

Revenue Recognition & Provision

July 2006



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1

Revenue Recognition & Provision

No significant
change from
SSAP to HKAS

Firstly, what is revenue?

As defined in HKAS 18, **Revenue** is

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

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2

Revenue – Different Sources

- Revenue may arise from different transactions and events and different HKAS should be observed, for example



HKAS 18 Revenue	• Sales of IT supplies and services
HKAS 18 Revenue	• Dividends
HKAS 17 Leases	• Rental and management fee
HKAS 17 Leases	• Meeting rooms and auditorium hiring fees income
HKAS 39 F. instruments	• Interest income
HKAS 18 Revenue	• Membership fee income
No specific HKFRS	• Donations (including designated donations)
HKAS 20 Gov't grants	• Subventions from the Government, Community Chest and The HK Jockey Club

Today's Agenda

1. Revenue Recognition
2. Government Grants
3. Provision, Contingent Liabilities and Contingent Assets
4. Financial Guarantee Contract

HKAS 18 Revenue
HKAS 18 Revenue
HKAS 17 Leases
HKAS 17 Leases
HKAS 39 F. instruments
HKAS 18 Revenue
No specific HKFRS
HKAS 20 Gov't grants

Revenue (HKAS 18)



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5

Revenue – What is it?

- **Income**
 - is defined in the *Framework for the Preparation and Presentation of Financial Statements* as:
 - increases in economic benefits during the accounting period in the form of inflows or
 - enhancements of assets or decreases of liabilities that result in increases in equity,
 - other than those relating to contributions from equity participants.
 - Income encompasses both revenue and gains.
- **Revenue** is **income** that
 - arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends and royalties.

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6

Revenue – What is it?

- **Revenue** includes
 - only the gross inflows of economic benefits received and receivable by the entity on its own account.
- Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes
 - are not economic benefits which flow to the entity and
 - do not result in increases in equity.
 - Therefore, they are excluded from revenue.
- Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity.
 - The amounts collected on behalf of the principal are not revenue.
 - Instead, revenue is the amount of commission.

Revenue – Recognition Issue

- The primary issue in accounting for revenue is
 - determining when to recognise revenue.
- Revenue is recognised when
 - it is probable that future economic benefits will flow to the entity and
 - these benefits can be measured reliably.
- HKAS 18 identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised.
- It also provides practical guidance on the application of these criteria.



Revenue – Measurement

- **Revenue** shall be measured at the fair value of the consideration received or receivable.
 - Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
 - The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset.
 - It is measured at
 - the fair value of the consideration received or receivable
 - taking into account the amount of any trade discounts and volume rebates allowed by the entity.
 - In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable.

Revenue – Measurement

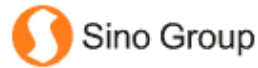
- Discounting required when inflow deferred
- When the inflow of cash or cash equivalents is deferred,
 - the fair value of the consideration may be less than the nominal amount of cash received or receivable.
 - When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.
 - The imputed rate of interest is the more clearly determinable of either:
 - a) prevailing rate for a similar instrument of an issuer with a similar credit rating; or
 - b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.
- The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue

Example: An entity may provide

- interest free credit to the buyer or
- accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods.

Revenue – Measurement

Case



Sino Land Company Limited

2005 Annual Report stated that:

- Where properties are sold under deferred terms, the difference between the sales prices with and without such terms
 - is treated as deferred interest income and
 - is released to the income statement on a straight line basis over the repayment period commencing from the completion of the relevant sales agreements.

Revenue – Measurement

Different from
HKAS 16, 38

Exchange of goods or services

Similar

Dissimilar

1. Similar goods or services

- When goods or services are exchanged or swapped for goods or services which are of a similar nature and value,
 - the exchange is not regarded as a transaction which generates revenue.
- This is often the case with commodities like oil or milk where suppliers exchange or swap inventories in various locations to fulfil demand on a timely basis in a particular location.



Revenue – Measurement

Different from
HKAS 16, 38

Exchange of goods or services

Similar

Dissimilar

2. Dissimilar goods and services

- When goods are sold or services are rendered in exchange for dissimilar goods or services
 - the exchange is regarded as a transaction which generates revenue.
- The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred.
- When the fair value of the goods or services received cannot be measured reliably
 - the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.



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13

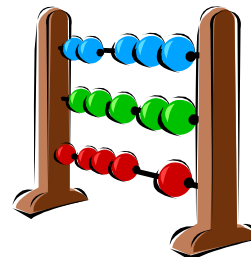
Revenue – Covered in HKAS 18

Sale of goods

Rendering of services

Interest, royalties and dividend

- HKAS 18 shall be applied in accounting for revenue arising from the following transactions and events:
 - a) the sale of goods;
 - b) the rendering of services; and
 - c) the use by others of entity assets yielding interest, royalties and dividends.



