

# MEMBERS' HANDBOOK

## Update No.205

(Issued 30 August 2017)

The following Amendments are effective for annual reporting periods beginning on or after 1 January 2017:

- *Disclosure Initiative* (Amendments to HKAS 7)
- *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to HKAS 12)

The amendments were previously set out in the Appendix to the respective Standards but are now incorporated into the relevant Standards and Basis for Conclusions.

<b><u>Document Reference and Title</u></b>	<b><u>Instructions</u></b>	<b><u>Explanations</u></b>
<b><u>VOLUME II</u></b>		
<a href="#"><u>Contents of Volume II</u></a>	Discard existing page i and replace with revised page i.	Revised contents page
<b>HONG KONG ACCOUNTING STANDARDS (HKAS)</b>		
<a href="#"><u>HKAS 1 Presentation of Financial Statements</u></a>	Replace the cover page and page 102 with revised cover page and page 102.	Amendments due to effective of the Amendments to HKAS 7 <i>Disclosure Initiative</i>
<a href="#"><u>HKAS 7 Statement of Cash Flows</u></a>	Replace the cover page and pages 2-3, 11-12, 19 and 23 with revised cover page and pages 2-3, 11-12, 19 and 23. Insert page 11A after page 11, page 21A after page 21 and pages 22A-22C after page 22. Discard pages 13A-13C and 24-28.	Amendments due to effective of the Amendments to HKAS 7 <i>Disclosure Initiative</i>
<a href="#"><u>HKAS 12 Income Taxes</u></a>	Replace the cover page and pages 2, 4, 5, 19, 36, 61, 63 and 68 with revised cover page and pages 2, 4, 5, 19-19A, 36-36A, 61-61D, 63-63A and 68-68D. Discard pages 62A-62H and 69-73.	Amendments due to effective of the Amendments to HKAS 12 <i>Recognition of Deferred Tax Assets for Unrealised Losses</i>



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(Updated to August 2017)

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HKAS 1 (Revised)  
Revised January ~~August~~ 2017

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Effective for annual periods  
beginning on or after 1 January 2009

*Hong Kong Accounting Standard 1 (Revised)*

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# Presentation of Financial Statements



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### Part III: Illustrative examples of capital disclosures (paragraphs 134–136)

#### An entity that is not a regulated financial institution

IG10 The following example illustrates the application of paragraphs 134 and 135 for an entity that is not a financial institution and is not subject to an externally imposed capital requirement. In this example, the entity monitors capital using a debt-to-adjusted capital ratio. Other entities may use different methods to monitor capital. The example is also relatively simple. An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of paragraphs 134 and 135. In determining the form and content of the disclosure to satisfy those requirements, an entity also considers the disclosure requirements set out in paragraphs 44A–44E of IAS 7 *Statement of Cash Flows*.

##### Facts

Group A manufactures and sells cars. Group A includes a finance subsidiary that provides finance to customers, primarily in the form of leases. Group A is not subject to any externally imposed capital requirements.

##### Example disclosure

The Group's objectives when managing capital are:

- to safeguard the entity's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders, and
- to provide an adequate return to shareholders by pricing products and services commensurately with the level of risk.

The Group sets the amount of capital in proportion to risk. The Group manages the capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares, or sell assets to reduce debt.

Consistently with others in the industry, the Group monitors capital on the basis of the debt-to-adjusted capital ratio. This ratio is calculated as net debt ÷ adjusted capital. Net debt is calculated as total debt (as shown in the statement of financial position) less cash and cash equivalents. Adjusted capital comprises all components of equity (ie share capital, share premium, non-controlling interests, retained earnings, and revaluation surplus) other than amounts accumulated in equity relating to cash flow hedges, and includes some forms of subordinated debt.

*continued...*

*Hong Kong Accounting Standard 7*

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# Statement of Cash Flows



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## Hong Kong Accounting Standard 7

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Hong Kong Accounting Standard 7 *Statement of Cash Flows* (HKAS 7) is set out in paragraphs 1-58~~60~~. All the paragraphs have equal authority. HKAS 7 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

- 44 Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. The exclusion of non-cash transactions from the statement of cash flows is consistent with the objective of a statement of cash flows as these items do not involve cash flows in the current period. Examples of non-cash transactions are:
- (a) the acquisition of assets either by assuming directly related liabilities or by means of a finance lease;
  - (b) the acquisition of an entity by means of an equity issue; and
  - (c) the conversion of debt to equity.

## **Changes in liabilities arising from financing activities**

**44A An entity shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.**

44B To the extent necessary to satisfy the requirement in paragraph 44A, an entity shall disclose the following changes in liabilities arising from financing activities:

- (a) changes from financing cash flows;
- (b) changes arising from obtaining or losing control of subsidiaries or other businesses;
- (c) the effect of changes in foreign exchange rates;
- (d) changes in fair values; and
- (e) other changes.

44C Liabilities arising from financing activities are liabilities for which cash flows were, or future cash flows will be, classified in the statement of cash flows as cash flows from financing activities. In addition, the disclosure requirement in paragraph 44A also applies to changes in financial assets (for example, assets that hedge liabilities arising from financing activities) if cash flows from those financial assets were, or future cash flows will be, included in cash flows from financing activities.

44D One way to fulfil the disclosure requirement in paragraph 44A is by providing a reconciliation between the opening and closing balances in the statement of financial position for liabilities arising from financing activities, including the changes identified in paragraph 44B. Where an entity discloses such a reconciliation, it shall provide sufficient information to enable users of the financial statements to link items included in the reconciliation to the statement of financial position and the statement of cash flows.

44E If an entity provides the disclosure required by paragraph 44A in combination with disclosures of changes in other assets and liabilities, it shall disclose the changes in liabilities arising from financing activities separately from changes in those other assets and liabilities.

## **Components of cash and cash equivalents**

**45 An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.**

46 In view of the variety of cash management practices and banking arrangements around the world and in order to comply with HKAS 1 *Presentation of Financial Statements*, an entity discloses the policy which it adopts in determining the composition of cash and cash equivalents.

- 47 The effect of any change in the policy for determining components of cash and cash equivalents, for example, a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio, is reported in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

## Other disclosures

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- 48 **An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.**
- 49 There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the group. Examples include cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by the parent or other subsidiaries.
- 50 Additional information may be relevant to users in understanding the financial position and liquidity of an entity. Disclosure of this information, together with a commentary by management, is encouraged and may include:
- (a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities;
  - (b) [deleted]
  - (c) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity; and
  - (d) the amount of the cash flows arising from the operating, investing and financing activities of each reportable segment (see HKFRS 8 *Operating Segments*).
- 51 The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the entity is investing adequately in the maintenance of its operating capacity. An entity that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

- 52 The disclosure of segmental cash flows enables users to obtain a better understanding of the relationship between the cash flows of the business as a whole and those of its component parts and the availability and variability of segmental cash flows.

## Effective date

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- 53 **This Hong Kong Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.**
- 54 **HKAS 27 (as amended in 2008) amended paragraphs 39 – 42 and added paragraphs 42A and 42B. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendments shall be applied for that earlier period. The amendments shall be applied retrospectively.**
- 55 Paragraph 14 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact and apply paragraph 68A of HKAS 16.
- 56 Paragraph 16 was amended by *Improvements to HKFRSs* issued in May 2009. An entity shall apply that amendment for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 57 HKFRS 10 and HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 37, 38 and 42B and deleted paragraph 50(b). An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.
- 58 *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27(2011)), issued in December 2012, amended paragraphs 42A and 42B and added paragraph 40A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies those amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.
- 59 *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition]*
- 60 *Disclosure Initiative* (Amendments to HKAS 7), issued in January 2016, added paragraphs 44A–44E. An entity shall apply those amendments for annual periods beginning on or after 1 January 2017. Earlier application is permitted. When the entity first applies those amendments, it is not required to provide comparative information for preceding periods.

