Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.20	**Related party disclosures**	3
3.20.01	Identify the parties that may be related to a business entity in accordance with HKAS 24	
3.20.02	Identify the related party disclosures	
3.20.03	Explain the importance of being able to identify and disclose related party transactions	

1 HKAS 24 *Related Party Disclosures*

Topic highlights

HKAS 24 is a disclosure standard. It does not prescribe any debits or credits. Its aim is to help users understand whether the financial statements may have been affected by transactions which were not on normal commercial terms. These sorts of transactions can arise when an entity has transactions with entities or individuals who influence or are influenced by the entity. These entities and individuals are called related parties. Disclosures of these transactions increase the accountability of management to users of the financial statements.

Users of financial statements would normally and reasonably assume that the transactions reported in those financial statements took place on normal commercial terms, i.e. on what is called an **arm's length basis**.

If the two parties to the transaction were in some way closely related, e.g. family members or fellow companies in a group, normal commercial terms may not apply. One party may influence or be influenced by the other.

Therefore, HKAS 24 requires full disclosure of transactions with certain parties who are defined as being related to the reporting entity which is producing the financial statements.

It is important to remember that disclosure of a related party transaction does not necessarily mean there is anything wrong with the transaction. The transaction may in fact be on normal commercial terms, or, if it is not, there may be very good reasons which are in the best interests of the entity. It is simply about providing users with information which may be of interest to them and to allow them to draw their own conclusions about the nature of the transaction, its effect on the financial statements, its appropriateness and the stewardship of management.

HKAS 24.1

1.1 Objective

HKAS 24 aims to ensure that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by material transactions with them. In other words, this is a standard which is primarily concerned with **disclosure**.

HKAS 24.3

1.2 Scope

According to the standard, related party transactions and outstanding balances are to be presented in separate financial statements of a parent, venturer or investor as well as in consolidated financial statements. Disclosures should be in accordance with HKAS 27 and HKFRS 10.

This is an amendment to the previous version of HKAS 24 which did not require disclosure in the separate financial statements of a parent or wholly-owned subsidiary that are made available or published with the group's financial statements.

Related party transactions and outstanding balances with other entities in the group are to be disclosed in an entity's financial statements. However, no intragroup transactions and balances except for those between an investment entity and its subsidiaries are to be shown as they are eliminated in the preparation of consolidated financial statements.

An investment entity is a particular type of parent company defined in Chapter 26.

HKAS 24.9

1.3 Definitions

The following important definitions are given by the standard. The definitions of **control** and **significant influence** are the same as those given in HKAS 27, 28 and 31.

Key terms

Related party is a person or entity that is related to the entity that is preparing its financial statements.

(a) A person or a close member of that person's family is related to a reporting entity if that person:

  (i) has control or joint control over the reporting entity;

  (ii) has significant influence over the reporting entity; or

  (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:

  (i) the entity and the reporting entity are members of the same group

  (ii) one entity is an associate or joint venture of the other entity (or an associate or joint venture of a group of which the other entity is a member)

  (iii) both entities are joint ventures of the same third party

  (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity

  (v) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity

  (vi) the entity is controlled or jointly controlled by a person identified in (a)

  (vii) the person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or a parent of the entity)

Related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement.

Joint control is the contractually agreed sharing of control over an economic activity.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner
(b) children of that person's spouse or domestic partner; and
(c) dependants of that person or that person's spouse or domestic partner *(HKAS 24)*

HKAS 24.10,12

1.3.1 Related party relationships

When considering each possible related party relationship, attention must be paid to the **substance of the relationship, not merely the legal form**.

The standard also clarifies that in the definition of a related party:

- an associate includes subsidiaries of the associate
- a joint venture includes subsidiaries of the joint venture

For example, an associate's subsidiary and the investor that has significant influence over the associate are related to each other.

Example: Parent and subsidiaries

Parent entity has a controlling interest in Subsidiaries A, B and C, and has significant influence over Associates 1 and 2. Subsidiary C has significant influence over Associate 3.

Are they related parties of each other?

Solution

For Parent's separate financial statements, both subsidiaries and all three associates are classified as related parties.

For Subsidiary A's financial statements, Parent, Subsidiaries B and C, and all three associates are classified as related parties.

For Subsidiary B's separate financial statements, Parent, Subsidiaries A and C, and all three associates are related parties.

For Subsidiary C's financial statements, Parent, Subsidiaries A and B and all three associates are related parties.

For the financial statements of Associates 1, 2 and 3, Parent and Subsidiaries A, B and C are their related parties. Associates 1, 2 and 3 are not classified as related to each other.

For Parent's consolidated financial statements, Associates 1, 2 and 3 are related to the Group.

HKAS 24.11

1.3.2 Relationships which are not related parties

HKAS 24 lists the following which are **not necessarily related parties**.

(a) Two entities simply because they have a director or other key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

(b) Two venturers, simply because they share joint control over a joint venture.

(c) Certain other bodies, simply as a result of their role in normal business dealings with the entity:

  (i) providers of finance

  (ii) trade unions

  (iii) public utilities

  (iv) government departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity

  simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).

(d) Any single customer, supplier, franchisor, distributor, or general agent with whom the entity transacts a significant amount of business, simply by virtue of the resulting economic dependence.

HKAS 24.21

1.3.3 Related party transactions

HKAS 24 provides examples of transactions which may take place between related parties. They include:

- purchases or sales of goods (finished or unfinished)
- purchases or sales of property and other assets

- rendering or receiving of services
- leases
- transfer of research and development
- transfers under licence agreements
- provision of finance
- provisions of guarantees and collateral security
- settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

HKAS 24.13,17-19,23,24

1.4 Disclosure

A notable feature of HKAS 24 is that it is almost wholly concerned with disclosures. Its provisions supplement those disclosure requirements required by national company legislation and other HKAS (especially HKAS 1 and HKFRS 12).

Relationships between **parents and subsidiaries** must be **disclosed irrespective** of **whether** any **transactions** have **taken place between** the related parties. An entity must disclose the **name** of its **parent** and, if different, the **ultimate controlling party**. This will enable a reader of the financial statements to be able to form a view about the effects of a related party relationship on the reporting entity.

If neither the parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

An entity should disclose **key management personnel compensation** in total for each of the following categories:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payment

Where **related party transactions** have occurred during the period, the nature of the related party relationship should be disclosed together with (as a minimum):

(a) The amount of the transactions

(b) The amount of outstanding balances, including commitments, and

  (i) their terms and conditions including whether they are secured and the nature of the consideration to be provided in settlement; and

  (ii) details of any guarantees given or received

(c) Provisions for doubtful debts related to the amount of outstanding balances, and

(d) The expense recognised during the period in respect of bad and doubtful debts due from related parties.

