Issues in Presentation of Financial Statements

(HKAS 1, 7, 8 & 24)

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Today's Agenda

- HKAS 1 Presentation of Financial Statements
- HKAS 7 Cash Flow Statements
- HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- HKAS 24 Related Party Disclosures

Simple but Comprehensive

Contentious and key issues

Real Life Cases and Examples

Today's Agenda

HKAS 1 Presentation of Financial Statements

Presentation of Financial Statements (HKAS 1)

1. Purpose of financial statements
2. Components of financial statements
3. Overall considerations
4. Structure and content

1. Purpose of Financial Statements

- To provide information about
  - financial position,
  - financial performance, and
  - cash flows of an entity,

  That is useful to a wide range of users in making economic decisions
- To also show the results of management's stewardship of the resources entrusted to it

- To meet this objective, financial statements provide information about the entity's:
  - Assets
  - Liabilities
  - Equity
  - Income and expenses, including gains and losses
  - Other changes in equity
  - Cash flows

Thus, we have ……

2. Components of Financial Statements

A complete set of financial statements comprises:

a) a balance sheet;

b) an income statement;

c) a statement of changes in equity showing either: another name?

   i) all changes in equity, or

   ii) changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders;

d) a cash flow statement; and

e) notes, comprising a summary of significant accounting policies and other explanatory notes.

3. Overall Consideration

a) True and fair view and compliance with HKFRSs
b) Going concern
c) Accrual basis of accounting
d) Consistency of presentation
e) Materiality and aggregation
f) Offsetting
g) Comparative information

3. Overall Consideration

a) True and fair view and compliance with HKFRSs
- Financial statements shall give a true and fair view of the financial position, financial performance and cash flows of an entity.
  - True and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with
    - the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework.
  - The application of HKFRSs, with additional disclosure when necessary, is presumed to result in financial statements that give a true and fair view.

No such precisely statement before!

3. Overall Consideration

a) True and fair view and compliance with HKFRSs

- Statement of compliance
  - An entity whose financial statements comply with HKFRSs shall make an explicit and unreserved statement of such compliance in the notes.
  - Financial statements shall not be described as complying with HKFRSs
    - unless they comply with all the requirements of HKFRSs.
  - In virtually all circumstances, a true and fair view is achieved by
    - compliance with applicable HKFRSs.

3. Overall Consideration

a) True and fair view and compliance with HKFRSs

- A true and fair view also requires an entity:
  a) to select and apply accounting policies in accordance with HKAS 8
  b) to present information, including accounting policies, in a manner that provides ***relevant***, ***reliable***, ***comparable*** and ***understandable*** information.
  c) to provide additional disclosures
     - when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.
- Inappropriate accounting policies are not rectified either
  - by disclosure of the accounting policies used, or
  - by notes or explanatory material.

3. Overall Consideration

a) True and fair view and compliance with HKFRSs

- Departure from Standard or Interpretation (Simplified)
  - In the extremely rare circumstances in which management concludes that
    - compliance with a requirement in a standard or an interpretation would be so misleading that
    - it would conflict with the objective of financial statements set out in the Framework
      - ➢ the entity shall depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.

3. Overall Consideration

a) True and fair view and compliance with HKFRSs

- Departure from Standard or Interpretation (Simplified)
  - Then, the following disclosure is required:
    - a) management has concluded that the financial statements give a true and fair view;
    - b) that it has complied with applicable standards and interpretations, except that it has departed from a particular requirement;
    - c) the title of the standard or interpretation from which the entity has departed, the nature of the departure, the reason why that treatment would be so misleading, and the treatment adopted; and
    - d) for each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.

3. Overall Consideration

Case

Interim Report 2005 clearly stated that:

THE HONGKONG AND SHANGHAI HOTELS, LIMITED
香港上海大酒店有限公司

- The directors consider it inappropriate for the company to adopt two particular aspects of the new/revised HKFRSs as these would result in the financial statements, in the view of the directors, either:
  - not reflecting the commercial substance of the business or
  - being subject to significant potential short-term volatility, as explained below …….

3. Overall Consideration

Case

Interim Report 2005 clearly stated that:

THE HONGKONG AND SHANGHAI HOTELS, LIMITED
香港上海大酒店有限公司

- HKAS 40 "Investment property" requires an assessment of the fair value of investment properties.
- The group intends to follow the same accounting treatment as adopted in 2004, which is to value such investment properties on an annual basis.
- Accordingly, the investment properties were not revalued at 30 June 2005, since the directors consider that such change of practice could introduce a significant element of short-term volatility into the income statement in respect of assets which are being held on a long-term basis by the group ……
- It is not practicable to estimate the financial effect of this non-compliance as no interim valuation of the properties has been conducted.

At year-end, revaluation would still be conducted.

3. Overall Consideration

Case

Interim Report 2005 clearly stated that:

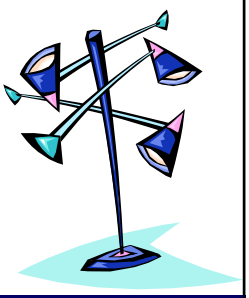
THE HONGKONG AND SHANGHAI HOTELS, LIMITED
香港上海大酒店有限公司

- HKAS 12 "Income Taxes", together with HKAS-INT 21 "Income Taxes – Recovery of Revalued Non-Depreciable Assets", requires deferred taxation to be recognised on any revaluation movements on investment properties.
  - It is further provided that any such deferred tax liability should be calculated at the profits tax rate in the case of assets which the management has no definite intention to sell.
- The company has not made such provision in respect of its HK investment properties since the directors consider that such provision would result in the financial statements not reflecting the commercial substance of the business
  - *since, should any such sale eventuate, any gain would be regarded as capital in nature and would not be subject to any tax in HK.*
- Should this aspect of HKAS 12 have been adopted, deferred tax liabilities amounting to HK$2,008 million on the revaluation surpluses arising from revaluation of HK investment properties would have been provided.

(estimate - over 12% of the net assets at 30 June 2005)

3. Overall Consideration

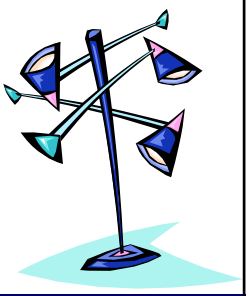
a) True and fair view and compliance with HKFRSs
- Departure but such departure is prohibited
  - In the extremely rare circumstances in which management concludes that
    - compliance with a requirement in a standard or an interpretation would be so misleading that
    - it would conflict with the objective of financial statements set out in the Framework
    - but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing ……



3. Overall Consideration

a) True and fair view and compliance with HKFRSs

- Departure but such departure is prohibited
  - by disclosing:
    a) the title of the standard or interpretation in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Framework; and
    b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to give a true and fair view.



3. Overall Consideration

a) True and fair view and compliance with HKFRSs

- When assessing whether complying with a specific requirement in a standard or an interpretation would be so misleading that it would conflict with the objective of financial statements set out in the Framework
  - management considers:
    a) why the objective of financial statements is not achieved in the particular circumstances; and
    b) how the entity's circumstances differ from those of other entities that comply with the requirement.
      - If other entities in similar circumstances comply with the requirement,
        - » there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the Framework.

