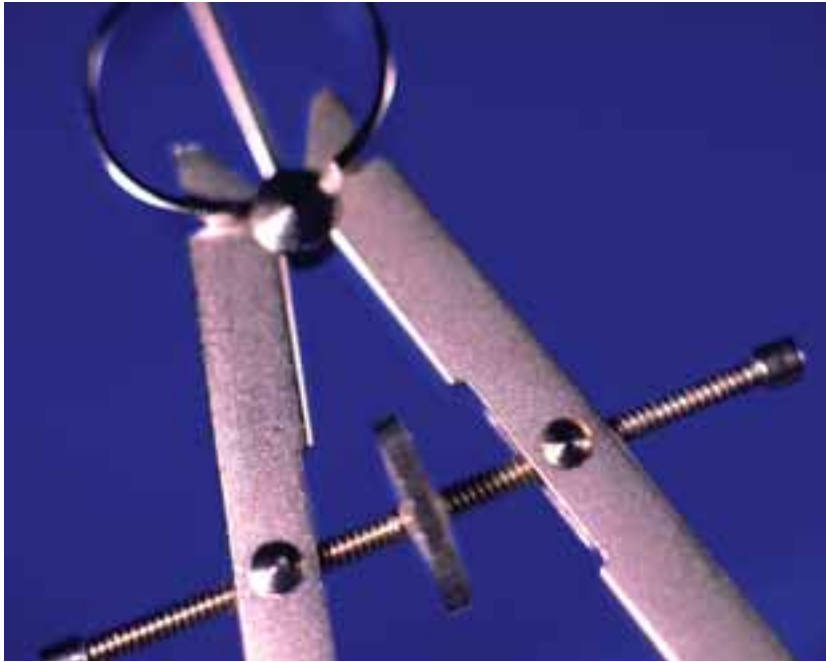


HKAS 32 and HKAS 39: Financial Instruments



Some of the most radical and far-reaching changes in Hong Kong Financial Reporting Standards (HKFRS) apply to accounting for financial instruments, under HKAS 32 and HKAS 39. Chew Ping Teo talks through some of the challenges in understanding and complying with the standards.

Who has been most affected by the changes in reporting for financial instruments?

HKAS 39 establishes principles for recognising, derecognising and measuring financial assets and financial liabilities, while HKAS 32 sets out many of the presentation and disclosure requirements relating to them. Their aim is to promote the extensive use of fair value accounting for financial assets and financial liabilities, including derivatives. It is a common misconception that these standards only impact banks and other financial institutions. They also affect the reporting of nonfinancial organisations and the way they plan their treasury operations and implement risk management strategies.

What are the implications of HKAS 32 for financial reporting?

Other than stipulating a number of very comprehensive disclosure requirements concerning the reporting entity's risk management policies, hedging activities and fair value of financial instruments, the main implication of HKAS 32 is the requirement to classify liability and equity according to the substance of the contractual arrangement. Entities issuing redeemable instruments must be aware that the "substance over legal form" requirement under HKAS 32 may result in the redeemable preference shares being classified as liability rather than equity. This requirement will have implications for the entity's debt to equity ratio and debt covenant. It may also affect overall profitability, where dividends relating to preference shares classified as liabilities are charged through profit and loss.

The other major implication on HKAS 32 concerns accounting for "compound instruments," such as convertible bonds and redeemable convertible preference shares. The standard requires the "convertible component" to be separated from the "debt component." One very critical point, of which issuers should be aware, is that the convertible component should be classified as equity if, and only if, the conversion results in a fixed amount for a fixed number of the issuer's shares. If the conversion proceeds or price are variable, the conversion option should be accounted as a derivative instrument under HKAS 39. This requires fair value measurement at every reporting period with fair value changes reported through profit and loss.

What are the implications of HKAS 39 for financial reporting?

The most fundamental implication is the need to measure financial instruments at fair value on initial recognition. This could affect the granting of interest-free or off-market loans, for example loans within a group of companies, or credit arrangements to customers, allowing deferral of payment. For financial reporting periods beginning on or after 1 January 2006, HKAS 39 requires fair value measurement on initial recognition for credit default financial guarantees, which are rather common between a listed company and its subsidiaries.

While encouraging the use of fair value, HKAS 39 also imposes restrictions on cost and amortised cost measurements. For example, investments in quoted debt securities can only be measured at amortised cost under the “held to maturity” (HTM) category if the entity has the intention and ability to hold the securities to maturity. While the HTM concept is relatively similar to the previous SSAP 24, held to maturity investments under HKAS 39 are subject to the “tainting” rule, which prohibits an entity from classifying any investment as HTM (including existing HTM portfolio) if it has sold or reclassified such an investment before its maturity date during the current or preceding two years.

