



# HKFRS: Question session

## Highlights from the Institute's annual accounting update

### Speakers:

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**I**n a set of group accounts prepared under the Hong Kong Companies Ordinance, the holding company's profit and loss account is not required. Can we say that both the states of affairs of the company and group are true and fair without full presentation of the company's profit and loss account? If yes, should it also apply to companies not incorporated under the Hong Kong Companies Ordinance?

*Raphael Ding:* The Hong Kong Companies Ordinance requires a profit and loss account, and a balance sheet to be prepared and laid before the annual general meeting of a Hong Kong incorporated company (section 122(1) and (2)). The requirements for the balance sheet to show a "true and fair view" of the "state of affairs" of a Hong Kong company, and for the profit and loss account to show a "true and fair view" of the "profit or loss" of the company, come from section 123(1).

It is obvious that in the Hong Kong Companies Ordinance the profit and loss account and the balance sheet are two separate documents and each is capable of giving a stand-alone "true and fair view," one on the "profit or loss" and one on the "state of affairs." The idea that no "true and fair view" can be given unless a complete set of financial statements – income statement, cash flow statement, balance sheet, statement of changes in equity and notes – is presented is derived from IAS 1 (HKAS 1). In paragraph 13 of HKAS 1, the "true and fair view" is on the "financial position, financial performance and cash flows."

In practice, when auditors report on the statutory accounts of a Hong Kong incorporated company, they express an opinion on the accounts as a whole and combine the two views in one sentence in the audit opinion paragraph, instead of giving two separate audit opinions on two separate documents. However, when they issue an audit qualification, the auditors will make a conscious distinction

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between the effect on the profit or loss, balance sheet and or cash flows, and express separate audit opinions.

In my view, it seems logical – whether under the Hong Kong Companies Ordinance or under HKAS 1 – that the company level balance sheet is capable of giving a “true and fair view” of the “state of affairs” or “financial position” of a company.

**Can a Hong Kong company limited by guarantee apply SME-FRF?**

*Raphael Ding:* No. Section 141D(1) of the Hong Kong Companies Ordinance provides that “all the shareholders of a private company may agree in writing to apply section 141D.” Under the definition of section 29, a “private company” is one which “by its articles restricts the right to transfer its shares and limits the number of its members to 50.” A company limited by guarantee does not have share capital and there is no restriction on the number of members

under section 10. It therefore appears that section 141D was intended for companies limited by shares only.

**How do we discount a loan with floating interest rate to get the fair value on initial recognition? Suppose the loan is based on the prima rate and of two-year duration.**

*Chew Ping Teo:* AG7 provides that for floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

Varying interest payments are a contractual term of a floating rate instrument. It would be inappropriate to determine at inception a

single rate to discount estimated future cash flows. Instead, the changes in the floating interest rate are reflected in the income statement as and when such changes occur.

**In case of cross guarantee to the bank between two companies obtaining bank loans, do the companies have to do the same disclosure under HKAS 39?**

*Chew Ping Teo:* The HKAS 39 Financial Guarantee Contracts (amendment) requires issuer of a financial guarantee contract to measure the financial guarantee contract at fair value upon initial recognition. In the scenario of cross guarantee between two entities, to the extent the cross guarantee contract meets the definition of a financial guarantee contract under HKAS 39, both entities should measure the contract at fair value on initial recognition.

It should be noted that if the issuer of such financial guarantee contract has previously asserted explicitly that it regards such contract as an insurance contract and has used accounting applicable to insurance contracts, the issuer may elect to apply either the requirement of HKAS 39 or HKFRS 4 to such financial guarantee contracts.

**Is there any transitional provision for HKAS 21 amendment?**

*Ernest Lee:* HKAS 21 amendment “Net investment in a Foreign Operation” does not specify any transitional arrangement. Any change in accounting policies resulting from the initial application of the amendment should be applied in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

**Is the capital reported under HKAS 1 amendment the same as equity?**

*Ernest Lee:* Although for the purposes of the disclosure under the amendment



to HKAS 1, capital would often equate with equity as defined in HKFRSs, it might also include or exclude some components. For example, some entities regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges).

