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Financial Reporting in Hong Kong
Closing out for 2013 Financial Year

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There are many accounting standards that become mandatorily effective for 2013 financial year. This special edition of ***Financial Reporting in Hong Kong*** contains a summary of accounting standards that are mandatorily effective for 2013 financial year. Application of many of these Standards requires significant judgement – how these new Standards are applied by entities for the first time would probably be the area of the regulatory focus when regulators review entities' financial statements.

This newsletter also highlights topical issues taking into account the current economic conditions (e.g. impairment). Impairment would continue to be an area of regulatory focus (in particular, the appropriateness of assumptions and inputs used in determining whether or not impairment is required and if so, the amount of impairment loss).

Recently, the Secretary For Financial Services and the Treasury has appointed 3 March 2014 as the commencement date of the new Companies Ordinance in Hong Kong. This newsletter gives a summary of the new Companies Ordinance.

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Section 1 – Accounting standards that are mandatorily effective for year ended 31 December 2013

Below is an overview of new and revised Hong Kong Financial Reporting Standards (HKFRSs) that are mandatorily effective for the year ended 31 December 2013. The Standards below are effective for annual periods that begin on or after 1 January 2013 (unless specified otherwise).

New and revised HKFRSs on consolidation, joint arrangements, associates and disclosures ('package of five')	**Application**
HKFRS 10 *Consolidated Financial Statements*	Retrospective application, with specific transitional provisions.
HKFRS 11 *Joint Arrangements*	Retrospective application, with specific transitional provisions.
HKFRS 12 *Disclosure of Interests in Other Entities*	Retrospective application, with specific transitional provisions.
Amendments to HKFRS 10, HKFRS 11 and HKFRS 12 *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance*	Retrospective application. The amendments clarify certain transition guidance on the application of HKFRS 10, HKFRS 11 and HKFRS 12 for the first time.
HKAS 27 *Separate Financial Statements* (as revised in 2011)	Retrospective application.
HKAS 28 *Investments in Associates and Joint Ventures* (as revised in 2011)	Retrospective application.

Note: For your information, the effective date of the application of the package of five may not be 1 January 2013 in certain jurisdictions. For example:

- *In European regions where entities apply IFRSs as Adopted for Use in the European Union, the effective date will be annual periods beginning on or after 1 January 2014.*
- *In Singapore where entities apply Financial Reporting Standards issued by the Accounting Standards Council, the effective date will be annual periods beginning on or after 1 January 2014.*
- *In China where entities apply China Accounting Standards, exposure drafts have just been issued.*

New HKFRS on fair value measurement	**Application**
HKFRS 13 *Fair Value Measurement*	Prospective application. The disclosure requirements of HKFRS 13 need not be applied in comparative information provided for periods before initial application of HKFRS 13.
Revised HKFRS on employee benefits	**Application**
HKAS 19 *Employee Benefits* (as revised in 2011)	Retrospective application, with specific transitional provisions.

Amendments to other HKFRSs	Application
Amendments to HKFRS 1 *Government Loans*	Retrospective application.
Amendments to HKFRS 7 *Disclosures - Offsetting Financial Assets and Financial Liabilities*	Retrospective application.
Amendments to HKAS 1 *Presentation of Items of Other Comprehensive Income (effective for annual periods beginning or after 1 July 2012)*	Retrospective application.
Annual Improvements to HKFRSs 2009-2011 Cycle	Retrospective application.

New Interpretation	Application
HK (IFRIC) – Int 20 *Stripping Costs in the Production Phase of a Surface Mine*	This Interpretation should be applied to production stripping costs incurred on or after the beginning of the earliest period presented, with specific transitional provisions.

New and revised HKFRSs on consolidation, joint arrangements, associates and disclosures

In June 2011, the HKICPA issued the 'package of five'. In July 2012, the HKICPA issued amendments to HKFRS 10, HKFRS 11 and HKFRS 12 *Consolidated Financial Statements, Joint Arrangements and Disclosures of Interests in Other Entities: Transition Guidance* to clarify certain transitional guidance on the application of HKFRS 10, HKFRS 11 and HKFRS 12 for the first time.

The table below is a high level summary of the scope of each of the five new and revised Standards.

Old standard	New or revised standard	Issues
HKAS 27 *Consolidated and Separate Financial Statements* that sets out requirements for both consolidated and separate financial statements HK (SIC) – Int 12 *Consolidation – Special Purpose Entities*	HKFRS 10 replaces the part of HKAS 27 that deals with consolidated financial statements and HK (SIC) – Int 12.	Under HKFRS 10, there is only one basis for consolidation for all entities, and that basis is control. This change is to remove the perceived inconsistency between the previous version of HKAS 27 and HK (SIC) – Int 12; the former used a control concept while the latter placed greater emphasis on risks and rewards. Issues dealt with by HKFRS 10 include: • ***When should an investor consolidate an investee?*** Similar to the previous version of HKAS 27, the new Standard uses the concept of control in determining whether an investor needs to consolidate an investee. However, the definition of control under the new Standard has been changed (please see the discussion ***below*** for the new definition of control). • ***How to consolidate a subsidiary?*** Most of the requirements regarding consolidation procedures have been carried forward unchanged from the previous standard. • ***How to account for changes in a parent's interest over its subsidiaries (e.g. 'loss of control' and 'no loss of control' scenarios')?*** Most of the requirements have been carried forward unchanged from the previous Standard.
	HKAS 27 (as revised in 2011) *Separate Financial Statements*	• The revised Standard sets out the requirements regarding separate financial statements only. Most of the requirements in the revised Standard are carried forward

Old standard	New or revised standard	Issues
		unchanged from the previous Standard.
HKAS 31 *Interests in Joint Ventures* HK (SIC)-Int 13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*	HKFRS 11 replaces HKAS 31 and HK (SIC) – Int 13.	• ***Is an investee a joint arrangement within the scope of HKFRS 11?*** The answer depends on whether parties to the arrangement have joint control over the investee. The definition of joint control under the new Standard is the same as the old Standard except that the new definition focuses on 'relevant activities of an investee' rather than just on 'operating and financial activities of the investee'. This is to align with the new definition of control under HKFRS 10. Therefore, when an investor determines whether it shares control over an investee with other parties, it should refer to HKFRS 10 regarding the definition of control. • ***How should a joint arrangement be classified and accounted for?*** HKFRS 11 has two types of joint arrangements which are joint ventures and joint operations (please see the discussion ***below*** for the classification requirements).
HKAS 28 *Investments in Associates*	HKAS 28 (as revised in 2011) *Investments in Associates and Joint Ventures*	• Similar to the previous Standard, the revised Standard deals with how to apply the equity method of accounting. However, the scope of the revised Standard has been changed so that it covers investments in joint ventures as well because HKFRS 11 requires investments in joint ventures to be accounted for using the equity method of accounting.
Various standards	HKFRS 12 *Disclosure of Interests in Other Entities*	• HKFRS 12 is a new disclosure Standard that sets out what entities need to disclose in their annual consolidated financial statements when they have interests in subsidiaries, joint arrangements, associates or unconsolidated structured entities. • HKFRS 12 requires extensive disclosures.

HKFRS 10 Consolidated Financial Statements

New definition of control under HKFRS 10

HKFRS 10 includes a more robust definition of control (compared to the part of HKAS 27 it replaces) in order to address unintentional weaknesses of the definition of control set out in the previous Standard. The definition of control under HKFRS 10 includes the following three elements:

a) power over an investee;
b) exposure, or rights, to variable returns from its involvement with the investee; and
c) ability to use its power over the investee to affect the amount of the investor's returns.

All three elements must be met for an investor to have control over an investee.

With regard to the first criterion (i.e. power over an investee), HKFRS 10 states that an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities of the investee, which are the activities that significantly affect the returns of the investee (not merely financial and operating activities as set out in the previous Standard).

With regard to the second criterion (i.e. exposure or rights), HKFRS 10 requires that, in assessing control, only substantive rights (i.e. rights that the holder has the practical ability to exercise) are considered. For a right to be substantive, the right needs to be currently exercisable at the time when decisions about the relevant activities need to be made.

The application of HKFRS 10 requires significant judgement in a number of areas as follows:

- Identification of an investee's 'relevant activities'. This may be particularly challenging in the context of a 'special purpose entity' that has activities with a limited scope.
- Consideration of whether the investor has the practical ability to exercise a right (i.e. whether the right is substantive), or whether a right is 'protective' (i.e. designed only to protect the interests of the investor, but not to give power over the investee).
- Assessment of whether an investee has the practical ability to direct relevant activities unilaterally even though it does not have the majority of voting rights (this is sometimes referred to as 'de facto control'). On de facto control, HKFRS 10 does not give any bright line – instead, HKFRS 10 includes a number of illustrative examples (e.g. when an investor owns 48% equity interest and voting power of an investee with the remaining 52% widely owned by many unrelated investors, the illustrative example in HKFRS 10 states that it is clear that the investor has de facto control over the investee).
- Determination of whether a decision maker is acting on its own account (as 'principal') or on behalf of another party (as 'agent'). For example, a fund manager manages a fund and has discretion over some activities of the fund. Whether the fund manager has control over the fund requires an analysis to be performed as to whether the fund manager is acting as a principal or an agent. If the fund manager is acting as the principal for the fund it manages, it should consolidate the fund. Conversely, if the fund manager is merely acting as the agent, it should not consolidate the fund.

