(f) ASBE 11 *Share-based Payment*

The fair values of share-based payment transactions in exchange for employee services must be measured and recognised as expenses in the income statement.

(g) ASBE 12 *Debt Restructuring*

Gains or losses on debt restructuring are recognised in profit or loss for the period.

(h) ASBE 14 *Revenue*

Coherent with the latest development of the IFRS, ASBE 14 adopts a five-step revenue recognition model, which provides that an enterprise should recognise revenue when the enterprise satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service, which refers to the ability to direct the use of, and obtain substantially all of the benefits from, the good or service.

(i) *ASBE 16 Government Grants*

Government grants related to assets should be recognised as deferred income in the balance sheet and subsequently amortised to profit or loss on a reasonable and systematic basis over the useful life of the asset. Alternatively, the grants could be offset against the carrying amount of the related assets.

Government grants related to income should be credited to profit or loss or offset against the related costs unless the grants are intended to compensate future expenses or losses, in this case the grants should be deferred.

(j) ASBE 17 *Borrowing Costs*

Borrowing costs incurred for funds borrowed and used for the purpose of the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of the asset.

(k) ASBE 18 *Income Taxes*

The tax payable method is prohibited. The tax effect accounting method should be applied to account for the tax effect of temporary differences. The tax effect of all temporary differences between the carrying amount of assets or liabilities and their tax bases is recognised as a deferred income tax liability or asset, but not the differences on initial recognition.

(l) ASBE 20 *Business Combinations*

The acquisition method should be applied to account for business combinations not involving enterprises under common control.

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Under that method, the acquirer should recognise the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date at fair value.

Goodwill is no longer amortised. Instead, the acquirer should test the goodwill for impairment annually in accordance with ASBE 8 *Impairment of Assets*.

Where negative goodwill arises, the acquirer needs to reassess the measurement of the cost of combination and the fair value of the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date. After that assessment, any remaining negative goodwill is recognised immediately in profit or loss as other operating revenue.

(m) ASBE 21 *Leases*

Finance leased assets are recognised by the lessee at the lower of either the fair value of the leased asset at the commencement of the lease term or the present value of the minimum lease payments.

(n) ASBE 22 *Recognition and Measurement of Financial Instruments*

Financial assets are classified into four new categories:

(1) financial assets at fair value through profit or loss;

(2) held-to-maturity investments;

(3) loans and receivables; and

(4) available-for-sale financial assets.

Note: See the revised ASBE 22 in Chapter 24 ASBE 22 *Recognition and Measurement of Financial Instruments*. Financial assets are now classified as measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss.

(o) ASBE 23 *Transfer of Financial Assets*

Derecognition of a financial asset should be determined based on the extent to which the risks and rewards of ownership of the asset are transferred.

(p) ASBE 24 *Hedge Accounting*

Special hedge accounting methods can be applied only when certain strict criteria are met.

(q) ASBE 33 *Consolidated Financial Statements*

In respect of the scope of consolidation for consolidated financial statements, greater emphasis is placed on the concept of control.

Minority stockholders' interest should be presented separately in the consolidated balance sheet within stockholders' equity.

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(r) ASBE 37 *Presentation of Financial Instruments*

A non-derivative financial instrument that contains both a liability and an equity component (such as a convertible bond) is to be split and the two components are accounted for separately.

Further, the MOF issued the supplementary *Explanatory Guidance* of ASBE (2006). The *Explanatory Guidance* provides detailed explanations and examples for the requirements in the *Specific Standards*. It also covers certain significant improvements and amendments so as to facilitate ongoing convergence with IFRS. However, since the *Explanatory Guidance* is not mandatory, it will only be covered in this manual, where relevant. It may be noted that in the case of any conflict between an ASBE and the *Explanatory Guidance*, the requirement in the ASBE prevails.

The structure of this book is as follows:

- ¶1-300 introduces the development of Chinese Accounting Standards since the last edition (2013 edition).
- Chapter 2 deals with the *Basic Standard*.
- Chapters 3 to 44 discuss each ASBE in detail, incorporating the provisions of the *Application Guidance* and *Interpretations*. On top of that, the key differences in accounting requirements between the relevant ASBE and IFRS are addressed. These chapters will also cover the specific provisions of the *Explanatory Guidance*, where relevant.
- Chapter 45 deals with the *Accounting Standards for Small-sized Enterprises* (also see ¶1-400 below).
- To assist readers in having a quick grasp of the *Application Guidance*, a summary of its major accounting requirements is provided in Chapter 46.

¶1-300 Development of Chinese Accounting Standards since the last edition (2013)

New standards include:

(1) ASBE 39 *Fair Value Measurement;*

(2) ASBE 40 *Joint Arrangements;*

(3) ASBE 41 *Disclosure of Interests in Other Entities;* and

(4) ASBE 42 *Non-current Assets Held for Sale and Discontinued Operations*.

Revised standards include:

(1) *Basic Standard;*

(2) ASBE 2 *Long-term Equity Investments;*

(3) ASBE 9 *Employee Benefits;*

(4) ASBE 14 *Revenue;*

(5) ASBE 16 *Government Grants;*

(6) ASBE 22 *Recognition and Measurement of Financial Instruments;*

(7) ASBE 23 *Transfer of Financial Assets;*

(8) ASBE 24 *Hedge Accounting;*

(9) ASBE 30 *Presentation of Financial Statements;*

(10) ASBE 33 *Consolidated Financial Statements;* and

(11) ASBE 37 *Presentation of Financial Instruments*.

New interpretations include:

(1) Interpretation No. 6 (*Caikuai* [2014] No. 1);

(2) Interpretation No. 7 (*Caikuai* [2015] No. 19);

(3) Interpretation No. 8 (*Caikuai* [2015] No. 23);

(4) Interpretation No. 9 (*Caikuai* [2017] No. 16);

(5) Interpretation No. 10 (*Caikuai* [2017] No. 17);

(6) Interpretation No. 11 (*Caikuai* [2017] No. 18); and

(7) Interpretation No. 12 (*Caikuai* [2017] No. 19).

The Appendix provides a table of comparison between Chinese Accounting Standards and IFRS as at 30 November 2018.

¶1-400 Accounting standards for small-sized enterprises

In addition to the accounting standards stated in ¶1-200 and ¶1-300, the *Accounting Standards for Small-sized Enterprises* (ASSE) was issued by the MOF on 18 October 2011 to replace *Accounting System for Small-sized Enterprises*. The ASSE will be effective from 1 January 2013 and the early adoption is allowed.

The ASSE is applicable to qualified small and micro-sized enterprises established in China that do not issue securities to the general public. It does not apply to financial institutions, group companies, or qualified small and micro-sized enterprises that choose to adopt the ASBE.

A summary of the requirements of the ASSE is presented in Chapter 45.

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¶1-500 Appendix: Table of comparison: Chinese Accounting Standards and IFRS

The table below provides a comparison between Chinese Accounting Standards and IFRS as at 31 July 2018.

Chinese Accounting Standards	IFRS
Basic Standard Explanatory Guidance — Chapter 1 *Basic Standard*	Framework for the Preparation and Presentation of Financial Statements (replaced by revised *Conceptual Framework for Financial Reporting 2018*) Relevant paragraphs of IAS 1 Presentation of Financial Statements
Specific Standards, Application Guidance, Relevant Interpretations and Explanatory Guidance	
ASBE 1 Inventories Application Guidance — ASBE 1 Explanatory Guidance — Chapter 2 *Inventories*	IAS 2 Inventories
ASBE 2 Long-term Equity Investments Interpretation No. 9 (*Caikuai* [2017] No. 16)	IAS 27 Separate Financial Statements IAS 28 Investments in Associates and Joint Ventures
ASBE 3 Investment Property Application Guidance — ASBE 3 Explanatory Guidance — Chapter 4 *Investment Property*	IAS 40 Investment Property
ASBE 4 Fixed Assets Application Guidance — ASBE 4 Interpretation No. 6 (*Caikuai* [2014] No. 1) Interpretation No. 10 (*Caikuai* [2017] No. 17) Explanatory Guidance — Chapter 5 *Fixed Assets*	IAS 16 Property, Plant and Equipment
ASBE 5 Biological Assets Application Guidance — ASBE 5 Explanatory Guidance — Chapter 6 *Biological Assets*	IAS 40 Agriculture

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Chinese Accounting Standards	IFRS
ASBE 6 Intangible Assets Application Guidance — ASBE 6 Explanatory Guidance — Chapter 7 *Intangible Assets* Interpretation No. 12 (*Caikuai* [2017] No. 19)	IAS 38 Intangible Assets
ASBE 7 Exchange of Non-monetary Assets Application Guidance — ASBE 7	Relevant paragraphs of IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets and IAS 40 Investment Property
ASBE 8 Impairment of Assets Application Guidance — ASBE 8 Explanatory Guidance — Chapter 9 *Impairment of Assets*	IAS 36 Impairment of Assets
ASBE 9 Employee Benefits Application Guidance — ASBE 9	IAS 19 Employee Benefits
ASBE 10 Enterprise Annuity Fund Application Guidance — ASBE 10	IAS 26 Accounting and Reporting by Retirement Benefits Plans
ASBE 11 Share-based Payment Application Guidance — ASBE 11 Interpretation No. 3 (*Caikuai* [2009] No. 8) Explanatory Guidance — Chapter 11 *Share-based Payment*	IFRS 2 Share-based Payment
ASBE 12 Debt Restructuring Application Guidance — ASBE 12 Explanatory Guidance — Chapter 13 *Debt Restructuring*	Relevant paragraphs of IFRS 9 Financial Instruments IFRIC-Int 19 Extinguishing Financial Liabilities with Equity Instruments
ASBE 13 Contingencies Application Guidance — ASBE 13 Explanatory Guidance — Chapter 14 *Contingencies*	IAS 37 Provisions, Contingent Liabilities and Contingent Assets
ASBE 14 Revenue	IFRS 15 Revenue from Contracts with Customers
ASBE 15 Construction Contracts Interpretation No. 3 (*Caikuai* [2009] No. 8) (ASBE 15 will be superseded by ASBE 14 Revenue)	IAS 11 Construction Contracts (IAS 11 was superseded by IFRS 15 Revenue from Contracts with Customers)

