

I**The Context and Conceptual Framework of Financial Reporting**

Learning Objectives

After studying this chapter, you should be able to:

1. Appreciate the emergence of the decision-usefulness objective of general purpose financial reporting.
 2. Understand the broad context of financial reporting from the viewpoint of its preparation, regulation, use and market consequences.
 3. Understand the purpose and applicability of HKICPA's/IASB's *Framework for the Preparation and Presentation of Financial Statements*.
 4. Understand the underlying assumptions and qualitative characteristics of financial statements.
 5. Know and be able to apply the definitions of the five elements of financial statements – assets, liabilities, equity, income and expenses.
 6. Understand the recognition criteria for items in the elements of financial statements.
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Introduction

In today's society, companies have many stakeholders. Stakeholders are parties demanding financial and other corporate information to facilitate their decision-making, to facilitate the monitoring of management, or to interpret contracts or agreements that include requirements based on such information. Stakeholders are groups that will be economically impacted by a company – especially if it is a large and complex organisation like a multinational company group.

Apart from the demands from stakeholders for companies to report financial and other corporate information, there are also the supply-side forces affecting corporate reporting. The supply of corporate information provided to external stakeholders involves those regulatory and market forces that affect the content of financial reports and other corporate announcements and the timing of their release. The corporate reporting environment in most countries is built around an institutional framework. This involves (1) companies and securities legislation, (2) various government oversight bodies to develop and enforce companies and securities regulations and

accounting and auditing standards, and (3) a professional accounting body to direct its members in their work of preparing and disseminating corporate financial information for their employer or their clients.

Accounting, in the financial reporting branch of the discipline, has the overriding objective of being 'decision-useful' to a wide range of an organisation's stakeholders. The definition of accounting has long been established as:

The process of identifying, measuring and communicating financial and other quantitative information about economic entities to permit informed judgements and decisions by users of the information (combines definitions from AAA Statement of Basic Accounting Theory, 1966 and AICPA Accounting Principles Statement No. 4, 1970).

The 'users' referred to in this definition will have diverse demands for information suited to their own decision needs' and it becomes impractical for companies to provide reports that satisfy all these users' needs. So, in terms of supplying financial information, the concept of 'general purpose financial reporting' has been established. The objective developed by the International Accounting Standards Board (IASB) in its *Framework* for external reporting by entities, and adopted by the Council of the Hong Kong Institute of Certified Public Accountants (HKICPA), is stated as follows:

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements prepared for this purpose meet the common needs of most users (HKICPA's Framework, 2004, clause 12 and 13).

This chapter details and evaluates the conceptual framework which has evolved in the modern era in response to the accounting profession's and corporate and securities regulator's acceptance of a user-oriented objective for corporate financial reporting. In particular, HKICPA's *Framework* will be presented in this chapter. Hong Kong Financial Reporting Standards (HKFRSs) are based on the *Framework*, which addresses the concepts underlying the information presented in general purpose financial statements.

Conceptual Framework

The *Framework for the Preparation and Presentation of Financial Statements*, as issued in revised form by the Council of HKICPA on September 2004, is converged with the International Accounting Standards Board's (IASB) *Framework*. The *Framework* provides the concepts that address the nature, purpose and broad content of financial reporting and underlie the preparation and presentation of financial statements for external users. The concepts in the *Framework* are not set out as *requirements* for preparing general purpose financial reports. They are integral to generally accepted accounting practices (GAAPs) in Hong Kong, but their status is non-mandatory. Only the accounting standards and financial reporting standards (ie HKASs and HKFRSs) and interpretations of those standards (ie HKAS Interpretations and HKFRS

Interpretations) are mandated pursuant to section 18A of the *Professional Accountants Ordinance* (Chapter 50).

The *Framework* deals with the objectives of financial statements, the qualitative characteristics that information in financial statements should possess, and the definition, recognition and measurement of the primary elements in financial statements. It applies to all *reporting entities*, defined as enterprises for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

The purpose of the *Framework* is to:

- give guidance to the Council of HKICPA in developing new financial reporting standards and reviewing existing standards. Accounting standards will be more consistent and logical if they are developed from an orderly set of concepts;
- assist preparers of financial statements in applying HKFRSs. The concepts guide preparers in their broader fulfilment of GAAPs;
- assist auditors in forming an opinion as to whether financial statements conform with HKFRSs. An independent review by the auditor of the recognition and measurement decisions by preparers relating to revenues, expenses, assets and liabilities in the financial statements can be undertaken by reference to the details about primary elements;
- assist users of financial statements in interpreting the information. The quality of disclosures can be judged by users against the list of qualitative characteristics; and provide those who are interested in the work of Council with information about its approach to the formulation of HKFRSs. The process of communication between the Council of HKICPA and its constituents can be enhanced because the conceptual underpinnings of proposed accounting standards will be more apparent.

Users and their Information Needs

These are identified in the *Framework* as including the following:

- (1) Investors – present and potential shareholders and their advisers who are concerned with the risk inherent in, and return provided by, their investments;
- (2) Employees – employees and their representative groups who are interested in information about the stability and profitability of their employers;
- (3) Lenders – they are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due;
- (4) Suppliers and other trade creditors – they are interested in information that enables them to determine over the short-term whether amounts owing to them will be paid when due, and whether the enterprise has growth prospects that enable business expansion for its suppliers;
- (5) Customers – they have an interest in information about the continuance of the enterprise, especially when they have a long-term involvement with it;
- (6) Governments and their agencies – they are interested in the allocation of resources and other activities of the enterprise in order to determine the need to regulate these activities and obtain national statistics; and

- (7) Public – enterprises affect members of the public in various ways through their contribution to the local economy, community and environment. The public may be interested in investment activities that impact on local employment or the patronage of local suppliers.

The Broad Financial Reporting Context

Taking a broad view, financial reporting by entities is conducted in context which can be described as in Figure 1.1. The model given in the figure is based on the view that the financial reporting environment comprises four interrelated components:

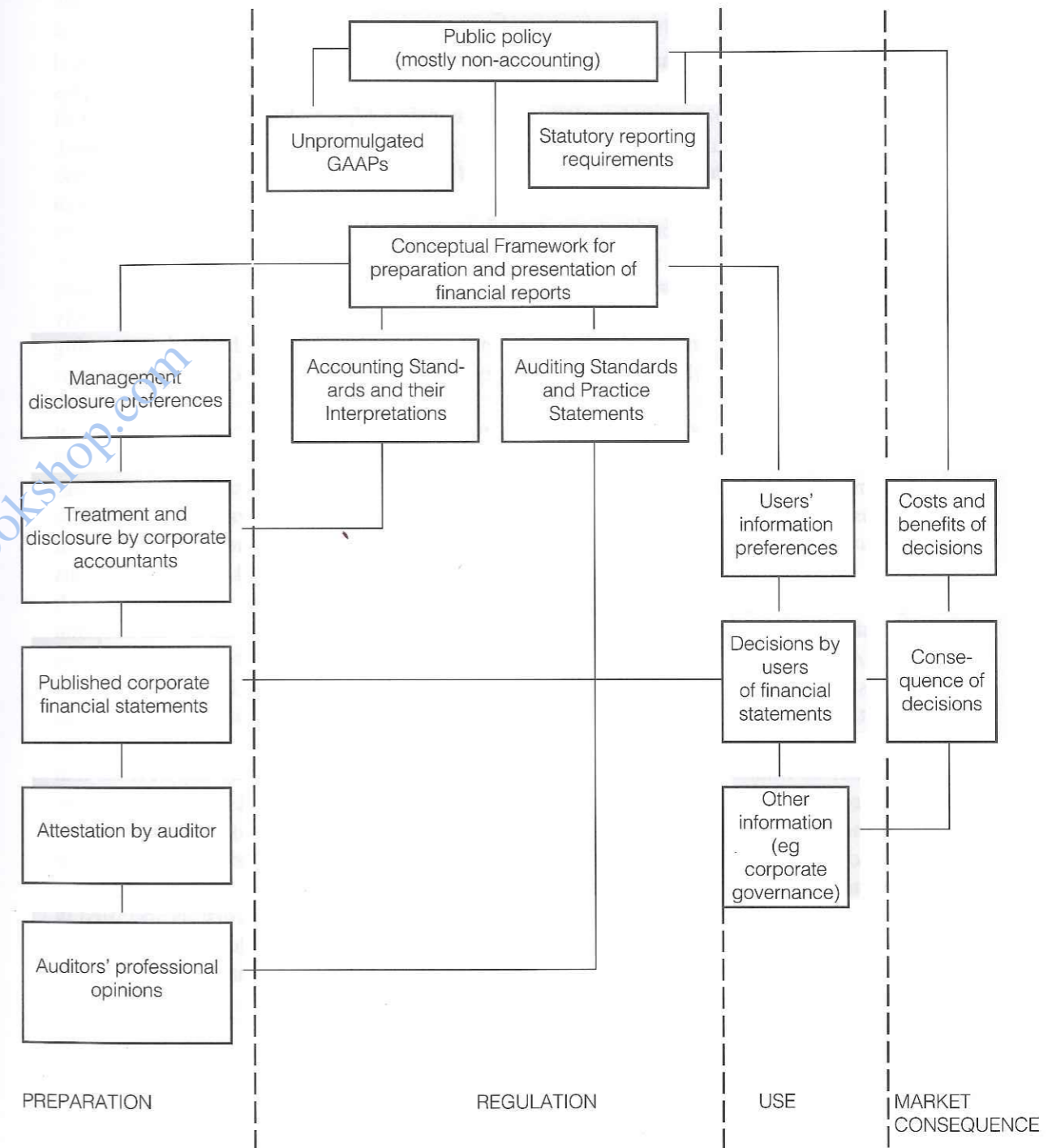
- preparation of corporate financial information;
- regulation of corporate financial reports;
- use of published financial reports; and
- market consequences of decisions based on published financial reports.

The model centres around the regulatory nature of the financial reporting environment. Accounting policy-makers choose sets of regulations which will govern, to a large degree, the preparation and audit of published financial reports. The model suggests that policy-makers, including corporate legislators, share-market regulators, and the accounting profession itself, are influenced by feedback from four sources:

- the preferences for accounting treatment and disclosure expressed by financial statement producers, comprising corporate management, corporate accountants, and appointed external auditors;
- the preferences for financial information by external users of corporate reports, particularly existing shareholders;
- the perceived net payoff (ie benefits to costs) in the market arising from actions taken by financial statement users; and
- public policies (mostly non-accounting) implicitly or explicitly prescribed by the relevant socio-political regime of a country.

Figure 1.1 assumes a form of regulation similar to that for Hong Kong. The regulation of the market for corporate financial information could be undertaken in different ways and to different degrees. For example, government might adopt a prescriptive approach by which detailed principles, rules, and procedures are laid down and enforced by law. If the degree of prescription is high, there is low influence by private sector professional bodies in accounting regulation. Alternatively, legal regulations may provide only general requirements related to minimum corporate disclosure requirements, and professional accounting bodies may provide standards to extend the statutory regulations and to assist in their interpretation and implementation. In such an environment, as is the case for Hong Kong, reliance is placed on the independent judgement of those professionally qualified to prepare financial reports in line with generally accepted criteria as well as regulatory requirements.

Figure 1.1
The Broad Context of Financial Reporting



Source: Adapted from May and Sundem (1976).