**D. Segment information**

	Segment A	Segment B	Total
Cash flows from:			
Operating activities	1,520	(140)	1,380
Investing activities	(640)	160	(480)
Financing activities	(570)	(220)	(790)
	<u>310</u>	<u>(200)</u>	<u>110</u>

**E. Reconciliation of liabilities arising from financing activities**

	<u>20X1</u>	<u>Cash flows</u>	<u>Non-cash changes</u>		<u>20X2</u>
			<u>Acquisition</u>	<u>New leases</u>	
<u>Long-term borrowings</u>	<u>1,040</u>	<u>250</u>	<u>200</u>	<u>=</u>	<u>1,490</u>
<u>Lease liabilities</u>	<u>=</u>	<u>(90)</u>	<u>=</u>	<u>900</u>	<u>810</u>
<u>Long-term debt</u>	<u>1,040</u>	<u>160</u>	<u>200</u>	<u>900</u>	<u>2,300</u>

**Alternative presentation (indirect method)**

As an alternative, in an indirect method statement of cash flows, operating profit before working capital changes is sometimes presented as follows:

Revenues excluding investment income	30,650
Operating expense excluding depreciation	<u>(26,910)</u>
Operating profit before working capital changes	<u><u>3,740</u></u>

## **Appendix C**

### **Reconciliation of liabilities arising from financing activities**

- 1 This appendix illustrates one possible way of providing the disclosures required by paragraphs 44A–44E.
- 2 The appendix shows only current period amounts. Corresponding amounts for the preceding period are required to be presented in accordance with IAS 1 *Presentation of Financial Statements*.

	<b><u>20X1</u></b>	<b><u>Cash flows</u></b>	<b><u>Non-cash changes</u></b>			<b><u>20X2</u></b>
			<b><u>Acquisition</u></b>	<b><u>Foreign exchange movement</u></b>	<b><u>Fair value changes</u></b>	
<u>Long-term borrowings</u>	<u>22,000</u>	<u>(1,000)</u>	=	=	=	<u>21,000</u>
<u>Short-term borrowings</u>	<u>10,000</u>	<u>(500)</u>	=	<u>200</u>	=	<u>9,700</u>
<u>Lease liabilities</u>	<u>4,000</u>	<u>(800)</u>	<u>300</u>	=	=	<u>3,500</u>
<u>Assets held to hedge long-term borrowings</u>	<u>(675)</u>	<u>150</u>	=	=	<u>(25)</u>	<u>(550)</u>
<u>Total liabilities from financing activities</u>	<u>35,325</u>	<u>(2,150)</u>	<u>300</u>	<u>200</u>	<u>(25)</u>	<u>33,650</u>

## **Changes in liabilities arising from financing activities (paragraphs 44A–44E)**

### **Background to the January 2016 Amendments**

- BC9 In January 2016 the Board amended IAS 7 to require entities to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities. The amendments were in response to requests from users, including those received at the Board's *Financial Reporting Disclosure Discussion Forum* in January 2013 and reflected in the resulting *Feedback Statement* ('the *Feedback Statement*'), which was issued in May 2013. Users highlighted that understanding an entity's cash flows is critical to their analysis and that there is a need for improved disclosures about an entity's debt, including changes in debt during the reporting period. The *Feedback Statement* noted that users had been consistently asking for the Board to introduce a requirement for entities to disclose and explain a net debt reconciliation.
- BC10 In early 2014, to understand the reasons for their requests for more disclosure about net debt, the Board undertook a survey of investors. The survey sought information about why investors seek to understand the changes in debt between the beginning and the end of a reporting period. The survey also sought input on disclosures about cash and cash equivalents. On the basis of the survey, the Board identified that investors use a net debt reconciliation in their analysis of the entity:
- (a) to check their understanding of the entity's cash flows, because it provides a reconciliation between the statement of financial position and the statement of cash flows;
  - (b) to improve their confidence in forecasting the entity's future cash flows when they can use a reconciliation to check their understanding of the entity's cash flows;
  - (c) to provide information about the entity's sources of finance and how those sources have been used over time; and
  - (d) to help them understand the entity's exposure to risks associated with financing.
- BC11 The survey helped the Board to understand why investors were calling for improved disclosures about changes in debt during the reporting period. The Board noted that one challenge in responding to this need was that debt is not defined or required to be disclosed in current IFRS Standards. The Board noted that finding a commonly agreed definition of debt would be difficult. However, the Board decided that it could use the definition of financing activities in IAS 7. It therefore decided to propose a requirement to disclose a reconciliation between the amounts in the opening and the amounts in the closing statements of financial position for liabilities for which cash flows were, or future cash flows will be, classified as financing activities in the statement of cash flows.
- BC12 IAS 7 defines financing activities as activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. The Board proposed that a reconciliation of liabilities arising from financing activities would provide the information about debt that users of financial statements were requesting.
- BC13 In December 2014 the Board published an Exposure Draft *Disclosure Initiative* (Proposed amendments to IAS 7) ('the 2014 Exposure Draft') seeking views on the proposals for a reconciliation of liabilities arising from financing activities.

### **Feedback on the proposals set out in the Exposure Draft**

- BC14 The feedback received on the 2014 Exposure Draft provided evidence that the disclosure would provide users of financial statements with the information they were seeking in order to analyse an entity's cash flows. The Board decided to finalise the amendments to IAS 7 ('the 2016 Amendments'); paragraphs BC15–BC24 set out how the Board responded to the feedback received on the 2014 Exposure Draft.

## **The objective of the disclosure**

- BC15 Feedback on the 2014 Exposure Draft noted that the proposal did not set out a disclosure objective, and consequently it was not sufficiently clear how entities would determine the most appropriate way to provide the required disclosure. The Board agreed with this feedback and included an objective within the requirement set out in paragraph 44A of the 2016 Amendments.
- BC16 In setting the disclosure objective the Board decided the objective should reflect the needs of the users of financial statements, including those summarised in paragraph BC10.

## **Application of the 2016 Amendments to financial institutions**

- BC17 Some respondents to the 2014 Exposure Draft from financial institutions stated that the proposals would provide little or no relevant information to users of their financial statements because:
- (a) only some of the sources of finance for a financial institution are classified as 'financing activities' (for example, deposits from customers provide finance but in practice the resulting cash flows are typically classified as operating cash flows). A reconciliation may therefore provide an incomplete picture of the changes in the financing structure of a financial institution; and
- (b) other disclosure requirements (for example, comprehensive regulatory disclosure requirements) may already result in sufficient disclosure about an entity's financing structure.
- BC18 After taking into consideration the feedback from respondents from financial institutions, the Board decided that the disclosure requirement could be satisfied in various ways, and not only by providing a reconciliation. The Board noted that when an entity is considering whether it has fulfilled the disclosure requirement, it should take into consideration:
- (a) the extent to which information about changes in liabilities arising from financing activities provides relevant information to its users, considering the needs of users summarised in paragraph BC10; and
- (b) whether the entity is satisfying the disclosure requirement through other disclosures included in the financial statements.
- BC19 The Board therefore decided that a reconciliation between the opening and closing balances in the statement of financial position for liabilities arising from financing activities is one way to fulfil the disclosure requirement but should not be a mandatory format.