3. Overall Consideration

Case

How's about this →

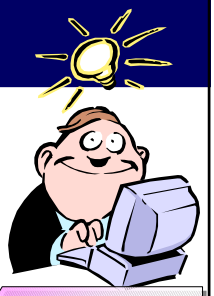
However, ***2005 Final Results Announcement*** disclosed that

- provision for deferred tax was finally made with regard to revaluation of the HK investment properties (total HK$2.2 billion) at 2005 year-end.

3. Overall Consideration

a) True and fair view and compliance with HKFRSs
b) Going concern
c) Accrual basis of accounting
d) Consistency of presentation
e) Materiality and aggregation
f) Offsetting
g) Comparative information

3. Overall Consideration



e) Materiality and Aggregation

- Each material class of similar items shall be
  - presented separately in the financial statements.
- Items of a dissimilar nature or function shall be
  - presented separately unless they are immaterial.
- Applying the concept of materiality means that a specific disclosure requirement in a HKFRS need not be satisfied if the information is not material.

What is the situation of recognition and measurement?

What is materials?

- Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements.
- Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances.
- The size or nature of the item, or a combination of both, could be the determining factor.

3. Overall Consideration

f) Offsetting

- Assets and liabilities, and income and expenses, shall not be offset
  - unless required or permitted by a HKFRS.
- It is important that assets and liabilities, and income and expenses, are reported separately.
  - Measuring assets net of valuation allowances — for example, obsolescence allowances on inventories and doubtful debts allowances on receivables — is not offsetting.

3. Overall Consideration

f) Offsetting

- During ordinary activities, some transactions that do not generate revenue but are incidental to the main revenue-generating activities.
  - The results of such transactions are presented, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction.
- For example:
  a) gains and losses on the disposal of non-current assets
     - including investments and operating assets, are reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses; and
  b) expenditure related to a provision
     - that is recognised in accordance with HKAS 37 and reimbursed under a contractual arrangement with a third party (for example, a supplier's warranty agreement) may be netted against the related reimbursement.

3. Overall Consideration

g) Comparative information

- Except when a HKFRS permits or requires otherwise, comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements.
- When the presentation or classification of items in the financial statements is amended, comparative amounts shall be reclassified unless the reclassification is impracticable.
- When comparative amounts are reclassified, an entity shall disclose:
  a) the nature of the reclassification;
  b) the amount of each item or class of items that is reclassified; and
  c) the reason for the reclassification.

Amended requirements

- **In the past**
  - only the reason for and a description of the nature of material reclassifications should be disclosed.
  - Exemption for disclosure of comparative information for the reconciliation of movements in fixed assets is also removed

4. Structure and Content

- Identification of the financial statements
- Reporting period
- Balance sheet
  1. Current/Non-current distinction
  2. Current assets
  3. Current liabilities
  4. Information to be presented on the face of the balance sheet
  5. Information to be presented either on the face of the balance sheet or in the notes
- Income statement
  1. Profit or loss for the period
  2. Information to be presented on the face of the income statement
  3. Information to be presented either on the face of the income statement or in the notes
- Statement of changes in equity
- Cash flow statement
- Notes

Current/Non-current Distinction

- An entity shall present
  - current and non-current assets, and
  - current and non-current liabilities,

  as separate classifications on the face of its balance sheet

- Except when a presentation based on liquidity provides information
  - If that information is reliable and is more relevant
  - When that exception applies, all assets and liabilities shall be presented broadly in order of liquidity

Current Assets

- An asset shall be classified as **current** when it satisfies any of the following criteria:
  a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
  b) it is held primarily for the purpose of being traded;
  c) it is expected to be realised within 12 months after the balance sheet date; or
  d) it is cash or a cash equivalent
     - unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the balance sheet date.

New requirements

- All other assets shall be classified as **non-current**.

Examples:
- Deposits pledged to bank (how long?)
- Fixed deposits over 1 year maturity

Current Assets

Case

Consolidated Balance Sheet

As at 31 December 2005

(Financial figures are expressed in Hong Kong Dollar)

香港交易所 HKEx

	Note	2005 $'000	As restated 2004 $'000
NON-CURRENT ASSETS			
Fixed assets	17(a)	257,876	324,300
Investment property	18	17,700	13,300
Lease premiums for land	19	94,123	94,670
Investments in associates	20	64,581	38,731
Clearing House Funds	21	1,340,410	1,861,487
Compensation Fund Reserve Account	22	38,410	37,451
Time deposit with maturity over one year		38,768	38,941
Contributions to The HKEx Employees' Share Award Scheme	31(c)	30,037	–
Deferred tax assets	36(e)	3,060	1,227
Other assets		20,374	13,142
		1,905,339	2,423,249

Current Assets

- Can a non-current asset reclassified if it fulfil the definition of current asset later?
  - Assets classified as non-current in accordance with HKAS 1 shall not be reclassified as current assets
    - until they meet the criteria to be classified as held for sale in accordance with HKFRS 5
  - Assets of a class that an entity would normally regard as non-current that are acquired exclusively with a view to resale shall not be classified as current
    - unless they meet the criteria to be classified as held for sale in accordance with HKFRS 5

No non-current assets can be classified as current unless the criteria in HKFRS 5 are fulfilled, mainly

- Available for immediate sale
- Highly probable to make the sale

Current Assets

Case

Li & Fung Limited

- In its 2005 Interim Report, full set of HKFRS was adopted and the report set out that:
  - Available-for-sale financial assets are non-derivatives that are either
    - designated in this category or
    - not classified in any of the other categories (i.e. loans and receivables, financial assets at fair value through profit or loss and held-to-maturity investments).
  - They are included in non-current assets
    - unless management intends to dispose of the investment within 12 months of the balance sheet date.

Similar in 2005 Annual Report

Is it current?

Current Liabilities

- A liability shall be classified as **current** when it satisfies any of the following criteria:
  a) it is expected to be settled in the entity's normal operating cycle;
  b) it is held primarily for the purpose of being traded;
  c) it is due to be settled within 12 months after the balance sheet date; or
  d) the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.
  New requirements
- All other liabilities shall be classified as **non-current**.

Implication

Current Liabilities

Revised rules on classifying a liability as current or non-current

- A liability held for traded ⇒ **current**
- A financial liability due within 12 months after the B/S date ⇒ **current**
  – even if an agreement to refinance on a long-term basis is completed after the B/S date *(only disclosed as non-adjusting event)*
    - If an entity has discretion to refinance ⇒ **non-current**
    - If an entity without discretion to refinance ⇒ **current**

- A non-current financial liability is payable on demand with a breach on a condition of its loan agreement on or before the B/S date
  – If the lender agreed not to demand payment
    - after the B/S date ⇒ **current** *(only disclosed as non-adjusting event)*
    - by the B/S date ⇒ **non-current**

Implication

Current Liabilities

Case

Note 12 to Interim Report 2006

- Breach of loan covenants
  - As at 30 June 2006, in respect of certain bank loans with an aggregate carrying amount of HK$1,529,806,000, the Group breached certain financial covenants of the banks loans.
  - Since the lenders have not agreed to waive its right to demand immediate payment as at the balance sheet date, the loans have been classified as current liabilities in these financial statements at 30 June 2006.

Current Assets and Liabilities

Example

Can the following be classified as current assets?

- 3-month fixed deposits pledged to a bank to secure a mortgage loan of 5 years ✗
- 2-year fixed deposits with a bank ✗

Can the following be classified as non-current liabilities?