Approaches to Accounting Policy-making

The ways in which accounting policy-makers could approach their decisions on accounting regulation could be to take either of the following:

- A pragmatic, or **conventional**, approach which evolves in response to real-world practical problems, broadly leading to the formulation of some guiding general postulates and principles as a result of inductive reasoning. It typically consists of case-by-case development of regulations of accounting practices, similar to the way in which common law has developed.
- A deductive, or **decision-usefulness**, approach built on a comprehensive conceptual framework. This approach moves from general propositions about the objectives of financial reporting to the derivation of particular principles and then specific methods for accounting.

The pragmatic approach represents the conventional views of accounting that existed before mandatory standard-setting bodies were established. Theories for accounting were essentially concerned with what accountants do. The conventional approach has emphasised accounting practice as the basis from which to develop theory. Hence, conventional accounting theory is descriptive in character.

Under the pragmatic approach, financial reporting is largely left to the independent judgement of those qualified by training and experience to confirm that financial reports follow a general principle prescribed by law, and embedded in the social framework, known as the 'true and fair view'. Thus, it was not unusual in the past for the directors and management of a company to elect not to comply with an accounting standard issued by the previous Hong Kong Society of Accountants (HKSA) on grounds that applying the particular standard would cause the accounts not to present a true and fair view. The ability to depart from an accounting standard in such circumstances has commonly been termed the 'true and fair view override'. Since the adoption of the *Framework* and HKAS 1 'Presentation of Financial Statements', this 'true and fair override' is still permitted in extremely rare circumstances. HKAS 1 (paras 17 and 18) requires that if, in the opinion of management, compliance with a requirement in a Standard or an Interpretation would be so misleading that it would conflict with the objective and qualitative characteristics of financial statements set out in the *Framework*, then it may depart from that particular requirement to give a true and fair view. But full disclosure must be given about the nature of the departure, the treatment that the Standard or Interpretation would require, the reason why that treatment would be so misleading, the treatment adopted and the financial impact of the departure on each item in the financial statements.

The decision-usefulness is now fully embedded in the HKICPA's *Framework*, as specified in the objective of financial statements. This approach is developed from a deductive reasoning process in which a comprehensive conceptual framework is built upon the primary objective of making financial reports useful to users.

Underlying Assumptions

The *Framework* identifies two fundamental assumptions that underlie the approach to preparing and presenting financial statements. These are the assumptions that an accrual basis of accounting applies and that the reporting entity is expected to remain a going concern.

Accrual Basis

Accounting treatment is to recognise the effects of transactions and events when they occur rather than when cash or its equivalent is received or paid. These recognised transactions and events are to be reported in the financial statements of the periods in which they occur. Under the accrual assumption, a company's financial position and performance can change with or without any cash changing hands. For transactions or events where cash does not change hands, there will usually occur a change in a right to receive cash in the future or an obligation to pay cash in the future.

Going Concern

The accrual basis is applied in financial statements on the assumption that a company is a going concern and will continue in operation for the foreseeable future. This assumption cannot be met when a company's directors and management have decided, or have a reasonable expectation, that the company will be liquidated or partially discontinue its operations in the near future. When such an intention or expectation exists, the financial statements in the period prior to liquidation or discontinuation must be prepared on a different basis to accrual accounting. The users of financial statements of such a company will have a vital interest in the net amount of cash that can be generated from its assets in the short term. So a cash basis of accounting would replace the accrual basis.

Qualitative Characteristics of Financial Statements

To be useful for decision-making, information selected for inclusion in general purpose financial statements should have certain qualitative characteristics or attributes. The *Framework* identifies four principal qualitative characteristics: understandability, relevance, reliability and comparability. Other characteristics are ingredients of the principal characteristics of relevance and reliability, or are constraints on relevant and reliable information. While the *Framework* does not show its set of characteristics in the form of a hierarchy of qualities, it infers that there is a hierarchy as illustrated in Figure 1.2.

Understandability

Information should be presented in a way that is readily understood by users. Users are assumed to have a reasonable knowledge of business and economic activities and accounting. Relevant

information about complex matters should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

Relevance

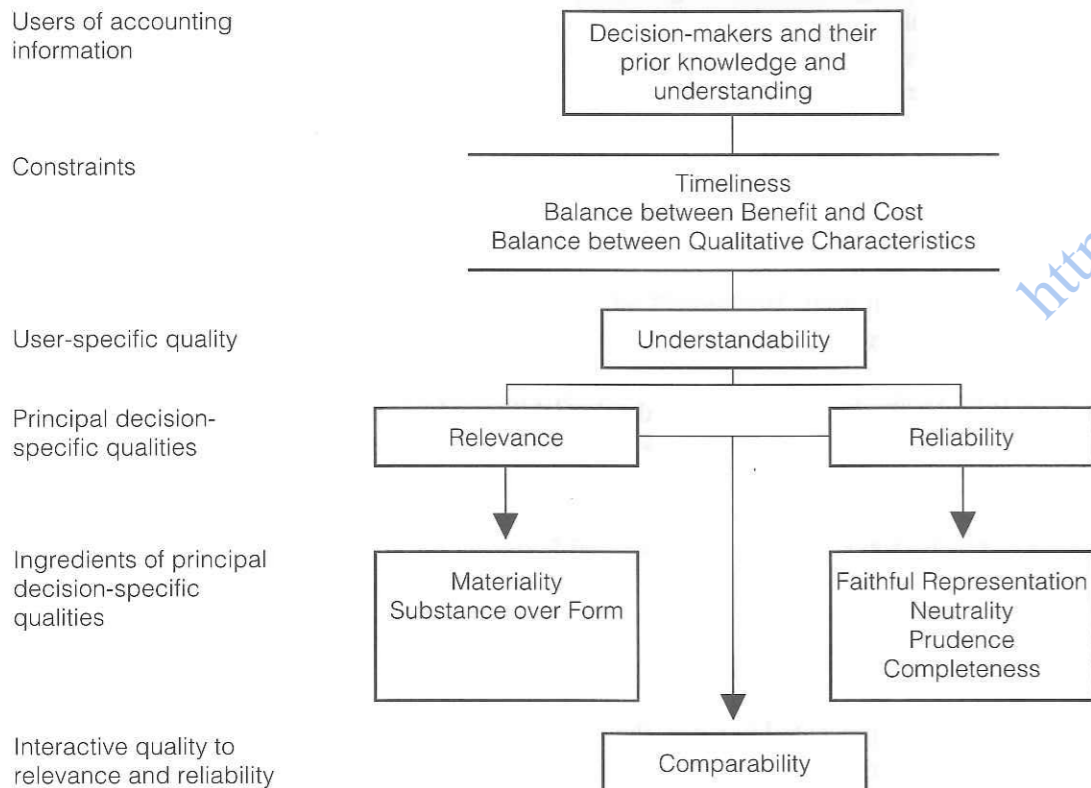
Information is relevant when it influences the economic decisions of users. Information in financial statements can do that by having both a predictive and confirmatory role. First, it can help users to make predictions through their evaluation and projection of past, present or future events. Second, it can help users to confirm their past predictions by clarifying or correcting their past evaluations.

Reliability

Information in financial statements is reliable if it is free from material error and bias, and can be depended on by users to represent events and transactions faithfully. Information is not reliable

Figure 1.2

A Hierarchy of Qualitative Characteristics for Financial Reporting



when it is purposely designed to influence users' decisions in a particular direction – the information lacks neutrality.

Materiality

Materiality is a component of relevance. Information is material if its omission or misstatement could influence the economic decisions of users. Materiality depends on the size of the item. It infers a cut-off point, above which the item needs to be separately disclosed in financial statements. For example, if advertising expense is more than 10% of total operating expenses, it is likely to be deemed material and needs to be disclosed separately rather than hidden in the aggregate amount for operating expenses. But the *Framework* does not provide quantified measures of a cut-off point to establish the existence of materiality.

Substance Over Form

Financial statements should reflect the substance and economic reality of transactions and not necessarily their legal form in order to be relevant to economic decision-making of users. For example, if a company sold a building in a way that legally passes ownership to the purchaser for a low consideration, but other legal agreements exist that ensure the company continues to get full use and all future economic benefits from the building as a cost equivalent to the consideration received, then it should not be accounted for as a disposal of an asset because that is not the substance or economic reality of what happened.

Faithful Representation

To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, when a bank reports its asset 'loans receivable', it should not ignore the reality of its currently existing problem loans merely because it is confident that the economy will turn out of a recession into a growth economy next year.

Neutrality

To be reliable, the information contained in financial statements must be free from bias. This means that the information is not designed in a way that intentionally leads the users to make an economic decision that the preparer of the information would like them to make.

Prudence

Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates that are required because of uncertainties surrounding many events and circumstances, such as the collectability of doubtful receivables or the probable useful life of equipment. It aims to ensure assets or income are not overstated, and liabilities and expenses are not understated. But prudence does not allow deliberate under- or overstating, because the financial statements would not be neutral.

Completeness

To be reliable, information in financial statements must be complete within the bounds of materiality and cost. Omissions make financial statements just as wrong as unreliable or irrelevant information.

Comparability

To be both relevant and reliable, information in financial statements must enable users to compare the information through time for any company so that they can identify trends in a company's financial position and performance. Users must also be able to compare the financial statements of different companies to make decisions about where to invest their capital and at what price. Disclosure of accounting policies is essential for comparability.

Timeliness

A constraint on providing relevant information is that its reporting is unduly delayed. To provide information on a timely basis, it may often be necessary to report before all aspects of a transaction or other events are known, thus reducing reliability.

Balance between Benefit and Cost

This pervasive constraint is that the costs of providing information should not exceed the benefits derived from it. The evaluation of benefits and costs is, however, substantially a judgemental process. So it is difficult to apply the cost-benefit test in any particular case. Standards-setters should be aware of this constraint.

Balance between Qualitative Characteristics

The relative importance of the various qualitative characteristics in different cases is a matter of professional judgement. The hierarchy of qualities in Figure 1.2 suggests that relevance and

reliability are the twin overriding qualities of financial statements. There is a trade-off between relevance and reliability. For example, the fair value of non-current assets is more relevant to users of financial statements than the historical cost of these assets, but is a less reliable measure.

The Elements of Financial Statements

The second component of fundamentals underlying general purpose financial reporting is the identification and definition of the elements that comprise the financial statements. Broad classes of transactions and events are known as the elements of financial statements. These elements are directly related to the measurement of financial position and performance. Elements directly related to financial position (ie the Balance Sheet) are assets, liabilities and equity. Elements directly related to financial performance (ie the Income Statement) are income and expenses. The Cash Flow Statement reflects both Income Statement elements and Balance Sheet elements. The Cash Flow Statement does not present any additional elements of financial statements.

The *Framework* defines the five elements as follows:

Assets

An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise (*Framework*, para 49(a)).

According to this definition, the essential characteristics of an asset are (a) control by the enterprise, (b) the result of past events, and (c) future economic benefits.

'Control by the enterprise' is concerned with the capacity of the enterprise to benefit from the asset in the pursuit of the enterprise's objectives and to deny or regulate the access of others to that benefit. The power to prevent others from enjoying the benefits from an asset generally results from ownership. Suppose a company has an exceptionally skilled employee who attracts many customers to the company. The company might regard the employee as an asset because he or she generates future economic benefits. But the employee does not meet the asset test of control by the company over generation of future economic benefits. Hence, the employee is not owned by the company, so if the employee were to resign, the company would lose the benefits without any compensation. It is possible, however, that future economic benefits may be secured by possession without ownership. This would be the case with leased assets.