## **Information that supplements the disclosures**

- BC20 Some respondents to the 2014 Exposure Draft expressed a concern that the proposals in the Exposure Draft were too restrictive because, in their view:
- (a) the proposed disclosure would not include liabilities that an entity considers to be sources of finance although the entity does not classify them as financing activities (for example, pension liabilities); and
- (b) entities that already provided a net debt reconciliation (a reconciliation of movements in a net balance comprising debt less cash and cash equivalents) would be prevented from providing such a reconciliation, even if users would find it useful.
- BC21 The Board did not intend to prevent entities from providing information required by paragraph 44A in a format that combines it with information about changes in other assets and liabilities. For example, an entity could provide that information as part of a net debt reconciliation, as described in paragraph BC20(b). To ensure users can identify the information required by paragraph 44A, the format selected needs to distinguish that information from information about changes in other assets and liabilities. In finalising the 2016 Amendments, the Board clarified these points in paragraph 44E.

## **Financial assets**

BC22 Some respondents to the 2014 Exposure Draft asked the Board to clarify whether changes in financial assets held to hedge financial liabilities could also be included in the disclosure required by the 2016 Amendments. The Board noted that paragraph G.2 of the Guidance on implementing IFRS 9 *Financial Instruments* states that cash flows arising from a hedging instrument are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. Consequently, the Board clarified in paragraph 44C that changes in financial assets held to hedge financial liabilities are included in the disclosure required by paragraph 44A.

## **Cost-benefit considerations**

BC23 The Board considered the feedback received on perceived costs and benefits in finalising the 2016 Amendments. The Board noted that there will be initial costs for preparers to update information technology systems to enable changes in liabilities arising from financing activities to be tracked and collated. The Board also acknowledged that disclosing additional information could result in costs relating to extending the existing internal controls and audit processes of the entity. However, the Board noted that much of the information is already available to preparers. It also noted that the 2016 Amendments do not change the recognition or measurement for liabilities arising from financing activities; instead, they track changes in those items. Consequently, the Board concluded that it does not foresee any significant ongoing cost related to providing this information, and that the informational benefits to users of financial statements would outweigh the costs.

## **Illustrative example**

BC24 Some respondents to the 2014 Exposure Draft stated that the example proposed within the Exposure Draft was too simplistic and might not help preparers in disclosing relevant information, because in practice the reconciliation would be more detailed. To address this feedback, the Board inserted a further example in the illustrative examples accompanying IAS 7.

## **Other disclosures**

BC25 To supplement the current disclosure requirements in paragraph 48 of IAS 7 the 2014 Exposure Draft proposed additional disclosure requirements about an entity's liquidity such as restrictions that affect an entity's decision to use cash and cash equivalent balances. However, in the light of the responses, the Board decided that further work is needed before it can determine whether and how to finalise requirements arising from that proposal. The Board decided to continue that work without delaying the improvements to financial reporting that it expects will result from adding paragraphs 44A–44E to IAS 7. The Board may also, in due course, consider adding to its technical work programme a project that would look at liquidity disclosures more broadly.

## **Transition and effective date**

### **Amendments to IAS 7**

BC26 The Board concluded that timely application of the 2016 Amendments would respond to a long-standing request from users of financial statements. Thus, the Board decided that the 2016 Amendments should be applied for annual reporting periods beginning on or after 1 January 2017, with early application permitted.

BC27 Because the 2016 Amendments were issued in January 2016, which is less than one year before the beginning of the period when some entities could be required to apply them, the Board exempted entities from providing comparative information when they first apply the amendments.

## Dissenting opinion

The following contains dissenting opinion to the Amendments to IAS 7 that are not yet effective.

### Dissent of Mr Takatsugu Ochi from *Disclosure Initiative* (Amendments to IAS 7)

- DO1 Mr Ochi voted against the publication of *Disclosure Initiative* (Amendments to IAS 7) (the 2016 Amendments). The reasons for his dissent are set out below.
- DO2 Mr Ochi believes that financial statements that reflect the 2016 Amendments may provide incomplete information about an entity's management of liquidity. The objective of the 2016 Amendments is to require disclosures that enable users to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes. However, Mr Ochi thinks that users of financial statements are seeking clearer information about entities' management of liquidity risk. Consequently, he thinks that the information provided by the 2016 Amendments will not meet users' needs. Mr Ochi thinks that the Board has issued these amendments without setting a clear vision of overall improvements to the disclosure about an entity's liquidity risk management. He thinks that this could confuse and mislead users of financial statements.
- DO3 The objective mentioned in paragraph DO2 refers to liabilities arising from financing activities. Paragraph 44C specifies that those liabilities are liabilities for which cash flows were, or future cash flows will be, classified in the statement of cash flows as cash flows from financing activities. However, Mr Ochi thinks that specifying the scope of the disclosure requirement in this way does not capture the information that users need. This is because changes in liabilities arising from financing activities are different from the information used to assess liquidity risk management. Because IAS 7 permits an entity to classify some cash flows (such as interest payments) as either operating or financing, the understanding of what constitutes changes in liabilities arising from financing activities may vary among preparers. In Mr Ochi's view, preparers may have a more precise understanding about what constitutes information on liquidity risk than simply understanding changes in liabilities arising from financing activities.
- DO4 Mr Ochi also thinks that if an entity provides the disclosures required by paragraph 44A in combination with disclosure of changes in the amount of cash and cash equivalents and does not disclose information about the location and availability of the cash and cash equivalents, the disclosure is sometimes irrelevant to how an entity manages liquidity. If users expect to obtain a full picture of an entity's liquidity risk management as a result of the 2016 Amendments, they may be confused and misled.
- DO5 Mr Ochi thinks that providing the disclosure may require excessive work and hence may be inefficient from a preparer's point of view. He notes that the Board may conduct research regarding the effectiveness of IAS 7. Because he regards IAS 7 as having some significant shortcomings, he believes that issuing amendments based on the existing statement of cash flows is not a worthwhile endeavour. He also thinks that it could reduce the clarity of the statement of cash flows.
- DO6 Mr Ochi also has a significant concern regarding the costs required to prepare the disclosure. Although the 2016 Amendments are disclosure-only amendments, all reporting entities will need to consider providing this disclosure. For this disclosure, an entity may be required to adjust items already presented as operating and financing activities in a statement of cash flows (for example, interest payments that are classified as operating activities), which may require system changes. Concurrently, an entity may also have to initiate system changes to prepare for applying IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* (both effective on 1 January 2018) as well as IFRS 16 *Leases* (effective on 1 January 2019). Mr Ochi believes that the costs that will be incurred by entities as a consequence of those other changes will be considerable and he thinks that this fact is not reflected in the conclusion the Board had reached as a consequence of its assessment of costs pertaining to this disclosure. Taking these matters into consideration, Mr Ochi believes that the costs of the 2016 Amendments will outweigh the benefits.

