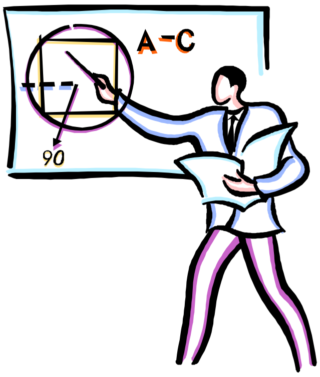
EAS on Financial Reporting

22 October 2006



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Today's Agenda

Importance of Special Topics

HKAS 17	Leases
HKAS 40	Investment Property
HKAS 12	Income Taxes
HKAS 39	Financial Instruments
HKFRS 2	Share-based Payments

Past Papers

Examples

Leases (HKAS 17)

Classification of Leases

The classification of leases adopted in HKAS 17

- Is based on the extent to which risks and rewards incidental to ownership of a leased asset lie the the lessor or the leseee.

Risks and Rewards

Finance Lease

- A finance lease
  - is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.
  - Title may or may not eventually be transferred.

Operating Lease

- An operating lease
  - is a lease other than a finance lease

Classification of Leases

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.
- Indicators of a finance lease include:

Finance Lease

Operating Lease

a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Classification of Leases

- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

Finance Lease

Operating Lease

- Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:
  a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
  b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
  c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Classification of Leases

Example

- Fat Choy has financed its business expansion by acquiring new production plant and equipment through utilising certain leasing arrangements during the year.
- The leases
  - include options enabling Fat Choy to purchase the assets at their fair values at the end of the lease term. — Indicator of finance lease?
  - will last for five years, which is also the expected useful life of the assets. √ Indicator of finance lease?
  - Give Fat Choy the right to cancel the leases, and the lessor's losses associated with the cancellation will be borne by Fat Choy. √ Indicator of finance lease?
- For simplicity, Fat Choy would like to record these acquisitions off the balance sheet and charge all leasing charges to income.
- Discuss the appropriate accounting treatment.

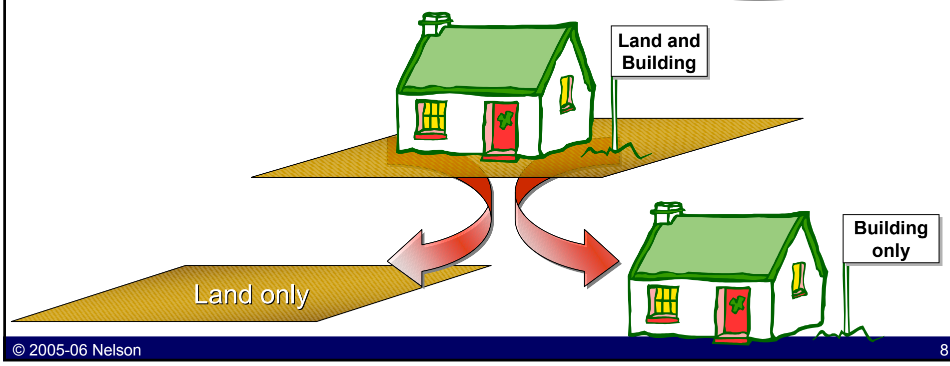
(HKICPA CPA QP 2004 Dec adapted)

Leases – Separate Measurement

1. Introducing several new paragraphs

   ➢ New requirements with significant impact, mainly ……

Separate measurement
(of the land and buildings elements) at the inception of the lease



Leases – Separate Measurement

- As before, lease classification is made
  - at the inception of the lease
  - leases of land and buildings are classified as operating or finance leases
    - ➢ in the same way as leases of other assets

Land only

Building only

Leases – Separate Measurement

Lease of land

- Land normally has an indefinite economic life
- If title of leasehold land is not expected to pass to the lessee
  - ⇒ Lessee normally does not receive substantially all of the risks and rewards incidental to the ownership
  - ⇒ In which case the lease of land will be an **operating lease**
    - payment acquiring such leasehold represents **prepaid lease payments**
    - amortised over the lease term in accordance with the pattern of benefits provided

Land only → Leasehold land without title pass → **Operating Lease**

Leases – Separate Measurement

Lease of land ⇨ **Lease of land and buildings**

If a lease contains land and buildings elements

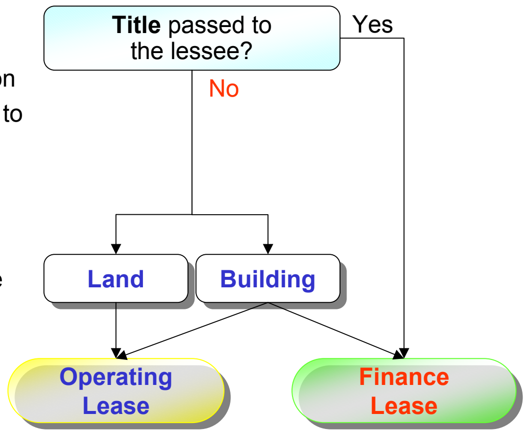
- 2 elements are considered separately for lease classification

If **title** of both elements is expected to pass to the lessee

- Both elements are classified as **finance lease**

If **title** of land or both elements is NOT expected to pass to the lessee

- The land element alone is normally classified as an **operating lease**
- The building element is considered separately

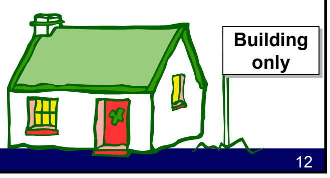


Leases – Separate Measurement

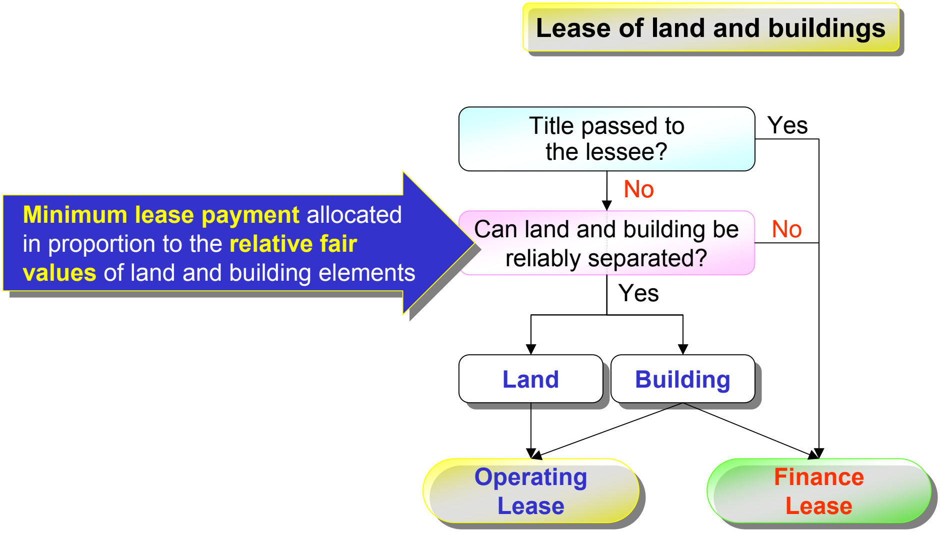
Lease of land and buildings

- To classify and account for a lease of land and buildings
  - the minimum lease payments (including any lump-sum upfront payments) are allocated between
    - – the land and
    - – the buildings elements
  - in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease

Relative Fair Value



Leases – Separate Measurement



Leases – Separate Measurement

Example

Entity A

- paid a land premium to lease a land from the HKSAR government for 50 years
- then, constructed a building on the land for own use

10 years later, Entity B "acquired" the interest of the land and building from Entity A for own use

Assuming Entity B "acquired" the property at HK$20 million and at that time

- A similar land has a fair value of $12M
- Construction cost of a similar building is $4M

- HK$ 20M to be separated in proportion to the relative fair values of the land and building element at the inception of the lease, i.e. by HK$ 12M to HK$ 4M
- Then, the separate measurement will result in:

Land	= HK$15M	($20M × $12M / $16M)
Building	= HK$ 5M	($20M × $ 4M / $16M)

Leases – Separate Measurement

Lease of land and buildings

- If the lease payments cannot be allocated reliably between the 2 elements
  - the entire lease is classified as a **finance lease**
  - unless it is clear that both elements are operating leases, in which case the entire lease is classified as an **operating lease**

- For a lease of land and building if the land is immaterial
  - The lease may be treated as a single unit and classified as finance or operating leases

Land only

Building only

Leases – HK Interpretation 4

In accordance **HKAS 17**

- Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the **Lease Term** (unless another systematic basis is more representative of the time pattern of the user's benefit)

Lease Term is defined as the non-cancellable period for which
- the lessee has contracted to lease the asset
- together with any further terms
  - for which the lessee has the option to continue to lease the asset, with or without further payment,
  - when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Lessee has the option

At the inception

Investment Property (HKAS 40)

Definitions – Revised

- Amended and clearer definition on an investment property

SSAP 13

An investment property is an interest in land and/or buildings:

a) in respect of which construction work and development have been completed; and

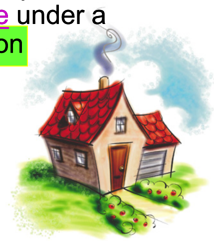
b) which is held for its investment potential, any rental income being negotiated at arm's length

HKAS 40

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

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

b) sale in the ordinary course of business



Definitions – Revised

Example

- Amended and clearer definition on an investment property

Examples of investment property under HKAS 40 include:

- Property leased out under operating leases
- Property held for long-term capital appreciation
- Property held for a currently undetermined future use
- Vacant property to be leased out under operating leases

HKAS 40

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

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

b) sale in the ordinary course of business

How's about property held by the lessee under an operating lease?

Definitions – Extend to Operating Leases

- A property interest
  - that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if
    - the property would otherwise meet the definition of an investment property and
    - the lessee uses the Fair Value Model
- This classification alternative is available on a property-by-property basis
- However, once this classification alternative is selected for one such property interest held under an operating lease, all properties classified as investment property shall be accounted for using the Fair Value Model

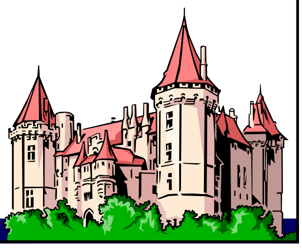
An entity has a choice

Simple?