'Result of past events' is a characteristic of an asset that refers to the fact that the enterprise has already obtained access to, and control over, the future economic benefits of the asset. The right of access to future economic benefits is certain, even though the amount of those benefits may be uncertain. Assets must be obtained from transactions or other events such as purchase, internal development, design and production activity, accretion and discovery.

'Future economic benefits' refers to the fact that an asset must be more than an object or a right. From an accounting viewpoint, an object or a right is not an asset unless it is expected to provide future economic benefits to the enterprise. For example, an office building in the district of a city that has been permanently overtaken by unemployed 'squatters' (eg in Johannesburg) will be of no use to the enterprise and cannot be sold by the enterprise. It can provide no future economic benefits to the enterprise and is not an asset. Accounts receivable, on the other hand,

are an asset not because they are a right but because they represent future economic benefits in the form of cash inflows from settlement. It should be noted that future economic benefits are not always synonymous with net cash inflows; they can take the form of the future provision of needed or desired services to public which enable the enterprise to meet its objectives. For example, a collection of artefacts or works of art held by a museum or gallery would be an asset to that museum or gallery. Hence, it is the presence of future economic benefits, in the form of future net cash inflows or the provision of future services that meet the objectives of the enterprise, not the physical or other forms of an object or right, that is relevant in assessing whether an asset exists.

Liabilities

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits (*Framework*, para 49(b)).

Under this definition, the essential characteristics of a liability are (a) existence of a present obligation of the enterprise, (b) the result of past events, and (c) a future sacrifice of economic benefits.

'Existence of a present obligation of the enterprise' first implies the involvement of two separate parties: the reporting entity and an outside entity. Thus, an internal commitment by the management of an enterprise to provide for future repairs and maintenance of equipment, or to acquire assets in the future, does not create a liability. This is the distinction between a present obligation and a future commitment. Second, it is to be noted that the obligation to an outside party can be legal, equitable or constructively unavoidable. A 'legal' obligation can arise from a contract (eg a loan agreement, an invoice to pay for the purchase of goods or services, a warranty agreement on products sold to customers) or from a requirement imposed by a legally authorised body or legislation (eg payment due under the *Inland Revenue Act*, payment of damages awarded against the enterprise by a court). An 'equitable' obligation can arise from social or moral considerations rather than legal sanctions. An example of an equitable obligation is when an enterprise, based on moral considerations, undertakes to recall a faulty product from its customers and fixes it at the enterprise's cost without charge to the customer, even though the legal warranty period has expired. Such a commitment would create a liability. An unavoidable 'constructive obligation' is a particular situation (other than a contract or government imposed requirement) which leaves the enterprise with little, if any, discretion to be able to avoid the outflow of resources. An example is the practice of paying periodic bonuses to employees even though the enterprise is not contractually bound to do so.

'Result of past events' means that a transaction or event that creates a present liability must have already happened. A present liability cannot be created by a future transaction or event. Even if it is certain that an enterprise will borrow in the future, no liability exists at present. For example, when an agreement to borrow has been signed, but the lender has not yet made funds available to the enterprise and, therefore, an obligation to repay the loan has not yet resulted, then a present liability cannot be recognised.

'A future sacrifice of economic benefits' means that settlement of a present obligation involves the enterprise giving up resources embodying economic benefits in order to satisfy the

claim of the other party. In most cases this future sacrifice will be cash payment, but it may be the surrender of another asset such as a receivable or the performance of a service.

There can be a considerable degree of estimation required in the measurement of some liabilities. These liabilities can be described as provisions. When a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if it is difficult to estimate. Examples include provision for future payments to be made under existing warranties and provision to cover future pension obligations to employees.

Equity

Equity is defined as the residual interest in the assets of the enterprise after deducting all its liabilities (*Framework*, para 49(c)). Creditors or lenders can be viewed as external claimants on the assets of the enterprise, and owners or shareholders are internal claimants. The internal claimants are also described as the residual equity holders because legally they have claims only against the assets remaining after the liabilities have been settled. In short, the definition of residual equity is assets minus liabilities. In reality, this is not a definition but a measurement rule. The definition does not specify the characteristics of equity, only how it should be measured. Equity exists only because there are assets and liabilities; it is recognised in the financial statements only when assets and liabilities are recognised.

Income

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants (*Framework*, para 70(a)).

This is a broad definition that encompasses both revenue and gains.

Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent (*Framework*, para 74). An element of revenue, in the above definition of income, is that revenue is a flow in the form of an inflow or enhancement of an asset or a settlement of a liability. Another element of revenue, not made specific in the above definition of income, is that revenue arises from the producing or delivering of goods and rendering of services or other activities that constitute the enterprise's ongoing operations. The first element indicates that revenue could be an inflow or an enhancement of assets or decrease of liabilities. An inflow could be, for example, cash from a cash sale or new accounts receivable from a credit sale. An enhancement of assets is a much less likely possibility such as a sale where the consideration takes the form of a maintenance agreement or an agreement to upgrade existing facilities. A decrease in liabilities might be, for example, a situation where an enterprise sells goods to one of its existing creditor and arranges as consideration for the sale a decrease in a pre-existing account payable with that creditor.

Apart from revenues, the definition of income encompasses gains. Gains are defined as representing other items that meet the definition of income, apart from revenue arising in the course of ordinary activities. They may, or may not, arise in the course of the ordinary activities of an enterprise. Gains include realised amounts that can arise, for example, on the disposal of

non-current assets or sale of investments. Gains also include unrealised amounts that can arise, for example, on the revaluation of marketable securities or non-current assets, or a favourable movement in a foreign current exchange rate associated with the translation of a foreign subsidiary's accounts.

Expenses

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrence of liabilities that result in decreases in equity, other than those relating to contributions from equity participants (*Framework*, para 70(a)). This is a broad definition that encompasses losses as well as those expenses that arise in the course of the ordinary activities of the enterprise.

Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of sales, wages and depreciation. They take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment (*Framework*, para 78). Expenses from ordinary activities may be an outflow of assets to an outside entity (eg cash paid for wages, rent or interest, or inventory transferred to a customer). Alternatively, expenses may be other forms of 'using up' assets during ordinary operations (eg depreciation on non-current assets, expiration of prepaid insurance). Other cases will associate expenses with incurrence of liabilities (eg wages or rent accrued as a liability on the balance date).

Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise (*Framework*, para 79). Losses include, for example, those realised from disasters such as fire or flood as well as those arising on the disposal of non-current assets. Losses also include unrealised losses, for example, impairment of a non-current asset due to the recoverable amount falling below the carrying amount of that asset, or an increase in rate of exchange for a foreign currency in respect of the borrowings of an enterprise in that currency.

Capital Maintenance Adjustments and Profit Determination

As explained in *Framework*, para 81:

The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves.

The maintenance of capital, in general terms, means an enterprise has maintained as much capital at the end of the period as it had at the beginning of the period. Any amount above that required to maintain capital intact for the period is profit. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have

been deducted from income. If expenses exceed income, the residual amount is a net loss (*Framework*, para 105).

Concepts of capital maintenance can be broadly divided into 'financial capital maintenance' and 'physical capital maintenance'. The principal difference between the two concepts is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise.

Financial capital maintenance means that a profit is earned only if the financial or money amount of the net assets at the end of the period exceeds the financial or money amount of net assets at the beginning of the period (after excluding any distributions to, or contributions from, owners during the period). Under this concept, increases in the prices or valuations of assets held over the period, conventionally referred to as holding gains, are viewed as part of profits. Alternatively, physical capital maintenance means that a profit is earned only if physical productive capacity (also called operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period. All changes in valuations relating to the replacement cost of assets of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise. Under this concept, capital maintenance adjustments arising from increases in replacement cost of physical assets (essentially inventory and non-current assets) that have been held for the period are treated as part of equity and not as profit.

Recognition of the Elements of Financial Statements

While an item may meet the definition of an element, it is not to be recognised in the financial statements unless it also satisfies the criteria for recognition set out in para 83 of the *Framework*. This paragraph provides general recognition criteria for all five elements of financial statements. It states:

An item that meets the definition of an element should be recognised if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- (b) the item has a cost or value that can be measured with reliability.

These two recognition criteria indicate that tests relating to 'probability' and 'measurability' apply to a defined element before it is recognised in the financial statements. In recognition criterion (a) above, the determination of 'probable' is central to its application to any element. Unfortunately, the *Framework* does not define 'probable'. For guidance, the superseded HKSA Statement 2.01 *Framework* referred to 'probable' as 'more likely rather than less likely', suggesting that an element is to be recognised if there is more than 50% likelihood of future economic benefits flowing to or from the entity. In relation to recognition criterion (b) above, the term 'reliability' in the measurement of cost or value of an asset, liability, income or expense has a corresponding meaning to the qualitative characteristic of 'reliability'. An item can be measured reliably if it is free from material error and bias and can be depended on by users to represent events and transactions faithfully. In most cases, assets will have a cost or other values that can be measured reliably from past transaction data or other market information. An example of a situation where an asset could not be measured reliably would be a mining company that discovered, at

immaterial cost, evidence of minerals at one of its exploration sites, but is not in a position at the balance date to know the extent of the finding or its future commercial value.

Summary

This chapter has introduced the broad context and the conceptual framework for corporate financial reporting. It is this conceptual framework which overlies the regulatory framework of accounting. Whereas the conceptual framework comprises financial reporting objectives, assumptions, operating concepts, and qualitative characteristics, the regulatory framework is embodied in promulgated accounting standards and statutory reporting requirements. The conceptual framework provides the basis for guiding the accounting regulators themselves in developing new regulations. It also provides the basis for guiding accounting practitioners in making judgements on the implementation of financial reporting methods in compliance with the regulatory framework.

Taking a broad view of the context of financial reporting, this can be conceptualised as containing four interrelated components:

- the production of corporate financial reports;
- the regulation of corporate financial reports;
- the use of published financial reports; and
- the market consequences of decisions based on published financial reports.

Historically, the conceptual framework for financial reporting was developed in a pragmatic way, with various broad accounting assumptions, concepts, doctrines, and generally accepted accounting practices applied in a subjective manner so as to meet the criterion of a 'true and fair view'. With the issue of the HK *Framework for the Preparation and Presentation of Financial Statements* in June 1997 and its upgrade to the adoption of IASB's equivalent *Framework* in September 2004, the emphasis shifted towards a decision-usefulness approach to financial reporting based on a comprehensive, internally consistent, and conceptual framework. This chapter has detailed the guidance given in the *Framework* relating to objectives of financial reporting, underlying assumptions and qualitative characteristics of financial statements and the definitions and recognition criteria for the key elements in financial statements.

Questions and Exercises

1. What is the distinction between a pragmatic approach and a deductive approach to the development of a conceptual framework for the preparation and presentation of financial statements?
2. Financial statement information should be decision useful. What does this mean?
3. Guidance given in HKICPA's *Framework*, which is adopted from the IASB's *Framework*, is subjective and requires judgement to apply it. Would the HKICPA be better off to

abandon the *Framework* entirely and instead rely on establishing a very active standard interpretation committee that develops detailed guidance in response to requests from users and practicing accountants about the application and interpretation of accounting standards?