HKAS 12  
Revised June 2016 August 2017

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*Hong Kong Accounting Standard 12*

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# Income Taxes



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**BASIS FOR CONCLUSIONS**

Hong Kong Accounting Standard 12 *Income Taxes* (HKAS 12) is set out in paragraphs 1-99. All the paragraphs have equal authority. HKAS 12 shall be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

## Introduction

- IN1 HKAS 12 is effective for accounting periods beginning on or after 1 January 2005. The major features of HKAS 12 are as follows.
- IN2 HKAS 12 requires an entity to account for deferred tax using the balance sheet liability method, which focuses on temporary differences. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the statement of financial position. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.
- IN3 HKAS 12 requires an entity to recognise a deferred tax liability or (subject to certain conditions) asset for all temporary differences, with certain exceptions noted below.
- IN4 HKAS 12 requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised. Where an entity has a history of tax losses, the entity recognises a deferred tax asset only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available.
- IN5 As an exception to the general requirement set out in paragraph IN3 above, HKAS 12 prohibits the recognition of deferred tax liabilities and deferred tax assets arising from certain assets or liabilities whose carrying amount differs on initial recognition from their initial tax base.
- IN6 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures ~~arrangements~~, except to the extent that both of the following conditions are satisfied:
- (a) the parent, investor, ~~joint~~ ~~or~~ ~~venturer~~ ~~or~~ joint operator is able to control the timing of the reversal of the temporary difference; and
  - (b) it is probable that the temporary difference will not reverse in the foreseeable future.
- Where this exception has the result that no deferred tax liabilities have been recognised, HKAS 12 requires an entity to disclose the aggregate amount of the temporary differences concerned.
- IN7 HKAS 12 prohibits the recognition of deferred tax liabilities arising from the initial recognition of goodwill.
- IN8 HKAS 12 requires an entity to recognise a deferred tax liability in respect of asset revaluations.
- IN9 The tax consequences of recovering the carrying amount of certain assets or liabilities may depend on the manner of recovery or settlement, for example:
- (a) in certain countries, capital gains are not taxed at the same rate as other taxable income; and
  - (b) in some countries, the amount that is deducted for tax purposes on sale of an asset is greater than the amount that may be deducted as depreciation.
- HKAS 12 requires that the measurement of deferred tax liabilities and deferred tax assets should be based on the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities.
- IN10 HKAS 12 prohibits discounting of deferred tax assets and liabilities.
- IN11 HKAS 12 requires that an entity which makes the current/non-current distinction should not classify deferred tax assets and liabilities as current assets and liabilities.<sup>ψ</sup>

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<sup>ψ</sup> This requirement has been moved to paragraph 56 of HKAS 1 (Revised) *Presentation of Financial Statements*.

- 26 The following are examples of deductible temporary differences that result in deferred tax assets:
- (a) retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the entity or when retirement benefits are paid by the entity. A temporary difference exists between the carrying amount of the liability and its tax base; the tax base of the liability is usually nil. Such a deductible temporary difference results in a deferred tax asset as economic benefits will flow to the entity in the form of a deduction from taxable profits when contributions or retirement benefits are paid;
  - (b) research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset;
  - (c)\* with limited exceptions, an entity recognises the identifiable assets acquired and liabilities assumed in a business combination at their fair values at the acquisition date. When a liability assumed is recognised at the acquisition date but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects goodwill (see paragraph 66); and
  - (d) certain assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes (see paragraph 20). A deductible temporary difference arises if the tax base of the asset exceeds its carrying amount.

**Example illustrating paragraph 26(d)**

Identification of a deductible temporary difference at the end of Year 2:

Entity A purchases for \$1,000, at the beginning of Year 1, a debt instrument with a nominal value of \$1,000 payable on maturity in 5 years with an interest rate of 2% payable at the end of each year. The effective interest rate is 2%. The debt instrument is measured at fair value.

At the end of Year 2, the fair value of the debt instrument has decreased to \$918 as a result of an increase in market interest rates to 5%. It is probable that Entity A will collect all the contractual cash flows if it continues to hold the debt instrument.

Any gains (losses) on the debt instrument are taxable (deductible) only when realised. The gains (losses) arising on the sale or maturity of the debt instrument are calculated for tax purposes as the difference between the amount collected and the original cost of the debt instrument.

Accordingly, the tax base of the debt instrument is its original cost.

The difference between the carrying amount of the debt instrument in Entity A's statement of financial position of \$918 and its tax base of \$1,000 gives rise to a deductible temporary difference of \$82 at the end of Year 2 (see paragraphs 20 and 26(d)), irrespective of whether Entity A expects to recover the carrying amount of the debt instrument by sale or by use, ie by holding it and collecting contractual cash flows, or a combination of both.

This is because deductible temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods, when the carrying amount of the asset or liability is recovered or settled (see paragraph 5). Entity A obtains a deduction equivalent to the tax base of the asset of \$1,000 in determining taxable profit (tax loss) either on sale or on maturity.

\* Amendment effective for annual periods beginning on or after 1 July 2009.

27 The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

27A When an entity assesses whether taxable profits will be available against which it can utilise a deductible temporary difference, it considers whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference. If tax law imposes no such restrictions, an entity assesses a deductible temporary difference in combination with all of its other deductible temporary differences. However, if tax law restricts the utilisation of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type.

28 It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

- (a) in the same period as the expected reversal of the deductible temporary difference; or
- (b) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise.

29 When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:

- (a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity:
  - (i) compares the deductible temporary differences with future taxable profit that excludes tax deductions resulting from the reversal of those deductible temporary differences. This comparison shows the extent to which the future taxable profit is sufficient for the entity to deduct the amounts resulting from the reversal of those deductible temporary differences.
  - (ii) ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilized; ~~or,~~
- (b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

29A The estimate of probable future taxable profit may include the recovery of some of an entity's assets for more than their carrying amount if there is sufficient evidence that it is probable that the entity will achieve this. For example, when an asset is measured at fair value, the entity shall consider whether there is sufficient evidence to conclude that it is probable that the entity will recover the asset for more than its carrying amount. This may be the case, for example, when an entity expects to hold a fixed-rate debt instrument and collect the contractual cash flows.

- 93 Paragraph 68 shall be applied prospectively from the effective date of HKFRS 3 (as revised in 2008) to the recognition of deferred tax assets acquired in business combinations.
- 94 Therefore, entities shall not adjust the accounting for prior business combinations if tax benefits failed to satisfy the criteria for separate recognition as of the acquisition date and are recognised after the acquisition date, unless the benefits are recognised within the measurement period and result from new information about facts and circumstances that existed at the acquisition date. Other tax benefits recognised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).
- 95 HKFRS 3 (as revised in 2008) amended paragraphs 21 and 67 and added paragraphs 32A and 81(j) and (k). An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.
- 96 [Deleted]
- 97 [Deleted]
- 98 Paragraph 52 was renumbered as 51A, paragraph 10 and the examples following paragraph 51A were amended, and paragraphs 51B and 51C and the following example and paragraphs 51D, 51E and 99 were added by *Deferred Tax: Recovery of Underlying Assets*, issued in December 2010. An entity shall apply those amendments for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.
- 98A HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 2, 15, 18(e), 24, 38, 39, 43–45, 81(f), 87 and 87C. An entity shall apply those amendments when it applies HKFRS 11.
- 98B *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 77 and deleted paragraph 77A. An entity shall apply those amendments when it applies HKAS 1 as amended in July 2011.
- 98C *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)), issued in December 2012, amended paragraphs 58 and 68C. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies those amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.
- 98D [Deleted]
- 98E [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]
- 98F [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]
- 98G [This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]
- 98H *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to HKAS 12), issued in January 2016, amended paragraph 29 and added paragraphs 27A, 29A and the example following paragraph 26. An entity shall apply those amendments for annual periods beginning on or after 1 January 2017. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, on initial application of the amendment, the change in the opening equity of the earliest comparative period may be recognised in opening retained earnings (or in another component of equity, as appropriate), without allocating the change between opening retained earnings and other components of equity. If an entity applies this relief, it shall disclose that fact.