These disclosures should be made separately for the following categories of related party:

- The parent
- Entities with joint control or significant influence over the entity
- Subsidiaries
- Associates
- Joint ventures in which the entity is a venturer
- Key management personnel of the entity or its parent, and
- Other related parties

Substantiation is a must if an entity decides to put up disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions.

Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

HKAS 24.25,26

1.4.1 Government related entities

The disclosures listed above need not be made in respect of transactions with:

(a) a government that has control, joint control or significant influence over the reporting entity, and

(b) another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

Instead, the reporting entity should disclose:

(a) the name of the government and the nature of its relationship with the reporting entity

(b) information in sufficient detail to enable users of the financial statements to understand the effect of related party transactions on those financial statements, including:

   (i) the nature and amount of each individually significant transaction, and

   (ii) for other transactions that are collectively significant, a qualitative or quantitative indication of their extent.

1.5 The importance of disclosure

As we have already said, in the absence of information to the contrary, users of the financial statements are likely to assume that an entity has entered into all of its transactions on an arm's length basis, and acted in its own interests throughout an accounting period. Therefore they would assume that the entity's results and position are a true reflection of the performance of the entity and the stewardship of the management.

Where related party transactions have occurred this is not always the case. For example, the following may affect the financial statements:

- The provision of a longer credit period to related parties
- A lower selling price to related parties
- Transactions which would not occur without the related party relationship
- Transactions with third parties which are affected by a related party relationship

Such transactions may have an adverse effect on the financial statements. Take, for example, the situation where a director of Company A is the majority shareholder in Company B, and uses the position of influence in Company A to ensure that Company A buys goods from Company B at inflated prices. The profits of Company A are therefore lower than they might otherwise be and the profits of Company B are higher. The shareholders of Company A are entitled to know about this related party transaction so that they may assess its effect on the profits of Company A, and the stewardship of the director.

Of course not all related party transactions are on preferential terms for one party or the other, however they may be. The disclosures required by the standard are therefore designed to allow users of the accounts to assess this.

1.6 Section summary

HKAS 24 is primarily concerned with **disclosure**. You should learn the following:

- **Definitions**: these are very important
- Relationships covered
- Relationships that **may not** necessarily be between related parties
- **Disclosures**: again, very important, representing the whole purpose of the standard

Self-test question 1

Anthony Co. (A) is an 80% owned subsidiary of Basso Co. (B). The directors of A are W, X, Y and Z. Which of the following are related parties of A?

C, which is not part of the B group, but of which W is a director.

D, who owns 20% of the shares in A.

E, the financial controller of A (who is not a director of A).

F, the wife of the chairman of P, a company in the B group.

(The answer is at the end of the chapter)

Topic recap

HKAS 24 Related Party Disclosures

Objective: to ensure that financial statements contain the disclosures necessary to draw attention to the possibility that financial position and performance may have been affected by material transactions with related parties.

Related party

A **person** (or close family member of that person) is related to an entity if they
- control/jointly control the entity
- are key management personnel

An **entity** is related to another entity if:
- they are members of the same group
- one is an associate or joint venture of the other
- both are joint ventures of another party
- one is a joint venture and the other an associate of another party
- one is a post-employment benefits plan of the other or of an entity related to the other
- the entity is controlled/jointly controlled by a person listed above
- a person listed above is key management personnel or has significant influence of the other entity

Not included:
- Two entities with key management personnel in common
- Two venturers which share control over a joint venture
- Bodies engaged in normal business dealings such as providers of finance

Related party transaction

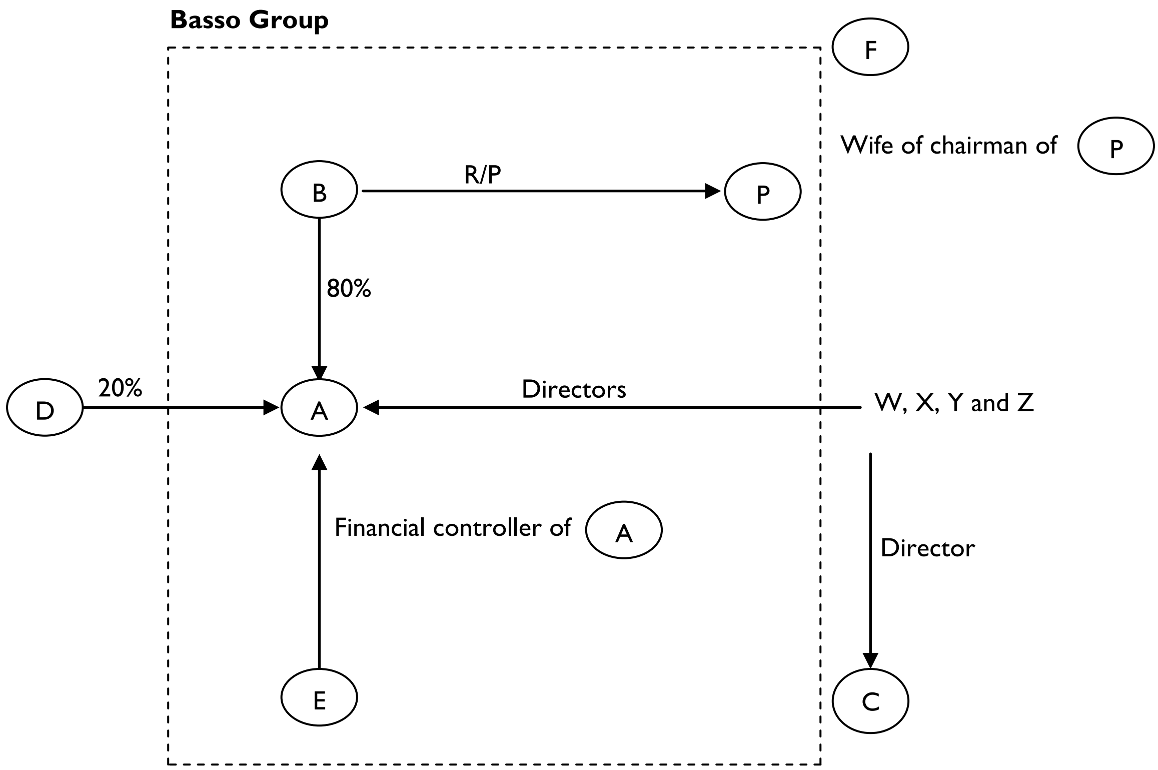
A transfer of resources, services or obligations between a reporting entity and a related party regardless of whether a price is charged