HKFRS 10 requires investors to make a balanced assessment of all relevant factors and to reassess the conclusion whenever facts and circumstances indicate that there are changes to any element of control, with consolidation of an investee commencing or ceasing whenever control is obtained or lost.

Transitional provisions under HKFRS 10

Specific transitional provisions are given for entities that apply HKFRS 10 for the first time. Specifically, entities are required to make the 'control' assessment in accordance with HKFRS 10 at the date of initial application, which is the beginning of the annual reporting period for which HKFRS 10 is applied for the first time. For example, where an entity applies HKFRS 10 for the first time when it prepares its consolidated financial statements for the year ended 31 December 2013, the date of initial application is 1 January 2013.

No adjustments are required when the 'control' conclusion made at the date of initial application of HKFRS 10 is the same before and after the application of HKFRS 10. However, adjustments are required when the 'control' conclusion made at the date of initial application of HKFRS 10 is different from that before the application of HKFRS 10.

Scenario	Adjustments required
Scenario 1 Investees that were not consolidated under the previous version of HKAS 27/ HK (SIC) – Int 12 will be consolidated under HKFRS 10 (assessment made at the date of initial application of HKFRS 10)	• Identify the date of control in accordance with HKFRS 10 and apply HKFRS 3 as if that investee had been consolidated from that date (and thus had applied acquisition accounting in accordance with HKFRS 3); • When the date of control was determined to be earlier than the beginning of the immediately preceding period[1] (i.e. 1 January 2012 when an entity applies HKFRS 10 for the first time for the year ended 31 December 2013), an entity should make adjustments to equity at the beginning of the immediately preceding period between (a) the amount of assets, liabilities and non-controlling interests recognised and (b) the previous carrying amount of the investor's involvement with the investee; and • Adjust retrospectively the annual period immediately preceding the date of initial application (i.e. 2012 when an entity applies HKFRS 10 for the first time for the year ended 31 December 2013).
Scenario 2 Investees that were consolidated under the previous version of HKAS 27/ HK (SIC) – Int 12 will not be consolidated under HKFRS 10 (assessment made at the date of initial application of HKFRS 10)	• Measure the interest in the investee at the amount at which it would have been measured if the requirements of HKFRS 10 had been applied when the investor became involved with (but did not control in accordance with HKFRS 10); and • Adjust retrospectively the annual period immediately preceding the date of initial application, and make adjustments to equity at the beginning of the immediately preceding period, where appropriate.

HKFRS 11 Joint Arrangements

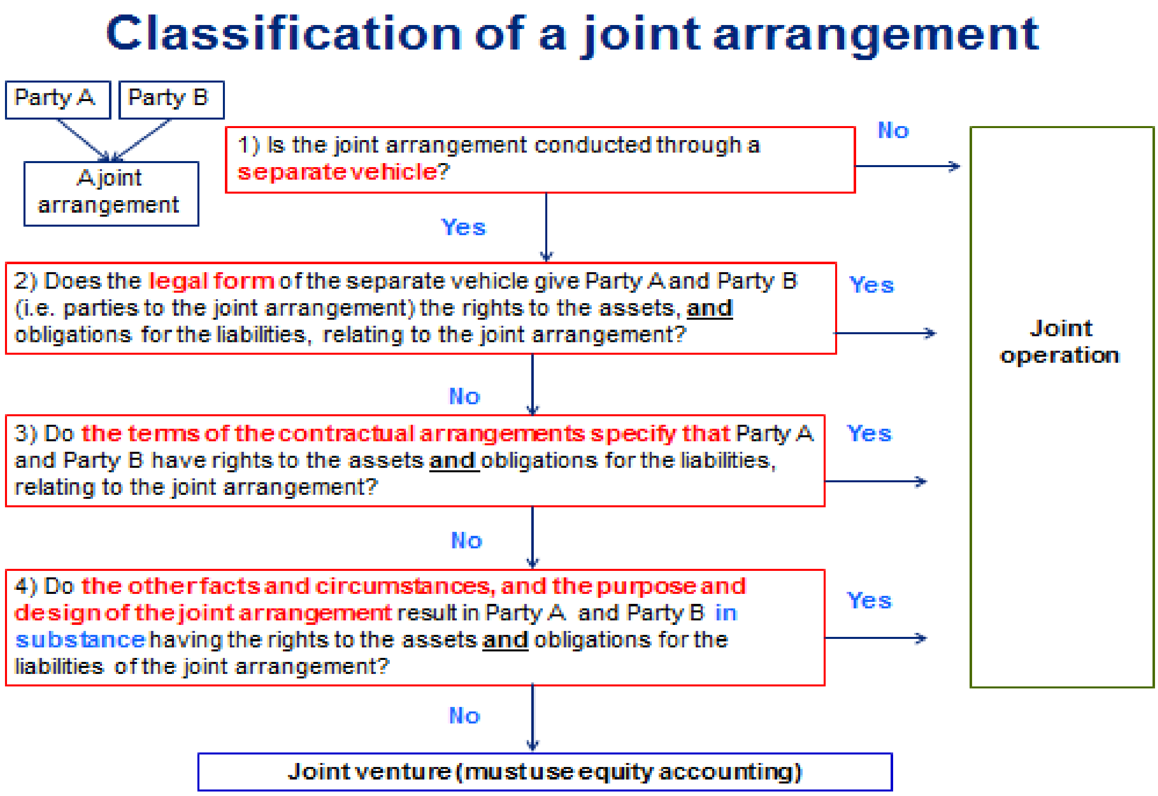
Two types of joint arrangements under HKFRS 11

HKFRS 11 deals with how a joint arrangement should be classified where two or more parties have *joint control*. There are two types of joint arrangements under HKFRS 11: *joint operations* and *joint ventures*. The classification of joint arrangements depends on the parties' rights and obligations under the arrangements.

Type of joint arrangement	Features	Accounting under HKFRS 11
Joint venture	Joint venturers have rights to the *net assets* of the arrangement.	Equity method of accounting –Proportionate consolidation is no longer allowed.
Joint operation	Joint operators have rights to the *assets and* obligations for the *liabilities* of the arrangement.	Each joint operator recognises its assets, liabilities, revenue and expenses, and its share of the assets, liabilities, revenue and expenses relating to its interest in the joint operation in accordance with the HKFRSs applicable to those particular assets, liabilities, revenues and expenses.

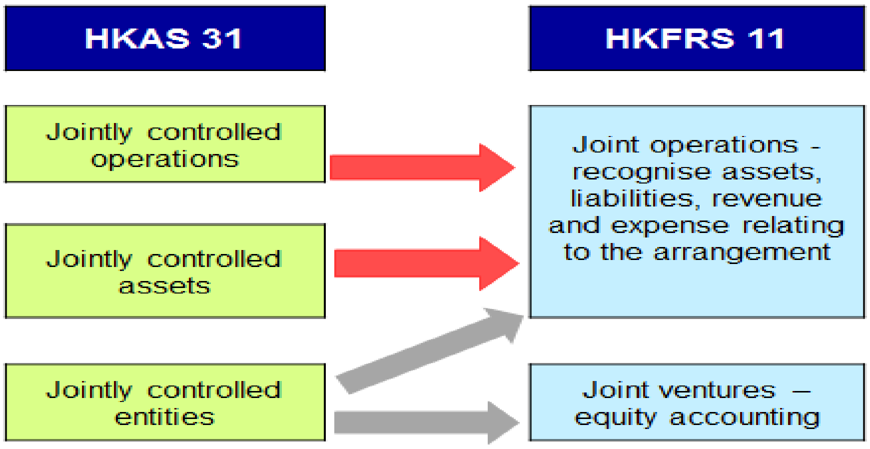
[1] Notwithstanding the references to the 'immediately preceding period' in HKFRS 10.C4–C5A, an entity may also present adjusted comparative information for any earlier periods presented, but is not required to do so. If an entity does present adjusted comparative information for any earlier periods, all references to the 'immediately preceding period' in the said paragraphs should be read as the 'earliest adjusted comparative period presented'.

HKFRS 11 adopts a 4-step approach in determining whether a joint arrangement should be classified as a joint venture or a joint operation (see the decision tree below). This approach is unlike HKAS 31 under which the existence of a separate vehicle is the key determinant to determine whether a joint arrangement should be classified as a jointly controlled entity.