Let's term this classification as "Operating Lease IP Alternative"

Definitions - Owner-Occupied Property

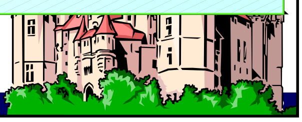
- Introduce a new term, **owner-occupied property**
  - Defined as a property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes
  - In substance, a property under HKAS 16
  - Being one of the examples that is NOT an investment property



Definitions - Owner-Occupied Property

Example

Examples that are NOT investment property include:	**Which HKAS?**
• Owner-occupied property	➢HKAS 16 & 17
• Property (completed or under development) intended for sale in the ordinary course of business	➢HKAS 2
• Property being constructed or developed for third parties	➢HKAS 11
• Property leased out under finance lease	➢HKAS 17
• Property that is being constructed or developed for future use as investment property	➢HKAS 16 & 17
• How's the classification for existing investment property being redeveloped for continued future use as investment property?	**Still Investment Property**



Definitions - Owner-Occupied Property

Refer back to HKAS 16 for definition of property, plant and equipment

- Property, plant and equipment are tangible items that:
  - a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
  - b) are expected to be used during more than one period.

Both for rental, how to distinguish?

Cash Flow → Extent of Ancillary Services

Investment Property

Owner-occupied Property

Definitions - Owner-Occupied Property

Cash Flow

- One of the key indicators in determining the classification between investment property and owner-occupied property

Investment Property

- held to earn rentals or for capital appreciation or both
- therefore, generates cash flows largely independently of the other assets held by an entity.

Owner-occupied property

- the production or supply of goods or services (or the use of property for administrative purposes)
- generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process

Definitions - Owner-Occupied Property

Cash Flow → Extent of Ancillary Services

- provided by an entity to the occupants of a property it holds is also considered

Ancillary services not significant → investment property

Significant ancillary services provided → owner-occupied property

e.g. a owner-managed hotel is not an investment property

If owner-managed hotel was classified as investment property before 2005, it should be reclassified as

- *property, plant and equipment* (HKAS 16) or
- *lease* (HKAS 17)

- **Significant impact on hotel group**

Definitions - Owner-Occupied Property

- It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property
- for example, there may be a spectrum from one end to another:

Ancillary services not significant ⟷ How to determine those in between these 2 ends? ⟷ **Significant ancillary services provided**

Passive investor
⇒ Investment property
⇒ Use HKAS 40

Significant exposure to variation in the cash flows
⇒ Owner-occupied
⇒ Use HKAS 16

- Then, judgement is required to determine
- Entities should develop consistent criteria for use in exercising the judgement

- **Significant impact on hotel group**

Definitions - Partially Used Only

- Some properties comprise a portion held as investment property and another portion NOT held as investment property.
- If these portions:

Could be sold separately — or leased out separately under a finance lease
⇒ an entity accounts for the portions separately

Could not be sold separately — ⇒ the property is investment property only if an insignificant portion is NOT held as investment property

Definitions - Partially Used Only

An entity owns property that is leased to, and occupied by, its parent or another subsidiary

⇒ The property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group

⇒ But, from the perspective of the entity that owns it, the property is investment property if it meets the definition of investment property

- The lessor treats the property as investment property in its individual financial statements.

Consolidated

Individual

Changed from SSAP 13
- 15% benchmark is removed
- Property leased to group companies is still investment property in an entity's individual financial statements

Measurement after Recognition

Introduce Cost Model and choose either **Fair Value Model**

and **Cost Model**

- HKAS 40 implicitly implies that the choice can only be elected on the first-time adoption of HKAS 40
- The model chosen should be applied to all investment properties, except for some identified exceptions.
- However, even Cost Model is adopted, HKAS 40 still requires all entities to determine the fair value of investment property ……
  - For disclosure purpose, the fair value of the investment property has to be disclosed in notes to the financial statement!
  - In determining the fair value of investment property for both cost model and fair value model

    ⇒ an entity is only encouraged, but not required, to rely on a professional valuer's valuation

Measurement after Recognition

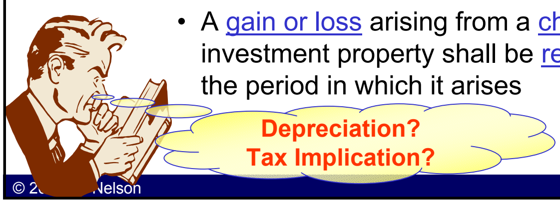
After initial recognition, an entity that chooses → **Fair Value Model**

- shall measure all of its investment property at fair value, except in the cases that

1. the fair value cannot be determined reliably, or
2. the cost model is chosen for the investment property backing liabilities that pay a return linked directly to the fair value of, or returns from specific assets including that investment property

- When a property interest held by a lessee under an operating lease is classified as an investment property

  ⇒ the fair value model must be applied for all investment properties
- A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises



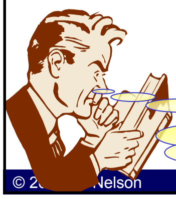
Measurement after Recognition

HKAS 40

Fair Value Model

- Uses fair value, instead of open market value
  - but in substance, they are similar
  - not the same as SSAP 13, HKAS 40 only encourages, but not requires, a profession valuation on a fair value
- Fair value is defined as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction
  - Same definition used in other HKFRSs and HKASs
  - But HKAS 40 provides more explanations unique for a fair value of a property
    - The fair value of investment property shall reflect market conditions at the balance sheet date

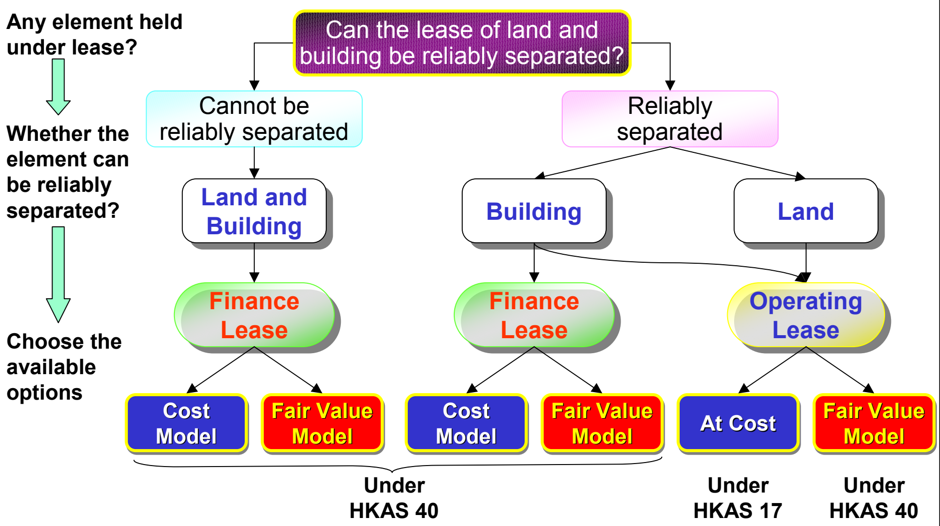
No depreciation required in HKAS 40



Depreciation?
Tax Implication?

Not our concern this time!
But be careful, good & bad ……

Application of HKAS 40 in HK



Income Taxes (HKAS 12)

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1. Overview

Focus on deferred taxes

Deferred taxes → Temporary difference → Tax base

HKAS 12 *Income taxes* adopts

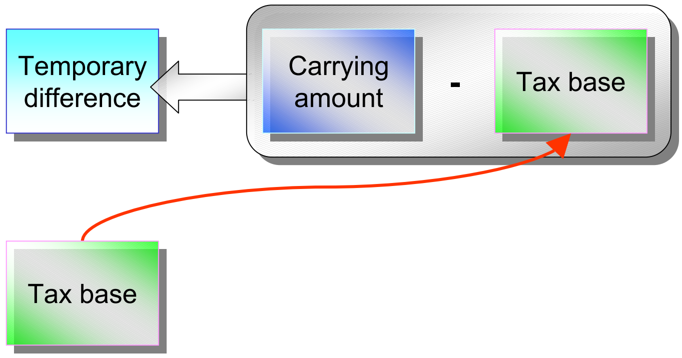
- **Balance sheet liability method**
  - Largely referenced to the temporary difference between an asset or liability's
    - carrying amount and
    - its tax base
- **Full provision approach**
  - Recognised all differences, except for some limited cases

3. Temporary Difference

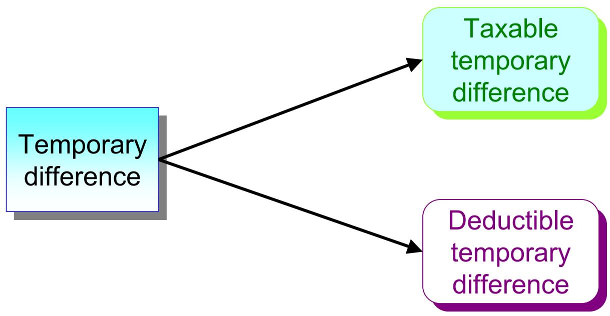
Tax base of an asset or liability is

- the amount attributed to that asset or liability for tax purposes

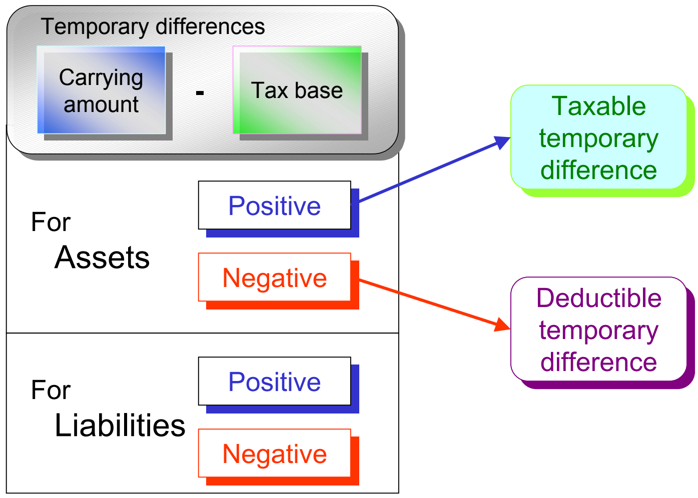
HKAS 12 provides guidance on calculating tax base ……