Include:
- purchases/sales of goods/services
- purchases/sales of assets
- leases
- transfers of research and development
- transfers under licence
- provision of finance
- provision of guarantees
- settlements of liabilities

Disclose:
- relationships between parents and subsidiaries (regardless of whether they have transacted)
- name of parent/ultimate controlling party
- key management personnel compensation (categorised)
- where related party transactions have occurred, disclose by category of related party:
  - Nature of the related party relationship
  - Amount of transactions
  - Outstanding balances and provisions against them
  - Bad debt expense recognised in respect of related parties

Answer to self-test question

Answer 1



1 C and A are subject to common influence from W, but C is not a related party unless one or both companies have subordinated their own separate interests in entering into a transaction. (This assumes that W is the only director to serve on both boards; if there were a common nucleus of directors, a related party relationship would almost certainly exist.)

2 D is almost certainly not a related party. According to the definition, D might be presumed to be a related party, but the existence of a parent company means that D is unlikely to be able to exert significant influence over A in practice (depends on your argument).

3 E may be a related party, despite the fact that he or she is not a director. A financial controller would probably come within the definition of key management personnel. The issue would be decided by the extent to which E is able to control or influence the policies of the company in practice.

4 F may be a related party. Companies P and A are under common control and F presumably falls within the definition of close family of a related party of B. F is not a related party if it can be demonstrated that she has not influenced the policies of A in such a way as to inhibit the pursuit of separate interest.

Exam practice

Company A

25 minutes

The following table sets out the details of shareholders and members of the board of directors of five entities:

	Shareholders	Member of board of Director(s)
Company A	Mr. Kwok (75%) Growth Investment Limited (GIL) (25%)	Mr. Kwok Mrs. Kwok (wife of Mr. Kwok) Mr. Ma on behalf of GIL
Company B	Mrs. Kwok (50%) Ms. Chan (50%)	Mrs. Kwok Ms. Chan
Company C	GIL (100%)	Mr. Wang
Company D	Mr. Ma (100%)	Mr. Ma
Company E	Mr. Scott (50%) Mr. Smith (50%)	Mr. Scott Mr. Smith Mrs. Kwok

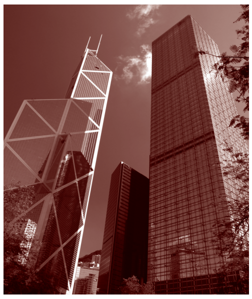
Required

Determine and explain whether the following entities and persons are related parties of Company A under HKAS 24 *Related Party Disclosures*.

(a) Company B
(b) Company C
(c) Company D
(d) Company E
(e) GIL
(f) Mr. Ma
(g) Ms. Chan
(h) Mr. Wang

(14 marks)

HKICPA June 2011



chapter 21

Accounting policies, changes in accounting estimates and errors; events after the reporting period

Topic list

Learning focus

HKAS 8 is relevant to all organisations preparing financial statements in accordance with HKFRS; it is important that you know how accounting policies should be selected, and when they, and accounting estimates can be changed.

HKAS 10 is also very relevant in practice as all entities have a period between the reporting date and authorising of the accounts during which time significant events may occur.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.01	**Accounting policies, changes in accounting estimates and errors**	3
3.01.01	Distinguish between accounting policies and accounting estimates in accordance with HKAS 8	
3.01.02	Account for a change in accounting policy	
3.01.03	Account for a change in accounting estimate	
3.01.04	Correct a prior period error	
3.15	**Events after the reporting period**	3
3.15.01	Explain the period during which there is responsibility for reporting events in accordance with HKAS 10	
3.15.02	Define adjusting and non-adjusting events	
3.15.03	Explain when the financial statements should be prepared on a basis other than going concern	

1 HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

Topic highlights

HKAS 8 deals with the treatment of changes in accounting estimates, changes in accounting policies and errors.

HKAS 8.1

1.1 Objective

The objective of HKAS 8 is to prescribe:

- The criteria for selecting and changing accounting policies
- The accounting treatment and disclosure of:
  - changes in accounting policies,
  - changes in accounting estimates, and
  - corrections of errors.

The standard is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

The standard was extensively revised in October 2008. The new title reflects the fact that the material on determining profit or loss for the period has been transferred to HKAS 1.

HKAS 8.5

1.2 Definitions

The following definitions are given in the standard.

Key terms

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Material. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Key terms (cont'd)

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

Prospective application of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

- applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed
- recognising the effect of the change in the accounting estimate in the current and future periods affected by the change

Impracticable. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following applies.

- The effects of the retrospective application or retrospective restatement are not determinable.
- The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.
- The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:
  (i) provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and
  (ii) would have been available when the financial statements for that prior period were authorised for issue, from other information. *(HKAS 8.5)*

2 Accounting policies

Topic highlights

Changes in accounting policy are applied **retrospectively**.

HKAS 8.7,10-13

2.1 Selection of accounting policy

Where an HKFRS specifically applies to a transaction, then the relevant accounting policy should be determined by applying that standard or interpretation.

Where there is no applicable HKFRS, management should use its **judgment** in developing and applying an accounting policy that results in information that is **relevant** and **reliable**. Management should refer to:

(a) the requirements in HKFRS dealing with **similar** and **related issues**.

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the *Conceptual Framework.*

Management may also consider the most recent pronouncements of **other standard-setting bodies** that use a similar conceptual framework to develop standards, other accounting literature, including Accounting Guidelines and Accounting Bulletins, and accepted industry practices if these do not conflict with the sources above.

An entity must select and apply its accounting policies for a period **consistently** for similar transactions, other events and conditions, unless a HKFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an HKFRS requires or permits categorisation of items, an appropriate accounting policy must be selected and applied consistently to each category.

HKAS 8.14,16,17

2.2 Changes in accounting policy

The same accounting policies are usually adopted from period to period, to allow users to analyse trends over time in profit, cash flows and financial position. **Changes in accounting policy will therefore be rare** and should be made only if the change:

(a) is required by an HKFRS, or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

The standard highlights two types of event which do not constitute changes in accounting policy.

(a) Adopting an accounting policy for a **new type of transaction** or event not dealt with previously by the entity.

(b) Adopting a **new accounting policy** for a transaction or event which has not occurred in the past or which was not material.