- 5-year term loan matured after year end but renewed for another 5 years after year end (before the issuance of the financial statements) ✗
- 2-year term loan to be matured with 12 months and the entity has a right to renew for another 2 years ✓

Balance Sheet

Minimum requirements on the face of the balance sheet

- As a minimum, the face of the balance sheet shall include line items that present the following amounts:
  a) property, plant and equipment;
  b) investment property;
  c) intangible assets ……
- The use of different measurement bases for different classes of assets suggests that their nature or function differs and, therefore, that they should be presented as separate line items.
  - For example, different classes of property, plant and equipment can be carried at
    - Cost, or
    - Revalued amounts

    in accordance with HKAS 16 PPE.

In the past, it use "may need"

Income Statement

- Minimum requirements on the face of the income statement
- Requires the disclosure on the face of the income statement:
  - Revenue (instead of turnover and other revenue)
  - Finance costs
  - Profit or loss for the period, and
  - The allocation of that amount between
    a) Profit or loss attributable to minority interest, and
    b) Profit or loss attributable to equity holders of the parent

    A similar requirement has been added for the statement of changes in equity and such allocated amounts are not to be presented as items of income or expense
- Not require to disclose the results of operating activities as a line item on the face of the income statement
- An entity shall not present any items of income and expense as extraordinary items, either on the face of the income statements or in the notes

Entities can still show it

Entities can't use it

Statement of Changes in Equity

- An entity shall present a statement of changes in equity showing on the face of the statement:
  a) profit or loss for the period;
  b) each item of income and expense for the period that, as required by HKFRSs, is recognised directly in equity, and the total of these items;
  c) total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable
     - to equity holders of the parent and
     - to minority interest; and
  d) for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with HKAS 8.

Any Change?

A revised requirement:

- A statement of changes in equity that comprises only these items shall be titled ➔ a statement of recognised income and expenses

Notes

New disclosures (an entity is required to disclose the following)

- Disclosure of accounting policies
  – The **judgements**, apart from those involving estimations, management has made
    - in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements *(in the summary of significant accounting policies or other notes)*

Examples – Management makes judgements in determining:

a) whether financial assets are held-to-maturity investments;
b) when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities;
c) whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and
d) whether the substance of the relationship between the entity and a special purpose entity indicates that the special purpose entity is controlled by the entity.

Notes

New disclosures (an entity is required to disclose the following)

- Key sources of estimation uncertainty
  - **Information about the key assumptions** concerning the future, and other **key sources of estimation uncertainty** at the balance sheet date,
    - that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year
  - In respect of those assets and liabilities, the notes shall include details of:
    a) their nature; and
    b) their carrying amount as at the balance sheet date

Examples – in the absence of recently observed market prices used to measure the following assets and liabilities, future-oriented estimates are necessary to measure:

- the recoverable amount of classes of PPE
- the effect of technological obsolescence on inventories

Estimates involve assumptions about such items as

- the risk adjustment to cash flows or discount rates used
- future changes in salaries and in prices affecting other costs.

Notes

New disclosures (an entity is required to disclose the following)

- Other disclosures

An entity shall disclose in the notes:

a) the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to equity holders during the period, and the related amount per share

(HK incorporated companies are required to show the aggregate amount which is recommended for distribution by way of dividend under a separate heading(s) in their balance sheet *(HK Co. Ord. 10th Sch., para 9(1)(e))*; and

b) the amount of any cumulative preference dividends not recognised.

Notes

New disclosures (an entity is required to disclose the following)

- Other disclosures

  An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

  a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);

  b) a description of the nature of the entity's operations and its principal activities; and

  c) the name of the parent and the ultimate parent of the group.

Any special?

"shall disclose" now, instead of "encouraged to disclose"

Notes

Case

ESPRIT

Esprit Holdings Limited

- Critical Accounting Estimates and Judgements
  - Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.
  - Critical accounting estimates and assumptions
    - The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results.
    - The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below …… (including (1) useful life and impairment of trademarks and (2) income taxes)

Notes – Additions in 2007

Capital disclosures

- An entity shall disclose information that enables users of its financial statements to evaluate
  - the entity's *objectives*, *policies* and *processes* for managing capital.

- To comply with the capital disclosures, the entity discloses the following:
  a) qualitative information about its objectives, policies and processes for managing capital, including (but not limited to):
     i) a description of what it manages as capital;
     ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
     iii) how it is meeting its objectives for managing capital.

Notes – Additions in 2007

Capital disclosures

- An entity shall disclose information that enables users of its financial statements to evaluate
  - the entity's *objectives*, *policies* and *processes* for managing capital.

- To comply with the capital disclosures, the entity discloses the following:
  b) summary quantitative data about what it manages as capital.
     Some entities regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital.
     Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges).
  c) any changes in (a) and (b) from the previous period.

Notes – Additions in 2007

Capital disclosures

- An entity shall disclose information that enables users of its financial statements to evaluate
  - the entity's *objectives*, *policies* and *processes* for managing capital.

- To comply with the capital disclosures, the entity discloses the following:
  d) whether during the period it complied with any externally imposed capital requirements to which it is subject.
  e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

  These disclosures shall be based on the information provided internally to the entity's key management personnel.

Notes – Additions in 2007

Case

- Early adopted capital disclosure in 2005 and its annual report states that (extract only):
  - The Group's objectives when managing capital are:
    - To safeguard the Group's ability to continue as a going concern, so that it continues to provide returns for shareholders and benefits for other stakeholders;
    - To support the Group's stability and growth; and
    - To provide capital for the purpose of strengthening the Group's risk management capability.

Notes – Additions in 2007

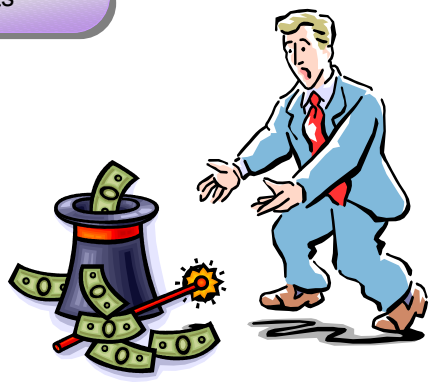
Case

- Early adopted capital disclosure in 2005 and its annual report states that (extract only):
  - The Group actively and regularly reviews and manages its capital structure to ensure optimal capital structure and shareholder returns, taking into consideration the future capital requirements of the Group and capital efficiency ……
  - The Group adopts a dividend policy …… while retaining 10 per cent of the profit as capital of the Group for future use.
  - The Group has set aside $1,500 million of retained earnings for the purpose of strengthening the risk management regime of the clearing houses and supporting their roles as central counterparties.
  - As in prior years, the Group monitors capital by reviewing the level of capital that is at the disposal of the Group ("adjusted capital"). Adjusted capital comprises all components of shareholders' equity other than the hedging reserve relating to cash flow hedges, designated reserves and investment revaluation reserve ……

Today's Agenda

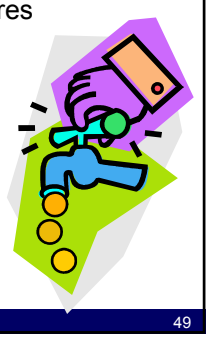
HKAS 1 Presentation of Financial Statements

HKAS 7 Cash Flow Statements

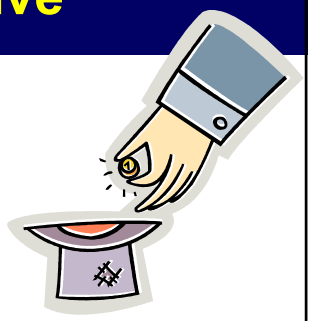


Contents of HKAS 7

1. Introduction
2. Presentation of a Cash Flow Statement
3. Reporting Cash Flows
4. Foreign Currency Cash Flows
5. Interest and Dividends
6. Taxes on Income
7. Investments in Subsidiaries, Associates and Joint Ventures
8. Acquisitions and Disposals of Subsidiaries and Other Business Units
9. Non-cash Transactions
10. Components of Cash and Cash Equivalents
11. Other Disclosures



1. Introduction – Objective



- Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess:
  - the ability of the entity to generate cash and cash equivalents and
  - the needs of the entity to utilise those cash flows.
- The economic decisions that are taken by users require an evaluation of:
  - the ability of an entity to generate cash and cash equivalents and
  - the timing and certainty of their generation.

