China Accounting Alert

January 2016

- The IASB issued a new standard that requires lessees to recognize most leases on their balance sheets. The new standard will be effective from 1 January 2019 with limited early application permitted.
- The HKICPA released its new and revised auditor reporting standards, which will be effective for audits of financial statements for periods ending on or after 15 December 2016.

IASB issues new leases standard

- **Highlights**

The International Accounting Standards Board (IASB or Board) issued IFRS 16 *Leases* (IFRS 16 or the new standard), which requires lessees to recognize assets and liabilities for most leases. For lessors, there is little change to the existing accounting in IAS 17 *Leases*.

The new standard will be effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided the new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, has been applied, or is applied at the same date as IFRS 16.

- **Key considerations**
  - **Lessee accounting**

Initial recognition and measurement

Lessees are required to initially recognize a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term.

The lease liability is measured at the present value of the lease payments to be made over the lease term. The right-of-use asset is initially measured at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Lessees are permitted to make an accounting policy election, by class of underlying asset, to apply a method like IAS 17's operating lease accounting and not recognize lease assets and lease liabilities for leases with a lease term of 12 months or less (i.e., short-term leases). Lessees also are permitted to make an election, on a lease-by-lease basis, to apply a method similar to current operating lease accounting to leases for which the underlying asset is of low value (i.e., low-value assets).

Subsequent measurement

Lessees accrete the lease liability to reflect interest and reduce the liability to reflect lease payments made. The related right-of-use asset is depreciated in accordance with the depreciation requirements of IAS 16 *Property, Plant and Equipment*. For lessees that depreciate the right-of-use asset on a straight-line basis, the aggregate of interest expense on the lease liability and depreciation of the right-of-use asset generally results in higher total periodic expense in the earlier periods of a lease. Lessees remeasure the lease liability upon the occurrence of certain events (e.g., change in the lease term, change in variable rents based on an index or rate), which is generally recognized as an adjustment to the right-of-use asset.

Lessees apply alternative subsequent measurement bases for the right-of-use asset under certain circumstances in accordance with IAS 16 and IAS 40 *Investment Property*.

Right-of-use assets are subject to impairment testing under IAS 36 *Impairment of Assets*.

Presentation

Right-of-use assets are either presented separately from other assets on the balance sheet or disclosed separately in the notes. Similarly, lease liabilities are either presented separately from other liabilities on the balance sheet or disclosed separately in the notes. Depreciation expense and interest expense cannot be combined in the income statement. In the cash flow statement, principal payments on the lease liability are presented within financing activities; interest payments are presented based on an accounting policy election in accordance with IAS 7 *Statement of Cash Flows*.

- **Lessor accounting**

  Initial recognition and measurement

  The accounting by lessors under the new standard is substantially unchanged from today's accounting in IAS 17. Lessors classify all leases using the same classification principle as in IAS 17 and distinguish between two types of leases: operating and finance leases.

  For operating leases, lessors continue to recognize the underlying asset. For finance leases, lessors derecognize the underlying asset and recognize a net investment in the lease similar to today's requirements. Any selling profit or loss is recognized at lease commencement.

  Subsequent measurement

  For operating leases, lessors recognize lease income on either a straight-line basis or another systematic basis that is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

  For finance leases, lessors recognize interest income for the accretion of the net investment in the lease and reduce that investment for payments received. The net investment in the lease is subject to the derecognition and impairment requirements in IFRS 9 *Financial Instruments*.

- **Transition**

  The new standard permits lessees to use either a full retrospective or a modified retrospective approach on transition for leases existing at the date of transition, with options to use certain transition reliefs.

Further details about the new leases standard are found in EY's *IFRS Developments* Issue 117.

Get ready for the new style auditor's report

In August 2015, the Hong Kong Institute of Certified Public Accountants (the "HKICPA") released its new and revised auditor reporting standards, which are designed to significantly enhance the value of the auditor's report for investors and other users of financial statements.

The new and revised auditor reporting standards refer principally to the new Hong Kong Standard on Auditing ("HKSA") 701 *Communicating Key Audit Matters in the Independent Auditor's Report* and a number of revised HKSAs, including HKSA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*, HKSA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report* and HKSA 570 (Revised) *Going Concern*. In August 2015, the HKICPA also issued HKSA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information* which requires a separate section in the auditor's report addressing the auditor's responsibilities for "other information" included in the annual report.

The new and revised auditor reporting standards will be effective for audits of financial statements for periods ending on or after **15 December 2016**. The requirements in these HKICPA's standards are the same as those in the equivalent International Standards on Auditing ("ISAs") issued by the International Auditing and Assurance Standards Board (the "IAASB"), which also have the same effective date.

- **How will the auditor's report be different?**

  The new style auditor's report will include much more information. It will set out in more detail the responsibilities of the auditors and what they have done when performing the audit. It will also present more clearly the responsibilities of management and those charged with governance (such as the Audit Committee) concerning the financial statements. Additional information will be included relating to the responsibilities of management and the auditors on going concern. Auditors will also be required to report on the procedures performed in respect of the other information presented in the annual report, but outside of the financial statements. The auditor's opinion paragraph, currently shown at the end of the auditor's report, will now be given a more prominent position towards the beginning of the report.

