

# HKFRS News

Shedding light on the HKICPA's activities\*

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*HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.*

## HK(IFRIC)-Int 11: HKFRS 2 – Group and Treasury Share Transactions

Hong Kong Institute of Certified Public Accountants (HKICPA) published HK(IFRIC)-Int 11: HKFRS 2 – *Group and Treasury Share Transactions* in January 2007. This interpretation applies to annual periods beginning on or after 1 March 2007 and should be applied retrospectively. Earlier application is permitted. Entities that apply it to an annual period beginning before that date should disclose this fact.

HK(IFRIC)-Int 11 addresses equity-settled awards and group schemes, as follows:

### 1. Equity-settled awards

- *Company issues the award, whether or not it (has to) buy:* an arrangement requiring the delivery of own equity instruments is accounted for as an equity-settled arrangement regardless of whether the entity chooses or is required to buy those equity instruments from another party to satisfy its obligation to its employees.
- *Shareholder settles the award:* arrangements are accounted for as an equity-settled share-based payment, whether the employee's rights to the entity's equity instruments are granted or settled by the entity or by the entity's shareholders.

### 2. Group schemes. The classification for share-based payment awards, which will be settled in parent company shares, granted to employees of a subsidiary:

- if the parent grants the award, it is treated as equity settled in both the consolidated financial statements of the parent and the financial statements of the employing subsidiary; and
- if the subsidiary grants the award, it is treated as cash settled in the financial statements of the employing subsidiary, even though it would be treated as equity settled in the consolidated financial statements of the parent.

The interpretation provides guidance on how to establish which entity has granted an award, as it focuses on the obligation to deliver the equity instruments. The presumption is that the entity that has taken on the obligation to deliver shares in settlement, either on vesting for a share award or on exercise for an option, is the grantor. HK(IFRIC)-Int 11 also confirms that where the vesting of an award is based on service within a group – rather than with a specific entity within the group – an expense for an equity-settled arrangement is recognised in each group entity that the employee works for, based on the fair value of the equity instruments measured at grant date from a group perspective. If an employee fails to meet the service condition because he leaves the group, the previously recognised expense is reversed in each entity that he has worked for. Tracking this information is likely to be difficult in practice if employees move around between group entities.

## Additional considerations

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### Funding arrangements between parent and subsidiary

If the parent grants rights over its equity instruments to the employees of its subsidiary (accounted for as an equity-settled share-based payment), the debit (HKFRS 2 expense) is recognised in the subsidiary's income statement with a credit to equity (as a capital contribution) over the vesting period of the share-based payment arrangement.

HK(IFRIC)-Int 11 does not address the accounting in the parent entity separate financial statements unlike draft interpretation D17. D17 indicated that the parent entity would debit its investment in subsidiary and credit equity for the equity instruments it has granted (if it is satisfying the obligation). This guidance has not been included in HK(IFRIC)-Int 11, but we believe that management should continue to apply it.

Funding arrangements between the parent and the subsidiary in many territories are arranged to obtain a tax deduction. Where the income statement expense is based on the HKFRS 2 charge rather than the funding payments, and the funding transaction is treated as a capital transaction rather than an expense, the tax deduction may not be available.

### Consolidation adjustments

More complex accounting arises if a group has awards granted by a subsidiary that are settled in parent company shares. The expense in the subsidiary's financial statements is based on cash-settled accounting – i.e. marked to fair value. It will also require additional record-keeping to ensure that the correct consolidation adjustments are made – in practice, management will need to keep track of two separate expense records.

The separate financial statements of the parent entity reflect the terms of any agreement between the subsidiary and the parent regarding provision of the shares. This may mean no impact – for example, if the subsidiary buys shares on the market – or no impact until the shares are issued – for example, if the subsidiary pays the parent fair value for the issue of new shares. Other arrangements may be more difficult.

The consolidation process will need to reverse any fair value adjustments applied in the subsidiary's financial statements. For example, if an award includes a market condition that is not met, the subsidiary records a cumulative expense of zero, the fair value of the liability. The consolidated financial statements of the parent would record the grant date fair value of the award. The consolidation process is also likely to impact the recognition of any tax deduction. For equity-settled awards where the (expected or actual) tax deduction exceeds the expense recognised, the excess tax benefit is recognised in equity. For cash-settled awards, any tax benefit is recognised in the income statement.

## Practical considerations

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Getting the documentation trail for share-based payments clear and complete is critical, as recent experience in the US regarding the determination of grant date has shown. Establishing which entity has granted an award is now just as important as establishing when the award was granted. Experience with HKFRS 2 demonstrates that having plan documentation that is unclear can have a significant accounting impact. The difference between classification as equity- or cash-settled or a difference of many months in the grant date are common problems, which would impact the expense measurement. Consideration of these issues is an integral part of the development of a share-based payment plan, not an after-thought. These are complex issues and preparers should seek advice from specialists.

### Scope and impact of HK(IFRIC)-Int 12

The HKICPA has approved HK(IFRIC)-Int 12, *Service Concession Arrangements* (expected to be published in February 2007). This interpretation applies to companies that participate in service concession arrangements. It provides guidance on the accounting by operators in public-to-private service concession arrangements. HK(IFRIC)-Int 12 applies to the annual periods beginning on or after 1 January 2008. Earlier application is permitted. Entities that apply it to an annual period beginning before that date should disclose the fact.

