



## Agenda

9:00 – 9:20	<b>Introduction</b>
9:20 – 10:50	<b>HKFRSs having a major impact (part I)</b>
10:50 – 11:05	<b>Break</b>
11:05 – 12:40	<b>HKFRSs having a major impact (part II)</b>
12:40 – 1:00	<b>Questions and Answers</b>
1:00 – 2:00	<b>Lunch</b>

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## Agenda

2:00 – 2:50	<b>HKFRSs having a major impact (part III)</b>
2:50 – 3:20	<b>HKFRSs having a moderate impact (part I)</b>
3:20 – 3:35	<b>Break</b>
3:35 – 4:15	<b>HKFRSs having a moderate impact (part II)</b>
4:15 – 4:30	<b>HKFRSs having a minor impact</b>
4:30 – 5:00	<b>HKFRSs : Their Profits Tax Implications</b>
5:00 – 5:20	<b>Questions and Answers</b>
5:20 – 5:30	<b>Closing Remarks</b>

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## Recent Developments and Emerging Trends

## IFRS Developments

- IASB replaced IASC – 1 April 2001
- IFRIC replaced SIC – 2002
- IASB adoption of old IASs and Interpretations
  - Resolution passed at first IASB meeting, April 2001:
 

*"All IAS and SIC continue to be applicable unless and until they are amended or withdrawn. IASB may amend or withdraw IAS and SIC Interpretations issued under previous constitutions of IASC as well as issue new Standards and Interpretations."*

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### **IASB Objective**

- (a) To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- (b) To promote the use and rigorous application of those standards; and
- (c) To bring about convergence of national accounting standards and International Accounting Standards to high quality solutions

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### **HKFRS Developments**

- Policy of the Financial Reporting Standards Committee (FRSC) of HKICPA to base HK accounting standards on IFRSs
- "Fully converged" with IFRSs for accounting periods beginning on or after 1 January 2005, except for a few minor differences

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### **HKFRS Developments**

- **HK standards restructured with IFRSs**
  - New name for Standards
    - **Hong Kong Financial Reporting Standards (HKFRSs)**
  - Superseded previous SSAPs and Interpretations
  - Numberings aligned with the equivalent IFRSs

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### **HKFRS Developments**

- **HKFRSs include**
  - Standards (HKASs & HKFRSs)
  - Interpretations (HKFRS-Ints, HKAS-Ints & HK-Ints)
  - Mandatory appendices
- **Accompanying guidance**
  - Basis for conclusions
  - Implementation guidance
- **Black-letter, grey-letter distinction retained, but both of equal authority**

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### **HKFRS Vs IFRS – Some Differences**

- **Consistency with Hong Kong Companies Ordinance**
  - HKAS 1 Presentation of Financial Statements
    - IAS 1: "fair presentation" and "present fairly"
    - HKAS 1: "true and fair view" and "give a true and fair view"

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### **HKFRS Vs IFRS – Some Differences (cont'd)**

- HKAS 27 Consolidated and Separate Financial Statements/HKFRS 3 Business Combinations
  - Only companies falling within the definition of a subsidiary under Section 2(4) may be consolidated
- SSAP 27 Accounting for Group Reconstruction is still effective
- Several "home-grown" Hong Kong Interpretations/Guidance
- Certain transitional provisions/effective dates

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## Recent and Emerging Trends in IFRS / HKFRS

- Balance between relevance and reliability
- Greater use of fair value
- More unrealised components of income
- No income smoothing, cost deferrals, general provisions (asset and liability approach)
- Moving off-balance sheet items onto balance sheet
- Measurement of individual assets, not portfolios
- Minimise intent-driven accounting
- Eliminate accounting choices
- More disclosures

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## Concordance Table - HKFRS/HKAS

All standards are effective for financial periods commencing 1 January 2005, unless otherwise indicated

HKFRS	Title	IFRS	Supersedes	Changes Effective
HKFRS 1	First-time Adoption of Hong Kong Financial Reporting Standards	IFRS 1	-	Transitional provisions Effective 1 January 2004
HKFRS 2	Share-based Payment	IFRS 2	-	Transitional provisions
HKFRS 3	Business Combinations	IFRS 3	SSAP 30 Interpretation 12, 13 and 15	Transitional provisions Agreement date on or after 1 January 2005
HKFRS 4	Insurance Contracts	IFRS 4	-	Transitional provisions
HKFRS 5	Non-current Assets Held for Sale and Discontinued Operations	IFRS 5	SSAP 33	Transitional provisions
HKFRS 6	Exploration for and Evaluation of Mineral Resources	IFRS 6	-	Transitional Provisions Effective 1 January 2006

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## Concordance Table – HKFRS/HKAS (cont'd)

HKAS	Title	IAS	Supersedes	Changes Effective
HKAS 1	Presentation of Financial Statements	IAS 1	SSAP 1 Interpretation 8	Retrospective
HKAS 2	Inventories	IAS 2	SSAP 22	Retrospective
HKAS 7	Cash Flow Statements	IAS 7	SSAP 15	Retrospective
HKAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	IAS 8	SSAP 2	Retrospective
HKAS 10	Events After the Balance Sheet Date	IAS 10	SSAP 9	Retrospective
HKAS 11	Construction Contracts	IAS 11	SSAP 23	No significant changes
HKAS 12	Income Taxes	IAS 12	SSAP 12	No significant changes
HKAS 14	Segment Reporting	IAS 14	SSAP 26	No significant changes
HKAS 16	Property, Plant and Equipment	IAS 16	SSAP 17 Interpretation 1&5	Retrospective
HKAS 17	Leases	IAS 17	SSAP 14	Retrospective
HKAS 18	Revenue	IAS 18	SSAP 18	No significant changes

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## Concordance Table – HKFRS/HKAS (cont'd)

HKAS	Title	IAS	Supersedes	Changes Effective
HKAS 19	Employee Benefits	IAS 19	SSAP 34	No significant changes
HKAS 19 Amendments	Actuarial Gains and Losses, Group Plans and Disclosures	Amendment to IAS 19	SSAP 34	Transitional provisions Effective 1 January 2006
HKAS 20	Accounting for Government Grants and Disclosure of Government Assistance	IAS 20	SSAP 35	No significant changes
HKAS 21	The Effects of Changes in Foreign Exchange Rates	IAS 21	SSAP 11	Transitional provisions
HKAS 23	Borrowing Costs	IAS 23	SSAP 19	Transitional provisions
HKAS 24	Related Party Disclosures	IAS 24	SSAP 20	Retrospective
HKAS 26	Accounting and Reporting by Retirement Benefit Plans	IAS 26	-	Retrospective
HKAS 27	Consolidated and Separate Financial Statements	IAS 27	SSAP 32 Interpretation 18	Retrospective
HKAS 28	Investments in Associates	IAS 28	SSAP 10 Interpretation 18	Retrospective

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## Concordance Table – HKFRS/HKAS (cont'd)

HKAS	Title	IAS	Supersedes	Changes Effective
HKAS 29	Financial Reporting in Hyperinflationary Economies	IAS 29	-	Retrospective
HKAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions	IAS 30	-	Retrospective
HKAS 31	Interests in Joint Ventures	IAS 31	SSAP 21	Retrospective
HKAS 32	Financial Instruments: Disclosure and Presentation	IAS 32	SSAP 24	Retrospective
HKAS 33	Earnings Per Share	IAS 33	SSAP 5 Interpretation 10	Retrospective
HKAS 34	Interim Financial Reporting	IAS 34	SSAP 25	No significant changes
HKAS 36	Impairment of Assets	IAS 36	SSAP 31	Transitional provisions
HKAS 37	Provisions, Contingent Liabilities and Contingent Assets	IAS 37	SSAP 28	No significant changes
HKAS 38	Intangible Assets	IAS 38	SSAP 29	Transitional provisions

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## Concordance Table – HKFRS/HKAS (cont'd)

HKAS	Title	IAS	Supersedes	Changes Effective
HKAS 39	Financial Instruments: Recognition and Measurement	IAS 39	SSAP 24	Transitional provisions
HKAS 39 Amendments	Transition and Initial Recognition of Financial Assets and Financial Liabilities	IAS 39	SSAP 24	Transitional provisions
HKAS 39 Amendments	➤Cash Flow Hedge Accounting for Forecast Intragroup Transactions ➤The Fair Value Option	IAS 39	-	Retrospective Effective 1 January 2006
HKAS 40	Investment Property	IAS 40	SSAP 13	Transitional provisions
HKAS 41	Agriculture	IAS 41	SSAP 36	No significant changes

**SSAP 27 Accounting for Group Reconstructions is still effective**

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### Concordance Table - HKFRS - Int

HKFRS-Int	Title	Equivalent IFRIC	Effective for periods beginning	Changes Effective
HKFRS - Int 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities	IFRIC 1	1 September 2004	Retrospective
HKFRS - Int 2	Members' Shares in Co-Operative Entities and Similar Instruments	IFRIC 2	1 January 2005	Retrospective
HKFRS - Int 4	Determining whether an Arrangement contains a Lease	IFRIC 4	1 January 2006	Transitional Provisions
HKFRS - Int 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds	IFRIC 5	1 January 2006	Retrospective

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### Concordance Table - HKAS - Int

HKAS-Int	Title	SIC	Supersedes	Changes Effective
HKAS-Int 10	Government Assistance - No Specific Relation to Operating Activities	SIC 10	SSAP 35	Retrospective
HKAS-Int 12	Consolidation - Special Purpose Entities	SIC 12	SSAP 32	Retrospective
HKAS-Int 13	Jointly Controlled Entities - Non-Monetary Contributions by Venturers	SIC 13	SSAP 21	Transitional Provisions
HKAS-Int 15	Operating Leases - Incentives	SIC 15	SSAP 14	Retrospective
HKAS-Int 21	Income Taxes - Recovery of Revalued Non-Depreciable Assets	SIC 21	Interpretation 20	Retrospective
HKAS-Int 25	Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders	SIC 25	Interpretation 21	No significant changes
HKAS-Int 27	Evaluating the Substance of Transactions in the Legal Form of a Lease	SIC 27	Interpretation 14	No significant changes
HKAS-Int 29	Disclosure - Service Concession Arrangements	SIC 29	Interpretation 16	No significant changes

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### Concordance Table - HKAS/HK- Int

HKAS-Int	Title	SIC	Supersedes	Changes Effective
HKAS-Int 31	Revenue - Barter Transactions Involving Advertising Services	SIC 31	Interpretation 17	No significant changes
HKAS-Int 32	Intangible Assets - Website Costs	SIC 32	Interpretation 19	No significant changes

HK - Int	Title	SIC	Effective	Changes Effective
HK-Int 1	The Appropriate Policies for Infrastructure Facilities	-	1 October 2004	Retrospective
HK-Int 2	The Appropriate Policies for Hotel Properties	-	1 January 2005	Retrospective
HK-Int 3	Revenue - Pre-completion Contracts for the Sale of Development Properties	-	1 January 2005	Transitional Provisions
HK-Int 4	Leases - Determination of the Length of Lease Term in respect of Hong Kong Land Leases	-	24th May 2005	Retrospective

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### IASB/HKICPA- Exposure Drafts

Exposure Drafts	Title
HKICPA Exposure Drafts	<ul style="list-style-type: none"> <li>Proposed Accounting Guideline on Merger Accounting</li> <li>SME Financial Reporting Framework and Financial Reporting Standard</li> </ul>
IASB/HKICPA Exposure Drafts	<ul style="list-style-type: none"> <li>ED 7 Financial Instruments: Disclosures</li> <li>Proposed Limited Amendment to IAS 39 Financial Instruments: Recognition and Measurement                             <ul style="list-style-type: none"> <li>Financial Guarantee Contracts and Credit Insurance</li> </ul> </li> <li>Proposed Amendment to IFRS 3 Business Combinations</li> <li>Proposed Amendments to IAS 27 Consolidated and Separate Financial Statements</li> <li>Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits</li> </ul>

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### IFRIC/HKICPA- Exposure Drafts

Draft Interpretation	Title
D5	Applying IAS 29 Financial Reporting in Hyperinflationary Economies for the First Time
D6	Multi-employer Plans
D9	Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions
D10	Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment
D11	Changes in Contributions to Employee Share Purchase Plans (ESPPs)
D12	Service Concession Arrangements - Determining the Accounting Model
D13	Service Concession Arrangements - the Financial Asset Model
D14	Service Concession Arrangements - the Intangible Asset Model
D15	Reassessment of Embedded Derivatives
D16	Scope of IFRS 2
D17	IFRS 2 - Group and Treasury Share Transactions

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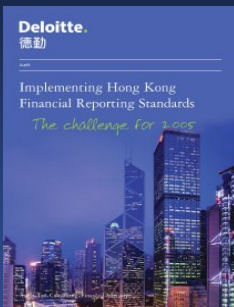
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**HKFRSs having a MAJOR impact**

## Implementing Hong Kong Financial Reporting Standards



*Classified the new Standards and Interpretations into 3 sections:*

- **Major**
- **Moderate**
- **Minor**

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## Major Impact - Standards

- **HKFRS 2** Share-based Payment
- **HKFRS 3** Business Combinations
- **HKFRS 5** Non-current Assets Held for Sale and Discontinued Operation
- **HKAS 17** Leases
- **HKAS 32/39** Financial Instruments
- **HKAS 36** Impairment of Assets
- **HKAS 38** Intangible Assets
- **HKAS 40** Investment Property

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## Major Impact - Interpretations

- **HK-Int 2** The Appropriate Policies for Hotel Properties
- **HK-Int 3** Revenue – Pre-completion Contracts for the Sale of Development Properties
- **HK-Int 4** Leases – Determination of the Length of Lease Term in respect of Hong Kong Land Leases

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## **HKFRS 2 Share-based Payment**

## HKFRS 2 Share-based Payment

- **HKFRS 2 is a new standard**
  - Does not replace existing SSAP.
  - Since 2002, SEHK required listed companies to disclose, in annual and interim reports, the fair value (FV) of options granted to directors, employees, and suppliers of goods and services.
    - But companies could omit with explanation of reason. Some did.
- Applies to all companies, listed and unlisted

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## HKFRS 2 Share-based Payment

- **SEHK computation models similar to those required by HKFRS 2.**
  - So may not be a significant new measurement burden for many *listed* companies.
  - But there will be the affect on reported earnings and equity.
  - And, of course, most *unlisted* companies never made the SEHK computations.

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### **HKFRS 2 Share-based Payment**

- **All share-based payment (SBP) transactions are recognised.**
  - Not just employee share options.
  - Includes:
    - Share purchase plans,
    - Share appreciation rights,
    - ESOPs, and
    - Plans that depend on future market performance.

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### **HKFRS 2 Share-based Payment**

- **HKFRS 2 applies when:**
  - Acquisition of all goods and services, not just employee services.
  - Entity issues its parent's or sub's shares or options to acquire goods or services.
  - Equity-settled and cash-settled SBPs.

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### **HKFRS 2 Share-based Payment**

- **Some share transactions are outside the scope of HKFRS 2:**
  - Share dividends.
  - Purchase or resale of treasury shares (HKAS 32).
  - Issuance of new shares.
  - Shares issued in business combination (HKFRS 3).
  - Derivatives that may be settled in shares (HKAS 39).

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### **HKFRS 2 Share-based Payment**

- **Recognition in accounts, not just note disclosure.**
- **Basic recognition and measurement principles for equity-settled SBP:**
  - Fair value measurement basis.
  - Expense recognised when goods or services received are consumed.