In the case of tangible non-current assets, if a policy of revaluation is adopted for the first time then this is treated, not as a change of accounting policy under HKAS 8, but as a revaluation under HKAS 16 *Property, Plant and Equipment* (see Chapter 5). The following paragraphs do not therefore apply to a change in policy to adopt revaluations.

HKAS 8.19,22-25

2.2.1 Accounting for a change in accounting policy

Where a change in accounting policy is the result of the initial application of an HKFRS, that change should be accounted for in accordance with the specific transitional provisions, if any, in that HKFRS. For example, HKFRS 13 *Fair Value Measurement*, issued in June 2011 should be applied prospectively from the first date on which it is applied.

Otherwise, a change in accounting policy should be applied retrospectively.

Retrospective application means that the new accounting policy is applied to transactions and events as if it had always been in use. In other words, the policy is applied from the earliest date such transactions or events occurred.

Where it is **impracticable** (see Key terms) to apply a change in accounting policy retrospectively because the cumulative amount of change cannot be determined, it should be applied prospectively.

HKAS 8.29,30

2.3 Disclosing changes in accounting policy

As a result of a change in accounting policy, retrospective adjustments should be reported as an adjustment to the opening balance of each affected component of equity.

Comparative information should also be restated unless it is impracticable to do so. This means that all comparative information must be restated **as if the new policy had always been in force**, with amounts relating to earlier periods reflected in an adjustment to opening reserves of the earliest period presented.

Certain **disclosures** are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods.

These include:

(a) reasons for the change

(b) amount of the adjustment for the current period and for each period presented

(c) amount of the adjustment relating to periods prior to those included in the comparative information

(d) the fact that comparative information has been restated or that it is impracticable to do so

An entity should also disclose information relevant to assessing the **impact of new HKFRS** on the financial statements where these have **not yet come into force**.

Example: Retrospective application

A training company capitalises all equipment based on cost but has not depreciated it over its useful life due to the amounts involved being immaterial. In advance of extensive capital expenditure, the company now wishes to change its accounting policy and apply in full the provisions of HKAS 16 *Property, Plant and Equipment.*

Details of the equipment are as follows:

	Acquisition date	*Cost*	*Fair value as at 1 January 20X6*	*Useful life/ remaining useful life (years)*
		$	$	
Equipment A	1 January 20X5	6,000	unknown	10
Equipment B	Unknown	10,000	8,000	10

The value-in-use is the same as fair value at 1 January 20X6. The financial period of the company ends on 31 December. Opening retained earnings are $700,000 on 1 January 20X5 and the company made a profit of $20,000 for the year ended 31 December 20X6 and $30,000 for the year ended 31 December 20X5 (excluding any adjustment for depreciation). In the year ended 31 December 20X6, the company elects to adopt HKAS 16 in full.

	1 January 20X5	*Depreciation*	*1 January 20X6*	*Depreciation*	*31 December 20X6*
	$		$		$
Equipment A		6,000 ÷ 10			
Cost	6,000		6,000		6,000
Accumulated depreciation	–	(600)	(600)	(600)	(1,200)
Carrying amount	6,000		5,400		4,800

	1 January 20X5	*Impairment loss*	*1 January 20X6*	*Depreciation*	*31 December 20X6*
	$		$		$
Equipment B				8,000 ÷ 10	
Cost	10,000	(2,000)	8,000		8,000
Accumulated depreciation	–		–	(800)	(800)
Carrying amount	10,000		8,000		7,200

Alternative

	1 December 20X5 $	*Depreciation*	*31 December 20X5* $	*Revaluation*	*1 January 20X6* $
Equipment B					
Cost	10,000	10,000 ÷ 10	10,000		8,000
Accumulated depreciation	–	(1,000)	(1,000)	(2,000)	–
				1,000	
Carrying amount	10,000		9,000	Impairment loss	8,000

As the company did not depreciate the equipment the carrying amount of the equipment would have been the original cost of $6,000 and $10,000 as at 31 December 20X6. As there has been a change in accounting policy in 20X6, the financial statements must be adjusted to present non-current assets as though HKAS 16 has always been applied. The table above depicts the changes in carrying amount if HKAS 16 had been applied on the initial recognition of the equipment.

Under these circumstances, the company must apply HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to adopt HKAS 16 and present one year's comparative information. The financial statement extracts will be as follows:

STATEMENT OF FINANCIAL POSITION RESTATED – EXTRACTS

	1 January 20X5 $	*Comparative*	*31 December 20X5* $		*31 December 20X6* $
Equipment A		6,000 ÷ 10			
Cost	6,000		6,000		6,000
Accumulated depreciation	–	(600)	(600)	(600)	(1,200)
	6,000		5,400		4,800

	1 January 20X5 $	*Comparative*	*31 December 20X5* $		*31 December 20X6* $
Equipment B				8,000 ÷ 10	
Cost	10,000	(2,000)	8,000		8,000
Accumulated depreciation	–		–	(800)	(800)
	10,000		8,000		7,200
Retained earnings	700,000	+27,400	727,400	+18,600	746,000

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME RESTATED – EXTRACTS

Year ended		*31 December 20X5* $	*31 December 20X6* $
Profit before depreciation		30,000	20,000
Depreciation	Equipment A	(600)	(600)
	Equipment B	0	(800)
Impairment	Equipment B	–	–
		27,400	18,600
Alternative presentation			
Profit before depreciation		30,000	20,000
Depreciation	Equipment A	(600)	(600)
	Equipment B	(1,000)	(800)
Impairment	Equipment B	(1,000)	–
		27,400	18,600

Based on the above extract, the 20X6 profit would be adjusted for depreciation of $1,400 and the opening retained earnings also adjusted for 20X5's depreciation/impairment charge of $2,600. One year's comparative must be presented which means the profits for last year and the opening retained earnings for last year are recalculated.

The adjustment must be made from the original date it affects the financial statements, this is known as retrospective application.

3 Accounting estimates

HKAS 8.32,33

Topic highlights

Changes in accounting estimate are *not* applied retrospectively.

Estimates arise in relation to business activities because of the **uncertainties inherent within them**. Judgments are made based on the most up-to-date information and the use of such estimates is a necessary part of the preparation of financial statements. It does not undermine their reliability.

Examples of accounting estimates include:

- a necessary **irrecoverable debt allowance**
- **useful lives** of depreciable assets
- provision for **obsolescence of inventory**
- warranty obligations

HKAS 8.36

3.1 Accounting for a change in accounting estimate

The **effect of a change in an accounting estimate** should be included in the determination of net profit or loss in one of:

(a) the period of the change, if the change affects that period only.
(b) the period of the change and future periods, if the change affects both.