Retrospective application is required for service concession arrangements within the scope of the interpretation, except in the rare circumstance when retrospective application is impracticable. The comparative period for most companies will cover all or a portion of 2007.

### What arrangements are within the scope of HK(IFRIC)-Int 12?

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HK(IFRIC)-Int 12 applies to arrangements where the grantor controls or regulates what services the operator provides with the infrastructure, to whom it must provide them and at what price. The grantor also controls any significant residual interest in the infrastructure at the end of the term of the arrangement. Roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks are examples of infrastructure frequently the subject of service concession arrangements.

Common features of service concession arrangements include:

- The grantor of the service agreement is a public sector entity or a private sector entity to which the responsibility for the service is delegated;
- The operator is not an agent acting on behalf of the grantor but responsible for at least some of the management of the infrastructure;

- The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices and arrangements for arbitrating disputes; and
- The operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement.

### Example

An arrangement relating to the construction and operation of a road tunnel by a third party may include the following characteristics:

- The contract is granted via a government agency that is responsible for the national network;
- The operator makes day-to-day decisions such as lane closure, staffing needs, etc.;

- There is a target operating capacity in on- and off-peak periods; and
- The tunnel reverts to the government agency after a specific term.

This interpretation has clarified that arrangements in the scope of HK(IFRIC)-Int 12 are outside of the scope of HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*. The table below provides the references to the standards that apply to typical private-to-public arrangements not covered by HK(IFRIC)-Int 12; there are no bright lines between the accounting requirements for public-to-private arrangements.

Category	Lessee	Service provider			Owner	
Typical arrangement types	Lease (e.g. operator leases asset from grantor)	Service and/or maintenance contract (specific tasks, e.g. debt collection)	Rehabilitate, operate, transfer	Build, operate, transfer	Build, own, operate	100% divestment/privatisation/corporate
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Operator and/or grantor		Operator	
Typical duration	8-20 years	1-5 years	25-30 years			Indefinite (or may be limited by licence)
Residual interest	Grantor				Operator	
Relevant HKFRSs	HKAS 17 <i>Leases</i>	HKAS 18 <i>Revenue</i>	HK(IFRIC)-Int 12 <i>Service Concession Arrangements</i>		HKAS 16 <i>Property, Plant and Equipment</i>	

## What are the major implications?

### Two different accounting models

HK(IFRIC)-Int 12 specifies the accounting treatment an operator applies to recognise the rights received under a service concession arrangement. Two models exist under the interpretation, as follows:

- Financial asset – an operator with a contractual and unconditional right to receive specified or determinable amounts of cash (or other financial asset) from the grantor recognises a financial asset. The financial asset is within the scope of HKAS 32 *Financial Instruments: Presentation*, HKAS 39 *Financial Instruments: Recognition and Measurement* and HKFRS 7 *Financial Instruments: Disclosures*; and

- Intangible asset – an operator with a right to charge the users of the public service recognises an intangible asset. There is no contractual right to receive cash when payments are contingent on usage. The licence is within the scope of HKAS 38 *Intangible Assets*.

For example:

Financial asset	Intangible asset
The road authority pays the operator for drivers' use of the tunnel	The operator charges the driver for use of the tunnel

The appropriate accounting model is not always obvious. Arrangements should be analysed in detail and may give rise to both a financial asset and an intangible asset. In such cases, management accounts separately for each

component of the consideration. One obvious result is that the landscape of the operator's balance sheet will change. Operators of service concession agreements will see their fixed assets change into financial and/or intangible assets.

## Recognition and measurement of revenues – separation of different components

The operator that provides construction or upgrade services, such as building the tunnel or upgrading it to new requirements, must account for revenue and costs in accordance with HKAS 11 *Construction Contracts*. Revenue from operation services, such as tolls from road users, is recognised in accordance with HKAS 18 *Revenue*. When the operator performs the two types of service (construction/upgrade services and operation services), such as building and operating the tunnel, the recognition criteria should be applied separately for each type of service. This may give rise to different profit margins on each service.

## What remains unchanged?

### Contractual obligation

HK(IFRIC)-Int 12 refers to HKAS 37 *Provisions, Contingent Assets and Contingent Liabilities* for management to determine whether or not a liability should be recorded – for example, maintaining the infrastructure to a specified level of serviceability, or restoring it at the end of the arrangement.

### Borrowing costs

The operator that is within the intangible asset model should comply with HKAS 23 *Borrowing costs* on capitalisation of interest. Capitalisation is permitted but not required. The Board may make capitalisation of interest mandatory when a revised HKAS 23 is published in 2007.

### Disclosure

The disclosure requirements set out in HKAS-Int 29 *Disclosure – Service Concession Arrangements* remain unchanged. Operators will also have to disclose how the service concession arrangement has been classified – i.e. intangible asset, financial asset or both.

## What further changes to expect?

### Amortisation and Depreciation

The HKICPA would consider amending HKAS 38 *Intangible Assets*, as part of its Annual Improvements process, to permit the use of a non-straightline amortisation method for intangible assets when reliable estimates of usage are available.

The HKICPA would also consider revising or withdrawing the current HK Interpretation 1 *The Appropriate Accounting Policies for Infrastructure Facilities* in light of HK(IFRIC)-Int 12.

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