4. With experienced accountants who intuitively know what is 'true and fair' in financial reporting, there is no need for a detailed conceptual framework. Do you agree? Explain.
5. 'The confirmatory and predictive roles are the principal ingredients of *relevance* for decision-usefulness.' Discuss.
6. For financial information to be *reliable*, what qualities should it possess?
7. In some cases, there may be a conflict between *relevance* and *reliability*. Explain with examples.
8. Distinguish between the definition and recognition of an element.
9. What are the essential characteristics of an asset?
10. 'Experienced and loyal employees have been called the most valuable asset of a business. Yet accountants leave them off the assets in the Balance Sheet.' Discuss.
11. 'For a liability to exist, the obligation must be legally, equitably or constructively unavoidable.' Discuss.
12. 'The definition of equity in the *Framework* is not a definition but a measurement rule.' Discuss.
13. Distinguish between revenue and a gain, and between expense and a loss.
14. A condition for recognising an asset in financial statements is that it has 'probable future economic benefits'. How would you interpret 'probable' in this context?
15. A special case is given in the international standard, *IAS 2 Inventories*, that allows gold mining companies to measure their inventories of gold at selling price rather than production cost, even before they have sold them. This means an income can be recognised at time of production. In other industries, income is recognised when the inventories are sold to outside customers. What concepts in the definition and recognition of income might the IASB considered with regard to accounting for gold production?
16. You are the financial accountant for a Hong Kong/China oil exploration joint venture company. You are well aware that finding recoverable oil is a chancy business. While geologists can help you determine whether oil is likely to be present under a tract of seabed in the South China Sea, there is no way to tell without drilling whether recoverable oil exists at a certain location. In the oil industry, you have to drill many exploratory wells in the hope

of finding recoverable oil. Some wells will be successful, many will not. But if you do not drill and take the risk of not succeeding, you will never have the chance to hitting a 'gusher'.

The oil company has prospecting rights over two tracts of seabed that are believed (based on geological characteristics) to contain oil fields. Below-sea exploratory wells were recently drilled on the two tracts. The exploratory well on the first tract produced a 'dry hole', that is, it was not successful in discovering recoverable oil. The second tract was successful in a big way. The amount of oil you expect to recover from this second well will be more than sufficient to cover the costs of both exploratory wells and yield an expected profit.

A director of the company has suggested that the exploration costs for these two tracts should be treated as assets, rather than expenses, since the exploration costs made the oil discovery possible. The management has turned to you for advice on the matter.

Question: Should the exploratory drilling costs for either or both of the oil wells be treated as an asset in the company's balance sheet? Discuss whether one or both of the oil wells meet the definition of an asset, and also the recognition criteria.

Readings

Hong Kong Institute of Certified Public Accountants, 'Framework for the Preparation and Presentation of Financial Statements', *Hong Kong Financial Reporting Standards*, 2005, www.hkicpa.org.hk/.

International Accounting Standards Board, 'Framework for the Preparation and Presentation of Financial Statements', *International Financial Reporting Standards*, London: IAC Foundation, www.iasb.org.

2

Accounting Standards in Hong Kong and Internationally

Learning Objectives

After studying this chapter, you should be able to:

1. Understand the organisations and processes associated with the shaping and promulgating of accounting and financial reporting standards and interpretations, both in Hong Kong and internationally.
 2. Appreciate the arguments for and against harmonisation of financial reporting standards internationally and the factors leading to the emergence of the IASB as a dominant force.
 3. Understand the due process for standards setting undertaken by the Financial Accounting Standards Committee (FASC) of the HKICPA.
 4. Identify the concordance between the IASB's and the HKICPA's standards and interpretations, and impacts of adopting HKFRSs.
 5. Recognise what a company needs to do when it adopts HKFRSs for the first time.
-

Introduction

The process of setting and applying accounting standards in order to regulate and standardise accounting treatment and disclosure practices in financial statements has recently become more international.

The term 'standard' in accounting can be defined as a method of, or an approach to, preparing financial statements which has been selected by the authoritative government ministry or professional body as the desirable method or approach to apply. By seeking to standardise the preparation of financial statements, accounting standards are concerned with both choice of method of accounting treatment and form and content of disclosure in external financial statements. In general, the need for a new accounting standard or revision to an existing accounting standard is triggered by the following developments:

- A controversial accounting practice is deficient.
- There are areas of difference in accounting which require strict definitive practice.
- An interested party makes a representation on some specific issues.

- There is a consequence for accounting practice arising from a change in the law.
- There are new developments in the international accounting profession.

The use of the word 'standard' instead of 'principle' may enable the old standard to be replaced by an improved standard if this becomes necessary and appropriate. A 'principle' is usually thought of as a comprehensive and fundamental doctrine which should not be subjected to regular review and revision, as would be the case with accounting 'standards'. In fact, during the past decade, more of the work of accounting standard-setters in developed countries has concentrated on revising existing accounting standards than on promulgating new ones.

Globally, there have been in 2005, and continue to be, moves by many countries to adopt International Financial Reporting Standards (IFRSs) rather than develop their accounting standards domestically. This chapter focuses on the structure and processes of standards setting in Hong Kong and how the HKICPA has taken steps to converge its HKASs with the IASB's IFRSs. An understanding is also given of what a company needs to do when it adopts HKFRSs for the first time.

Types of Accounting Standards

Accounting standards can be loosely classified according to their subject matter into the following types:

- presentation standards; and
- content-derivation standards.

Presentation Standards

This type of standard emphasises the specific format and items of information which, as a minimum, must be presented in financial reports. For example, such standards may specify that certain financial statements be presented (eg a cash flow statement) or that items be presented in a particular order or with a particular terminology in financial statements (eg finance costs in the Income Statement). These presentation standards, together with requirements in companies' legislation prescribing the form and minimum content of company financial reports, place few constraints upon the preparer in the choice of accounting policies and methods to use. Examples of presentation-type standards are:

HKAS 1	Presentation of Financial Statements
HKAS 7	Cash Flow Statements
HKAS 14	Segment Reporting
HKAS 24	Related Party Disclosures
HKAS 32	Financial Instruments: Disclosure and Presentation
HKAS 34	Interim Financial Reporting

Content-derivation Standards

Emphasis is on standardising or constraining the choice of accounting policies and methods. Such standards address the accounting treatment that preparers may apply in deriving the content of specific financial statement items or in deriving the content in more general circumstances requiring preparer judgements. These standards specify how specific transactions and events are to be measured and accounted for. Examples of content-derivation standards are:

HKAS 2	Inventories
HKAS 10	Events after the Balance Sheet Date
HKAS 17	Leases
HKAS 21	The Effects of Changes in Foreign Exchange Rates
HKAS 36	Impairment of Assets
HKAS 39	Financial Instruments: Recognition and Measurement

International Harmonisation and Globalisation of Financial Reporting Standards

Prior to 2000, the notion of harmonisation of accounting standards across countries was that individual countries would develop their own standards provided they were not 'logically in conflict' with standards of the International Accounting Standards Committee (IASC). Since the re-structuring of the IASC to become the International Accounting Standards Board (IASB), the trend has been directed towards adopting a single set of global accounting standards in many countries.

The advantages cited in favour of a single set of accounting standards globally include:

- high level of comparability of corporate financial information across borders;
- greater understandability – a common financial language – for foreign investors;
- greater transparency because of consistently high disclosure requirements in the standards;
- increased credibility of domestic capital markets to foreign capital providers and potential foreign merger partners;
- increased credibility of company financial statements in less-developed countries to potential lenders;
- portability of knowledge and education across national boundaries;
- lower cost of capital to companies who report under the financial reporting requirements of more than one country because they do not have to keep different sets of books;
- reduced national standard-setting costs; and
- lower susceptibility to political pressures than national standards.

The main line of argument against the globalisation or convergence of accounting standards is that each country needs to design its own accounting standards to fit the features specific to its own business environment, legal system, culture and political environment. It has been argued that accounting policies and practices adopted within particular countries are, to some extent, a direct reflection of the cultural and individual values and beliefs in those countries. However, the

increasing globalisation of business and the narrowing of international cultural differences point to the increasing acceptance of globalisation of accounting standards.

The International Accounting Standards Board and its Emerging Influence

A brief history of the IASC/IASB is outlined as follows:

- **Beginnings:** The idea of an international standard-setting body was initiated at the 10th World Accounting Congress at Sydney in 1972, nine countries agreed to form the IASC. The IASC commenced functioning in 1973 with an original 10-member professional bodies. Today, there are over 150-member countries.
- **1973-1990:** As a private sector non-government body, the IASC could not mandate compliance with accounting standards. International Accounting Standards (IASs) were criticised as low quality with too many choices.
- **1990-1994:** Reduction of flexibility in IASs was undertaken through the 'comparability project' which reduced the choice of alternative accounting methods allowed in many IASs.
- **1995:** The IASC and the International Organisation of Securities Commissions (IOSCO) reached an agreement. This agreement between the IOSCO and the IASC was that the IOSCO would recommend to member stock exchanges around the world that companies with cross-border listings were to use the IASs rather than their country's GAAP for securities listing purposes. In return, the IASC would undertake to prepare 30 high-quality core standards by the adoption date of 2000.
- **1995-2000:** The IASC pursued a work plan to complete a comprehensive core set of IASs. Thirty new/revised IASs were endorsed by the IOSCO in May 2000. They are referred to as the 'IASC 2000 standards' for adoption by companies with cross-border listing. The Hong Kong Stock Exchange (HKSE) endorsed the core IASs in 2000. This meant that the HKSE would accept financial reports prepared on the basis of IASs.
- **2000:** The IASC was restructured and became the IASB. The IASs became International Financial Reporting Standards (IFRSs). Note that IFRSs are the third series of revisions done to the IASs – first was the convergence project and second was the core standards project. The IASB has 14 Board Members chosen for their high level of expertise – 12 full-time and two part-time. Approval requires eight out of 14 votes. Seven full-time members have 'Liaison' responsibilities with national accounting standard-setters in countries throughout different regions of the world.
- **2000-2005:** The European Commission decreed in 2000 and legislated in 2001 for all EU companies listed on a stock exchange in a EU country to use IFRS standards in preparing consolidated financial statements for years commencing in 2005 and onwards. Many European companies were already using IASs before 2005 in preference to national accounting standards, particularly German and Swiss companies.
- Other countries to agree to converge their accounting standards into IFRSs with effect from 2005 included Australia, South Africa, Singapore, Hong Kong and Malaysia.
- In the US, the IASB and the US's Financial Accounting Standards Board (FASB) reached the 'Norwalk Agreement' in September 2002. This agreement was for short-term convergence of FASs with IFRSs by 2005 in standards that were already very similar; long-term convergence

for several more controversial areas of difference between the FASB and the IASB was planned by 2007. Joint projects of the IASB with the US's FASB are in progress in areas such as business combinations and concepts of revenue, liabilities and equity. Canada and New Zealand have decided to convert to IFRSs in 2007.