1. Introduction – Objective

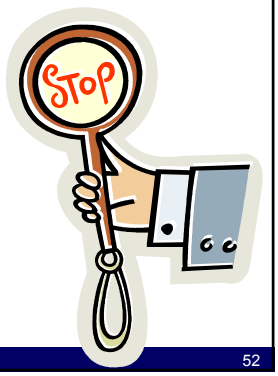
- The objective of HKAS 7 is
  - to require the provision of information about the historical changes in cash and cash equivalents of an entity
  - by means of a cash flow statement which classifies cash flows during the period from
    - operating,
    - investing and
    - financing activities.

1. Introduction – Scope

- An entity
  - shall prepare a cash flow statement in accordance with the requirements of HKAS 7 and
  - shall present it as an integral part of its financial statements for each period for which financial statements are presented.

- HKAS 7 supersedes SSAP 15
  - With the effect that all exemptions to:
    - small entity with less than $20 million revenue per annum
    - charity, and
    - non-profit making entities

  have been removed.



1. Introduction – Benefits

- Historical cash flow information
  - is often used as an indicator of the amount, timing and certainty of future cash flows.
  - is also useful
    - in checking the accuracy of past assessments of future cash flows, and
    - in examining
      - the relationship between profitability and net cash flow and
      - the impact of changing prices.

Predictive value

Confirmatory value

1. Introduction – Definitions

What is cash and cash equivalents?

- Cash
  - comprises cash on hand and demand deposits.
- Cash equivalents
  - are short-term, highly liquid investments
    - that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

1. Introduction – Definitions

What is cash and cash equivalents?

- Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.
- For an investment to qualify as a cash equivalent,
  - it must
    - be readily convertible to a known amount of cash and
    - be subject to an insignificant risk of changes in value.
  - Therefore, an investment normally qualifies as a cash equivalent
    - only when it has a short maturity of, say, 3 months or less from the date of acquisition.
- Equity investments are excluded from cash equivalents
  - unless they are, in substance, cash equivalents,
  - for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

1. Introduction – Definitions

What is cash and cash equivalents?

- Bank borrowings are generally considered to be financing activities.
- However, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management.

Bank loans cannot be cash equivalents

- In these circumstances, bank overdrafts are included as a component of cash and cash equivalents.
- A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

1. Introduction – Definitions

What is cash and cash equivalents?

- Cash flows exclude movements between items that constitute cash or cash equivalents
  - because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities.
- Cash management includes the investment of excess cash in cash equivalents.

2. Presentation of a Cash Flow Statement

What are cash flows?

- Cash flows
  - are inflows and outflows of cash and cash equivalents.

- The cash flow statement shall report cash flows during the period classified by
  - operating,
  - investing and
  - financing activities.

Operating

Investing

Financing

2. Presentation of a Cash Flow Statement

- An entity presents its cash flows from operating, investing and financing activities
  - in a manner which is most appropriate to its business.
- Classification by activity
  - provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents.
  - Such information may also be used to evaluate the relationships among those activities.
- A single transaction may include cash flows that are classified differently.
  - For example, when the cash repayment of a loan includes both interest and capital,
    - the interest element may be classified as an operating activity and
    - the capital element is classified as a financing activity.

Operating

Financing

3. Reporting Cash Flows

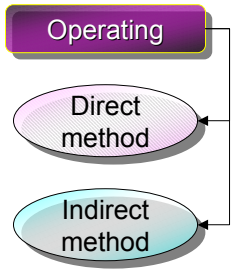
Operating

Investing

Financing

3. Reporting Cash Flows

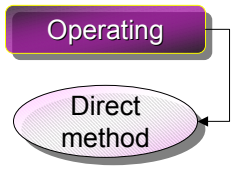
- An entity shall report cash flows from operating activities using either:
  a) the direct method
     - whereby major classes of gross cash receipts and gross cash payments are disclosed; or
  b) the indirect method
     - whereby profit or loss is adjusted for
       - the effects of transactions of a non-cash nature,
       - any deferrals or accruals of past or future operating cash receipts or payments, and
       - items of income or expense associated with investing or financing cash flows.



- Entities are encouraged to report cash flows from operating activities using the direct method.

3. Reporting Cash Flows

- The direct method provides information
  - which may be useful in estimating future cash flows and
  - which is not available under the indirect method.
- Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:
  a) from the accounting records of the entity; or
  b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the income statement for:
     i) changes during the period in inventories and operating receivables and payables;
     ii) other non-cash items; and
     iii) other items for which the cash effects are investing or financing cash flows.



3. Reporting Cash Flows

Example

Operating

Direct method

Direct Method Cash Flow Statement
(HKAS 7.18a)

	2006
	HK$
Cash flows from operating activities	
Cash receipts from customers	30,150
Cash paid to suppliers and employees	(27,600)
Cash generated from operations	2,550
Interest paid	(270)
Income taxes paid	(900)
Net cash from operating activities	1,380

3. Reporting Cash Flows

Operating

Indirect method

- Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:
  a) changes during the period in inventories and operating receivables and payables;
  b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, undistributed profits of associates, and minority interests; and
  c) all other items for which the cash effects are investing or financing cash flows.
- Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing
  – the revenues and expenses disclosed in the income statement and
  – the changes during the period in inventories and operating receivables and payables.

3. Reporting Cash Flows

Example

Operating

Indirect Method Cash Flow Statement

(HKAS 7.18b)

	2006	2006
Cash flows from operating activities		
Profit before taxation	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Investment income	(500)	
Interest expense	400	
Operating profit before working capital changes	3,740	
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
Cash generated from operations	2,550	
Interest paid	(270)	
Income taxes paid	(900)	
Net cash from operating activities		1,380

Indirect method

Alternative ……

3. Reporting Cash Flows

Example

Operating

Alternative Presentation (Indirect Method)

- As an alternative, in an indirect method cash flow statement, operating profit before working capital changes is sometimes presented as follows:

Revenues excluding investment income	30,650
Operating expense excluding depreciation	(26,910)
Operating profit before working capital changes	3,740

Indirect method

Alternative ……

3. Reporting Cash Flows

- An entity shall report separately major classes of
  - gross cash receipts and
  - gross cash payments

  arising from investing and financing activities,
  - except to the extent that cash flows described in HKAS 7 are reported on a net basis.

Investing

Financing

Gross Basis → Net Basis

3. Reporting Cash Flows

- Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:
  a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and
  b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Investing

Financing

Net Basis

- Cash flows arising from each of the following activities of a financial institution may be reported on a net basis:
  a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;
  b) the placement of deposits with and withdrawal of deposits from other financial institutions; and
  c) cash advances and loans made to customers and the repayment of those advances and loans.

