

Tackling HKFRS

If you have questions on how to apply Hong Kong Financial Reporting Standards, turn to this new column, where Deloitte addresses HKFRS issues faced by CPAs. Two areas covered this month involve financial guarantees and splitting leases of land and buildings

Financial guarantees

Paragraph 43 of HKAS 39 *Financial Instruments: Recognition and Measurement* requires the issuer of a financial guarantee contract to recognize a financial guarantee contract initially at fair value. In practice, a parent company may provide some form of financial guarantee to its subsidiary without charging a fee. How should a subsidiary account for such financial guarantee in the parent's separate financial statements? What factors do preparers and auditors need to consider in determining the fair value of financial guarantee contracts provided in relation to a subsidiary's bank borrowings?

The first thing that needs considering is whether the financial guarantee provided by the parent meets the definition of a financial guarantee contract under HKAS 39. For example, if the parent issues a

guarantee directly to a subsidiary in respect of the subsidiary's borrowings, or merely provides a general letter of support to the subsidiary, the instrument is unlikely to meet the definition. This is an undertaking by the parent to lend or contribute more money to its subsidiary, which will be accounted for as such only when the lending or contribution is made.

Where the parent issues the guarantee directly to a bank in relation to the subsidiary's bank borrowings and undertakes to reimburse the bank in the event of default by the subsidiary, the instrument is a financial guarantee contract. Unless the parent is eligible to apply the HKFRS 4 treatment, it needs to recognize the financial guarantee contract in accordance with HKAS 39 in its separate financial statements even though the group does not need to recognize this contract separately in the consolidated financial statements.

There are different ways to determine the fair value of a financial guarantee contract issued by the parent to the bank. One possible way is to estimate the fair value based on the fee that the subsidiary needs to pay an unrelated party to obtain a similar guarantee. Another way is to compute the fair value of the financial guarantee contract by reference to the difference between the contractual interest rate and the interest rate that the subsidiary would have been charged in the absence of a guarantee. A third way is to engage a professional valuer to obtain the fair value.

When determining the fair value, you also need to consider the general market practice of interest rate differentials for borrowings with and without guarantee, value and nature of other collaterals provided, terms and conditions of the subsidiary's unsecured external borrowings, and other capital injection or financial support plan for the subsidiary, if any.



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Splitting leases of land and buildings

Paragraph 16 of HKAS 17 *Leases* states that to determine the appropriate accounting for the land and buildings elements of a lease, the minimum lease payments (including any lump-sum upfront payments) should generally be allocated in proportion to the relative values of the leasehold interests in the land element and the buildings element of the lease at the inception of the lease.

If the lease payments cannot be allocated reliably between land and building, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

In practice, what factors do preparers and auditors need to consider before concluding that the lease payments cannot be allocated reliably between the land and buildings elements?

When judging whether the minimum lease payments (including any lump-sum upfront payment) can be allocated reliably between the land element and the building element, all facts and circumstances,

including the jurisdiction where the land and buildings are located, on a property-by-property basis, need to be considered.

For example, where an entity owns a unit or a floor within an office block in Hong Kong for its own use, typically the entity also owns a percentage share of an undivided interest in the leasehold land on which the building is situated. Given that the government retains ownership of the land, leasehold interests in property are the only means of purchasing such assets. In these circumstances, because land and buildings may not be sold or leased separately, it may not be possible to arrive at a meaningful allocation of the lease payments between land and building elements, and hence the entire lease payments may be included in the cost of land and buildings as a financial lease in property, plant and equipment.

Contrast the above with another example where the entity owns the entire office block in Hong Kong, also for its own use, as well as the leasehold interest in the whole plot of land. Given that plots of land may be sold

or leased separately, it is likely that the lease payments can be allocated reliably between the land and buildings elements, and hence the two elements need to be considered separately for financial lease and operating lease classification purposes.

It is worth highlighting that allocation of minimum lease payments under paragraph 16 of HKAS 17 shall be done based on the relative fair value of the leasehold interests in the land and buildings elements, which is different from the relative fair value of the land and buildings elements. This allocation reflects the extent to which the payments are intended to compensate the lessor for the use of the two separate elements. Normally, the future economic benefits of the land element with indefinite life will not be consumed, whereas those of the buildings element will be consumed to some extent over the term of a lease. Therefore, the allocation needs to be done on a weighted basis to provide the lessor a return on investments in the land and buildings elements, plus a compensation for the consumption of the buildings element.