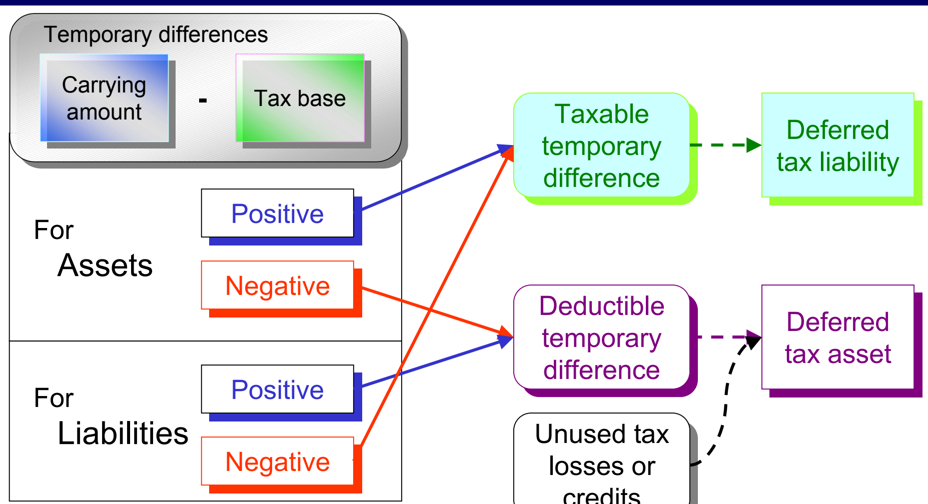
3. Temporary Difference



3. Temporary Difference



3. Temporary Difference



Balance sheet liability method

3. Temporary Differences

Deferred tax assets or liabilities = Temporary differences x Tax rates

All recognised?

Taxable temporary difference → Deferred tax liability

Deductible temporary difference → Deferred tax asset

Unused tax losses or credits → Deferred tax asset

Balance sheet liability method

Full provision approach

4. Recognition of Deferred Tax Assets / Liabilities

Except for

Some cases specified in HKAS 12

A deferred tax liability shall be recognised for

all taxable temporary differences

Taxable temporary difference → Deferred tax liability

A deferred tax asset shall be recognised for

all deductible temporary differences

to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised

Deductible temporary difference → Deferred tax asset

Unused tax losses or credits → Deferred tax asset

Full provision approach

4. Recognition of Deferred Tax Assets / Liabilities

Except for
Some cases specified in HKAS 12

A deferred tax liability shall be recognised for
all taxable temporary differences

Taxable temporary difference → Deferred tax liability

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

a) deductible temporary differences,
b) the carry-forward of unused tax losses, and
c) the carry-forward of unused tax credits

Deductible temporary difference → Deferred tax asset

Unused tax losses or credits → Deferred tax asset

Full provision approach

4. Recognition of Deferred Tax Assets / Liabilities – Taxable temporary differences

Some cases specified in HKAS 12

A deferred tax liability shall be recognised for
all taxable temporary differences

Taxable temporary difference → Deferred tax liability

Except to the extent that the deferred tax liability arises from:

a) the initial recognition of goodwill; or ← Goodwill exemption

b) the initial recognition of an asset or liability in a transaction which
1. is not a business combination; and
2. at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss) ← Initial recognition exemption

4. Recognition of Deferred Tax Assets / Liabilities – Deductible temporary differences

Some cases specified in HKAS 12

A deferred tax asset shall be recognised for
all deductible temporary differences
to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised

Deductible temporary difference → Deferred tax asset

Unused tax losses or credits → Deferred tax asset

unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

- the initial recognition of an asset or liability in a transaction which
  1. is not a business combination; and
  2. at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)

Initial recognition exemption

4. Recognition of Deferred Tax Assets / Liabilities – Initial recognition exemption

Does deferred tax arise from initial recognition of an asset or liability?
- No → Recognise deferred tax (subject to other exceptions)
- Yes ↓

Is the recognition resulted from a business combination?
- Yes → Recognise deferred tax (subject to other exceptions)
- No ↓

Does it affect either accounting profit/loss or taxable profit/loss at the time of the transaction?
- Yes → Recognise deferred tax (subject to other exceptions)
- No ↓

Not recognise deferred tax asset/liability

- the initial recognition of an asset or liability in a transaction which
  1. is not a business combination; and
  2. at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)

4. Recognition of Deferred Tax Assets / Liabilities – Initial recognition exemption

Examples in Hong Kong:

- Land cost of a property? √
- Cost of demolishing of a building? √
- Intangible assets not tax deductible e.g. purchase of trademarks? √
- ~~Prescribed fixed assets?~~ ×

- the initial recognition of an asset or liability in a transaction which
  1. is not a business combination; and
  2. at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)

4. Recognition of Deferred Tax Assets / Liabilities – Goodwill

Some cases specified in HKAS 12

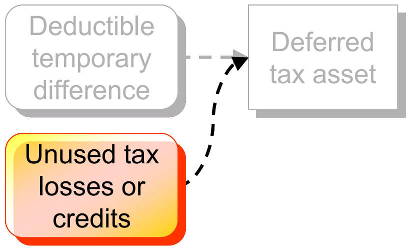
As discussed, an entity shall not recognise a deferred tax liability arising from

a) the initial recognition of goodwill, or

~~b) goodwill for which amortisation is not deductible for tax purposes~~

4. Recognition of Deferred Tax Assets / Liabilities – Unused tax losses and tax credits

A deferred tax asset shall be recognised for the carry-forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised



Example criteria in assessing available taxable profit:

a) whether there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity
b) whether it is probable to have taxable profits before the unused tax losses or unused tax credits expire;
c) Whether the unused tax losses result from identifiable causes which are unlikely to recur; and
d) whether tax planning opportunities are available

4. Recognition of Deferred Tax Assets / Liabilities – Unrecognised deferred tax assets

- At each balance sheet date, an entity re-assesses unrecognised deferred tax assets
- Recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered

Examples

- An improvement in trading conditions - may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria set out above
- When an entity re-assesses deferred tax assets at the date of a business combination or subsequently

4. Recognition of Deferred Tax Assets / Liabilities – Subsidiary, branch, associate, JV

An entity shall recognise

1. a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:
   a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
   b) it is probable that the temporary difference will not reverse in the foreseeable future
2. deferred tax asset for all deductible temporary differences 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:
   a) the temporary difference will reverse in the foreseeable future; and
   b) taxable profit will be available against which the temporary difference can be utilised.

5. Measurement

Deferred tax assets or liabilities = Temporary differences x Tax rates

a. Tax rate

- 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
- The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities
- Deferred tax assets and liabilities shall not be discounted

5. Measurement

Deferred tax assets or liabilities = Temporary differences x Tax rates

Example

Changes in the applicable tax rate

An entity has an asset with

- a carrying amount of $100
- a tax base of $60

Tax rate - 20% for the asset were sold
- 30% for other income

Answers

Temporary difference: $40 ($100 - $60)

a) If it expects to sell the asset without further use

Deferred tax liability: $8 ($40 at 20%)

b) if it expects to retain the asset and recover its carrying amount through use

Deferred tax liability: $12 ($40 at 30%)

5. Measurement

Deferred tax assets or liabilities = Temporary differences x Tax rates

a. Tax rate

b. Deferred tax assets

- The carrying amount of a deferred tax asset shall be reviewed at each balance sheet date
- An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised
- Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available

5. Measurement

Deferred tax assets or liabilities

Dr Tax expenses
Cr Deferred tax liabilities

Dr Deferred tax assets
Cr Tax income

- Current and deferred tax shall be recognised as income or an expense and included in the net profit or loss for the period

6. Recognition of deferred tax charge/credit

Dr Tax expenses, or Equity, or Goodwill
Cr Deferred tax liabilities

Dr Deferred tax assets
Cr Tax income, or Equity, or Goodwill

- Current and deferred tax shall be recognised as income or an expense and included in the net profit or loss for the period *except to the extent that the tax arises from:*
  a) a transaction or event which is recognised, in the same or a different period, directly in equity; or
  b) a business combination that is an acquisition

6. Recognition of deferred tax charge/credit
– Charged or credited to equity directly

Dr Tax expenses and Equity
Cr Deferred tax liabilities

- Current tax and deferred tax shall be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity

Certain HKASs and HKASs require or permit certain items to be credited or charged directly to equity, examples include

1. Revaluation difference on property, plant and equipment under HKAS 16
2. Prior period adjustment from either a change in accounting policy or the correction of a fundamental error under HKAS 8.
3. Exchange differences on translation of a foreign entity's financial statements under HKAS 21.

6. Recognition of deferred tax charge/credit
– Deferred tax arising from a business combination

Dr Tax expenses or Goodwill
Cr Deferred tax liabilities

Dr Deferred tax assets
Cr Tax income or Goodwill

- Temporary differences may arise in a business combination.
- In accordance with HKFRS 3, an entity recognises any resulting deferred tax assets (to the extent they meet the recognition criteria) or deferred tax liabilities are recognised as identifiable assets and liabilities at the date of acquisition
- Consequently, those deferred tax assets and liabilities affect goodwill or "negative goodwill".
- However, in accordance with HKAS 12, an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.

6. Recognition of deferred tax charge/credit
– Deferred tax arising from a business combination

Dr Tax expenses or Goodwill
Cr Deferred tax liabilities

Dr Deferred tax assets
Cr Tax income or Goodwill

- For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree.
- In such cases, the acquirer
  - recognises a deferred tax asset,
  - but does not include it as part of the accounting for business combination, and
  - therefore does not take it into account in determining the goodwill or the "negative goodwill".

6. Recognition of deferred tax charge/credit
– Deferred tax arising from a business combination

Dr Tax expenses or Goodwil
Cr Deferred tax liabilit

Dr Deferred tax assets
Cr Tax income or Goo

Deferred tax assets can be recognised subsequent to the date of acquisition but the acquirer cannot recognise negative goodwill, nor does it increase the negative goodwill.

