

Financial Reporting Issues and Updates 2007 and 2008

30 April 2008



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Today's Agenda

Financial Instruments: Disclosures
(HKFRS 7)

Capital Disclosures
(Amendment to HKAS 1)

Recap Session

Amendments Effective
after 1 Jan. 2008

Potential development and
amendments in 2008-09



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Today's Agenda

Financial Instruments: Disclosures (HKFRS 7)



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Introduction of HKFRS 7

- The objective of HKFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- 1) the significance of financial instruments for the entity's
 - financial position and
 - financial performance; and
- 2) the nature and extent of risks arising from financial instruments to which the entity is exposed
 - during the period and
 - at the reporting date, andhow the entity manages those risks.

Significance

- Balance sheet
- Income statement
- Other disclosures

Nature and Extent

- Qualitative disclosures
- Quantitative disclosures

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Introduction: Classes and Level

- An entity decides, in the light of its circumstances,
 - how much detail it provides to satisfy the requirements of HKFRS 7,
 - how much emphasis it places on different aspects of the requirements and
 - how it aggregates information to display the overall picture without combining information with different characteristics.
- It is necessary to strike a balance between
 - overburdening financial statements with excessive detail that may not assist users of financial statements and
 - obscuring important information as a result of too much aggregation.



Significance

Nature and Extent

1. Significance of Financial Instruments

- An entity shall disclose information that enables users of its financial statements to evaluate
 - the significance of financial instruments for its financial position and performance.

Significance

Balance Sheet

Income Statement and Equity

Other Disclosures



1. Significance of Financial Instruments

Balance Sheet

The carrying amounts of each of the following categories, as defined in HKAS 39, shall be disclosed either on the face of the balance sheet or in the notes:

- a) financial assets at fair value through P/L, showing separately
 - i) those designated as such upon initial recognition and
 - ii) those classified as held for trading in accordance with HKAS 39;
- b) held-to-maturity investments;
- c) loans and receivables;
- d) available-for-sale financial assets;
- e) financial liabilities at fair value through P/L, showing separately
 - i) those designated as such upon initial recognition and
 - ii) those classified as held for trading in accordance with HKAS 39; and
- f) financial liabilities measured at amortized cost.

New in
HKFRS 7

HKAS 32 only
requires such
disclosures

1. Significance of Financial Instruments

Case



	Financial assets at fair value through profit or loss held for trading RMB'000	Loans and receivables RMB'000	Available- for-sale financial assets RMB'000	Total RMB'000
Financial assets included in other assets (note 18)	-	80,000	-	80,000
Interests in associates (notes 22)	-	10,000	-	10,000
Interests in jointly-controlled entities (note 23)	-	19,128	-	19,128
Available-for-sale investments	-	-	462,178	462,178
Financial assets included in prepayments, deposits and other receivables	-	321,664	-	321,664
Trade receivables	-	293,870	-	293,870
Bills receivables	-	52,346	-	52,346
Equity investments at fair value through profit or loss	102,439	-	-	102,439
Derivative financial instruments	4,440	-	-	4,440
Pledged deposits	-	52,088	-	52,088
Cash and cash equivalents	-	2,184,510	-	2,184,510
	106,879	3,013,606	462,178	3,582,663

1. Significance of Financial Instruments

Income Statement and Equity

An entity shall disclose the following items either on the face of the financial statements or in the notes:

- a) net gains or net losses on:
 - i) financial assets or financial liabilities at fair value through P/L, showing separately
 - those on financial assets or financial liabilities designated as such upon initial recognition, and
 - those on financial assets or financial liabilities that are classified as held for trading in accordance with HKAS 39;
 - ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in profit or loss for the period;
 - iii) held-to-maturity investments;
 - iv) loans and receivables; and
 - v) financial liabilities measured at amortized cost

New in
HKFRS 7

HKAS 32
requires
this only

New in
HKFRS 7

1. Significance of Financial Instruments

Income Statement and Equity

An entity shall disclose the following items either on the face of the financial statements or in the notes:

- b) total interest income and total interest expense for financial assets or financial liabilities that are not at fair value through P/L;
- c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:
 - i) financial assets or financial liabilities that are not at fair value through profit or loss; and
 - ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;
- d) interest income on impaired financial assets accrued in accordance with HKAS 39.AG93, and
- e) the amount of any impairment loss for each class of financial asset.



New in
HKFRS 7

1. Significance of Financial Instruments

Other Disclosures

- Disclosure requirements on accounting policies, hedge accounting and fair value are similar to HKAS 32.
- HKFRS 7 additionally requires:
 - a) in fair value hedges, gains or losses:
 - i) on the hedging instrument; and
 - ii) on the hedged item attributable to the hedged risk.
 - b) the ineffectiveness recognised in profit or loss that arises from cash flow hedges; and
 - c) the ineffectiveness recognised in profit or loss that arises from hedges of net investments in foreign operations.

New in
HKFRS 7



2. Nature and Extent of Risks



Significance

Nature and Extent

2. Nature and Extent of Risks



- An entity shall disclose information that enables users of its financial statements to evaluate
 - the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.
- The disclosures required focus on the risks that arise from financial instruments and how they have been managed.
- These risks typically include, but are not limited to
 - credit risk,
 - liquidity risk and
 - market risk.

Nature and Extent

Qualitative Disclosures

Quantitative Disclosures

2. Nature and Extent of Risks

- The disclosures in respect of the nature and extent of risks arising from financial instruments can be either
 1. given in the financial statements or
 2. incorporated by cross-reference from the financial statements to some other statement, that is available to users of the financial statements
 - on the same terms as the financial statements and
 - at the same time.

e.g. risk report, or management commentary

Without the information incorporated by cross-reference, the financial statements are incomplete.
(HKFRS 7.BC46)

Qualitative Disclosures

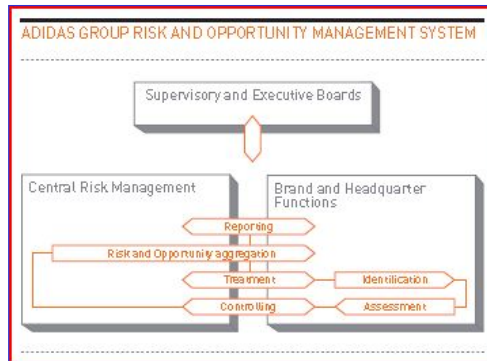
Quantitative Disclosures

2. Nature and Extent of Risks

Example

- Adidas's 13-page
 - “Risk and Opportunity Report”
- HSBC's 97-page
 - “The Management of Risk”
incorporated in the Report of Directors

e.g. risk report, or
management
commentary



Qualitative Disclosures

Quantitative Disclosures

2. Nature and Extent of Risks

Qualitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
 - a) The exposures to risk and how they arise;
 - b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk
 - c) Any changes in (a) or (b) from the previous period.