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Chinese Accounting Standards	IFRS
ASBE 16 Government Grants	IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
ASBE 17 Borrowing Costs Application Guidance — ASBE 17	IAS 23 Borrowing Costs
ASBE 18 Income Taxes Application Guidance — ASBE 18 Explanatory Guidance — Chapter 19 *Income Taxes*	IAS 12 Income Taxes
ASBE 19 Foreign Currency Translation Application Guidance — ASBE 19 Explanatory Guidance — Chapter 20 *Foreign Currency Translation*	IAS 21 The Effects of Changes in Foreign Exchange Rates IAS 29 Financial Reporting in Hyperinflationary Economies
ASBE 20 Business Combinations Application Guidance — ASBE 20 Interpretation No. 4 (*Caikuai* [2010] No. 15) Interpretation No. 5 (*Caikuai* [2012] No. 19) Explanatory Guidance — Chapter 21 *Business Combinations*	IFRS 3 Business Combinations
ASBE 21 Leases Application Guidance — ASBE 21 Interpretation No. 1 (*Caikuai* [2007] No. 14) Interpretation No. 2 (*Caikuai* [2008] No. 11) Explanatory Guidance — Chapter 22 *Leases*	IAS 17 Leases SIC-15 Operating Leases — Incentives SIC-27 Evaluating the Substance of Transactions involving the Legal Form of a Lease (Note: IAS 17, SIC-15 and SIC-27 will be superseded by IFRS 16 Leases, effective for annual periods beginning on or after 1 January 2019)
ASBE 22 Recognition and Measurement of Financial Instruments ASBE 23 Transfer of Financial Assets ASBE 24 Hedge Accounting	IFRS 9 Financial Instruments

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Chinese Accounting Standards	IFRS
ASBE 25 Direct Insurance Contracts ASBE 26 Reinsurance Contracts *Caikuai* [2010] No. 15 certain accounting requirements in relation to insurance contracts *Notice on Transitional Arrangements for Insurance Enterprises to Implement Relevant New Accounting Standards for Financial Instruments*" (*Caikuai* [2017] No. 20)	IFRS 4 Insurance Contracts (Note: IFRS 4 will be superseded by IFRS 17 Insurance Contracts, effective for annual periods beginning on or after 1 January 2021)
ASBE 27 Extraction of Petroleum and Natural Gas Application Guidance — ASBE 27	IFRS 6 Exploration for and Evaluation of Mineral Resources
ASBE 28 Changes in Accounting Policies and Estimates, and Corrections of Errors Application Guidance — ASBE 28 Explanatory Guidance — Chapter 29 *Changes in Accounting Policies and Estimates, and Corrections of Errors*	IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
ASBE 29 Events after the Balance Sheet Date	IAS 10 Events after the Reporting Period
ASBE 30 Presentation of Financial Statements	IAS 1 Presentation of Financial Statements
ASBE 31 Cash Flow Statements Application Guidance — ASBE 31 Explanatory Guidance — Chapter 32 *Cash Flow Statements*	IAS 7 Statement of Cash Flows
ASBE 32 Interim Financial Reporting Explanatory Guidance — Chapter 33 *Interim Financial Reporting*	IAS 34 Interim Financial Reporting
ASBE 33 Consolidated Financial Statements	IFRS 10 Consolidated Financial Statements
ASBE 34 Earnings Per Share Application Guidance — ASBE 34 Explanatory Guidance — Chapter 35 *Earnings Per Share*	IAS 33 Earnings Per Share

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Illustration 5.7

OP Enterprise occupies an office building for its own use.

The enterprise transfers the building to investment property under the cost model as is evident by the letting of the building on a five-year operating lease to a third party on 1 December 2017. On 1 December 2017, the building's carrying amount is RMB12,000,000 (cost of RMB18,000,000 less accumulated depreciation of RMB6,000,000).

In this case, the relevant journal entries to record the transfer on 1 December 2017 would be as follows:

		RMB	RMB
Dr	Investment property — Buildings (Cost)	18,000,000	
Dr	Accumulated depreciation	6,000,000	
Cr	Fixed assets — Buildings		18,000,000
Cr	Investment property accumulated depreciation		6,000,000

(to record the transfer of an office building from owner-occupied property to investment property under the cost model)

¶5-520 Transfers under the fair value model

Transfers from investment properties should only be made when there is a change of use. This may occur because an owner decides to occupy a property that was previously used as an investment property, or there may be an intention to dispose of the investment property.

For a transfer from investment property carried at fair value to owner-occupied property, ASBE 3 provides that the property's fair value at the date of transfer is the carrying amount of owner-occupied property for subsequent accounting under ASBE 4 *Fixed Assets* (para 15). ASBE 3 requires the difference between the fair value and carrying amount to be recognised in gain or loss on changes in fair value for the period (para 15).

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Illustration 5.8

QR Enterprise lets out a building on a three-year operating lease to a third party. The enterprise classifies the building as investment property and accounts for it by the use of fair value model. The lease ends on 30 November 2017. On 1 December 2017, the enterprise occupies the building for its administrative use. On this date, the building's carrying amount and fair value is RMB19,500,000 (cost of RMB18,000,000 plus gain on changes in fair value of RMB1,500,000) and RMB20,000,000 respectively.

In this case, the relevant journal entries to record the transfer on 1 December 2017 would be as follows:

		RMB	RMB
Dr	Fixed assets — Buildings	20,000,000	
Cr	Investment property — Buildings (Cost)		18,000,000
Cr	Investment property — Buildings (Changes in fair value)		1,500,000
Cr	Gain or loss on changes in fair value		500,000

(to record the transfer of a building from investment property under fair value model to owner-occupied property)

For a transfer from an owner-occupied property or inventory to investment property that will be carried at fair value, the investment property should be recorded according to its fair value at the date of transfer. ASBE 3 and the *Application Guidance* provide that the difference between the carrying amount of the property and its fair value at the date of transfer should be accounted for as follows (para 16):

(a) where the fair value is less than the carrying amount, the decrease is recognised as loss on changes in fair value for the period; and

(b) where the fair value is greater than the carrying amount, the increase is recognised in other comprehensive income. On disposal of that investment property, the portion of other comprehensive income previously in owners' equity should be transferred out to cost of other operations for the period.

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Illustration 5.9

ST Enterprise occupies several buildings for its own use.

The enterprise transfers one of its buildings (an owner-occupied property) to investment property carried at fair value as is evident by the letting of the building on a three-year operating lease to a third party. At the date of transfer, the building's carrying amount and fair value is RMB12,000,000 (cost of RMB18,000,000 less accumulated depreciation of RMB6,000,000) and RMB20,000,000 respectively.

In this case, the building (now classified as investment property) should be recorded at its fair value at the date of transfer, i.e. RMB20,000,000. The excess of fair value over the carrying amount, RMB8,000,000, would be credited to other comprehensive income.

The relevant journal entries to record the transfer would be as follows:

		RMB	RMB
Dr	Investment property — Buildings (Cost)	20,000,000	
Dr	Accumulated depreciation	6,000,000	
Cr	Fixed assets — Buildings		18,000,000
Cr	Other comprehensive income		8,000,000

(to record the transfer of a building from owner-occupied property to investment property under the fair value model)

Illustration 5.10

Assume ST Enterprise in Illustration 5.9, except that the fair value of the building is RMB10,800,000 at the date of transfer.

In this case, the building (now classified as investment property) should be recorded at its fair value at the date of transfer, i.e. RMB10,800,000. The deficit of fair value over the carrying amount, RMB1,200,000, would be debited to gain or loss on changes in fair value.

The relevant journal entries to record the transfer would be as follows:

		RMB	RMB
Dr	Investment property — Buildings (Cost)	10,800,000	
Dr	Gain or loss on changes in fair value	1,200,000	

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Dr	Accumulated depreciation	6,000,000	
Cr	Fixed assets — Buildings		18,000,000

(to record the transfer of a building from owner-occupied property to investment property under the fair value model)

It may be noted that IAS 40 *Investment Property* requires that for a transfer from inventories to investment property that will be carried at fair value, any gain or loss on its carrying amount immediately before the transfer should be recognised in profit or loss. The treatment of transfers from inventories to investment property that will be carried at fair value is consistent with the treatment of sales of inventories.

¶5-600 Disposals

ASBE 3 provides that an investment property should be derecognised (para 17):

(a) on disposal; or

(b) when the property is permanently withdrawn from use and no economic benefits are expected from its disposal.

For investment property that has been sold, transferred, retired or destroyed, ASBE 3 provides that any difference between the disposal proceeds and the carrying amount of the property less related taxes should be recognised in profit or loss for the period (para 18).

¶5-700 Disclosures

ASBE 3 requires an enterprise to disclose in the notes the following information (para 19):

(a) classes of investment property, their amount and whether the fair value or the cost model is applied;

(b) if it applies the cost model, the depreciation or amortisation of investment property and accumulated impairment losses;

(c) if it applies the fair value model, the basis and methods applied in determining the fair value of investment property and the amount of changes in fair value recognised in profit or loss;

(d) circumstances and reasons for the transfer of the investment property, and its effect on profit or loss and owners' equity; and

(e) the disposal of investment property for the period and its effect on profit or loss.

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(b) From 1 January 2020, for listed enterprises within the territory of China.

(c) From 1 January 2021, for non-listed enterprises that apply ASBE.

Earlier application of ASBE 14 is encouraged.

DEFINITIONS AND TYPES OF CONSTRUCTION CONTRACTS

¶17-210 Definitions

Construction contract is defined in ASBE 15 as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use (para 2).

The negotiation of the contract price of construction contracts would result in the classification of contracts into one of the two broad categories below:

(a) a fixed price contract; and

(b) a cost plus contract.

A *fixed price* contract is a construction contract in which the construction price is determined based on a fixed contract price, or a fixed unit price of output. The price is not subject to adjustment arising from costs incurred by the contractor (para 3).

A *cost plus* contract is a construction contract in which the construction price is determined based on contract allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee (para 3).

¶17-220 Segmenting and combining construction contracts

The requirements of ASBE 15 are usually applied to each construction contract, such as a building, bridge, dam, road, ship, tunnel, aircraft, etc. (para 4).

In certain circumstances, however, a construction contract may deal with the construction of a number of assets in a single contract or a group of contracts. To reflect the substance of a contract or a group of contracts, it is necessary to segment the separately identifiable components of a single contract, or to combine a group of contracts (para 4).

Segmenting a contract is a process of dividing a single contract, which covers more than one asset, into two or more profit centres for accounting purposes. ASBE 15 provides that where a contract covers the construction of a number of assets, the construction of each asset should be treated as a single (or separate) construction contract when (para 5):

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(a) each asset has its own independent (or separate) construction plan;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the revenue and costs of each asset can be identified separately.