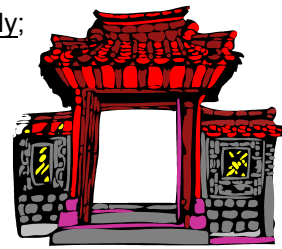
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14

Revenue – Sale of Goods

Main Principle

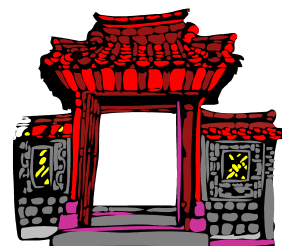
- Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:
 - a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
 - b) the entity retains
 - neither continuing managerial involvement to the degree usually associated with ownership
 - nor effective control over the goods sold;
 - c) the amount of revenue can be measured reliably;
 - d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.



Revenue – Sale of Goods

Main Principle

- The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer
 - requires an examination of the circumstances of the transaction.
- In most cases, the transfer of risks and rewards of ownership
 - coincides with the transfer of the legal title or the passing of possession to the buyer.
 - This is the case for most retail sales.
- In other cases, the transfer of the risks and rewards of ownership
 - occurs at a different time from the transfer of legal title or the passing of possession.



Revenue – Sale of Goods

Case



The Hong Kong Society of Panda Conservation

- Accounting policy on sale of goods
 - Revenue is recognised when goods are delivered to customers,
 - which is taken to be the point in time when the customer has accepted the goods and the related risks and rewards of ownership.

Revenue – Sale of Goods

Inflow of Future Economic Benefits Not Probable

Revenue not recognised if inflow is not probable

- Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity.
- In some cases, this may not be probable
 - until the consideration is received or
 - until an uncertainty is removed.

- For example, it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country.
 - When the permission is granted, the uncertainty is removed and revenue is recognised.



Revenue – Sale of Goods

Inflow of Future Economic Benefits Not Probable

Inflow is not probable after revenue is recognised

- When an uncertainty arises about the collectibility of an amount already included in revenue
 - the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense,
 - rather than as an adjustment of the amount of revenue originally recognised.

No offsetting



Revenue – Sale of Goods

Matching of Revenues and Expenses

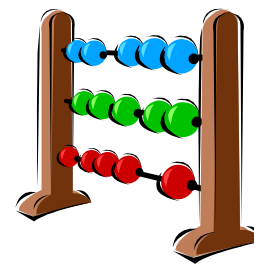
- Revenue and expenses that relate to the same transaction or other event are recognised simultaneously
 - this process is commonly referred to as the matching of revenues and expenses.
- Expenses, including warranties and other costs to be incurred after the shipment of the goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied.
- However, revenue cannot be recognised when the expenses cannot be measured reliably;
 - in such circumstances, any consideration already received for the sale of the goods is recognised as a liability.

Revenue – Rendering of Services

Sale of goods

Rendering of services

Interest, royalties and dividend



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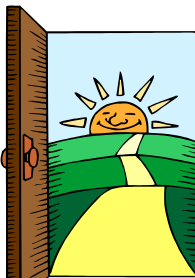
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Revenue – Rendering of Services

Main Principle

- When the outcome of a transaction involving the rendering of services can be estimated reliably
 - revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date.

Often referred to as the *percentage of completion method*



- The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:
 - a) the amount of revenue can be measured reliably;
 - b) it is probable that the economic benefits associated with the transaction will flow to the entity;
 - c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and
 - d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

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22

Revenue – Rendering of Services

- Under the percentage of completion method
 - revenue is recognised in the accounting periods in which the services are rendered.
- The recognition of revenue on this basis provides
 - useful information on the extent of service activity and performance during a period.
- HKAS 11 *Construction Contracts* also requires the recognition of revenue on this basis.
 - The requirements of HKAS 11 are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services.

Revenue – Rendering of Services

Example

Installation fees

- Installation fees are recognised as revenue by reference to the stage of completion of the installation
 - unless they are incidental to the sale of a product in which case they are recognised when the goods are sold.

Advertising commissions

- Media commissions are recognised when the related advertisement or commercial appears before the public.
- Production commissions are recognised by reference to the stage of completion of the project.

Revenue – Rendering of Services

Inflow of Future Economic Benefits Not Probable

- Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity.
- However, when an uncertainty arises about the collectibility of an amount already included in revenue
 - the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense,
 - rather than as an adjustment of the amount of revenue originally recognised.



No offsetting

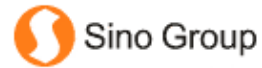
Revenue – Rendering of Services

Reliable Estimates of Revenue

- An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:
 - a) each party's enforceable rights regarding the service to be provided and received by the parties;
 - b) the consideration to be exchanged; and
 - c) the manner and terms of settlement.
- It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system.
- The entity reviews and, when necessary, revises the estimates of revenue as the service is performed.
- The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

Revenue – Rendering of Services

Case



Sino Land Company Limited

2005 Annual Report stated that:

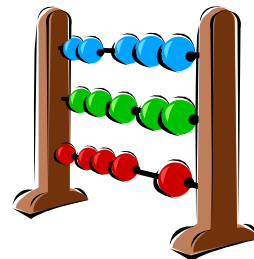
- Building management and service fee income
 - is recognised on an appropriate basis over the relevant period in which the services are rendered.