From the decision-tree above, entities are required to take into account not only the legal form of the joint arrangement but also the related contractual arrangements and the specific facts and circumstances (including the purpose and design) to determine how a joint arrangement should be classified under HKFRS 11. Significant effort may be required to accumulate the necessary information and to prepare the analysis.

Upon application of HKFRS 11, the following changes may occur:



Transitional provisions under HKFRS 11

HKFRS 11 requires retrospective application with the following transitional provisions:

Scenario	Adjustments required
Scenario 1 The joint arrangement is a joint venture under HKFRS 11 which was previously treated as a jointly controlled entity and proportionate consolidation was applied	• Recognise the investment in the joint venture as at the beginning of the immediately preceding period (i.e. 1 January 2012 if entities apply HKFRS 11 for the first time for the year ended 31 December 2013) and measure it as the aggregate of the carrying amounts of the assets and liabilities the investor had previously proportionately consolidated, including any goodwill arising from acquisition; • Assess impairment on the initial investment as at the beginning of the immediately preceding period in accordance with paragraphs 40 – 43 of HKAS 28 (as revised in 2011); and • Adjust retrospectively the annual period immediately preceding the date of initial application.
Scenario 2 The joint arrangement is a joint operation under HKFRS 11 which was previously treated as a jointly controlled entity and the equity method of accounting was applied	• Derecognise the investment that was previously accounted for using the equity method of accounting as at the beginning of the immediately preceding period (i.e. 1 January 2012 if entities apply HKFRS 11 for the first time for the year ended 31 December 2013); • Recognise the joint operator's share of each of the assets and the liabilities (including any goodwill) in a specified proportion in accordance with the contractual arrangements as at the beginning of the immediately preceding period; and • Recognise the difference resulting from the above adjustments against goodwill or retained earnings, as appropriate.

HKFRS 12 Disclosure of Interests in Other Entities

HKFRS 12 is a new disclosure Standard that sets out what entities need to disclose in their annual consolidated financial statements when they have interests in subsidiaries, joint arrangements, associates or unconsolidated structured entities (broadly the same as special purpose entities under HK (SIC) – Int 12).

HKFRS 12 aims to provide users of financial statements with information that helps evaluate the nature of, and risks associated with, the reporting entity's interests in other entities, as well as the effects of those interests on the investor's financial statements.

HKFRS 12 requires extensive disclosures. The table below includes some of the new disclosures required by HKFRS 12. Significant effort may be required to accumulate the necessary information for disclosure purposes.

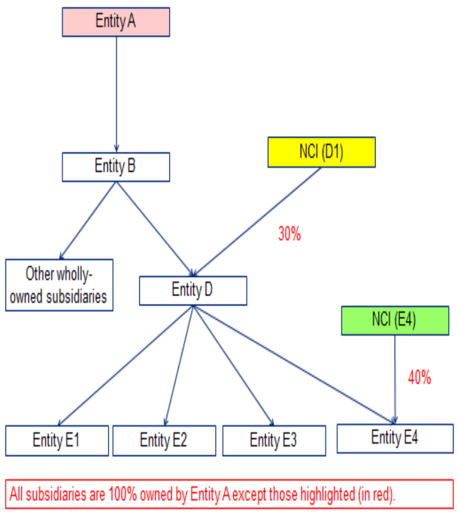
Nature of investment	Some new disclosures required by HKFRS 12
1) Investments in subsidiaries in consolidated financial statements	• Significant judgements and assumptions a reporting entity has made in determining whether or not it has control over an investee. • Information about the composition of the reporting entity group. • Summarised financial information of each subsidiary that has *material NCI to the Group* (extensive disclosures are required (see B10 and B11 of HKFRS 12). See **below** for illustrative examples.
2) Investments in joint arrangements and associates	• Significant judgements and assumptions a reporting entity has made in determining (a) whether or not it has joint control/significant influence over an investee, and (b) how a joint arrangement is classified. • Summarised financial information about each *material* joint venture or associate (extensive disclosures are required (see B12 – B15 of HKFRS 12). • An entity should also disclose, in aggregate, the carrying amount of its interests in all individually immaterial joint ventures or associates that are accounted for using the equity method, with the following information being separately disclosed including a) profit or loss from continuing operations, post-tax profit or loss from discontinued operations, other comprehensive income, and total comprehensive income. • Information about risks associated with the reporting entity's interests in joint ventures and associates.
3) Investments in unconsolidated structured entities	• Information about the nature and extent of the reporting entity's interests in unconsolidated structured entities (e.g. qualitative and quantitative information about the nature, purpose, size, and activities of the structured entity and how the structured entity is financed). • Information about risks associated with the reporting entity's interests in unconsolidated structured entities.

Recently, we have published **Illustrative Annual Financial Statements 2013** that provides illustrative disclosures required by HKFRS 12.

Illustrative examples

As mentioned above, for each subsidiary that has material non-controlling interests (NCI) to the reporting entity, HKFRS 12 requires summarised financial information of that subsidiary to be disclosed. Summarised financial information includes current assets, non-current assets, current liabilities and non-current liabilities, revenue, profit or loss and total comprehensive income as well as cash flows of the subsidiary to enable users to understand the interests that NCI have in the group's activities and cash flows.

Below are examples.

Facts	Is summarised financial information required to be disclosed in the Group's consolidated financial statements? If so, what summarised financial information should be disclosed?
Example 1: Entity A needs to prepare consolidated financial statements Group A has two NCIs (NCI (D1) and NCI (E4)). 	In preparing Entity A's consolidated financial statements, Entity A needs to determine whether NCI (D1) and NCI (E4) are material to the Group. HKFRS 12 does not specify what is meant by 'material'. Nor does it give any bright line as to what is meant by 'material'. Entities should establish their policies and apply them consistently. As an example, Entity A should take into account the followings to determine whether a NCI is material to the Group: a) profit (loss) attributable to the NCI vs profit of the Group; and b) net assets attributable to the NCI vs net assets of the Group. Having compared between profit of sub-group D attributable to NCI (D1) and profit of the Group and net assets of sub-group D attributable to NCI (D1) and net assets of the Group, Entity A concludes that NCI (D1) is material to the Group (for example, sub-group D's profit attributable to NCI (D1) and sub-group D' net assets attributable to NCI (D1) represent more than 10% of the Group's profit and net assets). Entity A concludes that NCI (E4) is not material to the Group as both the profit and net assets attributable to NCI (E4) amount to only 2%. Since NCI (D1) is material to the Group, as a minimum, the following summarised financial statements of sub-group D should be made in the consolidated financial statements of Entity A: • consolidated non-current assets of sub-group D, • consolidated current assets of sub-group D, • consolidated non-current liabilities of sub-group D, • consolidated current liabilities of sub-group D, • consolidated revenue of sub-group D, • consolidated profit or loss of sub-group D; • consolidated total comprehensive income of sub-group D; • Cash flow information of sub-group D (which in our view should include at least information about operating, investing and financing cash flows); • profit or loss allocated to NCI (D1); • accumulated NCI (D1) at the end of the reporting period; and • dividends paid to NCI (D1).
Example 2: Same facts as Example 1, except that Entity A concludes that both NCI (D1) and NCI (E4) are material to the Group.	In addition to the consolidated summarised financial information of sub-group D to be disclosed in the consolidated financial statements of Entity A, Entity A should also disclose a) summarised financial information of E4 in the consolidated financial statements of Entity A and b) the fact that Entity E4 is 60% held by Entity D. .

HKFRS 13 Fair Value Measurement

Key concepts under HKFRS 13

HKFRS 13 establishes a single source of guidance for fair value measurements and disclosures about fair value measurements. HKFRS 13 does not change the requirements regarding which items should be measured or disclosed at fair value.

The scope of HKFRS 13 is broad; it applies to both financial instrument items and non-financial instrument items for which other HKFRSs require or permit fair value measurements and disclosures about fair value measurements, subject to a few exceptions.

HKFRS 13 gives a new definition of fair value for financial reporting purposes. Fair value under HKFRS 13 is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market condition (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.

In applying the new definition of fair value, HKFRS 13 requires the following concepts:

- The unit of account for measuring fair value (i.e., at an individual asset or liability or groups of assets or liabilities level) should be consistent with the unit of account applied by the applicable Standard requiring or permitting the use of fair values. For example, in fair-valuing a financial asset that is measured in accordance with HKAS 39, reference should be made to HKAS 39 to identify the unit of account for fair value measurement purpose.

Unit of account for equity investments

The determination of the unit of account for financial assets that are investments in subsidiaries, joint ventures and associates measured at fair value is currently included as an item on the IASB's work programme, with an exposure draft scheduled for the first quarter of 2014.

This question becomes relevant when such an investment is measured at fair value, for example when the recoverable amount of the investment is estimated based on fair value less costs of disposal for the purposes of impairment testing, and the investee in question has shares quoted in an active market (i.e., with a 'Level 1' price available).