An example would be the construction of a building, covering the canteen, recreation facilities, etc. Each of these assets is treated as a single (individual or separate) construction contract if all the aforesaid conditions in paragraph 5 are satisfied.

For accounting purposes, a group of contracts may be combined if they are so closely interrelated that they are, in substance, part of a single contract with an overall profit margin. Therefore, ASBE 15 provides that a group of contracts (whether with a single customer or with several customers) should be combined and treated as a single construction contract when (para 7):

(a) the group of contracts is signed as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

An example of a group of contracts would be the construction of a railway system jointly by two local government authorities linking two provinces in China. One single tender is submitted for the project but two separate contracts were entered into as it involves two different parties. In this case, it is likely that the project is negotiated and finally signed as a single package because one contract cannot be independently awarded without the other. The contract will ascertain the overall profit margin in the tender submission. The railway construction work will be performed concurrently or in a continuous sequence. Therefore, the "two" separate contracts for this "single" project should be treated as a single construction contract.

A contract may also provide for the construction of additional assets at the option of the customer or may be amended to include the construction of an additional asset. ASBE 15 requires the construction of the additional asset to be treated as a separate construction contract when (para 6):

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

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CONTRACT REVENUE AND CONTRACT COSTS

¶17-300 Contract revenue and contract costs

In accounting for construction contracts under ASBE 15, it is useful to first examine:

(a) what constitutes the contract revenue; and

(b) what cost elements should be included in the contract costs.

¶17-310 Contract revenue

Contract revenue should comprise (para 8):

(a) the contract price (i.e. the initial amount of revenue agreed in the contract); and

(b) revenue resulting from variations in contract, claims and incentive payments.

Contract price

The contract price may be formulated, as mentioned in ¶17-210, as:

(a) *fixed price contract* — where the contractor agrees to a fixed contract price or rate; or

(b) *cost plus contract* — where the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

Some construction contracts may contain characteristics of both, a fixed price contract and a cost plus contract.

Variations in contract

A *variation* is an instruction by the customer for a change in the scope of the work to be performed under the contract.

An example of a variation is when the material to be used for the roof of a building is changed upon the request of the customer.

A variation will lead to an increase or decrease in the construction costs and may also lead to an increase or decrease in contract revenue.

The increase or decrease in the construction costs is accounted for based on the actual costs incurred.

As for the change in the contract revenue, ASBE 15 provides that revenue arising from a variation in contract should be included in contract revenue only when (para 9):

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(a) the customer will approve the variation and the amount of revenue arising from the variation; and

(b) the amount of revenue can be measured reliably.

Claims

A *claim* is the amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price (para 10).

A claim may arise from, for example, delays in construction work due to certain action or non-action on the part of the customer.

The revenue arising from claims is normally subject to a high degree of uncertainty and often depends on the outcome of negotiations. ASBE 15 provides that revenue arising from a claim should be included in contract revenue only when the following conditions are satisfied (para 10):

(a) negotiations have reached an advanced stage such that the customer will accept the claims; and

(b) the amount that will be accepted by the customer can be measured reliably.

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Incentive payments

An incentive payment is an additional amount paid to the contractor as agreed by customers if specified performance standards are met or exceeded.

For example, a construction contract may provide for a bonus payment for early completion of the contract.

ASBE 15 provides that revenue arising from an incentive payment should be included in contract revenue only when (para 11):

(a) the contract is sufficiently advanced that the specified performance standard will be met or exceeded; and

(b) the amount of the incentive payment can be measured reliably.

Illustration 17.1

On 1 July 2014, AB Construction Enterprise entered into a long-term contract to build a bridge for an agreed contract price of RMB10,000,000. The terms of contract provide that the construction is to be completed by 31 December 2017 and an incentive clause which allows a 2% increase in contract price if the contract is completed one month before the agreed completion date.

On 1 August 2017, the contract is substantially completed and it is expected that the estimated date of final completion will be two months earlier. The client agrees to pay the incentive bonus of RMB200,000 to AB Construction Enterprise.

In this case, the requirements of paragraph 11 are satisfied and therefore, the revenue arising from the incentive payment is included in contract revenue.

¶17-320 Contract costs

Contract costs should comprise direct and indirect costs incurred in and attributable to a contract for the period from the date the contract is signed to the final completion of the contract (para 12).

ASBE 17 *Borrowing Costs* also provides that an enterprise should capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Qualifying assets include construction projects.

Direct costs

Direct costs are those costs that relate directly to a specific contract and fall into one of the following four categories (para 13):

(a) costs of materials used;

(b) labour costs;

(c) utilisation expenses of equipment; and

(d) other direct costs that are directly chargeable to the contract (including costs incurred for and directly related to the contract, such as costs of design and technical assistance, costs of moving materials to and from the contract site, costs of using production tools and apparatus, costs of inspection and testing, costs of site feasibility testing, costs of construction work handover, costs of site clear-up, etc.).

Direct costs are included as part of contract costs incurred (para 15).

Indirect costs

Indirect costs are those incurred by the construction unit or production unit of an enterprise for organising and managing operations (para 14), including costs such as amortisation of temporary facilities; salaries, bonus and employee welfare expenses incurred by the management personnel of the construction and production units; labour protection expenses, depreciation and maintenance of fixed assets, supplies consumed, amortisation of low-valued consumables, heating fees, water and electricity

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charges, office expenses, travelling expenses, property insurance expenses, work maintenance expenses, sewage discharge fee, etc.

Indirect costs are allocated to contract costs on a systematic and reasonable basis at the balance sheet date (para 15).

There may be many bases of allocation of indirect costs, such as labour costs, direct costs, etc.

Illustration 17.2

The construction unit "COI" of CD Construction Enterprise concurrently engages in construction work for contract A, B and C. The labour costs incurred during the period for contract A, B and C were RMB1,500,000, RMB900,000 and RMB600,000 respectively. Indirect costs (electricity, water, depreciation and maintenance of fixed assets, etc.) incurred for the entire contracting activity of construction unit "COI" during the period were RMB240,000. CD Construction Enterprise uses labour costs as the basis for allocation of indirect costs.

In this case, since the indirect costs are not directed toward any specific contract but is incurred for the entire contracting activity (i.e. concurrently for contract A, B and C), CD Construction Enterprise should allocate the costs on a systematic and reasonable basis of allocation.

The allocation ratio for indirect costs (based on the labour costs basis) is equal to 8% i.e. RMB240,000/(RMB1,500,000 + RMB900,000 + RMB600,000).

The indirect costs allocated to the individual contracts are therefore computed as follows:

Contract A	=	RMB1,500,000 × 8%	=	RMB120,000
Contract B	=	RMB900,000 × 8%	=	RMB72,000
Contract C	=	RMB600,000 × 8%	=	RMB48,000

The relevant journal entries are as follows:

			RMB'000	RMB'000
(a)	When indirect costs are incurred:			
	Dr	Construction in progress — Indirect costs	240	
	Cr	Cash in bank, etc.		240

(b) Allocation of indirect costs at the balance sheet date:

		RMB'000	RMB'000
Dr	Construction in progress — Contract A	120	
Dr	Construction in progress — Contract B	72	
Dr	Construction in progress — Contract C	48	
Cr	Construction in progress — Indirect costs		240

Other issues relating to contract costs

ASBE 15 provides that contract costs should be reduced by other incidental income related to the contract, for example, proceeds from the disposal of surplus materials and the disposal of plant and equipment at the completion of the contract. It means that the incidental income should not be included in contract revenue, but is offset against contract costs (para 16).

ASBE 15 specifically excludes the following from contract costs as they are not attributable to the construction activity (para 17):

(a) selling expenses;

(b) administrative expenses; and

(c) financial expenses, such as borrowing costs incurred for the construction contract that do not satisfy the criteria for capitalisation under ASBE 17 *Borrowing Costs.*

The above items should be recognised as an expense in the period in which they are incurred.

Some enterprises, in bidding for and securing contracts, spend significant amount before any contract is signed. There has been uncertainty over whether costs incurred before a contract is obtained (often known as pre-contract costs) should be recognised as assets (and charged as expenses over the life of the contract) or as immediate expenses. ASBE 15 does not specifically deal with pre-contract costs.

In any case, whether a contract will be obtained or not is subject to uncertainty and depends on the outcome of negotiations. Hence, for the reason of simplicity and ease of auditing, ASBE 15 specifically provides that costs arising from signing the contract (e.g. travelling expenses, tendering expenses) should be recognised directly as expenses for the period. The debit entry would be made to "Administrative expenses" (para 17).

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Types of contract costs

Contract costs can be divided into two categories:

(a) costs incurred to date; and

(b) estimated costs to complete.

The costs incurred to date include cost incurred after the signing and acceptance of the contract. Estimated costs to complete are the anticipated costs required for the completion of a contract.

RECOGNITION OF CONTRACT REVENUE AND CONTRACT EXPENSES

¶17-400 Recognition of contract revenue and contract expenses

Revenue may be recognised during construction rather than at the completion of the contract. This is appropriate since in long-term construction contracts, both the contractor and the buyer normally have enforceable rights. The buyer has the legal right to require specific performance from the contractor while the contractor has the right to require the buyer to make progress payments during the period of construction. The economic substance of the contract activity is that a continuous sale occurs when the contract activity progresses.

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ASBE 15 requires the stage of completion method to account for revenue recognition under construction contracts. This method is often referred to as the percentage of completion method.

Under the percentage of completion method, the contract revenue is recognised periodically as the contract activity progresses. The costs incurred are matched with the revenue recognised. The resultant excess or deficit represents the recognised amount of profit or loss based on the proportion of work completed for each accounting period. This method provides useful information on the extent of contract activity and performance during a period.

Under ASBE 15, the amount of periodic revenue to be recognised in the income statement under the percentage of completion method depends on whether or not the outcome of the construction contract can be estimated reliably:

(a) where the outcome of the construction contract can be estimated reliably, ASBE 15 provides that the contract revenue and contract costs should be recognised as revenue and expenses by reference to the percentage of completion method at the balance sheet date (para 18); and

(b) where the outcome of the construction contract cannot be estimated reliably, different accounting treatment should be applied as follows (para 25):

(i) if it is probable that contract costs incurred are recoverable, contract revenue should be recognised only to the extent of recoverable contract costs incurred, and contract costs should be recognised as contract expenses in the period in which they are incurred; and

(ii) if it is probable that contract costs incurred are not recoverable, no contract revenue is recognised, and contract costs are recognised immediately as contract expenses in the period in which they are incurred.

