

profit and loss account (and, where appropriate, group accounts) together with accompanying notes thereto.

Details of the matters on which auditors are required to report are set out in **chapter 56** of this book.

In carrying out their duties, auditors have a right of access at all times to the books, accounts and vouchers of the company, and are entitled to require such information and explanations as they think necessary from the officers of the company. [s 141(5)]

The auditors of a company are entitled to attend any general meeting of the company and to receive all notices of, and other communications relating to, any general meeting which any member of the company is entitled to receive. Auditors are also entitled to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors. [s 141(7)]

2.2.4.3 Resignation and removal

An auditor may resign from office at any time by notice in writing to the registered office of the company. [s 140A(1)] This notice must include a statement to the effect that there are no circumstances in connection with the auditor's resignation that should be brought to the notice of the members or creditors of the company or, where there are such circumstances, a statement of any such circumstances. The company must send a copy of this notice to the Registrar of Companies (Registrar) and, if it includes a statement setting out any circumstances connected with the resignation, a copy must also be sent to every person entitled to receive a copy of the auditor's report. [s 140A(3)] The auditors in these circumstances also have the right to request an extraordinary general meeting to consider the circumstances surrounding the resignation. [s 140B(1)]

An auditor may also be removed from office at any time before the expiration of his term, and notwithstanding any agreed term under his appointment, by the passing of an ordinary resolution by the members. [s 131(6)] When a public company passes such a resolution to remove an auditor, it must notify the Registrar within 14 days. An auditor who has been removed is entitled to attend and be heard at the annual general meeting at which his term of office would otherwise have expired, as well as any general meeting at which it is proposed to fill the vacancy caused by his removal. [s 132(6)]

The directors, or the company in general meeting, may appoint an auditor to fill a casual vacancy where one arises as a result of a resignation or removal before the end of the auditor's period of office. [s 131(5)]

2.2.5 Dissolution

A company may be dissolved in a number of ways:

- striking off the name from the register of companies;
- deregistration;
- on completion of a winding-up; and
- by order of the court.

2.2.5.1 Striking off

The Registrar may strike the name of a company off the register of companies and arrange for its dissolution in either of the following circumstances:

- when the Registrar has reasonable cause to believe that the company is not carrying on business or in operation [s 291]; or
- when the Registrar has reasonable cause to believe that the company is keeping a register of members at any place outside Hong Kong without a valid licence. [s 103]

2.2.5.2 Deregistration

An application for the deregistration of a private company may be made to the Registrar by the company or a director or member of the company. [s 291AA] Such an application can only be made if all of the following conditions are met:

- all of the members agree;
- the company has never commenced operations, or it ceased operations more than three months before the application; and
- the company has no outstanding liabilities.

The application for deregistration must be in the specified form and must be accompanied by a notice from the Commissioner of Inland Revenue that he has no objection to the deregistration. The Registrar will publish a notice stating that, unless an objection is received within three months, the Registrar may deregister the company and dissolve it. If, at the end of three months, the Registrar has received no objection, he may deregister the company by publishing a notice in the Gazette. On deregistration, the company is dissolved.

2.2.5.3 Winding-up

A company may be wound up voluntarily or by order of the court. Usually, in the case of a voluntary winding-up, the company itself resolves that it should be wound up. If the company is solvent, the voluntary winding-up can be a members' voluntary winding-up. In this case, the majority of directors make a statutory declaration to the effect that, after full inquiry, they have formed the opinion that the company will be able to pay its debts in full within twelve months of the date of the commencement of winding-up. Such a declaration must include a statement of the company's assets and liabilities, must be made within the five weeks before the winding-up resolution is passed and must be delivered to the Registrar not later than the time of delivery of that resolution.

If the company is insolvent, the voluntary winding-up is termed a creditors' voluntary winding-up. In this case, the company must convene a meeting of creditors either on the day that the resolution for voluntary winding-up is to be proposed or on the following day. The directors must ensure that a statement of affairs of the company, together with a list of the creditors and the amounts of their claims, are laid before the meeting. The directors must also appoint a director to preside at the meeting of creditors. At that meeting, the creditors may nominate a person to be liquidator and may also appoint a committee of inspection.

A special procedure for voluntary winding-up is also available for an insolvent company under section 228A. Under this special procedure, if the majority of directors have formed the opinion that the company cannot by reason of its liabilities continue its business, they may resolve at a meeting of directors that, because of its liabilities, the company cannot continue its business, that the company needs to be wound up, that there are good and sufficient

reasons for using section 228A, and that meetings of creditors will be convened within a specified period. One of the directors must then make a statutory declaration verifying written statements signed by the directors recording the resolution passed by them. The statutory declaration should be delivered to the Registrar within 7 days from the date the declaration is made, whereupon the winding-up commences. Immediately after that, the directors must appoint a person as a provisional liquidator in the winding-up to act until a liquidator is appointed.

A company in voluntary liquidation is dissolved three months from the date that the final return submitted by the liquidator to the Registrar is registered.

A company may be wound up by order of the court in a number of circumstances. The most common situation is when a company is unable to pay its debts – for example, when a creditor serves a demand on the registered office of the debtor company for payment of a debt exceeding HK\$10,000 and the amount remains unpaid three weeks later.

In other cases, a company may be wound up by the court if the company so resolves, if the company has no members, or if the court decides that it is just and equitable that the company should be wound up.

When the affairs of a company wound up by the court have been completed, the liquidator may apply to court for an order that the company be dissolved from the date of the order [s 227]. If no such application were made, the company would be dissolved 2 years from the registration by the Registrar of a certificate issued by the Official Receiver when the winding-up is completed and the liquidator released [s 226A].

2.2.5.4 Court order

The court may order that a company be struck off the register and dissolved if either:

- it appears to the court that it would not be appropriate to wind up the company [s 291A]; or
- the company transfers the whole of its undertaking or property to another company as part of a scheme for the reconstruction or amalgamation of companies. [s 167]

2.3 Unlimited company

An unlimited company is defined by the *Companies Ordinance* as a company not having any limit on the liability of its members. [s 4(2)(c)]

An unlimited company which is formed and registered under the *Companies Ordinance* is a separate legal entity and should not be confused with an unincorporated business using the term 'company' in its name. Unlike an unincorporated entity, an unlimited company is bound by the requirements imposed on companies by the *Companies Ordinance*. An unlimited company enjoys the benefits of separate legal identity, including perpetual succession, and the ability to hold property and investments in its own name.

2.4 Company limited by guarantee

A company limited by guarantee is defined by the *Companies Ordinance* [s 4(2)(b)] as a company having the liability of its members limited by its memorandum to such amount as the members have undertaken to contribute to the assets of the company in the event of its being wound up. This type of company is typically used for charities and organisations such as hospitals and schools which are non-profit organisations. However, from 13 February

2004, following amendment to the *Companies Ordinance*, incorporation of a company limited by guarantee with share capital is prohibited.

2.5 Branch

Instead of incorporating a company in Hong Kong, an overseas company may establish a branch for the purpose of doing business in Hong Kong. Within one month of commencing business, the branch is required to register with the Companies Registry.

On registration, the branch is required to deposit with the Companies Registry a copy of the Memorandum of Association and Articles of Association of the overseas company (or other instrument establishing the company); the names and particulars of the directors and secretary; the registered office and address of the place of business in Hong Kong; and the name and address of a person who is resident in Hong Kong and is authorised to accept the service of writs and other legal documents in Hong Kong. If the original documents are written in a language other than English or Chinese, they must be accompanied by certified English or Chinese translations.

An overseas company registered locally is also required to file a copy of its balance sheet, profit and loss account, group accounts, and directors' and auditor's reports at the time of its initial registration and annually thereafter. This requirement entails filing the full company accounts and not just an account of trade in Hong Kong. Exemption from the filing requirement is granted, in general, only to companies that have the characteristics of private companies and that are not obliged, in the country of their incorporation, to publish or make available copies of the accounts for inspection.