## **Withdrawal of HK(SIC)- Int 21**

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- 99 The amendments made by *Deferred Tax: Recovery of Underlying Assets*, issued in December 2010, supersede Hong Kong (SIC) Interpretation 21 *Income Taxes—Recovery of Revalued Non-Depreciable Assets*.

### **Acknowledgement**

**The Hong Kong Institute of Certified Public Accountants is indebted to the Australian Accounting Research Foundation for granting permission to use material from its Standard AASB 1020 "Income taxes" as some of the explanatory guidance and illustrative examples in this Standard.**

On 31 December 20X1 the intrinsic value of the replacement awards is CU120. Entity A recognises a deferred tax asset of CU48 (CU120 × 40%). Entity A recognises deferred tax income of CU16 (CU48 – CU32) from the increase in the intrinsic value of the replacement awards. The accounting entry is as follows:

	<b>CU</b>	<b>CU</b>
Dr Deferred tax asset	16	
Cr Deferred tax income		16

If the replacement awards had not been tax-deductible under current tax law, Entity A would not have recognised a deferred tax asset on the acquisition date. Entity A would have accounted for any subsequent events that result in a tax deduction related to the replacement award in the deferred tax income or expense of the period in which the subsequent event occurred.

Paragraphs B56 – B62 of IFRS 3 provide guidance on determining which portion of a replacement award is part of the consideration transferred in a business combination and which portion is attributable to future service and thus a post-combination remuneration expense. Deferred tax assets and liabilities on replacement awards that are post-combination expenses are accounted for in accordance with the general principles as illustrated in Example 5.

## **Example 7—Debt instruments measured at fair value**

### **Debt instruments**

At 31 December 20X1, Entity Z holds a portfolio of three debt instruments:

<u>Debt Instrument</u>	<u>Cost (CU)</u>	<u>Fair value (CU)</u>	<u>Contractual interest rate</u>
<u>A</u>	<u>2,000,000</u>	<u>1,942,857</u>	<u>2.00%</u>
<u>B</u>	<u>750,000</u>	<u>778,571</u>	<u>9.00%</u>
<u>C</u>	<u>2,000,000</u>	<u>1,961,905</u>	<u>3.00%</u>

Entity Z acquired all the debt instruments on issuance for their nominal value. The terms of the debt instruments require the issuer to pay the nominal value of the debt instruments on their maturity on 31 December 20X2.

Interest is paid at the end of each year at the contractually fixed rate, which equalled the market interest rate when the debt instruments were acquired. At the end of 20X1, the market interest rate is 5 per cent, which has caused the fair value of Debt Instruments A and C to fall below their cost and the fair value of Debt Instrument B to rise above its cost. It is probable that Entity Z will receive all the contractual cash flows if it continues to hold the debt instruments.

At the end of 20X1, Entity Z expects that it will recover the carrying amounts of Debt Instruments A and B through use, ie by continuing to hold them and collecting contractual cash flows, and Debt Instrument C by sale at the beginning of 20X2 for its fair value on 31 December 20X1. It is assumed that no other tax planning opportunity is available to Entity Z that would enable it to sell Debt Instrument B to generate a capital gain against which it could offset the capital loss arising from selling Debt Instrument C.

The debt instruments are measured at fair value through other comprehensive income in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*<sup>¶</sup>).

### **Tax law**

The tax base of the debt instruments is cost, which tax law allows to be offset either on maturity when principal is paid or against the sale proceeds when the debt instruments are sold. Tax law specifies that gains (losses) on the debt instruments are taxable (deductible) only when realised.

Tax law distinguishes ordinary gains and losses from capital gains and losses. Ordinary losses can be offset against both ordinary gains and capital gains. Capital losses can only be offset against capital gains. Capital losses can be carried forward for 5 years and ordinary losses can be carried forward for 20 years.

<sup>¶</sup> IFRS 9 replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

Ordinary gains are taxed at 30 per cent and capital gains are taxed at 10 per cent.

Tax law classifies interest income from the debt instruments as 'ordinary' and gains and losses arising on the sale of the debt instruments as 'capital'. Losses that arise if the issuer of the debt instrument fails to pay the principal on maturity are classified as ordinary by tax law.

## **General**

On 31 December 20X1, Entity Z has, from other sources, taxable temporary differences of CU50,000 and deductible temporary differences of CU430,000, which will reverse in ordinary taxable profit (or ordinary tax loss) in 20X2.

At the end of 20X1, it is probable that Entity Z will report to the tax authorities an ordinary tax loss of CU200,000 for the year 20X2. This tax loss includes all taxable economic benefits and tax deductions for which temporary differences exist on 31 December 20X1 and that are classified as ordinary by tax law. These amounts contribute equally to the loss for the period according to tax law.

Entity Z has no capital gains against which it can utilise capital losses arising in the years 20X1–20X2.

Except for the information given in the previous paragraphs, there is no further information that is relevant to Entity Z's accounting for deferred taxes in the period 20X1–20X2.

## **Temporary differences**

At the end of 20X1, Entity Z identifies the following temporary differences:

	<u>Carrying amount (CU)</u>	<u>Tax base (CU)</u>	<u>Taxable temporary differences (CU)</u>	<u>Deductible temporary differences (CU)</u>
<u>Debt Instrument A</u>	1,942,857	2,000,000		57,143
<u>Debt Instrument B</u>	778,571	750,000	28,571	
<u>Debt Instrument C</u>	1,961,905	2,000,000		38,095
<u>Other sources</u>	Not specified		50,000	430,000

The difference between the carrying amount of an asset or liability and its tax base gives rise to a deductible (taxable) temporary difference (see paragraphs 20 and 26(d) of the Standard). This is because deductible (taxable) temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base, which will result in amounts that are deductible (taxable) in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled (see paragraph 5 of the Standard).

## **Utilisation of deductible temporary differences**

With some exceptions, deferred tax assets arising from deductible temporary differences are recognised to the extent that sufficient future taxable profit will be available against which the deductible temporary differences are utilised (see paragraph 24 of the Standard).

Paragraphs 28–29 of IAS 12 identify the sources of taxable profits against which an entity can utilise deductible temporary differences. They include:

- (a) future reversal of existing taxable temporary differences;
- (b) taxable profit in future periods; and
- (c) tax planning opportunities.

The deductible temporary difference that arises from Debt Instrument C is assessed separately for utilisation. This is because tax law classifies the loss resulting from recovering the carrying amount of Debt Instrument C by sale as capital and allows capital losses to be offset only against capital gains (see paragraph 27A of the Standard).

The separate assessment results in not recognising a deferred tax asset for the deductible temporary difference that arises from Debt Instrument C because Entity Z has no source of taxable profit available that tax law classifies as capital.

In contrast, the deductible temporary difference that arises from Debt Instrument A and other sources are assessed for utilisation in combination with one another. This is because their related tax deductions would be classified as ordinary by tax law.

The tax deductions represented by the deductible temporary differences related to Debt Instrument A are classified as ordinary because the tax law classifies the effect on taxable profit (tax loss) from deducting the tax base on maturity as ordinary.

