FUNDAMENTALS OF ACCOUNTING AND LAW IN BANKING

香港銀行學會
The Hong Kong Institute of Bankers

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Preface

Bankers are not usually accountants or lawyers, but they need to know how accounting and the law apply to banking operations. This book gives readers a basic understanding of these two specialist fields as they relate to the banking profession in an international financial centre like Hong Kong.

Part 1 introduces the basic principles and practices of accounting, and how they apply to business decision-making. These include financial reporting, interpretation of financial results, valuation, accounting for planning and budgeting, and capital expenditure analysis and performance measures.

Part 2 focuses on general law principles, negotiable instruments and the regulatory framework in banking and financial markets. While the specifics refer to Hong Kong, the general principles are applicable internationally, being based on the British common-law sytem. In particular, this book concentrates on the law of contracts, which is the bedrock on which business rests. How to make a contract valid is fundamental to banking and commerce.

There is emphasis on the regulatory framework that governs banking practices, highlighting important ordinances, regulatory bodies and international regulatory agreements. In Hong Kong, the Banking Ordinance is fundamental to banking operations; violation of its provisions can result in the revocation of bank licenses. Global agreements on banking regulations such as Basel I in 1998 and Basel II in 2006 are important as well, given the international nature and interconnectedness of banks and other financial institutions in the city.

Despite the book's specialised coverage, it is not written as an accounting and law text. It is meant to be accessible to bankers and other professionals who are interested in acquiring fundamental knowledge about law and banking. This book can also be used as a textbook for an introductory college banking course and serve as reference for banking practitioners and other professionals.

Featuring summaries, highlights and illustrations, this book is a useful resource in the classroom and the workplace for bankers and other professionals. The study guides with revision questions, which will be regularly updated, are particularly helpful for those who are taking the AHKIB Examination on the Fundamentals of Accounting and Law in Banking.

This book would not have been possible without the contribution and support of veteran bankers and academics whose names and brief biographies are listed on the following page. The Hong Kong Institute of Bankers and future banking professionals owe them a special note of thanks.

In addition, we are indebted to the following persons for their assistance, advice, support and encouragement by making valuable comments and suggestions on the original manuscript:

Mr. Wilson Bae, Mr. Simon Chan, Ms. Annie Fung, Ms. Helen Kwok, Mr. Samuel Law, Dr. Raymond Lee, and professors, lecturers and management of Hang Seng Management College.

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Dr. Tony Shieh has taught at City University of Hong Kong's Department of Accountancy for 10 years and won a Teaching Excellence Award winner in 2002. He has a PhD in Accounting and MBA in Finance from New York University and is a Certified Information Systems Auditor (CISA).

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Dr. Michael Wong is an Associate Professor at City University of Hong Kong and the Founding President of CTRISKS. He has trained more than 5,000 banking risk officers and regulators in Asia, and advised more than 20 banks on risk modeling and risk process reengineering.

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Mr. Ivan Young is an experienced lawyer admitted to the bar in England, Hong Kong and New Zealand. He is the Senior Vice President and Head of Legal and Compliance at Chinatrust Commercial Bank (Hong Kong). Before that, he had served as Head of Legal and Compliance at a Hong Kong-listed bank for 17 years.