- Other countries in Asia-Pacific region adopting IFRSs include: China, Japan and Korea who have adopted only a few IFRS-compatible accounting standards. Other national GAAPs in Asia-Pacific countries are purportedly based on IFRSs, but existing evidence indicates the standards are only selectively applied.
- In Russia, listed holding companies and banks will use IFRSs from 2005, with other large companies being phased in through to 2007.

Table of Concordance for Hong Kong Standards and Interpretations

As explained in the HKICPA's Members' Handbook Vol 11, and on the website www.hkicpa.org.hk (click 'standards & technical', then 'accounting & financial reporting', then 'due process & comparison with IFRS'), there has been a major overhaul of accounting standards and interpretations with effect from 1 January 2005, in order to converge with equivalent international standards and interpretations. Note that international standards were coded as IASs up to 2000 and as IFRSs from 2000 onward; the international interpretations were coded as SIC-Int's up to 2000 and as IFRIC-Int's from 2000 onward.

All Hong Kong Statements of Standard Accounting Practice (SSAP) and SSAP-Interpretations which existed up to 1 January 2005, for which there are equivalent International Accounting Standards (IASs) and Interpretations by the IASB's Standards Interpretation Committee (SIC), are replaced by Hong Kong Accounting Standards (HKASs) and HKAS-Interpretations (HKAS-Int). The numbers of HKASs and HKAS-Int's are set up to correspond to the equivalent IAS and SIC-Interpretation. Each individual HKAS and HKAS-Int contains comparison details between that standard or interpretation and its IASB equivalent. There are 27 former SSAPs that have an equivalent IAS and have been replaced by a HKAS. In addition, there are two former SSAPs that are equivalent to IFRSs and have become HKFRSs from 2005.

Apart from the conversion of former HK SSAPs, there are four new HKASs created as from 2005 (equivalent to a IAS where no former HK SSAP existed) and seven HKFRSs (as at March 2006) created to be equivalent to new IFRSs that had been recently issued.

In relation to Interpretations of standards that are issued, there are former HK SSAP Interpretations that have an equivalent SIC-Interpretation and have been re-issued as HKAS-Int's. In addition, there is one new HKFRS-Int (as at March 2006) created to be equivalent to a recent IFRIC-Int.

The concordance table of standards and interpretations is given in Table 2.1.

The Due Process for Standards Setting in Hong Kong

The Nature of HKFRSs

As explained in the Preface to 'Hong Kong Financial Reporting Standards' (HKICPA, October 2004), the term 'Hong Kong Financial Reporting Standards' (HKFRS) is an all-embracing

Table 2.1
Table of Concordance – Standards and Interpretations

Hong Kong Accounting Standards (HKAS)			
HKAS No.	Title	IAS No.	Previous SSAP No.
HKAS 1	Presentation of Financial Statements	IAS 1	SSAP 1
HKAS 2	Inventories	IAS 2	SSAP 22
HKAS 7	Cash Flow Statements	IAS 7	SSAP 15
HKAS 8	Accounting Policies, Changes in Accounting Estimates and Errors (previously known as Net Profit or Loss for the Period, Changes in Accounting Policies and Fundamental Errors)	IAS 8	SSAP 2
HKAS 10	Events after the Balance Sheet Date	IAS 10	SSAP 9
HKAS 11	Construction Contracts	IAS 11	SSAP 23
HKAS 12	Income Taxes	IAS 12	SSAP 12
HKAS 14	Segment Reporting	IAS 14	SSAP 26
HKAS 16	Property, Plant and Equipment	IAS 16	SSAP 17
HKAS 17	Leases	IAS 17	SSAP 14
HKAS 18	Revenue	IAS 18	SSAP 18
HKAS 19	Employee Benefits	IAS 19	SSAP 34
HKAS 20	Accounting for Government Grants and Disclosure of Government Assistance	IAS 20	SSAP 35
HKAS 21	The Effects of Changes in Foreign Exchange Rates	IAS 21	SSAP 11
HKAS 23	Borrowing Costs	IAS 23	SSAP 19
HKAS 24	Related Party Disclosures	IAS 24	SSAP 20
HKAS 26	Accounting and Reporting by Retirement Benefit Plans	IAS 26	–
HKAS 27	Consolidated and Separate Financial Statements (previously known as Consolidated Financial Statements and Accounting for Investments in Subsidiaries)	IAS 27	SSAP 32
HKAS 28	Investments in Associates (previously known as Accounting for Investments in Associates)	IAS 28	SSAP 10
HKAS 29	Financial Reporting in Hyperinflationary Economies	IAS 29	–
HKAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions	IAS 30	–
HKAS 31	Interests in Joint Ventures (previously known as Accounting for Interests in Joint Ventures)	IAS 31	SSAP 21
HKAS 32	Financial Instruments: Disclosure and Presentation	IAS 32	–
HKAS 33	Earnings Per Share	IAS 33	SSAP 5
HKAS 34	Interim Financial Reporting	IAS 34	SSAP 25

HKAS No.	Title	IAS No.	Previous SSAP No.
HKAS 36	Impairment of Assets	IAS 36	SSAP 31
HKAS 37	Provisions, Contingent Liabilities and Contingent Assets	IAS 37	SSAP 28
HKAS 38	Intangible Assets	IAS 38	SSAP 29
HKAS 39	Financial Instruments: Recognition and Measurement	IAS 39	SSAP 24
HKAS 40	Investment Property	IAS 40	SSAP 13
HKAS 41	Agriculture	IAS 41	SSAP 36
Hong Kong Financial Reporting Standards (HKFRS)			
HKFRS No.	Title	IFRS No.	Previous SSAP No.
HKFRS 1	First-time Adoption of Hong Kong Financial Reporting Standards	IFRS 1	–
HKFRS 2	Share-based Payment	IFRS 2	–
HKFRS 3	Business Combinations	IFRS 3	SSAP 30
HKFRS 4	Insurance Contracts	IFRS 4	–
HKFRS 5	Non-current Assets held for Sale and Discontinued Operations	IFRS 5	SSAP 33
HKFRS 6	Exploration for and Evaluation of Mineral Resources	IFRS 6	–
HKFRS 7	Financial Instruments: Disclosures	IFRS 7	–
HKAS-Interpretations (HKAS-Int)			
HKAS-Int No.	Title	SIC Interpretation No.	Previous Interpretation No.
12	Consolidation – Special Purpose Entities	12	Incorporated in SSAP 32
13	Jointly Controlled Entities – Non-monetary Contributions by Venturers	13	Incorporated in SSAP 21
15	Operating Leases – Incentives	15	Incorporated in SSAP 14
21	Income Taxes – Recovery of Revalued Non-depreciable Assets	21	Interpretation 20
25	Income Taxes – Changes in the Tax Status of an Enterprise or its Shareholders	25	Interpretation 21
27	Evaluating the Substance of Transactions in the Legal Form of a Lease	27	Interpretation 14
29	Disclosure – Service Concession Arrangements	29	Interpretation 16
31	Revenue – Barter Transactions Involving Advertising Services	31	Interpretation 17
32	Intangible Assets – Website Costs	32	Interpretation 19

HKFRS-Interpretation (HKFRS-Int)			
HKFRS-Int No.	Title	IFRIC Interpretation No.	Previous Interpretation No.
1	Changes in Existing Decommissioning, Restoration and Similar Liabilities	1	—

expression that includes all HKFRSs, HKASs, SSAPs and Interpretations issued by the Council of the HKICPA. HKFRSs set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in general purpose financial statements. HKFRSs are based on the *Framework for the Preparation and Presentation of Financial Statements*, which addresses the concepts underlying the information presented in general purpose financial statements (see Chapter 1). The appropriate application of HKFRS, with additional disclosure when necessary, is said to result in financial statements that give a true and fair view.

Entities Required to Comply with HKFRSs

The Council of the HKICPA has determined that HKFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, not to public sector or not-for-profit entities. The scope of profit-oriented entities required to comply with HKFRSs is established in the *Framework* (para 8) as:

A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Profit-oriented entities, according to the HKICPA, include those engaged in commercial, industrial, financial and similar activities (such as mutual insurance or other mutual cooperative entities) and provide dividends or other economic benefits directly to their owners, members or participants. But, if the entity has a relatively small number of owners who have direct access to, or direct involvement in, the financial management of the entity, then they do not need to rely on externally reported financial statements for their major source of financial information about the enterprise. This would be the case for many small-to-medium enterprises (SMEs).

The HKICPA has drafted a SME Financial Reporting Framework (SME-FRF) and Financial Reporting Standard (SME-FRS) which are standards of accounting practices for SMEs that qualify for reporting under the SME-FRF. This book does not cover these types of reporting entities. It only relates to enterprises that are required to comply with the HKFRSs.

The Due Process

The due process of setting HKFRSs is summarised as follows:

- The Council of the HKICPA is given statutory power under the *Professional Accountants' Ordinance* (Section 18A, Chapter 50) to issue or specify any accounting standards, exposure drafts or discussion documents.
- The Council has given its Financial Accounting Standards Committee (FASC) the responsibility to develop standards and achieve convergence with IFRSs. The FASC may form advisory sub-committees or engage other specialist advisors in preparing new and revised HKFRSs.
- The Urgent Issues and Interpretations Sub-committee (UII) is a sub-committee formed under the auspices of the FASC. The role of the UII is to address current issues arising in financial reporting practice and prepare interpretations of HKFRSs for consideration by the FASC. This role includes providing timely guidance on newly identified financial reporting issues, using the *Framework* as a key reference point. These issues arise because a matter has not been specifically addressed in HKFRSs or because unsatisfactory or conflicting interpretations of HKFRSs have developed in practice. The UII develops Interpretations that aim to promote the rigorous and uniform application of HKFRSs.
- The HKICPA also has a Standard-setting Steering Board (SSSB) responsible for reviewing and advising on the HKICPA's overall strategy, policies and processes for setting accounting standards. It advises the FASC on priorities and major projects for standard-setting.
- The actual due process of developing standards and interpretations is co-ordinated closely to the IASB's due process. The steps taken by the FASC and the UII for projects are normally as follows:
 - (a) the technical and professional staff at the HKICPA are asked to identify and review all the issues associated with an exposure draft or a draft interpretation issued by the IASB for possible adoption in Hong Kong or any other topics and to consider the application of the *Framework* to the issues;
 - (b) study pronouncements of the IASB and other standard-setting bodies and accepted industry practices about the issues;
 - (c) consult the SSSB about the advisability of adding the topic to the FASC or the UII's agenda;
 - (d) form an advisory group to give advice to the FASC on the project;
 - (e) publish for public comment a discussion document;
 - (f) publish for public comment an exposure draft or a draft interpretation;
 - (g) publish within an exposure draft a basis for conclusions;
 - (h) consider all comments received within the comment period on discussion documents, exposure drafts and draft interpretations and, when appropriate, prepare a comment letter to the IASB;
 - (i) following the publication of the finalised IFRS or Interpretation of IFRS, consider the changes made, if any, by the IASB;
 - (j) Council to approve a standard or an interpretation;
 - (k) publish within a standard a basis for conclusions, if appropriate, explaining how the conclusions were reached and give background information that may help users of HKFRSs to apply them in practice;
 - (l) on occasion, the FASC will consult with the IASB in a proactive way to raise issues specific to Hong Kong.