Capital disclosed for the purposes of the requirements under the amendment to HKAS 1 may not necessarily be the same as equity as defined in HKFRSs.

### Is merger accounting allowed under HKFRS, but not IFRS?

*Ernest Lee:* The Hong Kong AG5 *Merger Accounting for Common Control Combinations* provides guidance on business combinations involving entities under common control when merger accounting is adopted. Business combinations involving entities under common control fall outside the scope of IFRS 3. IFRSs do not prohibit the use of merger accounting for business combinations under common control. It is just silent on this specific issue. However, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* contains requirements for the selection of accounting policies in the absence of a standard or an interpretation that specifically applies to an issue, in which case an entity selects an appropriate accounting policy in accordance with the requirements set out in IAS 8.

**If the ultimate holding company is a Hong Kong incorporated company and the immediate holding company is an overseas incorporated company (e.g. British Virgin Islands company), can the subsidiary apply S141D?**

*Raphael Ding:* No. The definition of a subsidiary under section 2(4) of the Hong Kong Companies Ordinance includes sub-subsidiary.

### Can a Hong Kong company with a money-lending license apply for S141D?

*Raphael Ding:* No. Please refer to section 141D(3)(e).

### How should equity loan be disclosed in the financial statements of the subsidiary? Should it be presented as a liability or an item in the statement of changes in equity?

*Raphael Ding:* It should be presented as liability by the subsidiary.

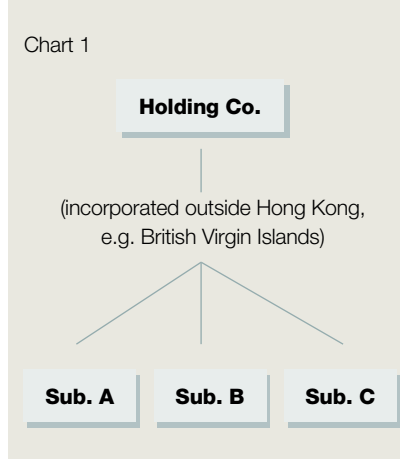
**It seems that the revaluation going through to profit and loss account entirely has created large variations of profits over the years for listed companies. This creates misconceptions and confusion to users, especially those who are not very knowledgeable to the standards.**

*Raphael Ding:* Under the conceptual framework of IFRS/HKFRS, the financial performance of an entity is a measure of management's ability to enhance the value of the entity's net worth. It should be measured as the changes in the net asset value of an entity between two balance sheet dates, whether those changes are due to profit or loss from operation and or to changes in the value of the entity's investment portfolio. If the income statement is to reflect the financial performance of the entity, it should try to incorporate all such changes, whether they are realized or not.

**When recognizing an existing interest-free loan from the director without a fixed repayment term on the first adoption of HKAS 39, which date should we use to determine the fair value of the loan? At the date of the advance of the loan, at the beginning or any date of the financial year?**

*Raphael Ding:* Under the transitional provisions of HKAS 39.104(d), at

the beginning of the financial year in which HKAS 39 is initially applied, an entity is required to apply the criteria in paragraphs 43-54 to identify those financial instruments and re-measure them as appropriate. The interest-free loan should be re-measured at the date of advance. Any adjustment of the previous carrying amount should be recognized as an adjustment of the balance of retained earnings or, if appropriate, another category of equity at the beginning of the financial year in which HKAS 39 is initially applied.



**We are the auditor of the above group (see chart 1). The subsidiaries are incorporated in Hong Kong. The principal activities of all subsidiaries are property holding and for rental income. Is it possible for all subsidiaries to adopt SME-FRF, whereas the holding company is going to adopt the big GAAP?**

*Raphael Ding:* All subsidiaries qualified for reporting under the SME-FRF since they all satisfy the criteria set out in section 141D of the Hong Kong Companies Ordinance.