If, at the end of an accounting period, it is probable that the expected total contract costs will exceed total contract revenue (i.e. where a loss is anticipated), ASBE 15 provides that the whole amount of the expected loss should be recognised as an expense immediately (para 27). This provision applies whether or not the outcome of the contract can be estimated reliably.

¶17-410 Outcome of a contract can be estimated reliably

Circumstances under which the outcome of the construction contract can be estimated reliably are provided for in ASBE 15 as follows:

(a) In the case of a fixed price contract, when all the following conditions are satisfied (para 19):

(i) the total contract revenue can be measured reliably;

(ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;

(iii) the actual contract costs incurred can be clearly identified and measured reliably; and

(iv) both the stage of contract completion and the additional contract costs to complete the contract can be determined reliably.

(b) In the case of a cost plus contract, when all the following conditions are satisfied (para 20):

(i) it is probable that the economic benefits associated with the contract will flow to the enterprise; and

(ii) the actual contract costs incurred can be clearly identified and measured reliably.

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Where the outcome of the construction contract can be estimated reliably, the contract revenue should be recognised by reference to the stage of completion of the contract activity at the balance sheet date.

Thus, where the outcome of the construction contract can be estimated reliably and the percentage of completion method is used, it is necessary to ascertain the stage of completion of the contract activity at the balance sheet date.

The stage of completion of a contract at the balance sheet date may be determined in various ways. Enterprises should use a method that measures reliably the work performed. Depending on the nature of the contract, the methods may include (para 21):

(a) the proportion of the contract costs actually incurred for work performed to date bear to the estimated total contract costs (also referred to as the cost-to-cost basis);

(b) the proportion of the completion of the contract work to date bear to the estimated total contract work; or

(c) survey of work performed.

To illustrate the determination of the percentage of completion under the cost-to-cost and the survey of work performed bases, consider the following case.

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Illustration 17.3

EF Construction Enterprise entered into a long-term contract to construct a piece of real estate. The contract commenced on 1 January 2015 and was expected to be completed by 31 December 2017.

The agreed contract price was RMB2,000,000. The following details relate to the contract activity progress (all figures are estimated reliably at the end of year):

	2015	2016
	RMB'000	RMB'000
Cumulated costs incurred to date	600	1,100
Estimated costs to complete	1,200	660
Agreed value of work completed	570	1,080

The enterprise's accounting policy is to recognise contract revenue and costs by reference to the percentage of completion of the contract at the balance sheet date.

Required:

Calculate the contract's percentage of completion at the year-ends of 31 December 2015 and 2016 under:

(a) the cost-to-cost basis; and

(b) the survey of work performed.

Suggested solution:

(a) Cost-to-cost basis

	2015	2016
	RMB'000	**RMB'000**
Costs incurred to date	600	1,100
Estimated costs to complete	1,200	660
Estimated total costs	1,800	1,760

Percentage of completion (cost-to-cost basis)		
Costs incurred to date ÷ Estimated total costs		
RMB600,000 ÷ RMB1,800,000	33.3%	
RMB1,100,000 ÷ RMB1,760,000		62.5%

(b) Survey of work performed

	2015	2016
	RMB'000	**RMB'000**
Contract price	2,000	2,000
Agreed value of work completed	570	1,080

Percentage of completion (survey of work performed)		
Agreed value of work completed ÷ Contract price		
RMB570,000 ÷ RMB2,000,000	28.5%	
RMB1,080,000 ÷ RMB2,000,000		54.0%

The cost-to-cost basis has been found to be one of the most popular bases used to determine the extent of contract activity progress toward completion. Under this basis, the amount of revenue to be recognised for the current period in accordance with paragraph 23 is determined as follows:

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$$\frac{\text{Cost incurred to date}}{\text{Cumulative costs incurred + Estimated costs to complete}} \times \text{Contract price} - \text{Revenue previously recognised} = \text{Revenue recognised for current period}$$

The amount of construction gross profit to be recognised for the current period can be determined as follows:

$$\frac{\text{Cost incurred to date}}{\text{Cumulative costs incurred + Estimated costs to complete}} \times \text{Expected total gross profit} - \text{Gross profit previously recognised} = \text{Gross profit recognised for current period}$$

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When the cost-to-cost basis is used, care should be taken to exclude those costs that do not reflect work performed, such as construction costs that relate to future activity on contract (e.g. costs of materials purchased for the contract but not installed or used during contract performance) and advance payments made to sub-contractors (para 22).

Illustration 17.4

Assume EF Construction Enterprise in Illustration 17.3. After analysis, it was found that contract costs incurred at the year-end of 2016 include RMB50,000 for standard materials stored at the site to be used in 2017 to complete the contract.

In this case, paragraph 22 provides that contract costs of RMB50,000 for standard materials at 31 December 2016 that relate to future activity (in 2017) would be ignored in the calculation of the percentage of completion at 31 December 2016.

	2016
	RMB'000
Costs incurred to date	1,100
Estimated costs to complete	660
Estimated total costs	1,760
Percentage of completion (cost-to-cost basis)	
Costs incurred to date ÷ Estimated total costs	
(RMB1,100,000 – RMB50,000) ÷ RMB1,760,000	59.7%

Illustration 31.1

The management of AB Enterprise completes its 2017 financial reports on 27 February 2018. On 19 March 2018, the board of directors reviews the financial reports and authorises them for issue. The enterprise announces its profit and other financial information on 20 March 2018. The financial reports are made available to shareholders on 3 April 2018. The shareholders approve the financial reports at their annual meeting on 13 May 2018.

In this case, the date when the financial reports are authorised for issue is 19 March 2018, the date of authorisation by the board of directors. Events after the balance sheet date cover the period from 1 January 2018 to 19 March 2018 (both days inclusive).

For purposes of accounting, events after the balance sheet date can be categorised into two types (para 2):

(a) those that provide new or additional evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and

(b) those that are indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

¶31-200 Adjusting events after the balance sheet date

Adjusting events after the balance sheet date are events after the balance sheet date that provide new or additional evidence that existed at the balance sheet date (para 2).

ASBE 29 provides that an enterprise should adjust its financial statements at the balance sheet date to reflect adjusting events after the balance sheet date (para 4).

Illustration 31.2

CD Enterprise had among its accounts receivables a receivable, YZ Enterprise, with a balance of RMB500,000 as at 31 December 2017. As at 31 December 2017, CD Enterprise was of the opinion that the debt was wholly collectible and, therefore, did not make any provision for bad debts in respect of this debt. On 18 February 2018, it learnt that YZ Enterprise had been placed under receivership. This event was an event after the balance sheet date (occurring between the balance sheet date of 31 December 2017 and assumed date of financial statements authorised for issue by the board of directors of 15 April 2018).

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For one to be placed under receivership, one would have been in financial difficulty for the past months. Thus, the fact that YZ Enterprise was placed under receivership on 18 February 2018 indicated that, as at 31 December 2017, YZ Enterprise was already in financial difficulty. Thus, this event after the balance sheet date provided additional evidence of conditions that had existed at the balance sheet date (collectability of the accounts receivable), and therefore was an adjusting event after the balance sheet date.

In this case, the adjusting journal entry debiting bad debts and crediting provision for bad debts would be made to the 2017 financial statements. Assuming that the accounts receivable was able to pay only RMB0.20 for every RMB1 owed, then the amount of adjustment required would be RMB400,000.

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ASBE 29 provides the following examples of events after the balance sheet date which are classified as adjusting events (para 5):

(a) the settlement after the balance sheet date of a litigation case whereby the court judgement confirms that an enterprise already had a present obligation at the balance sheet date. The enterprise should adjust any previously recognised estimated liability related to this court case or should recognise a new liability;

(b) the receipt of a confirmation after the balance sheet date, indicating that an asset was impaired at the balance sheet date, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. Examples of such events are:

- the sale of inventories after the balance sheet date may give additional evidence about their net realisable value at the balance sheet date; and
- the bankruptcy of a customer that occurs after the balance sheet date usually confirms that a loss existed at the balance sheet date on an accounts receivable and that the enterprise has to adjust the carrying amount of the accounts receivable;

(c) the further determination after the balance sheet date of the cost of assets purchased, or the proceeds from assets sold, before the balance sheet date; and

(d) the discovery after the balance sheet date of fraud or errors in the financial statements.

Illustration 31.3

EF Enterprise is in litigation as at 31 December 2017. The enterprise was sued for infringement of the copyright of product "X105" which was sold during the year. Legal proceedings have started and EF Enterprise disputed against the case. The enterprise's lawyers advised that it is not probable that EF Enterprise will lose the case. Hence, EF Enterprise has not recognised any estimated liability.

On 13 March 2018 as a result of the court's decision, however, EF Enterprise lost the case and had to pay compensation of RMB2,000,000.

The financial reports of EF Enterprise are expected to be authorised for issue on 15 April 2018.

In this case, the sale of products is an event that occurred before the balance sheet date. The resolution on 13 March 2018 (after the balance sheet date) of a court case confirms the enterprise's present obligation at the balance sheet date requiring recognition of an estimated liability (compensation for damages) not previously made. This is an adjusting event after the balance sheet date.

For adjusting events after the balance sheet date, an enterprise should adjust the amounts of assets, liabilities and owners' equity recognised at the balance sheet date, and revenue and expenses for the period ended accordingly. It may be noted that the necessary adjustment should also be made for the supporting statements to the balance sheet and income statement, as well as supplementary information in the cash flow statement.

The adjusting events after the balance sheet date should be accounted for in the following ways:

(a) events relating to profit/loss should be recorded in the "adjustment to prior years' profit or loss" account. An adjustment that results in an increase in profit or a decrease in loss of prior years and a resultant decrease in the income tax should be credited to this account. An adjustment that results in a decrease in profit or an increase in loss of prior years and a resultant increase in the income tax should be debited to this account. The credit or debit balance of this account should be transferred to the "profit to be distributed — undistributed profit" account;

(b) adjusting events relating to profit distribution should be recorded directly in the "profit to be distributed — undistributed profit" account;

(c) adjusting events not relating to profit/loss and profit distribution should be adjusted against related accounts; and

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(d) upon completion of the above accounting treatment, the amount of related financial statement items should be adjusted as follows:

(i) the amounts of relevant items in the financial statements prepared at the balance sheet date;

(ii) the beginning balances of relevant items in the financial statements of the current year;

(iii) the prior years' amounts of relevant financial statements when comparative financial statements are presented; and

(iv) the amounts of relevant items in the notes to financial statements should be adjusted, if necessary, following the above adjustments.