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### **HKFRS 2 Share-based Payment**

- **Example A: Fully vested shares or share rights issued to employees:**
  - Presumed to relate to past service – expense fair value (FV) of shares or rights immediately.
- **Example B: Shares or share rights issued to acquire inventory:**
  - FV is part of cost of inventory. Expense when inventory is sold or impaired.
- **Example C: Share options issued to employees with 3-year vesting period:**
  - Expense FV of options over vesting period.

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### **HKFRS 2 Share-based Payment**

- **Fair value measurement principle:**
  - Employee and other personal service transactions:
    - Measure FV of shares issued.
    - Estimate at grant date.
  - Acquisition of goods and non-employee service:
    - Measure FV of goods or services received.
    - Measure at date of receipt.

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### HKFRS 2 Share-based Payment

- **Measuring employee options:**
  - HKFRS 2 does not specify a particular measurement model.
  - Factors need by Black-Scholes and Binomial models:
    - Strike price.
    - Current share price.
    - Volatility.
    - Risk free interest rate.
    - Dividend yield.
  - Binomial goes further by breaking the time to expiration into "steps" and applying different factors to different steps. More complicated but more precise.

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### HKFRS 2 Share-based Payment

- **Measuring employee options:**
  - Initial fair value measurement is not adjusted for vesting conditions.
    - Instead, adjust number of shares expected to be issued.
    - On-going "true-up".

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### HKFRS 2 Share-based Payment

- **Example D - employee options:**
  - 10 options granted to each of 10 executives (100 total) on 1 Jan 2005.
  - Options vest at end of 3 year period if employee is still working.
  - FV of each option is \$15.
  - Company expects all 100 options to vest.

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### HKFRS 2 Share-based Payment

- **Example D - continued:**
  - Journal entry at 1 Jan 2005:
    - None. HKFRS 2 says estimate at grant date but account for services received and equity when options vest.
  - Half-yearly reporting.

Entry at 30 June 2005:	Dr	Cr
Share option expense	250	
Equity		250
$(100 \times 15) / 6 \text{ half-years} = 250$		

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### HKFRS 2 Share-based Payment

- **Example E – "true up":**
  - Same as example D but assume one employee leaves in 2<sup>nd</sup> half of 2006.
  - Employee forfeits all 10 options.

Entry at 31 Dec 2006:	Dr	Cr
Share option expense	150	
Equity		150
$(90 \times 15) / 6 \text{ half-years} = 225.$		
$[225 \times 4] - [250 \times 3] = 150.$		

**Quiz: Expense in 2007 will be \$???**

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### HKFRS 2 Share-based Payment

- **What if FV cannot be measured reliably ("rare case")?**
  - HKFRS 2: FV can be measured reliably in "virtually all cases".
  - But if true, initially measure at intrinsic value (FV of shares less exercise price).
    - Often zero.
  - Then, remeasure intrinsic value at each reporting date until settlement date. Changes in intrinsic value recognised in profit and loss.

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### HKFRS 2 Share-based Payment

- What if vesting is based on performance conditions?
  - HKFRS 2 distinguishes between two types of performance conditions:
    - Market based:** Vesting is related to price of company's shares.
    - Non-market based:** Vesting based on achieving a specific growth in revenue, profit, or EPS or having an IPO.

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### HKFRS 2 Share-based Payment

- Market based:**
  - Reflect the condition in estimating FV at grant date.
  - Thereafter, do not adjust number of shares (or vesting date) for actual results.
- Non-market based:**
  - Exclude from FV at grant date.
  - Continually "true up" by adjusting number of shares (or vesting date) to actual.

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### HKFRS 2 Share-based Payment

- What about cash-settled SBP?
  - Company is required to pay cash or other assets (not its own shares).
  - Measure FV of liability at each reporting date.
  - Changes in FV of liability are recognised in profit and loss unless the goods or services acquired are recognised as part of the cost of an asset.

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### HKFRS 2 Share-based Payment

- Example F – Cash settled stock appreciation right granted 1 Jan 2005:**
  - Vests after 3 years.
  - Cash payment for excess of price of company's share over \$10.
  - Assume FV of SARs expected to vest over 3-year period is:
    - \$120 at end of 2005.
    - \$210 at end of 2006.
    - \$300 at end of 2007.

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### HKFRS 2 Share-based Payment

#### Example F – continued

Entry at 31 Dec 2005:	Dr	Cr
Share option expense	40	
Liability		40
[120 x (1 year / 3 years)] = 40		
Entry at 31 Dec 2006:		
[210 x (2 years / 3 years)] – 40 = 100		
Entry at 31 Dec 2007:		
[300 - (40 + 100)] = 160		

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### HKFRS 2 Share-based Payment

- Other issues addressed in HKFRS 2 (no time to cover today):**
  - Equity settled with cash alternatives.
  - Modification of terms.
  - Cancellation or settlement.
  - Replacements and reloads.

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## HKFRS 2 Share-based Payment

- **Required disclosures**
  - Nature and extent of share-based payment arrangements that existed during the period.
  - How the FV of goods/services received or equity instruments granted was determined.
  - Effect of share-based payment transactions on period's profit or loss and on financial position.

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## HKFRS 2 Share-based Payment

- **Effective date and transition**
  - Annual periods starting 1 Jan 2005.
  - Applies to grants after 7 November 2002 that have not yet vested by effective date.
    - **Option to apply fully retrospectively if FVs were previously disclosed.**
  - For cash settled, all liabilities at effective date must be recognised.
  - Restate prior periods and adjust opening retained earnings of earliest period presented.

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## HKFRS 2 Share-based Payment

- **Example G — Disclosures**
  - Accounting policy note
    - HKFRS 2 adopted 1 Jan 2005.
    - Applied to all grants after 7 Nov 2002 that were unvested on 1 Jan 2005.
    - Equity settled SBP measured at date of grant using Black-Scholes pricing model, taking into account the effects of non-transferability, exercise restrictions, and behavioural considerations.

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## HKFRS 2 Share-based Payment

- **Example G — Disclosures, continued**
  - Share-based payment note
    - Describe option plan and terms.
    - Schedule showing number and weighted average exercise price of options outstanding at start of period; new grants; forfeitures; exercises; expirations; and period-end outstanding.
    - Inputs to Black-Scholes model, including how expected volatility was determined.

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## HKFRS 2 Share-based Payment

- **Hint of potential impact on HK listed companies?**
  - In USA, FAS 123R is similar to IFRS 2. Bear Stearns estimated the impact of expensing in 2004 would have been as follows:
    - **S&P 500: income from continuing operations reduced 5%.**
    - **NASDAQ 100 ('high tech'): income from continuing operations reduced 22%.**

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- **HSBC 2004 IFRS 2 (HKFRS 2) footnote:**

IFRS 2 requires companies to adopt a fair-value-based method of accounting for share-based compensation plans which takes into account vesting conditions related to market performance, for example total shareholder return. Under this method, compensation cost is measured at the date of grant based on the assessed value of the award and is recognised over the service period, which is usually the vesting period.

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■ **HSBC 2004 IFRS 2 (HKFRS 2) footnote: (cont'd)**

In respect of other vesting conditions, an estimate of the number of options that will lapse before they vest is made at grant date and adjustments to this estimate are made over the service period. Accordingly, the expense recognised reflects, over time, the actual number of lapsed options for non-market performance-related conditions....

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■ **HSBC 2004 IFRS 2 (HKFRS 2) footnote: (cont'd)**

HSBC has undertaken full retrospective application of IFRS 2, as permitted by IFRS 1, and recognised the fair value of share-based payments to employees whilst reversing charges made in respect of employee share schemes under UK GAAP. This resulted in a US\$152 million reduction in operating profit for the year ended 31 December 2004 (first half of 2004: US\$55 million; second half of 2004: US\$97 million).

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**HKFRS 3/HKAS 36/HKAS 38  
Business Combinations/Impairment of  
Assets/Intangible Assets**

**Overview of HKFRS 3, HKAS 38  
and HKAS 36**

- **HKFRS 3 Business Combinations**
  - Accounting for business combinations within scope
  - Application of purchase method
- **HKAS 38 Intangible Assets**
  - Recognition criteria
  - Finite or indefinite useful lives
  - Cost model or revaluation model
- **HKAS 36 Impairment of Assets**
  - Measuring recoverable amount
  - Cash generating units and goodwill
  - Reversing an impairment loss



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**Key Changes in HKFRS 3**

Method	→	Must use purchase method for business combinations within scope
Assets and liabilities acquired	→	More intangible assets & contingent liabilities recognised and measured at fair values
Goodwill	→	Not amortised and tested for impairment annually and in the financial year when goodwill arises
Negative goodwill	→	Recognised in profit or loss immediately
Restructuring costs?	→	Only recognised to the extent acquiree's liability exists at acquisition date

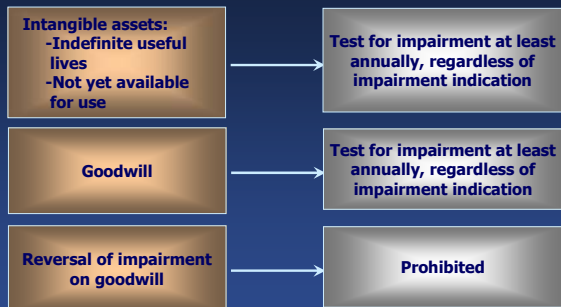
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**Key Changes in HKAS 38**

Acquisition as part of business combinations	→	Probability recognition criteria is always considered satisfied
Useful lives	→	Presumption of not exceeding 20 years is removed, may be indefinite Indefinite life assets not amortised
Impairment tests	→	No annual requirement for finite life assets with useful life > 20 years Test indefinite life assets at least annually, regardless of impairment indication

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### Key Changes in HKAS 36



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### Key Differences between HKFRS 3/IFRS 3

	HKFRS 3	IFRS 3
Definition of subsidiaries	Provides background information on why HK incorporated companies should use definition of subsidiary under Companies Ordinance S2(4)	No such specifications
Effective date	Agreement date of business combination on or after 1 January 2005	Agreement date of business combination on or after 31 March 2004

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### HKFRS 3 - Scope

- **Business combination** = A business combination is the bringing together of separate entities or businesses into one reporting entity
- HKFRS 3 applies to all business combinations except
  - combinations of entities under common control
  - formations of joint ventures
  - combinations of mutual entities
  - combinations by contract without exchange of ownership interest

Proposal to remove 3

### HKFRS 3 - Scope

- For business combinations outside the scope of HKFRS 3, no HKFRS addressing the appropriate accounting treatment
- Purchase method, or another appropriate accounting method can be selected
  - Merger accounting is commonly used for combinations of entities under common control

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### Common Control

- The combining entities are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory
- Controlled by an individual or by a group of individuals acting together under a contractual arrangement
  - Extent of minority interests is not relevant

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### Application of the Purchase Method

- All business combinations are accounted for by the purchase method
- Applying the purchase method
  - Step 1 - An acquirer is identified
  - Step 2 - The cost of the business combination is measured
  - Step 3 - The cost is allocated, at acquisition, to the assets, liabilities and contingent liabilities



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### Identifying an Acquirer



- An acquirer must be identified
- **Guidance on identifying the acquirer**
  - Respective sizes / relative fair value of entities
  - Power to govern financial and operating policies of combined entity
  - Voting rights in combined entity
- The acquirer for accounting purposes may not be the legal acquirer (reverse acquisitions)
- Where a new entity is formed one of the pre-existing entities must be identified as acquirer

67

### Cost of a Business Combination

- An acquirer measures the cost as the total of
  - fair values at date of exchange of assets given, liabilities incurred and equity instruments issued, plus
  - any directly attributable costs
- **Equity instruments**
  - If market price exists - use price at date of exchange
  - If market price doesn't exist/unreliable - use other valuation technique

68

### Other Direct Costs

- Only those costs directly attributable to the combination can be capitalised
  - Such as professional fees paid to accountants, legal advisers, valuers and other consultants to effect the combination
- General administrative costs, including the costs of maintaining an acquisitions department
  - ➔ cannot be capitalised as cost of business combination

69

### Allocating the Cost

- Allocate cost to fair values of assets, liabilities and contingent liabilities assumed
  - Only allocate to those that exist at acquisition date
- Identify all intangibles that may require separate recognition
  - I.e. meet the definition of intangible asset and can be measured reliably
- Measure contingent liabilities if reliably measurable
  - Amount based on the amount a third party would charge to assume the liability

70

### HKAS 38 Intangible Assets Acquired through Business Combination

- Recognised separately from goodwill if
  - meet the definition of an intangible asset
  - fair value can be measured reliably
- The probability recognition criterion is always considered to be satisfied
  - e.g. in-process research and development projects recognised at fair value even though R&D project does not meet recognition criteria in the acquiree's books



71

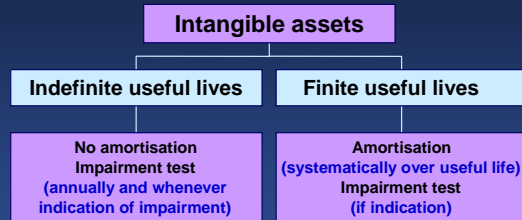
### HKAS 38 Intangible Assets - Identifiability

- An intangible asset is an identifiable non-monetary asset without physical substance
- Identifiable if
  - separable, or
  - arises from contractual or other legal rights



72

## HKAS 38 Intangible Assets - Classification



73

## Restructuring Provision

- Only recognise separately to the extent they exist at acquisition date (based on recognition criteria under HKAS 37)
- Otherwise post-combination expense



74

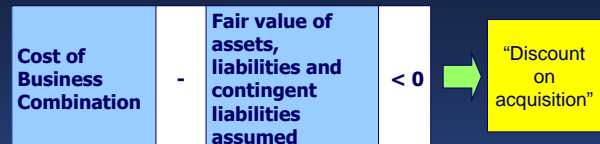
## Goodwill



- Recognise as an asset at date of transaction
- Do not amortise
- Test for impairment at least annually

75

## "Discount on Acquisition"



- Total of net assets > cost of acquisition = "discount"
  - No negative goodwill
- Reassess the fair values originally determined
- Any remaining excess is recognised in profit and loss immediately

76

## Cost Adjustments

### Cost adjustments:

- Contingent consideration => subsequent change to cost dependent on specific contingent events
- Adjustment to provisional fair values
- Recognition of deferred tax assets after initial accounting is complete

77

## Contingent Consideration

- Accounting for adjustments to the cost of a business combination which are contingent on future events (e.g. consideration contingent on profitability of the acquiree)
  - include in the cost of combination if **probable** and can be **measured reliably** at acquisition date
  - treat as an adjustment to cost if subsequently meets condition
  - otherwise exclude
  - If excluded, subsequent adjustment should be treated as adjustment to the cost of business combination



78

### Provisional Values

- **Adjustments to provisional fair values**
  - Within 12 months of the acquisition date (Initial accounting period)
    - Must state the values assigned originally are provisional values
    - Retrospectively adjust the carrying amount of the asset, liability or contingent liability against goodwill or "discount"
    - Comparative information presented for the periods before the completion of initial accounting should be presented as if the initial accounting has been completed from acquisition date

79

### Provisional Values (cont'd)

- After 12 months from the acquisition date
  - Account for the adjustments in accordance with HKAS 8, either as an error or changes in estimates

80

### Deferred Tax Asset

- **Recognition of deferred tax assets after the initial accounting is complete**
  - If potential tax benefits (as at acquisition date) subsequently meet the recognition criteria, account for deferred tax assets in accordance with HKAS 12
  - Reduce carrying amount of goodwill as an expense
  - Must not result in the recognition, or an increase of "discount" on acquisition

Time Limit

81

### HKAS 36 Impairment of Assets

- Frequency of impairment testing
  - When should impairment testing be performed?