3. Reporting Cash Flows

Example

- Examples of cash receipts and payments cash receipts and payments on behalf of customers (when the cash flows reflect the activities of the customer rather than those of the entity) are
  a) the acceptance and repayment of demand deposits of a bank;
  b) funds held for customers by an investment entity; and
  c) rents collected on behalf of, and paid over to, the owners of properties.

- Examples of cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short are
  – advances made for, and the repayment of:
    a) principal amounts relating to credit card customers;
    b) the purchase and sale of investments; and
    c) other short-term borrowings, for example, those which have a maturity period of three months or less.

3. Reporting Cash Flows

Example

Cash flows from investing activities		
Acquisition of subsidiary X, net of cash acquired	(550)	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Payment of finance lease liabilities	(90)	
Dividends paid	(1,200)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		110
Cash and cash equivalents at beginning of period		120
Cash and cash equivalents at end of period		230

Note required

Can be operating

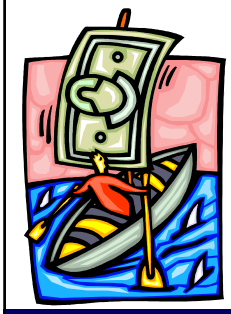
Reconciliation required (on cash components)

4. Foreign Currency Cash Flows

- Cash flows arising from transactions in a foreign currency shall be
  - recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.
- The cash flows of a foreign subsidiary shall be
  - translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows.

4. Foreign Currency Cash Flows

- Cash flows denominated in a foreign currency are reported in a manner consistent with HKAS 21 *Accounting for the Effects of Changes in Foreign Exchange Rates*.
- This permits the use of an exchange rate that approximates the actual rate.
  - For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions or the translation of the cash flows of a foreign subsidiary.
- However, HKAS 21 does not permit use of the exchange rate at the balance sheet date when translating the cash flows of a foreign subsidiary.



4. Foreign Currency Cash Flows

- Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows.
  - However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement
    - in order to reconcile cash and cash equivalents at the beginning and the end of the period.
  - This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

5. Interests and Dividends

- Cash flows from interest and dividends received and paid
  - shall each be disclosed separately.
- Each shall be classified in a consistent manner from period to period as either
  - operating,
  - investing or
  - financing activities.
- The total amount of interest paid during a period is disclosed in the cash flow statement whether it has been
  - recognised as an expense in the income statement or
  - capitalised in accordance with the allowed alternative treatment in HKAS 23 *Borrowing Costs*.

5. Interests and Dividends

- Interest paid and interest and dividends received
  - are usually classified as operating cash flows for a financial institution.
  - However, there is no consensus on the classification of these cash flows for other entities.
- In consequence, interest paid and interest and dividend received may be classified
  - as operating cash flows
    - because they enter into the determination of profit or loss.
  - alternatively, as financing cash flows (for interest paid) and investing cash flows (interest and dividend received) respectively,
    - because they are costs of obtaining financial resources or returns on investments.

5. Interests and Dividends

- Dividends paid
  - may be classified as a financing cash flow because they are a cost of obtaining financial resources.
  - alternatively, may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.

5. Interests and Dividends

Case

taifook大福 securities group 證券集團

2005 Annual Report – Cash Flow Statements (Extract)

	2005	2004
	HK$'000	HK$'000
Cash generated from operations	27,603	61,669
Non-financing interest received	29,472	3,200
Hong Kong profits tax refunded/(paid), net	6,575	(2,428)
Dividends received from listed investments	1,915	2,592
Dividends received from unlisted investments	–	898
Dividends paid	(23,373)	(43,833)
Net cash inflow from operating activities	42,192	22,098

6. Taxes on Income

- Cash flows arising from taxes on income shall be
  - separately disclosed and
  - classified as cash flows from operating activities
    - unless they can be specifically identified with financing and investing activities.

6. Taxes on Income

- Taxes on income may arise on transactions of different activities (operating, investing or financing).
  - But the related tax cash flows are often impracticable to identify
  - Thus, taxes paid are usually classified as cash flows from operating activities.
- However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities
  - the tax cash flow is classified as an investing or financing activity as appropriate.
- When tax cash flows are allocated over more than one class of activity,
  - the total amount of taxes paid is disclosed.

7. Subsidiary, Associate and JV

Subsidiaries and Associates

- When accounting for an investment in an associate or a subsidiary accounted for by use of the equity or cost method,
  - an investor restricts its reporting in the cash flow statement to
    - the cash flows between itself and the investee, for example, to dividends and advances.

Equity or Cost Method

7. Subsidiary, Associate and JV

For jointly controlled entities

- When reporting using proportionate consolidation,
  - includes in its consolidated cash flow statement
    - its proportionate share of the jointly controlled entity's cash flows.
- When reporting using the equity method
  - includes in its cash flow statement
    - the cash flows in respect of its investments in the jointly controlled entity, and
    - distributions and other payments or receipts between it and the jointly controlled entity.

Proportionate Consolidation

Equity or Cost Method

8. Acquisition and Disposal of Subsidiary

- The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units shall be
  - presented separately and
  - classified as investing activities.

8. Acquisition and Disposal of Subsidiary

- An entity shall disclose, in aggregate, in respect of both acquisitions and disposals of subsidiaries or other business units during the period each of the following:
  a) the total purchase or disposal consideration;
  b) the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents;
  c) the amount of cash and cash equivalents in the subsidiary or business unit acquired or disposed of; and
  d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiary or business unit acquired or disposed of, summarised by each major category.

8. Acquisition and Disposal of Subsidiary

- Such separate presentation and separate disclosure
  – helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities.
- The cash flow effects of disposals
  – are not deducted from those of acquisitions.
- The aggregate amount of the cash paid or received as purchase or sale consideration is reported in the cash flow statement
  – net of cash and cash equivalents acquired or disposed of.

8. Acquisition and Disposal of Subsidiary

Example

Notes to cash flow statements

- Acquisition of Subsidiary

  During the period the group acquired subsidiary X. The fair value of assets acquired and liabilities assumed were as follows:

	HK$
Cash	40
Inventories	100
Accounts receivable	100
Property, plant and equipment	650
Trade payables	(100)
Long-term debt	(200)
Total purchase price	590
Less: Cash of X	(40)
Cash flow on acquisition net of cash acquired	550

9. Non-Cash Transactions

- Investing and financing transactions that do not require the use of cash or cash equivalents
  - shall be excluded from a cash flow statement.
- Such transactions shall be disclosed elsewhere in the financial statements
  - in a way that provides all the relevant information about these investing and financing activities.
- Examples of non-cash transactions are:
  a) the acquisition of assets either
     - by assuming directly related liabilities or
     - by means of a finance lease;

  b) the acquisition of an entity by means of an equity issue; and

  c) the conversion of debt to equity.

9. Non-Cash Transactions

Example

Notes to cash flow statements

- Property, Plant and Equipment

  During the period, the Group acquired property, plant and equipment with an aggregate cost of $1,250

  - of which $900 was acquired by means of finance leases.

  Cash payments of $350 were made to purchase property, plant and equipment.

10. Cash and Cash Equivalents

- An entity shall
  - disclose the components of cash and cash equivalents and
  - present a reconciliation of
    - the amounts in its cash flow statement with
    - the equivalent items reported in the balance sheet.