Illustration 31.4

GH Enterprise had among its accounts receivables an outstanding amount of RMB600,000 due from WX Enterprise as at 31 December 2017. In preparing the 2017 financial statements, a 5% provision for bad debts amounting to RMB30,000 was made against WX Enterprise. The net amount of RMB570,000 due from WX Enterprise had been included under the total accounts receivable of RMB1,000,000 stated in the balance sheet.

On 10 February 2018, a letter was received from WX Enterprise for its liquidation in process. It was expected that 20% of the amount due from WX Enterprise is recoverable.

GH Enterprise appropriates 10% and 5% of net profit to the statutory surplus reserve and statutory public welfare fund respectively. Ignore other appropriations and no dividend has been proposed.

Assume that the financial reports were authorised for issue on 10 April 2018 and the applicable income tax rate is 25%.

In this case, the receipt of a letter regarding the liquidation of WX Enterprise provided additional evidence of conditions that had existed at the balance sheet date (collectability of the accounts receivable), and therefore was an adjusting event after the balance sheet date.

Therefore, GH Enterprise should adjust the amounts of assets, liabilities and owners' equity recognised at the balance sheet date, and revenue and expenses for the period ended accordingly.

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The relevant adjusting entries are as follows:

(a) Adjust provision for bad debts:

		RMB	RMB
Dr	Adjustment to prior years' profit or loss	450,000	
Cr	Provision for bad debts (RMB600,000 × 80% – RMB30,000)		450,000

(b) Adjust income tax payable:

		RMB	RMB
Dr	Deferred tax assets (RMB450,000 × 25%)	112,500	
Cr	Adjustment to prior years' profit or loss		112,500

(c) Transfer balance of "Adjustment to prior years' profit or loss" to profit to be distributed

		RMB	RMB
Dr	Profit to be distributed — Undistributed profit	337,500	
Cr	Adjustment to prior years' profit or loss (RMB450,000 – RMB112,500)		337,500

(d) Adjust surplus reserves

		RMB	RMB
Dr	Surplus reserves — Statutory surplus reserve (RMB337,500 × 10%)	33,750	
Dr	Surplus reserves — Statutory public welfare fund (RMB337,500 × 5%)	16,875	
Cr	Profit to be distributed — Undistributed profit		50,625

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In the 2017 financial statements that follow, assuming that the columns of *before-adjusting amounts* are given, the adjusted financial statements (after the adjusting entries (a) to (d) have been made) are presented below (those amounts of the adjusted financial statements items are highlighted in **bold** and ***italic***):

Balance sheet at 31 December 2017

Prepared by GH Enterprise					**Unit: RMB'000**
Assets	**Before adjust-ment**	**After adjust-ment**	**Liabilities and owners' (stockholders') equity**	**Before adjust-ment**	**After adjust-ment**
Current assets			**Current liabilities**		
Monetary funds	1,970	1,970	Accounts payable	200	200
Accounts receivable	**1,000**	***550***	Employee compensation payable	400	400
Inventories	600	600	Taxes payable	**300**	***187.5***
Payments in advance	50	50	Other payables	150	150
Total current assets	3,620	3,170	Total current liabilities	1,050	937.5
Non-current assets			**Non-current liabilities**		
Fixed assets — cost	3,180	3,180	Long-term borrowings	2,000	2,000
Total non-current assets	3,180	3,180	Total non-current liabilities	2,000	2,000
			Total liabilities	3,050	2,937.5
			Owners' (stockholders') equity		
			Paid-in capital (stock)	2,400	2,400

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			Other equity instruments Including: Preference shares		
			Perpetual debts	0	0
			Capital surplus	0	0
			Less: Treasury stock	0	0
			Other comprehensive income	0	0
			Surplus reserves (including: Statutory public welfare fund: 67 (before adjustment), 51.925 (after adjustment))	**200**	**149.375**
			Undistributed profit	**1,150**	**863.125**
			Total owners' (stockholders') equity	3,750	3,412.5
Total assets	6,800	6,350	Total liabilities and owners' (stockholders') equity	6,800	6,350

Income statement for the year ended 31 December 2017

Prepared by GH Enterprise		Unit: RMB'000
Item	Before adjustment	After adjustment
I. Revenue from operations	5,200	5,200
Less: Cost of operations	3,300	3,300
Tax and surcharge for operations	10	10
Selling expenses	80	80
Administrative expenses	**720**	**1,170**
Financial expenses	50	50
Impairment losses of assets	0	0

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Item	Before adjustment	After adjustment
Add: Gains on changes in fair value	0	0
Investment income	0	0
Including: Investment income from associated enterprises and joint venture enterprises	0	0
Gains on disposal of assets	0	0
Other income	0	0
II. Operating profit	1,040	590
Add: Non-operating revenue	20	20
Less: Non-operating expenses	0	0
III. Profit before tax	1,060	610
Less: Income tax expense	**350**	**237.5**
IV. Net profit	710	372.5

Note: There is no other comprehensive income for the year.

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Statement of Changes in Owners' (or Stockholders') Equity (extract) for the year ended 31 December 2017

Prepared by: GH Enterprise		Unit: RMB'000
Item	Before adjustment	After adjustment
I. Ending balance of prior year		
Undistributed profit	**546.5**	**546.5**
Add: Changes in accounting policy	0	0
Corrections of prior period errors	0	0
II. Beginning balance of current year		
Undistributed profit	**546.5**	**546.5**
III. Changes in amount for the current year		
Add: Net profit	**710**	**372.5**
Less: Profit to be distributed		
Appropriation of statutory surplus reserve (10%)	**71**	**37.25**
Appropriation of statutory public welfare fund (5%)	**35.5**	**18.625**
Dividends proposed on common stock	0	0
IV. Ending balance of current year	1,150	863.125

¶31-300 Non–adjusting events after the balance sheet date

Non–adjusting events after the balance sheet date are events after the balance sheet date that are indicative of conditions that arose after the balance sheet date (para 2).

> **Illustration 31.5**
>
> Assume CD Enterprise in Illustration 31.2.
>
> If CD Enterprise had commenced trading with YZ Enterprise only in January 2018, the event after the balance sheet date of YZ Enterprise being placed under receivership on 18 February 2018 would have only been indicative of a condition (that is, collectability of the accounts receivable) that had arisen after the balance sheet date. Therefore, this would have been a case of a non–adjusting event after the balance sheet date.

Another example of a non–adjusting event after the balance sheet date is where an enterprise acquires a subsidiary, say, in March 2018. In this case, the after balance sheet acquisition of investment in the subsidiaries does not provide new or additional evidence of conditions that existed at the balance sheet date and, therefore, is a non–adjusting event after the balance sheet date.

ASBE 29 provides that an enterprise should not adjust its financial statements at the balance sheet date to reflect non–adjusting events after the balance sheet date (para 6).

ASBE 29 provides the following examples of non–adjusting events after the balance sheet date (para 7):

(a) commencing major litigation, arbitration or commitment after the balance sheet date;

(b) abnormally large changes in asset prices, taxation policy or foreign exchange rates after the balance sheet date;

(c) significant losses of assets as a result of a natural disaster after the balance sheet date;

(d) issues of shares and bonds, and the raising of substantial borrowings from outside parties after the balance sheet date;

(e) transfer from capital surplus to capital after the balance sheet date;

(f) incurring substantial losses after the balance sheet date; and

(g) incurring a business combination or disposing of a subsidiary after the balance sheet date.

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ASBE 29 provides that an enterprise should disclose the following information in the notes relating to each material non–adjusting event after the balance sheet date (para 9(2)):

(a) the nature and details of the event; and

(b) an estimate of its effect on the financial position and operating performance (or an explanatory statement that such estimate cannot be made).

> **Illustration 31.6**
>
> IJ Enterprise intended to issue its 2017 financial reports on 30 March 2018.
>
> On 15 February 2018, IJ Enterprise acquired a 60% interest in UV Enterprise and obtained control of UV Enterprise (a subsidiary), for a cash consideration of RMB10,000,000. The fair value of the net identifiable assets of UV Enterprise at that date was RMB8,200,000.
>
> In this case, the event of acquiring the subsidiary after the balance sheet date (being a non–adjusting event after the balance sheet date) may be disclosed in the notes to the financial statements of IJ Enterprise's 2017 annual reports as follows:
>
> **Note:**
>
> **Events after balance sheet date**
>
> "After the balance sheet date, the enterprise acquired a 60% interest in UV Enterprise and obtained control of UV Enterprise (a subsidiary) for a cash consideration of RMB10,000,000. The fair value of the net identifiable assets of UV Enterprise at the acquisition date was RMB8,200,000."

OTHER ISSUES — DATE OF AUTHORISATION FOR ISSUE, DIVIDENDS, GOING CONCERN

¶31-410 Date of authorisation for issue

It is important for users to know when the financial reports were authorised for issue, because the financial reports do not reflect events after this date.

ASBE 29 requires an enterprise to disclose in the notes (para 9(a)):

(a) the date when the financial reports were authorised for issue; and

(b) who gave that authorisation.

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Under the relevant laws and administrative regulations, if the enterprise's owners or others have the power to amend the financial reports after issue, the enterprise should disclose that fact.

An illustration of the disclosure required under paragraph 9(a) is shown below:

> **Illustration 31.7**
>
> **Note:**
>
> *Authorisation of financial reports*
>
> The financial reports of KL Enterprise and the consolidated financial reports of the Group for the year ended 31 December 2017 were authorised for issue in accordance with a directors' resolution dated 10 February 2018.

¶31-420 Dividends

ASBE 29 provides that an enterprise should not recognise dividends or profit to be distributed as a liability at the balance sheet date if they are included in the profit distribution plan of the enterprise or declared to be distributed upon approval after the balance sheet date (para 8). Those dividends should be separately disclosed in the notes. The rationale is that the obligation to pay dividends arises only after they are declared, so if dividends are declared after the balance sheet date, then the enterprise does not have a present obligation at the balance sheet date under ASBE 13 *Contingencies*, and consequently, no liability should be recognised in the balance sheet. It follows that dividends declared before the balance sheet date (which have not been paid by the balance sheet date) should be recognised as a liability in the balance sheet.

Paragraph 34 of ASBE 30 *Presentation of Financial Statements* also requires the total amount of dividends declared after the balance sheet date but before the financial reports are authorised for issue, and the related amount per share, to be disclosed in the notes.