Example

	Fair value	BV at subsidiary	Tax base
Net assets acquired	$1,200	$1,000	$1,000
Subsidiary's used tax losses			$1,000
Tax rate			20%
⇒ Taxable temporary difference			$200
Deductible temporary difference			$1,000

Deferred tax assets may be recognised as one of the identifiable assets in the acquisition (subject to limitations).

7. Presentation

a. Offset

An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:

a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

b) the deferred tax assets and the deferred tax liabilities 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 deferred tax liabilities or assets are expected to be settled or recovered

7. Presentation

a. Offset

b. Tax expenses and income

- The tax expense and income related to profit or loss from ordinary activities shall be presented on the face of the income statement

II. HK(SIC) Interpretation 21

1. Issue

- Under HKAS 12.51, the measurement of deferred tax liabilities and assets should reflect
  - the tax consequences that would follow from the manner in which
  - the entity expects, at the balance sheet date, to recover or settle the carrying amount of those assets and liabilities that give rise to temporary differences.

1. Issue

- HKAS 12.20 notes that
  - the revaluation of an asset does not always affect taxable profit (tax loss) in the period of the revaluation and
  - that the tax base of the asset may not be adjusted as a result of the revaluation.
- If the future recovery of the carrying amount will be taxable
  - any difference between
    - the carrying amount of the revalued asset and
    - its tax base

    is a temporary difference and gives rise to a deferred tax liability or asset.

1. Issue

- The issue is how to interpret the term "recovery" in relation to an asset that
  - is not depreciated (non-depreciable asset) and
  - is revalued under the revaluation model of HKAS 16 (HKAS 16.31).

- HK(SIC) Interpretation 21

  "also applies to investment properties which
  - are carried at revalued amounts under HKAS 40.33
  - but would be considered non-depreciable if HKAS 16 were to be applied."

- Interpretation 20 (superseded)

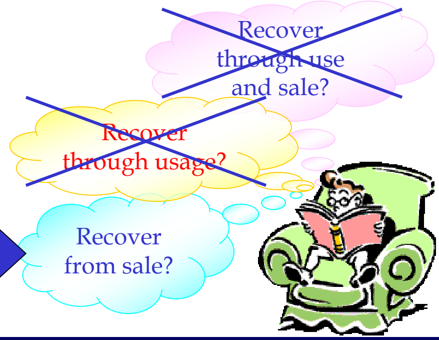
  "also applies to investment properties which
  - are carried at revalued amounts under SSAP 13."

Implied that
- an investment property if under HKAS 16 would be depreciable, like land in HK,
- the conclusion in HK(SIC) Interpretation 21 is not applicable to that property

2. Conclusions

- The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset under the revaluation model of HKAS 16 (HKAS 16.31) should be measured
  - on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale,
    - regardless of the basis of measuring the carrying amount of that asset.

No depreciation implies
➢ not expected to recover from usage



3. Conclusions

Tax rate on sale ⟷ Not the same ⟷ Tax rate on usage

Used for non-depreciable asset

What's the implication on land in HK?

- Accordingly, if the tax law specifies
  - a tax rate applicable to the taxable amount derived from the sale of an asset
  - that differs from the tax rate applicable to the taxable amount derived from using an asset
    - ➢ the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

3. Implication to Property in HK

Tax rate on sale ⟺ Not the same ⟺ Tax rate on usage

Used for non-depreciable asset

What's the implication on land in HK?

- Remember the scope identified in issue before ……

- HK(SIC) Interpretation 21
  "also applies to investment properties which
  - are carried at revalued amounts under HKAS 40.33
  - but would be considered non-depreciable if HKAS 16 were to be applied."

Implied that
- an investment property if under HKAS 16 would be depreciable, like land in HK,
- the conclusion in HK(SIC) Interpretation 21 is not applicable to that property

3. Implication to Property in HK

Tax rate on sale ⟺ Not the same ⟺ Tax rate on usage

Used for non-depreciable asset

What's the implication on land in HK?

- It implies that
  - the management cannot rely on HK(SIC) Interpretation 21 to assume the tax consequences being recovered from sale
  - It has to consider which tax consequences that would follow from the manner in which the entity expects to recover the carrying amount of the investment property
- As an investment property is generally held to earn rentals
  - the profits tax rate would best reflect the tax consequences of an investment property in HK
  - unless the management has a definite intention to dispose of the investment property in future

Different from the past in most cases

CPA QP FPE: 2003 Dec Case II Q2b

Introduction

- You are auditing WTL's accounts for the year ended 30 Sep. 2003.
- Ms. Lee of WRL had a conversation with your assistant in their meeting.
- As the auditor of WTL, explain to Miss Lee the key deferred taxation implications arising from the issues identified if WTL adopted HKAS 12.

Sourced from HKICPA

CPA QP FPE: 2003 Dec Case II Q2b

Answers

- Under HKAS 12, it is inherent in the recognition of an asset that the reporting enterprise expects to recover the carrying amount of that asset through receipt of cash or other assets, through use, through sale, or through use and subsequent sale.
- These expected future economic benefits associated with an asset are generally taxable and the enterprise's investment in the asset is deductible against this taxable income under the relevant tax jurisdiction.
- If the carrying amount of the recognised asset at a given date is higher than the deductible amount for income tax purposes at that date
  - a net taxable amount will result in future periods when the carrying amount of the assets is recovered
    i.e. a *taxable temporary difference* arises.

CPA QP FPE: 2003 Dec Case II Q2b

Answers

- If the carrying amount of the recognised asset at a given date is lower than the deductible amount for income tax purposes at that date
  - a net deductible amount will result in future periods when the carrying amount of the assets is recovered
    i.e. a *deductible temporary difference* arises.
- HKAS 12 requires that deferred tax charges or credits should be recognised as income or an expense and included in the net profit or loss for the period.
- However, deferred tax charges or credits should be charged or credited directly to equity to the extent that the tax arises from a transaction or event which is charged, in the same or a different period, directly in equity.
- HKAS 12 does not set out specific transitional arrangement, therefore, it should be applied retrospectively in accordance with HKAS 8 when it is first adopted, unless this is not practical.

CPA QP FPE: 2003 Dec Case II Q2b

An assistant noticed the following on WTL:

- We notice that your company's policy is to carry office for own use at valuation.
- The opening gross carrying amount was based on the valuation of 4 years ago.
- The market value of Office A at 30 Sep. 2003 was HK$32 million.
- The original cost of Office A was HK$2 million and the tax written down value at 1 Oct. 2002 was HK$500,000.
- During the year ended 30 Sep. 2003, capital allowance claimed was HK$100,000.
- Depreciation charged for the year was HK$1.5 million and the opening carrying amount was HK$38 million.
- At a tax rate of 16%, there would be a very significant deferred tax implication for this year's financial statements.

In fact, it is also testing your basic accounting knowledge in PPE!

Sourced from HKICPA

CPA QP FPE: 2003 Dec Case II Q2b

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- Depreciation charged for the year was HK$1.5 million and the opening carrying amount was HK$38 million.
- At a tax rate of 16%, there would be a very significant deferred tax implication for this year's financial statements.

At 1 Oct. 2002 (Opening)
Carrying amount
(given) = $38 M
Tax base (given) = $500,000
Temporary difference = $37.5 M

At 30 Sep. 2003
Carrying amount
($38 M – $1.5 M) = $36.5 M
Tax base
($500K – $100K) = $400,000
Temporary difference = $36.1 M

Taxable ~~or deductible?~~

CPA QP FPE: 2003 Dec Case II Q2b

Dr PPE Revaluation Reserves ($37.5M x 16%) $6 M
Cr Deferred tax liabilities $6 M

Dr Deferred tax liabilities
($36.1M x 16% = $5.776M)
($5.776M – $6M) $224,000
Cr Tax expenses – Deferred tax $224,000

At 1 Oct. 2002 (Opening)
Carrying amount
(given) = $38 M
Tax base (given) = $500,000
Temporary difference = $37.5 M

At 30 Sep. 2003
Carrying amount
($38 M – $1.5 M) = $36.5 M
Tax base
($500K – $100K) = $400,000
Temporary difference = $36.1 M

Did you notice?

- The market value of Office A at 30 Sep. 2003 was HK$32 million.
- How's the effect if write-down is made?

Taxable ~~or deductible?~~

CPA QP FPE: 2003 Dec Case II Q2b

Dr PPE Revaluation Reserves ($37.5M x 16%) $6 M
Cr Deferred tax liabilities $6 M

Dr Deferred tax liabilities ($36.1M x 16% = $5.776M) ($5.776M – $6M) $224,000
Cr Tax expenses – Deferred tax $224,000

Dr Deferred tax liabilities ($31.6M x 16% = $5.056M) ($5.056 M – $5.776M) $720,000
Cr PPE Revaluation Reserves $720,000

At 1 Oct. 2002 (Opening)
Carrying amount (given) = $38 M
Tax base (given) = $500,000
Temporary difference = $37.5 M

At 30 Sep. 2003
Carrying amount ($38 M – $1.5 M) = $36.5 M
Tax base ($500K – $100K) = $400,000
Temporary difference = $36.1 M

At 30 Sep. 2003 (Revalued)
Carrying amount = $32 M
Tax base = $400,000
Temporary difference = $31.6 M

CPA QP FPE: 2003 Dec Case II Q2b

Assistant:

- Professional valuations of Office C (which is an investment property) and Office D (which is held for resale) as at 30 Sep. 2003 were HK$23 million and HK$28 million respectively, while their carrying amounts at that date was HK$25 million and HK$30 million respectively.
- We consider that these values should be reflected in this year's financial statements, since they account for more than 30% of your company's total assets.

Sourced from HKICPA

CPA QP FPE: 2003 Dec Case II Q2b

Answers

Office C

- Assuming that the depreciation allowances for Office C during the year were not material, total deductible temporary differences of HK$2 million ($23M – $25M) would arise for these investment properties when they were stated at their open market value at 30 Sep. 2003.
- The management has to consider which tax consequences that would follow from the manner in which the entity expects to recover the carrying amount of the investment property.
- As an investment property is generally held to earn rentals
  - the profits tax rate (i.e. 16%) would best reflect the tax consequences of an investment property in HK
  - unless the management has a definite intention to dispose of the investment property in future

CPA QP FPE: 2003 Dec Case II Q2b

Answers

Office D

- If WTL is able to claim deduction in respect of the diminution in value of Office D as trading stocks, there will be no temporary difference since the carrying amount was the same as the tax deductible amount when WTL recovers Office D in future periods.
- If WTL is not able to claim deduction in respect of the diminution in value of Office D, there will be a deductible temporary difference of HK$2 million in respective of Office D since the tax deductible amount of Office D was higher than its carrying amount by HK$2 million.