10. Cash and Cash Equivalents

- In view of the variety of cash management practices and banking arrangements around the world and in order to comply with HKAS 1 *Presentation of Financial Statements*,
  - an entity discloses the policy which it adopts in determining the composition of cash and cash equivalents.
- An entity also reports
  - the effect of any change in the policy for determining components of cash and cash equivalents,
    - For example, a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio, is reported in accordance with HKAS 8.

10. Cash and Cash Equivalents

Example

Note to cash flow statements

- Cash and Cash Equivalents

  Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts:

	2007 HK$	2006 HK$
Cash on hand and balances with banks	40	25
Short-term investments	190	135
Cash and cash equivalents as previously reported	230	160
Effect of exchange rate changes	-	(40)
Cash and cash equivalents as restated	230	120

11. Other Disclosures

- An entity shall disclose, together with a commentary by management,
  - the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.
- There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the group.
- Examples include
  - cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the parent or other subsidiaries.

11. Other Disclosures

- Additional information may be relevant to users in understanding the financial position and liquidity of an entity.
- Disclosure of this information, together with a commentary by management, is encouraged and may include:
  a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities;
  b) the aggregate amounts of the cash flows from each of operating, investing and financing activities related to interests in joint ventures reported using proportionate consolidation;
  c) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity; and
  d) the amount of the cash flows arising from the operating, investing and financing activities of each reported industry and geographical segment (see HKAS 14 *Segment Reporting*).

Operating Capacity

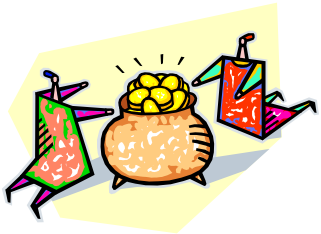
Segmental cash flows

11. Other Disclosures

Example

Notes to cash flow statements

- Cash and cash equivalents
  - Cash and cash equivalents at the end of the period include deposits with banks of $100 held by a subsidiary that are not freely remissible to the holding company because of currency exchange restrictions.
  - The Group has undrawn borrowing facilities of $2,000, of which $700 may be used only for future expansion.



11. Other Disclosures

Operating Capacity

- The separate disclosure of
  - cash flows that represent increases in operating capacity and
  - cash flows that are required to maintain operating capacity

  is useful in enabling the user to determine whether the entity is investing adequately in the maintenance of its operating capacity.
- An entity that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

Segmental cash flows

- The disclosure of segmental cash flows
  - enables users to obtain a better understanding of the relationship between the cash flows of the business as a whole and those of its component parts and the availability and variability of segmental cash flows.

11. Other Disclosures

Example

Notes to cash flow statements

- Segment Information

	Segment A	Segment B	Total
Cash flows from:			
Operating activities	1,520	(140)	1,380
Investing activities	(640)	160	(480)
Financing activities	(570)	(220)	(790)
	310	(200)	110

Today's Agenda

HKAS 1 Presentation of Financial Statements

HKAS 7 Cash Flow Statements

HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

HKAS 8

Accounting policies
⇓
Select & apply
⇓
Changes

Accounting estimates

Errors

HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

- Shall be applied in
  a) Selecting and applying accounting policies, and
  b) Accounting for:
     a) Changes in accounting policies,
     b) Changes in accounting estimates, and
     c) Corrections of prior period errors.

Accounting Policies

Accounting policies

Accounting policies are

- the specific principles, bases, conventions, rules and practices applied by an entity in *preparing* and *presenting* financial statements
- Preparing ⇒ Recognition and Measurement
- Presenting ⇒ Presentation

Accounting Policies: Select & Apply

Accounting policies
⇓
Select & apply

For such transactions, events or conditions:

- If there is a HKFRS or an Interpretation
  - the accounting policy shall be determined by applying the HKFRS or Interpretation and
  - considering any relevant Implementation Guidance
- If there is NO HKFRS or Interpretation
  - management shall use its ***judgement*** in developing & applying an accounting policy that results in information that is:
    - a) relevant to the economic decision-making needs of users; and
    - b) reliable, in that the financial statements:
      - i) represent faithfully the financial position, financial performance and cash flows of the entity;
      - ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
      - iii) are neutral, ie free from bias;
      - iv) are prudent; and
      - v) are complete in all material respects.

Accounting Policies: Select & Apply

Accounting policies
⇓
Select &

For such transactions, events or conditions:

- If there is a HKFRS or an Interpretation
  - the accounting policy shall be determined by applying the HKFRS or Interpretation and
  - considering any relevant Implementation Guidance
- If there is NO HKFRS or Interpretation

In making the such judgement,

1) management shall consider the applicability of, the following sources in descending order:
   - a) the requirements and guidance in HKFRS and Interpretations dealing with similar and related issues; and
   - b) the definitions, recognition criteria and measurement concepts for elements in the Framework.
2) management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in point 1 above.

Accounting Policies: Select & Apply

Accounting policies
⇓
Select & apply

Any change on accounting policies?

- An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions
- Unless a HKFRS or an Interpretation specifically requires or permits categorisation of items for which different policies may be appropriate.
- If a HKFRS or an Interpretation requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category

Accounting Policies: Changes

Accounting policies
⇓
Select & apply
⇓
Changes

A change of accounting policy occurs

– where there is a change to any one of the components of
  1) recognition criteria,
  2) measurement basis
  3) method of presentation
– any change that does not affect any of these 3 components is not a change in accounting policy (and may only be a change in accounting estimates)

An entity shall change an accounting policy only if the change:

Initial application of HKFRS

a) is required by a HKFRS/HKAS or an Interpretation; or
b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Voluntary Changes

Accounting Policies: Changes

Accounting policies
⇓
Select & apply
⇓
Changes

The following are not changes in accounting policies:

a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and

b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial

The initial application of a policy to revalue assets in accordance with

- HKAS 16 *Property, Plant and Equipment* or
- HKAS 38 *Intangible Assets*

is a change in an accounting policy to be dealt with as a revaluation in accordance with HKAS 16 or HKAS 38, rather than in accordance with HKAS 8

Accounting Policies: Changes

Example

Accounting policies
⇓
Select & apply
⇓
Changes

- An entity has previously written all finance costs off to the profit and loss account as incurred.
- The entity now wishes to capitalise interest on borrowing incurred to finance the construction of property.

- This decision involves a change in:
  1. Recognition – the costs are now included as part of an asset.
  2. Presentation – the costs are now presented in the balance sheet, rather than in the profit and loss account.
- Therefore, the decision represents a change in accounting policy.

Accounting Policies: Changes

Example

Accounting policies
⇓
Select & apply
⇓
Changes

- An entity has previously depreciated vehicles using the reducing balance method at 40% per year.
- It now proposes to depreciate vehicles using the straight-line method over five years.

- This decision does not involve a change in all 3 key criteria:
  1. Assets are still carried at cost less accumulated depreciation.
  2. Depreciation is still allocated to individual accounting periods so as to reflect the consumption of economic benefits.
  3. No indication that assets and depreciation are presented in a different way in the balance sheet and the income statement.
- Therefore, this is a change in accounting estimate and not a change in accounting policy.
- HKAS 8 also clarifies that the above change is a change in accounting estimate, not a change in accounting policy.