¶31-430 Going concern

For enterprises that are not financially healthy, events after the balance sheet date should also be reviewed for the appropriateness of the going concern basis of accounting.

Deterioration in the operating results and financial position after the balance sheet date may indicate a need to consider whether it is still proper to use the going concern assumption in the preparation of the financial statements. If the going concern assumption is no longer appropriate, the effect will

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then be so persuasive that a fundamental change in the basis of accounting is required.

In such circumstances, ASBE 29 provides that the enterprise should not prepare the financial statements on a going concern basis (para 3).

It may be noted that the *Application Guidance* to ASBE 30 *Presentation of Financial Statements* requires that an enterprise's management should make an assessment of the enterprise's ability to continue as a going concern when preparing the financial statements. When there is significant doubt about the enterprise's ability to continue as a going concern, the factors that give rise to this doubt should be disclosed in the notes. When it is no longer reasonable to prepare financial statements on a going concern basis, ASBE 30 and the *Application Guidance* require that fact to be disclosed in the notes, together with the basis on which the financial statements are prepared and the reason why the financial statements are not prepared on the going concern basis. The *Application Guidance* to ASBE 30 further provides that the enterprise is not operating on a going concern basis when it formally decides or is forced to liquidate or cease trading in the current or next accounting period.

> **Illustration 31.8**
>
> MN Enterprise prepared its financial statements for the year ended 31 December 2017. On 7 January 2018, the board of directors decided to dispose of the enterprise's assets and liquidate the enterprise.
>
> In this case, the enterprise's financial statements for the year ended 31 December 2017 should not be prepared on a going concern basis. Instead, the liquidation basis should be used.

DISCLOSURE

¶31-500 Updating disclosure about conditions at the balance sheet date

Apart from the disclosure discussed above, ASBE 29 further provides that if an enterprise receives information after the balance sheet date that affects conditions that existed at the balance sheet date, it should update disclosures that relate to those conditions in light of the new or further evidence (para 10).

An example of the need to update disclosures is when evidence becomes available after the balance sheet date concerning a contingent liability that existed at the balance sheet date.

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Illustration 31.9

OP Enterprise was sued by its competitor for patent infringement, but this has been denied by OP Enterprise. There was only a contingent liability disclosed in the financial statements of OP Enterprise at 31 December 2017.

On 15 January 2018, the court awarded RMB1,000,000 damages against OP Enterprise.

In this case, if the financial statements have not yet been authorised for issue, OP Enterprise should replace the contingent liability by recognising an estimated liability for RMB1,000,000 in its financial statements to 31 December 2017. The accounting entries are as follows:

		RMB	RMB
Dr	Non-operating expenses	1,000,000	
Cr	Estimated liabilities — Pending litigation		1,000,000

In addition to considering whether it should recognise or change an estimated liability under ASBE 13 *Contingencies*, an enterprise updates its disclosures of the contingent liability in light of that new or further evidence.

¶31-600 Appendix — Case study

This Appendix provides an analysis of a short case study on events after the balance sheet date.

Case Study 31.10

QR Enterprise was a manufacturer and trader of consumer products.

The auditors of QR Enterprise were finalising their audits of the 2017 financial statements and hoped to meet the proposed deadline of 15 May 2018 when the financial reports were expected to be authorised for issue.

The following list was prepared by the audit senior on the job for the attention of the audit manager:

(a) On 11 January 2018, the enterprise's factory was destroyed by fire caused by sabotage. The factory was not insured sufficiently and the loss suffered from the fire was estimated to be RMB500,000.

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(b) The enterprise acquired 1,000,000 shares of ST Enterprise at a cost of RMB2,500,000 in 2014 (ST Enterprise's stock capital consisted of 10,000,000 ordinary shares of RMB1 each). On 31 December 2017, a provision for impairment of long-term investments of RMB500,000 was made in respect of these shares due to the decline in their market value. These shares were sold on 20 February 2018, resulting in a loss of RMB100,000. The loss of RMB100,000 reflected a further deterioration in share prices after 31 December 2018.

(c) During the first week of March 2018, the enterprise held a "sale" to clear the old inventories of 2017 Christmas goods and 2018 Chinese New Year goods, where all the goods were sold at 40% of the cost. In early December 2018, the enterprise purchased RMB1,000,000 of Christmas goods (for the Christmas on 25 December 2017) and RMB1,000,000 of Chinese New Year goods (for the Chinese New Year in February 2018), and as at 31 December 2017, RMB100,000 of Christmas goods and all the RMB1,000,000 of Chinese New Year goods were in the store. These goods were carried at cost and no provision for inventory write-down has been made as at 31 December 2017.

(d) In mid-March 2018, manufacturing defects were discovered in Product "Y101" and product "Z203". Product "Y101" was manufactured and sold since July 2017 and product "Z203" was one of its new products manufactured and sold in the first quarter of 2018. As both the products are made to order, the amount of inventories is immaterial. QR Enterprise was advised by its lawyers that it was probable that the enterprise will have to pay damages of RMB500,000 for product "Y101" and RMB100,000 for product "Z203". Further, QR Enterprise has to pay the legal costs of RMB40,000.

Required:

Assume you are the audit manager. Discuss whether the above events after the balance sheet date should be classified as "adjusting" or "non–adjusting" events after the balance sheet date in accordance with ASBE 29 *Events after the Balance Sheet Date* and suggest appropriate accounting treatments.

Note:

Assume all the above matters are material in relation to the enterprise's financial statements, and ignore tax effects.

In this case, the basic EPS is calculated as follows:

= Net profit attributable to ordinary shareholders of the parent / Weighted average number of ordinary shares of the parent outstanding

= RMB27,000,000 / 10,000,000

= RMB2.70

¶36-220 Additional shares issued at full market price

If an enterprise issues additional ordinary shares during the year for cash or other consideration and at full market price, it is necessary to compute the weighted average number of ordinary shares outstanding during the period.

Illustration 36.2

CD Enterprise was incorporated in 2014 with a fully paid-up share capital of 100,000,000 ordinary shares of RMB1 each. On 1 October 2017, it issued additional 12,000,000 ordinary shares at full market price for cash.

In this case, the calculation of the basic EPS for 2017 would involve the determination of the weighted average number of ordinary shares outstanding during 2017, which may be computed as follows:

Weighted average number of ordinary shares outstanding in 2017:

= 100,000,000 outstanding for 12 months plus 12,000,000 outstanding for three months

= 100,000,000 × 12/12 + 12,000,000 × 3/12

= 103,000,000

Or

= 100,000,000 outstanding for the first nine months plus 112,000,000 outstanding for the last three months

= 100,000,000 × 9/12 + 112,000,000 × 3/12

= 103,000,000

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¶36-230 Stock buy-back

If an enterprise buys back its own ordinary shares during the year, it is also necessary to compute the weighted average number of ordinary shares outstanding.

Illustration 36.3

Assume that CD Enterprise in Illustration 36.2 exercises a stock buy-back on 1 December 2017 involving buying back 6,000,000 of its own ordinary shares.

In this case, the calculation of the basic EPS for 2017 would involve the determination of the weighted average number of ordinary shares outstanding during 2017, which may be computed as follows:

Weighted average number of ordinary shares outstanding in 2017:

= 100,000,000 outstanding for 12 months plus 12,000,000 outstanding for three months minus 6,000,000 buy-back for one month

= 100,000,000 × 12/12 + 12,000,000 × 3/12 – 6,000,000 × 1/12

= 102,500,000

Or

= 100,000,000 outstanding for the first nine months plus 112,000,000 outstanding for the next two months plus 106,000,000 outstanding for the last month

= 100,000,000 × 9/12 + 112,000,000 × 2/12 + 106,000,000 × 1/12

= 102,500,000

DILUTED EARNINGS PER SHARE

¶36-300 Diluted earnings per share

An enterprise with "potential ordinary shares" which are dilutive in nature is required to present both the basic and the diluted EPS figures.

The computation of the basic EPS is as discussed in ¶36-200 above.

When there are dilutive potential ordinary shares, an enterprise should, in calculating diluted EPS, adjust the net profit attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding, for the effects of dilutive potential ordinary shares (para 7).

Dilutive potential ordinary shares are defined in ASBE 34 as potential ordinary shares when their conversion to ordinary shares during the period

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would decrease EPS or increase loss per share (para 7 and the *Explanatory Guidance* — Chapter 35 *Earnings Per Share*). Potential ordinary shares issued by enterprises in China mainly include convertible bonds, convertible preference shares, warrants, share options, etc.

For the purpose of calculating diluted EPS, ASBE 34 provides that an enterprise should adjust the net profit attributable to ordinary shareholders during the period for the effect of (para 8):

(a) any interest recognised as expense in the period related to the dilutive potential ordinary shares;

(b) any dividends related to dilutive potential ordinary shares deducted in arriving at net profit or loss attributable to ordinary shareholders; and

(c) any income or expense that would result from the conversion of the dilutive potential ordinary shares.

The conversion of potential ordinary shares may lead to consequential changes in income or expenses. For example, the reduction of interest expense related to the conversion of potential ordinary shares into issued ordinary shares and the resulting increase in profit may lead to an increase in the expense related to a profit–sharing and bonus plan implemented by an enterprise. For the purpose of calculating diluted EPS, the net profit attributable to ordinary shareholders during the period is to be adjusted for any such consequential changes in income or expense.

The adjustment made above should take into account the related income tax effect. For convertible bonds, the *Application Guidance* specifically provides that the interest adjustment in (a) above should be the after-tax amount. In respect of financial instruments that comprise both liability and equity components, the *Explanatory Guidance* — Chapter 35 *Earnings Per Share* provides that the adjustment in (a) and (b) should be made for interest, gain or loss relating to the part of financial liability. For warrants and share options, the *Application Guidance* provides that normally the net profit amount (the numerator) should not change.

The diluted EPS is calculated based on the "if converted" assumption. Under the "if converted" assumption, ASBE 34 provides that both the numerator (net profit attributable to the ordinary shareholders) and the denominator (weighted average number of ordinary shares outstanding) for the diluted EPS computation are adjusted as if all the dilutive potential ordinary shares have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares (para 9).

It is important to note that the diluted EPS presented should be the "worst" possible. Thus, only those potential ordinary shares that are "dilutive" in nature are included in the computation of the diluted EPS. Potential ordinary shares that are "antidilutive" in nature should be excluded.

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The following illustration demonstrates the computation of the basic and diluted EPS for an enterprise that has issued dilutive convertible loan stocks or bonds.

