



Tackling HKFRS

Deloitte addresses three Hong Kong Financial Reporting Standards issues often encountered by CPAs

1. Determination of reasonably possible range in sensitivity analysis

Background:

In preparing sensitivity analysis in accordance to paragraph 40(a) of HKFRS 7 *Financial Instruments: Disclosures*, the reporting entity needs to determine what it considers to be a reasonably possible change in the relevant risk variable and should consider both the economic

environment in which it operates and the time frame over which it is making the assessment.

Question:

What factors does an entity need to consider in determining its reasonable possible range?

Answer:

HKFRS 7 *Financial Instruments: Disclosures* requires a sensitivity analysis

to show the effect on an entity's profit or loss and equity of a reasonably possible change of market risk (including currency risk, interest rate risk and other price risk). However, HKFRS do not define what a reasonably possible change in the relevant risk variables is, and management is expected to make judgment appropriate to the entity's specific circumstances.

Management can assess the range of change in the relevant risk variables

by reference to factors such as historic volatility of the underlying variables (e.g. exchange rates, interest rates and stock market indices), implied volatility from forward and future market transactions, and its own expectation of the future change of these variables.

In addition, the entity should consider the possible sensitivity effect on individual financial instrument balance, even for the same type of market risk exposure. For example, both bank borrowings and bank deposits bearing variable interest rates expose the entity to cash flow interest rate risk. However, by past experience, if the prime rate on bank borrowings increases, the interest rate on bank deposits may not increase to the same extent as the increase in prime rate. Hence, it may be more reasonable to apply a different range of possible change for bank borrowing balance and bank deposit balance in preparing the analysis.

Take another example of a Hong Kong sourcing company, which purchases goods from different countries. The company may be exposed to various foreign currency risks on its trade payable balances denominated in different currencies. In this circumstance, the company may need to disclose a sensitivity analysis for each significant currency exposure, taking into consideration any pegged or managed relationship between the functional currency and other currencies (such as that between Hong Kong dollars and United States dollars) which would limit the future possible change in exchange rates. Furthermore, whether the other country's economy is growing or in a downturn would also affect the extent of appreciation (or depreciation) of a currency in the coming period. Management needs to

have a reasonable understanding of the relevant country's economy in order to determine the reasonably possible change of such risk variable.

It is also worth noting that the market risk disclosures may include the sensitivity effect of non-financial risk on financial instruments. For example, an airline company that has entered into forward contracts on oil price capable of net settlement may need to disclose the sensitivity analysis based on its expectation of a reasonable possible change in the commodity price risk.

2. Deferred taxation on the revaluation of investment property

Background:

The accounting policy of listed companies engaged in property investment states that surpluses or deficits arising on the revaluation of investment properties requires the provision of deferred taxation on these surpluses or deficits.

Question:

Does it somewhat contradict the Hong Kong tax regime as no capital gain tax will be levied in disposal of properties?

Answer:

While there is no capital gain tax on disposal of properties under the current Hong Kong tax regime, there is no contradiction with the requirements on deferred taxation under HKAS 12 *Income Taxes*. Unless the property is freehold land, when assessing the effect of deferred tax liabilities (or assets), one is required to determine the manner in which the carrying amount of the investment property is expected to be recovered according to paragraphs 51 and 52 of HKAS 12. Whether the

recovery of an asset is expected to be through use or through sale would affect the two crucial elements in the calculation of the deferred tax amount, namely applicable tax rate and tax base.

If the investment property is intended to be leased out for rental income, its carrying amount can be considered recovered through use. Under the current Hong Kong tax regime, such rental income would form part of taxable profits. In this circumstance, the applicable tax rate for deferred tax calculation would be the profits tax rate currently at 16.5 percent, and this rate is applied on the difference between the carrying amount of the investment property and its tax base to derive the deferred tax amount.

If the entity decides to dispose of the investment property, the carrying amount of the property is expected to be recovered through sale. In this circumstance, the applicable tax rate would be the rate of capital gain tax, which is currently zero in Hong Kong. Accordingly, the deferred tax balance would become zero.

In practice, the expected manner of recovery may change during the life of the property, depending on management's intention, which may be affected by the state of property markets or some other external and internal factors. Where there is a change of intention, the applicable tax rate and the tax base shall reflect the new expected manner of recovery. It is worth highlighting that HKAS 12 does not impose the same "highly probable" requirement compared to that under HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Hence, the applicable tax rate and tax base would be revised if the management has changed its intention from rental to sale, even if the property

may not satisfy the non-current asset held for sale classification under HKFRS 5.

3. Non-reciprocal transfer of non-monetary asset

Background:

HKAS 16 *Property, Plant and Equipment* requires property, plant and equipment that qualifies for recognition as an asset to be initially measured at its cost. Paragraph 6 of HKAS 16 defines cost as the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire an asset at the time of its acquisition or construction.

Questions:

In the absence of a standard or an interpretation, what is the suggested accounting treatment by the recipient for a non-reciprocal transfer of non-monetary asset contributed by an owner acting in its capacity as an equity participant or a third party?

Answer:

In such non-reciprocal transaction, no consideration has been paid by the entity that receives the non-monetary asset to the owner or the third party.

When an entity receives an asset for zero consideration, careful judgment taking into account all facts and circumstances is essential before the entity concludes that the transaction is indeed a non-reciprocal transfer; that is, it is a free gift and not part of a wider exchange transaction arrangement. The following discussion assumes that the receipts of assets by an entity are genuine non-reciprocal transactions.

To deal with the accounting for non-reciprocal transfers of assets, the following two issues have to be addressed:

“When an entity receives an asset for zero consideration, careful judgment taking into account all facts and circumstances is essential before the entity concludes that the transaction is indeed a non-reciprocal transfer; that is, it is a free gift and not part of a wider exchange transaction arrangement.”

- (i) How the entity that receives the non-monetary asset measures the asset initially
 - (ii) How the entity accounts for the corresponding credit balance and the entity recognizes the credit balance in profit or loss or in equity
- Paragraph 7 of HKAS 18 Revenue defines revenue as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.
 - Paragraph 70 of the framework defines income as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

On (i), HKFRS do not provide specific guidance on how an entity should measure non-monetary assets resulting from non-reciprocal transfers by its owners or by a third party. In practice, entities that receive non-monetary assets commonly recognize the assets received at their fair values. This practice is consistent with one of the qualitative characteristics set out in the *Framework for the Preparation and Presentation of Financial Statements*, that is information provided in the financial statements must be relevant to the decision-making needs of users. To properly understand future cash flow implications for making economic decisions, users generally would expect the value of assets be reflected in the financial statements.

On (ii), the following should be taken into account in determining how the credit side of the transaction should be accounted for:

In light of the above, the credit balance arising from the non-reciprocal transfers of assets by an entity's owners should be recognized directly in equity.

However, regarding non-reciprocal transfers of non-monetary assets to an entity by a third party (unless it acts on behalf of the entity's owners), the resulting credit balance should be recognized in profit or loss. This approach is also consistent with the income approach adopted in the accounting for government grants set out in HKAS 20.