Intangible assets and tangible assets with a definite life



Only test if there is an indication of impairment

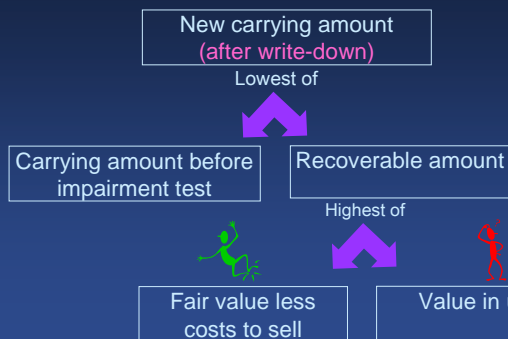
Goodwill and intangible assets with an indefinite life or not in service



Systematically test at least once a year at a fixed date (not necessarily at the balance sheet date) + extra test if there is indication of impairment in the interim period

82

### HKAS 36 Impairment Model



83

### HKAS 36 Impairment of Goodwill

- **Allocate goodwill to cash generating units (CGUs) before impairment test**
  - the smallest group of assets generating independent cash inflows
  - represents the lowest level at which goodwill is monitored internally
  - not larger than a segment (HKAS 14)
- **Impairment test annually per CGU**
  - not necessarily at year end

84

### **HKAS 36 Allocation of Impairment Loss**

- The impairment loss is allocated as follows
  1. Reduce the carrying amount of any goodwill allocated to the CGU (or group of units)
  2. Reduce the carrying amounts of the other assets (pro rata based on carrying amounts)
- A write-down due to an impairment is recognised in profit or loss
- Reversal of write-down of goodwill is prohibited

85

### **HKFRS 3 Transitional Provisions**

- Effective for business combinations on or after 1 Jan 2005
- Existing goodwill carried at amortised cost
  - Discontinue amortising goodwill in first period beginning on or after 1 Jan 2005
  - Eliminate accumulated amortisation against the carrying amount of goodwill at start of first period beginning on or after 1 Jan 2005
  - Test carrying amount of goodwill for impairment

86

### **HKFRS 3 Transitional Provisions**

- Negative goodwill
  - Derecognise at start of first reporting period beginning on or after 1 Jan 2005
    - Adjustment made to opening retained earnings
- Goodwill deducted from equity
  - Should not be recognised in profit or loss when the related business is disposed of

(IFRS 3: Effective on or after 31 March 2004)

87

### **Early Application**

- Earlier application allowed if
  - sufficient information obtained at the time the combinations are initially accounted for
  - HKAS 36 and HKAS 38 applied from the same date
  - applied to all business combinations occurring after that date

88

### **Proposed Amendments to IFRS 3/HKFRS 3**

- Measure the business acquired at its total fair value
  - Recognise goodwill attributable to any non-controlling interests (minority interests)
- Expense payments to third parties
- Fewer exceptions to the fair value principle
- Include business combinations involving mutual entities and those achieved by contract alone
- Account for acquisitions of non-controlling equity interests after the business combination as transactions with owners

89

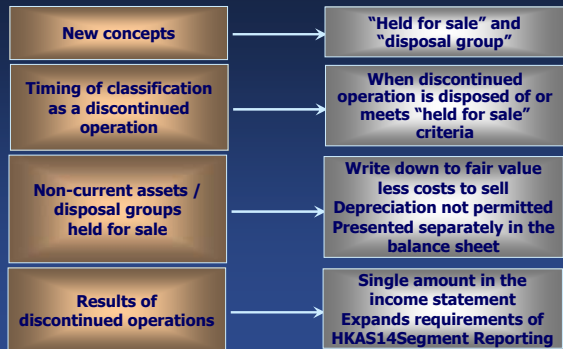


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### **HKFRS 5 Non-current Assets Held for Sale and Discontinued Operations**



## Key Changes in HKFRS 5



91

## Scope

- The classification and presentation requirements apply to all recognised non-current assets and to all disposal groups

### Disposal group –

- A group of assets and associated liabilities to be disposed of, by sale or otherwise, as a group in a single transaction
- Includes goodwill acquired in business combination if group is a CGU to which goodwill was assigned (HKAS 36)



92

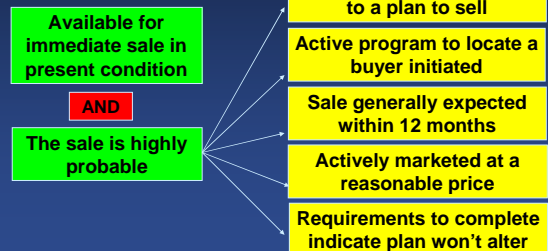
## Scope Exemptions

- Exceptions from measurement requirements
  - Deferred tax assets (HKAS 12)
  - Assets arising from employee benefits (HKAS 19)
  - Contractual rights under insurance contracts (HKFRS 4 Insurance Contracts)
  - Financial assets within the scope of HKAS 39
  - Non-current assets accounted for in accordance with the fair value model (HKAS 40 Investment Property)
  - Non-current assets measured at fair value less estimated point-of-sale costs (HKAS 41 Agriculture)

93

## Held for Sale Classification

- "Held for sale" criteria (para 7,8)



94

## Held for Sale

- If non current assets (disposal group) are acquired exclusively with a view to disposal, they are classified as held for sale if
  - sale is expected < 12 months; and
  - highly probable that full criteria (HKFRS 5.7-8) will be met within short period after acquisition (3 months)
- Non current assets that are to be abandoned are not classified as held for sale
  - May be classified as discontinued operations when eventually abandoned

95

## Held for Sale - Measurement

- The following principles apply on classification as held for sale
  - Immediately before classification - carrying amount measured in accordance with applicable HKFRS
  - After classification - measure at the lower of carrying amount and fair value less costs to sell

96

## Held for Sale – Measurement (cont'd)

- Impairment losses for write downs - profit or loss
- Subsequent increases in fair value - recognised if not in excess of the cumulative impairment loss (under HKFRS 5 or HKAS 36)
- **No depreciation**

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## Held for Sale Criteria No Longer Met

- Cease to classify the asset (or disposal group) as held for sale
- The entity shall then measure it at lower of
  - its carrying amount before classified as held for sale, adjusted for depreciation, amortisation or revaluations otherwise recognised, and
  - its recoverable amount at date of subsequent decision not to sell

Held for sale

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## Discontinued Operations

### Discontinued operation

Component of an entity that has been disposed of

OR

Classified as held for sale

AND

represents separate major line of business or geographical area of operations, or

part of single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or

is a subsidiary acquired exclusively with view to resale

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## Presentation and Disclosure – Discontinued Operations

- A single amount on the face of the income statement comprising the total of
  - post-tax profit or loss of the discontinued operation and
  - post-tax gain or loss recognised on the measurement to fair value less costs to sell or on disposal
- Analysis of that amount on the face or in the notes

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## Presentation and Disclosure – Discontinued Operations (cont'd)

- Net cash flows attributable to operating, investing, and financing activities
  - Separately on face of cash flow statement or in the notes
- Prior periods are required to be re-presented

101

## HKAS 27 Consolidation Exemption

- Subsidiaries acquired with view to resale < 12 months are no longer excluded from consolidation
- HKFRS 5
  - If subsidiary is classified as held for sale, it is presented as a disposal group classified as held for sale
  - Assets and liabilities of subsidiary = disposal group
    - Two separate line items for assets and liabilities
    - Measure at lower of carrying amount and fair value less costs to sell
    - No depreciation



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### **Transitional Provisions**

- Apply prospectively for annual periods beginning on or after 1 Jan 2005
- Early application is encouraged, but
  - HKFRS 5 must be applied to **all** non-current assets (or disposal groups) that meet criteria after that date
  - Valuations and other information needed must have been obtained at time criteria originally met
  - Early application must be disclosed

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### **HKAS 32/39 Financial Instruments: Disclosure and Presentation, Recognition and Measurement**

### **Background**

- HKAS 32: **Presentation and Disclosure of Financial Instruments.**
- **Covers:**
  - Classification as debt or equity.
  - Offsetting in the balance sheet.
  - Disclosure (including fair values of all financial assets and liabilities).
- **New standard. No SSAP.**

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### **Background**

- HKAS 39: **Financial Instruments: Recognition and Measurement.**
- **Covers:**
  - Which financial instruments to recognise in balance sheet.
  - How to measure them.
  - When to derecognise them.
  - Impairment recognition.
  - Hedge accounting.
- **New standard. SSAP 24 had covered only investments.**

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### **Definitions**

- **These are the same in both HKAS 32 and HKAS 39.**
  - Financial instrument.
  - Financial asset.
  - Financial liability.
  - Equity instrument.
  - Derivative.
  - Embedded derivative

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### **Definitions**

- **Financial instrument:**
  - A contract that creates a financial asset of one entity and a financial liability of another entity.
    - **Financial assets and liabilities are defined in the next slides.**

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### Definitions

#### Financial asset:

- Cash, or
- Right to receive cash or other financial asset, or
- Right to exchange financial instruments at a potential gain, or
- Equity instrument of another entity.

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### Definitions

#### Financial liability:

- Obligation to deliver cash or other financial asset to another entity, or
- Obligation to exchange financial instruments at potential loss, or
- Obligation to pay a variable number of an entity's own shares.

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### Definitions

#### Examples of financial instruments:

- Cash.
- Demand and time deposits.
- Commercial bills.
- Accounts, notes and loans receivable and payable.

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### Definitions

#### More examples of FI:

- Debt and equity securities:
  - FI from the perspective of both the issuer and the holder.
  - Note this includes investments in subsidiaries, associates, and joint ventures.
- Asset backed securities such as repurchase agreements and securitised packages of receivables.

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### Definitions

#### More examples of FI:

- Derivatives.
  - To be defined shortly.
- Lease payables and receivables.
- Insurance companies: rights and obligations under insurance contracts.
- Employers: rights and obligations under pension contracts.
- Share options.

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### Definitions

#### Equity instrument:

- Contract evidencing a residual interest in an enterprise's assets.
  - Includes share options and warrants.
  - Obligations indexed to factors other than share price are not equity instruments even if they will be settled by an enterprise's own shares.

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### Definitions

- **Derivative:**
  - Financial instrument whose value changes due to a change in a specified rate, index or price.
    - Sometimes called the “underlying”.
  - Little or no initial net investment.
  - Settled at a future date.
  - Usually: net settlement.

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### Definitions

- **Embedded derivative:**
  - A component of a combined instrument that includes a host contract and a derivative. The component’s cash flows vary in the same way as a stand-alone derivative.

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### Definitions

- **Examples of embedded derivative:**
  - Equity conversion feature of a convertible debt instrument.
  - Contract to purchase a commodity at a fixed price for future delivery.
  - Floating-rate interest payments.
  - Inflation indexed lease payments.
  - An option to prepay a loan at its amortised amount.

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### Parts of HKAS 32 that I Will Cover

Classification as debt or equity	YES
Split accounting for compound instruments	BRIEFLY
Treasury shares	NO
Costs of issuing equity securities	NO
Offsetting	NO
Disclosure	BRIEFLY

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### Classification as Debt or Equity

- **Classification as debt or equity – general principles:**
  - Substance over form.
  - Classification is made once, at issuance, not changed later.

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### Classification as Debt or Equity

- **An instrument is a liability if –**
  - Issuer has a contractual obligation to deliver cash or other financial asset
- Or**
- Holder has right to demand cash or other financial asset.
- **It is equity only if the entity has an unconditional right to avoid paying cash or other financial asset.**

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### Classification Example

- **Normal preference shares:**
  - No fixed maturity, dividends payable only if declared.
  - **Equity.**
- **Mandatorily redeemable preference shares:**
  - Fixed maturity, fixed dividend.
  - **Liability.**
  - Dividend must be treated as interest.

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### Compound Financial Instruments

- **Definition of a compound financial instrument:**
  - A single instrument containing both a liability component and an equity instrument of the issuer.
  - Example: debt convertible into a fixed number of shares.
- **Under HKAS 32: The issuer recognises and accounts for each component separately.**

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### HKAS 32 - Disclosure

- **We will cover disclosure after we finish all of HKAS 39.**
  - Easier to understand after considering recognition, measurement, and hedging.

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### HKAS 39 - Scope

- **HKAS 39 applies to all financial instruments except:**
  - Investments in subsidiaries, associates, and joint ventures.
  - Rights and obligations under leases.
  - Employer pension obligations and assets.
  - Rights and obligations under insurance contracts.
  - Issuer accounting for issuance of equity instruments.
  - Share-based payment transactions.

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### Scope

- **Included in HKAS 39:**
  - Some guarantees:
    - **Current proposal.**
  - Some loan commitments:
    - If can be settled in cash,
    - If practice of selling the loan shortly after origination, OR
    - If issuer wishes to designate as fair value through profit and loss.

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### 4 Categories of Financial Assets

Loans and receivables	Amortised cost
Held to maturity	Amortised cost
Available for sale	Fair value*, value changes to equity
Fair value through P&L	Fair value*, value changes to P&L

\*If FV cannot be measured reliably, then use cost.

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### **Classification of Financial Assets**

#### **1. Measured at FV through P&L:**

- Acquired or issued and held for trading:
  - Includes all derivatives unless a hedging instrument.
- Designated by entity on initial recognition (FV Option or FVO).
  - Option for each individual financial asset (and liability), but only if FV can be measured reliably and "accounting mismatch" – next slide...

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### **Classification of Financial Assets**

#### **▪ June 2005 revision to HKAS 39 restricts use of FVO to elimination of an "accounting mismatch":**

- Two items (eg asset and liability, at least one of which is financial) are managed jointly, and management evaluates their performance on a FV basis, but the financial instrument would otherwise be required to be measured on a basis other than FV through P&L.

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### **Classification of Financial Assets**

#### **2. Held to maturity investments**

- Non-derivative financial assets with fixed or determinable payments and fixed maturity.
- Entity must have positive intent and ability to hold to maturity.
- Equity instruments generally may not be classified as HTM.
  - Exception: Mandatorily redeemable preferred classified as debt.
- "Interest only strips" also may not be classified as HTM. No "maturity".

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### **Classification of Financial Assets**

#### **▪ For HTM, entity must have both the positive intent and ability to hold to maturity.**

- For entire life of the instrument.
- No intent to sell in response to market conditions.
- Issuer does not have the right to settle the instrument at an amount significantly below amortised cost.

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### **Classification of Financial Assets**

#### **▪ HTM: Callable debt security:**

- Can be HTM if entity intends to hold to call.

#### **▪ Puttable debt security:**

- Not HTM. Intent of purchasing puttable security is to exercise the put.

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### **Classification of Financial Assets**

#### **3. Loans and receivables:**

- Non-derivative.
- Not quoted in active market. If yes, these must be HTM, FV through P&L, or available for sale (AFS).
- Not intended for sale in near term. If yes, these are FV through P&L.
- Not designated (a) to be measured at FV through P&L or (b) as AFS ("AFS Option").
- Not acquired at a discount for a reason other than credit risk.

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### **Classification of Financial Assets**

- **Loans and receivables can include (unless publicly quoted):**
  - Loan assets.
  - Trade receivables.
  - Investments in unquoted debt instruments.
  - Bank deposits.

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### **Classification of Financial Assets**

#### **4. Available for sale (AFS)**

- If a financial asset does not fit in another category, it is AFS.
- Any loans and receivables can be designated here by choice ("**AFS Option**").