Illustration 36.4

EF Enterprise was incorporated in 2014 with a paid-up capital of 5,000,000 ordinary shares of RMB1 each.

On 1 October 2016, EF Enterprise issued RMB10,000,000 convertible loan stocks (CLS). The CLS carry a gross interest rate of 10% and are convertible into ordinary shares at a rate of 1 ordinary share for RMB10 of CLS, commencing 1 January 2018.

The interest on loan stocks does not meet the conditions for capitalisation and hence is recognised in profit or loss for the period. For simplicity, ignore the splitting of convertible loan stocks into a liability and an equity component and assume that the nominal interest rate equals the effective interest rate.

EF Enterprise's net profit was RMB10,000,000 for each of the years ended 31 December 2016 and 2017. Assume an income tax rate of 25%.

For 2016:

Basic EPS

Net profit attributable to ordinary shareholders		
Net profit		RMB10,000,000
Weighted average number of ordinary shares outstanding		
Ordinary shares		5,000,000
Basic EPS	=	RMB10,000,000 / 5,000,000
	=	RMB2

Diluted EPS

Net profit attributable to ordinary shareholders		
Net profit		RMB10,000,000
Add: Interest expense (net of income tax)		187,500
	=	10,187,500

Weighted average number of ordinary shares outstanding

Ordinary shares		5,000,000
Add: Ordinary shares resulting from assumed conversion of CLS		250,000
	=	5,250,000

Diluted EPS	=	RMB10,187,500 / 5,250,000
	=	RMB1.94

For 2017:

Basic EPS

Net profit attributable to ordinary shareholders

Net profit	RMB10,000,000

Weighted average number of ordinary shares outstanding

Ordinary shares	5,000,000

Basic EPS	=	RMB10,000,000 / 5,000,000
	=	RMB2

Diluted EPS

Net profit attributable to ordinary shareholders

Net profit		RMB10,000,000
Add: Interest expense (net of income tax)		750,000
	=	10,750,000

Weighted average number of ordinary shares outstanding

Ordinary shares		5,000,000
Add: Ordinary shares resulting from assumed conversion of CLS		1,000,000
	=	6,000,000

Diluted EPS	=	RMB10,750,000 / 6,000,000
	=	RMB1.79

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Notes to the solution:

(1) For the 2016 basic EPS calculation, the amount of net profit attributable to ordinary shareholders is RMB10,000,000, and the weighted average number of ordinary shares outstanding is 5,000,000. Therefore, the basic EPS is RMB2.

(2) For the computation of the 2016 diluted EPS, it is assumed that the CLS were converted into 1,000,000 ordinary shares as at 1 October 2016. Thus, the weighted average number of ordinary shares outstanding is deemed to be 5,250,000 (5,000,000 + 1,000,000 × 3/12).

Since the CLS are deemed to have been converted into ordinary shares, interest on the CLS of RMB250,000 (RMB10,000,000 × 10% × 3/12) would not have to be paid and therefore the after-tax profit would be increased by RMB187,500 (RMB250,000 × (1 − 25%)) and the net profit attributable to ordinary shareholders would be RMB10,187,500.

The diluted EPS is, therefore, RMB1.94.

(3) For the 2017 basic EPS calculation, the amount of net profit attributable to ordinary shareholders is RMB10,000,000, and the weighted average number of ordinary shares outstanding is 5,000,000 shares. Therefore, the basic EPS is RMB2.

(4) For the computation of the 2017 diluted EPS, it is assumed that the CLS were converted into 1,000,000 ordinary shares as at 1 January 2017. Thus, the weighted average number of ordinary shares outstanding is deemed to be 6,000,000 (5,000,000 + 1,000,000).

Since the CLS are deemed to have been converted into ordinary shares, interest on the CLS of RMB1,000,000 (RMB10,000,000 × 10%) would not have to be paid and therefore the after-tax profit would be increased by RMB750,000 (RMB1,000,000 × (1 − 25%)) and the net profit attributable to ordinary shareholders would be RMB10,750,000.

The diluted EPS is, therefore, RMB1.79.

(5) Note that, in the above case, even though the CLS are convertible only from 2018 onwards, the 2016 diluted EPS is still computed based on the assumption that all the CLS were converted into ordinary shares on 1 October 2016, and the 2017 diluted EPS is computed based on the assumption that all the CLS were converted into ordinary shares on 1 January 2017.

Where part of the potential ordinary shares has actually been converted during the year, the weighted average number of ordinary shares outstanding for the basic EPS computation will be calculated based on the date of conversion during the year. However, in computing the diluted EPS, the potential ordinary shares that are actually converted during the year are assumed to have been converted at the beginning of the year. This is consistent with the assumption used in the computation of diluted EPS in the previous years, so that the denominator in the formula for the computation of the diluted EPS is consistent throughout the years.

Illustration 36.5

GH Enterprise was incorporated on 1 January 2012 with a fully paid-up share capital of 100,000,000 ordinary shares of RMB1 each.

On 30 September 2014, the enterprise issued RMB100,000,000 convertible loan stocks (CLS). The CLS carry a gross interest rate of 12% and are convertible into ordinary shares at a rate of 100 ordinary shares for RMB1,000 of CLS.

The interest on convertible loan stocks does not meet the conditions for capitalisation and hence is recognised in profit or loss for the period. For simplicity, ignore the splitting of convertible loan stocks into a liability and an equity component and assume that the nominal interest rate equals the effective interest rate.

On 30 September 2016, RMB40,000,000 of the CLS were converted into 4,000,000 ordinary shares.

Interest on the CLS are payable each calendar quarter of the year, such that those CLS that are converted at the end of each quarter would be entitled to the interest for that quarter.

For the year ended 31 December 2016, the enterprise's net profit was RMB500,000,000. Assume an income tax rate of 25%.

In this case, the computation of the 2016 EPS is as follows:

Basic EPS

Net profit attributable to ordinary shareholders		
Net profit		RMB500,000,000
Weighted average number of ordinary shares outstanding		
Ordinary shares		100,000,000
Add: Ordinary shares issued on conversion of CLS		1,000,000
	=	101,000,000

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Basic EPS	=	RMB500,000,000 / 101,000,000
	=	RMB4.95

Diluted EPS

Net profit attributable to ordinary shareholders		
Net profit		RMB500,000,000
Add: Interest expense (net of income tax)		8,100,000
	=	508,100,000
Weighted average number of ordinary shares outstanding		
Ordinary shares		100,000,000
Add: Ordinary shares issued on conversion of CLS		4,000,000
Add: Ordinary shares resulting from assumed conversion of CLS		6,000,000
	=	110,000,000
Diluted EPS	=	RMB508,100,000 / 110,000,000
	=	RMB4.62

Notes to the solution:

(1) In this case, there is a conversion of RMB40,000,000 CLS into 4,000,000 ordinary shares on 30 September 2016. In the computation of the basic EPS, the weighted average number of ordinary shares issued on the conversion is 1,000,000 (4,000,000 × 3/12).

(2) For the computation of the diluted EPS for 2016, the conversion is assumed to have taken place on 1 January 2016. Thus, the weighted average number of ordinary shares issued on the conversion is 4,000,000 (4,000,000 × 12/12).

It may be noted that the above calculation will ensure that the weighted average number of ordinary shares outstanding in the computation of diluted EPS for 2016 is the same as those in previous years, despite the fact that there was an actual conversion of part of the CLS during 2016.

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(3) Interest of RMB10,800,000 (RMB40,000,000 × 12% × 9/12 + RMB60,000,000 × 12%) on the RMB40,000,000 CLS converted on 30 September 2016 and on the RMB60,000,000 CLS that remain outstanding as at 31 December 2016 has been charged against the profit of 2016. For the computation of the diluted EPS, all of the RMB100,000,000 CLS is assumed to have been converted on 1 January 2016, and consequently, no interest will be payable. Therefore, in the computation of the diluted EPS, the after-tax effect of interest of RMB8,100,000 (RMB10,800,000 × (1 – 25%)) is added back to the net profit attributable to ordinary shareholders.

In the years after the year during which all the potential ordinary shares have been converted (also in the year in which all the potential ordinary shares are converted if they are converted at the beginning of the year), diluted EPS would no longer be necessary because the enterprise would now have no potential ordinary shares.

Illustration 36.6

Assume that all the remaining convertible loan stocks of GH Enterprise in Illustration 36.5 were converted on or before 31 December 2017.

For the year 2018 (and thereafter), GH Enterprise will have no potential ordinary shares, and therefore only the basic EPS is required to be presented.

Assume that the net profit of GH Enterprise for the year ended 31 December 2018 is RMB300,000,000; its 2018 basic EPS will be RMB2.73 (net profit attributable to ordinary shareholders of RMB300,000,000 divided by the weighted average number of ordinary shares outstanding of 110,000,000).

¶36-310 Share options and warrants

Where an enterprise has granted share options or issued warrants subscribing to the ordinary shares of the enterprise, and if the exercise of these share options and warrants has a dilutive effect, the enterprise will have to present both the basic EPS and the diluted EPS.

The diluted EPS is calculated on the assumption that the share options and warrants had been exercised at the beginning of the period (or the date of issue, if later) and the maximum number of new ordinary shares had been issued under the terms of the share options and warrants (so as to present the "worst" situation).

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To incorporate the effects of the share options and warrants in the computation of the diluted EPS, ASBE 34 uses the principle of "stock buy-back" (or treasury stock).

Under the principle of stock buy-back, the proceeds received from the assumed exercise of the share options and warrants are deemed to have been used to buy back the enterprise's own ordinary shares from the market at the average market price of ordinary shares during the period (para 10).

If the exercise price under the share options and warrants is lower than the average market price of the ordinary shares during the period, the application of the stock buy-back principle would have the effect of increasing the denominator (i.e. the weighted average number of ordinary shares outstanding) of the diluted EPS computation (while the numerator, i.e. the net profit figure is not affected).

Theoretically, every market transaction for an enterprise's ordinary shares should be included in calculating the average market price of ordinary shares during the period. The *Application Guidance* provides that, as a practical matter, the average market price of the ordinary shares is normally calculated based on a simple average of weekly or monthly prices from the trading of representative shares. When prices are relatively stable, closing market prices are used for calculating the representative price. When prices fluctuate widely, an average of the high and low prices is used for calculating the representative price. The method used to calculate the average market price is used consistently once selected, and cannot be changed arbitrarily unless there is supporting evidence to demonstrate that the original method of calculation is no longer appropriate.