CPA QP FPE: 2003 Dec Case II Q2b

Assistant:

- We noticed that at 30 Sep. 2003, your company held some inventories acquired for distribution to FPI.
- Since the expected distribution agreement with FPI did not materialise and the goods have been made to FPI's specific requirements and USA standards, you may need to write-off the inventories if you are not able to sell them at a price above their cost before the approval of the financial statements.

Miss Lee

- The inventories at cost of HK$7 million were purchased for FPI and we are in the process of claiming from FPI for the losses we suffered.
- We are also contacting other buyers in the USA to try to sell these specialised goods.
- Some of them may be willing to take the inventories although we don't know whether this will happen at this moment.

Sourced from HKICPA

CPA QP FPE: 2003 Dec Case II Q2b

Answers

- If the inventories ordered for FPI were written off and if the write-off was not recognised for deduction for income tax purpose until a later year, a deductible temporary difference of HK$7 million would arise.
- HKAS 12 requires that a deferred tax asset should be recognised for such deductible temporary differences to the extent that
  - it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.
- It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when
  - there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse in the same period as the expected reversal of the deductible temporary difference or in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

CPA QP FPE: 2003 Dec Case II Q2b

Answers

- Since the taxable temporary difference at 30 Sep. 2003 relating to Office A was HK$31.6 million, it is likely that WTL would satisfy these conditions and could recognise the full amount of deferred tax asset of HK$1.12 million (HK$7 million x 16%) in relation to the inventories (and the possible deferred tax asset of HK$0.32 million (HK$2 million x 16%) in relation to Office D).
- Since the deferred tax assets arise as a result of the recognition of a cost of sales during the year in accordance with HKAS 2, the deferred tax credit should be recognised in WTL's income statement for the year ended 30 September 2003. (That is: debit "Deferred Tax Assets" by HK$1.12 million; credit "Tax Expense – Deferred tax" by HK$1.12 million.)
- If the write-off of inventories was recognised for tax deduction purpose in determining the assessable profit for the year, no temporary difference would arise and therefore no deferred tax asset should be recognised.

Financial Instrument (HKAS 39)

Summary of Changes

Scope	• Extended the scope to all contract to buy and sell of non-financial items that meet the scope.
Definitions	• Financial instruments, including derivatives, are clearly defined.
Initial Recognition	• All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).
Measurement	• Except for strict conditions are fulfilled, all financial assets are measured at fair value
Derecognition	• Detailed derecognition rules are set out.

Initial Recognition

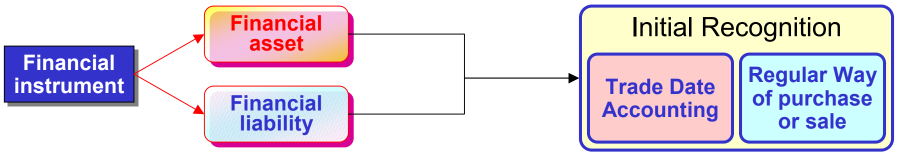
Scope

Definitions

Initial Recognition

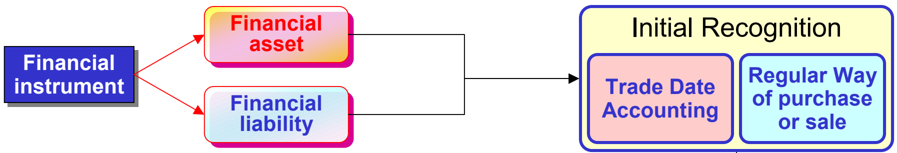
- All financial instruments, including derivatives, are recognised in the balance sheet (on balance sheet).

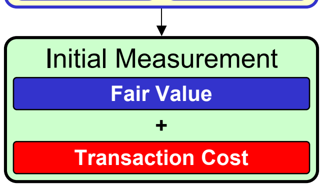
Initial Recognition



- An entity shall recognise financial instruments on its balance sheet when and only when the entity <u>becomes a party to the contractual provisions</u> of the instruments
  - ➢ Implies **trade date accounting** for all cases
  - ➢ Only **a regular way purchase or sale** (e.g. purchase of derivatives is not a regular way of purchase) can be accounted for by
    - either **trade date accounting** or **settlement date accounting**

Initial Recognition & Measurement





- When a financial asset or financial liability is recognised initially, an entity shall measure the **<u>financial asset</u>** or a **<u>financial liability</u>**
  - – at its ***fair value***
  - – plus transaction costs (except for those classified *at fair value through profit or loss*)

Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of HK$50,000 to an important new customer in 1 Jan. 2005
  - The interest rate on the loan is 4%
  - The current market lending rates for similar loans to customers with a similar credit risk profile is 6%
- Entity A believes that the future business to be generated with this new customer will lead to a profitable lending relationship.

- On initial recognition, Entity A should recognise the carrying amount of the loan at the fair value of the payments that it will receive from the customer.
- How is the fair value of the payments at initial recognition calculated?

Initial Recognition & Measurement

Example

	Cash inflow	Discount factor	Present value
31.12.2005	\$ 50,000 x 4% = \$ 2,000	$1 / (1 + 6\%)^1$	\$ 1,887
31.12.2006	\$ 2,000	$1 / (1 + 6\%)^2$	\$ 1,780
31.12.2007	\$ 52,000	$1 / (1 + 6\%)^3$	\$ 43,660
		Fair value at initial recognition	*\$ 47,327*

- Discounting the interest and principal repayments using the market rate of 6%, Entity A will recognise an originated loan of HK$47,327.
- The difference of HK$2,673 is expensed immediately
  - as the expectation about future lending relationships does not qualify for recognition as an intangible asset.

Measurement after Recognition

Scope

Definitions

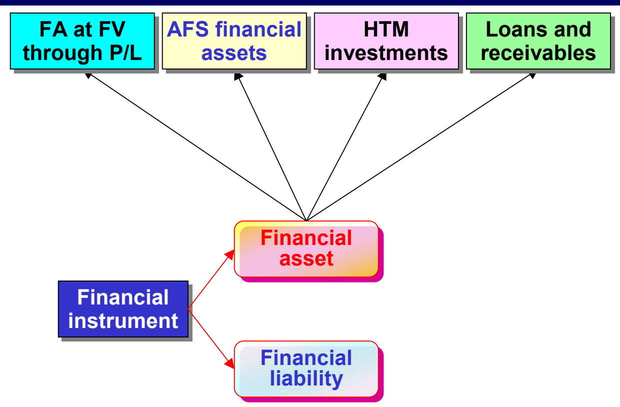
Initial Recognition

Measurement

- Except for strict conditions are fulfilled, all financial assets are measured at fair value

4-category classification will <u>affect the subsequent measurement</u> of financial assets (but <u>not the initial measurement</u>).

Measurement – Classification



4-category classification will <u>affect the subsequent measurement</u> of financial assets (but <u>not the initial measurement</u>).

Measurement – Classification

FA at FV through P/L

Definition – for Financial Assets at Fair Value through P/L

A financial asset that meets either of the following 2 conditions.

a) It is classified as **held for trading**, if: **An entity has NO choice**

i) it is acquired/incurred principally for the purpose of selling or repurchasing it in the near term;

ii) there is evidence of a recent actual pattern of short-term profit-taking on it; or

iii) a derivative
(except for a designated and effective hedging instrument)

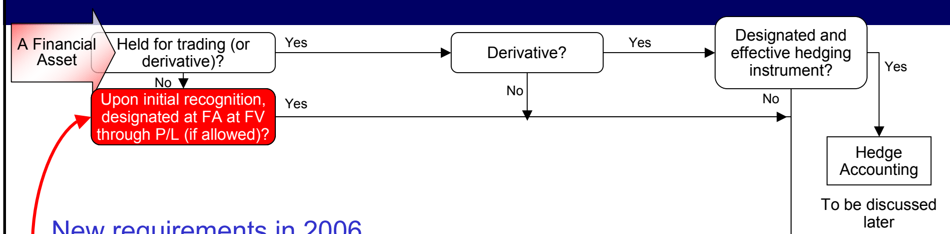
b) Upon **initial recognition** it is **designated** by the entity as at fair value through profit or loss, except for investments in equity instruments that **An entity has a choice**

- do not have a quoted market price in an active market, and
- whose fair value cannot be reliably measured.

But …… new requirements for 2006

Measurement – Classification

Financial asset



New requirements in 2006

– The Fair Value Option (Jul. 2005)

- Restrict a company's option in designating a financial asset (or financial liability) at FV through P/L
- Only allow to designate if conditions are met

3 Conditions to Designate

FA at FV through P/L

Measurement – Classification

Financial asset

FA at FV through P/L

Definition – for Financial Assets at Fair Value through P/L

Effective from 1.1.2006: Upon initial recognition, an entity may designate a financial asset or financial liability as at fair value through profit or loss only:

- when permitted by paragraph 11A of HKAS 39 (in order to avoid separation of embedded derivative from hybrid contract), or
- when doing so results in more relevant information, because either
  - i) it eliminates or significantly reduces a measurement or recognition inconsistency
  - ii) financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

1. Embedded Derivative Condition

2. Eliminates Inconsistency

3. Managed on Fair Value Basis

3 Conditions to Designate

Measurement – Classification

FA at FV through P/L

AFS financial assets

Definition – for Available-for-sale financial assets

- Those non-derivative financial assets that are designated as available for sale, or
- Those not classified into other categories

An entity has a choice

- Implies
  - ⇒ Except for those held for trading, all the remaining financial assets can be designated as AFS financial assets
  - ⇒ Loans and receivables and HTM investments can also be initially designated as AFS financial assets

Measurement – Classification

FA at FV through P/L | AFS financial assets | **HTM investments**

Definition
for Held-to-Maturity Investments

- Non-derivative financial assets with fixed or determinable payments and fixed maturity
- That the entity has the positive intention and ability to hold to maturity, other than
  - those initially designated as FA at FV through P/L
  - those designated as AFS financial assets
  - those that meet the definition of loans and receivables

- A debt instrument with a variable interest rate can satisfy the criteria for a HTM investment.
- Equity instruments cannot be HTM investments either
  - because they have an indefinite life (such as ordinary shares) or
  - because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights).