**If a building situated on leasehold land is developed or acquired for resale, would the land and building**

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be accounted for and disclosed under HKAS 2? Would HKAS 17 apply in this case?

*Raphael Ding:* HKAS 2 applies to both land and buildings held for sale in the ordinary course of business.

**If a hotel property is accounted for under the cost model and the amortization of land and depreciation of the building are on the same basis, must we separately disclose land prepayment?**

*Raphael Ding:* Yes. HKAS 17.15 requires land and buildings to be considered separately for the purposes of lease classification. Under HKAS 17.16 to 17.18, separate classification is not required if the lease payments cannot be allocated reliably between the land and building elements at the inception of the lease; or the hotel property satisfies the investment property definition and is carried at fair value; or the land element is insignificant.

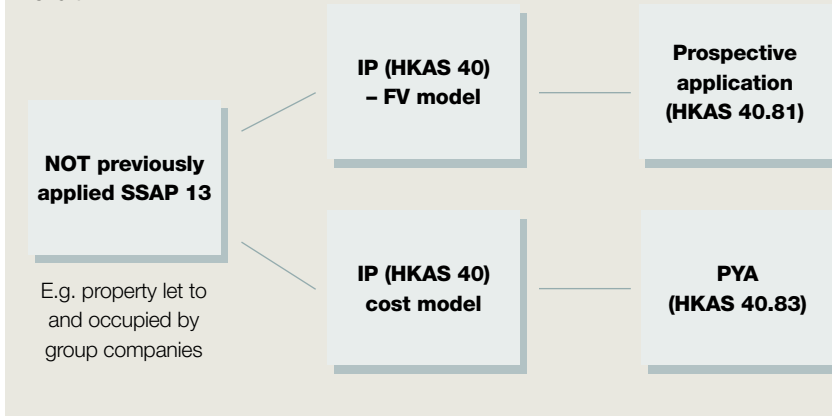
**Company A has a property, which was let to another group company for rental purpose. In the consolidated level, company A's property was split into two components: Land and building. However, in single company level, company A's property can be classified as investment property. Is it compulsory in company A's single company level to classify the property as an investment property?**

*Raphael Ding:* Yes, company A is required to account for the property as investment property (HKAS 40.15 and basis for conclusion B21-B24).

**Referring to the illustration (chart 2), if fair value model was chosen, "prospective application" can be applied. Can we treat company A's property in 2006 as investment property whereas in 2005 as property, plant and equipment? What about cumulative gain in fair value? Does the**

**Accounting for property interests – transitional provisions**

Chart 2



**gain go through the income statement or does it go to reserve? Is it strange to have different classification?**

*Raphael Ding:* For company A, it is a change in accounting policy. Instead of full prior year adjustment, HKAS 40 only requires an adjustment of the opening balance of retained earnings.

**Do we need to keep two sets of books? One for consolidated level, the other one for singleton.**

*Raphael Ding:* No.

**When should the assessment be made on whether an arrangement is considered as a lease (Int. 4)?**

*Ernest Lee:* Paragraphs 10 and 11 of Hong Kong (IFRIC) Interpretation 4 *Determining whether an Arrangement contains a Lease* state clearly when the assessment and reassessment should be made on whether an arrangement is, or contains, a lease.

Please note that the requirements in the captioned paragraphs relating to reassessment do not alter the requirements of HKAS 17 *Leases*. If an arrangement that contains a lease is required to be reassessed and found still to contain a lease, the lease is reclassified as a finance lease or an operating lease

only if so required by paragraph 13 of HKAS 17.

**If a property value cannot be split between land cost and building cost, and the property is not being mortgaged, can the building be classified under finance lease? If not, what should be the depreciation rate?**

*Raphael Ding:* Whether the property is under mortgage or not is irrelevant for determining the accounting treatment because what is at issue is the debit side of the transaction.