Prior to the conclusion of that IASB project, it is possible to view the unit of account to be the investment as a whole and thus to justify an adjustment to a fair value measurement based on the product of a quoted price per share and the number of shares held (often referred to as 'P x Q') to reflect the premium that would be paid for control, joint control or significant influence over an investee. It should be noted that any such adjustment would be unobservable (i.e., a 'Level 3' input). If significant, this would result in the entire fair value measurement being categorised as 'Level 3' and, therefore, in a requirement to provide the additional disclosures stipulated by IFRS 13 with regard to Level 3 fair value measurement (for example, a description of the valuation process and inputs used and of sensitivity to changes in the unobservable input used).

Other quoted equity investments that are measured at fair value in accordance with either HKFRS 9 or HKAS 39 are not the subject of these discussions. For such assets the unit of account is viewed as the individual share and no adjustment should be made to a 'Level 1' share price.

- For non-financial assets, fair value is based on the 'highest and best use' of that asset, regardless of whether the entity chooses to use the asset in a different way.

> **The highest and best use of a non-financial asset**
>
> The highest and best use of a non-financial asset (e.g. land and buildings and intangible assets etc.) may differ from its current use. For example, in a business combination where the acquiree has an asset that the acquirer does not intend to use (e.g. a patent for a product which the acquirer does not intend to manufacture) it is clear that the fair value of this asset must still reflect the optimal use of the asset by a market participant – it is not appropriate to assign a value of nil due to the acquirer's future intentions.

- 'Non-performance risk' (the risk that a party to the item will not perform under its obligations) must be incorporated into the valuation of both assets and liabilities.

> **Credit risk in derivative valuations**
>
> When determining the fair value of derivatives, it is common for a starting point to be derived based on forecast expected cash flows discounted at a 'risk free' rate. However, to incorporate non-performance risk as required by HKFRS 13, it is necessary to adjust this value to reflect the risk of default by each party to the contract. Such an adjustment may commonly be required to valuations provided by a bank for over the counter (OTC) derivatives as these may not include the effect of non-performance risk.
>
> An adjustment to counterparty credit risk is often referred to as a credit valuation adjustment (CVA), with own credit risk reflected through a debit valuation adjustment (DVA).

- The fair value of a liability is based on the concept of a transfer value, rather than settlement value.
- The valuation assumes that the asset is sold or the liability transferred in the principal (or most advantageous) market to which the entity has access.

Disclosures under HKFRS 13

HKFRS 13 requires ***extensive quantitative*** and ***qualitative*** disclosures about the techniques used to determine fair values and the inputs to those techniques. This includes disclosing the level within the fair value hierarchy within which fair value measurements are categorised.

> **The fair value hierarchy**
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> The fair value hierarchy is not a new concept. It was introduced a few years ago when HKFRS 7 *Financial Instruments: Disclosures* was issued. HKFRS 13 extends the fair value hierarchy requirement to non-financial instruments. Specifically, under HKFRS 13, the fair value hierarchy requirement is applicable to all assets and liabilities that are either measured at fair value or for which fair value is disclosed.
>
> The fair value hierarchy categorises inputs to a valuation based on how observable they are:
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> - Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
>
> - Level 2 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
>
> - Level 3 – Level 3 are unobservable inputs for the asset or liability.
>
> The entire asset or liability is classified at the lowest level of any input that is significant to the measurement of that item.

Level 3 classification does not necessarily mean that the fair value is not reliable – Level 3 classification merely reflects the fact that unobservable data are used in arriving at the fair value.

Additional disclosures on valuation processes and sensitivities to unobservable inputs are required for all assets and liabilities categorised as 'Level 3'.

2013 financial year is the first year in which fair value hierarchy disclosure has to be applied to non-financial instruments (e.g. investment properties). Due to the unique feature of each property, it is ***unlikely*** to categorise the fair value of real estate properties as 'Level 1'. Whether or not the fair value should be classified as 'Level 2' or 'Level 3' would depend on inputs and assumptions used to estimate the fair value.

Below are examples.

- Example 1 – Entity A owns a number of residential apartment units in Sha Tin, Hong Kong. The fair value of each apartment unit is based on the recent transaction prices of similar units in the same block of building or the building nearby (e.g. recent transaction price of HK$ [xx] per square ft. multiplied by [] square ft. of the subject apartment unit.). The recent transaction prices are observable inputs. Where there are no significant adjustments to the observable inputs (i.e. the recent transaction price), the fair value may qualify as 'Level 2' classification. However, where there are no sufficient recent transactions of similar units to justify that there is an active market for the properties, 'Level 2' classification is not appropriate and hence should be classified as 'Level 3' instead.

- Example 2 - Entity A owns a commercial property in Admiralty, Hong Kong (land and the entire block of building) – there are no buy and sell transactions in the market for similar properties. In determining the fair value of the commercial property, Entity A engages a valuer to determine the fair value. The valuer adopts an income capitalisation approach - it estimates the rental income and rental yield with reference to the average rental income / rental yield of commercial properties located in Admiralty and Wan Chai. Given the fact that significant judgement may be involved in arriving at the estimates, the fair value of the commercial building should be categorised as 'Level 3.

Recently, we have published **Illustrative Annual Financial Statements 2013** that provides illustrative disclosures required by HKFRS 13.

HKAS 19 Employee Benefits (as revised in 2011)

HKAS 19 (as revised in 2011) changes the accounting for defined benefit plans and termination benefits. The most significant change relates to the accounting for changes in defined benefit obligations and plan assets. The amendments require the recognition of changes in defined benefit obligations and in the fair value of plan assets when they occur, and hence eliminate the 'corridor approach' permitted under the previous version of HKAS 19 and accelerate the recognition of past service costs. The amendments require all actuarial gains and losses to be recognised immediately through other comprehensive income in order for the net pension asset or liability recognised in the statement of financial position to reflect the full value of the plan deficit or surplus.

Another significant change to HKAS 19 relates to the presentation of changes in defined benefit obligations and plan assets with changes being split into three components:

- Service cost: recognised in profit or loss and includes current and past service cost as well as gains or losses on settlements.
- Net interest: recognised in profit or loss and calculated by applying the discount rate at the beginning of each reporting period to the net defined benefit liability or asset at the beginning of that reporting period, taking into account any changes in the net defined benefit liability (asset) during the period as a result of contribution and benefit payments.
- Remeasurement: recognised in other comprehensive income and comprises actuarial gains and losses on the defined benefit obligation, the excess of the actual return on plan assets over the change in plan assets due to the passage of time, and the changes, if any, due to the impact of the asset ceiling.

As a result, the profit or loss will no longer include an expected return on plan assets; instead, imputed finance income is calculated on the plan assets and is recognised as part of the net interest cost in profit or loss. Any actual return above or below the imputed finance income on plan assets is recognised as part of remeasurement in other comprehensive income.

> **Discount rate**
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> The identification of a suitable high quality corporate bond (HQCB) yield for use in discounting defined benefit obligations has been a challenging issue for some time, particularly in regions such as the Eurozone where the population of AAA and AA-rated bonds fell following the financial crisis. The revised version of HKAS 19 neither changes this concept nor offers additional guidance on how a suitable discount rate may be determined.
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> The IFRS Interpretations Committee has discussed this issue a number of times and in November 2013 issued an agenda decision stating the following:
>
> - 'high quality' as used in paragraph 83 of IAS 19 (which is identical to HKAS 19) reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds;
> - a reduction in the number of HQCB should not result in a change to the concept of high quality;
> - an entity's methods and techniques used for determining the discount rate so as to reflect the yields on HQCB would not be expected to change significantly from period to period;
> - the discount rate applied to a defined benefit obligation is typically a significant actuarial assumption which should be disclosed in accordance with paragraphs 144-145 of IAS 19; and
> - the identification of the HQCB population used as a basis to determine the discount rate requires the use of judgement and may often have a significant effect on the entity's financial statements. This would require disclosure in accordance with paragraph 122 of IAS 1 (which is identical to HKAS 1).

Amendments to HKFRS 1 Government Loans

The amendments provide relief to first-time adopters of HKFRSs by amending HKFRS 1 to allow prospective application of HKAS 39 *Financial Instruments: Recognition and Measurement* or HKFRS 9 *Financial Instruments* and paragraph 10A of HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* to government loans outstanding at the date of transition to HKFRSs.

Amendments to HKFRS 7 Disclosures–Offsetting Financial Assets and Financial Liabilities

HKAS 32 *Financial Instruments: Presentation* requires offsetting of financial assets and financial liabilities when certain criteria are met. The amendments to HKFRS 7 require entities to disclose information about rights of offset and related arrangements (such as collateral posting requirements) for financial instruments under an enforceable master netting agreement or similar arrangement.

