurements may be dispersed. As a result, HKFRS 13 was issued to standardise.

HKFRS 13 applies when another HKFRS requires or permits FV measurements or disclosures about FV measurements, except for:
- share-based payment transactions (see HKFRS 2)
- leasing transactions (see HKAS 17)
- measurements that have some similarities to FV but are not FV (e.g. NRV in HKAS 2 or VIU in HKAS 36)

In other words, HKFRS 13 applies to both financial and non-financial instrument items.

The mindmap of HKFRS 13 is as follows:

Mindmap of HKFRS 13

New Definition of FV:
- Orderly Transaction between Market Participants

(12.4.1)

⇩

FV Measurement (apply to both financial and non-financial instruments):
- Consider Characteristics
- Consider Principle Market and Most Advantageous Market
- Concept of Highest and Best Use for Non-Financial Assets
- Concept of Non-Performance Risk for Liabilities
- Bid-Ask Spread Relax

(12.4.1.1)

⇩

Valuation Techniques:
- Market Approach
- Cost Approach
- Income Approach

(12.4.1.2)

⇦ Categories of Input

FV Hierarchy:
- Level 1
- Leve 2
- Level 3

(12.4.2)

Disclosures
- Extensive Quantitative and Qualitative disclosures

(12.4.3)

12.4.1 Fair Value Measurement

First and foremost, HKFRS 13 clarifies the meaning of FV.

Definition:

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 (i.e. an exit price).

The above definition implies that FV is a market-based measurement, not an entity-specific measurement. Therefore, when measuring FV, the entity uses the assumptions that market participants would use under current market conditions, including assumptions about risk.

12.4.1.1 Guidance on FV Measurement

HKFRS 13 is a lengthy standard. The below table summarises the key guidance on the measurement of FV:

Aspects	**Remarks**
Consider the Characteristics of Asset or Liability being measured [HKFRS 13 para 11]	The entity should take into account the characteristics of the asset or liability that a market participant would take into account when pricing the asset or liability at measurement date. For example: ▪ the condition and location of the asset ▪ any restrictions on the sale and use of the asset
Orderly Transaction under Current Market Conditions [HKFRS 13 para 15 & 16]	FV measurement assumes an orderly transaction between market participants at the measurement date under current market conditions. In essence, the transaction is assumed to 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. **Principal market** is the market with the greatest volume and level of activity for the asset or liability. **Most advantageous market** is the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.
Non-Financial Asset - Highest and Best Use [HKFRS 13 para 27]	The FV measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use. **Highest and Best Use** is the use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used.

Liability or the Entity's Own Equity Instruments [HKFRS 13 para 34]	The FV measurement of liability or an entity's own equity instruments assumes that they are transferred to a market participant <u>without settlement, extinguishment, or cancellation</u> at the measurement date.
Liability - Non-Performance Risk [HKFRS 13 para 42]	The <u>FV of a liability reflects the effect of non-performance risk</u> (i.e. the risk the entity will not fulfil an obligation). Non-performance risk includes, but may not be limited to, an entity's own credit risk. Non-performance risk is assumed to be the same before and after the transfer of the liability.
Exception to Financial Assets and Liabilities with Offsetting Positions [HKFRS 13 para 48 & 96]	The entity may hold a group of financial assets and financial liabilities is exposed to market risks and to the credit risk of each of the counterparties. If the entity manages that group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the entity is permitted to apply an exception for measuring FV under HKFRS 13. This exception permits the entity to measure FV of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (i.e. an asset) for a particular risk exposure or to transfer a net short position (i.e. a liability) for a particular risk exposure. If the entity makes an accounting policy decision to use the above exception, it should disclose that fact.
Bid and Ask Prices [HKFRS 13 para 70 & 71]	Certain asset or liability (e.g. listed shares) may have a bid price and an ask price. The price within the bid-ask spread that is most representative of FV in the circumstances shall be used to measure FV. In other words, HKFRS 13 permits, but does not require, to use bid prices for asset positions and ask prices for liability positions. The use of mid-market pricing may also be used.

12.4.1.2 Valuation Techniques

While the valuation for listed securities is typically straightforward, there are circumstances where valuation techniques are necessary, especially for unlisted assets and liabilities.

HKFRS 13 [para 62] outlines 3 widely used valuation techniques:

Valuation Technique	Remarks
Market Approach	Uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities (e.g. a business).
Cost Approach	Reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost).
Income Approach	Converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts.

HKFRS 13 [para 61 & 67] states that the entity should use valuation techniques that:

- Are appropriate in the circumstances
- for which sufficient data are available, thereby maximising the use of relevant observable inputs and minimising the use of unobservable inputs

12.4.2 Fair Value Hierarchy

To increase consistency and comparability in FV measurements and related disclosures, HKFRS 13 establishes a FV hierarchy that categorises the inputs used in valuation techniques into 3 levels:

[Note: This FV hierarchy is similar to what HKFRS 7 requires for financial instruments but HKFRS 13 extends the FV hierarchy requirement to non-financial instruments.]