Contributors listed in alphabetical order by last name

About the Hong Kong Institute of Bankers

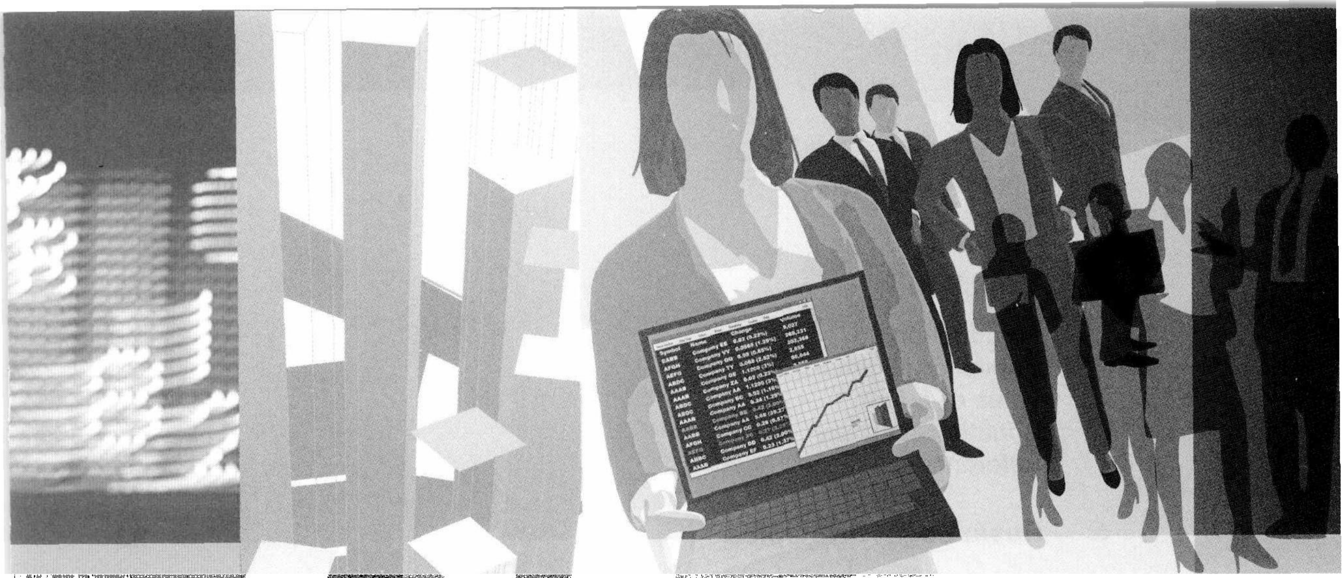
Established in 1963, the Hong Kong Institute of Bankers (HKIB)—formerly known as The Chartered Institute of Bankers – Hong Kong Centre—is a non-profit organisation whose membership represents a broad cross-section of the banking and finance industry.

The HKIB works to achieve its vision—the sustained growth of the banking industry and the enhancement of the professional standards of practitioners—through the provision of high-quality education. Backed by decades of banking knowledge, the HKIB awards professional qualifications that are widely recognised by the banking and finance industry, not only in Hong Kong, Macau and Mainland China but the world over. The achievements of the HKIB in developing human capital in the banking industry are reflected in its position as the Professional Writer of the Specification of Competency Standards (SCS) for the banking sector of the Qualifications Framework (QF) of the Hong Kong SAR.

Rapid changes in the banking and financial landscape make it ever more important for individuals to engage in continuous professional development to maintain their competitive edge. To meet this need, the HKIB designs and organises a comprehensive portfolio of professional examinations and training programmes to meet the needs of its members. The Institute's flagship courses, such as its Associateship (AHKIB) and Certified Financial Management Planner (CFMP) programmes, give practitioners not only mastery of local and regional practice but also provide the international perspective that is essential for today's industry professional.

The HKIB's comprehensive training programmes, which align advanced teaching methodologies with the needs of professional practice, also have a wide appeal for professionals from other disciplines, including the accounting, IT and legal fields, where knowledge of financial practice is becoming increasingly essential.

For more information on the HKIB, its professional courses and related activities, visit its website at: www.hkib.org.



Contents

CHAPTER 1

1

Financial Reporting

Learning objectives

After studying this chapter, you should be able to:

1. Describe the framework for the preparation of financial statements.

2. Obtain the knowledge of practical application of Hong Kong Financial Reporting Standards (HKFRS) issued by the Hong Kong Institute of Certified Public Accountants.

3. Illustrate how to prepare company balance sheets,[1] income statements, statements of changes in equity, and statements of cash flows in accordance with Companies Ordinance requirements.

[1]Under revised HKAS1 effective for annual periods beginning on or after 1 January 2009, *balance sheet* and *cash flow statement* should now be titled *statement of financial position* and *statement of cash flow. Income statement* should be separated into *income statement* and a *statement of comprehensive income*. However, we still use the terms *balance sheet, income statement* and *cash flow statements* for this chapter in order to be consistent with the *AHKIB Examinations Handbook 2009 Syllabus.*

Introduction

This chapter discusses Hong Kong (HK) framework for the preparation of financial statements. The rationales and purposes behind the framework will also be illustrated. In addition, practical application of statements of standard accounting practice issued by the Hong Kong Institute of Certified Public Accountants (HKICPA) will be studied. Finally, we will discuss how to understand a company by reading its company balance sheets, profit and loss statements, and statements of cash flow in accordance with the Companies Ordinance.