Enforcement of Compliance with HKFRSs

Members of the HKICPAs who take responsibility for giving advice to clients or employers about the preparation of financial statements, or who are directly involved in preparing financial statements, are expected to observe and apply HKFRSs as a professional, in a self-regulatory approach. There is no requirement in the *Companies Ordinance* to enforce compliance with HKFRSs. However, the Council of the HKICPA, through its Discipline Committee may undertake an internal inquiry into apparent failure by members to observe HKFRSs or failure to disclose significant departures from HKFRSs.

Current Impacts in Financial Statements of Adopting HKFRSs

The following summarises major impacts in adoption of the new set of HKFRSs on financial reporting in Hong Kong:

- There will be a movement away from historical-cost towards the reporting of fair values. The recent HKFRSs reflect greater use of fair value in measuring transactions. Examples of the use of fair values for measuring profits include:
 - impairment loss recognition requiring write-down of assets to recoverable amount (fair value).
 - financial instruments have a requirement to measure trading investments at fair values and also an option to measure all other financial assets and financial liabilities at fair values, with changes in these values to be recorded in income.
 - recognition in income is also required for changes in fair values on investment in real estate.

Examples of assets being reported at fair values, rather than at cost, include:

- ‘available-for-sale’ investments
 - investment property, including leases of land
 - commodity inventories
 - biological assets and agricultural produce.
- There will be more volatility of reported profit and less opportunity for income smoothing. Some SSAPs were designed to smooth out the volatility of earnings from period to period by means of cost and revenue deferrals and accruals of future costs. As a result, the balance sheet included deferred costs that did not meet the definition of an asset because they would not result in future cash flows to the company, as well as deferred revenues and provisions that did not meet the definition of a liability because they did not obligate the company to make a future cash payment. Recent HKFRSs have rejected income smoothing by, for example:

- taking a balance sheet approach to deferred taxes
 - not allowing accruals for future losses and restructurings
 - using rigorous hedge accounting rules.
- There will be less off-balance sheet items. In the past, companies could keep certain obligations and expenses off their books. Recent HKFRSs have moved off-balance sheet items onto the balance sheet, for example:
 - special purpose entities in consolidated financial statements
 - share-based payments, especially to directors and top executives
 - derivatives, including types of hedging instruments.
 - There will be elimination of some choices of accounting methods. In the past, SSAPs allowed companies to choose between two or more acceptable methods of accounting for the same transaction. These accounting choices are slowly being eliminated from HKFRSs.

First-time Adoption of Hong Kong Equivalents to IFRSs

HKFRS 1 ‘First-time Adoption of Hong Kong Financial Reporting Standards’ prescribes the accounting treatment that an entity is to apply when it adopts HKFRSs for the first time as the basis for preparing its financial statements and interim financial reports. For most reporting entities in Hong Kong, their first-time adoption will occur in their 2005-06 financial year.

In particular, HKFRS 1 requires that an entity shall, in its opening Hong Kong-equivalents-to-IFRSs balance sheet:

- (a) recognise all assets and liabilities whose recognition is required by HKFRSs;
- (b) not recognise items as assets or liabilities if HKFRSs do not permit such recognition;
- (c) reclassify items that are a different type of asset, liability or component of equity under HKFRSs; and
- (d) apply HKFRSs in measuring all recognised assets and liabilities.

The accounting policies that an entity uses in its opening Hong Kong-equivalents-to-IFRSs financial statements may differ from those previously used under HK SSAPs. The resulting adjustments shall be recognised directly in retained earnings (or, if appropriate, another category of equity) at the date of transition.

Illustrations of adjustments required by entities on first-time adoption are given below.

- (a) Eliminating previous assets and liabilities from the opening balance sheet if they do not qualify for recognition under HKFRSs. These include, for example:
 - HKAS 38 does not permit recognising as an intangible asset, expenditure on research, start-up, pre-operating and pre-opening costs, training, advertising and promotion, and

- relocation. If previous SSAPs recognised these assets, they are eliminated against retained earnings in the opening balance sheet.
- Any accrual of liabilities for restructurings, future operating losses or major overhauls that do not meet the conditions for recognition of a provision under HKAS 37 are eliminated in the opening balance sheet.
- (b) Recognising all assets and liabilities required to be recognised by HKFRSs even if they were never previously recognised under SSAPs. Examples are:
- Recognition of all derivative financial assets and liabilities, including embedded derivatives, as required under HKAS 39.
 - Recognition of liabilities to the employer under a defined benefit plan, including obligations for medical and life insurance, termination benefits and deferred compensation, as required by HKAS 19.
 - Recognition of provisions as liabilities, such as obligations for onerous contracts, site restoration, guarantees and litigation, as required under HKAS 37.
- (c) Reclassifying previous SSAP opening balance sheet items into the appropriate HKFRSs classification. Examples are:
- HKAS 32 has principles for classifying items as financial liabilities or equity. Hence, redeemable preference shares that may have been classified as equity under previous SSAPs would be reclassified as liabilities in the opening balance sheet.
 - The reclassification principle would apply for the purpose of defining reportable segments under HKAS 14 as compared to former SSAP 26.
- (d) The general measurement principle is to apply HKFRS in measuring all recognised assets and liabilities. Examples where measurement is expected to require adjustments include:
- HKAS 36 requires non-current assets to be written down to recoverable amount if this has fallen below carrying amount.
 - Biological and agricultural assets are to be measured at fair value, not cost, under HKAS 41.

Summary

Globalisation of capital markets and business has resulted in movement beyond harmonisation of accounting standards internationally towards the adoption by national accounting standard-setters of the international financial reporting standards of the IASB. In Hong Kong, the HKICPA has decided to be amongst the first wave of countries (including countries in the European Union) to fully adopt IFRSs from 2005. The IASB has emerged as a dominant force in the development and promulgation of accounting standards.

The due process for setting standards and interpretations of standards undertaken by the HKICPA have been modified since 2004 to co-ordinate closely with the IASB's process. The

adoption of new HKASs and HKFRSs to replace the former SSAPs will have a significant impact on the reported profit, assets and equity of Hong Kong companies who must undertake 'first-time adoption' of these new standards for reporting years commencing on or after 1 January 2005.

Questions and Exercises

1. Distinguish between:
 - (a) presentation standards
 - (b) content-derivation standards.
2. What is the difference between International Accounting Standards and International Financial Reporting Standards?
3. 'The arguments in favour of having a single set of high quality accounting standards globally are far too strong for any country to continue to resist converging their own GAAPs with IFRSs.' Do you agree? Discuss.
4. What are the three most important developments in the history of the IASC/IASB that have enabled it to bring about convergence of accounting standards internationally.
5. Distinguish between SSAPs, HKASs, HKFRSs, IASs, IFRSs, HK-Int's and SIC-Int's.
6. Briefly describe the procedures for preparing accounting standards in Hong Kong.
7. Outline the different roles of the following HKICPA boards or committees:
 - (a) Standard-setting Steering Board
 - (b) Financial Accounting Standards Committee
 - (c) Urgent Issues and Interpretations Sub-committee
8. What types of entities are required to comply with HKFRSs?
9. What impacts on the information reported in financial statements of Hong Kong companies can be expected after they adopt HKFRSs compared to before adoption of HKFRSs?
10. Under HKFRS 1 'First-time Adoption of Hong Kong Financial Reporting Standards', what are the steps an entity is required to follow in making adjustments in its opening balance sheet?
11. 'Because the HKICPA/HKSA sought to harmonise its SSAPs with IASs over the past decade up to 2004, there will be very few, if any, accounting treatments in the new HKASs

- requiring adjustments to be made in the opening balance sheet of the first-time adopting companies.' Do you agree? Discuss.
12. You are the accountant of a successful medium-sized Japanese company. The company has grown to the point where its owners can no longer supply all the capital the company needs for expansion. The owners have asked you to set out some options for raising capital either in Japan or in Asian capital markets. With that in mind, you have begun some discussions with bankers in Hong Kong, Singapore, Taipei and Kuala Lumpur. You have also spoken with some investment bankers about the possibility of an initial public offering on the Hong Kong Stock Exchange. Currently, your company prepares financial statements in conformity with Japanese GAAPs (generally accepted accounting principles and standards). Japanese companies and securities law allows you to use IFRSs instead of Japanese GAAP. The owners of the company are hesitant to change to IFRSs because of the cost involved and also their concern that IFRSs would require too much disclosure.

Required:

Make the case to the owners of the company in favour of switching to IFRSs.

Readings

- Alfredson, K., Leo, K., Picker, R., Pacter, P., and Radford, J., *Applying International Accounting Standards*, Milton Qld: John Wiley & Sons, Ch.1, 2005.
- Hong Kong Institute of Certified Public Accountants, 'Preface to Hong Kong Financial Reporting Standards', *Members Handbook*, Volume II, HKICPA, 2005 (website: www.hkicpa.org.hk).
- International Accounting Standards Board, *International Financial Reporting Standards*, London: IASC Foundation, 2005 (website: www.iasb.org/standards).

The Statutory Framework of Financial Reporting

Learning Objectives

After studying this chapter, you should be able to:

1. Appreciate the complementary roles of statutory, institutional, and professional regulation of company financial reporting.
2. Understand the types of companies and their statutory obligations for keeping and presenting accounts.
3. Know the form and content of financial disclosure required by public companies under the Tenth Schedule of the *Companies Ordinance*.
4. Know the disclosure requirements of the Stock Exchange listing requirements.
5. Understand realised profits and distributable profits.
6. Define and calculate the maximum amount a company can distribute to its shareholders.

Introduction

Hong Kong has followed the UK approach in the authoritative means of regulating corporate financial reporting. It relies on two main elements:

- a general procedure and disclosure framework prescribed by companies statutes; and
- the professional judgements, recommendations, conventions, and rules issued by the accounting profession and other institutions involved in the securities environment, specifically the Stock Exchange.

The *Companies Ordinance* has been the main statute which has shaped the disclosure requirements of companies in Hong Kong. The detailed disclosure requirements regarding the contents of the accounts are contained in the Tenth Schedule of the *Companies Ordinance*. The disclosure requirements of certain private companies are prescribed in the Eleventh Schedule. The ordinance also specifies the information to be contained in the annual directors' report and auditors' report. All these disclosure requirements are enforceable by law.

Learning Objectives

After studying this chapter, you should be able to:

1. Debate the accounting issue concerned with expensing versus capitalising approaches to accounting for leases.
2. Explain the nature and classifications of lease contracts.
3. Apply the required accounting treatment to operating leases and finance leases on the accounts of the lessee.
4. Apply the required accounting treatment to operating leases and finance leases in the accounts of the lessor.
5. Be familiar with the disclosure requirements under HKAS 17 for both lessees and lessors.
6. Understand the accounting treatment for leasehold properties.

Introduction

Since the 1970s, lease and hire purchase contracts have been viewed as an alternative form of financing new or replacement assets. Businesses seeking to obtain the longer-term right to use depreciable assets such as vehicles, equipment, furniture, and buildings will typically choose between the options of 'borrow and buy' or a lease or hire purchase contract. For short-term use of such assets, the 'borrow or buy' option is usually considered not viable by a business.