Revenue – Interest, Royalties & Dividend

Sale of goods

Rendering of services

Interest, royalties and dividend



Revenue – Interest, Royalties & Dividend

Main Principle

- Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised on the bases set out in the following paragraph when:
 - a) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - b) the amount of the revenue can be measured reliably.
- Revenue shall be recognised on the following bases:
 - a) interest shall be recognised using the effective interest method as set out in HKAS 39, paragraphs 9 and AG5-AG8;
 - b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and
 - c) dividends shall be recognised when the shareholder's right to receive payment is established.

Revenue – Interest, Royalties & Dividend

Case



香港公益金
THE COMMUNITY CHEST

Accounting policy on recognition of income (annual report 2005/06):

- Income from donations is recognised when
 - cash is received and includes all sums received up to the balance sheet date.
- Dividend income from unlisted investments is recognised only when
 - the shareholder's right to receive payment is established.
- Dividend income from listed investments is recognised when
 - the share price of the investment goes ex-dividend.
- Interest income from bank deposits and debt securities investments are accrued
 - on a time-apportioned basis on the principals and at the applicable rate.

Revenue – Disclosure

An entity shall disclose:

- a) the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- b) the amount of each significant category of revenue recognised during the period including revenue arising from:
 - i) the sale of goods;
 - ii) the rendering of services
 - iii) interest;
 - iv) royalties;
 - v) dividends; and
- c) the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.



Revenue – Disclosure

- An entity discloses any contingent liabilities and contingent assets in accordance with *HKAS 37 Provisions, Contingent Liabilities and Contingent Assets*.
- Contingent liabilities and contingent assets may arise from items such as
 - warranty costs,
 - claims,
 - penalties or
 - possible losses.



Government Grants (HKAS 20)



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33

Government Grants – Scope

- HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* shall be applied in
 - accounting for, and in the disclosure of, government grants and
 - the disclosure of other form of government assistance



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34

Government Grants – Government?



- Government refers to:
 - government,
 - government agencies, and
 - similar bodies whether local, national or international.

Not only government

Government Grants – Grants?



- Government grants:
 - are assistance by government in the form of **transfers of resources** to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.
 - exclude
 - those forms of government assistance which cannot reasonably have a value placed upon them and
 - transactions with government which cannot be distinguished from the normal trading transactions of the entity.
 - are sometimes called by other names
 - such as subsidies, subventions, or premiums.

Government Grants – Grants?



- Grants related to assets
 - are government grants whose primary condition is that an entity qualifying for them shall purchase, construct or otherwise acquire long-term assets
 - Subsidiary conditions may also be attached restricting
 - the type or location of the assets or
 - the periods during which they are to be acquired or held.
- Grants related to income
 - are government grants other than those related to assets.

Government Grants – Recognition

- Government grants, including non-monetary grants at fair value,
 - shall not be recognised until there is reasonable assurance that:
 - a) the entity will comply with the conditions attaching to them; and
 - b) the grants will be received.

- Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.
- The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant.
 - Thus, a grant is accounted for in the same manner
 - whether it is received in cash or
 - as a reduction of a liability to the government.

Government Grants – Recognition

Case



AIR CHINA LIMITED
中國國際航空股份有限公司

Financial statement 2004

Significant accounting policies on government grants

- Government grants are recognised at their fair values when
 - it is probable that the grant will be received and
 - all attaching conditions will be complied with.

Government Grants – Recognition

Income approach

Matching

- Government grants
 - shall be recognised as income
 - over the periods necessary to match them with the related costs which they are intended to compensate,
 - on a systematic basis.
 - shall not be credited directly to shareholders' interests.

deferred income
→ liabilities

Government Grants – Recognition

- A government grant that becomes receivable
 - as compensation for expenses or losses already incurred or
 - for the purpose of giving immediate financial support to the entity with no future related costs
 - shall be recognised as income of the period in which it becomes receivable.
- e.g. may be for giving immediate financial support to an entity rather than as an incentive to undertake specific expenditures

Income approach

Dr. Receivable
Cr. Income

Government Grants – Recognition

Case



HONG KONG TOURISM BOARD

Annual' Report 2004/05:

- Government subvention made to finance the general activities including normal capital expenditure of the Board is recognised as revenue in the income statement of the year in respect of which they become receivable.

Government Grants – Recognition

Non-monetary Government Grant

- A government grant may take the form of a transfer of a non-monetary asset
 - such as land or other resources, for the use of the entity.
- In these circumstances it is usual
 - to assess the fair value of the non-monetary asset and
 - to account for both grant and asset at that fair value.
- An alternative course that is sometimes followed is
 - to record both asset and grant at a nominal amount.



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43

Government Grants – Recognition

Government grants related to assets

including non-monetary grants at fair value shall be presented in the balance sheet either

- by setting up the grant as deferred income or
 - by deducting the grant in arriving at the carrying amount of the asset.
- Both are regarded as acceptable alternatives.