In assessing the utilisation of deductible temporary differences on 31 December 20X1, the following two steps are performed by Entity Z.

### **Step 1: Utilisation of deductible temporary differences because of the reversal of taxable temporary differences (see paragraph 28 of the Standard)**

Entity Z first assesses the availability of taxable temporary differences as follows:

	<u>(CU)</u>
<u>Expected reversal of deductible temporary differences in 20X2</u>	
<u>From Debt Instrument A</u>	<u>57,143</u>
<u>From other sources</u>	<u>430,000</u>
<u>Total reversal of deductible temporary differences</u>	<u>487,143</u>
<u>Expected reversal of taxable temporary differences in 20X2</u>	
<u>From Debt Instrument B</u>	<u>(28,571)</u>
<u>From other sources</u>	<u>(50,000)</u>
<u>Total reversal of taxable temporary differences</u>	<u>(78,571)</u>
<u>Utilisation because of the reversal of taxable temporary differences (Step 1)</u>	<u>78,571</u>
<u>Remaining deductible temporary differences to be assessed for utilisation in Step 2 (487,143 – 78,571)</u>	<u>408,572</u>

In Step 1, Entity Z can recognise a deferred tax asset in relation to a deductible temporary difference of CU78,571.

### **Step 2: Utilisation of deductible temporary differences because of future taxable profit (see paragraph 29(a) of the Standard)**

In this step, Entity Z assesses the availability of future taxable profit as follows:

	<u>(CU)</u>
<u>Probable future tax profit (loss) in 20X2 (upon which income taxes are payable (recoverable))</u>	<u>(200,000)</u>
<u>Add back: reversal of deductible temporary differences expected to reverse in 20X2</u>	<u>487,143</u>
<u>Less: reversal of taxable temporary differences (utilised in Step 1)</u>	<u>(78,571)</u>

<b><u>Probable taxable profit excluding tax deductions for assessing utilisation of deductible temporary differences in 20X2</u></b>	<u>208,572</u>
Remaining deductible temporary differences to be assessed for utilisation from Step 1	<u>408,572</u>
<b><u>Utilisation because of future taxable profit (Step 2)</u></b>	<u>208,572</u>
Utilisation because of the reversal of taxable temporary differences (Step 1)	<u>78,571</u>
<b><u>Total utilisation of deductible temporary differences</u></b>	<u><u>287,143</u></u>

The tax loss of CU200,000 includes the taxable economic benefit of CU2 million from the collection of the principal of Debt Instrument A and the equivalent tax deduction, because it is probable that Entity Z will recover the debt instrument for more than its carrying amount (see paragraph 29A of the Standard).

The utilisation of deductible temporary differences is not, however, assessed against probable future taxable profit for a period upon which income taxes are payable (see paragraph 5 of the Standard). Instead, the utilisation of deductible temporary differences is assessed against probable future taxable profit that excludes tax deductions resulting from the reversal of deductible temporary differences (see paragraph 29(a) of the Standard). Assessing the utilisation of deductible temporary differences against probable future taxable profits without excluding those deductions would lead to double counting the deductible temporary differences in that assessment.

In Step 2, Entity Z determines that it can recognise a deferred tax asset in relation to a future taxable profit, excluding tax deductions resulting from the reversal of deductible temporary differences, of CU208,572. Consequently, the total utilisation of deductible temporary differences amounts to CU287,143 (CU78,571 (Step 1) + CU208,572 (Step 2)).

### **Measurement of deferred tax assets and deferred tax liabilities**

Entity Z presents the following deferred tax assets and deferred tax liabilities in its financial statements on 31 December 20X1:

	(CU)
<u>Total taxable temporary differences</u>	<u>78,571</u>
<u>Total utilisation of deductible temporary differences</u>	<u>287,143</u>
<u>Deferred tax liabilities (78,571 at 30%)</u>	<u>23,571</u>
<u>Deferred tax assets (287,143 at 30%)</u>	<u>86,143</u>

The deferred tax assets and the deferred tax liabilities are measured using the tax rate for ordinary gains of 30 per cent, in accordance with the expected manner of recovery (settlement) of the underlying assets (liabilities) (see paragraph 51 of the Standard).

### **Allocation of changes in deferred tax assets between profit or loss and other comprehensive income**

Changes in deferred tax that arise from items that are recognised in profit or loss are recognised in profit or loss (see paragraph 58 of the Standard). Changes in deferred tax that arise from items that are recognised in other comprehensive income are recognised in other comprehensive income (see paragraph 61A of the Standard).

Entity Z did not recognise deferred tax assets for all of its deductible temporary differences at 31 December 20X1, and according to tax law all the tax deductions represented by the deductible temporary differences contribute equally to the tax loss for the period. Consequently, the assessment of the utilisation of deductible temporary differences does not specify whether the taxable profits are utilised for deferred tax items that are recognised in profit or loss (ie the deductible temporary differences from other sources) or whether instead the taxable profits are utilised for deferred tax items

that are recognised in other comprehensive income (ie the deductible temporary differences related to debt instruments classified as fair value through other comprehensive income).

For such situations, paragraph 63 of the Standard requires the changes in deferred taxes to be allocated to profit or loss and other comprehensive income on a reasonable pro rata basis or by another method that achieves a more appropriate allocation in the circumstances.

## Basis for Conclusions on IAS 12 *Income Taxes*

*This Basis for Conclusions accompanies, but is not part of, IAS 12.*

HKAS 12 is based on IAS 12 *Income Taxes*. In approving HKAS 12, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 12. Accordingly, there are no significant differences between HKAS 12 and IAS 12. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 12 referred to below generally correspond with those in HKAS 12.

### Introduction

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- BC1 When IAS 12 *Income Taxes* was issued by the International Accounting Standards Committee in 1996 to replace the previous IAS 12 *Accounting for Taxes on Income* (issued in July 1979), the Standard was not accompanied by a Basis for Conclusions. This Basis for Conclusions is not comprehensive. It summarises only the International Accounting Standards Board's considerations in making the amendments to IAS 12 contained in *Deferred Tax: Recovery of Underlying Assets* issued in December 2010. Individual Board members gave greater weight to some factors than to others.
- BC1A In August 2014 the Board published an Exposure Draft of proposed amendments to IAS 12 to clarify the requirements on recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value. The Board subsequently modified and confirmed the proposals and in January 2016 issued *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to IAS 12). The Board's considerations and reasons for its conclusions are discussed in paragraphs BC37–BC62.
- BC2 The Board amended IAS 12 to address an issue that arises when entities apply the measurement principle in IAS 12 to temporary differences relating to investment properties that are measured using the fair value model in IAS 40 *Investment Property*.
- BC3 In March 2009 the Board published an exposure draft, *Income Tax* (the 2009 exposure draft), proposing a new IFRS to replace IAS 12. In the 2009 exposure draft, the Board addressed this issue as part of a broad proposal relating to the determination of tax basis. In October 2009 the Board decided not to proceed with the proposals in the 2009 exposure draft and announced that, together with the US Financial Accounting Standards Board, it aimed to conduct a fundamental review of the accounting for income tax in the future. In the meantime, the Board would address specific significant current practice issues.
- BC4 In September 2010 the Board published proposals for addressing one of those practice issues in an exposure draft *Deferred Tax: Recovery of Underlying Assets* with a 60-day comment period. Although that is shorter than the Board's normal 120-day comment period, the Board concluded that this was justified because the amendments were straightforward and the exposure draft was short. In addition, the amendments were addressing a problem that existed in practice and needed to be solved as soon as possible. The Board considered the comments it received on the exposure draft and in December 2010 issued the amendments to IAS 12. The Board intends to address other practice issues arising from IAS 12 in due course, when other priorities on its agenda permit this.