Measurement – Classification

Subject to **Tainting Rule** below | **HTM investments**

Definition
for Held-to-Maturity Investments

An entity shall not classify any financial assets as held to maturity
- if the entity has,
  - during the current financial year or
  - during the two preceding financial years,
  - sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity
    (more than insignificant in relation to the total amount of held-to-maturity investments)

Measurement – Classification

FA at FV through P/L | AFS financial assets | HTM investments | **Loans and receivables** | Definition

- Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than
  - those the entity intends to sell immediately or in the near term (which shall be classified as held for trading)
  - those initially designated as FA at FV through P/L
  - those initially designated as AFS financial assets
  - those for which the holder may not recover substantially all of its the initial investment, other than because of credit deterioration, which shall be classified as AFS financial assets
- An interest acquired in a pool of assets that are not loans or receivables is not a loan or receivable (for example, an interest in a mutual fund or a similar fund).
- Examples include:
  loan assets, trade receivables, rental deposits, deposits held by banks ……

Measurement after Recognition

Classification determine
Subsequent Measurement

FA at FV through P/L — **at Fair Value** (to P/L)

AFS financial assets — **at Fair Value** (to equity)

at Cost

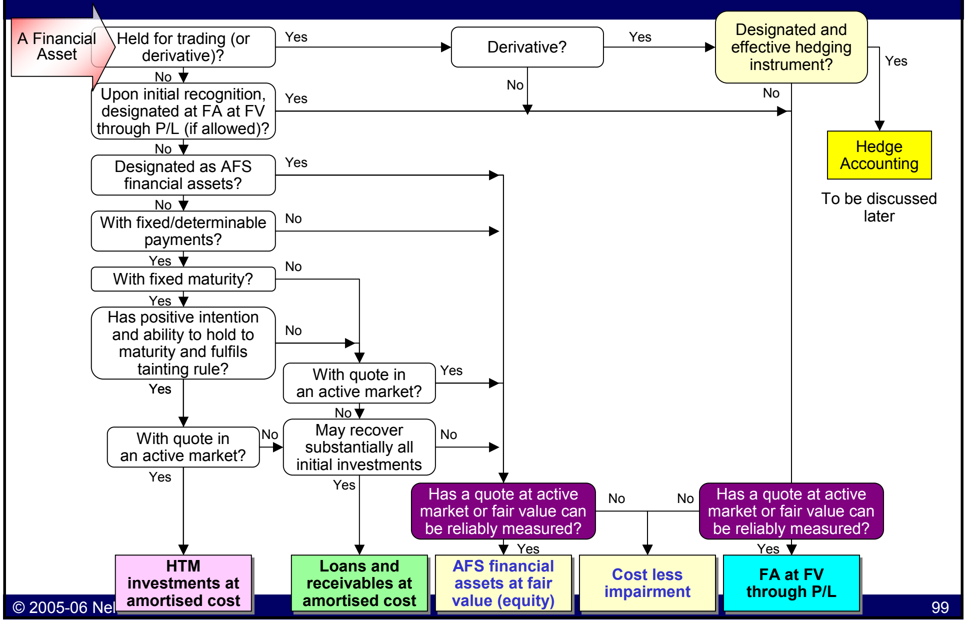
Except for
- investments in equity instruments that
  - do not have a quoted market price in an active market, and
  - whose fair value cannot be reliably measured

HTM investments — **at Amortised Cost**

Loans and receivables — **at Amortised Cost**

Amortised cost of a financial instrument is:
- amount at which the financial instrument is measured at initial recognition
- minus principal repayments,
- plus or minus the cumulative amortisation using **the effective interest method**, and
- minus any reduction for impairment or uncollectibility.

Measurement after Recognition



CPA QP – A: 2006 Feb Essay Q3(1)

- APES has the following investments as at 31 December 2005:
  - An investment in 300,000 ordinary shares of Silvermine Holding Limited (“SHL”) at a cost of HK$14.5 per share.
  - SHL’s ordinary shares are listed on the Hong Kong Stock Exchange (“HKSE”).
  - The quoted market price (current bid price) per share as at 31 December 2005 is HK$22.
  - APES has considered this investment to be held for trading purposes.
- Determine and explain how APES should recognise and measure these investments in the consolidated balance sheet as at 31 December 2005 in accordance with relevant Hong Kong Financial Reporting Standards.

CPA QP – A: 2006 Feb Essay Q3(1)

Answers

Investment in SHL

- Because the investment in SHL is held for trading, it is considered as a financial asset at fair value through profit or loss under HKAS 39.
- After initial recognition, the investment in SHL shall be measured at fair value, without any deduction for transaction costs APES may incur on sale or other disposal.
- The investment is measured at its fair value as at 31 December 2005, i.e. the current bid price of HK$22 per share.
- Carrying amount as at 31 December 2005:
  – 300,000 x HK$22 = HK$6,600,000.

CPA QP – A: 2006 Feb Essay Q3(2)

- APES has the following investments as at 31 December 2005:
  – On 1 July 2005, APES acquired 250,000 ordinary shares of Top Trend Limited ("TTL"), a privately owned enterprise, at a cost of HK$18 per share from the sole shareholder.
  – TTL has 5,000,000 ordinary shares in issue.
  – APES considers itself a passive investor and has not participated in TTL's financing and operating policy decisions.
  – APES has not designated this investment as at fair value through profit or loss from the acquisition date.
  – Although TTL has reported a profit and declared dividends continuously in the past year, it is considered that the fair value of these shares cannot be reliably measured as at 31 December 2005.
- Determine and explain how APES should recognise and measure these investments in the consolidated balance sheet as at 31 December 2005 in accordance with relevant Hong Kong Financial Reporting Standards.

CPA QP – A: 2006 Feb Essay Q3(2)

Answers

Investment in TTL

- The investment is classified as an available-for-sale financial asset under HKAS 39.
- After initial recognition, an available-for-sale financial asset shall be measured at its fair value, without any deduction for transaction costs it may incur on sale or other disposal, except for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured.
- As the ordinary shares of TTL have similar features, the investment shall be measured at cost less impairment loss.
- The amount of impairment loss is measured as the difference between the carrying amount of the investment and the present value of estimated future cash flow discounted at the current market rate of return for a similar financial asset.
- Assuming that the present value of the estimated future dividend discounted at the current market rate of return for a similar investment is greater than cost, the investment would be stated at HK$4,500,000 in APES's consolidated balance sheet as at 31 December 2005.

CPA QP – A: 2006 Feb Essay Q3(3)

- APES has the following investments as at 31 December 2005:
  - On 1 January 2005, APES purchased a certificate of deposit issued by a bank at HK$2,264,000 in the market.
  - The certificate of deposit carries interest at 4.25% per annum and is due to be redeemed by the bank at the nominal value of HK$2,500,000 on 31 December 2008.
  - Interest is payable annually on 31 December.
  - APES intends to hold this investment up to the redemption date.
  - The effective yield on the investment is approximately 6%.
- Determine and explain how APES should recognise and measure these investments in the consolidated balance sheet as at 31 December 2005 in accordance with relevant Hong Kong Financial Reporting Standards.

CPA QP – A: 2006 Feb Essay Q3(3)

Answers

Investment in certificate of deposit

- The investment is classified as loans and receivables under HKAS 39 as it is a non-derivative financial asset with fixed and determinable payment that is not quoted in an active market.
- If the investment is quoted in an active market, it is classified as held-to-maturity investment.
- It shall be measured at amortised cost using the effective interest method.
- Calculation of the amortised cost:
  - HK$[2,264,000 x (1 + 6%)] - (2,500,000 x 4.25%) = HK$2,293,590.

Measurement – Impairment

	Subsequent Measurement
FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value at Cost
HTM investments	at Amortised Cost
Loans and receivables	at Amortised Cost

Impairment

At each balance sheet date

- assess whether there is any objective evidence that a financial asset (or group of financial assets) is impaired.
- Conditions must be fulfilled in recognising impairment loss.

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at **Fair Value** →	• Implicitly, no impairment review is needed as gain or loss on change in fair value is recognised in profit or loss
AFS financial assets	at **Fair Value** →	• 2 conditions to effect impairment loss 1. when a decline in its fair value has been recognised directly in equity and 2. there is objective evidence that it is impaired • Then, the cumulative loss recognised directly in equity shall be • removed from equity and • recognised in profit or loss even the asset has not been derecognised.
	at **Cost** →	• Impairment loss is measured as the difference between • the carrying amount of the financial asset, and • the present value of estimated future cash flows discounted at the current market rate of return <u>for a similar financial asset</u>.
HTM investments		
Loans and receivables		

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L — at Fair Value

AFS financial assets — at Fair Value / at Cost

HTM investments — at **Amortised Cost** →

Loans and receivables — at **Amortised Cost** →

- The amount of impairment loss is measured as the difference between
  - the asset's <u>carrying amount</u>, and
  - the <u>present value of estimated future cash flows</u> (excluding future credit losses that have not been incurred) discounted at the financial asset's <u>original effective interest rate</u> (i.e. the effective interest rate computed at initial recognition)
- The carrying amount of the asset shall be reduced either
  - <u>directly</u> or
  - through <u>use of an allowance account</u>.
- The amount of the loss shall be recognised in <u>profit or loss</u>.

Measurement – Impairment

Outside the scope of HKAS 36

Impairment (if there is objective evidence)

FA at FV through P/L	at Fair Value
AFS financial assets	at Fair Value at Cost
HTM investments	**at Amortised Cost**
Loans and receivables	**at Amortised Cost**

Implication?

Sequence of Impairment Assessment

- First assesses whether objective evidence of impairment exists
  - individually for financial assets that are individually significant, and
  - individually or collectively for financial assets that are not individually significant.
- If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not
  - it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.
- Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

Measurement – Impairment

Example

Impairment Based on Ageing Analysis

- Entity A calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix
  - that specifies fixed provision rates for the number of days a loan has been classified as non-performing as follows:
    - 0% if less than 90 days
    - 20% if 90-180 days
    - 50% if 181-365 days, and
    - 100% if more than 365 days
- Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables?