Deferred Income

Deduct from Asset

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44

Government Grants – Presentation

Set up the grant as deferred income

- which is recognised as income on a systematic and rational basis over the useful life of the asset.

Deferred Income

Deduct the grant in arriving at the carrying amount of the asset.

- The grant is recognised as income over the life of a depreciable asset by way of a reduced depreciation charge.

Deduct from Asset

Government Grants – Presentation

- The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity.
- For this reason and in order to show the gross investment in assets, such movements are often disclosed as
 - separate items in the cash flow statement regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

Deferred Income

Deduct from Asset

Government Grants – Presentation

Example

- At end of Year 0, Bonsela Ltd has received a government grant of \$15,000 towards a machine costing \$100,000.
- The machine will be depreciated over an estimated useful life of 5 years on a straight-line basis.
- Prepare the extract of financial statements at the end of Year 1 in recognising the above transaction.

Government Grants – Presentation

Example

Recognising and presenting the government grant as deferred income:

Income Statement Extract

Depreciation (\$100,000 ÷ 5 years)	20,000
Release of grant (\$15,000 ÷ 5 years)	<u>(3,000)</u>
Net charge	<u>17,000</u>

Balance Sheet Extract

Non-current assets	
Machinery at cost	100,000
Accumulated depreciation	<u>(20,000)</u>
Net book value	<u>80,000</u>
Liabilities - deferred income	
Opening	15,000
Release to income statement	<u>(3,000)</u>
Closing	<u>12,000</u>

Government Grants – Presentation

Example

Recognising and presenting the government grant deducted from the cost of the asset

Balance Sheet Extract

Non-current assets

Machinery at cost (\$100,000 – \$15,000)	85,000
Accumulated depreciation (\$85,000 ÷ 5 years)	<u>(17,000)</u>
Net book value	<u>68,000</u>

Source from Foulks Lynch Pack

Government Grants – Presentation

Case



HONG KONG TOURISM BOARD

Annual Report 2004/05:

- Government subvention made for the purchase of office premises of the Board
 - is included in the balance sheet as deferred income and
 - is credited to the income statement by instalments over the expected useful life of the related asset on a basis consistent with the depreciation policy

Government Grants – Presentation

Grants related to income are either:

Credit in P/L

As a credit in the income statement, either

- separately or
- under a general heading such as “other income”;

Deduct from Expenses

Deducted in reporting the related expense.

Government Grants – Presentation

Case



Annual Report 2004/05:

- Government subventions of a capital nature (“capital subventions”)
 - are credited to the deferred income - capital subventions account and the corresponding amounts are capitalised as fixed assets
 - Each year, an amount equal to the depreciation charge for these assets and net book value of assets disposed is transferred from the deferred income - capital subventions account and credited to the statement of income and expenditure.
- Government grants in respect of certain employee benefits
 - are credited to deferred income and recognised as income to match against the related employee costs as and when these are incurred.

Government Grants – Repayable

- A government grant that becomes repayable shall be accounted for as a revision to an accounting estimate
 - see HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.



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53

Government Grants – Repayable

- Repayment of a grant related to income
 - shall be applied first against any unamortised deferred credit set up in respect of the grant.
 - To the extent that the repayment exceeds any such deferred credit, or where no deferred credit exists, the repayment shall be recognised immediately as an expense.



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54

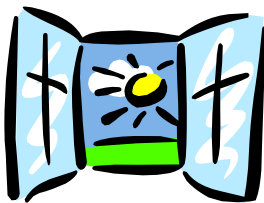
Government Grants – Repayable

- Repayment of a grant related to an asset shall be recorded by
 - increasing the carrying amount of the asset or
 - reducing the deferred income balance by the amount repayable.
- The cumulative additional depreciation that would have been recognised to date as an expense in the absence of the grant shall be recognised immediately as an expense.



- Circumstances giving rise to repayment of a grant related to an asset
 - may require consideration to be given to the **possible impairment** of the new carrying amount of the asset.

Government Grants – Disclosure



The following matters shall be disclosed:

- a. the **accounting policy** adopted for government grants
 - including the methods of presentation adopted in the financial statements;
- b. the **nature and extent of government grants** recognised in the financial statements and an **indication of other forms of government assistance** from which the entity has directly benefited; and
- c. **unfulfilled conditions** and **other contingencies** attaching to government assistance that has been recognised.