2. Nature and Extent of Risks

Quantitative Disclosures

- For each type of risk arising from financial instruments, an entity shall disclose:
 - a. Summary quantitative data about its exposure to that risk at the reporting date.
 - The level of detail of such disclosure is based on the information provided internally to key management personnel of the entity (as defined in HKAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.
 - b. the disclosures required in quantitative disclosures, to the extent not provided in (a), unless the risk is not material (see HKAS 1.29-31).
 - c. concentrations of risk if not apparent from (a) and (b)



2. Nature and Extent of Risks

Quantitative Disclosures

- When an entity (or its key management personnel) uses several methods to manage a risk exposure,
 - the entity is required to disclose information using the method or methods that provide the most relevant and reliable information. (Refers to HKAS 8 for relevant and reliable information)



2. Nature and Extent – Credit Risk

Quantitative Disclosures

Credit risk

- An entity shall disclose by class of financial instrument:
 - a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with HKAS 32);
 - b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;
 - c) information about the credit quality of financial assets that are neither past due nor impaired; and
 - d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.



2. Nature and Extent – Credit Risk

Case

Early adopted HKFRS 7 in 2005 and its annual report 2006 states that (extract only):



- Exposure to credit risk - as at 31 Dec., the financial assets and financial liabilities of the Group and HKEx that were exposed to credit risk and their maximum exposure were as follows:

	Group			
	2006		2005 (As restated)	
	Carrying amount in balance sheet \$'000	Maximum exposure to credit risk \$'000	Carrying amount in balance sheet \$'000	Maximum exposure to credit risk \$'000
Financial assets				
Clearing House Funds:				
Available-for-sale financial assets	317,212	317,212	224,137	224,137
Time deposits with original maturities over three months	-	-	30,290	30,290
Cash and cash equivalents	1,957,229	1,957,229	1,091,233	1,091,233
Compensation Fund Reserve Account:				
Available-for-sale financial assets	42,990	42,990	18,488	18,488
Cash and cash equivalents	8,653	8,653	30,240	30,240
Time deposit with maturity over one year	38,886	38,886	38,768	38,768
Other financial assets	18,583	18,583	17,162	17,162

2. Nature and Extent – Past Due

Quantitative Disclosures

Financial assets that are either past due or impaired

- An entity shall disclose by class of financial asset:
 - a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired;
 - b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and
 - c) for the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.



2. Nature and Extent – Liquidity Risk

Quantitative Disclosures

Liquidity risk

- Before HKFRS 7, contractual maturity analysis together with effective interest rate analysis was required by HKAS 32 for interest rate risk disclosure.
- HKFRS 7 now requires, for liquidity risk disclosure, an entity to disclose:
 - a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and
 - b) a description of how it manages the liquidity risk inherent in (a).



2. Nature and Extent – Market Risk

Quantitative Disclosures

Market risk

- HKFRS 7 requires the disclosures of sensitivity analysis.
- The disclosures of sensitivity analysis can be achieved by 2 approaches:
 - 1. Simple sensitivity analysis:**
 - sensitivity analysis for each type of market risk
 - 2. Interdependency sensitivity analysis:**
 - Sensitivity analysis that reflects interdependencies between risks variables



2. Nature and Extent – Market Risk

Quantitative Disclosures

Market risk

- is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices
- comprises three types of risk:
 - currency risk,
 - interest rate risk and
 - other price risk.



2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – Simple sensitivity analysis

- An entity shall disclose:
 - a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing:
 - how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
 - b) the methods and assumptions used in preparing the sensitivity analysis; and
 - c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

Assuming that a **reasonably possible change** in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date.



2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display
2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date
3. Judge the reasonably possible changes in the relevant risk variables at the reporting date
4. Calculate and show how profit or loss and equity would be affected at the reporting date

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – Simple sensitivity analysis

- For each type of market risk, an entity decides:
 - how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments.
- For example, an entity that trades financial instruments might disclose
 - Sensitivity analysis for each type of market risk separately for
 - financial instruments held for trading and
 - those not held for trading.
- If an entity has exposure to only one type of market risk in only one economic environment,
 - it would not show disaggregated information.

2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display



2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date

2. Nature and Extent – Sensitivity

Market Risk

Interest Rate Risk

- **Interest rate risk** arises
 - on interest-bearing financial instruments recognised in the balance sheet (e.g. loans and receivables and debt instruments issued) and
 - on some financial instruments not recognised in the balance sheet (e.g. some loan commitments).

2. Nature and Extent – Sensitivity

Market Risk

Currency Risk

- **Currency risk (or foreign exchange risk)** arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency in which they are measured.
 - For the purpose of HKFRS 7, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.
 - A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

2. Nature and Extent – Sensitivity

Market Risk

Other Price Risk

- **Other price risk** arises on financial instruments because of changes in, for example:
 - commodity prices or
 - equity prices.
- To comply with HKFRS 7, an entity might disclose the effect of a decrease in a specified variable, including:
 - stock market index,
 - commodity price, or
 - other risk variable.
- For example,
 - if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.

2. Nature and Extent – Sensitivity

Example

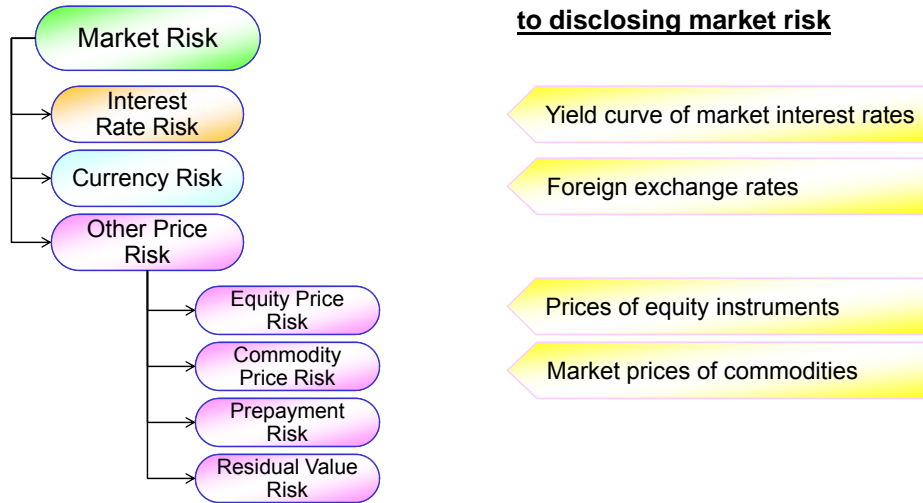
Market Risk

Other Price Risk

- Examples of financial instruments that give rise to equity price risk are
 - a) a holding of equities in another entity and
 - b) an investment in a trust that in turn holds investments in equity instruments.
- Other examples include
 - forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices.
 - The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

2. Nature and Extent – Sensitivity

Example



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2. Nature and Extent – Sensitivity

Example

Example of financial assets and liabilities

- Investment in bonds, bank deposits, interest-bearing borrowings, bank loans
- Trade receivables and payables in foreign currency, foreign loans
- Investments in equity securities and equity funds, equity-linked investments
- Investments in commodity funds and commodity-linked investments

Risk variables that are relevant to disclosing market risk

- Yield curve of market interest rates
- Foreign exchange rates
- Prices of equity instruments
- Market prices of commodities

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2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display
2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date
3. Judge the reasonably possible changes in the relevant risk variables at the reporting date

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – Simple sensitivity analysis

- In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:
 - a. the economic environments in which it operates.
 - b. the time frame over which it is making the assessment.
- A reasonably possible change should not include remote or “worst case” scenarios or “stress tests”.
- Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable.
- The sensitivity analysis shall show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

2. Nature and Extent – Sensitivity

Case

How can it be reasonably possible change?