2.6 Partnership

Partnerships are regulated by the *Partnership Ordinance*. Except for attorneys, professional accountants, stock exchange members, and others expressly exempted, partnerships may not have more than twenty partners. Partnerships should normally be constituted by written agreement, although a written agreement is not essential. Partnership agreements do not have to be filed in any public registry, nor do partnership financial statements have to be published.

With the exception of limited partners, each member of a partnership is jointly and severally liable for all debts and obligations incurred by the firm while he or she remains a partner. The partners may make arrangements between themselves as to the apportionment of the partnership's liabilities, but such arrangements do not affect joint liability as to third parties.

Notwithstanding this, under the *Limited Partnership Ordinance*, the liability of some partners may be limited, but at least one partner, called the general partner, must have unlimited liability. Limited partners must be silent partners (i.e. they may not take part in the management of the firm). Partners, whether limited or general, cannot make contracts with their partnerships.

Any name may be used for a partnership, but the word limited – or any abbreviation of it – cannot be used. Hong Kong partnerships usually include the term 'company' in their names.

Partnerships are not required by law to appoint auditors, although in practice some do so. If a partner dies or leaves a partnership or a new partner is admitted, unless an express agreement between partners exists to the contrary, the partnership is automatically dissolved by law. In the absence of an express agreement, a successor partnership can quickly be restructured.

2.7 Sole proprietorship

In a sole proprietorship, the owner bears all the risks and receives all the rewards from running the business. In Hong Kong, provided that the business is not illegal, the sole trader can run his or her business with few restrictions.

On formation, there is no requirement to register. However, as with companies and other entities, within one month of the commencement of business, application must be made to the Business Registration Office at the Inland Revenue Department for a business registration certificate. This certificate must be renewed annually at the prescribed fee and displayed in a conspicuous position in the place of business.

3 Preparation, filing and publishing of financial statements

3.1 Rules for preparing and filing financial statements

3.1.1 Definitions of accounts and financial statements

The term 'accounts' has not been formally defined, but is usually taken to refer to the formal accounting statements, i.e. balance sheets and income statements (both group and company), and other primary statements, such as the cash flow statement and statement of changes in equity, required by accounting standards. This approach is supported by the *Companies Ordinance* which defines accounts and group accounts as the profit and loss account and balance sheet of the company and group, respectively.

The term 'financial statements' has been adopted by the HKICPA. HKAS 1 *Presentation of Financial Statements* states that a complete set of financial statements comprises:

- a statement of financial position as at the end of the period;
- a statement of comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period; and
- notes comprising a summary of significant accounting policies and other explanatory information.

A statement of financial position as at the beginning of the earlier comparative period is required when an entity applies an accounting policy retrospectively or make a retrospective restatement of items in its financial statements or when it reclassifies item in its financial statements.

The term "financial statements" is also adopted in this book as the generic term which encompasses the legal concept of accounts.

The terminology of recent accounting standards has been modified in line with international usage (e.g. references to 'statement of comprehensive income' rather than 'profit and loss account'). Throughout this book, the revised terminology has been adopted – except where direct reference is made to the *Companies Ordinance*, when the original terminology of the legislation is used. In the preparation of financial statements, entities now normally follow the

international terminology though some continue to use the *Companies Ordinance* terminology.

3.1.2 Requirements to prepare financial statements

The directors of every company incorporated under the *Companies Ordinance* are required to prepare financial statements in respect of each accounting period, which include a balance sheet, profit and loss account and additional information provided by way of notes. [s 122] These statements must comply with the requirements of the *Companies Ordinance* as to their form and content. An exemption from the requirement to prepare group financial statements is given to groups where the holding company is, at the end of its financial year, itself a wholly-owned subsidiary. [s 124(2)(a)]

In addition to the statutory requirements, the financial statements should contain other financial information and additional disclosures as required by accounting standards. Listed companies also need to comply with the reporting requirements set out in the *Listing Rules* or the *GEM Rules*, as appropriate, issued by The Stock Exchange of Hong Kong Limited (SEHK).

3.1.3 True and fair view

The financial statements of a company are required to give a true and fair view of the profit or loss for the financial year and the state of affairs at the end of its financial year. [s 123 and s 126] This requirement overrides all other accounting requirements of the *Companies Ordinance* and accounting standards. In 2005, the *Companies Ordinance* was amended to introduce a 'true and fair view override' provision in relation to the preparation of individual company accounts/group accounts. A departure from the requirements of the *Tenth Schedule* and other sections of the *Companies Ordinance* will be allowed if compliance does not give rise to accounts that provide a true and fair view. However, the company has to disclose, in the accounts, the reasons, particulars and effect of such a non-compliance. Such a departure might occur where requirements under the accounting standards differ from those under the *Companies Ordinance*.

At the same time, the amendment requires that where mere compliance with the requirements of the *Tenth Schedule* and other sections of the *Companies Ordinance* is not sufficient to give rise to individual company accounts/group accounts giving a true and fair view, a company should provide additional information, as appropriate.

3.1.4 Role of accounting standards

HKAS 1 *Presentation of Financial Statements* specifies that the appropriate application of Hong Kong Financial Reporting Standards (HKFRSs), with additional disclosure when necessary, results, in virtually all circumstances, in financial statements that give a true and fair view. [HKAS 1.15] The terms 'fair presentation' and 'present fairly' used in IAS 1 are replaced by the terms 'true and fair view' and 'achieve a true and fair view' in HKAS 1 to match with the terms used in the *Companies Ordinance*. In the extremely rare circumstances where management concludes that compliance with a requirement in an accounting standard would be so misleading, that it would conflict with the objectives of financial statements set out in the *Framework for the Preparation and Presentation of Financial Statements*, and the relevant framework does not prohibit such a departure, an entity should depart from that requirement and make comprehensive disclosures, as set out in the Standard [HKAS 1.20].

of a loan), or a fully proportionate share of an asset (e.g. 60% of all cash flows). The right to receive the first 90% of cash flows on an asset is not deemed specifically identifiable and, therefore, the model would be applied to the whole asset. To the extent an entity derecognises an asset and retains some continuing involvement, proposed amendments to IFRS 7 would require extensive disclosures on the nature of and risks associated with the transferor's continuing involvement.

In practice, compared to the existing requirements, many more repurchase arrangements over assets that are highly liquid would achieve derecognition under the proposed model. The transferor will derecognise the asset and recognise a forward contract to buy the transferred asset back from the transferee; the transferee will recognise the asset and a forward contract to sell the transferred asset back to the transferor. In contrast, many securitisations and factoring arrangements would likely fail derecognition as it is common for the transferor to retain a disproportionate interest in the cash flows of the asset, usually credit risk, and the transferee does not usually have the right to transfer the asset for its own benefit.

The exposure draft contains an alternative approach proposed by a significant minority of Board members. Like the model described above, it is based on control. However, the model would require that if a transferor does not have access to *all* the cash flows the transferor recognised prior to the transfer, then the asset is derecognised and a new asset is recognised for any interest in part of the asset transferred. This is sometimes referred to as a 'components approach'. This model does not distinguish between a disproportionate or fully proportionate interest in cash flows and therefore would result in many more transfers achieving derecognition.

20 Financial instruments: hedge accounting – basics

1 Introduction

Entities enter into many transactions that aim to reduce risk, and ultimately reduce the variability in cash flows that arise from these risks. Entities enter into hedging transactions to hedge risks that are evident in items that are already recognised in the statement of financial position, as well as hedge risks for future transactions that have yet to occur.

Hedge accounting is a method of presentation that may be voluntarily applied to hedging transactions. The objective of hedge accounting is to ensure that the gain or loss on the hedging instrument is recognised in profit or loss in the same period when the item that is being hedged affects profit or loss. In other words, applying hedge accounting results in the 'matched' timing of recognition of gains and losses in profit or loss. Where an entity is perfectly hedged, the gains and losses on the hedging instrument and the hedged item perfectly offset in profit or loss in the same period.