In other words the change is applied prospectively.

Changes may occur in the circumstances which were in force at the time the estimate was calculated, or perhaps additional information or subsequent developments have come to light.

An example of a change in accounting estimate which affects only the **current period** is the irrecoverable debt estimate. However, a revision in the life over which an asset is depreciated would affect both the **current and future periods**, in the amount of the depreciation expense.

Reasonably enough, the effect of a change in an accounting estimate should be included in the **same expense classification** as was used previously for the estimate. This rule helps to ensure **consistency** between the financial statements of different periods.

The **materiality** of the change is also relevant. The nature and amount of a change in an accounting estimate that has a material effect in the current period (or which is expected to have a material effect in subsequent periods) should be disclosed. If it is not possible to quantify the amount, this impracticability should be disclosed.

HKAS 8.39,40

3.2 Disclosure of a change in accounting estimate

Where there is a change in accounting estimate, an entity must disclose the nature and amount of the change that has an effect in the current period or is expected to have an effect in future periods, unless it is impracticable to estimate that effect.

If the amount of the effect in future periods is not disclosed because estimating it is impracticable, that fact must be disclosed.

Illustration: Prospective application

All equipment is capitalised based on cost and depreciated over its useful life. As at 1 January 20X6, the equipment's productivity is lower than expected and machines frequently break down. A re-assessment of the remaining useful life has been done. Details of the equipment are as follows:

	Acquisition date	*Cost*	*Original useful life from 1 January 20X5*	*Remaining useful life from 1 Jan 20X6*
Equipment	1 January 20X5	$10,000	10 years	5 years

	1 January 20X5 $		*1 January 20X6* $		*31 December 20X6* $
Equipment		10,000 ÷ 10	10,000	9,000 ÷ 5	9,000
Cost	10,000		(1,000)	(1,800)	(1,800)
Acc depreciation	–	(1,000)	9,000		7,200
	10,000				

When the useful life changes, the depreciation charge will also change resulting in $1,800 being charged in the 20X6 financial statements. No adjustment to the comparative figures is required.

4 Errors

Topic highlights

Prior period errors must be corrected **retrospectively**.

Errors discovered during a current period which **relate to a prior period** may arise through:

- mathematical mistakes
- mistakes in the application of accounting policies
- misinterpretation of facts
- oversights
- fraud

Most of the time these errors can be **corrected through net profit or loss for the current period**. Where they are material prior period errors, however, this is not appropriate. The standard considers two possible treatments.

HKAS 8.42-45

4.1 Accounting treatment to correct an error

Prior period errors must be corrected retrospectively. This involves:

(a) either restating the comparative amounts for the prior period(s) in which the error occurred

(b) or, when the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period

so that the financial statements are presented **as if the error had never occurred**.

Only where it is **impracticable** to determine the cumulative effect of an error on prior periods can an entity correct an error **prospectively**.

HKAS 8.49

4.2 Disclosure of an error

The following must be disclosed in relation to an error:

(a) **Nature** of the prior period error.

(b) For each prior period, to the extent practicable, the **amount** of the correction.

  (i) For each financial statement line item affected
  (ii) If HKAS 33 applies, for basic and diluted earnings per share

(c) The amount of the correction at the **beginning of the earliest prior period** presented.

(d) If **retrospective restatement is impracticable** for a particular prior period, the **circumstances** that led to the existence of that condition and a description of how and from when the error has been corrected.

Subsequent periods need not repeat these disclosures.

Self-test question 1

During 20X7 Gordon Co. discovered that certain items had been included in inventory at 31 December 20X6, valued at $4.2 million, which had in fact been sold before the end of the reporting period and included correctly in revenue.

The following figures for 20X6 (as reported) and 20X7 (draft) are available:

	20X6	*20X7 (draft)*
	$'000	$'000
Sales	47,400	67,200
Cost of goods sold	(34,570)	(55,800)
Profit before taxation	12,830	11,400
Income taxes	(2,245)	(1,880)
Profit for the period	10,585	9,520

Retained earnings at 1 January 20X6 were $13 million. The cost of goods sold for 20X7 includes the $4.2 million error in opening inventory. The income tax rate was 16% for 20X6 and 20X7. No dividends have been declared or paid.

Required

Show the statement of profit or loss and other comprehensive income for 20X7, with the 20X6 comparative, and retained earnings.

(The answer is at the end of the chapter)

5 HKAS 10 *Events after the Reporting Period*

Topic highlights

HKAS 10 identifies events arising between the reporting date and date on which the financial statements are authorised for issue as either adjusting or non-adjusting. HKAS 10 should be familiar from your earlier studies, but it still could come up in part of a question.

HKAS 10.1

5.1 Objective

HKAS 10 prescribes:

- when an entity should adjust its financial statements for events after the reporting period; and
- the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.

HKAS 10.3

5.2 Definitions

Key term

The standard defines **events after the reporting period** as:

Those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

It goes on to classify such events as one of two types:

(a) those that provide evidence of conditions that existed at the end of the reporting period (**adjusting events** after the reporting period); and

(b) those that are indicative of conditions that arose after the reporting period (**non-adjusting events** after the reporting period).

HKAS 10.4-7

5.3 Events after the reporting period

The definition above defines an event after the reporting period as an event that occurs between the reporting date and the date that the financial statements are authorised for issue:

	End of reporting period ↓	Date of authorisation ↓
Accounting period	Events after the reporting period	

The authorisation process varies from entity to entity:

(a) Where an entity must submit its financial statements to shareholders for approval after the financial statements have been issued, the date of authorisation is the same as the date of issue;

(b) Where the management of an entity must issue the financial statements to a supervisory board for approval, the date of authorisation is the date on which the management authorises the financial statements for issue to the supervisory board.

Events after the reporting period include all events up to the date when the financial statements are authorised for issue, even if those events occur after the public announcement of profit or of other selected financial information.

HKAS 10.9

5.3.1 Adjusting events

Adjusting events add information on conditions that existed at the reporting date. They may include the following:

(a) The settlement after the reporting period of a court case which confirms an entity had a present obligation at the end of the reporting period.

(b) The bankruptcy of a customer after the reporting period which confirms that the receivables balance was overstated at the end of the reporting period.

(c) The sale of inventories after the year end at an amount lower than cost which confirms that inventories were overstated at the end of the reporting period.