Level of Inputs	Remarks
1 [HKFRS 13 para 76 & 77]	**Quoted** prices (**unadjusted**) in **active markets** for **identical** assets or liabilities that the entity can access at the measurement date. A quoted price in an active market provides the most reliable evidence of FV. A quoted price should be used without adjustment whenever available, except: ▪ when an entity holds a large number of similar (but not identical) assets or liabilities (e.g. debt securities) at FV and a quoted price in an active market is available but not readily accessible for each of those assets or liabilities individually (i.e. given the large number of similar assets or liabilities held by the entity, it would be difficult to obtain pricing information for each individual asset or liability at the measurement date). ▪ when a quoted price in an active market does not represent FV at the measurement date ▪ when measuring the FV of a liability or the 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
2 [HKFRS 13 para 81-83]	Inputs **other than quoted prices** included within Level 1 that are **observable** for the asset or liability, either directly or indirectly. For example: *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. 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. Level 2 inputs include the following: (a) quoted prices for similar assets or liabilities in active markets (b) quoted prices for identical or similar assets or liabilities in markets that are not active

	(c) inputs other than quoted prices that are observable for the asset or liability, for example: (i) interest rates and yield curves observable at commonly quoted intervals (ii) implied volatilities (iii) credit spreads (d) inputs that are derived principally from or corroborated by observable market data by correlation or other means ("market-corroborated inputs") Adjustments may be made on Level 2 inputs.
3 [HKFRS 13 para 86-89]	**Unobservable** inputs for the asset or liability. For example: *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. Unobservable inputs are used to measure FV <u>to the extent that relevant observable inputs are not available</u>, thereby allowing for situations in which there is little (if any) market activity for the asset or liability at the measurement date. An entity develops unobservable inputs <u>using the best information available</u> in the circumstances (e.g. the entity's own data), taking into account all information about market participant assumptions that is reasonably available.

The FV hierarchy gives the <u>highest priority to Level 1 inputs and the lowest priority to Level 3 inputs</u>. [HKFRS 13 para 72]

If the inputs used to measure FV are categorised into <u>different levels</u> of the FV hierarchy, the FV measurement is <u>categorised in its entirety in the level of the lowest level input that is significant</u> to the entire measurement (based on judgement). [HKFRS 13 para 73]

12.4.3 Disclosures of Fair Value Measurement

The entity should disclose, at a minimum, the following information for each class of assets and liabilities measured at FV after initial recognition:
[HKFRS 13 para 93]

Aspects	Remarks
Overall	▪ the **FV measurement** at the end of the reporting period ▪ the **level of the FV hierarchy** within which the FV measurements are categorised in their entirety (Level 1, 2 or 3)
Non-Recurring FV measurements	▪ the reasons for the measurement
Recurring FV Measurements	▪ the **amounts of any transfers between Level 1 and Level 2** ▪ the **reasons** for those transfers ▪ the **entity's policy** for determining when transfers between levels are deemed to have occurred
Level 2 and Level 3 only	▪ a **description of the valuation technique(s)** ▪ the **inputs used** in the FV measurement ▪ any change in the valuation techniques and the reason(s) for making such change
Level 3 only	▪ a **description of the valuation processes** used by the entity ▪ **quantitative information** about the significant unobservable inputs used ▪ a **reconciliation** from the opening balances to the closing balances: ▪ total gains or losses for the period recognised in profit or loss, separately out any unrealised gains or losses ▪ total gains or losses for the period recognised in other comprehensive income ▪ purchases, sales, issues and settlements ▪ the **amounts of any transfers into or out of Level 3** ▪ the **reasons** for those transfers ▪ the **entity's policy** for determining when transfers between levels are deemed to have occurred ▪ a **narrative description of the sensitivity** of the FV measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower FV measurement

	For financial assets and financial liabilities: If changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change FV significantly, the entity should: · state that fact · disclose the effect of those changes
Highest and Best Use of a Non-financial Asset	If the highest and best use of a non-financial asset **differs from its current use**, the entity should: · disclose that fact · why the non-financial asset is being used in a manner that differs from its highest and best use

Extract from QP MA Dec 16 Q7(b(ii) (18 marks – approximately 32 minutes)

High Return Limited ("HRL") entered into the following transactions during the year ended 31 December 2015:

1. HRL purchased 3,000,000 shares of Star Limited, a company listed on the Stock Exchange of Hong Kong, at a cost of HK$2,400,000 on 1 July 2015. The market share price of Star Limited was HK$1.20 per share as at 31 December 2015. HRL intended to sell the shares in the short term and make a profit. Such investments do not confer control, joint control or significant influence over Star Limited and the investments are under Level 1 in the fair value hierarchy.

2. HRL borrowed a loan from a bank on 1 January 2015 which carried interest at HIBOR plus 3% per annum payable in arrears every six months, and will mature on 31 December 2017 with a repayable on demand clause. The rate of HIBOR is determined at the first date of every six months.

= HRL entered into a foreign currency swap of Renminbi against HK$ with a bank at nil cost on 1 September 2015 for a period of two years. The fair value of the swap is HK$80,000 favourable to the bank as at 31 December 2015. The swap is under Level 2 in the fair value hierarchy.

Required:

(b) Describe the disclosures, in accordance with HK Interpretation 5 *Presentation of Financial Statements – Classification by the Borrow er of a Term Loan that Contains a Repayment on Demand Clause*, HKFRS 7 *Financial Instruments: Disclosures* and HKFRS 13 *Fair Value Measurement,* in the preparation of the financial statements of HRL for the year ended 31 December 2015 for:

ii. the foreign currency swap in respect of market risk and fair value measurement.

Answer 62 (QP MA Dec 16 Q7(b(ii))

Foreign currency swap

For the market risk disclosures of the foreign currency swap under HKFRS 7, it shall be described in the financial statements that the swap is exposed to other price risk and a sensitivity to show the effect on profit or loss of reasonably possible changes in the forward exchange rate of the Renminbi against the HK$ together with the methods and assumptions used in preparing such a sensitivity analysis should be disclosed.

As the investments are measured at fair value on a recurring basis in the financial statements after initial recognition, the following should be disclosed under HKFRS 13:

- the level of the fair value hierarchy within which the fair value measurement is categorised in its entirety (Level 1, 2 or 3); and
- a description of the valuation techniques and inputs used to develop those measurements.