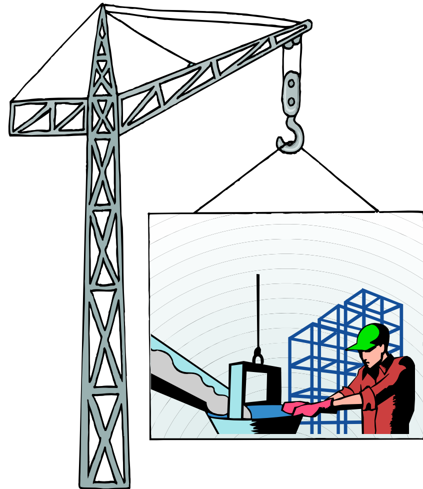
HKAS 11, 18 and 23

30 May 2007



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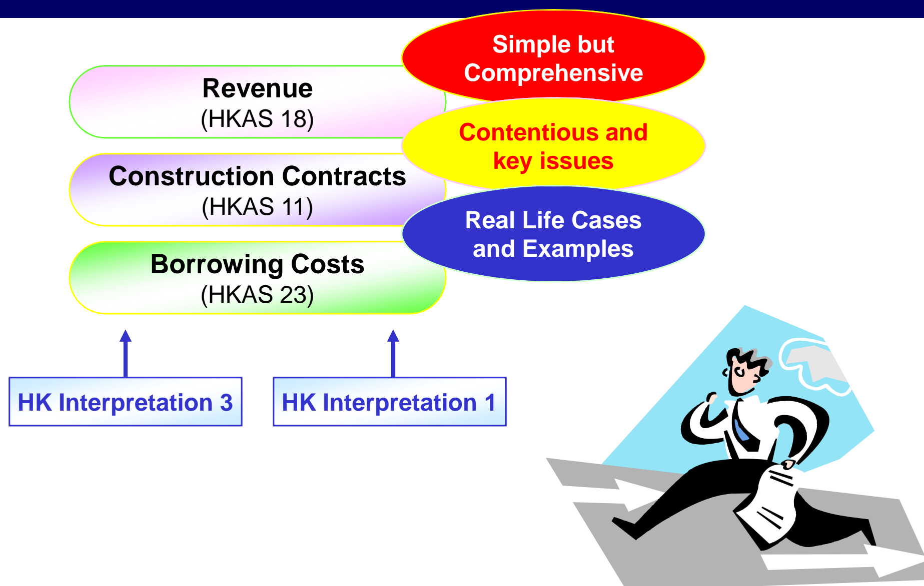
Tonight's Agenda



Revenue (HKAS 18)

Revenue – What is it?

- Income
  - is defined in the *Framework for the Preparation and Presentation of Financial Statements* as:
    - increases in economic benefits during the accounting period in the form of inflows or
    - enhancements of assets or decreases of liabilities that result in increases in equity,
    - other than those relating to contributions from equity participants.
  - Income encompasses both revenue and gains.

- Revenue is income that
  - arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends and royalties.

Revenue – What is it?

- Revenue includes
  - only the gross inflows of economic benefits received and receivable by the entity on its own account.

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

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Revenue – What is it?

Example

What is the difference between
- Revenue and
- Turnover ?

- No definition of turnover in HKFRS and the Companies Ordinance
- However, Footnote to HKAS 1.81 states that:
  - Hong Kong incorporated companies are required to disclose
    1. turnover for the financial year and
    2. the method by which it is arrived at (HKCO Tenth Sch. para 16).
  - Turnover
    - should consist of revenue arising from the principal activities of the entity and
    - therefore should not usually include those items of revenue and gains that arise incidentally.

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Revenue – Recognition Issue

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

Revenue – Measurement

- Revenue shall be measured at the fair value of the consideration received or receivable.

Fair value of consideration received/receivable

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

Revenue – Measurement

Discounting required when inflow deferred

- When the inflow of cash or cash equivalents is deferred,
  - the fair value of the consideration may be less than the nominal amount of cash received or receivable.

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

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

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Revenue – Measurement

Case

Sino Land Company Limited

2005 Annual Report stated that:

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

Same as HKAS 18?

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Revenue – Measurement

Example

Sales in Deferred Terms

- On 1.1.2006, Entity A sells a motor car to X at HK$66,200 by accepting the payments in the following terms:
  - Down payment HK$ 20,000
  - Repayment on 31.12.2006 22,000
  - Repayment on 31.12.2007 24,200
- Assumed that the imputed rate of interest for Entity A is 10%.
- Calculate the interest elements.

	Cash flow	Discount factor	Present value
01.01.2006	$ 20,000	$1 / (1 + 10\%)^0$	$ 20,000
31.12.2006	$ 22,000	$1 / (1 + 10\%)^1$	$ 20,000
31.12.2007	$ 24,200	$1 / (1 + 10\%)^2$	$ 20,000
		Fair value of the consideration	*$ 60,000*

- The interest element is HK$ 6,200 (to be deferred).

Revenue – Measurement

Different from HKAS 16, 38 …..

Exchange of goods or services — Similar | Dissimilar

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

Revenue – Measurement

Different from HKAS 16, 38 …..

Exchange of goods or services

Similar | Dissimilar

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

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Identification of the Transaction

- The recognition criteria in HKAS 18 is usually applied separately to each transaction.
- However, there are situations that the recognition criteria is:
  1. Applied to separately identifiable components of a single transaction
  2. Applied to two or more transactions together

Separately identifiable component of a single transaction

Two or more transactions together

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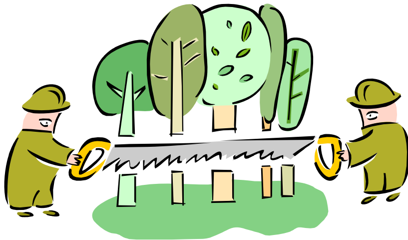
Identification of the Transaction

Example

- In certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

Separately identifiable component of a single transaction



- For example
  - when the selling price of a product includes an identifiable amount for subsequent servicing,
    - that amount is deferred and recognised as revenue over the period during which the service is performed.