Observed assessments by certain companies:

<u>Entity name</u>	<u>Currency</u>	<u>Interest rate</u>	<u>Other price</u>
• BASF	10% (drop only)	1%	10%
• BP plc	VaR	VaR	10%
• CLP Holdings Ltd.	1%	0.5%	15% (2006: 5%)
• DBS Group	10%	0.25%	10%
• Deutsche Telecom	10%	1%	N/M
• France Telecom	10%	1%	N/M
• Jardine Matheson Ltd.	10%	1%	25% (AFS)
• Recruit	7 – 12%	N/M	N/M
• Zijin Mining	10%	1%	N/M

2. Nature and Extent – Sensitivity

In order to disclose the simple sensitivity analysis, an entity should:

1. Decide how much detail it provides, how much emphasis it places and how it aggregates information to display
2. Identify each type of market risk to which the entity is exposed and the relevant risk variable at the reporting date
3. Judge the reasonably possible changes in the relevant risk variables at the reporting date
4. Calculate and show how profit or loss and equity would be affected at the reporting date

2. Nature and Extent – Sensitivity

- HKFRS 7 requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable. For this purpose:
 1. Entities are not required to determine what the profit or loss for the period would have been if relevant risk variables had been different.
 - Instead, entities disclose the effect on profit or loss and equity at the balance sheet date assuming that a reasonably possible change in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date.
 2. Entities are not required to disclose the effect on profit or loss and equity for each change within a range of reasonably possible changes of the relevant risk variable.
 - Disclosure of the effects of the changes at the limits (i.e. the upper and lower limits) of the reasonably possible range would be sufficient.

2. Nature and Extent – Sensitivity

Example

Market Risk

- HKFRS 7 requires separate disclosure on
 - the sensitivity of profit or loss (that arises, for example, from instruments classified as at fair value through profit or loss and impairments of available-for-sale financial assets) is disclosed separately from
 - the sensitivity of equity (that arises, for example, from instruments classified as available for sale).
- Financial instruments that an entity classifies as equity instruments are not remeasured.
 - Neither profit or loss nor equity will be affected by the equity price risk of those instruments.
 - Accordingly, no sensitivity analysis is required.

2. Nature and Extent – Sensitivity

Example

Example of financial assets and liabilities

- Investment in bonds, bank deposits, interest-bearing borrowings, bank loans

Risk variables that are relevant to disclosing market risk

Yield curve of market interest rates

- For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:
 - a) interest income and expense;
 - b) other line items of profit or loss (such as trading gains and losses); and
 - c) when applicable, equity.
- An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – **Interdependency Sensitivity Analysis**

- An entity can alternatively prepare and disclose a sensitivity analysis, such as Value-at-Risk (VaR), that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) so long as it uses such sensitivity analysis to manage financial risks.
- The entity shall also disclose:
 - a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
 - b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

2. Nature and Extent – Sensitivity

Quantitative Disclosures

Market risk – Interdependency Sensitivity Analysis

- An entity might comply the VaR methodology by disclosing
 - the type of VaR model used (eg whether the model relies on Monte Carlo simulations),
 - an explanation about how the model works and
 - the main assumptions (eg the holding period and confidence level).
- Entities might also disclose
 - the historical observation period and weightings applied to observations within that period,
 - an explanation of how options are dealt with in the calculations, and
 - which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

2. Nature and Extent – Sensitivity

Case



Royal Dutch Shell plc for 2007

- Shell uses risk management systems for recording and valuing instruments.
- There is regular review of mandated trading limits by senior management, daily monitoring of market risk exposure using value-at-risk (VAR) techniques (see below), daily monitoring of trading positions against limits and marking-to-market of trading exposures with a department independent of traders reviewing the market values applied to trading exposures.
- Shell's exposure to substantial trading losses is therefore considered limited.
- Shell utilises VAR techniques based on variance/covariance or Monte Carlo simulation models and make a statistical assessment of the market risk arising from possible future changes in market values over a 24-hour period and within a 95% confidence level.
- The calculation of the range of potential changes in fair value takes into account positions, the history of price movements and the correlation of these price movements.
- Each of the models is regularly back tested against actual fair value movements to ensure model integrity is maintained.

2. Nature and Extent – Sensitivity

Quantitative Disclosures

- Common approaches in estimating **Value at Risk (VaR)**
 - Variance-covariance approach
 - Same theoretical basis as portfolio theory and more straightforward
 - Weaknesses: not good at returns with non-linear or non-normal elements, say options
 - Historical simulation
 - Uses historical data to re-produce the distribution of return and no normality assumption
 - Weaknesses: depending on actual data observed
 - Monte Carlo simulation
 - Estimated from a simulated distribution, powerful and be able to handle any type of position
 - Weaknesses: difficult to implement and time-consuming



2. Nature and Extent – Sensitivity

Case

Reference to the time horizon and confidence level of some entities used in VaR analysis for 2007.....

<u>Entity name</u>	<u>Time horizon</u>	<u>Confidence</u>	<u>Method</u>	<u>Coverage</u>
• BASF	1 day	95%	VC	Commodity
• BMW	3 months	99%	HS	Interest
• BP plc	24 hours	95%	VC or HS	Market risk
• CLP	4 weeks	95%	VC	Energy price
• DBS Group	1 day	99%	HS	Trading market risk
• HKEx	10 day	95%	HS	Market risk
• HSBC	1 day	99%	HS	Market risk
• Nokia	1 month	95%	VC or MC	Market risk
• Shell	24 hours	95%	VC or MC	Price risk
• Standard Chartered	1 day	97.5%	HS	Trading book

Variance-Covariance (VS), Historical simulation (HS) and Monte Carlo simulation (MC)

2. Nature and Extent – Other

Quantitative Disclosures

Other market risk disclosures

- When the sensitivity analyses disclosed (by the 2 approaches) are unrepresentative of a risk inherent in a financial instrument
 - the entity shall disclose
 - that fact and
 - the reason it believes the sensitivity analyses are unrepresentative.



2. Nature and Extent – Other

Example

- Sensitivity analysis disclosed may be unrepresentative of a risk inherent in a financial instrument when:
 - a) a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis,
 - e.g. options that remain out of (or in) the money for the chosen change in the risk variable;
 - b) financial assets are illiquid,
 - e.g. when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty; or
 - c) an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

Today's Agenda

Capital Disclosures
(Amendment to HKAS 1)



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Capital Disclosures

- We used to consider that capital is

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

- HKAS 1 considers
 - “whether an entity can have a view of capital that differs from what IFRSs define as equity.” (HKAS 1.BC.47)
- It further clarifies that, although for the purposes of this disclosure
 - capital would often equate with equity as defined in HKFRSs,
 - it **might also include or exclude some components**.
- It also noted that the capital disclosure in HKAS 1 is intended to give entities the opportunity to describe
 - how they view the components of capital they manage, if this is **different from what HKFRSs define as equity**

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Capital Disclosures

- Based on the Framework & HKFRSs, the accounting equation should be:



- For some entities

$$\text{Capital} = \text{Equity}$$

- For some other entities

$$\text{Capital} = \text{Equity} - \text{Some Equity} + \text{Some Liabilities}$$

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.

$$\text{Capital} = \text{Equity} - \text{Some Equity} + \text{Some Liabilities}$$

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.

$$\text{Capital} = \text{Equity} - \text{Some Equity} + \text{Some Liabilities}$$

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.

$$\text{Capital} = \text{Equity} - \text{Some Equity} + \text{Some Liabilities}$$

Capital Disclosures

Case

China Communications Construction Co. Ltd.