IFRS 39 allows an entity to apply hedge accounting if an entity specifically designates the hedging instrument and the hedged item at inception of the hedge accounting relationship. Generally, there are two ways in which hedge accounting achieves the matching of gains and losses on the hedging instrument and the hedged item:

- changes in the fair value of the hedging instrument are recognised in profit or loss at the same time that a recognised asset or liability that is being hedged is adjusted for movements in the hedged risk with that adjustment also recognised in profit or loss in the same period. This is referred to as a fair value hedge because it is the exposure to changes in the fair value of the hedged item due to the designated risk that is being hedged; or
- changes in the fair value of the hedging instrument are recognised initially in other comprehensive income and reclassified from equity to profit or loss when the hedged item affects profit or loss. This is known as a cash flow hedge because it is the exposure to the variability in future cash flows that is being hedged.

A third and final category of hedge accounting is hedging a net investment in a foreign operation. This is accounted for similarly to cash flow hedges.

There are specific rules in the Standard that limit which financial instruments can be considered hedging instruments, and which items can be considered hedged items. In summary, a hedging instrument can be a derivative financial instrument or a non-derivative financial instrument (for hedges of foreign exchange risk only). The hedged item must be an identified hedged item or a group of items that could affect profit or loss.

When an entity wishes to apply hedge accounting, it must formally document in writing its intention to apply hedge accounting prospectively. Hedge accounting cannot be applied retrospectively. Additionally, hedge accounting must be consistent with the entity's established risk management strategy for that hedge relationship. The hedge documentation must identify the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and specify how the 'effectiveness' of the hedge relationship will be assessed and ineffectiveness measured.

Hedge accounting is only permitted if the hedge relationship is expected to be highly effective and it is actually effective within a quantitative range. To the extent that the hedging instrument and hedged item are not perfectly effective at offsetting each other, this ineffectiveness is immediately recognised in profit or loss.

HKAS 39 *Financial Instruments: Recognition and Measurement* does not mandate the use of hedge accounting. Hedge accounting is voluntary. If an entity does not wish to use hedge accounting it does not need to designate and document its hedging relationships. Where an entity applies the normal recognition and measurement requirements of HKAS 39 it may find in some cases that the effect on profit or loss of applying hedge accounting could be substantially the same as where hedge accounting is not applied. In such cases, an entity may well choose not to apply hedge accounting because there is very little benefit in doing so.

In some instances the fair value option (see 3.1.1 in chapter 14) can be used as an alternative to hedge accounting. If an accounting mismatch exists, which will result in profit or loss volatility, an entity may apply the fair value option to reduce this volatility instead of complying with the onerous conditions of hedge accounting. For example, where a derivative provides an economic hedge of a financial instrument that is not measured at fair value through profit or loss, an accounting measurement mismatch exists. In that situation, the fair value option applied to the hedged item would reduce the measurement mismatch. The simplicity of applying the fair value option does, however, come at a cost:

- hedge accounting can be discontinued at any time but fair value through profit or loss designation is irrevocable; and
- if fair value option is used, the entire change in fair value of the designated item must be recognised in profit or loss. This amount will not be an exact offset to the change in fair value of the hedging instrument where the hedging instrument is not hedging all the risks of the item that is designated under the fair value option. Hedge accounting allows the specific hedged risk to be designated, and therefore can achieve a greater reduction in profit or loss volatility.

This chapter discusses hedge accounting in the following sections:

Section 2	Definitions and mechanics of hedge accounting
Section 3	Hedged items
Section 4	Hedging instruments
Section 5	Hedge effectiveness
Section 6	Documentation

The more complex aspects of hedge accounting and detailed examples are included in chapters 21 and 22 respectively.

2 Definitions and mechanics of hedge accounting

HKAS 39 recognises three types of hedge accounting depending on the nature of the risk exposure:

- a fair value hedge;
- a cash flow hedge; and
- a hedge of a net investment in a foreign operation ('net investment hedge').

2.1 Definition of a fair value hedge

A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment or an identified portion of such an asset, a liability or a firm commitment that is attributable to a particular risk and could affect profit or loss. [HKAS 39.86(a)]

2.1.1 Examples of fair value exposure

Fair value exposures arise from existing assets or liabilities, including firm commitments. Fixed-rate financial assets and liabilities, for example, have a fair value exposure to changes in market rates of interest and changes in credit quality. Non-financial assets have a fair value exposure to changes in their market price, e.g. a commodity price. Some assets and liabilities have fair value exposures arising from more than one type of risk, e.g. interest rate, credit, foreign currency risk.

The following assets and liabilities are commonly fair value hedged:

- fixed rate liabilities like loans;
- fixed rate assets like investments in bonds;
- investments in equity securities; and
- firm commitments to buy/sell non-financial items at a fixed price.

Examples of fair value hedges include:

- a hedge of exposure to changes in the fair value of fixed rate debt as a result of changes in market interest rates (such a hedge could be entered into either by the issuer or by the holder);
- a hedge of the foreign currency risk of an unrecognised contractual commitment by an airline to purchase an aircraft for a fixed amount of a foreign currency at a future date; and
- a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electricity utility to purchase fuel at a fixed price at a specified date, with payment in its functional currency.

Further examples

A detailed illustration of the mechanics of a fair value hedge of interest rate risk of fixed rate debt is included in 2.1 of chapter 22.

2.1.2 Fair value hedge accounting

A fair value hedge that meets all the hedge accounting criteria is accounted for as follows: [HKAS 39.89]

- the gain or loss from re-measuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount (for a non-derivative hedging instrument) is recognised immediately in profit or loss; and
- the carrying amount of the hedged item is adjusted through profit or loss for the gain or loss on the hedged item attributable to the hedged risk. This applies even if the hedged item is an available-for-sale asset measured at fair value with changes in fair value recognised in other comprehensive income. This also applies if the hedged item is otherwise measured at cost.

2.1.3 Firm commitment

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. [HKAS 39.9]

A commitment is binding if it is enforceable either legally or otherwise. If the commitment is with a related party, consideration should be given as to whether in practice the right can be enforced. To be enforceable, the agreement should provide for remedies that are available to the parties to the contract in the event of non-performance. For example, a penalty could be specified at a fixed amount or equal to the change in market price of the item under the contract. Alternatively, the penalty may not be specifically stipulated in the agreement but may otherwise be applicable (for example remedies under law). When an entity is preparing its individual entity only financial statements the entity needs to consider carefully whether transactions between group entities meet the definition of a firm commitment as they may not be subject to remedies for non-performance either as part of the contract or under law. In many instances, particularly, in the absence of non-controlling interests that may require protection from the controlling interest, an agreement between group entities would not be binding.

Hedges of firm commitments are generally treated as fair value hedges under HKAS 39. However, there is one exception: if an entity is hedging the foreign currency risk in a firm commitment this may be accounted for either as a fair value hedge or a cash flow hedge. [HKAS 39.87]

Example 2.1.3A

Hedging foreign currency risk of a firm commitment

Entity B sells machinery at fixed prices in many jurisdictions. Entity B's functional currency is HK\$. Entity B enters into a contract with Entity D, whose functional currency is RMB, to sell machinery for delivery in six months' time at a fixed price in RMB that is determined today. In other words, Entity B has entered into a firm commitment with Entity D.

Entity B simultaneously enters into a foreign currency forward contract to hedge its future exposure to RMB arising from its firm commitment. This foreign currency forward contract can either be designated as a hedging instrument in a fair value hedge or a cash flow hedge as it is hedging the foreign currency risk of a firm commitment.

Example 2.1.3B

Fair value hedging a firm commitment

Entity E is a discount grocery chain with over 400 stores in the US, which enters into forward contracts to purchase various inventory items for its stores. On 1 June 20X0, Entity E enters into a forward contract to purchase 300,000 bushels of wheat from a wheat producer for a fixed price of US\$1.40 per bushel on 1 August 20X0. Entity E will use the wheat in its bakery operations. Entity E intends taking physical delivery of the wheat in accordance with its expected purchase requirements. If Entity E failed to take delivery of the wheat, it would be required to pay for any decrease in the value of the wheat and legal remedies will be available to the wheat producer.