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Identification of the Transaction

Example

- Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

- For example
  - an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date,
    - thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Two or more transactions together

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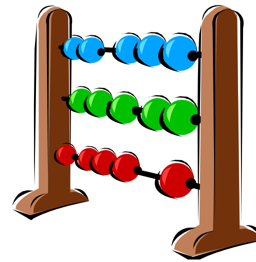
Revenue – Covered in HKAS 18

- Sale of goods
- Rendering of services
- Interest, royalties and dividend

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



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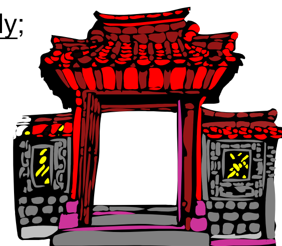
Revenue – Sale of Goods

Main Principle

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



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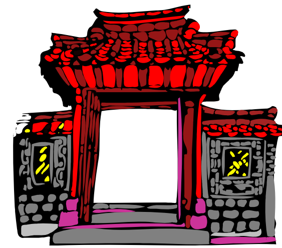
Revenue – Sale of Goods

Main Principle

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



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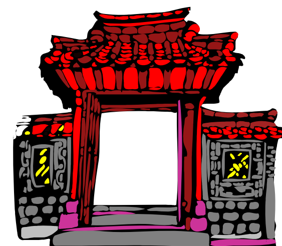
Revenue – Sale of Goods

Main Principle

- Several situations should be placed attention, including
  - A. The entity retains significant risks of ownership
  - B. The entity retains only insignificant risk of ownership
  - C. Inflow of future economic benefits may not be probable
  - D. Revenue and expenses relating to the same transaction

(A, B) Risk of ownership

(C, D) Other situations



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Revenue – Sale of Goods

Example

- Sale and repurchase agreements (other than swap transactions)
  - under which the seller concurrently agrees to repurchase the same goods at a later date, or
  - when the seller has a call option to repurchase, or
  - the buyer has a put option to require the repurchase, by the seller, of the goods
- Any difference if the goods involved are financial assets.

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Revenue – Sale of Goods

Example

1. For a sale and repurchase agreement on an asset other than a financial asset
   - the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised.
   - When the seller has retained the risks and rewards of ownership, even though legal title has been transferred
     - the transaction is a financing arrangement and
     - does not give rise to revenue.
2. For a sale and repurchase agreement on a financial asset
   - HKAS 39 applies.

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Revenue – Sale of Goods

Example

Goods shipped subject to conditions:

a) Installation and inspection

Revenue is normally recognised when
- the buyer accepts delivery, and
- installation and inspection are complete.

However, revenue is recognised immediately upon the buyer's acceptance of delivery when:

i) the installation process is simple in nature, or

ii) the inspection is performed only for purposes of final determination of contract prices

Example - the installation of a factory tested television receiver which only requires unpacking and connection of power and antennae

Example - shipments of iron ore, sugar or soya beans.

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Revenue – Sale of Goods

Example

Goods shipped subject to conditions:

b) On approval when the buyer has negotiated a limited right of return

- If there is uncertainty about the possibility of return, revenue is recognised when
  - the shipment has been formally accepted by the buyer or
  - the goods have been delivered and the time period for rejection has elapsed.

c) Consignment sales under which the recipient (buyer) undertakes to sell the goods on behalf of the shipper (seller)

- Revenue is recognised by the shipper when the goods are sold by the recipient to a third party.

d) Cash on delivery sales

- Revenue is recognised when
  - delivery is made and
  - cash is received by the seller or its agent.

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Revenue – Sale of Goods

Entity Retains Only Insignificant Risks of Ownership

- If an entity retains only an insignificant risk of ownership
  - the transaction is a sale and revenue is recognised.

- For example, a seller may retain the legal title to the goods solely to protect the collectibility of the amount due.
  - In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognised.

- Another example of an entity retaining only an insignificant risk of ownership may be a retail sale when a refund is offered if the customer is not satisfied.
  - Revenue in such cases is recognised at the time of sale provided the seller
    - can reliably estimate future returns and
    - recognises a liability for returns based on previous experience and other relevant factors.

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Revenue – Sale of Goods

Example

"Bill and hold" sales, in which delivery is delayed at the buyer's request but the buyer takes title and accepts billing.

- Revenue is recognised when the buyer takes title, provided:
  a) it is probable that delivery will be made;
  b) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;
  c) the buyer specifically acknowledges the deferred delivery instructions; and
  d) the usual payment terms apply.
- Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.

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Revenue – Sale of Goods

Inflow of Future Economic Benefits Not Probable

Revenue not recognised if inflow is not probable

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

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

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Revenue – Sale of Goods

Example

- Lay away sales under which the goods are delivered only when the buyer makes the final payment in a series of instalments

- Revenue from such sales is recognised
  - when the goods are delivered.
- However, when experience indicates that most such sales are consummated
  - revenue may be recognised when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the buyer.

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Revenue – Sale of Goods

Inflow of Future Economic Benefits Not Probable

Inflow is not probable after revenue is recognised

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

No offsetting

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Revenue – Sale of Goods

Matching of Revenues and Expenses

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

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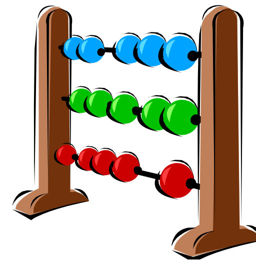
Revenue – Rendering of Services

Sale of goods

Rendering of services

Interest, royalties and dividend

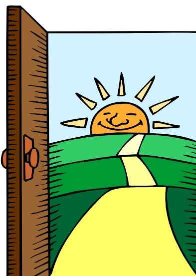


Revenue – Rendering of Services

Main Principle

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

Often referred to as the *percentage of completion method*



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

Revenue – Rendering of Services

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

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Revenue – Rendering of Services

Example

Installation fees

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

Advertising commissions

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

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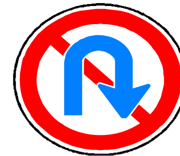
Revenue – Rendering of Services

Inflow of Future Economic Benefits Not Probable

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



No offsetting

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Revenue – Rendering of Services

Reliable Estimates of Revenue

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

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Revenue – Rendering of Services

Stage of Completion of a Transaction

- The stage of completion of a transaction may be determined by a variety of methods.
  - An entity uses the method that measures reliably the services performed.
- Depending on the nature of the transaction, the methods may include:
  a) surveys of work performed;
  b) services performed to date as a percentage of total services to be performed; or
  c) the proportion that costs incurred to date bear to the estimated total costs of the transaction.
    - Only costs that reflect services performed to date are included in costs incurred to date.
    - Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.
- Progress payments and advances received from customers often do not reflect the services performed.

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Revenue – Rendering of Services

Indeterminate Number of Acts and Significant Specific Act

- For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time,
  - revenue is recognised on a straight-line basis over the specified period
    - unless there is evidence that some other method better represents the stage of completion.
- When a specific act is much more significant than any other acts,
  - the recognition of revenue is postponed until the significant act is executed.

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Revenue – Rendering of Services

Example

- Servicing fees included in the price of the product

- When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support and product enhancement on the sale of software)
  - that amount is deferred and recognised as revenue over the period during which the service is performed.
- The amount deferred is that
  - which will cover the expected costs of the services under the agreement
  - together with a reasonable profit on those services.

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Revenue – Rendering of Services

Outcome of Services Not Estimated Reliably

- When the outcome of the transaction involving the rendering of services cannot be estimated reliably,
  - revenue shall be recognised only to the extent of the expenses recognised that are recoverable.

- During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably.
  - Nevertheless, it may be probable that the entity will recover the transaction costs incurred.
    - Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable.
    - As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

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Revenue – Rendering of Services

Outcome of Services Not Estimated Reliably

- When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered
  - revenue is not recognised and the costs incurred are recognised as an expense.
- When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist,
  - revenue is recognised in accordance with the main principle on recognising revenue on rendering of services
  - rather than in accordance with the above descriptions.