- The Group's objectives when managing capital are to safeguard the Group's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders and to maintain an optimal capital structure to reduce the cost of capital.
- In order to maintain or adjust the capital structure, the Group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares or sell assets to reduce debt.
- The Group monitors capital on the basis of the gearing ratio.
 - This ratio is calculated as net debt divided by total capital.
 - Net debt is calculated as total borrowings as shown in the consolidated balance sheet, less cash and cash equivalents.
 - Total capital is calculated as total equity as shown in the consolidated balance sheet plus net debt.
- The Group aims to maintain the gearing ratio at a reasonable level.

Today's Agenda

Recap Session



HKAS 39 Financial Instruments

Scope

- Extended the scope to all contract to buy and sell of non-financial items that meet the scope.

Definitions

- Financial instruments, including derivatives, are clearly defined.

Initial Recognition

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

Measurement

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

Initial Recognition

Scope

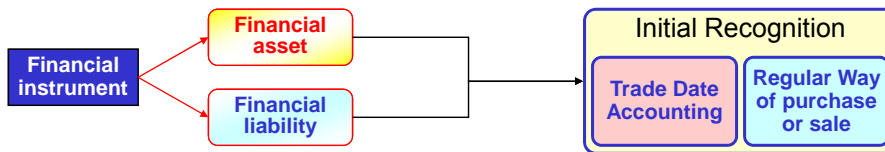
Definitions

Initial Recognition

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



Initial Recognition & Measurement



- An entity shall recognise financial instruments on its balance sheet when and only when the entity becomes a party to the contractual provisions of the instruments
 - Implies **trade date accounting** for all cases, except for a **regular way purchase or sale** (e.g. purchase of derivatives)
- When a financial asset or financial liability is recognised initially, an entity shall measure the **financial asset** or a **financial liability**
 - at its **fair value**
 - plus transaction costs (except for those classified *at fair value through profit or loss*)

Initial Recognition & Measurement

Example

Fair value at Initial Recognition – Low Interest Loan

- Entity A grants a 3-year loan of HK\$50,000 to a related party, B, on 1 Jan. 2005 as one kind of financial assistance to support B's operation.
 - A charges B at a interest rate of 2% as A expects the return on B's future operation would be higher.
 - A charges another related party at a current market lending rate of 6%
- Discuss the implication of the loan.

Fair value at Initial Recognition – No Interest Deposit

- Entity X is required to deposit HK\$50,000 to a customer in order to guarantee that it would complete the service contract in 5 years' time.
- When the contract completes (say after 5 years), the deposit would be refunded in full without any interest.

Initial Recognition & Measurement

Initial Measurement (HKAS 39.AG64)

- The fair value of a financial instrument on **initial recognition is normally the transaction price** (i.e. the fair value of the consideration given or received).
- However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique.
 - For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as
 - the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating.
 - Any additional amount lent is an expense or a reduction of income
 - unless it qualifies for recognition as some other type of asset.

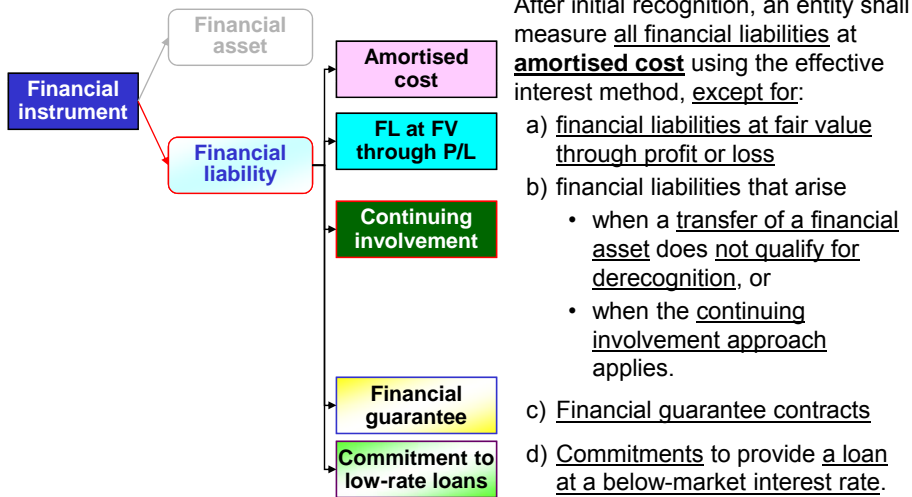
Financial Liabilities – Measurement



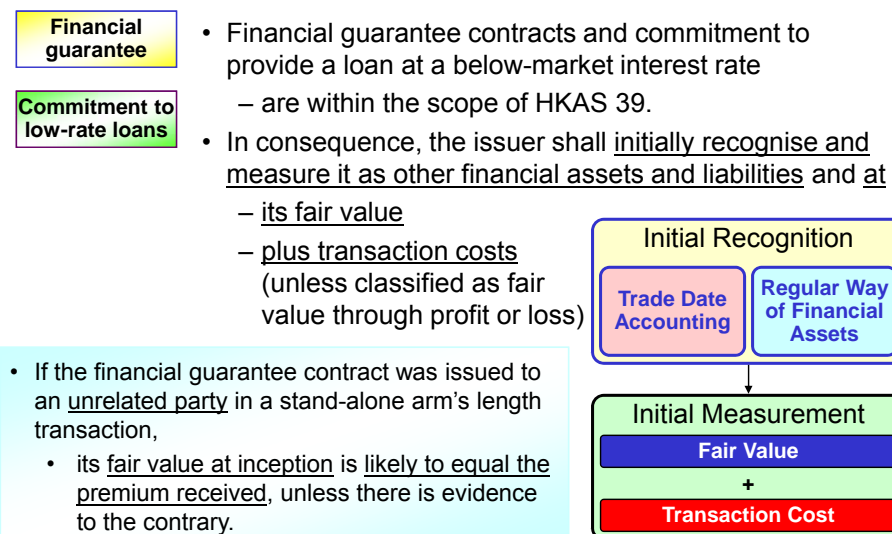
Measurement

• **Financial Liabilities – Subsequent Measurement**

Financial Liabilities – Measurement



Financial Liabilities – Measurement



Financial Liabilities – Measurement

Financial guarantee

Commitment to low-rate loans

- After initial recognition,
 - An issuer of such contract and such guarantee shall measure it at the higher of:
 - i) the amount determined in accordance with HKAS 37 Provisions, Contingent Liabilities and Contingent Assets; and
 - ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with HKAS 18 Revenue.



Financial Liabilities – Measurement

Financial guarantee

Asserted Explicitly

Used Insurance Accounting

- However, for financial guarantee contracts alone, such contracts may be excluded from the scope of HKAS 39
 - HKAS 39.2e states that:
 - “if an issuer of financial guarantee contracts
 - has previously asserted explicitly that it regards such contracts as insurance contracts and
 - has used accounting applicable to insurance contracts,
 - the issuer may elect to apply either
 - HKAS 39 or
 - HKFRS 4
- to such financial guarantee contracts (see paragraphs AG4 and AG4A).
- The issuer may make that election contract by contract, but the election for each contract is irrevocable.