What’s the most complex part of HKAS 39 – interpreting the standards or applying them in practice?

Understanding the concepts of derecognition, embedded derivative

and hedge accounting are probably the most complicated areas of the standard. HKAS 39 provides rather rigorous derecognition rules for financial assets and financial liabilities, so entities must carefully consider the derecognition rules governing transactions such as securitisation of financial assets, factoring of receivables and loan refinancing.

HKAS 39 also introduces the concept of embedded derivative. An embedded derivative is a component of a hybrid instrument that also includes non-derivative host contract – with the effect that some of the cash flows of hybrid instruments vary in a way similar to a stand-alone derivative. HKAS 39 requires these to be separated from their host contracts and accounted for as derivatives when certain conditions are met, particularly, when the embedded derivative is not closely related to the host contract. The concept of embedded derivative may create practical difficulties for many reporting entities.

Hedge accounting is perhaps the most complex area of HKAS 39, but is only permitted under limited circumstances, where certain strict conditions are met. These include the requirement for the hedging relationship to be clearly defined, measurable and highly effective. The preparation of hedging documentation at the inception of the hedge is also a must.

What are criteria for impairment of assets?

If a financial asset is not measured at fair value through the profit and loss account it should be reviewed regularly for possible impairment. The standard introduces a relatively new concept for impairment for financial assets measured at amortised

cost, i.e. those that are classified as loans and receivables and HTM, in which impairment loss is measured as the difference between the asset’s carrying amount and the present value of estimated cash flows discounted at the financial asset’s original effective interest rate. For financial asset classified as “available for sale” (AFS), the cumulative impairment loss is the difference between the acquisition cost and the current fair value. In assessing impairment loss for equity instruments classified as AFS, the standard provides that a significant or prolonged decline in fair value is objective evidence of impairment. Any subsequent reversal of impairment for AFS equity instruments should be accounted for through equity.

What are some possible tax implications?

There are several potential tax implications a reporting entity needs to consider. These questions include whether a financial instrument is capital or revenue in nature, the tax treatment of imputed interest, and the tax treatments for “economic hedges.” Some entities may hold derivative instruments for hedging purposes, but be required to report them as held for trading if the hedging activities do not meet the stringent hedge accounting requirements under HKAS 39.



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PRC taxation

Income tax for foreign investment enterprises

Kenny Lin explains how enterprise income tax is levied on foreign investment enterprises (FIEs) by the Chinese authorities.



The term foreign investment enterprise (FIE) refers to one of three kinds of venture, namely Sino-foreign equity joint ventures, Sino-foreign contractual joint ventures and wholly foreign-owned enterprises established in China. Joint ventures can enjoy various tax incentives, provided the proportion of investment contributed by the foreign partners exceeds a certain level. This level may range from 25 percent to 70 percent, depending on the overall size of the company's investment (see table, *below*). The policy has proved effective in attracting and prioritising large-scale foreign direct investment.

Income tax and tax holidays

The Ministry of Finance and the State Administration of Taxation (SAT) share executive authority over taxation. The state tax bureau is in charge of the collection of VAT and enterprise income tax, while the local tax bureau is in charge of the collection of income tax and business tax.

China uses a resident concept to determine the extent to which FIEs are liable for income tax, and requires FIEs to pay tax on income derived from

sources both inside and outside China. The state bureau levies tax at a rate of 30 percent, with an additional local tax of three percent. A tax credit is allowed where a company has paid foreign income tax on income derived from sources outside China.

China grants a five-year tax holiday to FIEs engaged in a production business, and which are scheduled to operate for a period of at least ten years. A company is exempt from enterprise income tax in its first two profitable years. The first profitable year is defined as the year in which the firm makes a profit after offsetting allowable accumulated losses. The company is then allowed a 50 percent tax reduction over the third, fourth and fifth years.

A foreign investor in a FIE that directly reinvests its share of profit in that FIE or in another FIE with an operating period of more than five years may obtain a tax refund equivalent to 40 percent of the enterprise income tax paid on the amount reinvested. Where profits are reinvested in high technology or export-oriented enterprises, the foreign investor may receive a full tax rebate.

Partly as a result of this policy, many foreign companies investing in China have strategic plans to reinvest profits for growth and expansion.