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Revenue – Rendering of Services

Case

Sino Land Company Limited

2005 Annual Report stated that:

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

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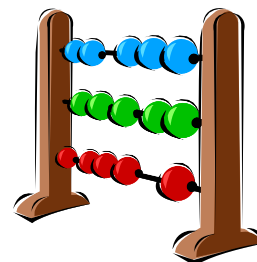
Revenue – Interest, Royalties & Dividend

Sale of goods

Rendering of services

Interest, royalties and dividend



Revenue – Interest, Royalties & Dividend

Main Principle

- Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised on the bases set out in the following paragraph when:
  - a) it is probable that the economic benefits associated with the transaction will flow to the entity; and
  - b) the amount of the revenue can be measured reliably.

- Revenue shall be recognised on the following bases:
  - a) interest shall be recognised using the effective interest method as set out in HKAS 39, paragraphs 9 and AG5-AG8;
  - b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and
  - c) dividends shall be recognised when the shareholder's right to receive payment is established.

Revenue – Interest, Royalties & Dividend

Interests

- When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between
  - pre-acquisition and
  - post-acquisition periods

  only the post-acquisition portion is recognised as revenue.

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Revenue – Interest, Royalties & Dividend

Example

Amortised Cost on 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 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 recognised $47,327 (as calculated below):

	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*

- Calculate the amortised cost each year end.

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Revenue – Interest, Royalties & Dividend

Example

	Balance b/f	Effective interest (6%)	Interest received (4%)	Balance c/f
31.12.2005	$ 47,327	$ 2,840	($ 2,000)	$ 48,167
31.12.2006	$ 48,167	$ 2,890	($ 2,000)	$ 49,057
31.12.2007	$ 49,057	$ 2,943	($ 2,000)	$ 50,000

- For example, at 31.12.2005, the entry is:

Dr	Loans receivable ($47,327 x 6%)	2,840	
Cr	Interest income (P/L)		2,840
	Being effective interest income recognised for the year.		
Dr	Cash (interest received, $50,000 x 4%)	2,000	
Cr	Loans receivable		2,000
	Being cash interest received.		

Revenue – Interest, Royalties & Dividend

Dividends

- When dividends on equity securities are declared from pre-acquisition profits
  - those dividends are deducted from the cost of the securities.
- If it is difficult to make such an allocation except on an arbitrary basis
  - dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.

Revenue – Interest, Royalties & Dividend

Recognition of Royalties Over the Terms of Agreement

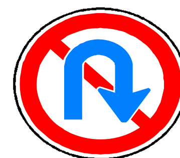
Royalties

- Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis
  - unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis.

Revenue – Interest, Royalties & Dividend

Inflow of Future Economic Benefits Not Probable

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



No offsetting

Revenue – Disclosure

An entity shall disclose:

a) the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;

b) the amount of each significant category of revenue recognised during the period including revenue arising from:
   i) the sale of goods;
   ii) the rendering of services
   iii) interest;
   iv) royalties;
   v) dividends; and

c) the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

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Revenue – Disclosure

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

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HK Interpretation 3

Pre-completion Contracts for the Sale of Development Properties

- Background
- Requirements under current framework
- Conclusion in Interpretation

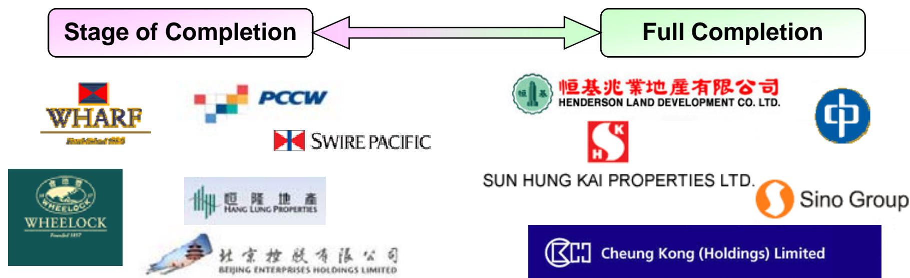
HK Interpretation 3

- Property development projects are usually long term projects.
- In many cases, property developers would enter into contracts to sell the properties in advance of the completion of the development
  - usually involve the payment of a deposit by the purchaser
  - payment may be refundable only
    - if the developer does not complete the development in accordance with the contracted timeframes and specifications, or
    - if there is some other breach of a contractual condition or statutory obligation.
- The balance of the purchase price is normally paid either at contractual settlement or in stages up to contractual settlement.

HK Interpretation 3

Case

- Property developers used to adopt various policies for recognising revenue arising from pre-completion contracts for the sale of development properties.
  - The stage of completion method was a commonly used policy.
  - Full completion method was another one used by some companies.



HK Interpretation 3

Case

Stage of Completion

Annual Report 2003/04 stated that:

- Profit on pre-sale of properties under development for sale
  - is recognised over the course of the development and
  - is calculated each year as a proportion of the total estimated profit to completion, the proportion used being the lower of
    - the proportion of construction costs incurred at the balance sheet date to estimated total construction costs and
    - the proportion of sales proceeds received and receivable at the balance sheet date to total sales proceeds in respect of the units sold.

HK Interpretation 3

Case

2004 Annual Report set out that:

- When properties under development are sold, income is recognised when the property is completed and the relevant occupation permit is issued by the Authorities.
- Payments received from the purchasers prior to this stage
  - are recorded as customers' deposits received and
  - are deducted from the value of stock of properties.

Full Completion

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Concerns & Construction Contract

- Concern has been expressed as to
  - whether the pre-completion contracts would satisfy the definition of construction contracts in HKAS 11 *Construction Contracts* and
  - if not, whether the stage of completion method would be acceptable under HKFRSs.
- Concern has also been expressed, in the absence of authoritative guidance, that
  - diverse or unacceptable practices would undermine
    - the relevance, reliability or comparability of financial statements.

Qualitative Characteristics of Financial Statements

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Concerns & Construction Contract

Definition fulfilled by property developers in HK?

- Concern has been expressed as to
  - whether the pre-completion contracts would satisfy the definition of construction contracts in HKAS 11 *Construction Contracts* and
  - if not, whether the stage of completion method would be acceptable under HKFRSs.

- A construction contract is
  - a contract specifically negotiated for the construction of an asset or a combination of assets
  - that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

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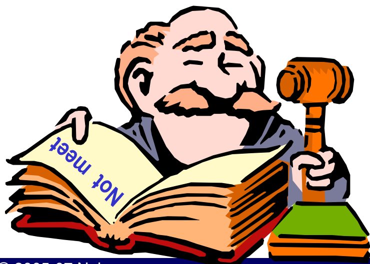
Conclusion by HK Interpretation 3

Definition fulfilled by property developers in HK?