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### **Classification of Financial Liabilities**

#### **1. Measured at FV through P&L:**

- Derivative liabilities.
- Short sales.
- Liabilities individually designated by entity on initial recognition ("**FV Option**").
  - But only if FV reliably measurable and "accounting mismatch".

#### **2. All others – at amortised cost.**

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### **Initial Recognition**

#### **Initial Recognition – General Rule:**

- Recognise a financial asset or liability when the entity becomes a party to the contractual provisions of the instrument.
  - This includes all derivatives.
  - Choice of trade date or settlement date recognition.

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### **Measurement – What is Fair Value?**

#### **Fair value:**

- Amount for which an asset could be exchanged, or liability settled, between knowledgeable, willing parties in an arms length transaction.

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### **What is Fair Value?**

#### **Fair value hierarchy:**

- Best: Published price quotation in active market.
  - Bid price for asset held or liability to be issued.
  - Asked price for asset to be acquired or liability held.
- If there is a published quotation but your asset will be sold in another market, may need to adjust.
- If no bid/asked prices, look to most recent transaction price.

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### *What is Fair Value?*

- **Fair value hierarchy:**
  - Only if no active market: Use a valuation technique.
    - Incorporate all factors that market participants would consider in setting a price.
    - Base on observable market data and conditions to the extent possible.

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### *Initial Measurement*

- **Financial assets and liabilities should be initially recognised at their fair value.**
  - Imputation of interest is required for no-interest or off-market interest loans.
  - Initial fair value includes directly attributable transaction costs only for financial assets or liabilities not measured at FV through P&L.
    - Can be "Day 1 Gain or Loss"

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### *Subsequent Measurement*

- **Financial Assets — On balance sheet measure at:**
  - Available for sale, held for trading, and designated (FVO): **Fair value, no deduction for future disposal costs.**
  - Loans and receivables and held-to-maturity investments: **Amortised cost using effective interest method.**
  - Unquoted equity instruments (and derivatives indexed to them) if FV cannot be reliably measured: **Cost.**

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### *Subsequent Measurement*

- **Change in FV after acquisition:**
  - Directly to equity for AFS.
  - Include in P&L for instruments measured at FV through P&L (including trading and FVO designated).
  - Of course, change in FV is not recognised for loans and receivables and HTM.

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### *Subsequent Measurement*

- **Financial liabilities:**
  - Derivative liabilities, short-sale liabilities, and those designated using the FVO: **At FV, with value changes in P&L.**
  - All others: **Amortised cost using effective interest method.**

143

### *Impairment*

- **All financial assets must be evaluated for impairment — except for those measured at FV through P&L.**
  - Individually significant items must be assessed on individual basis.
  - Impairment recognised only if a loss event has occurred.
  - Losses expected as a result of future events, no matter how likely, are not recognised.

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## Impairment

- **Assess impairment at each balance sheet date.**
- **If impaired, estimate the recoverable amount of that asset and recognise impairment loss.**
  - Assets carried at cost or amortised cost: Recognise a loss in P&L.
  - Assets carried at fair value - Loss that was recognised in equity is now recognised in P&L.

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## Derecognition

- **Derecognition defined:**
  - Removing a financial asset or financial liability from the balance sheet.
  - **Opposite of recognition.**
- In most transactions, the appropriate point for derecognition is clear.
  - **Substantially all risks and benefits are transferred at point of sale.**
- Sometimes, it is not so clear.

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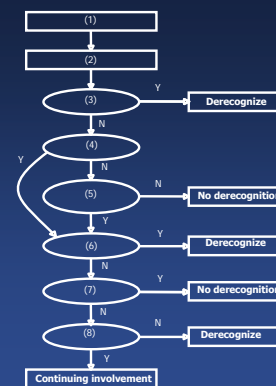
## Overview of Derecognition

<b>OVERVIEW:</b>		<b>Accounting treatment</b>
<b>Situation</b>		
Substantially all risks and rewards are transferred		Derecognise the old asset
Transferred and retained risks and rewards are both significant	Control is transferred	Continuing involvement approach
	Control is retained	
Substantially all risks and rewards are retained		Continue to recognize the old asset

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## Derecognition Flowchart

1. Consolidate all subsidiaries
2. All or part of an asset?
3. Has right to cash expired?
4. Transfer of right to collect cash?
5. Pass-through conditions met?
6. Substantially all risks/rewards transferred?
7. Substantially all risks/rewards retained?
8. Control retained?



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## Step 1 - Consolidate

- **Consolidate all subsidiaries (including SPEs):**
  - Consolidate an SPE if controlled.
- **Four indicators of control of an SPE:**
  - SPE's activities are conducted to meet the specific business needs of the entity that created it.
  - Entity that created the SPE has decision-making powers (presumed when SPE operates on "auto pilot").
  - Rights to obtain the majority of the benefits of operation of the SPE.
  - Majority of the residual or ownership risks.

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## Step 2 – All or Part?

- **Determine whether the flowchart should be applied to a part or all of an asset (or group of similar assets).**
- **Apply to all of the original asset subject to the transfer unless it is a transfer of:**
  - Specifically identified cash flows.
  - Proportionate share of cash flows (a percentage of all principal and interest cash flows).
  - Fully proportionate share of specifically identified cash flows.

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### Step 3 – Expired Rights

- **Have the rights to the cash flows from the asset expired?**
  - ☑ If yes – Derecognise the asset.
    - **Example: expired option**
  - ☑ If no - Go to step 4.

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### Step 4 – Transfer of Right to Collect Cash?

- **Has the entity transferred its rights to receive the cash flows from the asset?**
  - ☑ If yes – Go to step 6.
    - **Example: Sale of an asset**
  - ☑ If no - Go to step 5.
    - **Examples: Securitisations**

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### Step 5 – Pass-through?

- **Has the entity assumed an obligation to pay cash flows that meets three conditions:**
  - No obligation to pass on cash flows unless collected.
  - Cannot sell or pledge the asset.
  - Must remit cash flows without delay.
- ☑ **If yes – Go to step 6.**
  - **Example: Non-recourse sale.**
- ☑ **If no - Continue to recognise the asset.**

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### Step 6 – Risks/Rewards Transferred?

- **Has the entity transferred substantially all risks and rewards?**
  - ☑ If yes – Derecognise the asset.
  - ☑ If no – Go to step 7.
- **Examples**
  - Unconditional sale of a financial asset.
  - Sale with an option to buy back at fair value.
  - A right of first refusal at fair value.
  - A sale of a financial asset together with a put or call option that is deeply out of the money (highly unlikely to be exercised).

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### Step 7 – Risks/Rewards Retained?

- **Has the entity retained substantially all risks and rewards?**
  - ☑ If yes – Continue to recognise.
  - ☑ If no – Go to step 8.
- **Examples:**
  - Sale and repurchase transaction.
  - Securities lending agreement.
  - Sale of a financial asset with a total return swap.
  - Sale of short-term receivables with a guarantee to compensate for credit losses that are likely to occur.

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### Step 7, continued

- **The transfer of risks and rewards is evaluated by comparing the entity's exposure, before and after the transfer, to the variability in the amounts and timing of the net cash flows of the transferred asset (on a present value basis).**
  - Often obvious, otherwise a computation may be necessary.

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### Step 8 – Control Retained?

- If the transferor has neither retained nor transferred substantially all risks and rewards, then must consider control:
- Has the entity retained control of the asset?
  - ☑ If yes – Continue to recognise the asset to the extent of the continuing involvement.
  - ☑ If no – Derecognise the asset.

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### Step 8, continued

- Control means:
  - Unilateral and unrestricted right to sell the asset to a third party.
- Substantially all benefits and risks are transferred means:
  - Transferor cannot be forced to reacquire.
  - If the transferee is required to put the assets back to transferor but identical assets are traded in the market, derecognition may be appropriate.

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### Continuing Involvement

- If the transferor has retained control, continue to recognise the asset to the extent of the continuing involvement:
  - Lower of guarantee amount and carrying amount.

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### Continuing Involvement

- Example: Entity sells for 100 a loan portfolio carried at 100 and it guarantee the first 30 of credit losses. Value of guarantee is 10.

Dr Cash		100	
Dr Loss		10	
	Cr Liability arising from guarantee		30
	Cr Unearned guarantee fee		10
	Cr Receivables		70

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### Continuing Involvement

- Example: Entity sells for 102\* cash 90% of a loan portfolio of 100. FV of total portfolio is 110. It keeps a subordinated interest in the remaining 10.

Dr Cash		102	
Dr Subordination Asset		10	
	Cr Unearned fee		3
	Cr Subordination Liab.		10
	Cr Gain		9
	Cr Receivables		90

\*102 = 90% x 110 + 3 credit enhancement

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### Continuing Involvement

- What is the "subordination asset"?
  - Transferor's continuing involvement in the portion of the asset that was sold.
  - Transferor may have to pay 10 of consideration it received (out of cash flows from its retained interest) if there are losses in the portion sold.
- What is the "subordination liability"?
  - Transferor's conditional repayment obligation.

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### ***Derecognition of Financial Assets***

- **If derecognition is not allowed:**
  - Continue to recognise the financial asset (or portion).
  - Recognise a financial liability for the consideration received.
  - Subsequently, recognise income on the transferred asset to the extent of continuing involvement, and related expense incurred on the financial liability.
  - Asset and liability cannot be offset.
    - **Nor can income/expense be offset.**

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### ***Derecognition of Financial Assets***

- **If transferor provides non-cash collateral (such as securities) to transferee:**
  - Transferor keeps collateral on its books, segregated from other assets.
  - Transferee does not recognise it as an asset.
  - If transferee does sell, it recognises a liability to return the collateral.
  - If transferor defaults, it derecognises the collateral. Transferor recognises it as its asset.

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### ***Derecognition of Liabilities***

- **Remove a financial liability when it is extinguished, that is, when the obligation is discharged, is cancelled, or expires.**
- **Extinguishment occurs through:**
  - Debtor repays the creditor, or
  - Debtor is legally released from primary responsibility for the liability.
  - No derecognition for defeasance (transfer of assets to a trust).

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### ***Derivatives and Hedge Accounting***

- **Derivatives are futures, forwards, swaps, options, etc.**
- **Under HKAS 39, of course, all derivatives are:**
  - Recognised in the balance sheet.
  - Measured at fair value.
  - Value changes through P&L.
    - **Except for hedge of future cash flows, where the value change is deferred in equity until the future cash flow occurs.**

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### ***Embedded Derivatives***

- **Under HKAS 39, an embedded derivative must be separated from the host contract and accounted for separately if:**
  - Its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract.

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### ***Embedded Derivatives***

- **If embedded derivative must be separated from host:**
  - Host contract — Apply the relevant HKFRS.
  - Embedded derivative — Apply HKAS 39 (fair value, value changes in P&L).
  - The embedded derivative may be designated as a hedging instrument.
- **However: next slide...**

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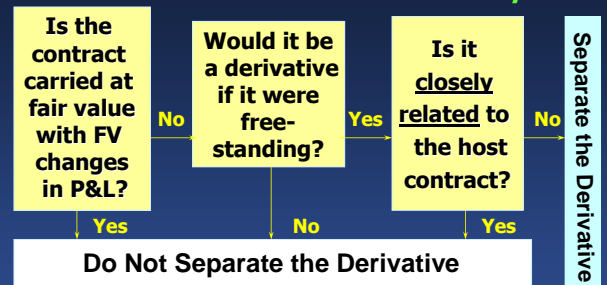
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### Embedded Derivatives

- If the combined (hybrid) contract is already at FV with FV changes in P&L, no need to separate out the derivative.
- If the derivative cannot be measured alone, entire combined (hybrid) contract must be at FV with value change in P&L.

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### Embedded Derivative Decision Steps



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### Embedded Derivatives

- Examples of closely related risks:

Host	Underlying
Debt	Interest, inflation
Equity	Equity of same issuer
Lease	Interest or inflation in same economic environment

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### Embedded Derivatives

- Example: Interest rates in a debt host:
  - Embedded derivatives linked to an interest rate or an interest rate index normally are closely related to the debt host.

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### Embedded Derivatives

- Example: Option to extend the term of a debt host:
  - An borrower's option to extend the term is not closely related to the host debt instrument, unless interest rates are reset to market at the extension date.

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### Embedded Derivatives

- Example: Option in a debt instrument that allows the issuer to prepay before maturity:
  - Closely related provided the exercise price of a prepayment option would not result in a significant gain or loss.

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### Embedded Derivative Examples

- **Lease host: Generally** closely related:
  - Indexed to the inflation rate of the enterprise's economic environment and no leverage.
  - Contingent rentals.
    - Based on either sales or variable interest rates.

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### Hedge Accounting

- **Hedging:**
  - Managing risks by using one financial instrument ["hedging instrument"] purposely to offset the variability in FV or cash flows of some recognised asset or liability, firm commitment, or future cash flows ["hedged item"].
- **Hedge accounting:**
  - Matching the change in FV of the hedging instrument and the hedged item in the same income statement.

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*The hedger's worry:  
Reporting the change in FV of hedged item and  
hedging instrument in different periods*

	Period 1	Period 2	Total
<b>Exposure</b>		30	30
<b>Derivative</b>	(30)		(30)
<b>P&amp;L</b>	(30)	30	0

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### Hedge Accounting Solution

	Period 1	Period 2	Result of Hedge
<b>Exposure</b>		30	30
<b>Derivative</b>	(30)		(30)
<b>P&amp;L</b>	(30)	30	0

**Fair Value Hedge** (points to Period 1 values)

**Cash Flow Hedge** (points to Period 2 values)

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### General Criteria for Hedge Accounting

- **HKAS 39 permits hedge accounting if:**
  - Designation and documentation.
  - Risk management reason.
  - Effectiveness (both expected and actual)..
- **Hedge accounting is optional:**
  - If you don't designate in writing, you don't qualify.

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### Hedge Effectiveness

- The degree to which offsetting of changes in fair value or cash flows attributable to a hedged risk is achieved by the hedging instrument.
- **To qualify for hedge accounting:**
  - Effectiveness must be measurable.
  - Hedge must be expected to be highly effective throughout the hedging period.

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### **Key Concepts: Fair Value Hedge**

- **Fair value exposure:**
  - Exposure to changes in the fair value of
    - a recognised asset or liability,
    - or an identified portion of a recognised asset or liability,
    - or an unrecognised firm commitment.
  - that is attributable to a specific risk and that affects reported net income.

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### **Mechanics: Fair Value Hedge**

- Derivatives are reported on the balance sheet at fair value.
- Changes in a derivative's FV are always recognised in earnings.
- Changes in the fair value of hedged items due to the hedged risk are recognised in earnings and adjust the carrying amount of those items.
  - Even if the item is otherwise carried at cost.
- **Net effect on P&L: Ineffectiveness.**

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### **Example: Fair Value Hedge**

- **Fixed rate loan receivable \$1,000. Accounted for at amortised cost.**
  - Holder hedges interest rate risk.
  - Rates decline.
  - Loss on derivative hits P&L.
  - Increase in fair value of loan receivable related to interest rate changes credited to P&L and adjusts carrying amount, even though loan is otherwise accounted for at amortised cost.

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### **Key Concepts: Cash Flow Hedge**

- **Cash flow exposure:**
  - Exposure to changes in future cash flows relating to a recognised asset or liability:
    - **Example: Variable rate bonds.**
  - Exposure to changes in future cash flows relating to a forecast transaction:
    - **Example: Anticipated issuance of fixed-rate debt.**

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### **Mechanics: Cash Flow Hedge**

- Derivatives are reported on the balance sheet at fair value.
- Changes in a derivative's fair value are recorded to equity to the extent the hedge is effective.
- Changes in the derivative's fair value are recognised in P&L when the cash flows or forecast transactions occur.
- **Only ineffectiveness hits P&L.**

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### **Example 1: Cash Flow Hedge**

- **Floating rate loan receivable \$1,000. Accounted for at amortised cost.**
  - Holder hedges future interest cash flows.
  - Interest rates decline.
  - Gain on derivative reported directly in equity.
  - Carrying amount of loan is not changed.
  - In future, when the lower interest payments are received, gain on derivative hits P&L.