Amendments to HKAS 1 Presentation of Items of Other Comprehensive Income

The amendments to HKAS 1 introduce new terminology for the statement of comprehensive income and income statement. Under the amendments to HKAS 1, a statement of comprehensive income is renamed as a statement of profit or loss and other comprehensive income and an income statement is renamed as a statement of profit or loss.

The amendments to HKAS 1 retain the option to present profit or loss and other comprehensive income in either a single statement or in two separate but consecutive statements. However, the amendments to HKAS 1 require additional disclosures to be made in the other comprehensive income section such that items of other comprehensive income are grouped into the following two categories:

- items that will not be reclassified subsequently to profit or loss (e.g. revaluation surplus on property, plant and equipment under HKAS 16 *Property, Plant and Equipment*, and revaluation surplus on intangible assets under HKAS 38 *Intangible Assets*); and
- items that may be reclassified subsequently to profit or loss when specific conditions are met (e.g. fair value changes on available-for-sale investments under HKAS 39, and fair value changes on hedging instruments in cash flow hedges).

Income tax on items of other comprehensive income is required to be allocated on the same basis – the amendments do not change the option to present items of other comprehensive income either before tax or net of tax.

Annual Improvements to HKFRSs 2009 - 2011 Cycle

The Annual Improvements include amendments to 5 HKFRSs, which have been summarised below.

Standard	Subject of amendment	Details
HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*	Repeated application of HKFRS 1	The amendments clarify that an entity may apply HKFRS 1 if its most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with HKFRSs, even if the entity applied HKFRS 1 in the past. An entity that does not elect to apply HKFRS 1 must apply HKFRSs retrospectively as if there was no interruption. An entity should disclose: a) the reason why it stopped applying HKFRSs; b) the reason why it is resuming the application of HKFRSs; and c) the reason why it has elected not to apply HKFRS 1, if applicable.
	Borrowing costs	The amendments clarify that borrowing costs capitalised under previous GAAP before the date of transition to HKFRSs may be carried forward without adjustment to the amount previously capitalised at the transition date. Borrowing costs incurred on or after the date of transition to HKFRSs that relate to qualifying assets under construction at the date of transition should be accounted for in accordance with HKAS 23 *Borrowing Costs*. The amendments also state that a first-time adopter can choose to apply HKAS 23 as of a date earlier than the transition date.
HKAS 1 *Presentation of Financial Statements*	Clarification of the requirements for comparative information	The amendments to HKAS 1 clarify that an entity is required to present a statement of financial position as at the beginning of the preceding period (third statement of financial position) only when the retrospective application of an accounting policy, restatement or reclassification has a material effect on the information in the third statement of financial position and that the related notes are not required to accompany the third statement of financial position. The amendments also clarify that additional comparative information is not necessary for periods beyond the minimum comparative financial statement requirements of HKAS 1. However, if additional comparative information is provided, the information should be presented in accordance with HKFRSs, including related note disclosure of comparative information for any additional statements. Presenting additional comparative information voluntarily would not trigger a requirement to provide a complete set of financial statements. However, the entity should present related note information for those additional statements.

Standard	Subject of amendment	Details
HKAS 16 *Property, Plant and Equipment*	Classification of servicing equipment	The amendments clarify that spare parts, stand-by equipment and servicing equipment should be classified as property, plant and equipment when they meet the definition of property, plant and equipment in HKAS 16 and as inventory otherwise.
HKAS 32 *Financial Instruments: Presentation*	Tax effect of distribution to holders of equity instruments	The amendments clarify that income tax on distributions to holders of an equity instrument and transaction costs of an equity transaction should be accounted for in accordance with HKAS 12 *Income Taxes*.
HKAS 34 *Interim Financial Reporting*	Interim financial reporting and segment information for total assets and liabilities	The amendments clarify that the total assets and total liabilities for a particular reportable segment would be separately disclosed in interim financial reporting only when the amounts are regularly provided to the chief operating decision maker and there has been a material change from the amounts disclosed in the last annual financial statements for that reportable segment.

HK (IFRIC) – Int 20 Stripping Costs in the Production Phase of a Surface Mine

HK (IFRIC) – Int 20 applies to waste removal costs that are incurred in surface mining activity during the production phase of a mine ('production stripping costs'). Under the Interpretation, the costs from this waste removal activity ('stripping') which provide improved access to ore is recognised as a non-current asset ('stripping activity asset') when certain criteria are met, whereas the costs of normal on-going operational stripping activities are accounted for in accordance with HKAS 2 *Inventories*. The stripping activity asset is accounted for as an addition to, or as an enhancement of, an existing asset and classified as tangible or intangible according to the nature of the existing asset of which it forms part.

An entity should apply this Interpretation to production stripping costs incurred on or after the beginning of the earliest period presented. Any previously recognised stripping asset balance should be reclassified as a part of an existing asset to which the stripping activity relates to the extent that there remains an identifiable component of the ore body with which the predecessor stripping asset can be associated. If there is no identifiable component of the ore body to which that predecessor stripping asset relates, it should be recognised in opening retained earnings at the beginning of the earliest period presented.

Section 2 – Accounting standards that allow early application for the year ended 31 December 2013 (not mandatory)

This section covers an overview of new and revised HKFRSs that are not yet mandatorily effective but allow early application for the year ended 31 December 2013. For this purpose, the discussion below reflects a cut-off date of 31 December 2013. When preparing the financial statements for the year ended 31 December 2013, entities should also consider and disclose the potential impact of the application of any new and revised HKFRSs issued by the HKICPA after 31 December 2013 but before the financial statements are authorised for issued.

New HKFRS on financial instruments	**Effective for annual periods beginning on or after**	**Application**
HKFRS 9 *Financial Instruments* (as revised in 2013)	Upon publication of the general hedge accounting element of HKFRS 9, the mandatory effective date of 1 January 20015 has been removed (however, early application is still permitted). HKFRS 9 states that the Standard is available for application. If an entity elects to apply the Standard (with the exception set out in the next paragraph below), it must apply ***all*** the requirements set out in HKFRS 9 at the same time with the statement of the application being disclosed in the notes to the financial statements. An entity may elect to apply the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss without applying the other requirements set out in HKFRS 9.	Retrospective application, with specific transitional provisions.
Amendments to HKAS 39 *Novation of Derivatives and Continuation of Hedge Accounting*	1 January 2014	Retrospective application.

Note: At its November 2013 meeting, the IASB tentatively decided that the mandatory effective date of IFRS 9 (which is identical to HKFRS 9) will be no earlier than annual periods beginning on or after 1 January 2017.

Amendments to other HKFRSs	**Effective for annual periods beginning on or after**	**Application**
Amendments to HKFRS 10, HKFRS 12 and HKAS 27 *Investment Entities*	1 January 2014	Retrospective application, with specific transitional provisions.
Amendments to HKAS 32 *Offsetting Financial Assets and Financial Liabilities*	1 January 2014	Retrospective application.
Amendments to HKAS 36 *Recoverable Amount Disclosures for Non-Financial Assets*	1 January 2014	Retrospective application.
HK (IFRIC) – Int 21 *Levies*	1 January 2014	Retrospective application.

HKFRS 9 Financial Instruments (as revised in 2013)

HKFRS 9 is a new Standard for financial instruments that is ultimately intended to replace HKAS 39 in its entirety.

The replacement project consists of the following three phases:

- Phase 1: Classification and measurement of financial assets and financial liabilities;
- Phase 2: Impairment methodology; and
- Phase 3: Hedge accounting.

Phase 1: Classification and measurement of financial assets and financial liabilities

HKFRS 9 contains new requirements for the classification and measurement of financial assets. Under HKFRS 9, all recognised financial assets that are currently within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement* will be subsequently measured at either amortised cost or fair value. A debt instrument that (i) is held within a business model whose objective is to collect the contractual cash flows and (ii) has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding is generally measured at amortised cost. All other debt instruments must be measured at fair value through profit or loss (FVTPL). A fair value option is available (provided that certain specified conditions are met) as an alternative to amortised cost measurement.

All equity investments within the scope of HKAS 39 are to be measured in the statement of financial position at fair value, with gains and losses recognised in profit or loss except that if an equity investment is not held for trading, an irrevocable election can be made at initial recognition to measure the investment at fair value through other comprehensive income (FVTOCI), with only dividend income generally recognised in profit or loss.

In November 2012, the IASB re-opened for discussion the classification and measurement requirements of financial assets and published an exposure draft proposing limited improvements to IFRS 9, which is identical to HKFRS 9 in all aspects. The exposure draft proposes a new category for debt investments, which is 'fair value through other comprehensive income' when certain criteria are met. The IASB is still in the process of redeliberation and has not yet issued the final amendments at the time of writing.

HKFRS 9 also contains requirements for the classification and measurement of financial liabilities and derecognition requirements. One major change from HKAS 39 relates to the presentation of changes in the fair value of a financial liability designated as at FVTPL attributable to changes in the credit risk of that liability, which changes are presented in other comprehensive income, unless the presentation of the effect of the change in the liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. Changes in fair value attributable to a financial liability's credit risk are not subsequently reclassified to profit or loss. Under HKAS 39, the entire amount of the change in the fair value of the financial liability designated as FVTPL is presented in profit or loss.