The transaction is a firm commitment because it is a binding agreement for the exchange of a specified quantity of wheat at a specified price on a specified future date. The forward contract is not accounted for as a derivative because Entity E intends to take physical delivery of wheat and has no past practice of settling similar contracts net. Entity E could enter into a contract to hedge the fair value exposure of the firm commitment due to the change in the price of wheat between 1 June 20X0 and 1 August 20X0, e.g. a net cash settled forward contract to sell wheat for a fixed price on 1 August. Such a contract would qualify as a hedging instrument in a fair value hedge of a firm commitment.

2.1.4 Fair value hedges of unrecognised firm commitments

When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss. [HKAS 39.93]

The changes in the fair value of the hedging instrument will also be recognised in profit or loss.

The initial carrying amount of the asset or the liability that results from the entity fulfilling the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the statement of financial position. **Example 2.2 in chapter 22** demonstrates the entries required when an entity hedges foreign currency risk of a firm commitment.

2.1.5 Discontinuance of fair value hedge accounting

An entity must discontinue prospectively fair value hedge accounting if: [HKAS 39.91]

- the hedging instrument expires or is sold, terminated or exercised (the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if it formed part of the entity's documented hedging strategy from inception. For rollover hedging strategies see 3.8 in chapter 21);
- the hedge no longer meets the hedge accounting criteria (for example, it is no longer highly effective or its effectiveness is no longer measurable); or
- the entity de-designates the hedge relationship.

Any adjustment to the carrying amount of the hedged item for the designated risk for interest-bearing financial instruments is amortised to profit or loss, with amortisation commencing no later than when the hedged item ceases to be adjusted. [HKAS 39.92] The amortisation is based on a recalculated effective interest rate at the date amortisation commences such that the adjustment is fully amortised by maturity.

Where amortisation begins as soon as a fair value adjustment exists, the adjustment to the carrying amount affects the effective interest rate calculation for the hedged item. In practice, to ease the administrative burden of amortising the adjustment while the hedged item continues to be adjusted for changes in fair value attributable to the hedged risk, it may be easier to defer amortising the adjustment until the hedged item ceases to be adjusted for the designated hedged risk. This is particularly true when the life of the hedge is the same as that of the hedged item. For example, if a fixed rate loan is issued at par and redeems at par, its fair value will move away from par over its life in response to changes in interest rates but will be pulled back to par on maturity. Therefore, any fair value adjustments to the carrying amount of the bond under a fair value hedge for interest rate risk will be reversed by the end of the hedge and will not require amortisation.

However, if an interest-bearing instrument is hedged for only a portion of its term to maturity (see 2.2 in chapter 21 for partial term hedging), deferring amortisation until cessation of the hedge relationship will result in a skewed effective interest rate in the remaining years to the maturity of the hedged item.

An entity must apply the same amortisation policy for all of its debt instruments, i.e. it cannot defer amortising fair value adjustments on some items and not on others.

Example 2.1.5**Amortising fair value hedge adjustments**

Bank J has a ¥10 million fixed-rate loan asset that is classified as an available-for-sale asset. Bank J hedged the fair value exposure of the asset using a forward contract. As a result of the hedge, the loan asset has been adjusted for changes in the fair value of the risk being hedged and that adjustment is recognised in profit or loss. If Bank J does not elect to start amortising the hedging gain or loss while the hedge is outstanding, the adjustment will remain as part of the available-for-sale asset, until the loan is sold or until the loan is no longer hedged. If hedge accounting ceases prior to the loan being sold, the fair value adjustment of the loan will be amortised through the revised effective interest over the expected remaining life of the loan.

If an entity discontinues hedge accounting by de-designating the hedging relationship, an entity may elect to designate prospectively a new hedging relationship with the same derivative hedging instrument provided the new hedging relationship meets the requirements for hedge accounting.

2.2 Definition of a cash flow hedge

A cash flow hedge is a hedge of the exposure to variability in cash flows that: [HKAS 39.86(b)]

- is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction; and
- could affect profit or loss.

Common assets and liabilities and forecast transactions that are cash flow hedged include:

- variable rate liabilities like loans;
- variable rate assets like investments in bonds;
- highly probable future issuance of fixed rate debt;
- forecast reinvestment of interest and principal received on fixed rate assets; and
- highly probable forecast sales and purchases.

An example of a cash flow hedge is a hedge of variable rate debt with a floating to fixed interest rate swap. The variability in cash flow arises due to the reset of interest rates. The cash flow hedge reduces future variability of interest cash flows on the debt. Another example of a cash flow hedge is a hedge of anticipated reinvestment of cash inflows and the anticipated refinancing or rollover of a financial liability. A hedging instrument that swaps one variable rate for another, e.g. LIBOR for EURIBOR, would not qualify in a cash flow hedge relationship as it does not reduce cash flow variability, it merely swaps the existing cash flow variability of the debt for cash flow variability determined on a different basis.

2.2.1 Forecast transactions

A forecast transaction is an uncommitted but anticipated future transaction. [HKAS 39.9]

It is important to distinguish between forecast transactions and firm commitments as forecast transactions are always cash flow hedged, whereas firm commitments are generally fair value hedged. The following table illustrates some examples of forecast transactions and, also illustrates the difference between a forecast transaction and a firm commitment:

Example 2.2.1**Examples of forecast transactions and firm commitments****Forecast transaction**

In May 20X1 an entity forecasts the purchase of 100,000 bushels of corn to be used in its manufacturing process in October 20X1.

Corporate Treasury forecasts the sale of an available-for-sale debt instrument at the end of the fourth quarter.

Corporate Treasury forecasts the purchase of a £25 million bond on 23 March 20X1 from an investment bank.

Firm commitment

An entity has signed a legally binding purchase agreement to take delivery of 100,000 bushels of corn on 30 September 20X1 for US\$2 per bushel.

Corporate Treasury signs a legally binding agreement with a third party to sell a specific available-for-sale debt instrument for par on 30 December 20X1.

Corporate Treasury enters into a legally binding purchase agreement with a bank to take delivery of a £25 million bond for par on 23 March 20X1.

Cash flow hedge accounting can be applied to a forecast transaction only if the transaction is highly probable. [HKAS 39.88(c)]

Highly probable is not defined in HKAS 39. The probability of occurrence must be significantly in excess of a 50 per cent likelihood, but not necessarily as high as 100 per cent as the entity can never claim a transaction that is not yet committed can be guaranteed to occur. HKFRS 5.BC81 also refers to 'highly probable' although in a different context. It states that in HKFRSs 'probable' is defined as "more likely than not" and that the 'highly probable' is regarded as implying a significantly higher probability than 'more likely than not' and as being equivalent to the phrase "likely to occur".

Probability is assessed based on observable facts and the relevant circumstances. In assessing the likelihood that a transaction will occur, consideration should be given to the following:

- the frequency of similar past transactions;
- the financial and operational ability of the entity to carry out the transaction;
- substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);
- the extent of loss or disruption of operations that could result if the transaction does not occur;
- the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering); and
- the entity's business plan.

In addition, both the length of time until a forecast transaction is projected to occur and the quantity of the forecast transaction should be considered in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable. For example, a transaction forecast to occur in five years may be less likely than a transaction forecast to occur in one year.

40 Earnings per share

1 Introduction

HKAS 33 *Earnings per Share* prescribes principles for the determination and presentation of earnings per share (EPS) information. The Standard was most recently amended when the revised version of HKFRS 3 *Business Combinations* was issued in March 2008.