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### Hedge of Firm Commitment

- Hedge of firm commitment is a fair value hedge, not cash flow hedge.
  - Exception: FX hedge of firm commitment can be cash flow hedge.
  - Example 2 on next slide illustrates this.

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### Example 2: Cash Flow Hedge with Basis Adjustment

- Airline whose functional currency is HK\$ orders Airbus for €100 million, when HK\$10=€1, delivery and payment in 2 years.
- Airline hedges FX risk by buying 2-year €/HK\$ forward.
- End of year 1, HK\$11=€1.
- End of year 2, HK\$11=€1.

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### Entry at end of Year 1

	Debit	Credit
<b>Derivative asset</b>	HK\$100m	
<b>Equity (Hedge)</b>		HK\$100m

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### Entries at end of Year 2 – With Basis Adjustment\*

	Debit	Credit
<b>Airplane</b>	HK\$1,100m	
<b>Cash</b>		HK\$1,100m
<b>Cash</b>	HK\$100m	
<b>Derivative asset</b>		HK\$100m
<b>*Equity (Hedge)</b>	HK\$100m	
<b>Airplane</b>		HK\$100m

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### Depreciation of Airplane

- **With basis adjustment:**
  - Depreciate airplane HK\$1,000 million over its useful life.
- **With no basis adjustment:**
  - Depreciate airplane HK\$1,100 million over its useful life.
  - The HK\$100m remaining in equity is amortised as FX gain over the life of airplane.

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### Macro Hedging

- **Under revised HKAS 39:**
  - An amount (rather than individual items) may be designated as the hedged item.
  - The change in value of the hedged position is reported in a separate balance sheet line item.
  - Prepayment risk is included by using expected repayment dates.

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### *Macro Hedging, continued*

- But banks still cannot designate core deposits as the hedged item.
  - Fair value of demand deposit cannot be less than amount due on demand.
  - Even if banks can forecast that demand will not occur until future dates.

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### *Transition*

- HKAS 32 and 39 are effective for annual periods beginning 1 January 2005.
- HKAS 32: Retrospective unless prior period information not available.
  - Reclassify items as debt or equity based on HKAS 32.
  - Retrospective "split accounting".

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### *Transition*

- HKAS 39 Transition:
  - Limited retrospective application:
    - Put all derivatives on balance sheet
    - Even if acquired before 2005.
    - Remeasure from cost to fair value for AFS and for FV through P&L items.
    - Adjust opening retained earnings.
  - Not retrospective for derecognition accounting. Leave old accounting.

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### *Transition*

- No retrospective hedge designation.
- Do not undo pre-2005 hedge accounting, but starting 2005 hedges must meet HKAS 39 requirements.
- For FV hedge:
  - Adjust balance sheet amount of hedged item as of 1 Jan 2005.
- For CF hedge:
  - Past deferred gains or losses on derivatives can no longer be in the balance sheet. Report in equity.

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### *Disclosures*

- All disclosures from old IAS 32 and old IAS 39 were combined in revised IAS 32 (HKAS 32) in Dec. 2003.
- Plus some new ones were added:
  - Relating to hedge accounting, methods and assumptions for determining fair values, amounts reported directly in equity, assets and liabilities designated for FV through P&L, and reclassifications.

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### *Disclosures, continued*

- IFRS 7 will be issued 18 August!
  - Will create a new Financial Instruments Disclosure standard, combining the HKAS 32 disclosures with new disclosures relating to risks and capital policies and interest rate sensitivity, among other things.
  - Will replace HKAS 30 (banks).
  - Effective 1 January 2007, but early application permitted in 2005.

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### **HKAS 32 Disclosures**

- **Disclose extent and nature of financial instruments including:**
  - Terms and conditions of each.
  - Principal amount.
  - Date of maturity.
  - Early settlement/conversion option.
  - Amount and timing of scheduled principal or sinking fund payments.
  - Amount and timing of interest and dividend payments.
  - Collateral.
  - Foreign currency denominations.

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### **HKAS 32 Disclosures**

- **Disclosure by class of financial asset and liability:**
  - Accounting policies for all financial instruments –
    - **Including recognition criteria and measurement principles.**
  - Exposure to interest rate risk –
    - **Including repricing dates and terms and effective interest rates.**

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### **HKAS 32 Disclosures**

- **Disclosure by class of financial asset and liability:**
  - Exposure to credit risk –
    - **Including amounts and significant concentrations.**

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### **HKAS 32 Disclosures**

- **Amounts of interest income and interest expense**
- **Amounts of gain or loss on financial assets and liability, separated between:**
  - Amounts reported in P&L.
  - Amounts reported directly in equity.

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### **HKAS 32 Disclosures**

- **Relating to hedges (separately for FV, CF, and foreign investment hedges):**
  - Description of the hedge.
  - Description of hedging instruments and their fair values.
  - Nature of the risks being hedged.
  - For cash flow hedges, the periods in which the cash flows are expected to occur, and when they are expected to enter into the determination of profit or loss.

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### **HKAS 32 Disclosures**

- **More relating to hedges if any gain/loss on derivative is deferred in equity:**
  - Amount recognised in equity.
  - Amount removed from equity and included in P&L for the period.
  - Amount removed from equity and included in the initial measurement of the carrying amount of a non-financial asset or non-financial liability in a hedged forecast transaction ("basis adjustment").

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### **HKAS 32 Disclosures**

- **Fair values of all financial instruments by category**
  - If fair values cannot be reliably measured (some unquoted equity and derivatives indexed to them), must explain.
  - Methods and assumptions used to determine fair values.
    - **Quoted price?**
    - **Valuation technique?**
  - Portion of total FV change not based on quoted prices.

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### **HKAS 32 Disclosures**

- **Is trade date or settlement date accounting used.**
- **Special disclosures for:**
  - Derecognitions.
  - Collateral given or received.
  - Compound financial instruments.
  - Impairments.
  - Defaults and breaches.

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### **HKAS 32 Disclosures**

- **Special disclosures for:**
  - Financial assets / liabilities held for trading.
  - Financial liabilities designated to be carried at FV through P&L
  - Reasons for a reclassification to/from amortised cost measurement.

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### **Added by IFRS/HKFRS 7**

- **Added disclosures for:**
  - Qualitative and quantitative disclosures about risks arising from financial instruments, and management's policies to dealing with those risks.
  - Credit risk and credit enhancements, including fair values of collateral.

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### **Added by IFRS/HKFRS 7**

- **More added disclosures:**
  - Interest rate risk, including cash flow and fair value risks
  - Sensitivity analyses for interest rate and FX risks.
  - Market risk, including asset quality and liquidity.
  - Maturity analysis for liquidity risk.
  - Residual value risks.
  - An entity's capital and policies for managing capital.

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### **Changes from Existing HK GAAP**

- **Old HK GAAP excluded many derivatives from balance sheet**
  - Argument was no up front cost, therefore no asset or liability. Account only at settlement.
  - Danger, of course, is nasty surprises for investors.
- **Permissiveness of old SSAP 24**
  - Investments in non-HTM debt and equity could be measured at either:
    - **Cost with impairment (long-term) or fair value through P&L (short-term), or**
    - **All at fair value — through P&L if short-term and through equity if long-term.**

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### *Changes from Existing HK GAAP*

- **Old HK GAAP had no requirement to disclose the fair values of financial assets and liabilities.**
  - HKAS 32 requires such disclosures (and much more).
- **Was no detailed standard on impairment of investments.**
  - Had allowed more management discretion.

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### *Changes from Existing HK GAAP*

- **Were almost no rules for hedge accounting.**
  - Companies decided for themselves.
  - HKAS 39 requires measurement of effectiveness; up-front designation.
  - Likely: Far fewer deferrals of gains and losses on derivatives.
- **Were no derecognition standards.**
  - Despite growing use of securitisations, securities lending, repurchase agreements.

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### *Regulatory Issues*

- **Debt-Equity classification**
  - Mandatorily redeemable preferred classified as liability under HKAS 32 is supplementary capital (equity) for Capital Adequacy Ratio purposes.
    - **And related dividends are dividends, not interest expense.**
  - No "split accounting" for regulatory purposes.

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### *Regulatory Issues*

- **Exclusions from regulatory capital – Basel Committee recommendations June 2004:**
  - Gains/losses on cash flow hedges that are deferred in equity should be excluded from Tier I and II capital.
  - Gains/losses from applying the FV option to a bank's own debt must be excluded from Tier I and II capital.

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### *Regulatory Issues*

- **Loan loss provisioning**
  - Measuring provisions based on "incurred losses" vs. "expected losses"
  - US issue: Does sale of an AFS investment at a loss suggest that bank should recognise in P&L all losses on AFS that are deferred in equity? US EITF said yes. US FRB says not necessarily. HKAS 39?

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*Thank you.*

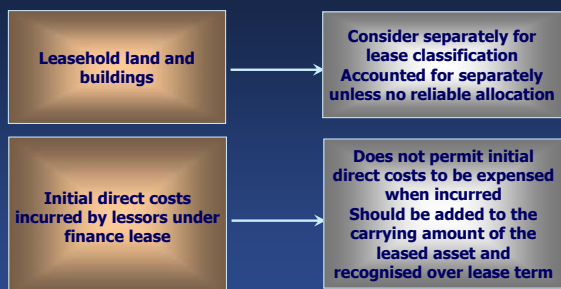
*Questions?*





## HKAS 17/40 Leases/Investment Property

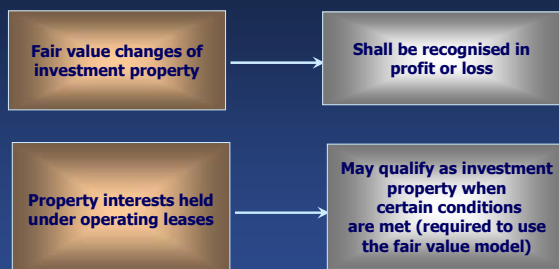
### Key Changes in HKAS 17



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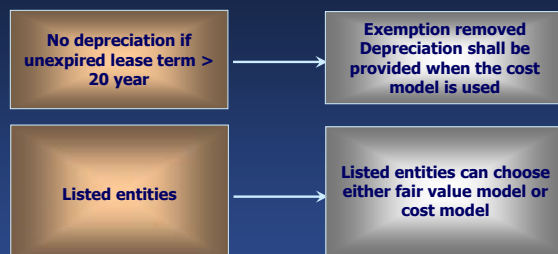
### Key Changes in HKAS 40



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### Key Changes in HKAS 40 (cont'd)



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## HKAS 17 Leases

### Leasehold Land and Building

- **Lease classification of leasehold land**
  - Land normally has an indefinite economic life
  - If title not expected to pass to the lessee by end of lease term
    - lessee normally does not receive substantially all risks and rewards
  - Hence, should be classified as operating lease
  - Payment made for acquisition of leasehold land represents PREPAID LEASE PAYMENTS
    - amortised over the lease term

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### Leasehold Land and Building

- **Separate measurement of the land and buildings elements is not required when**
  - interests in both land and buildings accounted for using fair value model, and
  - classified as investment properties (HKAS 40)
- **Otherwise consider separately for lease classification**



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### Leasehold Land and Building

- **If allocations between land and building elements can be made reliably**
  - Minimum lease payments allocated by relative fair values at inception
  - Leasehold land: Operating lease
  - Building element: Operating or finance depending on whether risks and rewards pass to the lessee
- **If allocations cannot be made reliably**
  - Treat entire lease as a finance lease unless clear both elements are operating leases

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### Initial Direct Costs

- **Incremental costs that are directly attributable to negotiating and arranging a lease**
- **Initial direct costs incurred by the lessor**
  - Finance leases other than those involving manufacturer or dealer lessors  
Included in the initial measurement of the finance lease receivable and spread over the lease term

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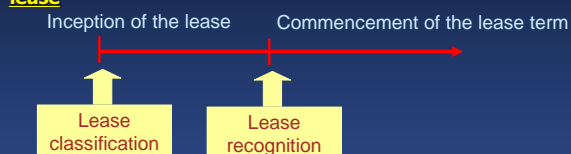
### Initial Direct Costs (cont'd)

- Finance leases involving manufacturers or dealer lessors  
Expensed when the selling profit is recognised
- Operating leases  
Spread over lease term

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### Classification and Initial Recognition of Leases

#### Distinguish between inception and commencement of the lease



**Inception of the lease** = earlier of date of the lease agreement and date of commitment by the parties to the principal provisions of the lease

**Commencement of the lease term** = the date from which lessee is entitled to exercise its right to use the leased asset

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### Effective Date & Transitional Provisions

- **Effective for annual periods beginning on or after 1 January 2005**
- **Earlier application is encouraged**
  - Need to disclose that fact
- **An entity that has previously applied SSAP 14 (r2000) shall apply amendments retrospectively**
  - Unless SSAP 14 (r2000) was not applied retrospectively for all leases entered into since entity first applied that Standard

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## HKAS 40 Investment Property

## Definition

- Investment property is
  - a property
    - Land or building
    - Part of a building
    - Or both land and building
  - held by owner or by lessee under a finance lease
  - to earn rentals or for capital appreciation purposes or both



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## Property Held under Operating Lease

- A property interest held by a lessee under an operating lease (e.g. leasehold land in Hong Kong / land use rights in the PRC) MAY be accounted for as investment property, if and only if:
  - the property would otherwise meet the definition of an investment property; and
  - the lessee uses THE FAIR VALUE MODEL
- Apply on a property-by-property basis

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## Property Held under Operating Lease

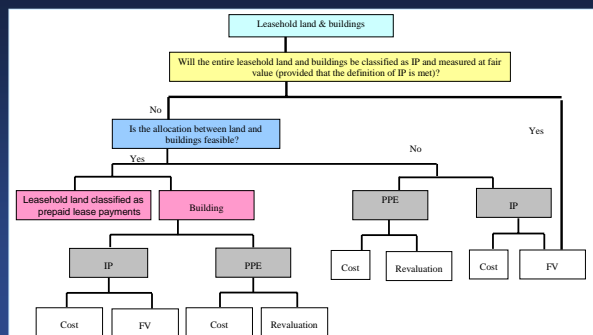
- Once a property interest has been classified as an investment property
  - all property interests classified as investment property are accounted for under fair value model
  - disclosure under HKAS 40 shall be followed



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## Classification of Leasehold Land and Buildings



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## Subsequent Measurement

### Cost model

- ➔ Cost less
  - accumulated depreciation
  - accumulated impairment losses



### Fair value model

- If choose to account for an investment property using the fair value model, all investment properties must also be fair-valued (unless under certain exceptions)
- Changes in fair value recognised in profit or loss

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## HKAS 40 – Transitional Provisions

### Case A)

Previously applied SSAP 13 and elects for the first time to classify property interests held under operating leases as investment properties

OR

Previously applied SSAP 13 and chooses to use the **FAIR VALUE MODEL**

- An adjustment to the opening balance of retained earnings for the period in which the election is first made

- **NOT REQUIRED** to restate comparative figures

- **ENCOURAGED** to adjust the opening balance of retained earnings for the earliest period presented *IF FV HAS PREVIOUSLY BEEN DISCLOSED PUBLICLY*