Illustration 36.7

On 1 January 2017, IJ Enterprise granted share options to its employees to buy 100,000 shares of the enterprise's ordinary shares at an exercise price of RMB1.50 per share.

The average market price of IJ Enterprise's ordinary shares during the year 2017 was RMB2 per share.

In this case, the effect of the share options on the computation of the enterprise's 2017 diluted EPS is an increase of the denominator (i.e. the weighted average number of ordinary shares outstanding) by 25,000 shares, as shown below:

Ordinary shares assumed to be issued	=	100,000
Ordinary shares assumed to be repurchased	=	Proceeds from the exercise of share options/Average market price

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	=	RMB150,000/RMB2
	=	75,000
Increase in ordinary shares outstanding	=	25,000

It may be appreciated that if the exercise price under the share options and warrants is higher than the average market price of the ordinary shares during the period, the share options and warrants will be antidilutive in nature, and should therefore be ignored for the purpose of diluted EPS computation. Also, if the exercise price is higher than the average market price of the ordinary shares during the period, the holders of the share options and warrants will not exercise the share options and warrants, and therefore it is illogical to include the share options and warrants in the computation of the diluted EPS.

The following illustration demonstrates the computation of the basic and the diluted EPS where an enterprise has issued share options.

Illustration 36.8

KL Enterprise was incorporated in 2012 with a fully paid-up capital of 100,000,000 ordinary shares of RMB1 each.

On 1 July 2016, KL Enterprise issued share options to its key employees to buy 20,000,000 ordinary shares at RMB3 per share effective 1 January 2018.

The average market price of the enterprise's ordinary shares for the years 2016 and 2017 was RMB4 and RMB5 per share, respectively.

KL Enterprise's net profit for each of the years ended 31 December 2016 and 2017 were RMB500,000,000.

For 2016:

Basic EPS

Net profit attributable to ordinary shareholders

Net profit RMB500,000,000

Weighted average number of ordinary shares outstanding

Ordinary shares 100,000,000

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Basic EPS	=	RMB500,000,000 / 100,000,000
	=	RMB5

Diluted EPS

Net profit attributable to ordinary shareholders

Net profit RMB500,000,000

Weighted average number of ordinary shares outstanding

Ordinary shares		100,000,000
Add: Effects of share options		2,500,000
	=	102,500,000

Diluted EPS	=	RMB500,000,000 / 102,500,000
	=	RMB4.88

For 2017:

Basic EPS

Net profit attributable to ordinary shareholders

Net profit RMB500,000,000

Weighted average number of ordinary shares outstanding

Ordinary shares 100,000,000

Basic EPS	=	RMB500,000,000 / 100,000,000
	=	RMB5

Diluted EPS

Net profit attributable to ordinary shareholders

Net profit RMB50,000,000

Weighted average number of ordinary shares outstanding

Ordinary shares		100,000,000
Add: Effects of share options		8,000,000
	=	108,000,000

Diluted EPS	=	RMB500,000,000 / 108,000,000
	=	RMB4.63

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Notes to the solution:

(1) For the 2016 basic EPS calculation, the amount of net profit attributable to ordinary shareholders is RMB500,000,000, and the weighted average number of ordinary shares outstanding is 100,000,000 shares. Therefore, the basic EPS is RMB5.

(2) For the computation of the 2016 diluted EPS, the share options are assumed to have been exercised on 1 July 2016 and therefore have the effect of increasing the denominator (i.e. weighted average number of ordinary shares outstanding) by 2,500,000 shares, and are computed as follows:

Ordinary shares assumed to be issued	=	20,000,000
Ordinary shares assumed to be repurchased (20,000,000 × RMB3/ RMB4)	=	15,000,000
Increase in ordinary shares outstanding	=	5,000,000
(outstanding for six months)		(× 6/12)
Weighted average number	=	2,500,000

The numerator (i.e. net profit figure) for the diluted EPS is not affected by the share options and remains at RMB500,000,000.

The diluted EPS is therefore RMB4.88.

(3) For the 2017 basic EPS calculation, the amount of net profit attributable to ordinary shareholders is RMB500,000,000, and the weighted average number of ordinary shares outstanding is 100,000,000 shares. Therefore, the basic EPS is RMB5.

(4) For the computation of the 2017 diluted EPS, the share options have the effect of increasing the denominator (i.e. weighted average number of ordinary shares outstanding) by 8,000,000 shares, and are computed as follows:

Ordinary shares assumed to be issued	=	20,000,000
Ordinary shares assumed to be repurchased (20,000,000 × RMB3/ RMB5)	=	12,000,000
Increase in ordinary shares outstanding	=	8,000,000

The numerator (i.e. net profit figure) for the diluted EPS is not affected by the share options, and remains at RMB50,000,000.

The diluted EPS is therefore RMB4.63.

(5) Note that even though the share options are exercisable only as from 1 January 2018, the 2016 diluted EPS is computed based on the assumption that all the share options are exercised on 1 July 2016, and the 2017 diluted EPS is computed based on the assumption that all the share options are exercised on 1 January 2017.

¶36-320 Written put options

For contracts that require the enterprise to repurchase its own ordinary shares (such as written put options), ASBE 34 provides that they should be included in the computation of diluted EPS if the effect is dilutive. These contracts will be dilutive if their repurchase price is above the average market price for the period (para 11). The potential dilutive effect on basic EPS should be calculated as follows:

(a) it should be assumed that at the beginning of the period, sufficient ordinary shares will be issued to raise proceeds to satisfy the repurchase contract;

(b) it should be assumed that the proceeds from the issue are used to buy back the ordinary shares to satisfy the repurchase contract; and

(c) the incremental ordinary shares should be included in the computation of diluted EPS.

Illustration 36.9

To illustrate the provisions of paragraph 11, assume that on 1 January 2017, MN Enterprise has 1,000,000 written put options outstanding on its ordinary shares with a repurchase price of RMB6. The average market price of its ordinary shares during 2017 is RMB4. In this case, for the purpose of computing diluted EPS for 2017, MN Enterprise will assume that:

(a) it issues 1,500,000 ordinary shares (so that it will have RMB6,000,000 (1,500,000 × RMB4) to satisfy its repurchase obligation of RMB6,000,000 (1,000,000 × RMB6)); and

(b) it uses the RMB6,000,000 to buy back 1,000,000 (RMB6,000,000/ RMB6) ordinary shares.

Thus, for the purpose of computing diluted EPS for 2017, the denominator will be increased by 500,000 (1,500,000 − 1,000,000) ordinary shares.

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¶36-330 Antidilution test

The profit (on the "per ordinary share" basis) attributable to the holders of potential ordinary shares could be higher or lower than the net profit (on the "per ordinary share" basis) attributable to the ordinary shareholders.

If the profit (on the "per ordinary share" basis) attributable to the potential ordinary shares is lower than that attributable to ordinary shares, the inclusion of the convertible securities in the calculation of the EPS would dilute the EPS figure, and these potential ordinary shares have been referred to in ¶36-300 above as "dilutive potential ordinary shares". On the reverse, the potential ordinary shares are said to be "antidilutive".

It may be noted that whether or not share options and warrants are dilutive depends on the average market price for the year versus the exercise price. If the exercise price is lower than the average market price, the share options and warrants are dilutive, and vice versa.

The *Explanatory Guidance* — Chapter 35 *Earnings Per Share* provides that the control number for the dilution test is "Net profit or loss from continuing operations". Potential ordinary shares should be treated as dilutive when their conversion to ordinary shares would decrease EPS or increase loss per share from continuing operations. The use of "net profit per share from continuing operations" (instead of the basic EPS) as the control number may, however, causes the diluted EPS to be higher than the basic EPS, as shown in Illustration 36.10 below.

In cases where there is only one class of potential ordinary shares, the test for antidilution is straightforward. If the profit, on the "per ordinary share" basis, of the potential ordinary share is higher than the basic EPS, then it may be concluded immediately that the potential ordinary share is "antidilutive" and, therefore, is to be disregarded in the computation of the diluted EPS.

However, in cases where there are more than one convertible securities, share options or warrants, the test for antidilution is slightly more complex. In these cases, it should be appreciated that it is possible to have a class of potential ordinary shares whose profit (on the "per ordinary share" basis) is lower than the basic EPS, and yet their inclusion in the computation of the diluted EPS may have an antidilution effect.

Illustration 36.10

OP Enterprise has in issue 100,000,000 ordinary shares, RMB100,000,000 of convertible loan stocks "A" (CLS(A)) which are convertible into 100,000,000 ordinary shares and RMB100,000,000 of convertible loan stocks "B" (CLS(B)) which are convertible into 100,000,000 ordinary shares.

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The interest on convertible loan stocks "A" and "B" does not meet the conditions for capitalisation and hence is recognised in profit or loss for the period. For simplicity, ignore the splitting of convertible loan stocks into a liability and an equity component and assume that the nominal interest rate equals the effective interest rate.

Assume the following for OP Enterprise for the year 2017:

(i) the basic EPS is 10 cents,

(ii) the earnings for RMB1 of CLS(A) is 8 cents, and

(iii) the earnings per RMB1 of CLS(B) is 4 cents.

In this case, the inclusion of all three securities would yield a diluted EPS of 7.3 cents ((10 cents + 8 cents + 4 cents)/3), whereas with the exclusion of the CLS(B), the diluted EPS would be lower at 7 cents ((10 cents + 4 cents)/2).

Thus, even though the earnings for the CLS(A) is lower than the basic EPS, it is still "antidilutive" in nature and should therefore be excluded from the computation of the diluted EPS.

Thus, in cases where there are more than one class of potential ordinary share, ASBE 34 provides that the potential ordinary shares should be considered in sequence from the most dilutive to the least dilutive in order to produce the least amount of diluted EPS (para 12).

The following procedure should be used for the antidilution test:

(a) compute the basic EPS;

(b) compute the earnings, on the "per ordinary share" basis, for each of the potential ordinary shares;

(c) those items in (b) with earnings "per ordinary share" higher than the basic EPS are, of course, antidilutive and are to be excluded in the computation of the diluted EPS;

(d) those items in (b) with earnings "per ordinary share" lower than the basic EPS are to be included in the computation of the diluted EPS on an "incremental" basis. The one with the lowest earnings "per ordinary share" is to be included first, and the one with the second lowest earnings included next and so on; and

(e) the "worst" diluted EPS will be obtained at the stage before the inclusion of the items in (b) which results in a diluted EPS higher than the one in the previous stage.

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