  The above-mentioned changes will be applicable to auditor's reports for listed and non-listed companies. Although the extent of the details required may vary depending on the circumstances of the particular entity subject to audit, in general they are an extension of what is currently presented and will be common to all auditor's reports. The most significant change however relates to the communication of Key Audit Matters, which is explained further below.

- ***Key Audit Matters ("KAMs")***

  The disclosure of KAMs is a new reporting requirement and is required for audits of listed entities only. KAMs are defined in HKSA 701 as "Those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance".

  Communicating KAMs has the objective of providing additional transparency about the audit by explaining how the auditors addressed the most important areas of the audit in reaching the audit opinion. The description of each KAM is required to include:

  - why the matter was considered to be one of most significance in the audit
  - how the matter was addressed in the audit
  - reference to the related disclosure(s), if any, in the financial statements

  The description of KAMs will be unique to each company and will require coordination with management and those charged with governance well ahead of the issuance of the auditor's report.

  Illustrative auditor's reports showing the new requirements can be found in HKSA 700 (Revised) on the HKICPA's website. In addition, a summary about the new and revised ISAs (which is also applicable to the Hong Kong standards) can be found in the IAASB's publication *At a Glance*.

- **Proposed Chinese Auditing Standards**

  In January 2016, the Chinese Institute of Certified Public Accountants (the "CICPA") in Mainland China issued for comment a number of proposed new and revised auditing standards covering matters similar to those above. The deadline for comment is 29 February 2016. Further details can be found on the CICPA's website.

IASB news and updates

- **IASB postpones the effective date for narrow scope amendments to IFRS 10 and IAS 28**

  The IASB has postponed the date when entities must apply changes introduced in 2014 through narrow-scope amendments to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*. The changes affect how an entity should determine any gain or loss it recognizes when assets are sold or contributed between the entity and its associate or joint venture. This postponement removes the current requirement to make these particular changes by 2016. The reason for postponing the effective date is that the IASB is planning a broader review that may result in the simplification of accounting for associates and joint ventures.

- **IASB Update for December 2015**

  The December 2015 issue of the *IASB Update* contains the IASB staff summary of the IASB meeting held from 15 to 16 December when the board discussed:

  - Effective Date of Amendments to IFRS 10 and IAS 28 - Due process
  - Disclosure Initiative
  - IFRS Implementation Issues
  - IFRS 3 *Business Combinations* - Definition of a business
  - Research program
  - Revenue from Contracts with Customers
  - Discount rates research

Mainland news and updates

- **Stock exchanges released Guidelines on Industry Information Disclosure**

  In December 2015, the Shanghai Stock Exchange and the Shenzhen Stock Exchange revised and set out a series of guidelines on industry information disclosure. The Shanghai Stock Exchange released the *Guidelines on Industry Information Disclosure for Listed Companies* for companies engaging in industries including oil and gas, iron and steel, construction, photovoltaics, clothing and press and publishing, which have become effective on 1 January 2016. The Shenzhen Stock Exchange released the *Guidelines on Industry Information Disclosure* for companies engaging in livestock and poultry and aquiculture business, businesses related to solid mineral resources, and real estate business, which have become effective upon release. It is noteworthy that unlike the previous ChiNext Board Guidelines on Industry Information Disclosure, the new guidelines by the Shenzhen Stock Exchange this time are applicable to all companies listed on the Shenzhen Stock Exchange. The disclosure guidelines set out the specific disclosure requirements for the specific industries (including the requirements regarding the notes to financial statements). In practice, since there may be circumstances where a company engages in multiple businesses, management may need to familiarize themselves with the information disclosure requirements for several industries in preparing the financial statements.

- **MOF released *Interpretation No.8 on Accounting Standards for Business Enterprises***

  At the end of 2015, the MOF released *Interpretation No.8 on Accounting Standards for Business Enterprises*, which provides specific guidelines for commercial banks on how to apply Accounting Standards for Business Enterprises to wealth management products (WMPs), that is, how commercial banks determine whether they control the WMPs they issued and how they should account for the issued WMPs. This Interpretation is applicable to financial reports for the year 2016 and thereafter. Retrospective application is required unless it is impracticable to do so.

EY publications

- **Applying IFRS: ITG discusses IFRS 9 impairment issues at December 2015 ITG meeting**

  The ITG met on 11 December 2015 to discuss a number of implementation issues on the expected credit loss impairment requirements of IFRS 9 *Financial Instruments*. This edition of *Applying IFRS* summarizes the discussions at the ITG's December meeting.

- **IFRS Developments Issue 116: IASB redeliberates clarifications to IFRS 15**

  The IASB redeliberated proposed amendments to clarify IFRS 15 *Revenue from Contracts with Customers* at the December 2015 meeting. This edition of *IFRS Developments* provides a summary of key decisions.

- **The Basel Committee Guidance on credit risk and accounting for expected credit losses**

  Guidance on credit risk and accounting for expected credit losses ("G-CRAECL") was issued by the Basel Committee on Banking Supervision in December 2015. The G-CRAECL aims to set out supervisory guidance on sound credit risk practices associated with the implementation of ECL accounting models for banks' lending exposures that include loans, loan commitments and financial guarantee contracts, but exclude debt securities. This follows the publication of IFRS 9 *Financial Instruments* by the IASB, application of which is mandatory for financial years beginning on or after 1 January 2018. This EY publication tells you what you need to know about the G-CRAECL.

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