Phase 2: Impairment methodology

In March 2013, the IASB issued a revised exposure draft that proposes a more forward-looking impairment model that reflects expected credit losses, as compared to the incurred loss model under IAS 39, which is identical to HKAS 39 in all aspects. The comment period ended on 5 July 2013. The IASB has not yet issued the final amendments at the time of writing. Finalised requirements to be included in IFRS 9 are due in the first half of 2014.

Phase 3: Hedge accounting

In December 2013, the HKICPA issued another revised version of HKFRS 9 that includes Chapter 6 *Hedge Accounting* (which is identical to the revised version of IFRS 9 issued in November 2013 by the IASB).

The principal changes as compared to the general hedge accounting under HKAS 39 are as follows:

- increased eligibility of hedging instruments;
- increased eligibility of hedged items;
- accounting for the time value component of options and forward contracts with less volatility in profit or loss.
- qualifying criteria for applying hedge accounting, HKFRS 9 employs a more principle based approach; and
- modification and discontinuation of hedging relationships.

The IASB's project on macro hedging (now decoupled from IFRS 9) is ongoing, with a discussion paper due early in Q1 of 2014.

Amendments to HKAS 39 Novation of Derivatives and Continuation of Hedge Accounting

The amendments to HKAS 39 provide relief from the requirement to discontinue hedge accounting when a derivative hedging instrument is novated under certain circumstances. The amendments also clarify that any change to the fair value of the derivative hedging instrument arising from the novation should be included in the assessment of hedge effectiveness. The amendments to HKAS 39 are effective for annual periods beginning on or after 1 January 2014. Retrospective application is required.

Amendments to HKFRS 10, HKFRS 12 and HKAS 27 Investment Entities

The amendments to HKFRS 10 introduce an exception from the requirement to consolidate subsidiaries for a parent that meets the definition of an investment entity. In terms of the exception, an investment entity is required to measure its interests in subsidiaries at fair value through profit or loss. The exception does not apply to subsidiaries of investment entities that provide investment-related services.

To qualify as an investment entity, certain criteria have to be met. Specifically, an entity is an investment entity when it:

- obtains funds from one or more investors for the purpose of providing them with professional investment management services;
- commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- measures and evaluates performance of substantially all of its investments on a fair value basis.

Consequential amendments to HKFRS 12 and HKAS 27 have been made to introduce new disclosure requirements for investment entities.

In general, the amendments require retrospective application, with specific transitional provisions.

Amendments to HKAS 32 Offsetting Financial Assets and Financial Liabilities

The amendments to HKAS 32 clarify existing application issues relating to the offsetting requirements. Specifically, the amendments clarify the meaning of ‘currently has a legally enforceable right of set-off’ and ‘simultaneous realisation and settlement’. The amendments to HKAS 32 are effective for annual periods beginning on or after 1 January 2014. Retrospective application is required.

Amendments to HKAS 36 Recoverable Amount Disclosures for Non-Financial Assets

The amendments to HKAS 36 remove the requirement to disclose the recoverable amount of a cash-generating unit (CGU) to which goodwill or other intangible assets with indefinite useful lives had been allocated when there has been no impairment or reversal of impairment of the related CGU. Furthermore, the amendments introduce additional disclosure requirements regarding the fair value hierarchy, key assumptions and valuation techniques used when the recoverable amount of an asset or CGU was determined based on its fair value less costs of disposal. The amendments to HKAS 36 are effective for annual periods beginning on or after 1 January 2014. Retrospective application is required.

HK (IFRIC) – Int 21 Levies

HK (IFRIC) – Int 21 *Levies* addresses the issue of when to recognise a liability to pay a levy. The Interpretation defines a levy, and specifies that the obligating event that gives rise to the liability is the activity that triggers the payment of the levy, as identified by legislation. The Interpretation provides guidance on how different levy arrangements should be accounted for; in particular, it clarifies that neither economic compulsion nor the going concern basis of financial statements preparation implies that an entity has a present obligation to pay a levy that will be triggered by operating in a future period. HK (IFRIC) – Int 21 is effective for annual periods beginning on or after 1 January 2014. Retrospective application is required.

Section 3 – Topical issue: Impairment and related issues

Impairment remains a key area of regulatory focus not only in Hong Kong but also in many countries around the world. Various Standards in the HKFRS bound volume provide specific guidance on impairment assessment. A high-level summary of impairnent and other related issues is as follows:

Items	Applicable HKFRS	Requirement
Inventories	HKAS 2 *Inventories*	HKAS 2 requires inventories to be measured at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.
Non-financial assets (e.g. owned-occupied property, plant and equipment, intangible assets and goodwill)	HKAS 36 *Impairment of Assets*	See below for details.
Financial assets within the scope of HKAS 39 or HKFRS 9 that are not measured at fair value through profit or loss (e.g. loans receivables and equity instruments measured at fair value with changes in fair value being recognised in other comprehensive income)	HKAS 39 or HKFRS 9	See below for details.
Investments in associates and joint ventures	HKAS 39 and HKAS 28	See below for details.
Deferred tax assets arising from deductible temporary differences and tax losses	HKAS 12 *Income Taxes*	Under HKAS 12, a deferred tax asset should be recognised for deductible tempoary differences and tax losses to the extent that it is probable that taxable profit will be available against which the deductible tempoary differences and tax losses can be utilised. Deferred tax assets which were recognised in prior periods may have to be reversed through profit or loss when it is no longer substantiable that it is probable that sufficient taxable profits wil be generated.

Impairment of non-financial assets (e.g. owner-occupied property, plant and equipment, intangible assets and goodwill)

For owner-occupied properties (e.g. a manufacturing plant) and intangible assets with finite lives, they need to be tested for impairment when there is an indication of impairment. HKAS 36.12 sets out a number of external and internal indicators, for example, observable indications that the value of the assets has been dropped, significant adverse changes in the technology, market, economic or legal environment in which the entity operates and asset obsolescence or physical damage etc..

For goodwill and recognised intangible assets with indefinite useful lives, they need to be tested for impairment loss on annual basis, irrespective of whether there is any indication of impairment.

Under HKAS 36, an impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount. The recoverable amount is the higher of the asset's (or cash-generating unit's) fair value less costs of disposal and its 'value in use' (the present value of the future cash flows expected to be derived from an asset or cash-generating unit). Testing for impairment using a value in use approach involves a number of steps, with careful consideration needed at each stage of the process. In particular, preparers should pay special attention to the following areas:

- The appropriate identification of cash-generating units (CGUs). A CGU is the smallest identifable group of assets that generates cash flows that are largely independent of the cash inflows from other assets or groups of assets. Cost-sharing arrangements should not result in the identification of larger CGUs.
- The supportability of cash-flow projections. Cash flow projections and assumptions must be documentated and supported. In particular, when the cash flow projections differ from market expectations about the economy or industry in which the entity operates or when previous forecasts have differed from actual results, it is critical to hav e further analysis as to how the projections can be substantiated.
- The appropriate allocation of goodwill to CGUs or groups of CGUs. Goodwill may be allocated to a group of CGUs, but that group must be the lowest level at which goodwill is monitored for internal management purposes and must not be larger than an operating segment (as defined in HKFRS 8 *Operating Segments*) before any aggregation is applied for disclosure of segment information. It is also important to remember that such an allocation does not mean that individual CGUs within that group no longer exist, in fact if there are indicators of an impairment at a CGU level IAS 36 requires a two-step approach, with the carrying amount of each CGU compared to its recoverable amount before the goodwill is added and the group of CGUs is tested again.
- The consistency of projections with forecasts used for impairment assessment in the prior period. If there are significant unfavourable variances between the actual results and forecasts made in prior year, it may indicate that the asset or CGU does not function as expected and hence there may be additional impairment to be recognised for the current period.
- The consistency of projections with forecasts used for other purposes (e.g. internal reports to key management personnel or external reports provided to existing or potential investors).
- The appropriateness of long-term growth and discount rates applied to the forecast cash flows. Application of the entity's overall weighted average cost of capital (WACC) to all CGUs (or groups of CGUs) may not be appropriate when the entity operates in a number of different markets. HKAS 36 specifically mentions country risk in this context and this might be a significant consideration in the current economic environment as some economies show signs of growth whilst others continue to struggle.
- The use of pre-tax discount rate to determine the asset's or CGU's value in use. HKAS 36 emphasises that the discount rate should be a pre-tax rate. Similarly, cash-flow projections should not include any income tax payments or receipts.
- The inclusion of goodwill in the functional currency of the foreign operation. HKAS 21 states that any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation should be treated as assets and liabilities of the foreign operation and hence should be expressed in the functional currency of the foreign operation. For impairment assessment purposes, goodwill should be included in the functional currency currency of the foreign operation.