In practice, lease and hire purchase arrangements are the equivalent of instalment purchase forms of acquisition financing. The express or implied intention of the parties to a longer-term lease contract is that the leased property will be substantially used up by the leasing entity, leaving relatively little residual value for the lessor. For a hire purchase contract, ownership of the property will, in fact, be transferred to the hiring entity at the completion of the contract. Therefore, on the basis of the substance of such contracts, it can be argued that balance sheet recognition is warranted. Despite the lack of legal ownership by the lessee during the period of a lease or hire purchase contract, in practice, the lessee has acquired the rights to substantially use up an asset. The accounting issue, then, is whether to expense lease payments straight to the

profit and loss account or, alternatively, to capitalise to the balance sheet the present value of future rights and obligations arising from a lease contract.

The Lease Capitalisation Issue

The primary argument against the capitalising of longer-term leases and hire purchase contracts is that these are a form of executory contract. An executory contract exists when the obligations of both parties to a contract are unperformed by the same proportion. At, say, half-way through a lease contract, the lessee remains 50% unperformed on lease payments and the lessor remains 50% unperformed on allowing the asset to be used. Traditionally, executory contracts have been excluded from the definition of assets and liabilities. If it is agreed that lease contracts give rise to assets and liabilities, then, it has been argued, all other executory contracts (such as a contract to employ an executive) will also give rise to assets and liabilities with the result that there is a fundamental change in accounting.

The arguments in favour of capitalisation are twofold. First, it is suggested that the conventional definition of assets and liabilities which excludes rights and obligations arising from executory contracts is interpreted too narrowly in relation to lease contracts. While it is true that a lessee has the obligation to make periodic payments under a lease agreement, the lessor, it is contended, has completely fulfilled all responsibilities. Therefore, in practice, a lease can be interpreted as non-executory and is to be included in the definition of assets and liabilities. Second, it is argued that unless leases are accounted for and disclosed in financial statements as assets and liabilities, there will be distortion of financial ratios such as gearing ratios and the rate of return on assets. The 'off-balance sheet' effect of non-capitalisation may cause firms to effectively breach trust deeds which limit the incurring of liabilities.

HKAS 17 'Leases' was introduced to rule on this accounting debate. The growth of leasing and hire purchase contracts in Hong Kong made it urgent to standardise the accounting practice. Prior to the introduction of an accounting standard on leases, the majority of lessees in Hong Kong did not give in their audited financial statements, and disclose the rights (assets) and obligations (liabilities) of, properties held under finance leases. Rather, they recorded the lease instalment payments or rentals as an operating expense in the profit and loss account.

Briefly, HKAS 17 requires that a finance lease should be capitalised by the lessee – ie accounted for as the purchase of rights to the use of the asset with simultaneous recognition of the obligation to make future payments. A hire purchase is normally accounted for in a similar way. Under an operating lease, only the rental will be taken into account by a lessee. It also requires considerable disclosure details in financial statements of both a lessee and lessor company for those leased and hired properties which meet the criteria for capitalisation.

Nature and Classification of Lease and Hire Purchase Contracts

Leases are contracts which grant to one party (the lessee) the right to possess and use land, buildings, equipment, furniture, or other property owned by another party (the lessor), for a stated period of time, in exchange for lease rental payments. A lease is defined as an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right

to use an asset for an agreed period of time. A lease contract may contain a variety of terms which provide for such matters as:

- the period of the lease and lease payments;
- default remedies;
- whether the lessee or lessor is responsible for executory costs (insurance, maintenance, etc);
- cancellability of the lease and if such requires mutual agreement;
- any guarantee of residual value if the lease is cancelled by the lessee to compensate the lessor for losses; and
- conditions applicable at the end of the lease period, including purchase rights by the lessee and residual guarantees.

Finance Lease versus Operating Lease

Because of different terms in lease contracts, HKAS 17 requires accountants to make a classification of all lease contracts into two types: finance lease and operating lease. A finance lease is:

A lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee.

An operating lease is simply defined as:

A lease other than a finance lease.

Since the accounting requirements for finance leases are radically different from those of operating leases, it is essential to determine at the outset whether a particular lease contract is of a finance or an operating type.

In essence, an operating lease is a short-term rental agreement which can be discontinued by the lessee at little or no penalty cost. As a result, the lessor retains most of the risks and benefits associated with ownership of the leased asset. A lessee will enter into an operating lease when purchasing the asset is not regarded as a viable alternative. For example, a Hong Kong business executive may lease a motor vehicle for use while visiting Vancouver for a month. In contrast, a finance lease is typically entered into for a substantial period of an asset's useful life when a lessee regards leasing as a means of financing the use of an asset without an immediate full cash payment. In this case, most of the risks and benefits associated with ownership of the asset are transferred from the lessor to the lessee.

It is difficult to set up a precise set of rules to distinguish between operating leases and finance leases. The basic principle is that if substantially the whole of the risks and rewards of ownership belongs to the lessee, the lease is a finance lease. On the other hand, if most of the risks and rewards of ownership stay with the lessor, the lease is an operating lease.

The risks of ownership of an asset include:

- technological obsolescence;

- losses from idle capacity;
- unsatisfactory performance that the asset is unable to provide expected benefits or services; and
- variations on return due to changing conditions.

The rewards of ownership of an asset include:

- profitable operation over the asset's economic life; and
- gain from appreciation in value or realisation of a residual value.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. HKAS 17 does not define the term 'substantially', nor does it prescribe quantitative criteria for this. It, however, provides some examples of situations which, individually or in combination, would indicate that a lease is a finance lease. These include:

- the lessor transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- the lease term is for the major part of the economic life of the asset, even if title is not transferred;
- at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

Other indicators for a finance lease are:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from fluctuations in the fair value of the asset fall to the lessee; and
- the lessee has the right to continue the lease for a secondary period at a rent which is substantially lower than market rent.

These examples and indicators are not always conclusive. They provide guidelines to assist accountants in assessing whether substantially all the risks and rewards are transferred.

'Minimum lease payments' are the payments over the lease term. In the case of lessee, minimum lease payments include:

- rental payments over the lease term; and
- any residual value guaranteed by the lessee or by a party related to the lessee.

The lessor will estimate the residual value of the leased asset at the end of the lease term, and the lessee will guarantee that, when the asset is returned to the lessor, it will realise at least a certain amount. The extent of guarantee is a matter of negotiation between lessee and lessor.

Residual value may also be guaranteed by a party related to the lessee, eg a company contracted with the lessee for providing maintenance service for the leased asset.

In case of the lessor, minimum lease payments include:

- rental payments by the lessee over the lease period; and
- any residual value guaranteed to the lessor by either:
 - (i) the lessee;
 - (ii) a party related to the lessee; or
 - (iii) an independent party financially capable of meeting this guarantee.

To determine whether the present value of the minimum lease payments at the inception of the lease amounts to at least substantially the fair value of the leased asset, the interest rate implicit in the lease contract is adopted.

Example 1

Lessee Ltd entered a three-year lease contract with Lessor Ltd on 1 January 20X1. The contract was for a robot machine which has a fair value of \$1,000,000. The lease terms included three annual lease payments of \$350,000 on 1 January each year commencing on 1 January 20X1, and a guaranteed residual value by Lessee Ltd of \$20,000. In addition, the manufacturer of the machine guaranteed to Lessor Ltd a further residual value of \$40,000. The interest rate implicit in the lease contract is 15%.

For Lessor Ltd, the minimum lease payments amount to \$1,110,000, comprising:

- annual rental of \$350,000 payable over three years by Lessee Ltd, totaling \$1,050,000;
- residual value guaranteed by Lessee Ltd, ie \$20,000; and
- residual value guaranteed by the manufacturer, ie \$40,000.

The present value of minimum lease payments is calculated below:

	Date	Payment	Factor (@15%)	Present value
		\$		\$
Lease payments	1 Jan 20X1	350,000	1.000	350,000
	1 Jan 20X2	350,000	0.870	304,500
	1 Jan 20X3	350,000	0.756	264,600
Guaranteed residual value				
– by Lessee Ltd	31 Dec 20X3	20,000	0.658	13,160
– by the manufacturer	31 Dec 20X3	40,000	0.658	26,320
		<u>1,110,000</u>		<u>958,580</u>

The present value of minimum lease payments is substantially equal to the fair value of the asset, ie 95.8% (\$958,580 / \$1,000,000) of the fair value of the asset. Therefore, the lease is classified as a finance lease.

For Lessee Ltd, the minimum lease payments amount to \$1,070,000, including:

- annual rental of \$350,000 payable over three years, totaling \$1,050,000; and
- residual value guaranteed by Lessee Ltd, ie \$20,000.

The present value of minimum lease payments is calculated below:

	Date	Payment	Factor (@15%)	Present value
		\$		\$
Lease payments	1 Jan 20X1	350,000	1.000	350,000
	1 Jan 20X2	350,000	0.870	304,500
	1 Jan 20X3	350,000	0.756	264,600
Guaranteed residual value				
– by Lessee Ltd	31 Dec 20X3	20,000	0.658	13,160
		<u>1,070,000</u>		<u>932,260</u>

For Lessee Ltd, the present value of minimum lease payments amounts to substantially the fair value of the asset, ie 93.2% (\$932,260 / \$1,000,000) of the fair value of the asset. Therefore, the lease is classified as a finance lease.

It can be seen that the present values of minimum lease payments are different for the lessor and the lessee. It is possible that the two parties will arrive at a different classification. For instance, a lease may be classified as a finance lease by the lessor while as an operating lease by the lessee. This may be the case if the lessor benefits from a significant residual value which is guaranteed by a party unrelated to the lessee.

Treatment of Hire Purchase Contracts

The definition of a finance lease in HKAS 17 includes hire purchase contract. A hire purchase contract is essentially a conditional sales contract. Title to the asset does not pass to the buyer at the time the asset is delivered, but remains with the seller until the final payment under the contract has been made. During the period of the contract, the buyer is renting or hiring the vehicle, equipment, or furniture. Purchase, and therefore legal ownership, by the buyer occurs only when the final instalment payment is made.

Legally, a hire purchase contract is different from a credit sales or instalment sales contract. Under an instalment sales contract, ownership passes to the buyer at the date of signing the contract. The buyer gains full ownership rights and the seller's rights are limited to those of a creditor. In spite of these legal differences between ownership passing to the buyer at the beginning of the repayment period for an instalment sales contract and the end of the repayment period for a hire purchase contract, these two types of contract should be accounted for in the same way. Under a hire purchase contract, it is to be assumed that a sale occurs which transfers substantially all the risks and rewards of ownership to the buyer at the date of signing the contract. In general terms, the fair market value of an asset under hire purchase contract and any freight charges are recorded by the buyer as an asset and a liability. This is to be done at the start

of the hire purchase contract, in spite of the fact that the asset is still legally owned by the seller and hired by the buyer. The effect of such accounting treatment is in line with the capitalisation approach required under HKAS 17 with the treatment of finance leases.

Accounting Methods for Lessees

Finance leases and operating leases are to be treated quite differently in the accounts of the lessee. Hire purchase contracts which are of a financing nature should be accounted for on a basis similar to finance leases.

Operating Lease

For an operating lease, lease payment should be recognised as an expense in the income statement on a straight-line basis over the lease term, unless another systematic basis is representative of the time pattern of the user's benefit. Assets and liabilities arise only from prepaid or accrued rental payments.