- **NOT ALLOWED** to adjust comparative figures if FV HAS NOT BEEN PREVIOUSLY DISCLOSED

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## HKAS 40 – Transitional Provisions

### Case B)

Previously applied SSAP 13 and chooses to use **COST MODEL** under HKAS 40

- **Is PERMITTED** to deem the CV of the investment property immediately before applying HKAS 40 on its effective date (or earlier) as cost; OR

- Can choose **RETROSPECTIVE** application

- **If do not opt for retrospective application**

- Any adjustments should be made to the opening balance of retained earnings for the period in which HKAS 40 is first applied

- Depreciation on deemed costs commences when the Standard is first applied

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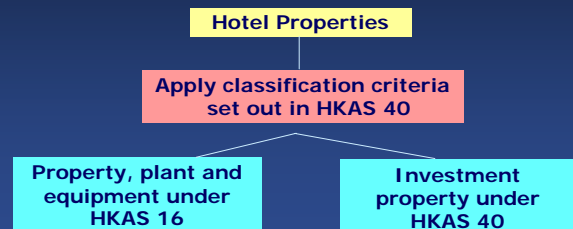


The challenge for 2005

## HK-Int 2 The Appropriate Accounting Policies for Hotel Properties

## Background

- No equivalent interpretation under IFRSs
- Developed to avoid hybrid of treatments under HKAS 16 and 40



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## HKAS 40 Classification

- If a property comprises two portions
  1. held to earn rentals or for capital appreciation; and
  2. held for use in the production or supply of goods or services or for administrative purposes

then account for the portions separately if the portions can be sold separately
- If portions cannot be sold separately, investment property only if **insignificant portion** held for use in the production of goods / services

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## Classification of Hotel Properties

- **Services provided are insignificant**
  - Example: the owner of an office building provides security and maintenance services to the tenants
- **Services provided are significant**
  - Example: entity owns and manages a hotel, services provided to guests are significant to arrangement as a whole



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## Owner-Operated Hotel Properties

- An owner-operated hotel property should be classified as property, plant and equipment
- Accounted for in accordance with HKAS 16
- **Must apply depreciation** regardless of using cost model or revaluation model
- Should be depreciated over the remaining useful life

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## Classification of Hotel Properties

- In some cases, judgement is needed to determine whether a property qualifies as investment property
  - Example: An owner of a hotel transfers some responsibilities to third parties under a management contract
- An entity develops criteria so that it can exercise judgement "consistently"
- HKAS 40.75 requires disclosure of criteria when classification is difficult

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## Transitional Provisions

- Effective for annual periods beginning on or after 1 January 2005
- Earlier application is encouraged
- Change in accounting policy in accordance with HKAS 8 (i.e. retrospective application)

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The challenge for 2005

## HK-Int 3 Revenue – Pre-completion Contracts for the Sale of Development Properties

## Background



- No equivalent interpretation under IFRSs
- Properties developers enter into contracts to sell properties before completion
  - Contracts involve deposits paid by purchaser, refundable if developer does not complete development in accordance with the contract
- In the past, various policies used to recognise revenue, including the stage of completion method

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## HKAS 11 or HKAS 18?

The contracts in question are not specifically negotiated for the construction of the properties so they DO NOT meet the definition of construction contracts (HKAS 11)

- **HKAS 11 stage of completion method is NOT appropriate**
- Apply HKAS 18, recognise revenue when criteria in HKAS 18.14 (risks and rewards test) are satisfied
- Likely to result in revenue being delayed

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### **Transitional Provisions**

- Apply to pre-completion contracts for the sale of development properties entered into on or after 1 Jan 2005
- Retrospective application for contracts entered into before 1 Jan 2005 is permitted but not required
  - If not applied retrospectively, continue to account for those contracts using existing method

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### **HK-Int 4 Leases – Determination of Length of Lease Term in respect of Hong Kong Land Leases .**

### **Background**

- No equivalent interpretation under IFRSs
- Developed due to concerns of the length of lease term for HKAS 16/17 purposes, in light of current land policy of HKSAR government

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### **Determine the Length of Lease Term**

#### **Question:**

How should the length of the lease term of a Hong Kong land lease be determined for the purpose of applying the amortisation (depreciation) requirements under HKAS 16 and HKAS 17, as appropriate?

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### **Determine the Length of Lease Term**

#### **Conclusion**

- Determine by reference to legal form and status
- Renewal of a lease is assumed only when the lessee has a renewal option and it is reasonably certain at inception that the lessee will exercise the option
- Options for extending the lease term not at the discretion of the lessee are not considered in determining lease term

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### **Determine the Length of Lease Term**

#### **Conclusion**

- Lessees shall not assume a HK land lease will be extended for a further 50 years, or any other period, while the HKSAR Government retains sole discretion as to whether to renew the lease term
- A general intention by the HKSAR Government to renew a property leases is not sufficient to include such extensions in the lease term



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## **Determine the Length of Lease Term**

### **Conclusion (cont'd):**

- Similarly, for leases in the New Territories expiring shortly before 30 June 2047, the legal limit shall be assumed to be the maximum lease term
- Leases that extend beyond 30 June 2047 (e.g. those leases with an original term of 999 years)
  - Lessees shall assume any legal rights that extend the lease term beyond 30 June 2047 will be protected for the full duration of the lease unless indicated otherwise

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## **Transitional Provisions & Effective Date**

- Effective on 24 May 2005
- Account for any changes resulting from the application of this interpretation
  - as change in accounting policy in accordance with HKAS 8; or
  - prospectively over the remaining lease term

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***HKFRSs having a MODERATE impact.***

## **Moderate Impact - Standards**

- HKFRS 1 First-time Adoption of Hong Kong Financial Reporting Standards
- HKFRS 4 Insurance Contracts
- HKFRS 6 Exploration for and Evaluation of Mineral Resources
- HKAS 1 Presentation of Financial Statements
- HKAS 7 Cash Flow Statements
- HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- HKAS 16 Property, Plant and Equipment
- HKAS 19 Employee Benefits
- HKAS 21 The Effects of Changes in Foreign Exchange Rates

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## **Moderate Impact - Standards**

- HKAS 23 Borrowing Costs
- HKAS 24 Related Party Disclosures
- HKAS 27 Consolidated and Separate Financial Statements
- HKAS 28 Investments in Associates
- HKAS 29 Financial Reporting in Hyperinflationary Economies
- HKAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions
- HKAS 31 Interests in Joint Ventures
- HKAS 33 Earnings per Share

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## **Moderate Impact - Interpretations**

- HKFRS-Int 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities
- HKFRS-Int 4 Determining whether an Arrangement contains a Lease
- HK-Int 1 The Appropriate Accounting Policies for Infrastructure Facilities

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## ***HKFRS 1 First-time Adoption of HKFRSs***

### ***HKFRS 1 First-time Adoption (1/4)***

- The following explanation is for a company adopting HKFRS for year ended 31 December 2005:
  - Select accounting policies based on HKFRSs at 31 Dec 2005.
  - Prepare 2004 and 2005 financial statements using those HKFRS and restate 1 Jan 2004 retained earnings.
  - But there are some exceptions for restating with HKFRS. Next slide...

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### ***HKFRS 1 First-time Adoption (2/4)***

- **Individually optional exceptions:**
  - Business combinations.
  - PP&E, intangibles, and investment property carried on cost method:
    - **One-time remeasure to FV.**
  - Employee benefits – actuarial gains and losses: Can start fresh.
  - Accumulated translation reserves.
- **Mandatory exceptions:**
  - Derecognition of financial instr.
  - Hedge accounting.

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### ***HKFRS 1 First-time Adoption (3/4)***

- **Applying HKFRSs retrospectively to 2004 and 2005:**
  - May have to add or remove assets and liabilities that were recognised (or not) under previous GAAP.
    - **Recognise all derivatives and embedded derivatives; deferred tax assets and liabilities; pension obligations.**
  - Undo provisions that do not qualify under HKAS 37 (general reserves).
  - Reclassifications.
  - Remeasurements.

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### ***HKFRS 1 First-time Adoption (4/4)***

- **Considerable disclosure:**
  - Can present pre-2004 data under old GAAP (disclosure).
  - Reconciliations from old GAAP to HKFRS numbers, with explanations of material adjustments.
  - Disclosure of impending change to HKFRSs (in 30 Jun reports).

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## ***HKFRS 4 Insurance Contracts***

### **HKFRS 4 Insurance Contracts (1/4)**

- Insurers exempted from certain requirements of HKFRSs, including HKAS 8 requirement to consider the Framework in determining accounting policies.
- Catastrophe reserves and equalisation provisions:
  - Prohibited.
  - Apply HKAS 37.

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### **HKFRS 4 Insurance Contracts (2/4)**

- Cannot offset insurance liabilities against reinsurance assets.
- Can remeasure insurance liabilities to reflect current market interest rates and other current assumptions.
- Deposit components of some insurance contracts must be unbundled and accounted for as liabilities.

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### **HKFRS 4 Insurance Contracts (3/4)**

- Accounting policy changes are restricted. Cannot introduce the following as new policies — but if these are current policies, can be continued:
  - Measuring insurance liabilities without discounting.
  - Measuring rights to future investment management fees above FV in market.
  - Using non-uniform accounting policies to measure liabilities of subsidiaries.

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### **HKFRS 4 Insurance Contracts (4/4)**

- Many new disclosures, including:
  - Accounting policies
  - Assets, liabilities, income, expense, cash flows relating to insurance
  - Measurement assumptions and changes in them (quantified).
  - Reconciliations of assets and liabilities.
  - Risk management policies.
  - Terms and conditions of insurance policies.
  - Insurance risk, interest rate risk, credit risk.
  - Embedded derivatives.

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### **HKFRS 6 Exploration for and Evaluation of Mineral Resources**

### **HKFRS 6 Extractive Industries (1/1)**

- There is no HKFRS on mining or oil and gas accounting.
- Companies can follow their existing accounting policies without regard to hierarchy in HKAS 8
  - Otherwise many capitalised exploration costs might not meet definition of an asset.
  - But impairment test required.
  - Requires disclosure of policies.
- Effective 2006. Early adoption permitted.

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## HKAS 1 Presentation of Financial Statements

### Scope of HKAS 1 and HKAS 8 (1/17)

- **HKAS 1 (was SSAP 1) Presentation**
  - Fair presentation
  - Materiality
  - Offsetting
  - Comparative information
  - Structure and content of financial statements and notes
  - Example financial statements
- **HKAS 8 (was SSAP 2) Policies**
  - Accounting policies
  - Changes in policies and estimates
  - Errors

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### HKAS 1 Presentation (2/17)

- **Old SSAP 1 terminology**
  - "True and fair view"
- **New HKAS 1 terminology**
  - Also "true and fair view"
- **Identical meanings to "fair presentation" used in IAS 1**
- **"True and fair override" expected to be "extremely rare"**

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### HKAS 1 Presentation (3/17)

- **Complete set of financial statements:**
  - Balance sheet
  - Income statement
  - Cash flow statements (HKAS 7)
    - **Exemption for companies with turnover < \$20M is removed.**
  - Statement of changes in equity
  - Notes / accounting policies
- **HKAS 1 prescribes formats and minimum line items.**

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### HKAS 1 Presentation (4/17)

- **New definition of materiality:**
  - Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions taken by users based on the financial statements.
    - **Size of item**
    - **Nature of item**

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### HKAS 1 Presentation (5/17)

- **Balance sheet presentation**
  - Current/non current asset and liability subtotals are required unless a liquidity presentation (no subtotals) is deemed "more relevant".
    - **No longer free choice.**

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### **HKAS 1 Presentation (6/17)**

- **Balance sheet classification as current or non-current:**
  - Long-term debt that has become currently payable because borrower has violated a covenant is a current liability if the problem is fixed after balance sheet date.
  - If, before year end, lender has waived its right to demand payment for full 12 months after balance sheet date, then classify as noncurrent.

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### **HKAS 1 Presentation (7/17)**

- **Income statement presentation**
  - Bottom line is "profit" or "loss" without the word "net".
  - Presentation of extraordinary items is prohibited.
  - No longer required to present:
    - "Results of operating activities".
    - "Profit or loss from ordinary activities".

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### **HKAS 1 Presentation (8/17)**

- **Income statement, continued**
  - **Discontinued operations:**
    - **Must show as a line item the total of (a) post-tax P&L of discontinued operations and (b) post-tax gain or loss on disposal of discontinued ops**

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### **HKAS 1 Presentation (9/17)**

- **New line items on face of balance sheet**
  - Investment properties (HKAS 40)
  - Biological assets (HKAS 41)
  - Current tax assets and liabilities
  - Deferred tax assets and liabilities
  - Assets held for sale (total and by "disposal groups" – HKFRS 5)
  - Liabilities included in "disposal groups" (HKFRS 5)

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### **HKAS 1 Presentation (10/17)**

- **Statement of changes in equity**
  - **Must show:**
    - a. **P&L,**
    - b. **all items of income and expense reported directly in equity, and**
    - c. **total of (a) and (b), allocated between equityholders of parent and minority interest.**

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### **HKAS 1 Presentation (11/17)**

- **New disclosure: Judgements**
  - **Disclose judgements made by the management in applying accounting policies that have the most significant effect on the amounts of items recognised in the financial statements.**

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### HKAS 1 Presentation (12/17)

- **Examples: Judgements disclosure**
  - Whether financial assets are held-to-maturity.
  - When substantially all risks and rewards of financial assets are transferred.
  - Whether, in substance, particular 'sales' of goods are sales or are financing arrangements that do not give rise to revenue.
  - Whether the substance of a relationship with an SPE indicates control.

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### HKAS 1 Presentation (13/17)

- **New disclosure: Measurement uncertainty**
  - Disclose the key assumptions about the future and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next year.

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### HKAS 1 Presentation (14/17)

- **Examples: Measurement uncertainty disclosure**
  - Value-in-use measurements of recoverable amounts.
  - Provisions subject to future outcome of litigation.
  - Technological obsolescence.
  - Pensions – discount rates, future salary changes.
  - Measurements dependent on future changes in costs such as long-term contracts.

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### HKAS 1 Presentation (15/17)

- **Minority interest**
  - Allocation of profit or loss to minority interests is not deducted in measuring profit or loss. Instead, face of income statement (next slide) shows:
    - **Profit or loss of the entity, allocated between:**
      - Portion of profit or loss attributable to equity holders of parent.
      - Portion of profit or loss attributable to minority interest.

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### HKAS 1 Presentation (16/17)

	X2	X1
Revenue	1,000	900
Expenses	<u>(800)</u>	<u>(740)</u>
Profit	200	160
	=====	=====
Attributable to:		
Minority	40	32
Equity holders		
of parent	<u>160</u>	<u>128</u>
	200	160
	=====	=====

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### HKAS 1 Presentation (17/17)

- **Appendix to HKAS 1 lists special disclosures required by Hong Kong Companies Ordinance that are not in HKASs:**
  - Organised into related HKASs and HKFRSs.

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## HKAS 7 Cash Flow Statements

### HKAS 7 Cash Flow Statement (1/1)

- All entities must present a cash flow statement.
- No exemptions for:
  - Unlisted companies with turnover less than \$20 million.
  - Charities and other non-profit organisations.
  - These exemptions were in SSAP 15.

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

### HKAS 8 Accounting Policies (1/4)

- Accounting policies hierarchy
  1. HKFRS/HKAS Standards and mandatory appendices.
  2. HKICPA Interpretations.
  3. Non-mandatory appendices.
  4. Implementation guidance.
  5. HKFRS Framework.
  - Framework has become mandatory
  6. Pronouncements by other standard setters with similar framework (FASB, UK ASB).
  7. Accepted industry practices.