Provisions, Contingent Liabilities and Contingent Assets (HKAS 37)



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57

Objective of HKAS 37

- To ensure appropriate [recognition criteria](#) and [measurement bases](#) are applied to

Provision

Contingent liabilities

Contingent assets

- that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount

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58

Scope of HKAS 37

- HKAS 37 shall be applied by all entities in accounting for

Provision

Contingent liabilities

Contingent assets

- Except:
 - a) those resulting from executory contracts, → **Executory contracts** are not covered by HKAS 37, but **Onerous executory contracts** are covered by HKAS 37 (discussed later)
except where the contract is onerous; and
 - b) those covered by another HKFRS
- 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

Provisions

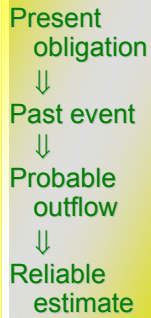
Definition

- A **provision** is
 - a liability of uncertain timing or amount
- A liability is
 - a present obligation of the entity arising from past events,
 - the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits
- Not include those adjustments to the carrying amount of assets, say provision for depreciation, provision for doubtful debt
- Distinguished from other liabilities such as trade payables and accruals because there is
 - Uncertainty about the timing or
 - Uncertainty about the amount of the future expenditure required in settlement

Provision

Provisions

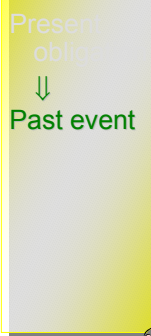
Definition → Recognition



- A provision shall be recognised when:
 - a) an entity has a present obligation (legal or constructive) as a result of a past event;
 - b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
 - c) a reliable estimate can be made of the amount of the obligation.
- If these conditions are not met, no provision shall be recognised.

Provisions

Definition → Recognition



- A past event that leads to a present obligation is called an

Obligating event

An obligating event is an event that creates

Legal Obligation

- a legal obligation or constructive obligation

Constructive Obligation

- that results in an entity having no realistic alternative to settling that obligation



Provisions

Definition → Recognition

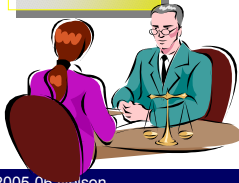
Present obligation
↓
Past event

Legal obligation is an obligation that derives from:
a) a contract (through its explicit or implicit terms);
b) legislation; or
c) other operation of law.



Constructive obligation is an obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities



Provisions

Definition → Recognition

Present obligation
↓
Past event

- The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date.
 - Independent of future actions (i.e. the future conduct of business)
 - Examples of such obligations are
 - Penalties or clean-up costs for unlawful environmental damage
 - Provision for the decommissioning costs of an oil installation (to the extent that the entity is obliged to rectify damage already caused)



Provisions

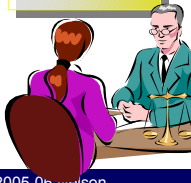
Example

Present obligation
↓
Past event

- Entity A in the nuclear power industry causes contamination but cleans up only when required by the law.
- Country X in which Entity A operates has had no legislation requiring cleaning up, and Entity A has been contaminating land there for many years.
- At 31 Dec. 2000, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year end.
- Is there present obligation as a result of a past obligating event?

Yes

- The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.
- As it is also probable to have an outflow of resources embodying economic benefits in settlement, a provision is recognised for the best estimate of the costs of the clean-up



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65

Provisions

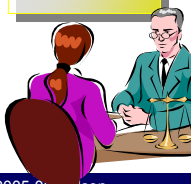
Example

Present obligation
↓
Past event

- Entity C operating power station
 - causes contamination and in Country Z where there is no environmental legislation.
 - has a widely published environmental policy in which it undertakes to clean up all contamination that it causes.
 - has a record of honouring this published policy.
- Is there present obligation as a result of a past obligating event?

Yes

- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.
- As it is also probable to have an outflow of resources embodying economic benefits in settlement, a provision is recognised for the best estimate of the costs of the clean-up

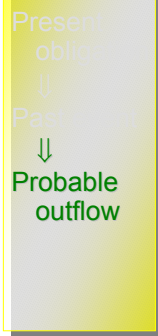


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Provisions

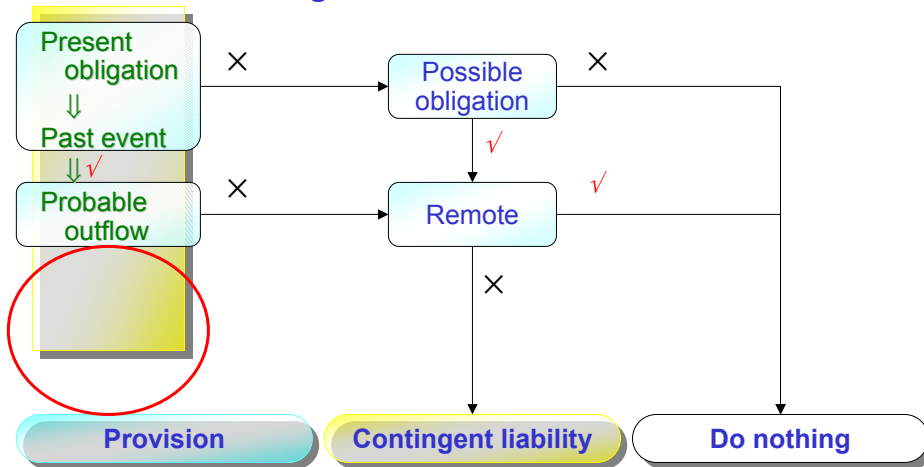
Definition → Recognition



- For recognition of provision, an entity also considers
 - the probability of an outflow of resources embodying economic benefits to settle that obligation
- An outflow of resources (or other event) is regarded as probable if the event is more likely than not to occur
 - i.e. the probability that the event will occur is greater than the probability that it will not
- Where it is not probable that a present obligation exists
 - an entity discloses a contingent liability, unless the possibility is remote
- Where there are a number of similar obligations (e.g. product warranties or similar contracts)
 - the probability is determined by considering the class of obligations as a whole

