



Tackling HKFRS

Deloitte addresses financial reporting issues arising from HKAS 32 and HKAS 39

Question 1:

(i) In respect of an amount due from a subsidiary, which is interest-free and has no fixed terms of repayment, how is such a financial asset accounted for in a parent's separate financial statements in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*?

(ii) Should the amount due from a subsidiary with the above-mentioned terms be classified as current or non-current assets in the parent's separate financial statements?

(iii) How should the amount due to a holding company be presented (current/non-current liability) in the subsidiary's financial statements?

(iv) Does the current/non-current presentation need to be consistent between the two sets of financial statements?

Answer:

(i) Inter-company accounts among group companies that meet the definition of financial assets and financial liabilities under HKAS 32 *Financial Instruments: Presentation* should follow the measurement principles under HKAS 39 *Financial Instruments: Recognition and Measurement*.

Paragraph 43 of HKAS 39 states that "when a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability." Accordingly, the amount due from a subsidiary that is interest-free and has no fixed repayment term shall be recognized initially in the balance sheet at its fair value (plus transaction costs that are directly attributable to the making of such advance, if any).

Further, AG 64 of HKAS 39 states that "for example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument with a similar credit rating." Accordingly, the initial fair value is arrived at by discounting expected future cash flows using the effective interest (i.e. the subsidiary's "would-have-been" borrowing rate at the date of the advance) over the period that the parent expects the advance to be outstanding.

(ii) HKAS 1 *Presentation of Financial Statements* governs the presentation of assets and liabilities in the balance sheet. Therefore, the amount due from a subsidiary is classified as current or non-current financial asset in the parent's separate financial statements in accordance with paragraph 66 of HKAS 1, which states:

“66. An entity shall classify an asset as current when:

- (a) It expects to realize the asset, or intends to sell or consume it, in its normal operating cycle.
- (b) It holds the asset primarily for the purpose of trading.
- (c) It expects to realize the asset within 12 months after the reporting period.
- (d) The asset is cash or a cash equivalent (as defined in HKAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

An entity shall classify all other assets as non-current.”

Accordingly, the amount should be classified as a non-current asset if the parent does not expect the advance to be repaid within 12 months from the balance sheet date.

(iii) Likewise, in the subsidiary’s financial statements, the amount due to a holding company is classified as current or non-current liability in accordance with paragraph 69 of HKAS 1, which states:

“69. An entity shall classify a liability as current when:

- (a) It expects to settle the liability in its normal operating cycle.
- (b) It holds the liability primarily for the purpose of trading.
- (c) The liability is due to be settled within 12 months after the reporting period.
- (d) The entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period.

An entity shall classify all other liabilities as non-current.”

For example, the amount should be classified as a current liability if the advance, even though it has no fixed terms of repayment, is repayable on demand of the parent, as the subsidiary does not have unconditional right to defer settlement of the liability for at

least 12 months after the balance sheet date in such cases.

(iv) As the current and non-current presentation of the inter-company balance in the financial statements of the parent and that of the subsidiary shall be made in accordance with paragraphs 66 and 69 of HKAS 1, respectively, from the perspective of different parties (i.e. the parent and the subsidiary), they need not be consistent.

Question 2:

If a compound financial instrument is issued with an anti-dilutive conversion price adjustment or is not in the functional currency of the issuer, do either of these features violate the “fixed-for-fixed” requirement under paragraph 16(b)(ii) of HKAS 32 Financial Instruments: Presentation? If so, how should the financial instrument be accounted for?

Answer:

HKAS 32 does not provide any guidance on whether anti-dilutive provisions in compound financial instruments result in the equity conversion feature failing the equity treatment (i.e. the conversion feature is not “fixed-for-fixed”).

Anti-dilutive adjustments may be structured to preserve the instrument holders’ relative potential equity interest in the issuer and compensate the instrument holders relative to the existing ordinary shareholders. For example, a convertible note may be issued with a specified conversion price subject to adjustment upon the note issuer issuing new shares to its existing shareholders at below market price or upon the payment of special dividends in excess of a specified level. If the anti-dilutive adjustments put the instrument holders in the same economic position relative to the existing ordinary shareholders as they were prior to the event, it can

be concluded that the anti-dilutive adjustments are not deemed to breach the “fixed-for-fixed” criterion.

However, this conclusion would not be appropriate if the relative economic position of the instrument holders is improved or worsens as a result of such adjustment.

Therefore, the assessment of whether anti-dilutive provisions in compound financial instruments would result in the equity conversion feature failing the equity treatment would depend on the specific terms of the instrument and should be evaluated very carefully on a case-by-case basis.

Another common question for the accounting of compound financial instruments is whether the “fixed-for-fixed” requirement under HKAS 32 for equity treatment for the conversion option component of a convertible note is not met if the convertible note is denominated in a currency different from the functional currency of the issuer. This issue will arise, for example, when a Hong Kong listed company, which has yuan as its functional currency, issues convertible notes that are denominated in Hong Kong dollars rather than yuan.

In 2005, the International Financial Reporting Interpretations Committee discussed the question on whether “a convertible bond denominated in a foreign currency (i.e. a currency other than the functional currency of the entity issuing the bond), which allows the holder to convert the bond into a fixed number of the entity’s equity instruments in exchange for a fixed amount of foreign currency” was “fixed-for-fixed.” The IFRIC concluded that under IAS 32, such contracts are liabilities. In other words, a convertible note denominated in foreign currency does not meet the “fixed-for-fixed” criterion and the conversion option component of the note should be accounted for a derivative liability.