(d) The determination after the reporting period of the cost of assets purchased or proceeds of the sale of assets before the end of the reporting period.

(e) The determination after the reporting period of the amount of profit-sharing or bonus payments which confirms the existence of obligation at the end of the reporting period.

(f) The discovery of fraud or errors showing the financial statements are incorrect.

Any event after the reporting period which indicates that an entity is no longer a going concern is classified as an adjusting event.

HKAS 10.12,22

5.3.2 Non-adjusting events

Non-adjusting events provide information about conditions arising after the reporting date. Examples may include the following:

(a) The destruction of a non-current asset in the period after the reporting date due to fire or flood.

(b) A decline in the fair value of investments after the reporting date due to circumstances arising after the reporting date.

(c) A major business combination after the reporting period.

(d) An announcement of a plan to discontinue an operation.

(e) Purchases of assets, classification of assets as held for sale (HKFRS 5), disposals of assets or expropriation of assets by government.

(f) An announcement of or commencement of a major restructuring.

(g) Share transactions after a reporting period.

(h) Abnormally large changes after the reporting period in foreign exchange rates.

(i) Changes in tax rates or tax laws enacted or announced after the reporting period.

(j) Entering into significant commitments.

(k) Commencing litigation due to events arising after the reporting period.

HKAS 10 is also clear that an equity dividend declared after the end of the reporting period is a non-adjusting event and should not be recognised as a liability. This is because there is no obligation at the reporting date; the obligation does not arise until the dividend is declared.

5.4 Accounting treatment

The accounting treatment of an event after the reporting period depends on how it is classified.

HKAS 10.8,14,19

5.4.1 Adjusting events

As the name suggests, the financial statements are adjusted to reflect an adjusting event. For example, the bankruptcy of a customer after the reporting period should be written off in the year-end financial statements as irrecoverable.

Disclosures within the financial statements should also be updated in the light of the adjusting event.

Where an event after the reporting date results in going concern issues, for example, management decides that it intends to liquidate the business or cease trading or that it has no other choice but to either cease trading or liquidate the business or there is a deterioration in operating results or financial position, the financial statements should be presented to reflect this decision. Therefore, the going concern assumption is no longer appropriate and the financial statements should be prepared on the break-up basis. Break-up basis accounts are discussed in more detail in section 13.2, Chapter 2.

HKAS 10.10,21

5.4.2 Non-adjusting events

Non-adjusting events do not result in adjustment to the financial statements, however where non-adjusting events are material, they should be disclosed.

The following should be disclosed for each material category of non-adjusting event after the reporting period:

(a) The nature of the event, and
(b) An estimate of its financial effect, or a statement that such an estimate cannot be made.

HKAS 10.17

5.5 Further disclosure

In addition to the disclosures in respect of both adjusting and non-adjusting events, an entity must disclose the date when the financial statements were authorised for issue and who gave that authorisation.

If the entity's owners or others have the power to amend the financial statements after issue, the entity must also disclose that fact.

Example: Adjusting or non-adjusting events

A company has a financial year end of 31 December 20X0 and the financial statements are authorised for issue on 31 March 20X1. The following events have arisen during the three months after the end of the reporting period:

1 The inventory of motor vehicles has deteriorated in value due to legislation passed on 31 January 20X1 which increases road tax and the new policy to introduce a one car per family limit.

2 An ordinary dividend of $0.1 million is declared after the reporting date.

3 The credit department discovered that a major customer owing $2 million has gone into liquidation.

Required

Discuss the implication of the above events and indicate whether they are adjusting or non-adjusting events.

Solution

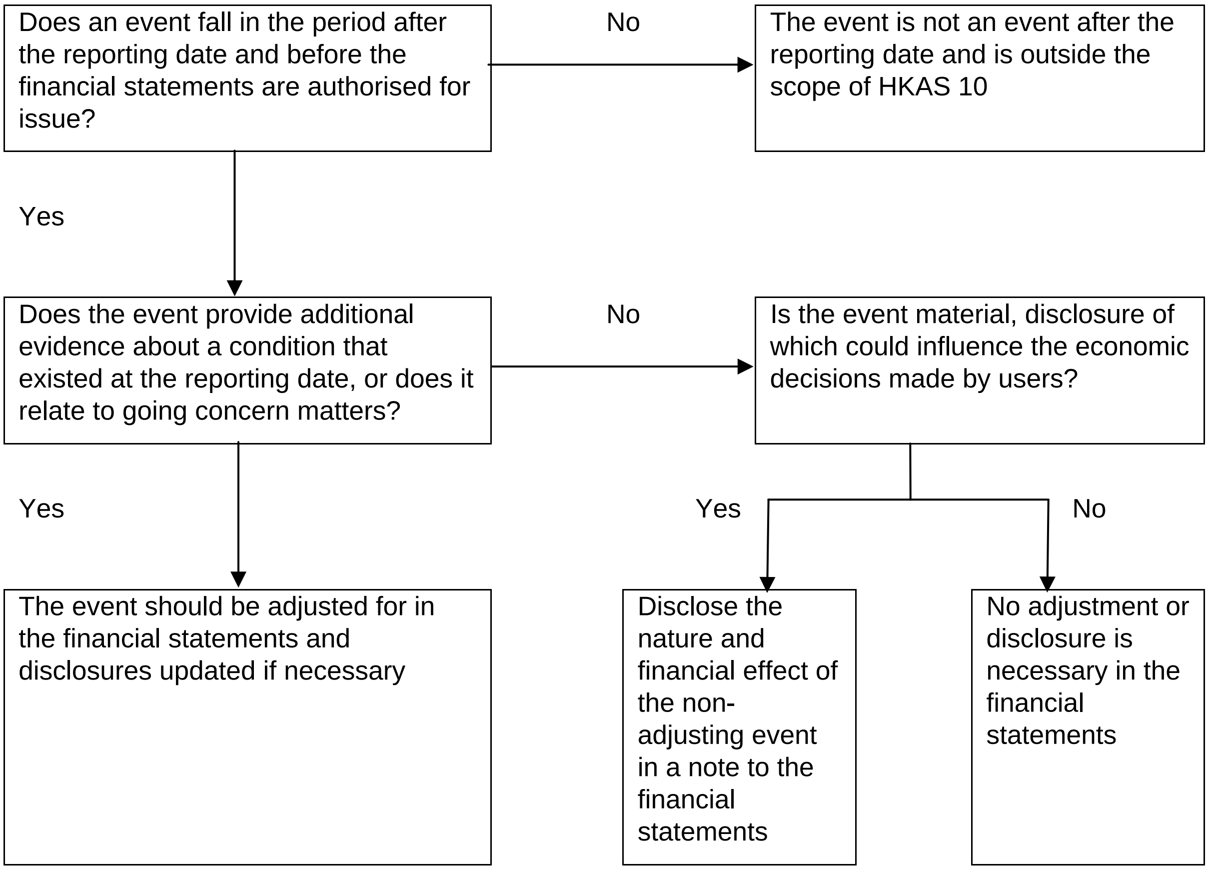
The impairment of inventory is a non-adjusting event because legislation is not passed until after the reporting date. Therefore, at the reporting date the value of inventory is unaffected.