Impairment of financial assets

Financial assets that not measured at fair value through profit or loss need to be considered for impairment in a different way to non-financial assets. The requirements of HKAS 39 (or, when applied, HKFRS 9) need to be considered carefully.

- It is important to remember that equity investments classified as available-for-sale (AFS) under HKAS 39 must be assessed for impairment at an *individual level*, rather than as part of a portfolio. Accordingly, entities will need to apply a *consistent* accounting policy to determine whether a fall in the value of an investment is 'significant' or 'prolonged' and, therefore, whether the investment is impaired.

The observations of the IFRS Interpretations Committee made in respect of this requirement in July 2009 remain valid, namely:

- that a fall in value that is *either* significant *or* prolonged results in an impairment, the standard cannot be read to mean that both are required;
- a fall in value is assessed in absolute terms, a decline being in line with a general fall in market values does not make it any less significant;
- a forecast recovery of value is not a relevant factor; and
- foreign currency denominated equity securities should be assessed for impairment in the entity's functional currency, not in the currency of the equity.

- Assets measured at amortised cost (e.g. loans receivables) should be assessed for the occurrence of events indicating that a loss has been incurred, including:

  - significant financial difficulty of the issuer or obligor;
  - a breach of contract, such as a default or delinquency in interest or principal payments;
  - it becoming probable that the borrower will enter bankruptcy or other financial reorganisation; and
  - the disappearance of an active market for that financial asset because of financial difficulties.

- Investments in subsidiaries, associates and joint ventures are only subject to the impairment requirements of HKAS 39 when they are accounted for using that standard (e.g. when an investor is preparing its separate financial statements).

Impairment of investments in associates and joint ventures

For investments in associates and joint venture that are accounted for using the equity method in accordance with HKAS 28, HKAS 28 requires entities to apply HKAS 39 to determine whether there are any impairment indicators.

Where there is an impairment indicator, impairment assessment needs to be performed. Consistent with HKAS 36, impairment loss should be quantified by comparing between the entire investment's carrying amount (including goodwill) and the investment's recoverable amount which is the higher of value in use and fair value less costs to sell. HKAS 28 contains specific guidance on how to determine the value in use of an investment in associate or a joint venture, which is as follows:

- an investor's share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds from the ultimate disposal of the investment; or
- the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Impairment disclosures

Informative disclosures are critical in providing users with an appropriate understanding of the judgements made in determining whether assets, financial or non-financial, are impaired and this has been an area of focus for regulators.

HKAS 36 and HKFRS 7 include detailed disclosure requirements for non-financial and financial assets respectively. It is important to give due focus to those that are intended to provide users with insight into the exercise undertaken and the key assumptions and judgements made. Regulators have indicated a particular focus on:

- the requirement in paragraph 134(d) of HKAS 36 to describe the approach taken to determine the key assumptions used in a value in use calculation (including the period over which cash flows have been projected based on forecasts approved by management, the long-term growth rate applied beyond that period and the discount rate applied to forecast cash flows);
- the requirement in paragraph 134(f) of HKAS 36 to provide a sensitivity analysis if a reasonably possible change in a key assumption would result in an impairment (such an assumption could be, for example, the margin achieved on sales as well as revenue growth or discount rate); and

- the requirements of HKFRS 7 to disclose information about the credit quality of assets that are neither past due nor impaired and the factors considered in determining that financial assets are impaired.

Disclosures should be made to reflect the specific facts and circumstances. 'Boilerplate' dislcosures that do not reflect the specific facts and circumstances of the entity are not appropriate.

Reversal of impairment of non-financial assets

Firstly, and most simply, it should be remembered that HKFRSs do not permit the reversal of an impairment of goodwill to be recognised under any circumstances.

In contrast, impairments of other non-financial assets within the scope of HKAS 36 are reversed when there is objective evidence that the previously recognised impairment loss has decreased. Indicators of such a decrease mirror the indicators for impairment stated by HKAS 36 but it is not necessary for an indicator of reversal to be the mirror of the indicator that led to the initial impairment. It is important to note that reversal of an impairment loss does not arise simply due to the passage of time resulting in the discounted value of future cash inflows increasing. An increase in those cash inflows (due to improved revenue forecasts), reduced forecast cash outflows (due to, for example, revised actuarial assumptions applied to a defined benefit obligation) or a decrease in the discount rate to be applied is necessary.

Once a possible reversal has been identified, a test of the asset (or CGU’s) recoverable amount is conducted in the same way as for an impairment review and any reversal recognised accordingly. Reversal of impairment can only increase the carrying amount of an asset to the value it would have had absent the original impairment, taking into account any additional depreciation or amortisation that would have been recognised without the original impairment.

Reversal of impairment of financial assets

In respect of reversal of impairment, equity investments classified as AFS are similar to goodwill in that reversal is not permitted. Subsequent to an impairment loss, any increase in value is recognised in other comprehensive income (OCI), not in profit or loss.

Impairments of AFS debt investments and of assets measured at amortised cost should be reversed through profit or loss account if an increase in value (for an AFS investment) or decrease in impairment loss (for an asset measured at amortised cost) can be related objectively to an event that occurred after the impairment was recognised.

Similar to non-financial assets, reversal of impairment of a financial asset cannot result in the entity making a ‘net profit’. Reversal of impairment of an AFS debt instrument recognised in profit or loss is limited to the impairment previously recognised in profit or loss. Similarly, reversal of impairment of an asset measured at amortised cost cannot result in the carrying amount of the asset exceeding its value had the impairment not occurred.

Presentation of impairment reversals

In addition to the recognition and measurement of impairment reversals, it is important to consider their presentation in profit or loss. This presentation would usually be expected to be in the same line in profit or loss as the original impairment.

Section 4 New Companies Ordinance in Hong Kong

Recently, the Secretary for Financial Services and the Treasury has appointed 3 March 2014 as the commencement date of the new Companies Ordinance (Chapter 622 of the Laws of Hong Kong) ("the new CO") and the subsidiary legislation. The new CO is a completely new Ordinance – it will come into operation on 3 March 2014 and will supersede most of the requirements set out in the existing Companies Ordinance (Cap 32).

Schedule 11 of the new CO contains specific transitional provisions to ensure smooth transition from the existing Companies Ordinance (Cap 32) to the new CO.

The new CO, which consists of more than 900 sections and 11 schedules, provides a modernised legal framework for the incorporation and operation of companies in Hong Kong. It aims to achieve four main objectives, namely, to a) enhance corporate governance, b) ensure better regulations, c) facilitate business and d) modernise the law.

Specifically, the new CO is divided into 21 parts as follows:

- **Part 1 (Preliminary)** sets out the title of the new CO, the commencement provision, and the definitions of various terms and expressions that are used in the new CO.

- **Part 2 (Registrar of Companies and Companies Register)** deals with the general functions and powers of the Registrar of Companies (“the Registrar”).

- **Part 3 (Company Formation and Related Matters, and Re-registration of Company)** deals with company formation, registration and related matters.

- **Part 4 (Share Capital)** deals with the core concepts about share capital, its creation, transfer and alteration. In particular, this Part introduces a mandatory no-par regime for all companies with a share capital to modernise the share capital regime.

- **Part 5 (Transactions in relation to Share Capital)** contains the provisions concerning capital maintenance (reduction of capital and purchase of a company’s own shares) and the giving of financial assistance by a company to another party for the purpose of acquiring shares of that company or its holding company. To facilitate business operation, this Part streamlines and rationalises the existing rules by introducing new exceptions based on the solvency test for reduction of capital, buy-backs and financial assistance.

- **Part 6 (Distribution of Profits and Assets)** deals with the distribution of profits and assets to members. The usual form of distribution is through payment of dividends. While there is no fundamental change to the current rules, the modernised language should facilitate easier understanding.

- **Part 7 (Debentures)** deals with a miscellany of matters concerning debentures.

- **Part 8 (Registration of Charges)** deals with the registration of charges by both Hong Kong and registered non-Hong Kong companies. It sets out the types of charges which require registration, the registration procedures and the consequences of non-compliance.

- **Part 9 (Accounts and Audit)** contains the accounting and auditing provisions in relation to the keeping of accounting records, the preparation and circulation of annual financial statements, directors’ and auditor’s reports and the appointment and rights of auditors. New provisions are introduced to facilitate small and medium-sized entities (SMEs) to take advantage of simplified accounting and reporting requirements, to require public and large companies to include an analytical business review in directors’ reports, and to enhance auditors’ right to information.

- **Part 10 (Directors and Company Secretaries)** deals with directors and company secretaries of a company. It mainly reorganises, with some modifications, the existing provisions of the Companies Ordinance (Cap. 32) relating to the appointment, removal and resignation of directors and company secretaries. This Part also clarifies the standard of directors’ duty of care, skill and diligence.