This chapter discusses the requirements of HKAS 33 in the following sections:

Section 2	Scope
Section 3	Definitions
Section 4	Calculation of basic earnings per share
Section 5	Calculation of diluted earnings per share
Section 6	Reporting additional earnings per share on an alternative basis
Section 7	Presentation and disclosure
Section 8	Future developments

2 Scope

When the IASB issued IFRS 8 *Operating Segments*, the international equivalent of HKFRS 8, it took the opportunity to amend IAS 33.2, so as to clarify the scope of the EPS Standard. Following that amendment, HKAS 33 applies to:
[HKAS 33.2 & 3]

- the separate or individual financial statements of an entity:
 - whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or
 - that files, or is in the process of filing, its financial statements with a securities commission or other regulatory information for the purpose of issuing ordinary shares in a public market; and
- the consolidated financial statements of a group with a parent:
 - whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or
 - that files, or is in the process of filing, its financial statements with a securities commission or other regulatory information for the purpose of issuing ordinary shares in a public market; and
- entities voluntarily choosing to present EPS information.

Prior to amendment by HKFRS 8, HKAS 33.2 referred to entities whose ordinary shares or potential ordinary shares are publicly traded and entities that are in the process of issuing ordinary shares or potential ordinary shares in public markets.

The amendment by HKFRS 8 makes clear that, for a group, it is the shares of the parent that must be considered. Thus, an unlisted group which includes a listed subsidiary is not automatically within the scope of the Standard.

The scope of the Standard includes entities that are in the process of filing financial statements with a securities commission or other regulatory information for the purpose of issuing ordinary shares in a public market. This means that EPS information is required in financial statements prepared for the purpose of the issue of a prospectus.

2.1 Mutual-to-shares conversions

The definition of a financial liability in HKAS 32 *Financial Instruments: Presentation* was amended in June 2008 in order for certain puttable financial instruments and obligations arising on liquidation to be presented as equity, as opposed to a financial liability. Prior to that amendment, many entities with a mutual form of ownership had no equity instruments under HKFRSs (see section 2.1.2 of chapter 15) as the most subordinate instrument issued by the entity had an obligation for the entity to pay cash or another financial asset. Due to the strict criteria in the amendments to HKAS 32, certain entities with a mutual form of ownership may continue to have no equity. In the instances where such entities convert from a mutual form of ownership to share ownership that is classified as equity, the EPS should be based on earnings subsequent to conversion as it is only for the period subsequent to conversion that the entity had equity instruments outstanding. Reporting EPS based on earnings subsequent to conversion may result in an EPS amount that will not be comparable to EPS amounts determined in future years. Further, such an EPS amount may not reflect fully the expected relationship between earnings for the period and the amount of outstanding shares at the end of the reporting period. Therefore, the statement of comprehensive income caption should be sufficiently descriptive to inform the reader of the unique nature of EPS in the year of conversion, and the method of presentation should be described in the notes.

The amended HKAS 32.11 recognises that puttable instruments and obligations arising on liquidation that are presented as equity following the amendment do meet the definition of a financial liability but are presented as equity as an exception. As HKAS 33 was not amended when the amendments to HKAS 32 were issued there was confusion as to whether HKAS 33 would apply to an entity which previously had no equity but following the amendments presented its puttable instruments or obligations arising at liquidation as equity. In August 2008, the IASB published an exposure draft (ED) *Simplifying Earnings per Share*, which proposes to amend IAS 32, the international equivalent of HKAS 32, to make clear that entities that previously had no equity that would present instruments as equity following the IAS 32 amendment should apply IAS 33, the international equivalent of HKAS 33, in the period when the amended IAS 32 is applied.

2.2 Entities voluntarily presenting EPS information

HKAS 33 requires that any entity that presents EPS information does so in accordance with that Standard. Therefore, any entity whose ordinary shares or potentially ordinary shares are not publicly traded that voluntarily presents EPS information is bound by the requirements of HKAS 33. [HKAS 33.3]

2.3 Consolidated and separate financial statements

Where an entity presents both consolidated financial statements and separate financial statements in accordance with HKAS 27 *Consolidated and Separate Financial Statements*: [HKAS 33.4]

- the disclosures required by HKAS 33 need only be given in respect of the consolidated information;

- if the entity chooses to disclose EPS information based on its separate financial statements, it is required to prepare that information in accordance with HKAS 33 and to present it only in its statement of comprehensive income; and
- EPS information based on the separate financial statements should not be presented in the consolidated financial statements (either in the statement of comprehensive income or in the notes).

If an entity presents the components of profit or loss in a separate income statement as described in HKAS 1(2007).81 (see section 5 of chapter 3), EPS should be presented only in that separate statement. [HKAS 33.4A]

2.4 Shares listed but not intended to be traded

Example 2.4

Shares listed but not intended to be traded

The shares of Company A are listed on the Luxembourg exchange. Company A has completed a listing for marketing purposes only because its investors (which are pension funds) are restricted by their governing laws to investing in listed entities. It is not expected that these shares will be traded.

Although these shares are not expected to be traded, nevertheless the entity is within the scope of HKAS 33 and EPS disclosures will be required. The notion of 'publicly traded' does not require the actual trading of shares, but the ability to trade the shares publicly.

3 Definitions

3.1 Ordinary share

HKAS 33 defines an ordinary share as an equity instrument that is subordinate to all other classes of equity instruments. [HKAS 33.5] An equity instrument is defined in HKAS 32 as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. [HKAS 32.11] The Standard explains that ordinary shares participate in profit for the period only after other types of shares (such as preference shares) have participated. Ordinary shares of the same class have the same rights to receive dividends, but it is possible for an entity to have more than one class of ordinary shares. [HKAS 33.6]

3.2 Potential ordinary share

A potential ordinary share is defined as a financial instrument or other contract that may entitle its holder to ordinary shares. [HKAS 33.5] Examples of potential ordinary shares include: [HKAS 33.7]

- financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares;
- options and warrants (i.e. financial instruments issued by the entity that give the holder the right to purchase ordinary shares); and
- shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets.

The concept that an instrument may be considered the equivalent of ordinary shares has evolved to meet the reporting needs of investors in entities that have issued certain types of convertible and other complex securities. The holders of these instruments can expect to

participate in the appreciation in value of the ordinary shares resulting principally from the earnings and earnings potential of the issuing entity. The attractiveness of these instruments to investors often is based on the potential right to participate in increases in the earnings potential of the entity, rather than on fixed returns or other senior security characteristics. The value of instruments that are considered potential ordinary shares is derived largely from the value of the ordinary shares to which they relate. Changes in the value of such instruments tend to reflect changes in the value of the ordinary shares.

3.2.1 Derivatives over own equity

If an entity enters into a derivative over its own ordinary shares that may entitle the holder to ordinary shares, that derivative is a potential ordinary share. This is the case where the settlement terms of the derivative permit or require settlement net in ordinary shares of the entity or in a fixed number of ordinary shares for a fixed amount of cash. This applies irrespective of whether the settlement terms are at the option of the holder or the issuer.

If, however, the settlement terms of the derivative permit only net settlement in cash or other financial assets, and/or settlement by the exchange of gross amounts of cash or other financial assets, the instrument does not 'entitle its holder to ordinary shares' and is not a potential ordinary share. This is true irrespective of whether the settlement terms are at the option of the holder or the issuer.

4 Calculation of basic earnings per share

The objective of basic EPS information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period. [HKAS 33.11] Basic EPS amounts are required to be calculated for: [HKAS 33.9]

- profit or loss attributable to ordinary equity holders of the parent entity; and
- if presented, profit or loss from continuing operations attributable to those equity holders.

Basic EPS is calculated as:
[HKAS 33.10]

$$\frac{\text{Profit (loss) attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

4.1 Earnings numerator

The starting point for the earnings numerator (for results both from continuing operations and for the entity as a whole) is the profit or loss after tax attributable to the equity holders of the parent entity (i.e. excluding the amount attributable to non-controlling interests). [HKAS 33.12]

4.1.1 Non-controlling interests

The profit or loss attributable to equity holders of the parent will be readily available, as it is required to be presented in the statement of comprehensive income (or, where applicable, the separate income statement), under HKAS 1 *Presentation of Financial Statements*, separately from the profit or loss attributable to non-controlling interests. [HKAS 1(2007).83] Where applicable, however, the profit for the period from continuing operations presented in the statement of comprehensive income (which is before the allocation to non-controlling interests) will need to be adjusted for the non-controlling interests' share of those earnings in order to arrive at the amount attributable to equity holders of the parent.