Provisions

Definition → Recognition



Provisions

Definition → Recognition



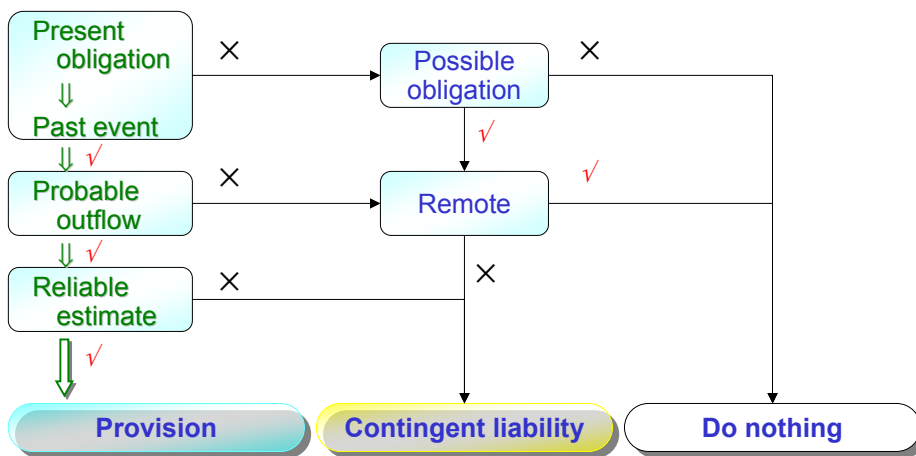
- Use of estimates
 - an essential part of the preparation of financial statements
 - does not undermine their reliability
 - especially true in the case of provisions, which by their nature are more uncertain than most other balance sheet items.
- An entity (except in extremely rare cases)
 - will be able to determine a range of possible outcomes and
 - can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

Provision

More on measurement

Provisions

Definition → Recognition



Provisions

Case



Medecins Sans Frontieres (International Financial Report 2004):

- Provisions and contingent liabilities are valued at their best estimate when MSF has a legal or constructive obligation as the result of a past event, and if it is probable that an outflow of assets will be required to settle the provision.

Contingent Liabilities

Definition → No Recognition → Disclosed unless remote

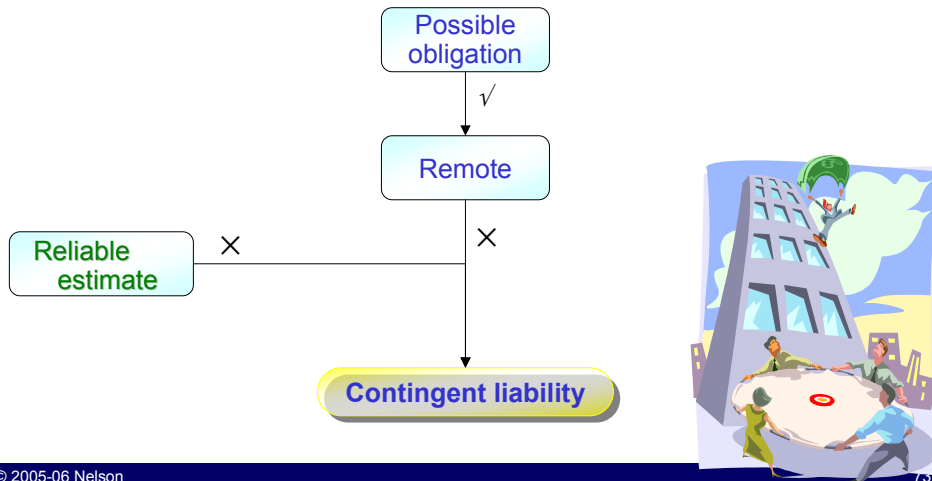
- A contingent liability is:
 - a **possible obligation** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
 - a present obligation that arises from past events but is not recognised because:
 - it is **not probable** that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - the amount of the obligation **cannot be measured with sufficient reliability**.
- An entity shall not recognise →

Contingent liability



Contingent Liabilities

Definition → No Recognition → Disclosed unless remote



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73

Contingent Liabilities

Case



HONG KONG TOURISM BOARD

Annual Report 2004/05:

- Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as a contingent liability,
 - unless the probability of outflow of economic benefits is remote.
- Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities
 - unless the probability of outflow of economic benefits is remote.