### Recovery of revalued non-depreciable assets

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- BC5 In December 2010, the Board incorporated in paragraph 51B of IAS 12 the consensus previously contained in SIC Interpretation 21 *Income Taxes—Recovery of Revalued Non-Depreciable Assets*. However, because paragraph 51C addresses investment property carried at fair value, the Board excluded such assets from the scope of paragraph 51B. Paragraphs BC6 and BC7 set out the basis that the Standing Interpretations Committee (SIC) gave for the conclusions it reached in developing the consensus expressed in SIC-21.
- BC6 The SIC noted that the *Framework for the Preparation and Presentation of Financial Statements*\* stated that an entity recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the entity. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered)

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\* IASC's *Framework for the Preparation and Presentation of Financial Statements* was adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistently with this, the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. In other words, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (ie consumed) through use. Deferred taxes associated with the non-depreciable asset reflect the tax consequences of selling the asset.

- BC35 Consequently, the Board concluded that the cost of requiring retrospective application is outweighed by the benefit of consistent application of the amendments by entities to all periods presented in the financial statements. Accordingly, the Board decided that entities should apply the amendments to IAS 12 retrospectively in accordance with IAS 8.

## First-time adoption of IFRSs

- BC36 The Board identified no reason to adjust the exception for application by a first-time adopter at its date of transition to IFRSs.

## **Recognition of Deferred Tax Assets for Unrealised Losses (2016 amendments)**

- BC37 The IFRS Interpretations Committee (the 'Interpretations Committee') was asked to provide guidance on how an entity determines, in accordance with IAS 12, whether to recognise a deferred tax asset when:

- (a) the entity has a debt instrument that is classified as an available-for-sale financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.<sup>8</sup> Changes in the market interest rate result in a decrease in the fair value of the debt instrument to below its cost (ie it has an 'unrealised loss');
- (b) it is probable that the issuer of the debt instrument will make all the contractual payments;
- (c) the tax base of the debt instrument is cost;
- (d) tax law does not allow a loss to be deducted on a debt instrument until the loss is realised for tax purposes;
- (e) the entity has the ability and intention to hold the debt instrument until the unrealised loss reverses (which may be at its maturity);
- (f) tax law distinguishes between capital gains and losses and ordinary income and losses. While capital losses can only be offset against capital gains, ordinary losses can be offset against both capital gains and ordinary income; and
- (g) the entity has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise deductible temporary differences.

- BC38 The Interpretations Committee reported to the Board that practice differed because of divergent views on the following questions:

- (a) Do decreases in the carrying amount of a fixed-rate debt instrument for which the principal is paid on maturity always give rise to a deductible temporary difference if this debt instrument is measured at fair value and if its tax base remains at cost? In particular, do they give rise to a deductible temporary difference if the debt instrument's holder expects to recover the carrying amount of the asset by use, ie continuing to hold it, and if it is probable that the issuer will pay all the contractual cash flows? (see paragraphs BC39–BC45)
- (b) Does an entity assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation if such recovery is probable? This question is relevant when taxable profit from other sources is insufficient for the utilisation of the deductible temporary differences related to debt instruments measured at fair value. In this case, an entity may only be able to recognise deferred tax assets for its deductible temporary differences if it is probable that it will collect the entire cash flows from the debt instrument and therefore recover it for more than its carrying amount. (see paragraphs BC46–BC54)
- (c) When an entity assesses whether it can utilise deductible temporary differences against probable future taxable profit, does that probable future taxable profit include

<sup>8</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. Under IFRS 9, the same question arises for debt instruments measured at fair value.

the effects of reversing deductible temporary differences? (see paragraphs BC55–BC56)

- (d) Does an entity assess whether a deferred tax asset is recognised for each deductible temporary difference separately or in combination with other deductible temporary differences? This question is relevant, for example, when tax law distinguishes capital gains and losses from other taxable gains and losses and capital losses can only be offset against capital gains. (see paragraphs BC57–BC59)

## **Existence of a deductible temporary difference**

- BC39 In the case of many debt instruments, the collection of the principal on maturity does not increase or decrease taxable profit that is reported for tax purposes. This is the case in the example illustrating paragraph 26(d) of IAS 12. Interest is paid at the contractual rate each year, and on maturity of the debt instrument the issuer pays the principal of CU1,000. In this example, if the investor continues to hold the debt instrument, the investor only pays taxes on the interest income. The collection of the principal does not trigger any tax payments.
- BC40 Because the collection of the principal does not increase or decrease the taxable profit that is reported for tax purposes, some thought that the collection of the principal is a non-taxable event. Sometimes, tax law does not explicitly address whether the collection of the principal has tax consequences. Consequently, proponents of this view thought that a difference between the carrying amount of the debt instrument in the statement of financial position and its higher tax base does not give rise to a deductible temporary difference, if this difference results from a loss that they expect will not be realised for tax purposes.
- BC41 Those who held this view thought that the loss would not be realised for tax purposes if the entity has the ability and intention to hold the debt instrument over the period until the loss reverses, which might be until maturity, and it is probable that the entity will receive all the contractual cash flows. In this case, differences between the carrying amount of the debt instrument in the statement of financial position and its tax base reverse over the period to maturity, as a result of continuing to hold the debt instrument.
- BC42 The Board considered the guidance in IAS 12 on the identification of temporary differences and rejected the reasoning presented in paragraphs BC40 and BC41. Paragraphs 20 and 26(d) of IAS 12 specify that a difference between the carrying amount of an asset measured at fair value and its higher tax base gives rise to a deductible temporary difference. This is because the calculation of a temporary difference in IAS 12 is based on the premise that the entity will recover the carrying amount of an asset, and hence economic benefits will flow to the entity in future periods to the extent of the asset's carrying amount at the end of the reporting period. In contrast, the view presented in paragraphs BC40 and BC41 is based on the assessment of the economic benefits that are expected at maturity. The Board noted that the existence of a deductible temporary difference depends solely on a comparison of the carrying amount of an asset and its tax base at the end of the reporting period, and is not affected by possible future changes in the carrying amount.
- BC43 Consequently, the Board concluded that decreases below cost in the carrying amount of a fixed-rate debt instrument measured at fair value for which the tax base remains at cost give rise to a deductible temporary difference. This applies irrespective of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use, ie continuing to hold it, or whether it is probable that the issuer will pay all the contractual cash flows. Normally, the collection of the entire principal does not increase or decrease taxable profit that is reported for tax purposes, because the tax base equals the inflow of taxable economic benefits when the principal is paid. Typically, the tax base of the debt instrument is deducted either on sale or on maturity.
- BC44 The economic benefit embodied in the related deferred tax asset arises from the ability of the holder of the debt instrument to achieve future taxable gains in the amount of the deductible temporary difference without paying taxes on those gains. In contrast, an entity that acquires the debt instrument described in the example illustrating paragraph 26(d) of IAS 12 for its fair value at the end of Year 2 (in the example, CU918) and continues to hold it, has to pay taxes on a gain of CU82, whereas the entity in that example will not pay any taxes on the collection of the CU1,000 of principal. The Board concluded that it was appropriate for the different tax consequences for these two holders of the same instrument to be reflected in the deferred tax accounting for the debt instrument.
- BC45 The Board has added an example after paragraph 26 of IAS 12 to illustrate the identification of a deductible temporary difference in the case of a fixed-rate debt instrument measured at fair value for which the principal is paid on maturity.

