



Let's get technical

This column is dedicated to answering questions submitted by members regarding Institute standards

Q. I am currently working in a textile manufacturing company and management is reviewing all its assets for impairment after identifying an indication of impairment in the current reporting period. As a result of the review, an impairment loss for plant and machinery is proposed to be recognized in the financial statements on the ground that the value in use is lower than the carrying amount despite the fact that we have also obtained an independent valuation report, which states that the fair value is higher than the carrying amount.

In this respect, should we be required to provide an impairment loss for plant and machinery given the fact that the "fair value" is higher than the carrying amount?

A. Paragraph 8 of HKAS 36 *Impairment of Assets* states that an asset is impaired when its carrying amount

exceeds its recoverable amount and paragraph 59 requires that if, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is referred to as an impairment loss.

Paragraph 9 further states that if any indication of impairment exists, the entity shall estimate the recoverable amount of the asset.

It is important to note paragraph 18, which defines recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. Paragraph 19 states that if either of these amounts exceeds the asset's carrying amount, the asset is not impaired.

Therefore, management should not recognize an impairment charge as the recoverable amount (higher of value in use and fair value less costs to sell) exceeds the carrying amount.

Management could recover the asset's carrying amount if it chooses to sell it rather than use it in its operations. Thus, no impairment would be recorded in this situation.

However, you have to ensure the fair value provided in the independent valuation report is indeed referring to "fair value less costs to sell" as defined in paragraph 6 of HKAS 36, that is, the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. In case where the element of "costs to sell" is not included in the valuation report, you are required to estimate the "costs to sell," which may include legal costs, stamp duty and similar transaction taxes, costs of removing the plant and equipment, and direct incremental costs to bring the plant and machinery into condition for its sale, excluding finance costs and income tax expense.

Members helping members

Do you want to help your fellow members? Try answering this question from a member and send an email to hkicpa@hkicpa.org.hk. Answers received by 18 August will be considered for inclusion in the October issue of A Plus.

Q. My company invests in an equity security of a listed company, which is classified as fair value through profit or loss in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*. In preparing the financial statements of my company, which price should I use for the purpose of measuring that equity security as at the balance sheet date?

Here is the answer to the question we asked members to help with in the June 2008 edition of A Plus:

Q. I would like to know under which situation(s), revenue arising from sale and repurchase agreement on an asset other than a financial asset can be recognized in order to comply with HKAS 18 *Revenue*?

A. Paragraph 35 of *Framework for the Preparation and Presentation of Financial Statements* states that it is necessary to account for and present transactions and other events in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form.

Further, paragraph 13 of HKAS 18 *Revenue* states that in certain circumstances, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

In appendix to HKAS 18, example 5 provides that for a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analyzed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognized. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue.

Depending on your circumstances, the following are possible scenarios with prescribed accounting treatments:

- a. Sale with repurchase obligation: Management should not recognize revenue on the transfer of the asset as the risks and rewards of ownership have not passed to the buyer. The asset should remain on the reporting entity's balance sheet and the proceeds received (such as cash) should be recognized as a collateralized borrowing.
- b. Sale with repurchase option: If the seller has an option to buy the asset back at a fixed price for a fixed period of time, management should not recognize revenue unless and until the repurchase option is allowed to lapse. The asset should remain on the reporting entity's balance sheet and the proceeds recognized as a collateralized borrowing until the reporting entity's right to repurchase the inventory lapses. However, if the repurchase option provides the seller to buy back the asset at market price and the goods are readily available in the market, revenue is recognized at the time of delivery. Management should exercise judgment in determining whether to recognize the revenue in question.

Please refer to paragraph 14 of HKAS 18, which sets out the recognition criteria for sale of goods and requires that revenue shall only be recognized when all the conditions have been satisfied. In particular, you should apply your professional judgment in relation to the requirement in paragraph 14(a) about determining whether significant risks and rewards of ownership have been transferred.

You can submit questions on technical issues by sending an email to hkicpa@hkicpa.org.hk. The standard setting team will answer these questions in accordance with the policy on handling members' technical questions which is posted on the Institute's website.