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74

Contingent Assets

Definition → No Recognition → Disclosed

- A contingent asset is:
 - a **possible asset** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
- An entity shall not recognise a contingent asset



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75

Provisions – Measurement

Definition → Recognition → Measurement

1. Best estimate
 - the amount recognised as a provision shall be the **best estimate** of the expenditure required to settle the present obligation at the balance sheet date.
 - expected value can be used
2. Risks and uncertainties
 - that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision

Provision

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76

Provisions – Measurement

Definition → Recognition → Measurement

3. Present Value

- 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
- the discount rate shall be a pre-tax rate that reflects
 - current market assessments of the time value of money and
 - the risks specific to the liability
 - not reflect risks for which future cash flow estimates have been adjusted

Provision

Provisions – Measurement

Definition → Recognition → Measurement

4. Future events

- that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur

5. Expected disposal of assets

- shall not be taken into account

Provision

Provisions – Measurement

Example

- Entity A is involved in a court case about the plagiarism of software.
- Legal opinion seems to indicate that Entity A will lose the case.
- Entity A estimates that
 - the most likely outcome (60% chance) will be a settlement payment of costs and penalties of \$1 million in 2 years' time
 - the best case scenario (30% chance) is deemed to be a settlement payment of \$500,000 in one year's time and
 - the worst case scenario (10% chance) will be a settlement payment of \$2 million in 3 years' time (discount rate is 5%)

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79

Provisions – Measurement

Example

- As regards the plagiarism case the following table illustrates the potential outcomes (present values at 5%):

	<u>\$000</u>	<u>Year</u>	<u>PV(\$000)</u>	<u>Probability</u>	<u>Total (\$)</u>
Best case	500	1	476	30%	142,857
Most likely	1,000	2	907	60%	544,218
Worse case	2,000	3	1,728	10%	172,768
					859,843

- As compared with the most likely outcome, which indicates a provision of \$907,000, the expected value of the provision as above is \$859,843.
- The difference, while an accounting estimate has been used, is not material.
- In consequence, a provision of \$860,000 can be made as it is estimated by a more scientific approach.

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80

Provisions – Measurement

Case



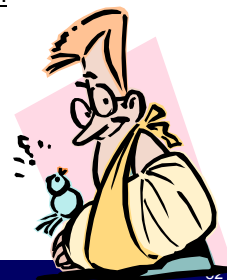
HONG KONG TOURISM BOARD

Annual Report 2004/05:

- Provisions are recognised for liabilities of uncertain timing or amount when the Board has a legal or constructive obligation arising as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made.
- Where the time value of money is material,
 - provisions are stated at the present value of the expenditure expected to settle the obligation.

Provisions – Reimbursements

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party
 - the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.
 - The reimbursement shall be treated as a separate asset.
 - The amount recognised for the reimbursement shall not exceed the amount of the provision.
 - In the income statement, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.



Provisions – Reimbursements

Case



Annual Report 2004/05:

- Provisions are recognised when the HA has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.
- Where the HA expects a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

Provisions – Changes and Use

- Provisions shall be
 - reviewed at each balance sheet date and
 - adjusted to reflect the current best estimate.
- If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation
 - the provision shall be reversed.
- A provision shall be used only for expenditures for which the provision was originally recognised.

Provisions – Application

- **Future operating losses**
 - Provisions shall not be recognised for future operating losses
- **Onerous Contracts**
 - Being a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it
(*unavoidable cost > economic benefits expected*)
 - If an entity has a contract that is onerous, the present obligation under the contract
 - shall be recognised and measured as a provision

Provisions – Application

Example

- Entity A operates profitably from a factory that it has leased under an operating lease.
 - During the year, Entity A relocates its operations to a new factory.
 - The lease on the old factory continues for the next 4 years.
 - Entity A cannot cancel that lease and the factory cannot be re-let to another user.
- The obligating event is the signing of the lease contract, which gives rise to a legal obligation.
 - When the lease becomes onerous (*unavoidable costs > economic benefits*), an outflow of resources embodying economic benefits is probable.
 - Until the lease becomes onerous, it is accounted under HKAS 17 *Leases*.
 - A provision is recognised for the best estimate of the unavoidable lease payments.

Provisions – Application

Restructuring

- A restructuring is a programme that is planned and controlled by management, and materially changes either:
 - a) the scope of a business undertaken by an entity; or
 - b) the manner in which that business is conducted
- A constructive obligation to restructure arises only when an entity:
 - a) has a detailed formal plan for the restructuring identifying at least:
 - i) the business or part of a business concerned;
 - ii) the principal locations affected;
 - iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
 - iv) the expenditures that will be undertaken; and
 - v) when the plan will be implemented; and
 - b) has raised a valid expectation in those affected that it will carry out the restructuring by
 - i) starting to implement that plan or
 - ii) announcing its main features to those affected by it.

When shall provision be recognised?

Provisions – Application

Restructuring

- No obligation arises for the sale of an operation until the entity is committed to the sale, i.e. there is a binding sale agreement.
- A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:
 - a) necessarily entailed by the restructuring; and
 - b) not associated with the ongoing activities of the entity.
- A restructuring provision does not include such costs as:
 - a) retraining or relocating continuing staff;
 - b) marketing; or
 - c) investment in new systems and distribution networks.