Accounting Policies: Changes

Accounting policies
⇓
Select & apply
⇓
Changes

Initial application of HKFRS

- Account for a change in accounting policy in accordance with the specific transitional provisions (if any)
- If there is no specific transitional provisions, apply the change *retrospectively*

Voluntary Changes

- Apply the change *retrospectively*
- For the purpose of HKAS 8, early application of a HKFRS is not a voluntary change in accounting policy

Retrospective Application

Accounting Policies: Changes

Subject to Limitation on Retrospective Application

Accounting policies
⇓
Select & apply
⇓
Changes

- If it is a retrospective application, the entity shall adjust
  - the opening balance of each affected component of equity for the earliest prior period presented, and
  - The comparative amounts disclosed for each prior period presented
  - **as if** the new accounting policy had always been applied.

Retrospective Application

Accounting Policies: Changes

Subject to Limitation on Retrospective Application

Accounting policies
⇓
Select & apply
⇓
Changes

When it is impracticable to determine:

a) the *period-specific effects* (of changing an accounting policy on comparative information for one or more prior periods presented), the entity shall
   - apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, (which may be the current period), and
   - make a corresponding adjustment to the opening balance of each affected component of equity for that period

b) the cumulative effect (at the beginning of the current period, of applying a new accounting policy to all prior periods), the entity shall
   - adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

Accounting Policies: Changes

Accounting policies
⇓
Select & apply
⇓
Changes

Initial application of HKFRS

Disclosures (when applicable)

a) the title of the Standard or Interpretation;
b) that the change in accounting policy is made in accordance with its transitional provisions;
c) the nature of the change in accounting policy;
d) description of the transitional provisions;
e) the transitional provisions that might have an effect on future periods;
f) the amount of the adjustment:
   i) for each financial statement line item affected; and
   ii) if HKAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share;
g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
h) if retrospective application is impracticable, the circumstances that led to its existence and a description of how and from when the change in accounting policy has been applied.

- *Financial statements of subsequent periods need not repeat these disclosures*

Accounting Policies: Changes

Accounting policies
⇓
Select & apply
⇓
Changes

Voluntary Changes

Disclosures (when applicable)

a) the nature of the change in accounting policy;
b) the reasons why applying the new accounting policy provides reliable and more relevant information;
c) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
   i) for each financial statement line item affected; and
   ii) if HKAS 33 applies to the entity, for basic and diluted earnings per share;
d) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
e) if retrospective application is impracticable, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

- *Financial statements of subsequent periods need not repeat these disclosures*

Accounting Policies: Changes

Accounting policies
⇓
Select & apply
⇓
Changes

HKFRS issued but not yet effective

When an entity has not applied a new Standard or Interpretation that has been issued but is not yet effective, the entity shall disclose:

a) this fact; and

b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Standard or Interpretation will have on the entity's financial statements in the period of initial application.

Accounting Policies: Changes

Case

CATHAY PACIFIC

2004 Annual Report

- HKICPA has issued new and revised standards (HKAS and HKFRS) which are effective for accounting periods beginning on or after 1st January 2005.
- The Group has decided not to early adopt these new standards in its financial statements for the year ended 31st December 2004 except for HKAS 24 "Related Party Disclosures".
- The Group
  - is in the process of making an assessment on the impact of the new standards and
  - has so far concluded that the adoption of them will not have a significant impact on its results of operations and financial position.
- The Group will continue with the assessment of the impact of the other new standards and significant changes may be identified as a result.

Why …… to be explained later

Accounting Policies: Changes

Example

HKFRSs that have been issued but are not yet effective for the year include the following HKFRSs which may be relevant to the company's operations and financial statements:

	Effective for annual periods beginning on or after
Amendments to HKAS 39 Financial instruments: recognition and measurement and HKFRS 4 Insurance contracts – Financial guarantee contracts	*1 January 2006*
HKFRS 7 Financial instruments: disclosures	*1 January 2007*
Amendments to HKAS 1 Presentation of financial statements: capital disclosures	*1 January 2007*

Initial assessment has indicated that the adoption of these HKFRSs would not have a significant impact on the company's financial statements in the year of initial application. The company will be continuing with the assessment of the impact of these HKFRSs and other significant changes may be identified as a result.

Changes in Accounting Estimates

Accounting policies
⇓
Select & apply
⇓
Changes
Accounting estimates

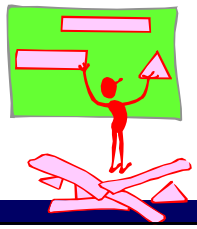
- As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated
- Estimation involves judgements based on the latest available, reliable information.
- For example, estimates may be required of:
  a) bad debt
  b) inventory obsolescence
  c) the fair value of financial assets or financial liabilities
  d) the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and
  e) warranty obligations.

Changes in Accounting Estimates

Accounting policies
⇓
Select & apply
⇓
Changes
Accounting estimates

A Change in Accounting Estimate

- is defined in HKAS 8 as:
  - an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset,
  - that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.
- Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors



Changes in Accounting Estimates

Accounting policies
⇓
Select & apply
⇓
Changes
Accounting estimates

- The effect of a change in an accounting estimate, other than a change to which the following point applies, shall be recognised prospectively by including it in profit or loss in:
  a) the period of the change, if the change affects that period only; or
  b) the period of the change and future periods, if the change affects both.
- To the extent that a change in an accounting estimate gives rise to changes
  - in assets and liabilities, or
  - relates to an item of equity,

  it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

Changes in Accounting Estimates

Accounting policies
⇓
Select & apply
⇓
Changes
Accounting estimates

Disclosures

- An entity shall disclose
  - the nature and amount of a change in an accounting estimate
    that has an effect in the current period or is expected to have an effect in future periods
    (except for the disclosure of the effect on future periods when it is impracticable to estimate that effect)
- If the amount of the effect in future periods is not disclosed because estimating it is impracticable, an entity shall disclose that fact

Errors

Accounting policies
⇓
Select & apply
⇓
Changes
Accounting estimates
Errors

What is Error?

- The concept of fundamental error is eliminated
- Errors are refined as *Prior Period Errors*
  - That are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:
    a) was available when financial statements for those periods were authorised for issue; and
    b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.
- Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Errors

Subject to Limitation on Retrospective Restatement

Accounting policies
⇓
Select & apply
⇓
Changes

Accounting estimates

Errors

Correction of material prior period errors

- An entity shall correct material prior period errors *retrospectively* in the first set of financial statements authorised for issue after their discovery by:
  a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or
  b) if the error occurred before the earlier prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented
- Termed as retrospective restatement
  – is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred

Errors

Subject to Limitation on Retrospective Restatement

Accounting policies
⇓
Select & apply
⇓
Changes

Accounting estimates

Errors

When it is impracticable to determine:

a) the *period-specific effects* (of an error on comparative information for one or more prior periods presented)
   - the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).

b) the *cumulative effect* (at the beginning of the current period, of an error on all prior periods)
   - the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable.

Errors

Accounting policies
⇓
Select & apply
⇓
Changes

Accounting estimates

Errors

Disclosures

- An entity shall disclose the following:
  a) the nature of the prior period error;
  b) for each prior period presented, to the extent practicable, the amount of the correction:
     i) for each financial statement line item affected; and
     ii) if HKAS 33 applies to the entity, for basic and diluted earnings per share;
  c) the amount of the correction at the beginning of the earliest prior period presented; and
  d) if retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected.
- *Financial statements of subsequent periods need not repeat these disclosures.*

Today's Agenda

HKAS 1 Presentation of Financial Statements

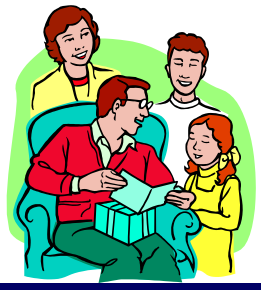
HKAS 7 Cash Flow Statements

HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

HKAS 24 Related Party Disclosures

Related Party Disclosures (HKAS 24)

- HKAS 24 *Related Party Disclosure* aims to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected:
  1) by the existence of related parties and
  2) by transactions and outstanding balances with such parties.