- Pre-completion contracts for the sale of development properties
  - do not meet the definition of construction contracts,
  - if the contracts in question are not specifically negotiated for the construction of the properties.



- Accordingly, these contracts
  - fall outside the scope of HKAS 11 and,
  - as a result, the stage of completion method as required under HKAS 11 shall not be used to recognise revenue arising from such contracts.

Then ……

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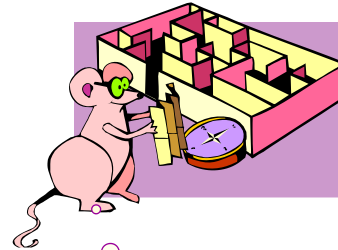
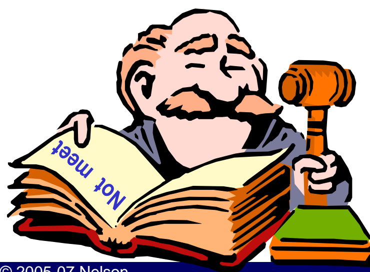
Conclusion by HK Interpretation 3

- Property developers shall
  - apply HKAS 18 in recognising revenue arising from pre-completion contracts for the sale of development properties that do not fall within the scope of HKAS 11, and
  - accordingly, recognise revenue only when all of the criteria specified in HKAS 18.14 are met.



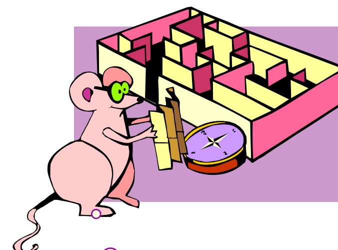


All criteria in para. 14 of HKAS 18?

HKAS 18.14

Back to HKAS 18, HKAS 18.14 sets out that:

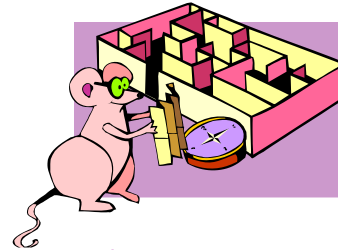
- Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:
  a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
  b) the entity retains neither continuing managerial involvement to the degree usually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



All criteria in para. 14 of HKAS 18?

HK Interpretation 3

Case



Implication to them?

HK Interpretation 3

Case

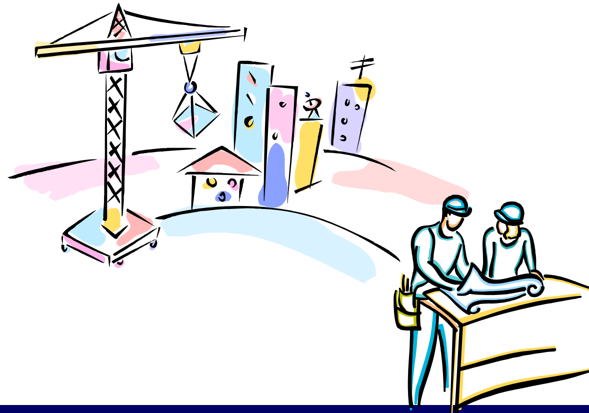
Annual Report 2003/04 stated that:

- Profit on pre-sale of properties under development for sale is recognised over the course of the development and is calculated each year as a proportion of the total estimated profit to completion ……

But Annual Report 2004/05 changed to that:

- With the introduction of the HK Interpretation 3 "Revenue – Pre-Completion contracts for the sale of development properties" issued by the HKICPA,
  - the Group now recognises revenue arising from pre-sale of properties upon completion of the development of property.

Construction Contract (HKAS 11)



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Objective and Scope

- The objective of HKAS 11 is to prescribe the accounting treatment of revenue and costs associated with construction contracts.
  - The primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed.
- HKAS 11 shall be applied in accounting for construction contracts in the financial statements of contractors.

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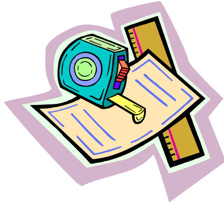
What is Contraction Contract?



- A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets
  - that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.
- There are usually 2 kinds of contracts:
  - **A fixed price contract**
    - is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.
  - **A cost plus contract**
    - is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

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What is Contraction Contract?

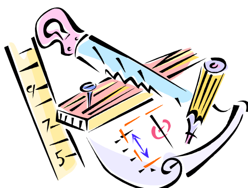
- For the purposes of HKAS 11, construction contracts include:
  a) contracts for the rendering of services
    - which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

  b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

Rendering of Services

Destruction

Restoration



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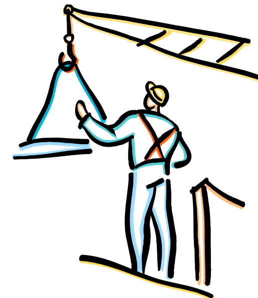
Combining or Segmenting?

Example

- In 2005, Entity A signed a construction contract of HK$50 million with Entity B to build an estate in Cheung Sa
- Entity A finished the foundation work and received the down payments of HK$10 million
- Entity B requires Entity A to transfer the finished properties of the whole estate to it by 3 phases.
- Discuss the implication to Entity A.



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Combining or Segmenting?

- The requirements of HKAS 11 are usually applied separately to each construction contract.
- However, in certain circumstances, it is necessary to apply HKAS 11 to
  - the separately identifiable components of a single contract or
  - to a group of contracts together

  in order to reflect the substance of a contract or a group of contracts.

Each part of a single contract

2 or more contracts together

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Combining or Segmenting?

- When a contract covers a number of assets, the construction of each asset shall be treated as a separate construction contract when:
  a) separate proposals have been submitted for each asset;
  b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
  c) the costs and revenues of each asset can be identified.

Each part of a single contract

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Combining or Segmenting?

- A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:
  a) the group of contracts is negotiated as a single package;
  b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
  c) the contracts are performed concurrently or in a continuous sequence.

2 or more contracts together

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Combining or Segmenting?

- A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset.
- The construction of the additional asset shall be treated as a separate construction contract when:
  a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
  b) the price of the asset is negotiated without regard to the original contract price.

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Contract Revenue & Contract Cost

Example

- In 2005, Entity A signed a construction contract of HK$50 million with Entity B to build an estate in Cheung Sa
- Entity A finished the foundation work and received the down payments of HK$10 million
- In 2006, Entity B could not source sufficient funds to continue the project and abolished the project.
- Entity A received HK$5 million compensation from Entity B on 30 June 2006.
- Discuss the implication

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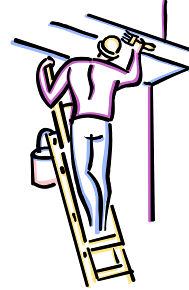
Contract Revenue & Contract Cost

- Contract revenue shall comprise:
  a) The initial amount of revenue agreed in the contract; and
  b) Variations in contract work, claims and incentive payments:
     i) to the extent that it is probable that they will result in revenue; and
     ii) they are capable of being reliably measured.