The dividend declared after the reporting date is non-adjusting also because as at the reporting date there is no obligation to pay a dividend.

The discovery of an irrecoverable debt in the post-reporting date period provides evidence that the debt could not be paid at the reporting date. Therefore, it is an adjusting event.

5.6 Summary decision tree

A decision tree for application of HKAS 10 is a useful summary of the key learning points:



Topic recap

HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Accounting policies

Specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

Accounting policies are **selected** by applying relevant HKFRS.

If no HKFRS is available, management should apply judgment and the policy should result in relevant and reliable information.

A **change** in accounting policy only arises where:
- required by an HKFRS
- it results in more reliable and relevant reporting

A **voluntary** change is applied retrospectively so that financial statements are presented as if the policy had always been applied.

Changes resulting from the introduction of a new HKFRS are applied in accordance with the transitional provisions of that HKFRS.

Disclose:
- Reasons for change
- Amount of adjustment for the current and prior periods
- The fact that comparative information is restated (or that it is impracticable)

Accounting estimates

Arise because of uncertainties and require judgment to be applied e.g. useful lives of depreciable assets, warranty obligations, allowance for receivables.

A **change** in accounting estimates is applied **prospectively** so that it affects only current/future accounting periods.

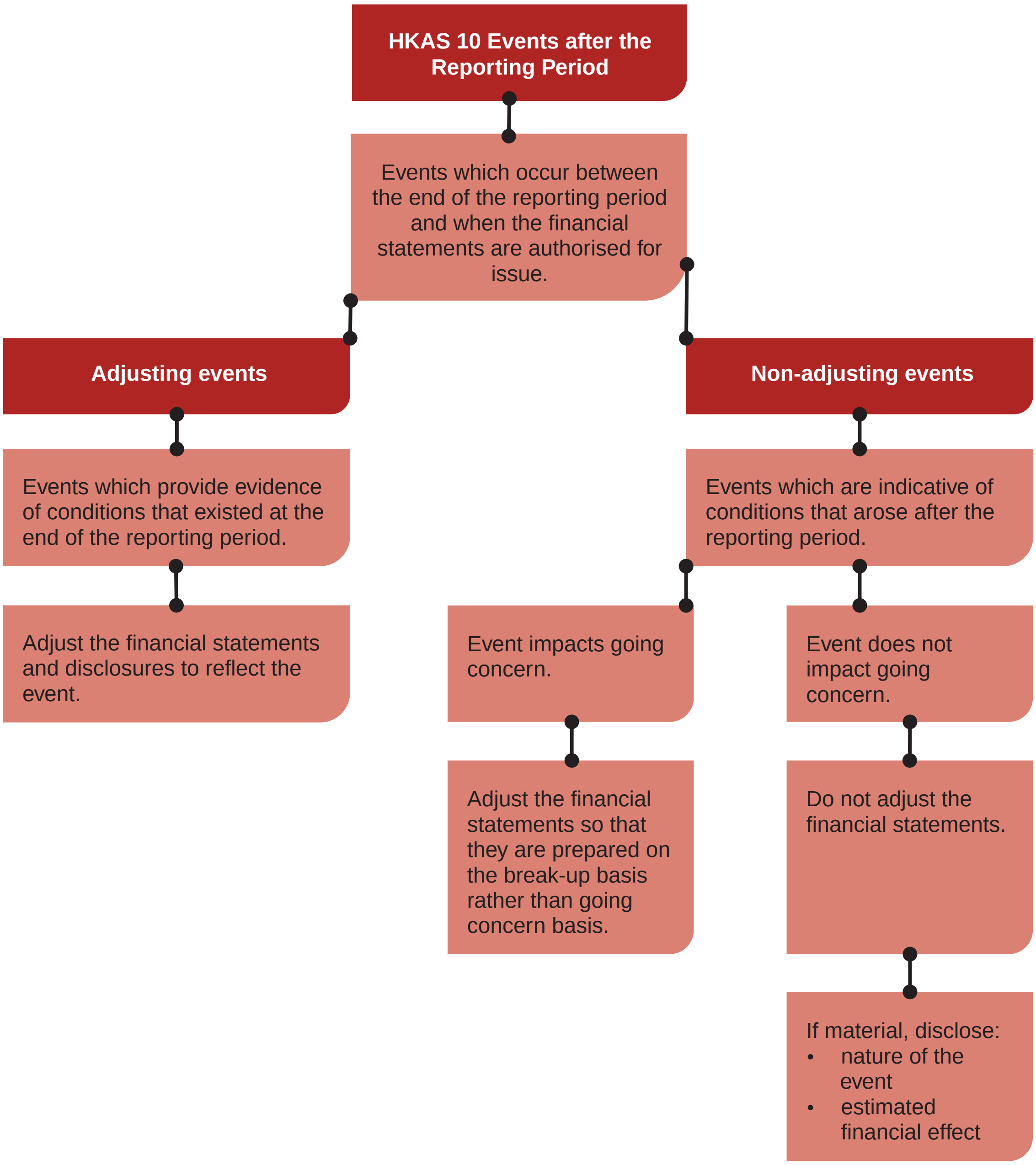
Disclose:
The nature and amount of the change unless impracticable to estimate

Errors

Omissions from and misstatements in prior period financial statements arising from a failure to use reliable information available for use or obtainable when the financial statements were prepared.

Unless impracticable, correct **retrospectively**.