Example 2

A company leases furniture for 10 weeks for a special exhibition of its new products. Rental payment of \$10,000 per week is required at the end of each week. At the end of the company's accounting year, two rental payments have been made and one payment is owing. The following accounting entries would be recorded:

Week 1	Dr. Rent expense	\$10,000	
	Cr. Bank		\$10,000
Week 2	Dr. Rent expense	\$10,000	
	Cr. Bank		\$10,000
Week 3 (year end)	Dr. Rent expense	\$10,000	
	Cr. Rent payable		\$10,000

In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. An example of such incentives is the reduced rent or rent-free incentive agreed by the lessor for an office building during the initial period of a lease term. The lessee should recognise these incentives as a reduction of lease payments on a systematic basis over the lease term.

Example 3

Lessee Ltd agreed to enter into a two-year lease arrangement for an office building on 1 January 20X1 with annual rental of \$10 million. The lessor agreed to a rent-free period for the first six months as an incentive for Lessee Ltd to enter into the lease. On 1 July 20X1, Lessee Ltd paid rental of \$5 million for six months, and paid annual rental of \$10 million on 1 January 20X2.

The accounting treatment for the lease payments in Lessee Ltd's book should be:

$$\text{Total lease payments: } \$10 \text{ million} \times 1\frac{1}{2} \text{ years} = \$15 \text{ million.}$$

Total lease payments should be apportioned over two years on a systematic basis. Thus, annual rental expense is \$7.5 million.

The journal entries are:

20X1	Dr. Rental expense	\$7.5 m	
	Cr. Accrued rental expense		\$2.5 m
	Cr. Bank		\$5 m
To record the accrued rental expense			
20X2	Dr. Rental expense	\$7.5 m	
	Dr. Accrued rental expense	\$2.5 m	
	Cr. Bank		\$10 m
To record payment of rental expense			

Finance Lease

Under a finance lease, the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life. In return, the lessee undertakes an obligation to pay an amount approximating to the fair value of the asset and the related finance charge. If such lease transactions are recorded in a similar way to operating lease transactions, the economic resources and the obligations of a company are understated. This distorts the financial ratios of the lessee. It is therefore appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments.

HKAS 17 requires lessees to recognise finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, at the present value of the minimum lease payments. In calculating the present value of the minimum lease payment, the discount factor is the interest rate implicit in the lease. If it is not practical to determine the implicit interest rate, the lessee's incremental borrowing rate should be used. The lessee's incremental borrowing rate of interest is the rate of interest that the lessee would have to pay for the fund necessary to purchase the asset with a similar term and with a similar security.

A fixed asset recognised in the balance sheet under a finance lease should be depreciated over the period during which the lessee expects to use the asset. If there is no reasonable certainty that the lessee will obtain the ownership of the asset by the end of the lease term, the leased asset should be depreciated over the shorter of the lease term and its useful life. Where there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be depreciated over the period that the lessee expects to own and use the asset. The depreciation policy used for leased assets should be consistent with that for depreciable assets which are owned.

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant period rate of interest on the remaining balance of the liability for each period.

Example 4

A lessee agrees to lease an item of equipment on 1 January 20X1 for the next five years involving annual payments in advance of \$100,000, payable on 1 January each year. At the expiration of the lease, the lessee has guaranteed a residual value of \$200,000 which is estimated to represent the total residual value for the lessor. The estimated useful life of the equipment is six years. The rate of interest implicit in the lease is 15%.

Required:

Give the journal entries to record the lease at the time of inception and for the first accounting year after inception. Also prepare a full schedule for straight-line depreciation of the leased asset and for constant-periodic-rate amortisation of the obligation.

Step 1: Calculate the present value of the minimum lease payments.

	Discount factor	Present value
First payment of \$100,000	@15% 1.000	\$ 100,000
Annuity of \$100,000 p.a. in arrears for four years @ 15%	2.855	285,500
Guaranteed residual of \$200,000 payable at the end of five years @ 15%	0.497	99,500
Present value of the lease		<u>485,000</u>

Step 2: Calculate the interest element to be charged in the first year against the lease obligation (liability).

Interest or finance charge for first year after inception = Implied interest rate of the lease × (Present value of lease obligation at inception – Initial advance lease payment if any).

Therefore, the interest charge for the year ended 31 December 20X1 = 0.15 (\$485,000 – \$100,000) = \$57,750.

Step 3: Calculate the depreciation expense, on a straight-line basis, to be charged against the lease asset.

Depreciation expense per annum = Present value of the lease (or its fair value if known)/Shorter of the lease term or the asset's useful life, assuming that the lessee will return the equipment by the end of the lease term.

Therefore, the depreciation expense = (\$485,000 – \$200,000) / 5 years = \$57,000.

Step 4: Journalise the lease inception and the first year.

1 January 20X1	Dr. Leased asset	\$485,000	
	Cr. Lease obligation		\$485,000
	Dr. Lease obligation	\$100,000	
	Cr. Bank		\$100,000
	To record lease capitalisation at inception of lease contract		
31 December 20X1	Dr. Interest charge	\$57,750	
	Cr. Lease obligation		\$57,750
	Dr. Depreciation expense on leased asset	\$57,000	
	Cr. Accumulated depreciation on leased asset		\$57,000
	To record year-end reduction in lease obligation and asset respectively		
1 January 20X2	Dr. Lease obligation	\$100,000	
	Cr. Bank		\$100,000
	To record second annual lease payment		

The following schedule shows the interest expense and the reduction in the liability over the lease period.

Lease Obligation Schedule					
Year	Outstanding balance at 1 Jan	Annual lease payment on 1 Jan	Outstanding balance after lease payment	Interest charge 15%	Outstanding balance at 31 Dec
20X1	485,000	100,000	385,000	57,750	442,750

20X2	442,750	100,000	342,750	51,413	394,163
20X3	394,163	100,000	294,163	44,124	338,287
20X4	338,287	100,000	238,287	35,743	274,030
20X5	274,030	100,000	174,030	25,970*	200,000

* Adjusted figure taking into account cumulative round-off effect.

31 December 20X5	Dr.	Interest charge	\$25,970	
	Cr.	Lease obligation		\$25,970
	Dr.	Depreciation expense on leased asset	\$57,000	
	Cr.	Accumulated depreciation on leased asset		\$57,000
	Dr.	Lease obligation	\$200,000	
	Cr.	Leased asset*		\$200,000

To record the return of leased asset at its guaranteed residual value

* If the lessee will obtain the ownership of the equipment by the end of the lease term, the credit entry would be made on the cash account.

Leased Asset Depreciation Schedule

Year	Depreciation expense (straight-line)	Accumulated depreciation on leased asset	Net book value of leased asset
	\$	\$	\$
1 Jan 20X1			485,000
31 Dec 20X1	57,000	57,000	428,000
31 Dec 20X2	57,000	114,000	371,000
31 Dec 20X3	57,000	171,000	314,000
31 Dec 20X4	57,000	228,000	257,000
31 Dec 20X5	57,000	285,000	200,000

If the lessee incurs costs associated with the negotiation and securing of the lease arrangements, these costs are identified as initial direct costs, ie costs directly attributable to activities performed by the lessee for a finance lease, and should be added to the amount recognised as an asset. Initial direct costs include commissions, legal fees, and internal costs that are incremental and directly attributable to negotiating and arranging the lease. They exclude general overheads such as those incurred by sales and marketing teams.

If the lease payments include a reimbursement of costs to the lessor, eg insurance and maintenance paid by the lessor, these costs are borne by the lessee and should be recognised as expenses.

Example 5

On 1 January 20X1, Lessor Ltd leased a machine to Lessee Ltd. The fair value of the machine at that date was \$450,000. An initial direct cost of \$10,000 was incurred by Lessee Ltd on signing up the lease agreement, which contains the following:

Lease term	4 years
Economic life of the machine	5 years
Annual payment, payable on 31 December (including \$3,000 to cover the reimbursement for the cost of insurance paid by Lessor Ltd)	\$123,000
Estimated residual value at end of the lease term	\$30,000
Residual value guaranteed by Lessee Ltd	\$20,000
Interest rate implicit in the lease	7%

The lease is cancelable, but cancellation will incur a monetary penalty equivalent to two years' rental payments. Lessee Ltd intends to return the asset to Lessor Ltd at the end of the lease term.

Analysis:

1. Present value of minimum lease payments

	Discount factor @ 7%	Present value
Annuity of \$120,000 p.a. in arrears for four years @7%	3.3872	406,464
Guaranteed residual value of \$20,000 payable at the end of 20X4	0.7629	15,258
		<u>421,722</u>

The present value of minimum lease payments amounts to 93.7% of the fair value of the leased assets. The lease term is for four years, representing a major part of the economic life of the leased asset. The cancellation of the lease will incur a monetary penalty equivalent to two years' rental payments. This is regarded as a non-cancelable lease. HKAS 17 defines a non-cancelable lease as a lease that is cancelable only:

- upon the occurrence of some remote contingency;
- with the permission of the lessor;
- if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
- upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonable certain.

Given no other information, the lease should be classified as a finance lease.

2. Schedule of lease payments

Lease Obligation Schedule				
	Outstanding balance at 1 Jan	Interest charge 7%	Annual lease payment	Outstanding balance at 31 Dec
20X1	421,722	29,521	120,000	331,243
20X2	331,243	23,187	120,000	234,430
20X3	234,430	16,410	120,000	130,840
20X4	130,840	9,160	120,000	20,000

3. Journal entries at the inception of the lease

1 January 20X1	Dr. Lease asset		\$421,722	
	Cr. Lease obligation			\$421,722
	To record lease capitalisation at inception of lease contract			

	Dr. Lease asset		\$10,000	
	Cr. Bank			\$10,000
	To record the initial direct cost			

4. Depreciation

If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the leased asset should be depreciated over its useful life. In this example, Lessee Ltd intends to return the asset to Lessor Ltd at the end of the lease term, the leased asset is therefore depreciated over the lease period, ie four years.

Annual depreciation is calculated as:

$$(\$421,722 + 10,000) / 4 \text{ years} = \$107,931$$

5. Journal entries at the end of the first year

31 December 20X1	Dr. Interest expense		\$29,521	
	Cr. Lease obligation			\$29,521
	To record the interest charge			
	Dr. Lease obligation		\$120,000	
	Dr. Insurance expense		\$3,000	
	Cr. Bank			\$123,000
	To record lease payment and reimbursement of cost paid by Lessor Ltd			

Dr. Depreciation expense	\$107,931	
Cr. Accumulated depreciation		\$107,931
To record depreciation on leased asset		

If there are indicators that a leased asset has become impaired, the lessee should apply HKAS 36 'Impairment of Assets' to account for impairment loss. The accounting for impairment of assets is discussed in Chapter 17.

Disclosure

For operating leases, the lessee should disclose the future minimum lease payments under non-cancelable operating leases, in aggregate and for each of the following periods:

- (i) not later than one year;
- (ii) later than one year and not later than five years; and
- (iii) later than five years.

For finance leases, the lessee should disclose:

- (i) the net carrying amount of each class of leasehold assets at the balance sheet date;
- (ii) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value; and
- (iii) the total of minimum lease payments at the balance sheet date and their present value for each of the following periods:
 - not later than one year;
 - later than one year and not later than five years; and
 - later than five years.

Example 6

Using the information in Example 4, the disclosure relating to the finance lease at 31 December 20X1 is:

- (i) Fixed asset held on finance lease:

Leasehold fixed assets	\$485,000
Less: Accumulated depreciation	57,000
	<u>428,000</u>