- Contract costs shall comprise:
  a) costs that relate directly to the specific contract;
  b) costs that are attributable to contract activity in general and can be allocated to the contract; and
  c) such other costs as are specifically chargeable to the customer under the terms of the contract.

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Contract Revenue & Contract Cost

Case

Annual Report 2005

- Contract revenue comprises
  - the agreed contract amount and
  - appropriate amounts from variation orders, claims and incentive payments.
- Contract costs incurred comprise
  - direct materials,
  - the costs of subcontracting,
  - direct labour and
  - an appropriate proportion of variable and fixed construction overheads.

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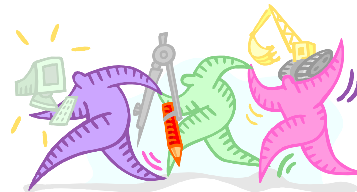
Recognition of Contract Revenue and Cost

Estimated Reliably

Stage of Completion

- When the outcome of a construction contract can be estimated reliably,
  - contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date.
- An expected loss on the construction contract
  - shall be recognised as an expense immediately in accordance with HKAS 11.



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Recognition of Contract Revenue and Cost

Example

Estimated Reliably

Fixed Price Contract

Cost Plus Contract

- How can we fulfil "estimated reliably"?
- Assuming Entity A enters into a construction contract with Entity X
  - Entity X would pay all the contract revenue at the inception of the contract
  - Entity A would incur the cost and finish it as soon as possible.
  - At year end, 80% of the contract has been completed
  - Can Entity A recognize 80% of the contract revenue and cost?
- Any differences between
  - Fixed price contract, and
  - Cost plus contract
    - For example, if Entity A can recharge any additional cost to Entity X

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Recognition of Contract Revenue and Cost

Estimated Reliably

Fixed Price Contract

- In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:
  a) total contract revenue can be measured reliably;
  b) it is probable that the economic benefits associated with the contract will flow to the entity;
  c) both the contract costs to complete the contract and the stage of contract completion at the balance sheet date can be measured reliably; and
  d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

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Recognition of Contract Revenue and Cost

Estimated Reliably

Cost Plus Contract

- In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:
  a) it is probable that the economic benefits associated with the contract will flow to the entity; and
  b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

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Recognition of Contract Revenue and Cost

Estimated Reliably

Fixed Price Contract

Cost Plus Contract

- The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits associated with the contract will flow to the entity.
- However, when an uncertainty arises about the collectibility of an amount already included in contract revenue, and already recognised in the income statement,
  - the uncollectable amount or the amount in respect of which recovery has ceased to be probable is
    - recognised as an expense
    - rather than as an adjustment of the amount of contract revenue.

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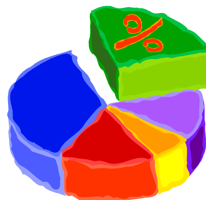
Recognition of Contract Revenue and Cost

Estimated Reliably

Stage of Completion

- The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as
  - the percentage of completion method.



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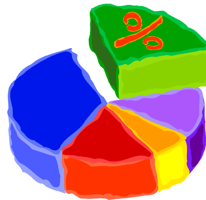
Recognition of Contract Revenue and Cost

- The stage of completion of a contract may be determined in a variety of ways.
- The entity uses the method that measures reliably the work performed.
- Depending on the nature of the contract, the methods may include:
  a) the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;
  b) surveys of work performed; or
  c) completion of a physical proportion of the contract work.

Cost Incurred To Date

Survey of Work

Physical Proportion



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Recognition of Contract Revenue and Cost

Example

- On 1 Jan. 2001, Vision Corp. signed a construction contract with a customer for 3 years with an agreed contract consideration of HK$200 million.
- The cost of the contract was estimated at HK$150 million.
- During the year to 31 Dec. 2001, Vision Corp. incurred contract cost of HK$70 million.
- The surveyor certified that 40% of the contract work had been completed on 31 Dec. 2001.
- On 31 Dec. 2001, Vision Corp. received a progress payment of HK$100 million.
- Which basis can be used as stage of completion of the contract?

$70 / $150 = 46.7%

Surveys of work = 40%

?

Progress payments and advances received from customers often do not reflect the work performed.

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Recognition of Contract Revenue and Cost

Case

SUN HUNG KAI PROPERTIES LTD.

Annual Report 2004/05

- Accounting policy on construction
  - Revenue in respect of building construction job is recognized on the percentage of completion method measured by reference to the proportion that
    - costs incurred to date bear to
    - estimated total costs for the contract.

Cost Incurred To Date

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Recognition of Contract Revenue and Cost

Case

Annual Report 2005

- Revenue from fixed price construction contracts is recognised on the percentage of completion method,
  - measured by reference to the proportion of costs incurred to date to the estimated total cost of the relevant contract.
- Revenue from cost plus construction contracts is recognised on the percentage of completion method,
  - by reference to the recoverable costs incurred during the period plus the related fee earned, measured by the proportion of costs incurred to date to the estimate total cost of the relevant contract.

Cost Incurred To Date

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Recognition of Contract Revenue and Cost

Case

Annual Report 2005

Accounting policy on construction revenue

- Revenue from a fixed price contract is recognized using the percentage of completion method,
  - measured by reference to the percentage of estimated value of work performed to date to total contract revenue.

Physical Proportion

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Recognition of Contract Revenue and Cost

- When the outcome of a construction contract cannot be estimated reliably:
  a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and
  b) contract costs shall be recognised as an expense in the period in which they are incurred.
- An expected loss on the construction contract shall be recognised as an expense immediately in accordance with HKAS 11.
- When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist,
  – revenue and expenses associated with the construction contract shall be recognised in as usual rather than as above.

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Recognition of Expected Losses

- When it is probable that total contract costs will exceed total contract revenue,
  - the expected loss shall be recognised as an expense immediately.
- The amount of such a loss is determined irrespective of:
  a) whether work has commenced on the contract;
  b) the stage of completion of contract activity; or
  c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with HKAS 11.

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Recognition of Expected Losses

Case

Annual Report 2005

- Provision is made for foreseeable losses as soon as they are anticipated by management.
- Where contract costs incurred to date plus recognised profits less recognised losses exceed progress billings,
  - the surplus is treated as an amount due from customer for contract work.
- Where progress billings exceed contract costs incurred to date plus recognised profits less recognised losses,
  - the surplus is treated as an amount due to customer for contract work.

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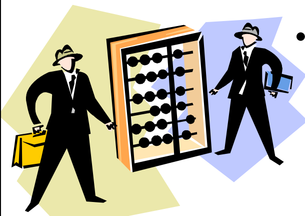
Changes in Estimates



- The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates on contract revenue and contract costs.
  - Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate on the outcome of a contract, is accounted for as a change in accounting estimate (see HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).
- The changed estimates are used in the determination of the amount of revenue and expenses recognised in the income statement
  - in the period in which the change is made and
  - in subsequent periods.