Scope

- HKAS 24 shall be applied in:
  a) identifying related party relationships and transactions;
  b) identifying outstanding balances between an entity and its related parties;
  c) identifying the circumstances in which disclosure of the items in (a) and (b) is required; and
  d) determining the disclosures to be made about those items.

Scope

- HKAS 24 requires disclosure of related party transactions and outstanding balances in
  - the separate financial statements of a parent, venturer or investor presented in accordance with HKAS 27 *Consolidated and Separate Financial Statements*.
- Intragroup related party transactions and outstanding balances are eliminated in the preparation of consolidated financial statements of the group
- No further exemption stated

- Removed the exemption:
  - For a wholly owned subsidiary from disclosing related party transactions in its separate financial statements
  - From disclosing transactions where specific exemptions are granted by statute (say 141D)

Purpose for Disclosures

- Related party relationships are a normal feature of commerce and business.
  - For example, the entity's ability to affect the financial and operating policies of the investee is through the presence of control, joint control or significant influence.
- A related party relationship could have an effect on the profit or loss and financial position of an entity.
  - Related parties may enter into transactions that unrelated parties would not.
  - Transactions between related parties may not be made at the same amounts as between unrelated parties.
- The profit or loss and financial position of an entity may be affected.
- The mere existence of the relationship may be sufficient to affect the transactions of the entity with other parties.
- For these reasons, knowledge of related party transactions, outstanding balances and relationships may affect assessments of an entity's operations by users of financial statements, including assessments of the risks and opportunities facing the entity.

Definition of a Related Party

- A party is related to an entity if:
  - directly, or indirectly through one or more intermediaries, the party:
    1. controls, is controlled by, or is under common control with, the entity;
    2. has an interest in the entity that gives it significant influence over the entity; or
    3. has joint control over the entity; or
  - the party is:
    1. an associate
    2. a joint venture in which the entity is a venturer
    3. a member of key management personnel of the entity or its parent (key management personnel)
    4. a close member of the family of any individual being a related party (close member)
    5. an entity that is controlled, jointly controlled or significantly influenced by any key management personnel or close member, or
    6. a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity

Common Significant Influence?

More clearly stated

Definition of a Related Party

Case

2004 Annual Report

- Related parties were previously considered to be related to the Group
  - if the Group had the ability, directly or indirectly, to
    - control the party or
    - exercise significant influence over the party

    in making financial and operating decisions, or vice versa, or
  - where the Group and the party were subject to
    - common control or
    - common significant influence.
- Related parties may be individuals or entities.
- With the introduction of HKAS 24,
  - parties that are subject to significant influence by shareholders of Cathay Pacific are no longer defined as related parties.
- Comparatives have been restated to comply with this new definition.

Definition of a Related Party

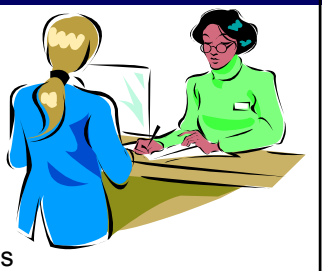
Case

2005 Annual Report

- Related parties are considered to be related to the Group
  - if the Group has the ability, directly or indirectly, to
    - control the party or
    - exercise significant influence over the party

    in making financial and operating decisions, or vice versa, or
  - where the Group and the party are subject to common control.
- Related parties may be individuals or entities.

Definition of a Related Party Transaction



- A related party transaction is
  - a transfer of resources, services or obligations
  - between related parties
  - regardless of whether a price is charged.

Definitions for Other Terms

- Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:
  a) the individual's domestic partner and children;
  b) children of the individual's domestic partner; and
  c) dependants of the individual or the individual's domestic partner.
- Compensation includes all employee benefits (as defined in HKAS 19 Employee Benefits) including employee benefits to which HKFRS 2 Share-based Payment applies.
- Key management personnel are those persons
  – having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.
- Control, Joint Control and Significant Influence
  – Same definition as other HKAS/HKFRS

Not Necessarily Related Party

- In the context of HKAS 24, the following are NOT necessarily related parties:
  a) 2 entities simply because they have a director or other member of key management personnel in common
  b) 2 venturers simply because they share joint control over a joint venture.
  c) (i) providers of finance,
     (ii) trade unions,
     (iii) public utilities, and
     (iv) government departments and agencies,
     simply by virtue of their normal dealings with an entity; and
  d) a customer, supplier, franchisor, distributor, or general agent with whom an entity transacts a significant volume of business, merely by virtue of the resulting economic dependence.

Disclosures

- Disclosures include
  - Relationships between parents and subsidiaries
    - irrespective of whether there have been transactions between those related parties.
  - The name of the entity's parent and, if different, the ultimate controlling party
  - If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed
  - Key management personnel compensation in total and for each of the following categories:
    a) short-term employee benefits;
    b) post-employment benefits;
    c) other long-term benefits;
    d) termination benefits; and
    e) share-based payment.

Disclosures

- If there are transactions between related parties, disclosures include:
  a) the amount of the transactions;
  b) the amount of outstanding balances and:
     i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
     ii) details of any guarantees given or received;
  c) provisions for doubtful debts related to the amount of outstanding balances; and
  d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.

Disclosures

- The disclosures required in previous slide shall be made separately for each of the following categories:
  a) the parent;
  b) entities with joint control or significant influence over the entity;
  c) subsidiaries;
  d) associates;
  e) joint ventures in which the entity is a venturer;
  f) key management personnel of the entity or its parent; and
  g) other related parties.
- Items of a similar nature may be disclosed in aggregate except when
  – separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity

Disclosures

Case

SWIRE PACIFIC

- Annual Report 2005

The following is a summary of other significant transactions between the group and related parties, in addition to those disclosed elsewhere in the accounts, which were carried out in the normal course of the group's business. These transactions were not connected transactions or continuing connected transactions under the Listing Rules.

	Notes	Jointly controlled companies		Associated companies		Fellow subsidiaries		Intermediate holding company	
		2005 HK$M	2004 HK$M	2005 HK$M	2004 HK$M	2005 HK$M	2004 HK$M	2005 HK$M	2004 HK$M
Revenue from	(a)								
– Sales of beverage drinks		–	–	12	12	–	–	–	–
– Sales of other goods		–	29	–	–	–	–	–	–
– Rendering of services		26	27	10	8	–	–	–	–
Purchases of beverage cans	(a)	146	140	–	–	–	–	–	–
Purchases of other goods	(a)	34	57	–	–	–	–	–	–
Purchases of services	(a)	–	–	18	14	13	10	–	–
Rental revenue	(b)	–	5	5	7	6	7	34	37
Interest income	(c)	7	7	19	10	–	–	–	–
Interest charges	(c)	7	1	–	–	–	–	–	–
Disposal of a subsidary		–	–	–	–	40	–	–	–

Issues in Presentation of Financial Statements

(HKAS 1, 7, 8 & 24) 23 November 2006

Full set of slides may be found in
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