4.1.2 The impact of preference shares

The profit or loss attributable to the equity holders of the parent entity will already be after deduction of dividends and other profit or loss effects relating to preference shares *classified as liabilities*. [HKAS 33.13] For the purposes of calculating basic EPS, the profit or loss attributable to the equity holders of the parent entity is further adjusted for the following after-tax amounts relating to preference shares *classified as equity*: [HKAS 33.12]

- preference dividends;
- differences arising on the settlement of such preference shares; and
- other similar effects of such preference shares.

4.1.2.1 Preference dividends

The after-tax amount of preference dividends to be deducted in determining the profit or loss attributable to ordinary equity holders of the parent entity is:
[HKAS 33.14]

- for non-cumulative preference shares classified as equity, the after-tax amount of preference dividends declared in respect of the period; and
- for cumulative preference shares classified as equity, the full after-tax amount of the required preference dividends for the period (whether or not declared). This does not include amounts paid or declared on cumulative preference shares in the current period in respect of previous periods.

For non-cumulative preference shares, dividends 'declared in respect of the period' are any dividends on the preference shares that are recognised as a liability at the end of the period, plus any dividends paid during the period that were not accrued at the end of the prior period. They do not include dividends declared after the end of the period that, in accordance with HKAS 10 *Events after the Reporting Period*, are not recognised as a liability.

Example 4.1.2.1

Liquidating dividends on preference shares

Company X issued one share of Series A Non-Voting Convertible Preference Shares for HK\$1,000,000. The liquidation preference on this preference share is HK\$1,000,000, plus a 12 per cent cumulative dividend from the issue date. Company X also issued one share of Series B Non-Voting Convertible Preference Shares for HK\$2,000,000. The shareholder of the Series B Preference share is entitled to a non-cumulative dividend at the rate of five per cent per annum on the liquidation preference. The liquidation preference is HK\$2,000,000, plus a 12 per cent cumulative dividend from the issue date. All payments on both preference shares are at the discretion of Company X and, therefore, they are both presented as equity.

In calculating profit or loss attributable to ordinary shareholders, Company X should not deduct the 12 per cent cumulative liquidating dividends for either the Series A or Series B shares. Although cumulative, the liquidating dividends are intended to provide a preference to the Series A and Series B preference shareholders in the event of a liquidation of Company X and, therefore, should not be included in determining profit or loss attributable to ordinary shareholders until a liquidating event occurs.

4.1.2.2 Differences arising on the settlement of preference shares

Differences may arise on the settlement of preference shares in the following circumstances:

- where the preference shares are repurchased under a tender offer, and the fair value of the consideration paid to the preference shareholders differs from their carrying

amount. Any excess of the fair value of the consideration over the carrying amount represents a return to the holders of the preference shares and is charged to retained earnings in the period of repurchase. This amount is deducted in calculating the earnings numerator for basic EPS. [HKAS 33.16] Any excess of the carrying amount of the shares over the fair value of the consideration is added in calculating the earnings numerator for basic EPS; [HKAS 33.18] and

- on early conversion of convertible preference shares, as a result of favourable changes to the original conversion terms or the payment of additional consideration. The excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms is a return to the preference shareholders, and is deducted in calculating the earnings numerator for basic EPS. [HKAS 33.17]

Some entities issue classes of shares characterised as 'tracking' or 'targeted' shares to measure the performance of a specific business unit or activity of the entity. The terms of tracking shares often allow the entity, at its option, to exchange or redeem one class of tracking shares for another class of tracking shares, such that the entity would have one less class of ordinary shares outstanding. The terms of this feature generally require a premium to be paid to the class being redeemed as a result of the transaction. In the period of redemption, profit or loss attributable to ordinary shareholders (whose shares are being used for the redemption) should be reduced by the premium over market value paid to redeem the tracking shares. The holders of the tracking shares being redeemed have received a benefit that constitutes an additional contractual return to them.

Example 4.1.2.2A

Payment of premium on redemption of tracking shares

Company X has two classes of ordinary shares outstanding that separately track the results of operations of two different businesses, Company A and Company B. Company X decides to redeem all of its outstanding Company B tracking shares in exchange for Company A tracking shares. The terms of the Company B shares being redeemed provide Company X with the right to redeem the Company B tracking shares, at its discretion, by issuing its Company A tracking shares with a market value equal to a 15 per cent premium over the market price of the Company B tracking shares at the time of redemption. As such, the fair value of Company A tracking shares to be exchanged for the Company B tracking shares will exceed the fair value of the Company B tracking shares by 15 per cent on the date the redemption is announced.

The profit or loss attributable to Company A tracking shares should be reduced by the amount of the 15 per cent premium when calculating the profit or loss attributable to Company A tracking shareholders for EPS purposes of Company X for the period.

Example 4.1.2.2B

Premium paid by a parent to redeem preference shares issued by a subsidiary

Company P, a publicly traded entity, has a wholly-owned subsidiary, Company S. Company S has preference shares outstanding held by parties outside the group that are classified as equity. The preference shares are redeemable at the option of Company S (with Company P's consent) in whole or in part, at varying dates, at HK\$100 per share plus accumulated and unpaid distributions to the date fixed for redemption. Consistent with the view that the subsidiary's preference shares represent a non-controlling interest in the parent's consolidated financial statements, dividends or accretions to a redemption price should be classified as income allocated to non-controlling interests in the consolidated statement of comprehensive income of the parent.

Company P decides to acquire Company S's preference shares. The premium paid by Company P to the third-party preference shareholders on the acquisition of Company S's preference shares is not recognised in the statement of comprehensive income of the consolidated entity as this represents a transaction with shareholders. Accordingly, the consolidated entity does not recognise in its statement of comprehensive income any gain or loss from the acquisition.

The premium paid to redeem Company S's preference shares should be deducted in computing profit or loss available to ordinary shareholders in the calculation of EPS in Company P's consolidated financial statements. The premium represents a return on investment to the holders of the preference shares and is not available to ordinary shareholders, similar to preference share dividends and accretion charges. As dividends and accretion charges on preference securities of a subsidiary are treated as income allocated to non-controlling interests, premiums paid to redeem Company S's preference shares also should be deducted in computing profit or loss attributable to ordinary shareholders in the calculation of earnings per share in Company P's consolidated financial statements.

4.1.2.3 Other effects of preference shares

The results for the period will also be adjusted for other appropriations recognised in respect of preference shares classified as equity. For example, preference shares may provide for a low initial dividend to compensate the entity for selling the shares at a discount, or an above-market dividend in later periods to compensate investors for purchasing the shares at a premium. (These are sometimes called increasing rate preference shares.) Where such shares are classified as equity, the discount or premium on issue is amortised to retained earnings using the effective interest method and treated as a preference dividend for the purposes of calculating basic earnings per share. [HKAS 33.15]

The following example, reproduced from Example 1 of the Illustrative Examples accompanying HKAS 33, illustrates the required adjustments in respect of increasing rate preference shares.

Example 4.1.2.3

Increasing rate preference shares

[HKAS 33 Illustrative Examples (Example 1)]

Entity D issued non-convertible, non-redeemable class A cumulative preference shares of CU100 par value on 1 January 20X1. The class A preference shares are entitled to a cumulative annual dividend of CU7 per share starting in 20X4.

At the time of issue, the market rate dividend yield on the class A preference shares was 7 per cent a year. Thus, Entity D could have expected to receive proceeds of approximately CU100 per class A preference share if the dividend rate of CU7 per share had been in effect at the date of issue.

In consideration of the dividend payment terms, however, the class A preference shares were issued at CU81.63 per share, i.e. at a discount of CU18.37 per share. The issue price can be calculated by taking the present value of CU100, discounted at 7 per cent over a three-year period.

Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes. To calculate basic earnings per share, the following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity:

4.8 Management contracts

Where a disclosable management contract is in force for the whole or part of the financial year, the directors' report should include a statement of the existence and duration of the contract and the name of any director interested therein. [s 162A(1)(a) & s 129D(3)(i)(a)]

A disclosable management contract is a contract entered into by the company, other than a contract of service with any director or any person engaged in the full-time employment of the company, whereby any individual, firm or body corporate undertakes the management and administration of the whole or any substantial part of any business of the company.

4.9 Charitable and other gifts

The *Companies Ordinance* requires disclosure of charitable and other donations, subject to certain de minimis limits. [s 129D(3)(d) and (e)] Wholly-owned subsidiaries of companies incorporated in Hong Kong are exempt from this requirement.

For a company which is not itself a wholly-owned subsidiary of a company incorporated in Hong Kong, and which has subsidiaries, disclosure is required if the company and its subsidiaries between them have made donations for charitable or other purposes of HK\$1,000 or more.

For a company which is not itself a wholly-owned subsidiary of a company incorporated in Hong Kong, and which has no subsidiaries, disclosure is required if the company has made donations for charitable or other purposes of HK\$10,000 or more.

4.10 Other matters

The directors' report is required to contain particulars of any other matters that are material for the appreciation of the state of the company's affairs provided that, in the opinion of the directors, the disclosure of such matters will not be harmful to the business of the company or its subsidiaries. [s 129D(3)(l)]

An example of a matter requiring disclosure under this heading would be an important or significant event affecting the company or any of its subsidiaries which has occurred since the end of the financial year. As discussed in **chapter 33** of this book, a similar requirement is imposed by HKAS 10 *Events after the Reporting Period* for the disclosure in the notes to the financial statements of non-adjusting events occurring after the reporting period that are so material that their non-disclosure would affect the ability of users of financial statements to reach a proper understanding of the financial position of the entity. To avoid unnecessary duplication of information in the directors' report and the financial statements, we suggest that a brief mention of the matter in the directors' report, together with a reference to the relevant note in the financial statements, will be sufficient in circumstances where the matter is also disclosed in the financial statements under HKAS 10.

4.11 Re-appointment of auditor

Although there is no statutory requirement for the directors' report to refer to the re-appointment of the auditor, it is general practice to do so, as illustrated in **example 4.11**.

Example 4.11

A resolution to re-appoint Messrs. Deloitte Touche Tohmatsu as auditor will be proposed at the forthcoming annual general meeting.

56 Reports on audited financial statements

1 Introduction

The form and content of the auditor's report issued as the result of an audit of a complete set of general purpose financial statements, including the related notes, of a reporting entity is set out in both Hong Kong Standard on Auditing 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* (HKSA 700) and Hong Kong Standard on Auditing 701 *Modifications to the Independent Auditor's Report* (HKSA 701), which were issued by the HKICPA in October 2006 and replaced Statement of Auditing Standards 600 *Auditors' Reports on Financial Statements*. HKSA 700 and HKSA 701 apply to all auditor's reports which express an opinion in terms of whether financial statements give a true and fair view, or where statutory or other specific requirements prescribe the use of such terms as 'presents fairly', 'exhibits a true and correct view' or 'properly prepared in accordance with'.

The view given by the financial statements is derived from a combination of fact and judgement, and consequently cannot be characterised as absolute. When reporting on financial statements, therefore, the auditor provides a level of assurance which is reasonable in that context but, equally, cannot be absolute. Consequently, it is important that readers of financial statements are made aware of the context in which the auditor's report is given. A major objective of both HKSA 700 and HKSA 701 therefore, is to achieve informative reporting by the auditor within the scope of their reporting obligations.

1.1 Companies Ordinance requirements

The majority of auditor's reports issued are reports on companies incorporated under the *Companies Ordinance*. Under the *Companies Ordinance*, the auditor is required to report to the members of the company on all annual accounts laid before the company in an annual general meeting during their tenure of office. For the purposes of the *Companies Ordinance*, annual accounts consist of a balance sheet and profit and loss account (using the terminology in the *Companies Ordinance*), together with accompanying notes thereto (and, where appropriate, group accounts).

In their report, the auditor must state their opinion as to whether the financial statements: [s 141(3)]

- give a true and fair view of the state of affairs of the company (and the group) as at the end of the financial year and of its profit or loss for the financial year; and
- have been properly prepared in accordance with the *Companies Ordinance*.

The auditor has a further duty to carry out such investigations as will enable them to form an opinion as to whether or not: [s 141(4)]

- proper accounting records have been kept by the company and proper returns adequate for the audit have been received from branches not visited; and
- the annual accounts are in agreement with the accounting records and returns.

If the auditor is of the opinion that any of the above requirements have not been met, this fact must be stated in their report.

The auditor also has a duty to report if they have not obtained all of the information and explanations that they require for the purposes of their audit.

The absence of any statement on the above matters in the auditor's report is, therefore, equivalent to an assurance that the auditor has satisfied themselves as to these matters.

1.2 Compliance with relevant accounting requirements

It is likely that a court would infer that financial statements, which meet the *Companies Ordinance* requirement for financial statements to give a true and fair view, will follow accounting standards, and that any departure would be sufficiently abnormal to require justification. Therefore, general compliance with accounting standards is necessary to meet the requirement that the directors prepare annual financial statements which give a true and fair view of a company's (group's) state of affairs and profit or loss.

Particulars of any material departure from accounting standards that the auditor agrees is necessary to give a true and fair view must be fully explained, together with the financial effects of the departure, unless this is impracticable or misleading in the context of giving a true and fair view (refer to also to **section 3** of **chapter 3**).

1.3 Financial statements

Reference to the term 'financial statements' in the auditor's report includes not only the balance sheet and profit and loss account (now called the statement of financial position and statement of comprehensive income respectively in HKFRS) as required by the *Companies Ordinance*, but also additional primary statements such as the statement of changes in equity and the statement of cash flows as well as the accounting policies and explanatory notes. Where required by an accounting standard, these additional primary statements are normally deemed necessary for the financial statements to give a true and fair view of the state of affairs and profit or loss, as required by the *Companies Ordinance*.

1.4 Presentation of the auditor's report

While it is not specifically addressed by HKSA 700, general practice in Hong Kong is to place the auditor's report before the financial statements to facilitate communication with the reader, and as such directors (or their equivalent) should be encouraged to position the auditor's report in this manner.

This chapter discusses the requirements of HKSA 700 and HKSA 701 in the following sections:

Section 2	Format and content of the auditor's report
Section 3	Modified auditor's report
Section 4	Other reports required by the Companies Ordinance

2 Format and content of the auditor's report

2.1 Introduction

HKSA 700 sets out the format and content of the auditor's report, requiring that it should include the following elements: [HKSA 700(17)]

- a title, clearly indicating that the report is being provided by an independent auditor;
- an appropriate addressee;

- an introductory paragraph, identifying the entity whose financial statements have been audited, as well as a statement that the financial statements have been audited. In addition, the introductory paragraph would also contain the following:
 - the title of each of the financial statements comprising the complete set of financial statements that were audited;
 - a reference to the summary of significant accounting policies and the other explanatory notes to the financial statements; and
 - the date and period covered by the financial statements;
- management's responsibility for the financial statements;
- auditor's responsibility;
- auditor's opinion;
- other reporting responsibilities;
- the signature of the auditor;
- the date of the auditor's report; and
- the address of the auditor.

While HKSA 700 does not require each of the above elements to be given in the order listed, we would expect that most auditors will do so because HKSA 700 clearly intends to establish a standard format to assist the reader in understanding the various matters which are of relevance, as well as any unusual circumstances that have occurred. HKSA 700 also indicates that the consistency of presentation of the auditor's report promotes credibility in the marketplace.

The layout of the standard unmodified auditor's report for a Hong Kong company, with referenced supporting guidance, is set out below.