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Disclosure

- An entity shall disclose:
  a) the amount of contract revenue recognised as revenue in the period;
  b) the methods used to determine the contract revenue recognised in the period; and
  c) the methods used to determine the stage of completion of contracts in progress.
- An entity shall disclose each of the following for contracts in progress at the balance sheet date:
  a) the aggregate amount of costs incurred and recognised profits (less recognised losses) to date;
  b) the amount of advances received; and
  c) the amount of retentions.
- An entity shall present:
  a) the gross amount due from customers for contract work as an asset; and
  b) the gross amount due to customers for contract work as a liability.

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Disclosure

- The gross amount due from customers for contract work is the net amount of:
  a) costs incurred plus recognised profits; less
  b) the sum of recognised losses and progress billings for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.
- The gross amount due to customers for contract work is the net amount of:
  a) costs incurred plus recognised profits; less
  b) the sum of recognised losses and progress billings for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).
- An entity discloses any contingent liabilities and contingent assets in accordance with HKAS 37*.* Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses.

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Disclosure

Case

Annual Report 2005

Accounting policy on construction contract

- Construction contracts in progress at the balance sheet date
  - are recorded in the balance sheet at
    - the net amount of costs incurred
    - plus recognized profit less recognized losses and
    - estimated value of work performed, including progress billing, and
  - are presented in the balance sheet as
    - the “Gross amount due from customers for contract work” (as an asset) or
    - the “Gross amount due to customers for contract work” (as a liability), as applicable.
- Progress billings for work performed on a contract not yet paid by customers are included in the balance sheet under
  - “Prepayments, deposits and other current assets”.

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Construction Contract

Example

- As set out before, on 1 Jan. 2001, Vision Corp. signed a construction contract with a customer for 3 years with an agreed contract consideration of HK$200 million.
- The cost of the contract was estimated at HK$150 million.
- During the year to 31 Dec. 2001, Vision Corp. incurred contract cost of HK$70 million.
- The surveyor certified that 40% of the contract work had been completed on 31 Dec. 2001.
- On 31 Dec. 2001, Vision Corp. received a progress payment of HK$100 million.
- Prepare the journal entries and extract of financial statements of Vision Corp. for the year ended 31 Dec. 2001.
- Assumed that the percentage of completion of the contract is based on the work certified by an independent surveyor appointed by the customer.

Surveys of work = 40%

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Construction Contract

Example

	Dr HK$'M	Cr HK$'M
Cash	100	
Progress payments		100
To recognize progress payments received		
Cost to date70		
Cash		70
To account for cost incurred to 31.12.2003		
Contract cost (40% x $150 million)	60	
Recognized profit	20	
Contract revenue (40% x $200 million)		80
To recognize profit on the contract		

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Construction Contract

Example

Income statement (Extract only)	HK$'M
Contract revenue	80
Contract cost	(60)
Recognized profit	20

Balance sheet (Extract only)	HK$'M
Gross amounts due from/to customers	
Cost incurred to date	70
Recognized profit	20
	90
Less: Progress payments	(100)
Gross amounts due to customers	(10)

Note: Gross amounts were in credit balance at year end and hence gross amounts due to customers were shown at year end

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HK Interpretation 1

The Appropriate Policies for Infrastructure Facilities

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HK Interpretation 1 – Sinking Fund

- Some companies in HK have adopted Sinking Fund Method in depreciating their infrastructure facilities, in particular toll roads, in their financial statements purporting to be in compliance with HKFRSs.

- Such companies disclosed an accounting policy that
  - the capital cost of an infrastructure asset was allocated by applying a sinking fund method whereby
    - the aggregate annual depreciation amounts, compounded at certain rates of return, up to the expiry of the infrastructure asset (e.g. toll road) concession periods,
    - will be equal to the total cost of the asset.

HK Interpretation 1 – Sinking Fund

Example

- A machine costs HK$600,000 with an estimated useful life of 3 years?
- Calculate deprecation for the years under difference depreciation methods.

	Year 1	Year 2	Year 3	Total
Straight-line basis	200	200	200	**600**
Reducing balance (at 70%)	420	126	38	**584**
Sum-of-year-digit	300	200	100	**600**
Sinking fund (compounded at 23.2%)	160	197 (160 x 123.2%)	243 (197 x 123.2%)	**600**

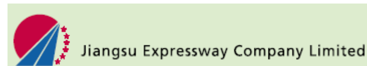
Sinking fund method allocates more depreciation to the later years.

➢ It is different from most depreciation methods (as above).

HK Interpretation 1 – Sinking Fund

Case

- Some listed companies stated that they had used a sinking fund method ……



HK Interpretation 1 – Sinking Fund

Case

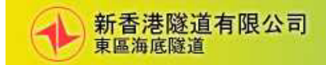
2002 Annual Report of Anhui Expressway Co. Ltd. stated that:

- Depreciation of toll roads and amortisation of land use rights in relation to toll roads are calculated to write off their cost on the basis of a sinking fund calculation whereby
  - annual depreciation amounts compounded
    - at an average rate of 7%, 6%, 3% and 4% per annum for Hening Expressway, 205 Tian Chang Section, Xuan Guang Expressway and Gao Jie Expressway respectively
  - will approximate the total carrying value of the toll roads and the land use rights
    - in relation to toll roads at the end of operating periods of respective toll roads.
- Please comment.

HK Interpretation 1 – Sinking Fund

Case

Depreciation on its tunnels



- **2002 Annual Report:**
  - Amortisation of vehicular tunnel (including land and buildings) is provided for over the franchise period on the basis of a sinking fund calculation whereby annual amounts compounded at the rate of 7% per annum will equal the net cost of the tunnel.
- **2003 Annual Report:**
  - Depreciation of the vehicular tunnel was provided with reference to projected usage of the tunnel through a sinking fund calculation.
- **2004 Annual Report:**
  - Depreciation of the vehicular tunnel was provided with reference to projected usage of the tunnel as compared to the actual tunnel usage.

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Conclusion by HK Interpretation 1

HK Int. 1 concludes that:

- The **Sinking Fund Method** is NOT an appropriate method of depreciating or amortising infrastructure assets,
  - regardless of whether the asset (or components thereof) is classified as
    - property, plant and equipment,
    - intangible assets or
    - operating lease prepayments.
- By definition, the sinking fund method
  - neither supports the view that consumption of economic benefits (such as in a Build-Operate-Transfer franchise) is determined by either the passage of time and/or usage.

Sinking Fund

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Conclusion by HK Interpretation 1

Case

2004 Annual Report of Anhui Expressway Co. Ltd. stated that:

- Depreciation of toll roads and land use rights in relation to toll roads is calculated to write off their cost on a units-of-usage basis whereby
  - depreciation is provided based on the share of traffic volume for a particular period over the projected total traffic volume throughout the periods for which the Group is granted the rights to operate those roads.
- It is the Group's policy to review regularly the projected total traffic volume throughout the operating periods of the respective toll roads.
- If it is considered appropriate, independent professional traffic studies will be obtained. Appropriate adjustment will be made should there be a material change.