## **Recovering an asset for more than its carrying amount**

- BC46 The Board noted that paragraph 29 of IAS 12 identifies taxable profit in future periods as one source of taxable profits against which an entity can utilise deductible temporary differences. Future taxable profit has to be probable to justify the recognition of deferred tax assets.
- BC47 The guidance in paragraph 29 of IAS 12 does not refer to the carrying amount of assets within the context of estimating probable future taxable profit. Some thought, however, that the carrying amount of an asset to which a temporary difference is related limits the estimate of future taxable profit. They argued that accounting for deferred taxes should be based on consistent assumptions, which implies that an entity cannot assume that, for one and the same asset, the entity will recover it:
- (a) for its carrying amount when determining deductible temporary differences and taxable temporary differences; as well as
- (b) for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation.
- BC48 Consequently, proponents of this view thought that an entity cannot assume that it will collect the entire principal of CU1,000 in the example illustrating paragraph 26(d) of IAS 12 when determining probable future taxable profit. Instead, they thought that an entity must assume that it will collect only the carrying amount of the asset.
- BC49 The Board noted however that determining temporary differences and estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation are two separate steps and the carrying amount of an asset is relevant only to determining temporary differences. The carrying amount of an asset does not limit the estimation of probable future taxable profit. In its estimate of probable future taxable profit, an entity includes the probable inflow of taxable economic benefits that results from recovering an asset. This probable inflow of taxable economic benefits may exceed the carrying amount of the asset.
- BC50 Moreover, a limitation on the estimate of probable future taxable profit by the carrying amount of assets can lead to inappropriate results in other scenarios. For example, a significant part of the assets of a profitable manufacturing entity is property, plant and equipment and inventories. Property, plant and equipment may be measured using the cost model (paragraph 30 of IAS 16 *Property, Plant and Equipment*) and inventories are measured at the lower of cost and net realisable value (paragraph 9 of IAS 2 *Inventories*). If such an entity expects to generate future taxable profit, it may be inconsistent to assume that it will only recover these assets for their carrying amount. This is because a significant part of the manufacturing entity's probable future taxable profit results from using those assets to generate taxable profit in excess of their carrying amount.
- BC51 If a limitation such as the one described in paragraph BC50 was made, then, for the purpose of consistency, the entity would need to assume that it will not recover any of its assets for more than their carrying amount. The Board decided that it would not be appropriate to limit the estimate of probable future taxable profit to the carrying amount of related assets only for assets to which temporary differences are related, because there is no basis for a different assessment that would depend on whether a deductible temporary difference is related to an asset or not.
- BC52 Some respondents to the Exposure Draft expressed concern that the guidance might be applied more broadly, and in their view, inappropriately, to other assets, and not merely to debt instruments measured at fair value. Some other respondents were concerned that any guidance would give the false impression that future taxable profit should be estimated on an individual asset basis. The Board noted that the principle that the estimate of probable future taxable profit includes an expected recovery of assets for more than their carrying amounts is not limited to any specific type or class of assets.
- BC53 However, the Board also noted that there are cases in which it may not be probable that an asset will be recovered for more than its carrying amount. An entity should not inappropriately assume that an asset will be recovered for more than its carrying amount. The Board thought that this is particularly important when the asset is measured at fair value. In response to that concern, the Board noted that entities will need to have sufficient evidence on which to base their estimate of probable future taxable profit, including when that estimate involves the recovery of an asset for more than its carrying amount. For example, in the case of a fixed-rate debt instrument measured at fair value, the entity may judge that the contractual nature of future cash flows, as well as the assessment of the likelihood that those contractual cash flows will be received, adequately supports the conclusion that it is probable that it will recover the

fixed-rate debt instrument for more than its carrying amount, if the expected cash flows exceed the debt instrument's carrying amount. The Board thought that such an example could enhance understanding and reduce the risk of arbitrary estimates of future taxable profit.

- BC54 The Board has added paragraph 29A to IAS 12 to clarify to what extent an entity's estimate of future taxable profit (paragraph 29) includes amounts from recovering assets for more than their carrying amounts.

### **Probable future taxable profit against which deductible temporary differences are assessed for utilisation**

- BC55 The Interpretations Committee observed that there is uncertainty about how to determine probable future taxable profit against which deductible temporary differences are assessed for utilisation when this profit is being assessed to determine the recognition of all deferred tax assets. The uncertainty relates to whether the probable future taxable profit should include or exclude deductions that will arise when those deductible temporary differences reverse.

- BC56 The Board noted that deductible temporary differences are utilised by deduction against taxable profit, excluding deductions arising from reversal of those deductible temporary differences. Consequently, taxable profit used for assessing the utilisation of deductible temporary differences is different from taxable profit on which income taxes are payable, as defined in paragraph 5 of IAS 12. If those deductions were not excluded, then they would be counted twice. The Board has amended paragraph 29(a) to clarify this.

### **Combined versus separate assessment**

- BC57 The Board considered the guidance in IAS 12 on the recognition of deferred tax assets. Paragraph 24 of IAS 12 requires deferred tax assets to be recognised only to the extent of probable future taxable profit against which the deductible temporary differences can be utilised. Paragraph 27 explains that:

- (a) the deductible temporary differences are utilised when their reversal results in deductions that are offset against taxable profits of future periods; and
- (b) economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset.

- BC58 The Board noted that:

- (a) tax law determines which deductions are offset against taxable income in determining taxable profits. The Board also noted that paragraph 5 of IAS 12 defines taxable profit as the profit of a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable.
- (b) no deferred tax asset is recognised if the reversal of the deductible temporary difference will not lead to tax deductions.

- BC59 Consequently, if tax law offsets a deduction against taxable income on an entity basis, without segregating deductions from different sources, an entity carries out a combined assessment of all its deductible temporary differences relating to the same taxation authority and the same taxable entity. However, if tax law offsets specific types of losses only against a particular type, or types, of income (for example, if tax law limits the offset of capital losses to capital gains), an entity assesses a deductible temporary difference in combination with other deductible temporary differences of that type(s), but separately from other deductible temporary differences. Segregating deductible temporary differences in accordance with tax law and assessing them on such a basis is necessary to determine whether taxable profits are sufficient to utilise deductible temporary differences. The Board has added paragraph 27A to IAS 12 to clarify this.

### **Transition**

- BC60 The Board decided to require the adjustment of comparative information for any earlier periods presented. However, this amendment allows the change in opening equity of the earliest comparative period presented that arises upon the first application of the amendment to be recognised in opening retained earnings (or in another component of equity, as appropriate), without the need to allocate the change between opening retained earnings and other components of equity. This is to avoid undue cost and effort.

- BC61 The Board noted that, with the exception of the amounts that would have to be adjusted within equity, the accounting required by these amendments is based on amounts and estimates at the end of the reporting periods. The changes to the accounting are mechanical in nature and so the Board expects that the cost of adjusting comparatives should not exceed the benefits of greater comparability.
- BC62 The Board has not added additional transition relief for first-time adopters. This is consistent with the fact that IFRS 1 *First-time Adoption of International Financial Reporting Standards* does not include an exception to, or exemption from, the retrospective application of the requirements in IAS 12.