- **Part 11 (Fair Dealing by Directors)** covers fair dealing by directors and deals with specified situations in which a director is perceived to have a conflict of interest.

- **Part 12 (Company Administration and Procedure)** governs resolutions and meetings, registers (including registers of members, directors and company secretaries), company records, registered offices, publication of company names and annual returns.

- **Part 13 (Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back)** restates, with some amendments, the provisions of Companies Ordinance (Cap.32) concerning schemes of arrangement, reconstructions or amalgamations of a company with other companies, and compulsory acquisitions.

- **Part 14 (Remedies for Protection of Companies' or Member's' Interests)** consolidates the existing provisions concerning shareholder remedies under the Companies Ordinance (Cap. 32). The scope and operation of the unfair prejudice remedy are refined.

- **Part 15 (Dissolution by Striking Off or Deregistration)** sets out the provisions on striking off and deregistration of defunct companies, restoration of companies that have been struck off or deregistered, and related matters (including treatment of properties of dissolved companies). It introduces changes which streamline the existing procedures for striking-off and restoration of companies. This Part also imposes new requirements to prevent any possible abuse of the deregistration procedure.

- **Part 16 (Non-Hong Kong Companies)** deals with companies incorporated outside Hong Kong which have established a place of business in Hong Kong. There is no fundamental change to the current rules.

- **Part 17 (Companies Not Formed, but Registrable, under this Ordinance)** deals with companies not formed under the new CO or a former Companies Ordinance but are eligible to be registered under the new CO. There is no fundamental change to the current rules.

- **Part 18 (Communications to and by Companies)** builds on the rules governing communications by a company to another person introduced in the Companies (Amendment) Ordinance 2010. The new rules will also facilitate electronic communications by a company's members and debenture holders to the company.

- **Part 19 (Investigations and Enquiries)** deals with investigations and enquiries into a company's affairs by inspectors and the Financial Secretary.

- **Part 20 (Miscellaneous)** contains a number of miscellaneous provisions, including miscellaneous offences and the new power for the Registrar to compound specified offences.

- **Part 21 (Consequential Amendments, and Transitional and Saving Provisions)** deals with the transitional and saving provisions and consequential amendments that are required for the commencement of the new CO.

Part 9 of the new CO – Accounts and audits

Part 9 of the new CO contains the accounting and auditing requirements, namely provisions in relation to the keeping of accounting records, the preparation and circulation of annual financial statements, directors' and auditors' reports and the appointment and rights of auditors. New provisions are introduced:

- to facilitate SMEs to take advantage of simplified accounting and reporting;
- to require public and other large companies to include an analytical business review in directors' reports; and
- to enhance auditors' right to information.

Based on section 358 of the new CO, the requirements of Part 9 with regard to the preparation of audited annual reports by companies are effective only for financial year beginning on or after the commencement date of the new CO (i.e. 3 March 2014). For example, for March-year end companies, the requirements set out in Part 9 of the new CO will be applicable since the year ending 31 March 2015. For December-year end companies, the requirements set out in Part 9 of the new CO will be applicable since the year ending 31 December 15.

Below is a summary of Part 9.

Relaxing the criteria for SMEs to prepare simplified financial and directors' reports i.e. the "reporting exemption"

Section 141D of the Companies Ordinance (Cap. 32) provides that a private company (other than a company which is a member of a corporate group and certain companies specifically excluded, such as insurance and stock-broking companies) may, with the written agreement of all its shareholders, prepare simplified accounts and simplified directors' reports in respect of one financial year at a time. According to the Small and Medium-sized Entity-Financial Reporting Framework ("SME-FRF") issued by the HKICPA, a Hong Kong company qualifies for reporting based on the SME-Financial Reporting Standard ("SME-FRS") if it satisfies the requirement under section 141D.

The new CO allows private companies and groups of private companies meeting certain size criteria to report under the SME-FRF.

Companies which qualify for simplified reporting are referred to in the new CO as companies "falling within the reporting exemption". The reporting exemptions are in respect of the specific requirements relating to the preparation of financial statements and directors' reports. The exemptions are set out in the following sections:

- **Section 380(3)** no requirement to disclose auditor's remuneration in financial statements.
- **Section 380(7**) no requirement for financial statements to give a "true and fair view".
- **Section 381(2**) subsidiary undertakings may be excluded from consolidated financial statements in accordance with applicable accounting standards.
- **Section 388(3)(a)** no requirement to include business review in directors' report.
- **Section 406(1)(b)** no requirement for auditor to express a "true and fair view" opinion on the financial statements.

Audit of the financial statements is still required for all companies, except dormant companies (section 447), under the new CO.

In August 2013, the HKICPA issued a Consultation Draft on SME-FRF & SME-FRS, with a comment deadline of 25 October 2013.

Below is a summary of the main changes proposed in the Consultation Draft as compared to the existing Standard:

- Inclusion of a summary of the criteria for "qualifying entities" with cross-references to the new CO;
- The accounting requirements are expanded to cover consolidated financial statements, business combinations and investments in other entities accounted for by application of the equity-method;
- Guidance on presenting a cash flow statement has been included – the preparation of a cash flow statement is optional. However, if a cash flow statement is presented then this guidance should be followed;
- Additional guidance material has been added on the non-exempt disclosure requirements in the new CO and certain other provisions of the new CO which are relevant to the SME-FRF & SME-FRS;
- Guidance has been added on the concept of "realized profits and losses" and the relationship between these and "recognised profits and losses" reported under the SME-FRS;
- Specific disclosure requirements have been added to the SME-FRF to cover the first year that a company transitions from e.g. full HKFRSs to SME-FRS;
- Additional disclosure requirements have been added to the Income Taxes section to disclose tax rates and unused tax losses;

- New guidance has been added on determining the "reporting currency" of an entity (which is based on the concept of functional currency in full HKFRSs);

- The definition of "related party" has been updated to align with the latest definition in full HKFRSs;

- The definitions of "active market" and "fair value" have been updated to be consistent with HKFRS 13 *Fair Value Measurement*;

- Guidance on determining whether an entity is acting as an agent or principal has been added to the appendix; and

- Some minor housekeeping has been done on the other parts of the SME-FRS (for example definitions added to the glossary that were previously only in the text, and other inconsistencies removed).

At the time of writing, the HKICPA has not yet issued a revised version of SME-FRF & SME-FRS.

Requiring public companies and other companies that do not qualify for simplified reporting to prepare a "business review" within the directors' report

Under the new CO, all companies (except those qualified for simplified reporting) are required to prepare, as part of the directors' report, a business review which is more analytical and forward-looking than the information required under Companies Ordinance (Cap. 32). Private companies not qualified for simplified reporting may opt out of the requirement to prepare a business review if so approved by a special resolution.

The business review will provide additional information for shareholders and help assess how the directors have performed their duties. In particular, the requirement to include information relating to environmental and employee matters that have a significant impact on the company is in line with international trends to promote corporate social responsibility.

Section 388 and Schedule 5 of the new CO provide for the directors' duty to prepare a directors' report and the detailed requirements of a business review. The business review consists of:

- a fair review of the company's business;
- a description of the principal risks and uncertainties facing the company;
- particulars of important events affecting the company that have occurred since the end of the financial year; and
- an indication of likely future development in the company's business.

To the extent necessary for an understanding of the development, performance or position of the company's business, a business review must include:

- an analysis using financial key performance indicators;
- a discussion on the company's environmental policies and performance and the company's compliance with the relevant laws and regulations that have a significant impact on the company; and
- an account of the company's key relationships with its employees, customers and suppliers and others that have a significant impact on the company on which the company's success depends.

The HKICPA will soon issue an exposure draft *Accounting Bulletin 5 Guidance for the Preparation of a Business Review under the Hong Kong Companies Ordinance for public comment* that aims to provide guidance on how to prepare a business review required by the new CO.

Streamlining disclosure requirements that overlap with the accounting standards

Under the new CO, to avoid any potential conflict between the Tenth Schedule under the Companies Ordinance (Cap. 32) and HKFRSs and between the Eleventh Schedule and SME-FRS, both Schedules are repealed, with only a small number of public interest disclosure requirements not covered by the HKFRSs or SME-FRS being retained in Schedule 4 of the new CO.

Schedule 4 includes the following public interest disclosures:

a) the aggregate amount of any outstanding loans to directors and employees to acquire shares in the company authorized under sections 280 and 281 of the new CO;
b) information regarding a company's ultimate parent undertaking; and
c) auditors' remuneration (applicable to companies not qualified for simplified reporting, required under paragraph 15 of the Tenth Schedule to Cap. 32).

In addition, Schedule 4 of the new CO requires a statement to be made in the financial statements as to whether they have been prepared in accordance with the applicable accounting standards, and to give the particulars of, and the reasons for, any material departure from those standards.

The new CO and related information is available at http://www.cr.gov.hk/en/companies_ordinance/.

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