Changed to units-of-usage basis

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Borrowing Costs (HKAS 23)

Amendments to IAS 23 issued in March 2007 …… and HK?

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Topics Covered

1. Objective and scope
2. What are borrowing costs?
3. Benchmark treatment: Expense
4. Allowed alternative treatment: Capitalisation

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1. Objective and Scope

- The objective of HKAS 23 is to prescribe the accounting treatment for borrowing costs.
- HKAS 23
  - generally requires the immediate expensing of borrowing costs, but
  - permits, as an allowed alternative treatment, the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.
- HKAS 23 shall be applied in accounting for borrowing costs, but does not deal with the actual or input cost of equity, including preferred capital not classified as a liability.

Benchmark – Expenses

Allowed Alternative – Capitalisation

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2. What Are Borrowing Costs?

- Borrowing costs
  - are interest and other costs incurred by an entity in connection with the borrowing of funds.
  - may include:
    a) interest on bank overdrafts and short-term and long-term borrowings;
    b) amortisation of discounts or premiums relating to borrowings;
    c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
    d) finance charges in respect of finance leases recognised in accordance with HKAS 17 *Leases*; and
    e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

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3. Benchmark Treatment: Expense

Recognition

- Borrowing costs shall be recognised as an expense in the period in which they are incurred.
- Under the benchmark treatment
  - borrowing costs are recognised as an expense in the period in which they are incurred regardless of how the borrowings are applied.

Benchmark – Expenses

Disclosure

- The financial statements shall disclose
  - the accounting policy adopted for borrowing costs.

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3. Benchmark Treatment: Expense

Amendments to IAS 23 issued in March 2007

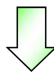
- Converged to the practice in US
- HK should follow soon
- Apply to borrowing costs relating to qualifying assets for which it begins capitalisation on or after 1 January 2009
- Remove the option of immediately recognising the borrowing costs as expenses
- IAS 23 does not apply to borrowing costs directly attributable to the acquisition, construction and production of a qualifying assets measured at fair value, say biological asset

Benchmark – Expense

4. Allowed Alternative: Capitalise

Recognition

- Borrowing costs shall be recognised as an expense in the period in which they are incurred,
  - except to the extent that they are capitalised in accordance with HKAS 23.



Allowed Alternative – Capitalisation

- What kinds of borrowing costs eligible for capitalisation?
- When does capitalisation commence?
- When does capitalisation suspense?
- When does capitalisation cease?

4. Allowed Alternative: Capitalise

Recognition → Eligible

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset *shall be capitalised* as part of the cost of that asset.
  - The amount of borrowing costs eligible for capitalisation shall be determined in accordance with HKAS 23.

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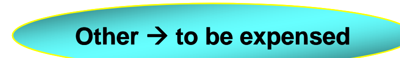
4. Allowed Alternative: Capitalise

Recognition → Eligible

- A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.
- Under the allowed alternative treatment,
  - borrowing costs that are directly attributable to the acquisition, construction or production of an asset are included in the cost of that asset.
- Such borrowing costs are capitalised as part of the cost of the asset when
  - it is probable that they will result in future economic benefits to the entity and
  - the costs can be measured reliably.
- Other borrowing costs are recognised as an expense in the period in which they are incurred.



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4. Allowed Alternative: Capitalise

Example

Recognition → Eligible

Qualifying Asset

Examples of qualifying assets:

- Inventories that require a substantial period of time to bring them to a saleable condition
- Manufacturing plants,
- Power generation facilities
- Investment properties

Examples of items cannot be qualifying assets:

- Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time
- Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

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4. Allowed Alternative: Capitalise

Recognition → Eligible

Qualifying Asset

Attributable borrowing cost

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that
  - would have been avoided if the expenditure on the qualifying asset had not been made.
- When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset,
  - the borrowing costs that directly relate to that qualifying asset can be readily identified.

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4. Allowed Alternative: Capitalise

Recognition → Eligible

- It may be difficult
  - to identify a direct relationship between particular borrowings and a qualifying asset and
  - to determine the borrowings that could otherwise have been avoided.

  e.g. when the financing activity of an entity is coordinated centrally.
- Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group.
- Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates.
- As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.

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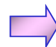
4. Allowed Alternative: Capitalise

Recognition → Eligible

Borrowing costs may be incurred from 2 sources in obtaining a qualifying asset:

1. Borrowed specifically for obtaining a qualifying asset
2. Borrowed generally and used for obtaining a qualifying asset



To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset

- the amount of borrowing costs eligible for capitalisation on that asset shall be determined as the **actual borrowing costs** incurred on that borrowing during the period
- less any investment income on the temporary investment of those borrowings.

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4. Allowed Alternative: Capitalise

Recognition → Eligible

- The financing arrangement for a qualifying asset may result in an entity
  - obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset.
- In such circumstances, the funds are often
  - temporarily invested pending their expenditures on the qualifying asset.
- In determining the amount of borrowing costs eligible for capitalisation during a period,
  - any investment income earned on such funds is deducted from the borrowing costs incurred.

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4. Allowed Alternative: Capitalise

Case

- Borrowing costs are expensed in the income statement in the period in which they are incurred,
  - except to the extent that they are capitalized as being attributable to the acquisition, construction or production of an asset which necessarily takes a substantial period of time to get ready for its intended use or sale.

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4. Allowed Alternative: Capitalise

Case

Beijing Enterprises Holdings Ltd.

- Has early adopted all new HKFRS in 2004 and stated that:
  - Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, i.e., assets that necessarily take a substantial period of time to get ready for their intended use or sale, are capitalized as part of the cost of those assets ……
  - Investment income earned on the temporary investment of specific borrowings pending their expenditure on qualifying assets is deducted from the borrowing costs capitalized.

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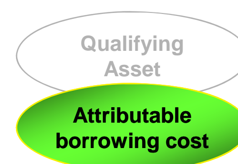
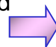
4. Allowed Alternative: Capitalise

Recognition → Eligible



Borrowing costs may be incurred from 2 sources in obtaining a qualifying asset:

1. Borrowed specifically for obtaining a qualifying asset
2. Borrowed generally and used for obtaining a qualifying asset



To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset

- the amount of borrowing costs eligible for capitalisation shall be determined by applying **a capitalisation rate** to the expenditures on that asset.

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4. Allowed Alternative: Capitalise

Recognition → Eligible

Borrowing costs may be incurred from 2 sources in obtaining a qualifying asset:

1. Borrowed specifically for obtaining a qualifying asset
2. Borrowed generally and used for obtaining a qualifying asset

- The **capitalisation rate** shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period,
  - other than borrowings made specifically for the purpose of obtaining a qualifying asset.
- The amount of borrowing costs capitalised during a period shall not exceed the amount of borrowing costs incurred during that period.