Tax filing and tax payment

Like many other jurisdictions, China's enterprise income tax is levied on an annual basis. Companies must pay tax in four quarterly estimated instalments, each due 15 days after the end of the quarter. Annual tax returns, together with audited financial statements and auditor's report, are due within five months from the end of the year. China allows a foreign enterprise that has two or more business establishments in China to consolidate its tax filing and payments. A standard, computerised reporting and payment procedure has been progressively rolled out around the country to reduce underpayments and loopholes. However, the dual administration system has led to some problems in terms of dual registration, tax return filing and divergent tax procedures among different provinces and municipalities.

Computation of taxable income

Tax is applied on net profit after the deduction of costs, expenses and losses in a tax year. However, many items cannot be treated as costs, expenses or losses in the computation of taxable income. These include:

- Purchase or construction costs of fixed assets
- Purchase or development costs of intangible assets
- Interest on capital

▶ Amount of investment ▶ Minimum registered capital for a FIE

US\$3 million or less	70% of total investment
US\$3-10 million	Higher of US\$2.1 million or 50% of total investment
US\$10-30 million	Higher of US\$5 million or 40% of total investment
Over US\$30 million	Higher of US\$12 million or 33.3% of total investment

A joint venture that fails to pay up its capital contribution on time, or in full in accordance with the joint venture contract, is deemed to have committed a breach of contract. This can lead to the dissolution of the venture.

- Income tax payments
- Fines for illegal activities and losses due to the confiscation of property
- Surcharges and fines for overdue payment of taxes
- The portion of losses arising from a natural disaster or accident that is covered by insurance compensation
- Unapproved donations
- Foreign social insurance premium
- Royalties paid to the head office
- Other expenses not related to production or business operations

Special deductions or restrictions apply in a number of areas, as outlined, *right*.

Tax enforcement

China's self-assessment tax system means the tax authorities allocate a lot of resources to tax audits. Companies are more likely to come under scrutiny if they show any of the following attributes:

- Continuing losses for more than two consecutive years
- Severe fluctuations in profits and losses
- Sharp decreases in profits following the expiration of a tax holiday period
- Expansion of operations despite losses or marginal profits
- Sizeable transactions with related parties
- Lower than average profit margins

Non-compliance can entail high penalties. For example, the penalty for failure to pay tax within the prescribed time limit is levied at 0.2 percent per day on the tax amount overdue. Understatement of income or overstatement of expenses in the tax return can lead to charges of tax evasion and be subject to a penalty at a rate of up to 500 percent of the underpaid amount.

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▶ Item	▶ Parameters
Depreciation	<ul style="list-style-type: none"> • The straight-line method is generally accepted, whereas other methods can be adopted only if approved by the tax authorities. • Minimum depreciation periods exist for different kinds of fixed assets. • The residual value is generally no less than ten percent of the original value. • Intangible assets are amortised using the straight-line method over a period of no less than ten years.
Pre-operating expenses	<ul style="list-style-type: none"> • These require amortisation over a period of at least five years.
Interest on loans	<ul style="list-style-type: none"> • Interest is generally deductible provided the interest rate has a commercial basis. • Interest on loans to construct or purchase fixed assets will usually need to be capitalised.
Management fees	<ul style="list-style-type: none"> • These are generally not deductible. However, if certain conditions are met, deductions may be allowed for administrative fees and other expenses recharged by an overseas head office or related party.
Entertainment expenses	<ul style="list-style-type: none"> • Production-oriented FIEs may allocate up to 0.5 percent of net sales for the first RMB15 million, plus 0.3 percent of net sales in excess of RMB15 million, to entertainment expenses. • Service-oriented FIEs may allocate up to one percent of total business income for the first RMB5 million, plus 0.5 percent of income in excess of RMB5 million.
Bad debts	<ul style="list-style-type: none"> • Enterprises carrying on a credit and leasing business may provide annually for bad debts for up to three percent of the year-end balances of loans or of accounts receivable, bills receivable and other receivables. • When bad debts exceed the provision for the preceding year, they can be deducted as a loss in the current year. Otherwise, the difference is taxable for the current year. • Accounts receivable can be written off as bad debts if the debtor is bankrupt, dies or has failed to repay the debt for over two years. • Bad debts recovered in the subsequent year are taxable for that year.
Loss carry-overs	<ul style="list-style-type: none"> • Net losses can carry forward for a period up to five years.
Dividends	<ul style="list-style-type: none"> • Dividends in FIEs are not taxable, and the relevant investment expenses are not deductible.