INDEPENDENT AUDITOR'S REPORT¹ TO THE MEMBERS OF XYZ LIMITED²

(incorporated in Hong Kong with limited liability)³

We have audited the financial statements of XYZ Limited (the "Company") set out on pages ... to ... , which comprise the statement of financial position as at 31 December 20X9, and the [income statement,] statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes⁴.

Directors' responsibilities for the financial statements⁵

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants (the

Guidance

1. Indicates that it is the report of an independent auditor (who has complied with the relevant ethical requirements concerning independence).
2. Identifies the person or persons to whom the report is addressed.
3. In Hong Kong, it is a common practice to disclose the place of incorporation/ establishment of the company.
4. Identifies the title of each of the financial statements that comprise the complete set of financial statements covered by the opinion.
5. Identifies those responsible for preparing financial statements. Under the *Companies Ordinance*, the directors are responsible for the preparation of financial statements which show a true and fair view. The report should indicate that the directors' responsibility includes: [HKSA 700(28)]

"HKICPA") and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility⁶

Our responsibility is to express an opinion on these financial statements based on our audit and to report our opinion solely to you, as a body, in accordance with section 141 of the Hong Kong Companies Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the HKICPA. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

- (i) designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- (ii) selecting and applying appropriate accounting policies; and
- (iii) making accounting estimates that are reasonable in the circumstances.

6. The auditor is required to state that their responsibility is to express an opinion on the financial statements based on their audit. [HKSA 700(32)]

The auditor is further required to describe the audit process by including the following explanatory text: [HKSA 700(37)]

- (i) An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;
- (ii) The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor should omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control; and
- (iii) An audit also includes evaluating the appropriateness of the accounting policies used, the

Opinion⁷

In our opinion the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X9 and of its profit [loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards⁸ and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Signature⁹
 Certified Public Accountants
 [Address]
 [Date]¹⁰

reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.

The auditor's report should also state that the auditors believe that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion. [HKSA 700(38)]

7. An auditor's report should contain a clear expression of opinion on the financial statements [HKSA 700(4)]
8. The auditor is required to identify the applicable reporting framework on which the financial statements are based to inform the reader as to the context in which the auditor's opinion is expressed. [HKSA 700(43)]
9. The signature would represent the name of the audit firm and/or the personal name of the auditor depending on the legal form of the auditor.
10. The auditor should date the report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. [HKSA 700(52)].

It should be noted that HKSA 700 does not prescribe the wording for each section heading but includes illustrative wording for the headings in the example reports attached to HKSA 700. Where the auditor's report is modified, the heading for the opinion section should be clearly signposted to inform the reader of the nature of the modification. Each of the elements of the auditor's report is discussed in further detail below.

2.2 Title and addressee

HKSA 700 requires the auditor's report to be addressed, as required by the circumstances of the engagement, to an appropriate addressee. In addition, the title should clearly indicate that the report is the report of an independent auditor. This informs the reader that the auditor has met all of the relevant ethical requirements regarding independence which have been issued by the relevant professional body, such as the HKICPA. This helps to distinguish an independent auditor's report from reports issued by others. Reports issued on the statutory financial statements of a company should be addressed to the members (normally the shareholders) of the company.

The report examples attached to HKSA 700 are addressed to the 'shareholders' of the company. As the *Companies Ordinance* requires the auditor to report to the company's members, we consider it to be more correct that statutory audit reports for companies are addressed to the members and not to the shareholders. This would also deal with situations where there are no shareholders, e.g. companies limited by guarantee.

2.3 Introductory paragraph

HKSA 700 requires the auditor's report to include an introductory paragraph identifying the entity whose financial statements have been audited, and the fact that the financial statements that have been audited. In addition, the introductory paragraph should also: [HKSA 700(22)]

- Identify the title of each of the financial statements that comprise the complete set of financial statements;
- Refer to the summary of significant accounting policies and other explanatory notes; and
- Specify the date and period covered by the financial statements.

The auditor's report should normally refer to financial statements instead of the accounts and notes. Reference in the directors' report should also be to financial statements. However, consistency of terminology is desirable and, if the directors prefer to use a term like 'accounts and notes' to describe the company's financial statements, then the auditor's report should do the same.

Usually the financial statements are accompanied by other financial information, such as that contained in the directors' report, chairman's statement, Management Discussion and Analysis and historical summaries. Under Hong Kong Standard on Auditing 720 *Other Information in Documents Containing Audited Financial Statements* (HKSA 720), the auditor should read the other information so as to identify any material inconsistencies between the financial statements and the other information. The auditor should seek to resolve any such material inconsistencies discovered or any material misstatements of facts in the other information of which they become aware. Otherwise, the auditor has no responsibility to report on this information. It is important, therefore, to identify clearly the financial statements to which the auditor's opinion relates. This is done by stating the title of each of the individual financial statements included in the complete set of financial statements. HKSA 700 also suggests that the auditor considers identifying the numbers of the pages in the annual report which contain the financial statements.

2.4 Responsibilities of the directors

In order to assist readers in understanding the nature and context of the opinion expressed by the auditor, the auditor's report should distinguish between the responsibilities of those who prepare financial statements, typically the directors, and those who audit them. In particular, readers need to be made aware that it is the directors of the reporting entity, and not the auditor, who determine the accounting policies to be followed. Accordingly, HKSA 700 requires the auditor's report to include separate sections setting out the respective responsibilities of directors (or equivalent persons) and auditor.

HKSA 700 makes reference to 'management' in the context of preparing the financial statements in accordance with the relevant accounting framework. In Hong Kong, under the *Companies Ordinance*, it is the directors of the company who are responsible for the preparation of the financial statements.

The directors' responsibilities as set out in HKSA 700, include: [HKSA 700(28)]

- designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- selecting and applying appropriate accounting policies; and
- making accounting estimates that are reasonable in the circumstances.

In some circumstances it may be necessary for the auditor to include additional responsibilities relevant to the preparation of the financial statements. This may be the case where local laws confer additional requirements on the preparers of the financial statements.

2.5 Responsibilities of auditor

HKSA 700 requires the auditor to state in their report that their responsibility is to express an opinion on the financial statements based on the audit. [HKSA 700(32)]

The auditor is also required to state that their audit was performed in accordance with Hong Kong Standards on Auditing, and that these standards require the auditor to comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

In Hong Kong, auditors will normally carry out their work in accordance with auditing standards issued by the HKICPA. Where the auditor is required to follow other auditing standards which are comparable to those issued by the HKICPA (e.g. International Standards on Auditing), the auditor should refer to those other standards.

Hong Kong Standard on Auditing 200 *Objectives and General Principles Governing an Audit of Financial Statements* (HKSA 200) states that the auditor should not represent compliance with Hong Kong Standards on Auditing unless the auditor has complied fully with all of the Hong Kong Standards on Auditing relevant to the audit. In exceptional circumstances, the auditor may depart from Auditing Standards in order to carry out the objectives of the audit more effectively. In such circumstances, the reasons for the departure should be properly documented in the auditor's working papers. Unless a departure from an auditing standard affecting significant information in the financial statements can be justified, it constitutes a limitation in the scope of the audit and will result in a qualified (except for – limitation) opinion or, in extreme circumstances, a disclaimer of opinion.

The auditor should describe the audit process by stating that: [HKSA 700(37)]

- an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;
- the procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control; and
- an audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.

Where the auditor has a separate responsibility to report on the effectiveness of the internal control, the auditor would not include the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control.

HKSA 700 requires the auditor to state that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion. [HKSA 700(38)]

2.6 Auditor's opinion

The auditor's report is required by HKSA 700 to include a separate section containing a clear expression of opinion on the financial statements. [HKSA 700(4)]

HKSA 700 also allows that where local standards, laws or generally accepted practice in a jurisdiction require or permit the auditor to elaborate on additional matters, such matters may be addressed in a separate paragraph following the opinion paragraph. [HKSA 700(45)]