Not necessarily.

- HKAS 39 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

CPA QP FPE: 2004 Dec Case II Q2

- Long Life Trading Limited ("Long Life"), a customer that Fat Choy has been doing business with for years, is facing short-term cash flow problems and is therefore not able to repay its trade debts for the last 6 months.
- This customer accounts for approximately 15% of Fat Choy's annual sales.
- Fat Choy's auditors, ABC & Company, suggested full allowance for the entire amount outstanding.

- Required:
  Advise Fat Choy of the appropriate accounting treatment for the above issue.

CPA QP FPE: 2004 Dec Case II Q2

Answers

- Theoretically, all receivables should be valued at an amount representing the present value of the expected future cash receipts. Since trade debts are short term, the amount of interest is small relative to the amount of the receivable.
- Consequently, the interest element for these trade debts is often ignored.
- Instead of valuing trade debts at a discounted present value, they are usually reported at their net realisable value, i.e. their expected cash value.
- This means that trade debts should be recorded net of estimated uncollectible items.
- Invariably, some trade debts will prove uncollectible.
- The simplest method for recognising the loss from these uncollectible accounts is to debit the expense and credit accounts receivable at the time it is determined that an account cannot be collected (direct write-off).
- Although the recognition of uncollectible debts in the period of their discovery is simple and convenient, this method does not provide for the matching of expenses with current revenues and does not report receivables at their expected cash value.
- Therefore procedures in estimating uncollectible debts by the allowance method is required.

CPA QP FPE: 2004 Dec Case II Q2

Answers

- As a result of the uncertainties inherent in business activities, many financial statement items including the bad debts cannot be measured with precision but can only be estimated.
- The estimation process involves judgements based on the latest information available (HKAS 8).
- *(For the purpose of this suggested solution, application of HKAS 39 is assumed though HKAS 39 prohibits early adoption.)*
- In accordance with HKAS 39, loans and receivables are
  - non-derivative financial assets
  - with fixed or determinable payments
  - that are not quoted in an active market, other than those:
    - that the entity intends to sell immediately or in the near term;
    - that the entity upon initial recognition designates as available-for-sale financial assets; or
    - for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration.
- Therefore, the trade receivables should be classified as loans and receivables and are subject to the relevant requirements of HKAS 39.

CPA QP FPE: 2004 Dec Case II Q2

Answers

- HKAS 39 requires that, after initial recognition, an entity should measure loans and receivables at amortised cost using the effective interest method.
- The amortised cost of a financial asset is:
  - the amount at which the financial asset is measured at initial recognition; minus
  - principal repayments; plus or minus
  - the cumulative amortisation using the effective interest method of the difference between the initially recognised amount and the maturity amount; and minus
  - any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.
- For the trade receivables from Fat Choy, there is no principal repayment and no difference between the initially recognised amount and the maturity amount.
- The amortised cost of the receivables from Fat Choy should therefore be the amount measured at its initial recognition less any reduction for impairment or uncollectibility.

CPA QP FPE: 2004 Dec Case II Q2

Answers

- HKAS 39 requires that if there is objective evidence that an impairment loss on loans and receivables carried at amortised cost has been incurred, the amount of the loss is measured as the difference between:
  - the asset's carrying amount; and
  - the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition).
- The carrying amount of the asset should be reduced either directly or through use of an allowance account.
- The amount of the loss should be recognised in profit or loss.
- Therefore Fat Choy's management needs to include a degree of caution in the exercise of judgments of estimates of bad debts required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.
- In this case, it is noted that Long Life is facing a short-term cash flow problem and therefore is not able to repay the trade debts it has owed to Fat Choy for the last 6 months. This information clearly indicates that an estimate is required of the amount which may be uncollectible.

Measurement – Summary

	Subsequent Measurement	Impairment	Reversal	Reclassification
FA at FV through P/L	at Fair Value to P/L	Not required	N/A	Not allowed
AFS financial assets	at Fair Value to Equity at Cost	From Equity to P/L To P/L	Related objectively to an event for debt instrument only	To HTM or AFS at Cost To AFS at Fair Value
HTM investments	at Amortised Cost	To P/L	Related objectively to an event	To AFS
Loans and receivables	at Amortised Cost	To P/L	Related objectively to an event	Not described in HKAS 39; implicitly, not feasible

CPA QP FPE: 2005 Jun Case II Q2a

- On 1 October 2004, to enhance its investment portfolio, GFL used $10 million to purchase from the market the debt instrument issued by Hong Kong Mortgage Corporation Limited ("HKMCL") on 24 February 2004 with maturity date 26 February 2007 and another $10 million to purchase the debt instrument issued by HKMCL on 24 February 2004 with maturity date 24 February 2011.
- GFL intends to hold the debt instruments until their maturity.
- During the year ended 31 March 2005, GFL received interest income of $0.2 million on the debt instrument with maturity date 26 February 2007 and interest income of $0.25 million on the debt instrument with maturity date 24 February 2011.
- Required:
  Discuss the accounting treatment of GFL's investment in the debt instruments issued by HKMCL.
- What will happen if GFL later changes its intention and does not hold them until maturity? (10 marks)

CPA QP FPE: 2005 Jun Case II Q2a

Answers

- In accordance with HKAS 39, when the debt instruments, as financial asset, are recognised initially, GFL should measure them at their fair values plus transaction costs that are directly attributable to the acquisition of the debt instruments.
- For the purpose of measuring the debt instruments after initial recognition, HKAS 39 classifies financial assets into four categories:
  a) financial assets at fair value through profit or loss;
  b) held-to-maturity investments;
  c) loans and receivables; and
  d) available-for-sale financial assets.
- In this case, the debt instruments would fall within the definition of held-to-maturity investments since the debt instruments are non-derivative financial assets with determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity and they are not:
  a) those that the entity upon initial recognition designates as at fair value through profit or loss;
  b) those that the entity designates as available for sale; and
  c) those that meet the definition of loans and receivables.

CPA QP FPE: 2005 Jun Case II Q2a

Answers

- Therefore, after initial recognition, GFL should measure the debt instruments as held-to-maturity investments at amortised cost using the effective interest method.
- The effective interest method would allocate the interest income over the relevant period using the effective interest rate which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument, or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.
- When calculating the effective interest rate, GFL should estimate cash flows considering all contractual terms of the debt instruments but shall not consider future credit losses.
- The calculation includes all fees paid or received between parties to the contract that are integral parts of the effective interest rate (see HKAS 18), transaction costs, and all other premiums or discounts.

CPA QP FPE: 2005 Jun Case II Q2a

Answers

- If there is objective evidence that an impairment loss on the held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss should be measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition).
- The carrying amount of the asset shall be reduced either directly or through use of an allowance account.
- The amount of the loss shall be recognised in profit or loss.
- If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for directly in equity, through the statement of changes in equity.
- Subsequently, the debt instruments, as available-for-sales financial assets, should be measured at their fair values, without any deduction for transaction costs which may be incurred on sale or other disposal.

CPA QP FPE: 2005 Jun Case II Q2a

Answers

- GFL shall not classify any financial assets as held to maturity if GFL has,
  - during the current financial year or
  - during the two preceding financial years,

  sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments), other than sales or reclassifications that:

  i) are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;

  ii) occur after GFL has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or

  iii) are attributable to an isolated event that is beyond GFL's control, is non-recurring and could not have been reasonably anticipated by GFL.

Derecognition

Scope

Definitions

Initial Recognition

Measurement

Derecognition

- Detailed derecognition rules are set out.

Financial instrument → Financial asset

Financial instrument → Financial liability

Derecognition of Financial Assets

An entity shall derecognise a **financial asset** when, and only when:

a) the contractual rights to the cash flows from the financial asset expire; or

b) it transfers the financial asset, and the transfer qualifies for derecognition

Direct derecognition

Further Test 1: Asset Transfer Test

Further Test 2: Risk and Reward Test

General principles

- **If passing both Further Tests ⇒ derecognise the asset**
- **If not passing Asset Transfer Test ⇒ not derecognise the asset**
- **If passing the Asset Transfer Test, but not passing Risk and Reward test ⇒ consider the entity's control over the asset, and extent of continuing involvement**

Derecognition of Financial Assets

Consolidate all subsidiaries (including any SPE) [Para. 15]

↓

Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets) [Para. 16]

↓

Have the rights to the cash flows from the asset expired? [Para. 17(a)] — Yes → **Derecognise the asset**

↓ No

Has the entity transferred its rights to receive the cash flows from the asset? [Para. 18(a)] — Yes → (to "Has the entity transferred substantially all risks and rewards")

↓ No

Has the entity assumed an obligation to pay the cash flows from the asset that meets the conditions in paragraph 19? [Para. 18(b)] — No → **Continue to recognise the asset**

↓ Yes

Has the entity transferred substantially all risks and rewards [Para. 20(a)] — Yes → **Derecognise the asset**

↓ No

Has the entity retained substantially all risks and rewards? [Para. 20(b)] — Yes → **Continue to recognise the asset**

↓ No

Has the entity retained control of the asset? [Para. 20(c)] — No → **Derecognise the asset**

↓ Yes

Continue to recognise the asset to the extent of the entity's continuing involvement

Derecognition of Financial Assets

- If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall
  - continue to recognise the transferred asset in its entirety
  - recognise a financial liability for the consideration received
  - in subsequent periods, recognise
    - any income on the transferred asset and
    - any expense incurred on the financial liability.

Recognise (create) a financial liability

Consideration received

Has the entity retained substantially all risks and rewards? [Para. 20(b)]

Yes

Continue to recognise the asset

Derecognition of Financial Assets

Example

For SMEs/SMPs ⇒ say Discounted Bills, Factored Trade Receivables
For larger entities ⇒ say Strip and Total return swap

Let's analyse a bill discounted to bank
⇒ At present, most entities derecognise bill receivable discounted to bank and disclose it as contingent liability
⇒ Is it appropriate under new derecognition criteria?