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### HKAS 8 Accounting Policies (2/4)

- Errors = material omissions or misstatements.
  - Materiality: Quantitative and qualitative assessment.
- Eliminates distinction between fundamental error and other material error.
- Retrospective treatment required for all errors unless impracticable.
  - Guidance on impracticability.

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### HKAS 8 Accounting Policies (3/4)

- Voluntary changes in accounting policies:
  - Requires retrospective application for all changes.
    - Recognition of changes in accounting policies in income statement prohibited.
  - Adjust opening retained earnings for earliest period presented.

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### HKAS 8 Accounting Policies (4/4)

- **New disclosures**
  - Disclosure of the effect of the adoption of a new Standard issued but not yet effective.
  - Amounts of adjustments from changes in accounting policies or corrections of errors.

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### HKAS 16 Property, Plant and Equipment

### HKAS 16 Property, Plant and Equipment (1/6)

- **Measurement at initial asset recognition:**
  - Future removal, dismantlement, and restoration costs:
    - Should be included in the original cost of the asset, with provision.
  - Changes in the estimate of the obligation should follow HKAS 8 and HKFRS INT 1 – prospective treatment.

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### HKAS 16 Property, Plant and Equipment (2/6)

- **Measurement at recognition:**
  - Exchanges of non-monetary assets (similar and dissimilar) other than inventories:
    - Fair value unless the exchange transaction lacks commercial substance or cannot be measured reliably.
    - Gain or loss recognised in P&L.
    - Old SSAP 17 did not measure similar exchanges at FV.

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### HKAS 16 Property, Plant and Equipment (3/6)

- **Measurement after recognition:**
  - Revaluation model continues to be an option:
    - HKAS 16 clarifies that this can be applied only when the fair value of the items to be revalued are reliably measurable.

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### HKAS 16 Property, Plant and Equipment (4/6)

- **Measurement after recognition**
  - Depreciation model – Component approach:
    - A separate depreciation charge must be determined for each significant part of an item of PP&E.
      - Different life, rate of consumption, separability.
      - Easy: jet engine and body of an airplane.
      - Not a lot of guidance in HKAS 16.

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### HKAS 16 Property, Plant and Equipment (5/6)

- **Measurement after recognition:**
  - **Depreciation:**
    - Depreciation begins when an item of PP&E is available for use, and continues until it is derecognised or is classified as held for disposal.
    - No depreciation of assets held for disposal.

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### HKAS 16 Property, Plant and Equipment (6/6)

- **Measurement after recognition:**
  - **Residual value rule changed:**
    - “**Estimated amount an entity would currently receive for the asset if the asset were already of the age and in the condition expected at the end of its useful life**”.
    - Do not include the effects of future inflation.
    - If residual value > carrying amount, stop depreciating.

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### HKAS 19 Employee Benefits

### HKAS 19 Employee Benefits (1/1)

- **HKAS 19 is similar to SSAP 34 in all material aspects**
  - HKAS 19 excludes equity compensation benefits (HKFRS 2)
- **Amendments to HKAS 19**
  - Additional option to recognise actuarial gains and losses in full in statement of recognised income and expense
  - Clarification for a contractual agreement under a multi-employer plan that determines how surplus is distributed
  - Requirements for group defined benefit plans in separate or individual accounts for group entities
  - Requires additional disclosures

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### HKAS 21 The Effects of Changes in Foreign Exchange Rates

### HKAS 21 The Effects of Changes in Foreign Exchange Rates (1/6)

- **Change in terminology**
  - Replaces notion of “reporting currency” with:
    - “**Functional currency**” and “**Presentation currency**”
- **Scope**
  - Excludes foreign currency derivatives in HKAS 39
  - Hedging guidance moved to HKAS 39

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### HKAS 21 The Effects of Changes in Foreign Exchange Rates (2/6)

- **Functional currency**
  - Primary economic environment in which entity operates
  - Each entity determines its own functional currency
  - Selection of functional currency is not a free choice but is based on underlying facts and circumstances
  - No more distinction between integral foreign operations and foreign entities (but similar result)
  - Change in functional currency accounted for prospectively

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### HKAS 21 The Effects of Changes in Foreign Exchange Rates (3/6)

- **Functional currency**
  - HKAS 21.9 factors
    - currency that influences sales prices
    - currency of country whose competitive forces and regulations determines sales prices
    - currency that influences labour and other costs of sale
  - HKAS 21.10 factors to be considered
    - currency in which the entity funds its activities
    - currency in which receipts from operating activities are retained



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### HKAS 21 The Effects of Changes in Foreign Exchange Rates (4/6)

- **Presentation currency**
  - A reporting entity can present its financial statements in any currency (or currencies)
  - "Normal" translations (not hyperinflationary)
    - assets and liabilities at the closing rate as of that balance sheet date
    - income statement items at the actual rate (average)
    - resulting exchange differences recognised as a separate component of equity

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### HKAS 21 The Effects of Changes in Foreign Exchange Rates (5/6)

- **Goodwill**
  - Goodwill and fair value adjustments that arise on acquisition of a foreign operation are translated at closing rate
    - Treatment as non-monetary items reported using the transaction exchange rate is eliminated

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### HKAS 21 The Effects of Changes in Foreign Exchange Rates (6/6)

- **Effective for annual periods beginning on or after 1 Jan 2005**
  - Apply retrospectively except for goodwill and fair value adjustments

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### HKAS 23 Borrowing Costs

### HKAS 23 Borrowing Costs (1/1)

- **Alternative treatment introduced**
  - Benchmark treatment
    - **Recognise as expense in period incurred**
  - Allowed alternative treatment (existing treatment under SSAP 19)
    - **Recognise as expense unless directly attributable to the acquisition, construction or production of qualifying assets**

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### HKAS 24 Related Party Disclosures

#### HKAS 24 Related Party Disclosures (1/4)

- **Scope**
  - Removes exemption for wholly owned subsidiaries and separate financial statements of parent
  - State-controlled entities are within the scope (those that are profit-oriented) for transactions with other state-controlled entities

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#### HKAS 24 Related Party Disclosures (2/4)

- **Definition**
  - "Related party" expanded by adding
    - **Disclosure of key management personnel compensation**
      - Includes non-executive directors
    - **Post-employment benefit plans for the benefit of employees of an entity, or of an entity that is related party to that entity**

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#### HKAS 24 Related Party Disclosures (3/4)

- **Disclosure requirements clarified / added**
  - Outstanding balances with related parties
    - **including whether secured, and the nature of consideration to be provided in settlement**
  - Details of any guarantees given or received
  - Provisions for doubtful debts on balances
  - The settlement of liabilities on behalf of the entity or by the entity on behalf of another party
  - The amounts of transactions and outstanding balances with related parties (proportions no longer sufficient)

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#### HKAS 24 Related Party Disclosures (4/4)

- **And more**
  - Expense recognised for bad or doubtful debts due from related parties
  - Classification of amounts into different categories of related party
  - Name of entity's parent and ultimate controlling party
    - **If neither produces F/S available for public use, the name of the next most senior parent that does so**
  - **Disclosure that related party transactions were at arm's length only made if substantiated**

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## ***HKAS 27 Consolidated and Separate Financial Statements***

### ***HKAS 27 Consolidated and Separate Financial Statements (1/7)***

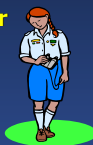
- **Scope clarification**
  - Applies to investments in subsidiaries, jointly controlled entities and associates in separate F/S
  - Applies to
    - Venture capital organisations,
    - Mutual funds, and
    - Unit trusts and similar entities

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### ***HKAS 27 Consolidated and Separate Financial Statements (2/7)***

- **Consolidation procedures**
  - Potential voting rights
    - Consider existence/effect of potential voting rights currently exercisable or convertible
  - Uniform accounting policies should be used
    - Practicability exception removed
  - Minority interests
    - Presented separately in the equity section



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### ***HKAS 27 Consolidated and Separate Financial Statements (3/7)***

- **Removes the exclusion for a parent from consolidating**
  - An entity that is operating under severe long-term restrictions that significantly impair its ability to transfer funds to the parent
    - However, may be an evidence of a loss of control
  - An entity under temporary control
    - Requires to "consolidate" as held for sale in accordance with HKFRS 5

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### ***HKAS 27 Consolidated and Separate Financial Statements (4/7)***

- **Exemption for an ENTITY from presenting consolidated financial statements**
  - ENTITY is a wholly owned or partially-owned subsidiary that received permission from owners
  - ENTITY's debt or equity instruments are not publicly traded
  - Not in process of a public filing for issue of such instruments, and
  - Ultimate or intermediate parent produces HKFRS / IFRS consolidated financial statements

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### ***HKAS 27 Consolidated and Separate Financial Statements (5/7)***

- **Investments in subsidiaries, associates and joint ventures in the separate F/S**
  - Accounted for at cost, or
  - Accounted for in accordance with HKAS 39
    - Investments accounted for in accordance with HKAS 39 in consolidated F/S, must be accounted for similarly in the separate F/S

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### **HKAS 27 Consolidated and Separate Financial Statements VS IAS 27 (6/7)**

- To reflect the requirements under the Hong Kong Companies Ordinance
- Definition of subsidiary for Hong Kong incorporated company in section 2(4) of the Ordinance

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### **Key Changes to Proposed Amendments to IAS 27 (7/7)**

- Proposed accounting treatments for changes in the parent's ownership interest that do not result in the loss of control of a subsidiary
  - parent's additional investment in its subsidiary
  - partial disposal of subsidiary (e.g. IPO but still retained control)
- Should be accounted for as transactions between equity holders

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### **HKAS 28 Investments in Associates**

### **HKAS 28 Investments in Associates (1/5)**

- Scope
  - Does not apply to investments in associates held by
    - venture capital organisations
    - mutual funds, unit trusts and similar entities including investment linked insurance funds
  - only if investment classified as held for trading or designated as fair value thru P/L under HKAS 39

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### **HKAS 28 Investments in Associates (2/5)**

- Equity method
  - Investments in associates under significant influence should be recognised using equity method
  - Eliminates exemption for associate operating under severe long-term restrictions that impair ability to transfer funds to investor
    - However, this may evidence lack of significant influence

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### **HKAS 28 Investments in Associates (3/5)**

- Different reporting dates
  - Adjustments for significant transactions
  - Difference < 3 months and consistent period to period
- Clarifies use of uniform accounting policies
- Goodwill related to an associate is included in the carrying amount of the investment

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### HKAS 28 Investments in Associates (4/5)

- **Individual financial statements**
  - If investor does not produce consolidated F/S (no subsidiaries), associate is measured using the equity method (same for joint ventures)
- **Presentation of share of taxation**
  - Under SSAP 10 included in "income taxes" of the Group
  - Under HKAS 28 included in "share of results of associates"

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### HKAS 28 Investments in Associates (5/5)

- **Presentation of "discount on acquisition"**
  - Under HKAS 28 included in "share of results of associates"

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### HKAS 31 Interests in Joint Ventures

### HKAS 31 Interests in Joint Ventures (1/3)

- **Scope**
  - Does not apply to venture capital organisations, mutual funds, and unit trusts and similar entities if held for trading or designated as fair value thru P/L under HKAS 39
  - Similar exemptions from proportionate consolidation or equity method as HKAS 27

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### HKAS 31 Interests in Joint Ventures (2/3)

- **Proportionate Consolidation**
  - combine share of each of the assets, liabilities, income and expenses of the JCE with similar items, line by line in F/S **OR**
  - include separate line items for the share of assets, liabilities, income and expenses of the JCE in the F/S
- **Equity Method**
  - Similar to existing SSAP 20

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### HKAS 31 Interests in Joint Ventures (3/3)

- **JCEs with net asset deficiencies**
  - **Equity accounting:** Limited to aggregate amount of the carrying amount of the investment and amount of long-term interests
    - unless have a legal or constructive obligation
  - **Proportionate accounting:** No such a limit

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## ***HKAS 29 Financial Reporting in Hyperinflationary Economies***

### ***HKAS 29 Financial Reporting in Hyperinflationary Economies (1/1)***

- **Applies to entities with operations in countries experiencing hyperinflation**
  - Consensus of the accounting profession, not by entity
- **Restatement in terms of measuring unit current at balance sheet date.**
  - Use of general price index
  - Complex and time consuming restatement method



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## ***HKAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions***

### ***HKAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions (1/2)***

- **Disclosure standard for banks and similar financial institutions**
  - Generally those entities regulated by HK's banking legislation
  - Comprehensive disclosure requirements
- **In the future many disclosure will apply to all entities (pending HKFRS 7)**

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### ***HKAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions (2/2)***

- **Disclosure include**
  - Fair values of each class of financial assets / liabilities (as HKAS 32/39)
  - Specific contingencies and commitments
  - Maturities of assets and liabilities
  - Concentrations of assets, liabilities and off-balance sheet items
  - Losses on loans and advances
  - General banking risks
  - Assets pledged as security

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## ***HKAS 33 Earnings per Share***



### HKAS 33 Earnings per Share (1/1)

- Additional guidance and illustrative examples on selected complex matters
- Disclosure requirements
  - Basic and diluted EPS amounts for profit or loss
    - Continuing ordinary operations
    - Discontinued operations
  - Prohibits disclosure of EPS on separate unconsolidated results within the consolidated F/S

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### HKFRS – Int 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

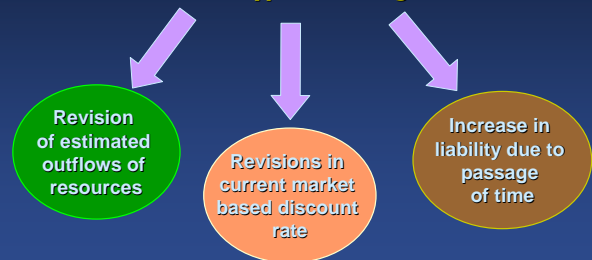
### HKFRS-Int 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities (1/2)

- Accounting for changes in decommissioning, restoration, and similar liabilities that have previously been recognised both as
  - part of the cost of an item of property, plant and equipment, and
  - as a liability
- Example: A liability recognised for decommissioning costs on closure of a nuclear power plant
  - Such as costs of decontamination and dismantlement of contaminated facilities

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### HKFRS-Int 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities (2/2)

HKFRS-Int 1 deals with three types of change



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The challenge for 2005

### HKFRS – Int 4 Determining whether an Arrangement contains a Lease

### HKFRS-Int 4 Determining whether an Arrangement contains a Lease (1/1)

- Covers arrangements that
  - Do not take the legal form of a lease
  - Convey rights to use assets in return for payments
- If arrangement meets following criteria – apply HKAS 17
  - Fulfillment depends on a specific asset
  - Conveys a right to control use of the underlying asset

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## ***HK– Int 1 The Appropriate Accounting Policies for Infrastructure Facilities***

### ***HK-Int 1 The Appropriate Accounting Policies for Infrastructure Facilities (1/1)***

- Applies to infrastructure facilities, e.g. toll roads and tunnels
  - Includes property plant and equipment, intangible assets or operating lease prepayments
- The sinking fund method is not an appropriate method of depreciating / amortising infrastructure assets

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## ***HKFRSs having a MINOR impact***

### ***Minor Impact - Standards***

- HKAS 2 Inventories
- HKAS 10 Events After the Balance Sheet Date
- HKAS 11 Construction Contracts
- HKAS 12 Income Taxes
- HKAS 14 Segment Reporting
- HKAS 18 Revenue
- HKAS 20 Accounting for Government Grants and Disclosure of Government Assistance
- HKAS 26 Accounting and Reporting by Retirement Benefit Plans
- HKAS 34 Interim Financial Reporting