Financial Liabilities – Measurement

Financial
guarantee

- **KPMG Singapore** (Aug. 2006):

- If a guarantee arrangement is accounted for under FRS 104 (which is based on IFRS 4 without modification) by a non-insurance entity,
 - the guarantee arrangement should be disclosed as a contingent liability.
- A liability is only recognised
 - if payment become probable.
- This treatment is consistent with the current position in accounting for financial guarantees by non insurance entities.

Asserted
Explicitly

Used Insurance
Accounting

Financial Liabilities – Measurement

Case

Financial
guarantee

Tristate Holdings Limited

- 2006 Annual Report
 - For guarantees provided by the Company for banking facilities granted to subsidiaries, the Company
 - regards such guarantees as insurance contracts and does not recognise liabilities for financial guarantees at inception,
 - but performs a liability adequacy test at each reporting date and recognise any deficiency in the liabilities in the income statement.

Financial Liabilities – Measurement

Financial guarantee

- HKFRS 4 *Insurance Contracts*:
Liability adequacy test (HKFRS 4.15)
 - An insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate,
 - using current estimates of future cash flows under its insurance contracts.
 - If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows,
 - the entire deficiency shall be recognised in profit or loss.

Financial Liabilities – Measurement

Case



Annual Report of 2007

- A financial guarantee contract is
 - a contract that requires the issuer (or guarantor) to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.
- Where the Group issues a financial guarantee, the fair value of the guarantee is initially recognised as deferred income within trade and other payables.
 - Where consideration is received or receivable for the issuance of the guarantee, the consideration is recognised in accordance with the Group's policies applicable to that category of asset.

Dr	Cash/Assets
Cr	Payables
 - Where no such consideration is received or receivable, an immediate expense is recognised in income statement on initial recognition of any deferred income.

Dr	Profit & loss
Cr	Payables

Financial Liabilities – Measurement

Case



Annual Report of 2007

- The amount of the guarantee initially recognised as deferred income
 - is amortised in income statement over the term of the guarantee as income from financial guarantees issued.
- In addition, provisions are recognised if and when
 - it becomes probable that the holder of the guarantee will call upon the Group under the guarantee and
 - the amount of that claim on the Group is expected to exceed the current carrying amount, i.e. the amount initially recognised less accumulated amortisation, where appropriate.

Dr Payables
Cr Profit & loss

Dr Profit & loss
Cr Payables

Financial Liabilities – Measurement

Case



How much did it have

Annual Report of 2007

- Most critical “In the opinion of the directors of the Company,
 - no material liabilities will arise from the above guarantees which arose in the ordinary course of business and
 - the fair value of the corporate guarantees granted by the Company is immaterial.

Financial Liabilities – Measurement

Case

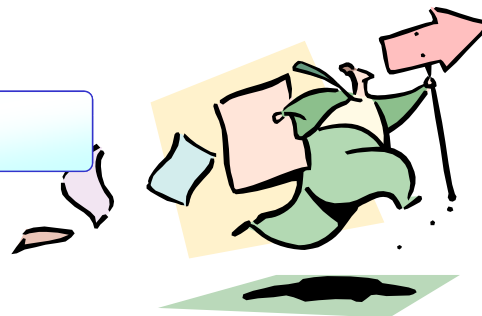


Note 51 “Contingent Liabilities” of 2006 Annual Report states that :

- a) Guarantees given and indemnities provided by the Group and the Company in respect of credit facilities granted to
 - Other than the guarantee provided by the Company as mentioned in item (a), the directors considered that the fair values of these financial guarantee contracts at their initial recognition are insignificant on the basis of short maturity periods and low applicable default rates.
 - The financial guarantee contracts of the Company have been recognised in the Company’s financial statements.

Today’s Agenda

Amendments Effective
after 1 Jan. 2008



Amendment Effective After 1.1.2008

Selected new interpretations and amendments to HKFRSs issued in 2006 to 2007

Effective for periods beginning on/after

- HK(IFRIC)12 *Service Concession Arrangements* (2007) ➤ 1 Jan. 2008
- HK(IFRIC)13 *Customer Loyalty Programmes* (2007) ➤ 1 Jul. 2008
- HK(IFRIC)14 *HKAS 19 —The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* (2007) ➤ 1 Jan. 2008
- HKFRS 8 *Operating Segments* (2007) ➤ 1 Jan. 2009
- HKAS 23 *Borrowing Costs* (2007) ➤ 1 Jan. 2009
- HKAS 1 *Presentation of Financial Statements* (2007) ➤ 1 Jan. 2009
- HKAS 27 *Consolidated and Separate Financial Statements* (2008) ➤ 1 Jul. 2009
- HKFRS 3 *Business Combination* (2008) ➤ 1 Jul. 2009


Customer Loyalty Programmes

(HK(IFRIC) Interpretation 13)

三賞一免佣優惠*

以商務「網上理財」交易本地證券，
尊享多重優惠。

▶詳情 *條款及細則適用




Background



- Customer loyalty programmes are used by entities to provide customers with incentives to buy their goods or services.
 - If a customer buys goods or services, the entity grants the customer award credits (often described as "points").
 - The customer can redeem the award credits for awards such as free or discounted goods or services.
- The programmes operate in a variety of ways.
 - Customers may be required to accumulate a specified minimum number or value of award credits before they are able to redeem them.
 - Award credits may be linked to individual purchases or groups of purchases, or to continued custom over a specified period.
 - The entity may operate the customer loyalty programme itself or participate in a programme operated by a third party.
 - The awards offered may include goods or services supplied by the entity itself and/or rights to claim goods or services from a third party.

Issues

- Whether the entity's obligation to provide free or discounted goods or services ("awards") in the future should be recognised and measured by:
 - i) allocating some of the consideration received or receivable from the sales transaction to the award credits and deferring the recognition of revenue (applying HKAS 18.13); or
 - ii) providing for the estimated future costs of supplying the awards (applying HKAS 18.19); and
- If consideration is allocated to the award credits:
 - i) how much should be allocated to them;
 - ii) when revenue should be recognised; and
 - iii) if a third party supplies the awards, how revenue should be measured.



Conclusions – Separation

- An entity shall
 - apply HKAS 18.13 and
 - account for award credits as a separately identifiable component of the sales transaction(s) in which they are granted (the "initial sale").
- The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between
 - the award credits and
 - the other components of the sale.

Separately
Identifiable
Component

Fair Value

Award Credit

Other
Components

Supplied by
the Entity Itself

Supplied by
the Third Party

Conclusions – Fair Value

- The consideration allocated to the award credits shall be measured by reference to their fair value,
 - i.e. the amount for which the award credits could be sold separately.
- If the fair value is not directly observable, it must be estimated.
- An entity may estimate the fair value of award credits by reference to
 - the fair value of the awards for which they could be redeemed.

Fair Value

Award Credit

Supplied by
the Entity Itself

Supplied by
the Third Party

Conclusions – Fair Value

- The fair value of the awards (for which they could be redeemed) would be reduced to take into account:
 - a) the fair value of awards that would be offered to customers who have not earned award credits from an initial sale; and
 - b) the proportion of award credits that are not expected to be redeemed by customers.
- If customers can choose from a range of different awards, the fair value of the award credits will reflect
 - the fair values of the range of available awards, weighted in proportion to the frequency with which each award is expected to be selected.