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4. Allowed Alternative: Capitalise

Recognition → Eligible

- In some circumstances, it is appropriate to
  - include all borrowings of the parents and its subsidiaries when computing a weighted average of the borrowing costs
- In other circumstances, it is appropriate for
  - each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.

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4. Allowed Alternative: Capitalise

Recognition

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

- When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value
  - ➢ the carrying amount is written down or written off in accordance with the requirements of other HKFRSs.
- In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other HKFRSs.

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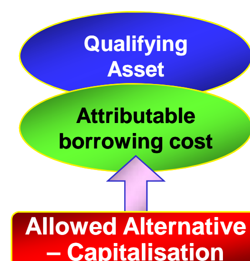
4. Allowed Alternative: Capitalise

Recognition → Commence



- The capitalisation of borrowing costs as part of the cost of a qualifying asset shall commence when:
  a. expenditures for the asset are being incurred;
  b. borrowing costs are being incurred; and
  c. activities that are necessary to prepare the asset for its intended use or sale are in progress.

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4. Allowed Alternative: Capitalise

Example

- Entity A constructs a scientific medical equipment for its own use, with a cost of HK$50 million and consider it as a qualified asset.
- Borrowing costs capitalised under HKAS 23 amounts to HK$6 million.
- It also receives a government grant of HK$5 million on that asset.
- Can the government grant received be recognised as part of the expenditure on qualified asset?

Expenditures on a qualifying asset

- include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities.
- are reduced by any progress payments received and grants received in connection with the asset (see HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*).

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4. Allowed Alternative: Capitalise

Example

- Before the construction of a property in a land, Entity GV has to prepare the construction plan and get the government approval.
- Borrowing costs have been incurred during the above period.
- Are these borrowing costs eligible for capitalisation under HKAS 23?

Yes

- The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset.
- They include technical and administrative work prior to the commencement of physical construction,
  - such as the activities associated with obtaining permits prior to the commencement of the physical construction.
- However, such activities exclude
  - the holding of an asset when no production or development that changes the asset's condition is taking place.

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4. Allowed Alternative: Capitalise

Recognition → Suspense

- Capitalisation of borrowing costs shall be suspended during extended periods in which active development is interrupted.

  Except for the following:
  - Not normally suspended during a period when substantial technical and administrative work is being carried out.
  - Not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

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4. Allowed Alternative: Capitalise

Recognition → Cease

- Capitalisation of borrowing costs shall cease
  - when **substantially all** the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
- When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalisation of borrowing costs shall cease
  - when **substantially all** the activities **necessary to prepare that part** for its intended use or sale are completed.

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4. Allowed Alternative: Capitalise

Example

Recognition → Cease

- Example of a qualifying asset for which each part is capable of being usable while construction continues on other parts
  - A business park comprising several buildings, each of which can be used individually
- Example of a qualifying asset that needs to be complete before any part can be used:
  - An industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

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4. Allowed Alternative: Capitalise

Example

- Entity A has finished the physical construction of a building for Miss Lee, subject to certain modification according to her specification after her inspection.
- Borrowing costs are incurred during the modification period
- Can these borrowing costs be capitalised?

No

- If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities of the property construction are complete.

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4. Allowed Alternative: Capitalise

Case

Wharf (Holdings) – 2004 Annual Report

- The capitalization of borrowing cost as part of the cost of a qualifying asset
  - commences when expenditure for the asset is incurred, borrowing costs are being incurred and activities to prepare the asset for its intended use or sale are in progress.
- Capitalization of borrowing costs
  - is suspended or ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are interrupted or complete.

4. Allowed Alternative: Capitalise

Disclosure

- The financial statements shall disclose:
  a. the accounting policy adopted for borrowing costs;
  b. the amount of borrowing costs capitalised during the period; and
  c. the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

4. Allowed Alternative: Capitalise

Example

- On 1 January 20x6 Rechno Co borrowed $15m to finance the production of two assets, both of which were expected to take a year to build.
- Production started during 2008.
- The loan facility was drawn down on 1 January 2008, and was utilised as follows, with the remaining funds invested temporarily.

	Asset X	Asset Y
	$m	$m
1 January 2008	2.5	5.0
1 July 2008	2.5	5.0

- The loan interest rate is 10% and Rechno Co can invest surplus funds at 8%.
- Ignoring compound interest, calculate the borrowing costs which may be captialised for each of the asset and consequently the cost of each asset at 31 Dec. 2008.

Source from ACCA 3.6 Revision Pack of BPP

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4. Allowed Alternative: Capitalise

Example

	Asset X	**Asset Y**
	$m	**$m**
Borrowing costs		
To 30 June 2008 ($2.5 m and $5.0 m x 10% x 6/12)	125	250
To 31 December 2008 ($5 m and $10.0 m x 10% x 6/12)	250	500
	375	750
Less: investment income		
To 30 June 2008 ($2.5 m and $5.0 m x 8% x 6/12)	(100)	(200)
	275	550
Cost of assets		
Expenditure incurred	5,000	10,000
Borrowing costs	275	550
	5,275	10,550

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4. Allowed Alternative: Capitalise

Example

- Zenzi Co had the following loans in place in 2008

	1 Jan 2008	31 Dec 2008
	$m	$m
10% bank loan repayable 2013	120	120
9.5% bank loan repayable 2011	80	80
8.9% debenture repayable 2018	--	150

- The 8.9% debenture was issued to fund the construction of a qualifying asset (a piece of mining equipment), construction of which began on 1 July 2008.
- On 1 Jan 2008, Zenzi Co began construction of a qualifying asset, a piece of machinery for a hydro-electric plant, using existing borrowings.
- Expenditure drawn down for the construction was:
  $30m on 1 Jan 2008 and $20m on 1 Oct 2008.
- Calculate the borrowing costs to be capitalised for the hydro-electric plant machine.

Source from ACCA 3.6 Revision Pack of BPP

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4. Allowed Alternative: Capitalise

Example

Capitalisation rate = Weighted average rate

$$= \left(10\% \times \frac{120}{120+80}\right) + \left(9.5\% \times \frac{80}{120+80}\right)$$

= 9.8%

Borrowing costs $= (\$30m \times 9.8\%) + \left(\$20m \times 9.8\% \times \frac{3}{12}\right)$

= $3.43m

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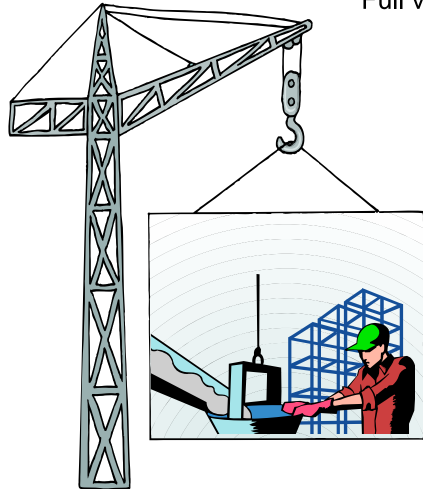
HKAS 11, 18 and 23

30 May 2007



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