HKAS 17.16 provides that if the lease payments cannot be allocated reliably between the leasehold land and building elements, the entire lease is classified as (asset under) finance lease, unless it is clear that both elements are operating lease. The cost or valuation of the leasehold land and building should be allocated on a reasonable basis and depreciated separately or the entire amount should be depreciated over the economic useful life or lease term, whichever is shorter.

**What is the difference in accounting treatment under HKFRS and SME-FRS regarding the splitting of land and building?**

*Raphael Ding:* Land and buildings are separable assets and are dealt with

separately for accounting purposes, whether or not they are acquired together. The only difference under SME-FRS is that leasehold land is classified as property, plant and equipment in accordance with section 3 of the SME-FRS.

**Cost model is chosen for investment properties. Fair value is required to be disclosed. However, if no comparable market transaction exists and no reliable estimate can be done (e.g. a factory built in China and no market information is available) the company does not have any information on the fair value of the investment properties.**

**Should the auditors' report be qualified on the issue that no fair value is disclosed? Or can the company only disclose the investment property under the cost model and disclose the fact that no fair value is available due to the above reasons without any qualified opinion by using HKAS 16?**

*Raphael Ding:* Under HKAS 40.53, there is a rebuttable presumption that the fair value of investment property can be reliably determined on a continuing basis. However, if there is clear evidence that the fair value is not reliably determinable on a continuing basis, the reporting entity shall use the cost model under HKAS 16 until disposal and also follow the relevant disclosures for cost model under HKAS 40.79, in particular HKAS 40.79(e). If the auditor accepts the reporting entity's treatment after considering its circumstances, there is no need to issue an audit qualification.

**If we adopt the cost model for an investment property and have split the land and building elements, HKAS 40 requires that the fair value of the building element be disclosed. Can the disclosure requirement be satisfied if we disclose the fair value of the**

**property as a whole (i.e. including land and building)?**

**We chose the cost model because the property was let to another group company and we do not want to create differences in carrying value between company and consolidated accounts.**

*Raphael Ding:* It is not prohibited by HKAS 40.79(e). Investment property is defined as "land or building or both," so disclosure of the fair value of the land and building combined appears acceptable. However, the financial statements should clearly indicate the fair value covers both elements.

**When we apply cost model on investment property, we need to state the market value. By applying cost model on investment property, leased land and building are disclosed separately. Under leased land and building do we need to split the market value for the land and building?**

*Raphael Ding:* Technically, yes. The land portion is not an investment property under HKAS 40 and the disclosure of fair value of land portion is not required under HKAS 17.

**Under HKAS 40, when cost model is adopted for the first year, how do we account for the reversal of impairment loss on investment property – through profit and loss account or through reserve? Is there any defined tax effect on the reversal of impairment loss on investment property?**

*Raphael Ding:* If the entity has previously applied SSAP 13 and chooses to use cost model under HKAS 40, the Standard permits it to deem the last carrying amount as the cost of that property and commence depreciation on the deemed cost. There is no question of reversing

previously recognized impairment losses. Recognition and reversal of subsequent impairment losses are dealt with in the normal way.

**Property, plant and equipment was purchased in 1997 at a cost of HK\$15 million, and the surveyor found that the land portion should be HK\$11 million and building portion should be HK\$4 million at the inception date. The fair value of the property was HK\$6.5 million, HK\$9 million and HK\$12 million in 2002, 2004 and year 2005 respectively. Should we record impairment loss for "prepaid lease premiums" in year 2002? According to HKAS 17.14, land lease premiums should be amortized over the lease term in accordance with the pattern of benefits provided.**

*Raphael Ding:* Yes, impairment should be recognized.

**The qualifying value under commercial building allowance is HK\$2.4 million and therefore the remaining HK\$1.6 million is treated as unrecognized temporary difference under initial exemption rule of HKAS 12. What is the implication of this unrecognized temporary difference when the property was impaired in 2002 and the reversal of impairment loss in 2004 and 2005?**

*Raphael Ding:* According to HKAS 12.22c, there is no deferred tax implication on impairment or reversal of impairment of the HK\$1.6 million unrecognized temporary difference.

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