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### ***Minor Impact – Standards / Interpretations***

- HKAS 37 Provisions, Contingent Liabilities and Contingent Assets
- HKAS 41 Agriculture
- HKFRS-Int 2 Members' Shares in Co-Operative Entities and Similar Instruments
- HKFRS-Int 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
- HKAS-Int 10 Government Assistance – No Specific Relation to Operating Activities
- HKAS-Int 12 Consolidation – Special Purpose Entities

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### ***Minor Impact - Interpretations***

- HKAS-Int 13 Jointly Controlled Entities – Non-monetary Contributions by Venturers
- HKAS-Int 15 Operating leases – Incentives
- HKAS-Int 21 Income Taxes – Recovery of Revalued Non-Depreciable Assets

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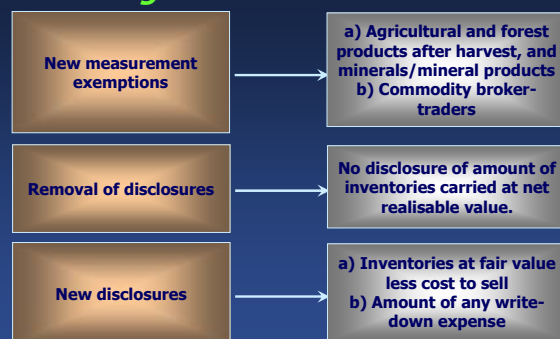
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### Minor Impact – Interpretations (cont'd)

- HKAS-Int 25 Income Taxes – Changes in the Tax Status of an Enterprise or its Shareholders
- HKAS-Int 27 Evaluating the Substance of Transactions in the Legal Form of a Lease
- HKAS-Int 29 Disclosure – Service Concession Arrangements
- HKAS-Int 31 Revenue – Barter Transactions Involving Advertising Services
- HKAS-Int 32 Intangible Assets – Website Costs

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### Changes in HKAS 2 Inventories



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### Changes to HKAS 14/34



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### HKAS-INT 21 Income Taxes – Recovery of Revalued Non-Depreciable Asset (1/3)

- INT 20 was replaced by HKAS-INT 21 (equivalent to SIC 21), *Recovery of Revalued Non-Depreciable Assets*
- The presumption that investment properties are recovered through sale under INT 20 was removed
- HKAS-INT 21 provides that the deferred tax impact arising from revaluation of a non-depreciable asset under HKAS 16.31 should be measured on the basis of the carrying amount will be recovered through sale

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### HKAS-INT 21 Income Taxes – Recovery of Revalued Non-Depreciable Asset (2/3)

- **Critical point:** would the investment property be depreciable if HKAS 16 were to be applied? Effectively, HKAS-INT 21:
  - Restricts the application to freehold land only
  - Results in potential deferred tax liability (on unrealised fair value gains) for “depreciable” investment properties held in use

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### HKAS-INT 21 Income Taxes – Recovery of Revalued Non-Depreciable Asset (3/3)

- Effective for annual periods beginning on or after 1 January 2005
- Earlier application is encouraged
- Change in accounting policy in accordance with HKAS 8 (i.e. should be applied retrospectively)

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## HKFRS : Their Profits Tax Implications

## Agenda

- The Rationale and the Common concern
  - Investment Property
  - Financial Instruments
  - Pre-completion contracts Sales
  - Share-based payment
- Caveat:
- The list contains some major items
  - This list is by no means exhaustive

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## The Rationale

## Prologue

- No definition in IRO in respect of the word "profits"
- Common law interpretation usually follows commercial accounting rules
- This is strengthened after the "Secan" case

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## Prologue

- New set of accounting standards adopted as from 1 January 2005
- Major principles adopted:
  - Mark-to-market basis for valuation
  - Flow through P&L accounts for most items
  - Both unrealised gains and loss will appear in profit and loss account
    - Examples: Investment property and financial instruments
  - Expenses/income that are recognized will appear in the profits and loss account
    - "Interest" on interest-free loan

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## Investment Property

## Investment Property

### Major Changes that may cause concerns in Hong Kong Profits Tax

- Definition of an Investment Property
- Adoption of Fair Value Model
- Operating Lease classified as Investment Property

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## Investment Property

### Definition of Investment Property

- Accounting classification is **indicative** as to the company's intention of holding the asset
- Tax Issue: trading assets or capital assets

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## Investment Property

### Concerns:

- Property held for **capital appreciation** is classified as investment property
  - Property that is not used for rental or own-used is often argued as trading assets and the gain from disposal is often argued by the IRD as trading gain
- Land held for a currently **undetermined future use**
  - Property with undetermined use is often considered as an indicator as trading assets

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## Investment Property

### Adoption of Fair Value Model

- Under FV model, any gain/loss resulting from the FV adjustment shall be recognized in the profit and loss account for the period in which it arises.
- Tax Issue: taxation of unrealised gain/loss?
  - Principle 1: Capital versus Revenue
  - Principle 2: Onshore versus Offshore

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## Investment Property

### Concerns:

- Brings forward the timing of any possible argument
- Taxation of unrealised trading gain, but loss (or smaller gain) upon realisation

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## Investment Property

### Operating Lease

- A property held under an operating lease that is classified as an IP shall be accounted for as a finance lease under HKAS 17.
- Tax Issue:
  - Whether the rental payment is tax deductible if the operating lease is classified as an IP?
    - Probably Yes under section 16(1)(b)

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## Investment Property

### Operating Lease

- **Tax Issue (con't):**
  - Whether capital allowance is available on such IP which is a building?
    - **Probably not unless the lease term of the operating lease is the same as the remaining lease year enjoyed by the lessor**

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## Investment Property

### Operating Lease

- **Tax Issue (con't):**
  - Whether any FV gain/loss would be taxable/deductible?
    - **Just like other Investment Property**
  - Once an operating lease is classified as an IP, all other IPs of the same entity would be required to adopt the FV model. Whether there is any undesirable tax exposure on the entity if it is required to use FV model on its other IPs?

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## *Pre-Completion Sales*

## Pre-Completion Sales

### Hong Kong Interpretation 3

- **Accounting Issue:**
  - recognizing revenue arising from pre-completion contracts for the sale of development properties by properly developer

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## Pre-Completion Sales

- **Treatment:**
  - If contracts are not specifically negotiated for the construction of properties, they do not meet the definition of construction contracts in HKAS 11;
  - Stage of completion method is not appropriate
  - HKAS 18 should be applied, as appropriate, in recognition of revenue

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## Pre-Completion Sales

- **Tax Implications:**
  - It would result in the revenue from pre-completion contracts would only be **recognized when the contracts are completed**
  - Thus, the assessment of profits arising from pre-completion contracts **may be deferred** as a result of the application of HKINT3.

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## Financial Instruments

## Financial Instruments

Major Changes in HKAS39 that may cause concerns in Hong Kong Profits Tax

- Classification
- Adoption of fair value model in valuation
- Accounting for Interest-free loan
- Rules for effective hedge accounting
- Accounting treatments for embedded financial derivatives.

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## Financial Instruments

Accounting Classification:

- Items adopt FV through P&L:
  - For the purposes of trading
  - All derivatives that are not hedges
  - Financial assets and liabilities **designated by the entity as fair value through profit or loss** upon initial recognition.
- Available-for-sale financial assets
  - non-derivative financial assets that are **designated as available for sale**

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## Financial Instruments

Concerns:

- Trading assets?
  - Trading assets, would, generally be included in the category of "FV through profit or loss".
  - "available-for-sale" is a catch-all category that could include capital and revenue assets.

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## Financial Instruments

Concerns (con't):

- Accounting valuation and treatment:
  - Items adopt FV through P&L: FV through P&L
    - Taxation of unrealized gain/loss if considered as trading assets
  - Available-for-sale: FV through equity
    - Taxation of unrealized gain/loss if considered as trading assets
    - But arguable, as accounting does not require it to be recognized in P&L

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## Financial Instruments

Concerns (con't):

- Change of Intention when there is a reclassification?
  - Sharkey v Werhner principle may be applied
- Financial Assets held by financial institutions
  - More than likely these assets will be regarded as trading assets
  - Arguable in the "held-to-maturity" classification

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## Financial Instruments

### Adoption of Fair Value Model

- Under FV model, any gain/loss resulting from the FV adjustment shall be recognized in the profit and loss account for the period in which it arises.
- Tax Issue: Same as Investment Property
  - Trading/Capital
  - Arising in or derived from HK
  - Brings forward the timing of any possible argument
  - Taxation of unrealised trading gain, but loss (or smaller gain) upon realisation

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## Financial Instruments

### Interest-Free Loan

- Interest-free loan is measured at fair value at initial recognition using effective interest rate method
- Loans with fixed repayment term between holding and subsidiary:
  - Will result in interest expense in the borrower's financial statement and interest income in the lender's financial statement

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## Financial Instruments

### Interest-Free Loan

- Tax Issues:
  - Interest Income taxable?
  - Interest expense deductible?
  - Follows the usual rules for interest income and expense

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## Financial Instruments

- Hedge accounting
- Tax Treatment:
  - Generally accepted the nature and source of a hedging transaction for tax purposes be the same as the nature and source of the underlying transaction
  - However, if the hedging instrument and the hedged item are classified differently in accounts, the tax treatment for the hedging instrument and the hedged item could therefore be considered separately

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## Financial Instruments

### Embedded Derivatives

- Under HKAS 39, some embedded derivatives are required to be separated from the host contract and accounted for separately.

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## Financial Instruments

### Embedded Derivatives

- Taxation:
  - One likely treatment is to take the legal form
  - That is one would render a hybrid instrument be one single instrument, which follows that the nature (i.e. capital or revenue) and locality of profit or loss of hybrid instrument are determined on the basis that it is one single instrument for tax purposes regardless the host contract and the embedded derivative are separately accounted for under HKAS 39.

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## ***Share-based payment***

## ***Share-based payment***

### **Two possible cases**

#### **▪ If equity settled:**

- Dr P&L
- Cr Share-based payment reserve account

#### **▪ If cash settled:**

- Dr P&L
- Cr Account payable

### **Vesting period**

- the value of the share-based payment transactions, no matter cash-settled or equity-settled, is required to be allocated over the vesting period

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## ***Share-based payment***

### **Taxation Issues**

#### **▪ Adjustments during the vesting period deductible or taxable?**

- Arguable,
- Expenses can be argued as incurred and deductible
- Reversal is likely taxable under section 15(2) if the original amount is deducted

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## ***Share-based payment***

### **Taxation Issues**

#### **▪ Equity-settled share-based payment**

- it is difficult to argue for tax deduction even if the fair value of the equity instrument is charged to profit and loss account as an expense because the IRD may argue that there is no liability incurred during the year

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***Upcoming Tax  
Interaction  
Seminar:  
October 2005***

***Thank you.  
Questions?***



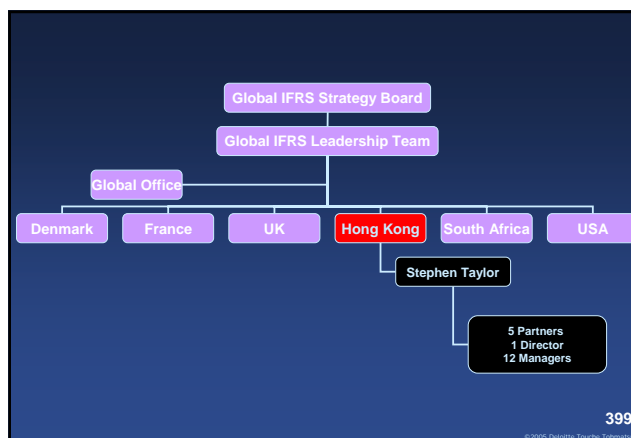
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## Deloitte IFRS Global Network and Resources

## Deloitte IFRS Global Network

- 2 tier structure
  - Global IFRS Strategy Board
    - Provides strategic direction and considers client and market related issues
  - Global IFRS Leadership Team
    - Consists of a global leader and 6 IFRS Centres of Excellence
    - Each Centre has a team of IFRS specialists
    - Responsible for technical decisions on interpretation issues

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**www.iasplus.com**  
1,200 pages and files, 350 mb of IAS stuff.

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## www.iasplus.com

- Day by day past news back to December 2000 (a new page updated almost daily);
- Detailed summaries of all Standards and Interpretations;
- E-Learning modules;
- Model IFRS financial statements and disclosure checklists;
- Comparisons of IFRS and various national GAAPs;
- Deloitte IFRS publications; and
- much much more.....

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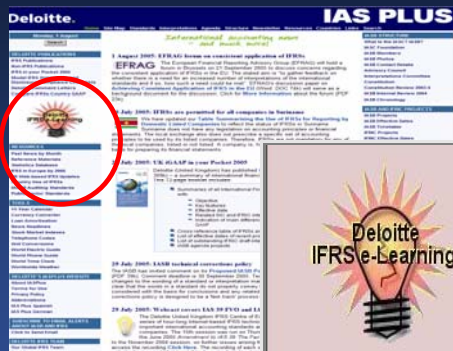
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## IFRS e-Learning



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## e-Learning – IAS 40 "Home page"

Overview

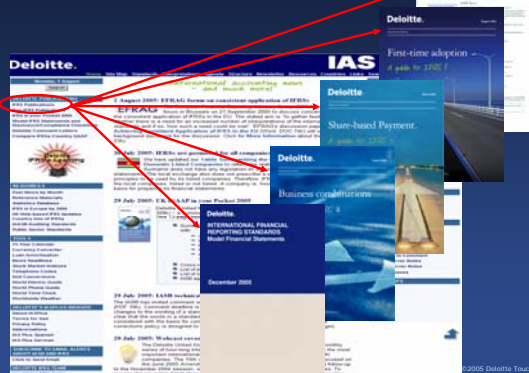
Four scenarios

Assessment



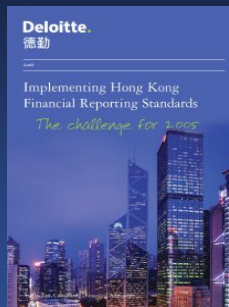
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## IFRS Publications



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## Implementing Hong Kong Financial Reporting Standards

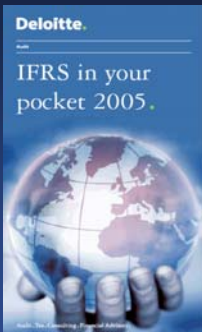


**Classified the new Standards and Interpretations into 3 sections:**

- Major
- Moderate
- Minor

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## IFRS in your Pocket 2005

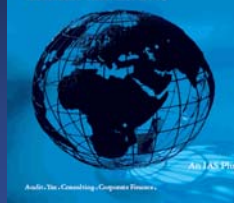


**IFRSs and HKFRSs are essentially identical.**

**Free at  
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IAS PLUS  
International Financial Reporting Standards  
Model financial statements and disclosure checklist 2005



**Model IFRS Financial Statements for 2005**

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***Some Other Resources that May  
be of Use to You***

***www.iasb.org***

- Official IASB news and press releases.
- **Meetings diary.**
- **Free downloads of EDs, discussion papers, newsletters**
- But must subscribe for standards, interpretations, supporting items (basis, illustrative guidance, etc.).

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***www.hkicpa.org.hk***

- Full text of:
  - HKFRSs, HKASs, Interpretations.
  - Without charge.
- IASB Exposure Drafts:
  - With opportunity to provide input to HKICPA response.

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