Essentials in Financial Reporting

Framework for the Preparation of Financial Statements

There are many similarities and only minor textual differences between the Hong Kong framework and the International Accounting Standards Board (IASB) framework. The chapter will emphasise the HK framework, according to the Council of HKICPA, formerly known as the Hong Kong Society of Accountants (HKSA) and hereafter referred to as 'Council'. The framework deals with:

- the objective of financial statements
- the qualitative characteristics that determine the usefulness of information in financial statements
- the definition, recognition and measurement of the elements from which financial statements are constructed
- concepts of capital and capital maintenance.

Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, an income statement, a statement of changes in financial position (which may be presented in a variety of ways; for example, as a statement of cash flow or a statement of funds flow), and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, these statements. Such schedules and supplementary information may deal with, for example, financial information about industrial and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

The framework applies to the financial statements of all commercial, industrial and business reporting enterprises, whether in the public or the private sectors. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Rationales Behind the Financial Statements

Accrual Basis

In order to meet their objectives, financial statements are prepared on the accrual basis of accounting (that is, as opposite to cash basis). Under this basis, the effects of transactions and other events are recognised when they occur (not as cash, or its equivalent as received or paid), and they are recorded in the accounting records and reported in the financial statements of the period to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash, but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that are most useful to users in making economic decisions. (*See HKAS1, para.25 'An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting'.*)

Going Concern

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used and the reason why the entity is not regarded as a going concern should be disclosed. (*See HKAS1, para.23 'When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern'.*)

Qualitative Characteristics of Financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a firm knowledge of business and economic activities, accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

Relevance

Information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events, or confirming or correcting their past evaluations. The predictive and confirmatory roles of information are interrelated. By applying the concept of relevance, we should consider both materiality and timeliness. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed. There are some accounting concepts to be considered:

- *Materiality*—the relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the enterprise irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important; for example, the amounts of inventories held in each of the main categories that are appropriate to the business. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic that information must have if it is to be useful.
- *Timeliness*—represents constraints on relevant and reliable information. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or another event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

Reliability

Moreover, information must also be reliable. Information has the quality of reliability when it is free from material error and bias, and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the enterprise to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose its amount and circumstances. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date that meet the recognition criteria. The concept of reliability is further divided into the following five areas.

- *Faithful presentation*—most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured, or in devising and applying measurement and presentation techniques that can convey messages corresponding with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.
- *Substance over form*—if the information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there were a transaction).
- *Neutrality*—in addition, the information contained in financial statements must be neutral; that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome.
- *Prudence*—the preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the

collectability of doubtful receivables, the probable useful life of plant and equipment, and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent, and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated, and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

- *Completeness*—furthermore, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading, and thus unreliable and deficient in terms of its relevance.

Comparability

Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise, and in a consistent way for different enterprises. An important implication of the qualitative characteristic of comparability is that users are informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Statements of Standard Accounting Practice and Guidelines, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist. Since users wish to compare the financial position, performance and changes in financial position of an enterprise over time, it is important that the financial statements show corresponding information for the preceding periods.

True and Fair View

Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an enterprise. Although this framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly, such information.

To conclude, there are many similarities between HK and IASB frameworks as mentioned above. However, while the IASB Framework contains a statement that some enterprises use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets, the HK Framework does not contain such a statement. In Hong Kong, enterprises typically do not use the current cost basis. It indicates that what is required in the framework should reflect the underlying nature within the Hong Kong context.

Practical Application of Hong Kong Financial Reporting Standards (HKFRS) Issued by the HKICPA

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public. They use financial statements in order to satisfy some of their different needs for information. The needs of those users include the following:

- Investors, the providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information that enables them to assess the ability of the enterprise to pay dividends.
- Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
- Lenders are interested in the information that enables them to determine whether their loans and the relevant interest due will be paid.
- Suppliers and other trade creditors are interested in the information that enables them to determine whether their receivables due will be paid. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuation of the enterprise as a major customer.
- Customers have an interest in the information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, it.
- Governments and their agencies are interested in the allocation of resources and, therefore, the corresponding activities of enterprises. In order to regulate the activities of enterprises, they also require the information to determine taxation policies as the basis for national income and similar statistics.