Disclosure – Provisions

- For each class of provision, an entity shall disclose:
 - a) the carrying amount at the beginning and end of the period;
 - b) additional provisions made in the period, including increases to existing provisions;
 - c) amounts used (i.e. incurred and charged against the provision) during the period;
 - d) unused amounts reversed during the period; and
 - e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.
- Comparative information is not required.
- An entity shall disclose the following for each class of provision:
 - a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
 - b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
 - c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Disclosure – Contingent Liabilities

- Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
 - a) an estimate of its financial effect;
 - b) an indication of the uncertainties relating to the amount or timing of any outflow; and
 - c) the possibility of any reimbursement.

Disclosure – Other

- Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the balance sheet date, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-52 of HKAS 37
- Where any of the information required in HKAS 37 is not disclosed because it is not practicable to do so, that fact shall be stated.
- In extremely rare cases, disclosure of some or all of the information can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset.
- In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Financial Guarantee Contracts



Financial Guarantee Contracts

- The amended requirements for financial guarantee contracts are issued in the form of limited amendments to
 - HKAS 39 Financial Instruments: Recognition and Measurement and
 - HKFRS 4 Insurance Contracts



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93

Financial Guarantee Contracts

- The amendments are intended to ensure that
 - issuers of financial guarantee contracts include the resulting liabilities in their balance sheet.
- Before these amendments, financial guarantee contracts were within the scope of HKFRS 4
 - HKAS 39 para. BC 22 states that IASB *“finalised IFRS 4 in early 2004 without specifying the accounting for these contracts (the financial guarantee contracts) and then published an exposure draft (of this amendment)”*



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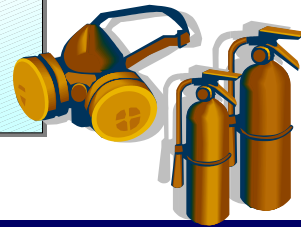
94

Financial Guarantee Contracts

Financial guarantee contract is defined as:

- a contract that requires 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.

- Financial guarantee contracts may have various legal forms, such as
 - a guarantee
 - some types of letter of credit
 - a credit default contract or
 - an insurance contract



Financial Guarantee Contracts

The amendments set out that:

- Although a financial guarantee contract meets the definition of an insurance contract in HKFRS 4 if the risk transferred is significant,
 - the issuer applies HKAS 39.
- Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts,
 - the issuer may elect to apply either
 - HKAS 39 or
 - HKFRS 4to such financial guarantee contracts.



Financial Guarantee Contracts

HKAS 39 (para. 47c and AG4) requires the issuer of a financial guarantee contract to measure the contract:

- *Initially*, at fair value.
 - If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.
- *Subsequently*, at the higher of:
 - i) the amount determined in accordance with *HKAS 37 Provisions, Contingent Liabilities and Contingent Assets*; and
 - ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with *HKAS 18 Revenue*.
 - unless the financial guarantee contract was designated at inception as at fair value through profit or loss or
 - unless paragraphs 29-37 and AG47-AG52 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies),

Financial Guarantee Contracts

- HKAS 39 does not contain exemptions for parents, subsidiaries or other entities under common control.
 - However, any differences are reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities
- An entity shall apply the amendment for annual periods beginning on or after 1 January 2006.
- Earlier application is encouraged.
 - If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to HKAS 32 and HKFRS 4 at the same time.



For Further Discussion



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99

For Further Discussion

As discussed

HKAS 20 requires that

- Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:
 - a) the entity will comply with the conditions attaching to them; and
 - b) the grants will be received.
- Government grants shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis. They shall not be credited directly to shareholders' interests.

unrecognised
income
→ liabilities

deferred
income
→ liabilities

Matching

But

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100

For Further Discussion

HKAS 37 and Framework for the Preparation and Presentation of Financial Statements state that

- A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- A **provision** is a liability of uncertain timing or amount.

unrecognised
income
→ liabilities

deferred
income
→ liabilities



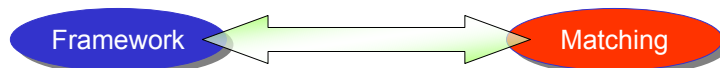
For Further Discussion

HKAS 37 and Framework for the Preparation and Presentation of Financial Statements state that

- A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- A **provision** is a liability of uncertain timing or amount.

Implies

- Designated or restrictive donations would still be liabilities until condition or restriction is met/released
- Some deferred income under HKAS 20 may "result in an entity recognising an amount in the balance sheet as deferred credit when the entity has no liability" (*IASB, Dec. 2005*)



IASB is considering to follow the approach of IAS (HKAS) 41 to amend IAS 20 and eliminate the conflict

Revenue Recognition & Provision

July 2006



Nelson Lam

nelson@nelsoncpa.com.hk
www.nelsoncpa.com.hk

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103