The contractual rights to receive the asset's cash flows are transferred

If the debtor is default on the payment, the entity has to repay the bank ⇒ risks are retained by the entity

Continue to recognise the bill receivables, and recognise a financial liability

CPA QP FPE: 2005 Jun Case II Q2b

- The $20 million used to purchase the debt instruments was borrowed by GFL from Credit Bank at an interest rate of 4% per annum.
- On 1 January 2005 (i.e. three months before 31 March 2005), GF Inc. entered into a loan sub-participation arrangement with Credit Bank.
- Under the arrangement, GF Inc. advanced a loan of $12 million at an interest rate of 4% per annum to Credit Bank on condition that repayment of the principal and interest of this loan would only be made on condition of the repayment of the principal and interest of the bank loan by GFL to Credit Bank.
- Credit Bank is prohibited from selling or pledging the loan to another party other than GF Inc.
- Besides, Credit Bank has an obligation to remit without material delay to GF Inc. upon its receipt of interest from GFL.
- During the year ended 31 March 2005, GFL paid interest of $0.4 million to Credit Bank whereas Credit Bank paid interest of $0.12 million to GF Inc.
- Required:
  Explain the concept of substance over form with reference to Credit Bank's loan sub-participation arrangement with GF Inc. (10 marks)

CPA QP FPE: 2005 Jun Case II Q2b

Answers

Substance over form

- The Framework for the Preparation and Presentation of Financial Statements indicates that the principle of substance over form applies if information is to represent faithfully the transactions and other events that it purports to represent.
- In other words, it is necessary that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
- The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form.
- For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist to ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset.
- In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).
- Sometimes, we have to consider a series of transaction as a whole to find out the substance of the activities.

CPA QP FPE: 2005 Jun Case II Q2b

Answers

Loan sub-participation arrangement

- In legal form, with the loan sub-participation arrangement, Credit Bank would create a new liability (the loan from GF Inc.) amounting to $12 million.
- The main issue with the loan sub-participation arrangement is whether Credit Bank has in substance transferred the risks and rewards of its financial assets (the loan to GFL) since the arrangement was made on condition that the repayment by Credit Bank to GF Inc. would only be made on condition of repayment by GFL to Credit Bank.
- HKAS 39 specifies that an entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer.
- An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset.

CPA QP FPE: 2005 Jun Case II Q2b

Answers

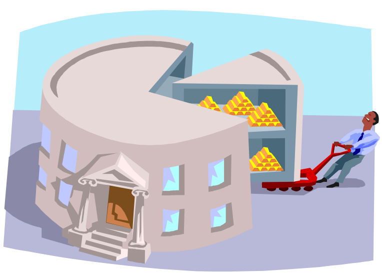
- HKAS 39 also states that when an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset', i.e. the loan to GFL), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients', i.e. GF Inc.), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the three conditions are met:
- In this case:
  a) Credit Bank has no obligation to pay amounts to the GF Inc. (eventual recipients) unless it collects equivalent amounts from the original asset.
  b) Credit Bank has an obligation to remit any cash flows it collects on behalf of the GF Inc. (eventual recipients) without material delay.
  c) Credit Bank is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to GF Inc. (eventual recipients) for the obligation to pay them cash flows.
- If substantially all the risks and rewards of ownership of this financial asset have been transferred, Credit Bank should derecognise the loan to GFL, rather than recognising a new obligation.

CPA QP FPE: 2005 Jun Case II Q2b

Answers

- A loan sub-participation is an example of an arrangement that has been quoted in HKAS 39 as meeting the three conditions necessary to treat the transaction as a transfer of a financial asset.
- HKAS 39 requires that arrangements that pass cash flows through one enterprise to another result in the financial asset being derecognised rather than a new obligation being recognised.
- Another important issue is whether and which pro-rata arrangements will be valid.
- In particular, can the original $20 million loan to GFL be partially extinguished by a transferred cash flow or does the transferred cash flow have to be equal to the obligation under the liability?
- In this case, Credit Bank has transferred only a portion of the original asset, and thus shall derecognise only a portion of its loan to GFL and recognise separately as assets the rights retained in the transfer.

Share-based Payment (HKFRS 2)



Share-based Payment

A Share-based payment transaction is

- A transaction in which the entity receives or acquires goods or services
  - as consideration for equity instruments of the entity (including shares or share options), or
    → e.g. Employee share option (ESO)
  - by incurring liabilities to the supplier of those good or services for amounts that are based on the price of the entity's shares or other equity instruments of the entity
    → e.g. Share appreciation rights

Equity-settled SBP transactions | **Cash-settled SBP transactions**

If either the entity or the supplier has a choice

SBP transactions with cash alternatives

Share-based Payment

Equity-settled SBP transactions

Recognition

- In the past, no recognition ⇒ Now, all share-based payment transactions shall be recognised

Measurement

- Using Fair Value measurement basis
  - To measure the goods or services received at the fair value of the goods or services received *(unless that fair value cannot be estimated reliably)*
  - To measure by reference to the fair value of the equity instruments granted *(if the entity cannot estimate reliably the fair value of the goods or services received)*

What is Fair Value of equity instruments, say share options?
- *Market price*, if available
- If market price is not available, *valuation model* (say option pricing model) can be used to estimate the Fair Value

Share-based Payment

Equity-settled SBP transactions

Recognition

- In the past, no recognition ⇒ Now, all share-based payment transactions shall be recognised

e.g. Employee share option (ESO)

Measurement

a. For transactions with employees and others providing similar services:

- To measure by reference to the fair value of the equity instruments granted *(as it is typically not possible to estimate reliably the fair value of employee services received)*
- The fair value of the equity instruments granted is measured at grant date

b. For transactions with other:

- There is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably.
- The fair value is measured at the date obtaining the goods or services

Share-based Payment

Equity-settled SBP transactions

When the goods or services received or acquired in a share-based transaction do not qualify for recognition as assets, they shall be recognised as expenses

→ e.g. over the vesting period of the share options

Recognition and Measurement

e.g. Share appreciation rights ← **Cash-settled SBP transactions**

- To measure the goods or services acquired and the liability incurred at the fair value of the liability
- To re-measure the fair value at each reporting date and at the date of settlement
- Any changes in fair value recognized in profit or loss in the period

CPA QP – A: 2005 May Essay Q4(a)

- On 1 April 2004, Best Compensation Company Limited, a listed company, adopted a share option plan that granted options to each of the four regional managers, Messrs. A, B, C and D, for the purchase of 100,000 shares of the company's ordinary shares of HK$1 par at an exercise price of HK$20 per share.
- The options granted on 1 April 2004 are exercisable within a two-year period beginning one year after the date of grant, provided that the manager is still an employee of the company when he exercises the options.
- On the date of grant, Best Compensation Company Limited's share was trading at HK$18 per share, and the fair value of the share option for purchase of one share was determined to be HK$5.
- The company expects that all outstanding share options will vest.
- On 1 November 2004, one regional manager, Mr. C, resigned from the company and his option shares were cancelled. The market price of the company's share was HK$21 per share on that day.

CPA QP – A: 2005 May Essay Q4(a)

- The market price of the company's share was HK$23 per share as at 31 December 2004.
- On 1 June 2005, 30,000, 40,000 and 50,000 option shares were exercised by each of the remaining three regional managers, Messrs. A, B and D, respectively, when the market price of the company's share was HK$28 per share.
- On 1 August 2005, Mr. A resigned from the company and his unexercised option shares were cancelled.
- The market price of the company's share was HK$26 per share on that day.

Required:

- Calculate the amount of compensation expense in relation to the share options granted by Best Compensation Company Limited for the year ended 31 December 2004 and the year ending 31 December 2005 respectively. (8 marks)

CPA QP – A: 2005 May Essay Q4(a)

Answers

- The amount of compensation expense in relation to the share options recognised in the income statement for the year ended 31 Dec. 2004:
  - As at 31 Dec. 2004, the company expected that all the 300,000 outstanding share options (400,000 – 100,000) would vest.
  - Based on the fair value of the share option at the date of grant, i.e. HK$5, total equity-settled share-based payment to the managers should be HK$1,500,000 (300,000 x HK$5).
  - This equity-settled share-based payment shall be expensed over the vesting period, i.e. from 1 April 2004 to 31 March 2005.
  - The total compensation expense for the year ended 2004 should therefore be HK$1,125,000.
  - Calculation: 300,000 x (9/12) x HK$5.

CPA QP – A: 2005 May Essay Q4(a)

Answers

- The amount of compensation expense in relation to the share options recognised in the income statement for the year ending 31 December 2005:
  - At the end of the vesting period, i.e. 31 March 2005, a total of 300,000 share options ultimately vested.
  - Based on the fair value of the share option at the date of grant, i.e. HK$5, the total compensation expense should therefore be HK$1,500,000 (300,000 x HK$5).
  - Since a total of HK$1,125,000 has been recognised in the year ended 31 December 2004, compensation expense for the three months ended 31 March 2005, and hence for the year ending 31 December 2005 should be HK$375,000 (HK$1,500,000 – HK$1,125,000).

CPA QP – A: 2005 May Essay Q4(b)

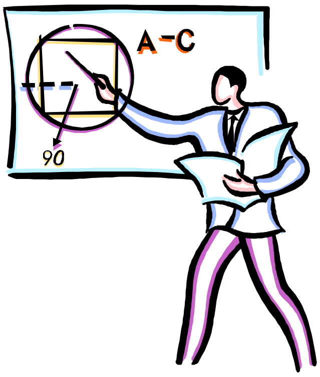
- Explain the principal differences in accounting treatment if share appreciation rights instead of a share option had been granted to the managers of Best Compensation Company Limited (4 marks)

- Share appreciation rights are examples of cash-settled share-based payments, as compared with a share option which is an example of equity-settled share-based payment.
  - Cash-settled share-based payments are share-based payment transactions that will be settled in cash or other assets (rather than with an entity's own equity instruments).
  - The amount of services received (i.e. the compensation expense incurred) during the period and liability recognised at each reporting date, shall be based on the fair value of share appreciation rights at each reporting date.
  - Unlike the amount of service recognised for the share options which were measured at their fair value at the grant date, the liability of the share appreciation rights will continue to be remeasured at the fair value of the reporting date until the liability is settled.
  - Any changes in fair value of the share appreciation rights should be recognised in profit or loss for the period as a compensation expense.

EAS on Financial Reporting

22 October 2006

Full set of slides may be found in
www.NelsonCPA.com.hk



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