Fair Value

Award Credit

Supplied by
the Entity Itself

Supplied by
the Third Party

Conclusions – Recognition

- If the entity supplies the awards itself, it shall recognise the consideration allocated to award credits as revenue when
 - award credits are redeemed and
 - it fulfils its obligations to supply awards.
- The amount of revenue recognised shall be based on
 - the number of award credits that have been redeemed in exchange for awards,
 - relative to the total number expected to be redeemed.



No. of Award Credits
Redeemed in Exchange
÷
Total No. of Award Credits
Expected to be Redeemed

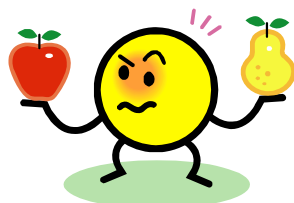
Supplied by
the Entity Itself

Conclusions – Recognition

- If a third party supplies the awards, the entity shall assess whether it is collecting the consideration allocated to the award credits
 - on its own account (i.e. as the principal in the transaction) or
 - on behalf of the third party (i.e. as an agent for the third party).

On its Own Account

On Behalf of the Third Party



Supplied by the Third Party

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Conclusions – Recognition

Example

- A grocery retailer operates a customer loyalty programme.
 - It grants programme members loyalty points when they spend a specified amount on groceries.
 - Programme members can redeem the points for further groceries.
 - The points have no expiry date.
- In one period, the entity grants 100 points (assume sales of \$2,000).
 - Management expects 80 of these points to be redeemed.
 - Management estimates the fair value of each loyalty point to be one currency unit (\$1), and defers revenue of \$100.

Dr	Cash	\$ 2,000	
Cr	Revenue		\$ 1,900
	Deferred income		100



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Conclusions – Recognition

Example

Year 1

- At the end of the first year, 40 points (pts) have been redeemed in exchange for groceries, i.e. half of those expected to be redeemed.
- The entity recognises revenue of $(40 / 80 \text{ pts}) \times \$100 = \$50$.

Dr	Deferred income	\$ 50	
Cr	Revenue		\$ 50

Year 2

- In the second year, management revises its expectations and now expects 90 points to be redeemed altogether.
- During the second year, 41 points are redeemed, bringing the total number redeemed to $40 + 41 = 81$ points.
- The cumulative revenue that the entity recognises is $(81 / 90 \text{ pts}) \times \$100 = \$90$.
- The entity has recognised revenue of \$50 in the first year, so it recognises \$40 in the second year.

Dr	Deferred income	\$ 40	
Cr	Revenue		\$ 40

Conclusions – Recognition

Example

Year 3

- In the third year, a further nine points are redeemed, taking the total number of points redeemed to $81 + 9 = 90$ points.
- Management continues to expect that only 90 points will ever be redeemed, ie that no more points will be redeemed after the third year.
- So the cumulative revenue to date is $(90 \text{ points} / 90 \text{ points}) \times \$100 = \$100$.
- The entity has already recognised \$90 of revenue (\$50 in the first year and \$40 in the second year).
- So it recognises the remaining \$10 in the third year.
- All of the revenue initially deferred has now been recognised.

Dr	Deferred income	\$ 10	
Cr	Revenue		\$ 10

Effective Date and Transition

- An entity shall apply HK(IFRIC) Interpretation 13 for annual periods beginning on or after 1 July 2008.
- Earlier application is permitted.
- If an entity applies the Interpretation for a period beginning before 1 July 2008, it shall disclose that fact.
- Changes in accounting policy shall be accounted for in accordance with HKAS 8.



HKFRS 8 Operating Segments



Background

- HKFRS 8 arises from the IASB's consideration of
 - FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131 of United States) issued in 1997, compared with IAS 14 *Segment Reporting*, which is similar to HKAS 14.
- HKFRS 8 achieves convergence with the requirements of SFAS 131.
 - The wording of HKFRS 8 is the same as that of SFAS 131 except for changes necessary to make the terminology consistent with that in other HKFRSs.



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Core Principle and Scope

Core Principle

- An entity shall disclose information to enable users of its financial statements to evaluate
 - the nature and financial effects of the business activities in which it engages and
 - the economic environments in which it operates.



Scope

- HKFRS 8 applies to:
 - the separate or individual financial statements of an entity with listed debt and equity
 - the consolidated financial statements of a group with a parent with listed debt and equity
 - The segment information of an entity which chooses to follow HKFRS 8
- If a financial report contains both the parent's consolidated financial statements and separate financial statements,
 - segment information is required only in the consolidated financial statements.

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Operating Segments

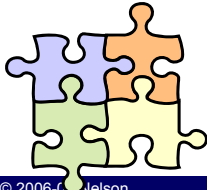
- An **operating segment** is a component of an entity:
 - that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
 - whose operating results are regularly reviewed by the entity's chief operating decision maker to
 - make decisions about resources to be allocated to the segment and
 - assess its performance, and
 - for which discrete financial information is available.

A business activity might have not yet earned any revenue

For example: CEO, COO, or a group of executive directors

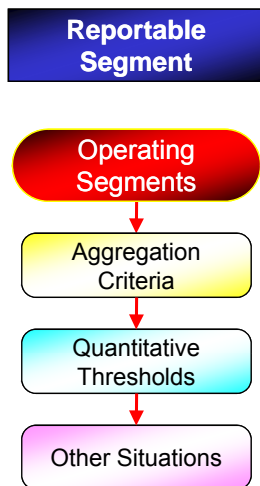
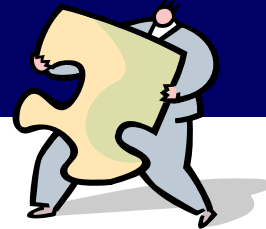
Not necessary be geographical areas or products

Operating Segments



- Not every part of an entity is necessarily an operating segment or part of an operating segment, say corporate headquarter

Reporting Segments



- An entity shall report separately information about each **operating segment** that
 - has been identified as operating segment or results from aggregating two or more of those segments under the **aggregation criteria**, and
 - exceeds the **quantitative thresholds** ("10% or more test").
- There are also other situations in which separate information about an operating segment shall be reported.

Disclosure

- To give effect to the core principle, an entity shall disclose the following for each period for which an income statement is presented:
 - a) general information as described in HKFRS 8;
 - b) information about
 - reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss,
 - segment assets, and
 - the basis of measurement; and
 - c) reconciliations of the totals of
 - segment revenues,
 - reported segment profit or loss,
 - segment assets, and
 - other material segment itemsto corresponding entity amounts.



General Information

Other Information

Reconciliations

Disclosure – Other Information

- An entity shall report a measure of profit or loss and total assets for each reportable segment.
- An entity shall report a measure of liabilities for each reportable segment if such an amount is regularly provided to the chief operating decision maker.

Other Information



Measurement

- The amount of each segment item reported shall be the measure reported to the chief operating decision maker
 - for the purposes of making decisions about allocating resources to the segment and assessing its performance.



- Compared with HKAS 14,
 - HKAS 14 required segment information to be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the consolidated group or entity.
 - HKAS 14 defines segment revenue, segment expense, segment result, segment assets and segment liabilities
 - HKFRS 8 does not define these terms but requires an explanation of how segment profit or loss, segment assets and segment liabilities are measured for each reportable segment.

Entity-Wide Disclosures

- All entities subject to HKFRS 8, including those that have a single reportable segment, are also required to have certain entity-wide disclosures, including:
 - the revenues from external customers for each product and service, or each group of similar products and services
 - certain geographical information
 - information about the extent of its reliance on its major customers.

Products and Services

Geographical Areas

Major Customers



Transition and Effective Date

- An entity shall apply HKFRS 8 in its annual financial statements for periods beginning on or after 1 January 2009.
- Earlier application is permitted.
- If an entity applies this HKFRS in its financial statements for a period before 1 January 2009, it shall disclose that fact.
- Segment information for prior years that is reported as comparative information for the initial year of application shall be restated to conform to the requirements of this HKFRS, unless
 - the necessary information is not available and
 - the cost to develop it would be excessive.



Today's Agenda



HKAS 1 Presentation of Financial Statements

HKAS 1 to be revised



HKAS 1 Presentation of Financial Statements (amended in Dec. 2007)

- Converged to IFRS and US and changes include:
 - A complete set of financial statements include:
 - Balance sheet → **Statement of financial position**
 - Profit and loss a/c → **Statement of comprehensive income (SCI)**
 - Cash flow statement → **Statement of cash flows**
 - But titles remain non-mandatory
 - Changes in equity divided between owner and non-owner changes in equity
 - Single statement (SCI) and two-statement (income statement and SCI) approach in presenting non-owner changes in equity

Summary of Changes

- A complete set of financial statements comprises:
 - a) a statement of financial position as at the end of the period;
 - b) a statement of comprehensive income for the period;
 - c) a statement of changes in equity for the period;
 - d) a statement of cash flows for the period;
 - e) notes, comprising a summary of significant accounting policies and other explanatory information; and
 - f) a statement of financial position as at the beginning of the earliest comparative period
 - when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or
 - when it reclassifies items in its financial statements.
- An entity may use titles for the statements other than those used in HKAS 1. (HKAS 1.10)

Now, we call it "Balance Sheet"

Now, we call it "Income Statement"

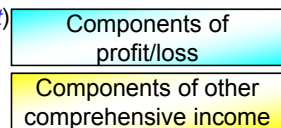
3 years' "balance sheets"

Summary of Changes

- Statement of comprehensive income can be further divided into 2 statements
- An entity shall present all items of income and expense recognised in a period:
 - a) in a single statement of comprehensive income, or
 - b) in two statements:
 - i. a statement displaying components of profit or loss (*separate income statement*) and
 - ii. a second statement beginning with profit or loss and displaying components of other comprehensive income (*statement of comprehensive income*). (HKAS 1.81)

One Statement Model

Two Statements Model



Summary of Changes

- Other comprehensive income comprises
 - items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other HKFRSs.
- The components of other comprehensive income include:
 - a) changes in revaluation surplus (see HKAS 16 and HKAS 38);
 - b) actuarial gains and losses on defined benefit plans recognised in accordance with HKAS 19.93A;
 - c) gains and losses arising from translating the financial statements of a foreign operation (see HKAS 21);
 - d) gains and losses on remeasuring available-for-sale financial assets (see HKAS 39);
 - e) the effective portion of gains and losses on hedging instruments in a cash flow hedge (see HKAS 39).

Components of other comprehensive income

Summary of Changes

- HKAS 1 requires an entity to disclose income tax relating to each component of other comprehensive income.
 - The previous version of HKAS 1 did not include such a requirement.
 - The purpose is to provide users with tax information relating to these components because the components often have tax rates different from those applied to profit or loss
- HKAS 1 also requires an entity to disclose reclassification adjustments relating to components of other comprehensive income.

Reclassification adjustments are defined as:

- amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or previous periods.

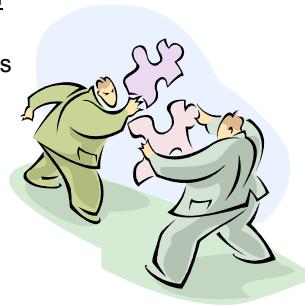
Components of other comprehensive income

HKAS 27 & HKFRS 3 (Revised 2008)

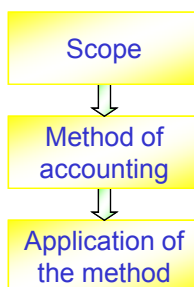


HKAS 27 (Revised 2008)

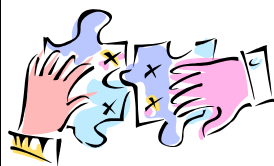
- Minority interests renamed as “non-controlling interests”, which
 - shall be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.
- Changes in a parent’s ownership interest in a subsidiary that do not result in a loss of control
 - are accounted for as equity transactions (i.e. transactions with owners in their capacity as owners)
 - i.e. no gain or loss on disposal of interests in subsidiary can be recognised in profit or loss if the subsidiary is still a subsidiary.



HKFRS 3 (Revised 2008)



- The objective of HKFRS 3 (revised 2008) is
 - to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects.
- To accomplish that, HKFRS 3 establishes principles and requirements for how the acquirer:
 - a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;
 - b) recognises and measures
 - the goodwill acquired in the business combination or
 - a gain from a bargain purchase; and What is it?
 - c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.



HKFRS 3 (Revised 2008)

Scope

- HKFRS 3 applies to a transaction or other event that meets the definition of a business combination.
- An entity shall determine whether a transaction or other event is a business combination by applying the definition in HKFRS 3,
 - which requires that the assets acquired and liabilities assumed constitute a business. (HKFRS 3.3)
- HKFRS 3 does not apply to:
 - a) the formation of a joint venture.
 - b) the acquisition of an asset or a group of assets that does not constitute a business.
 - Brief requirements set out for such acquisition and it does not give rise to goodwill
 - c) a combination of entities or businesses under common control.

AG 5 is still applicable

HKFRS 3 (Revised 2008)

Scope

Method of accounting

Application of the method

- An entity shall account for each business combination by applying the acquisition method. (HKFRS 3.4)
- Applying the acquisition method requires:
 - a) identifying the acquirer; Guidance in HKAS 27
 - b) determining the acquisition date; Date of control obtained
 - c) recognising and measuring
 - the identifiable assets acquired,
 - the liabilities assumed and
 - any non-controlling interest in the acquiree; and
 - d) recognising and measuring
 - goodwill or
 - a gain from a bargain purchase. (HKFRS 3.5)

HKFRS 3 (Revised 2008)

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Application of the method

- The acquirer shall measure the identifiable assets acquired and the liabilities assumed
 - at their **acquisition-date fair values**. (HKFRS 3.18) Affect acquisition in stages
- For each business combination, the acquirer shall measure any non-controlling interest in the acquiree either
 - at fair value or New alternative (“full goodwill method”)
 - at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. (HKFRS 3.19) Existing practice

HKFRS 3 (Revised 2008)

Critical Amendment

- Recognising and measuring goodwill or a gain from a bargain purchase

Application of the method

If fair value is adopted, it will affect the amount of goodwill

Practices changed

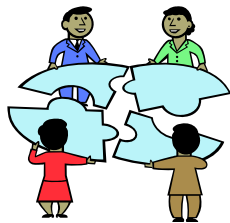
- The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:
 - a) the aggregate of:
 - i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;
 - ii) the amount of any non-controlling interest in the acquiree measured in accordance with HKFRS 3; and
 - iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
 - b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with HKFRS 3. (HKFRS 3. 32)

HKFRS 3 (Revised 2008)

- Additional guidance
 - Amended practices on business combination achieved in stages

Application of the method

- In a business combination achieved in stages, the acquirer shall
 - remeasure its previously held equity interest in the acquiree **at its acquisition-date fair value** and
 - recognise the resulting gain or loss, if any, in profit or loss. (HKFRS 3.42)



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HKFRS 3 (Revised 2008)

- Additional guidance
 - Amended practices on business combination achieved in stages

Application of the method

- In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income (for example, because the investment was classified as available for sale).
 - If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest. (HKFRS 3.42)
 - In other words, “the amount recognised directly in other comprehensive income is reclassified and included in the calculation of the gain or loss recognised in profit or loss”. (KPMG-UK, 2008.01)

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HKFRS 3 (Revised 2008)

Example

<u>On 1.1.2010</u>	<u>Parent P</u>	<u>Sub S</u>
Property	\$ 0	\$ 6,000
Investment	0	0
Cash at bank	<u>30,000</u>	<u>2,000</u>
	<u>30,000</u>	<u>8,000</u>
Issued equity	\$ (30,000)	\$ (5,000)
Retained earnings	<u>0</u>	<u>(3,000)</u>
	<u>(30,000)</u>	<u>(8,000)</u>

On 1.1.2010

- Parent P acquired 20% interest in Subsidiary S at \$3,500 by cash.
- Fair value of the property of S was \$8,000.

During 2010

- Parent P reported nil profit and profit of S was HK\$6,000 (became cash).
- Fair value of S is HK\$30,000 at year-end.
- P accounted for S as held for trading.

On 1.1.2011

- P acquired additional 60% interest in S at \$22,000 by cash.
- Fair value of the property of S was \$11,000.

HKFRS 3 (Revised 2008)

You would miss this

Example

	<u>1st Transaction</u>	<u>2nd Transaction</u>	<u>Total</u>
Cost of combinations (or investments)	<u>3,500</u>	<u>22,000</u>	25,500
Fair value information			
Property, at fair value	8,000	11,000	
Cash	2,000	2,000	
Cash (profit for the year)	<u>0</u>	<u>6,000</u>	
	10,000	19,000	
Ownership interest	<u>20%</u>	<u>60%</u>	80%
Share of fair value	<u>2,000</u>	<u>11,400</u>	
Goodwill	<u>1,500</u>	<u>10,600</u>	12,100

HKFRS 3 (Revised 2008)

Example

- Firstly, the acquirer (i.e. P) shall
 - remeasure its previously held equity interest in the acquiree (i.e. S) at its acquisition-date fair value and
 - recognise the resulting gain or loss, if any, in profit or loss.
- On 1.1.2011, P acquired additional 60% interest in S at \$22,000 by cash
 - It implies that previously held equity interest of 20% (acquired on 1.1.2010) should have a fair value of \$7,333 ($\$22,000 \div 60\% \times 20\%$)
 - The resulting gain should be recognised in profit or loss as follows:

	Dr(\$)	Cr(\$)
Dr Investment (\$7,333 – \$6,000)	1,333	
Cr Profit or loss		1,333
To remeasure the previously held 20% in S at acquisition-date fair value		

HKFRS 3 (Revised 2008)

Example

The calculation approach would be revised as

	NCI at old approach	NCI at fair value
	<u>New 1</u>	<u>New 2</u>
1. Consideration transferred	22,000	22,000
2. Non-controlling interest (NCI)	$(\$19K \times 20\%)$ 3,800	$(\$22K \div 60\% \times 20\%)$ 7,333
3. Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree	<u>7,333</u>	<u>7,333</u>
	<u>33,133</u>	<u>36,666</u>
Less: Acquisition-date amount of net identifiable assets		
Property, at fair value	11,000	11,000
Cash	2,000	2,000
Cash (profit for the year)	<u>6,000</u>	<u>6,000</u>
	<u>19,000</u>	<u>19,000</u>
Goodwill	<u>14,133</u>	<u>17,666</u>

HKFRS 3 (Revised 2008)

Example

<u>On 1.1.2011</u>	<u>Parent P</u>	<u>Sub S</u>	<u>Old</u>	<u>New 1</u>	<u>New 2</u>
Property	\$ 0	\$ 6,000	\$ 11,000	\$ 11,000	\$ 11,000
Goodwill	0	0	12,100	14,133	17,666
Investment	28,000	0	0	0	0
Cash at bank	<u>4,500</u>	<u>8,000</u>	<u>12,500</u>	<u>12,500</u>	<u>12,500</u>
	<u>32,500</u>	<u>14,000</u>	<u>35,600</u>	<u>37,633</u>	<u>41,166</u>
Issued equity	\$ (30,000)	\$ (5,000)	\$(30,000)	\$(30,000)	\$(30,000)
Retained earnings	(2,500)	(9,000)	(1,200)	(3,833)	(3,833)
Revaluation reserves	0	0	(600)	0	0
Minority interest	<u>0</u>	<u>0</u>	<u>(3,800)</u>	<u>(3,800)</u>	<u>(7,333)</u>
Non-controlling interests	<u>(32,500)</u>	<u>(14,000)</u>	<u>(35,600)</u>	<u>(37,633)</u>	<u>(41,166)</u>

HKFRS 3 (Revised 2008)

- HKFRS 3 (revised 2008) shall be applied prospectively to
 - business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009.
- Earlier application is permitted.
 - However, HKFRS 3 shall be applied only at the beginning of an annual reporting period that begins on or after 30 June 2007.
 - If an entity applies HKFRS 3 before 1 July 2009, it shall
 - disclose that fact and
 - apply HKAS 27 (as amended in 2008) at the same time.



Today's Agenda

Potential development and amendments in 2008-09



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Forthcoming Change in 2008 – 2009

- **Exposure Drafts finalised by IASB in 2008**
 - Financial Instruments: Puttable Instruments (IAS 32)
- **Exposure Drafts to be finalised in 2008**
(per IASB Work Plan – Project Timetable)
 - Related Party Disclosures (IAS 24)
 - Joint Ventures (IAS 31)
 - IFRS for SMEs
 - Earnings per Share: Treasury Stock Method (IAS 33)
 - Annual Improvement (first annual project)

Proposed 41 separate amendments affecting 25 different IFRSs



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Mr. Nelson Lam

MBA MSc BBA(Hons) ACA ACS ACIS CFA CPA(US) FCCA FCPA(Practising) FHKIoD MHKSI MSCA

- CFA Charterholder, Chartered Accountants and CPA(Practising)
- Appointed member of the Financial Reporting Review Panel under the Financial Reporting Council
- One of the regular and popular speakers and consultants in HKFRSs and IFRSs
- Regularly spoke and provided consultancy and advisory services and corporate training on the issues relating to HKFRSs and IFRSs to different professional, not-for-profit and listed entities in Hong Kong and Asia Pacific
- Invited to speak to CICPA in PRC, DSF of Macau, and professional in Seoul of Korea for the auditing and accounting standard convergence from 2006 to 2008
- His firm's website, www.NelsonCPA.com.hk, contains his presentation materials (over 200 sets of slides) for free public download
- Author of *Intermediate Financial Reporting: IFRS Perspective* (Forthcoming) and *Auditing and Assurance in Hong Kong* (2006) with Dr. Peter Lau

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Financial Reporting Issues and Updates 2007 and 2008

30 April 2008

Full set of slides in PDF can be found in
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