Disclose:
- Nature of the error
- Amount of correction for each prior period
- Amount of correction at the beginning of the earliest prior period presented


HKAS 10 Events after the Reporting Period
Events which occur between the end of the reporting period and when the financial statements are authorised for issue.
Adjusting events
Non-adjusting events
Events which provide evidence of conditions that existed at the end of the reporting period.
Events which are indicative of conditions that arose after the reporting period.
Adjust the financial statements and disclosures to reflect the event.
Event impacts going concern.
Event does not impact going concern.
Adjust the financial statements so that they are prepared on the break-up basis rather than going concern basis.
Do not adjust the financial statements.
If material, disclose:
• nature of the event
• estimated financial effect

Answer to self-test question

Answer 1

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	20X6	*20X7*
	$'000	$'000
Sales	47,400	67,200
Cost of goods sold (W1)	(38,770)	(51,600)
Profit before tax	8,630	15,600
Income tax (W2)	(1,573)	(2,552)
Profit for the year	7,057	13,048

RETAINED EARNINGS

	20X6	*20X7*
Opening retained earnings	$'000	$'000
As previously reported	13,000	23,585
Correction of prior period error (4,200 – 672)	–	(3,528)
As restated	13,000	20,057
Profit for the year	7,057	13,048
Closing retained earnings	20,057	33,105

WORKINGS

		20X6	*20X7*
1	Cost of goods sold		
		$'000	$'000
	As stated in question	34,570	55,800
	Inventory adjustment	4,200	(4,200)
		38,770	51,600
2	Income tax	*20X6*	*20X7*
		$'000	$'000
	As stated in question	2,245	1,880
	Inventory adjustment (4,200 × 16%)	(672)	672
		1,573	2,552

Exam practice

Star Workshop Inc — 20 minutes

In the preparation of the financial statements for the year ended 31 March 20X2 of Star Workshop Inc. (SW), the financial controller identified the following transactions / events which happened after the end of the reporting period but before the date when the financial statements are authorised for issue:

(a) A customer informed SW on 3 April 20X2 that all the goods delivered to the customer's warehouse on 25 March 20X2 were not produced in accordance with the agreed specification. SW reproduced the order and shipped the replacement goods to the customer on 10 April 20X2. The invoice of HK$8 million issued on 25 March 20X2 has not been cancelled and the customer had settled when it confirmed the acceptance of the replacement goods. **(4 marks)**

(b) The production of a plant has been suspended since 15 April 20X2 due to the sudden shortage of electricity supply. Sales orders of HK$15 million received in February 20X2 with a planned production and delivery in May 20X2 could not be fulfilled. According to the terms of the sale contracts, SW agreed to compensate the counterparty by 20% of the contract price for breach of contract. **(4 marks)**

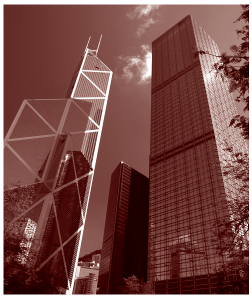
(c) An official letter issued on 8 April 20X2 by the local government regarding the approval of a subsidy of HK$5 million has been received. The subsidy was given to SW because of the employment of more than 1,000 local workers during the six months ended 31 December 20X1. According to the published government notice, enterprises are encouraged to employ local workers and, subject to approval, a discretionary subsidy will be granted. SW applied for the subsidy on 8 March 20X2. **(3 marks)**

Required

Discuss how the above transactions/events should be dealt with in the financial statements of SW for the year ended 31 March 20X2.

(Total = 11 marks)

HKICPA June 2012 (amended)


chapter 22

Earnings per share

Topic list

1 HKAS 33 *Earnings Per Share*

1.1 Objective of HKAS 33
1.2 Scope of HKAS 33
1.3 Definitions
1.4 Basic EPS
1.5 Weighted average number of ordinary shares: the effect of changes in capital
1.6 Diluted EPS
1.7 Diluted EPS: contingently issuable ordinary shares
1.8 Presentation
1.9 Significance of earnings per share
1.10 Limitations of EPS

Learning focus

HKAS 33 is applicable to listed entities. You should be aware of the calculation of EPS and, since this is a measurement of performance, how it can be manipulated.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.22	**Earnings per share**	3
3.22.01	Explain the meaning and significance of a company's earnings per share	
3.22.02	Calculate the earnings per share, including the impact of a bonus issue, a rights issue and an issue of shares at full market value in accordance with HKAS 33	
3.22.03	Explain the relevance of a company's diluted earnings per share	
3.22.04	Discuss the limitations of using earnings per share as a performance measure	

1 HKAS 33 *Earnings Per Share*

Topic highlights

Earnings per share is a measure of the amount of profits earned by a company for each ordinary share. Earnings are profits after tax and preference dividends.

HKAS 33.1

1.1 Objective of HKAS 33

HKAS 33 provides guidance on calculating and disclosing earnings per share (EPS). The purpose of disclosing EPS is to enable comparison of the performance of an entity, both over time and with other entities.

HKAS 33.2-4

1.2 Scope of HKAS 33

HKAS 33 has the following **scope restrictions**:

(a) Only companies with (potential) ordinary shares which are **publicly traded** need to present EPS (including companies in the process of being listed).

(b) EPS need only be presented on the basis of **consolidated results** where the parent's results are shown as well.

(c) Where companies **choose** to present EPS, even when they have no (potential) ordinary shares which are traded, they must do so according to HKAS 33.

HKAS 33.5-7

1.3 Definitions

The following definitions are given in HKAS 33.

Key terms

Ordinary share. An equity instrument that is subordinate to all other classes of equity instruments.

Potential ordinary share. A financial instrument or other contract that may entitle its holder to ordinary shares.

Options, warrants and their equivalents. Financial instruments that give the holder the right to purchase ordinary shares.

Contingently issuable ordinary shares are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

Contingent share agreement. An agreement to issue shares that is dependent on the satisfaction of specified conditions.

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

Antidilution is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of certain conditions.

(HKAS 33.5)

1.3.1 Ordinary shares

Ordinary shares are defined above as those shares which are subordinate to other classes of share capital. This means that ordinary shares participate in profit for the period **only after other types of shares**, e.g. preference shares. The standard also notes that there may be more than one class of ordinary shares and ordinary shares of the same class have the same right to receive dividends.

1.3.2 Potential ordinary shares

HKAS 33 identifies the following examples of potential ordinary shares:

(a) **Financial liabilities or equity instruments**, including preference shares, that are convertible into ordinary shares

(b) **Share warrants and options**

(c) Shares that would be issued upon the satisfaction of **certain conditions** resulting from contractual arrangements, such as the purchase of a business or other assets

HKAS 33.10

1.4 Basic EPS

Topic highlights

Basic EPS is calculated by dividing the profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.

Basic EPS is calculated as:

$$\frac{\text{Profit / (loss) attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

Both of the terms within this calculation require further explanation.

HKAS 33.12,14,16

1.4.1 Profit attributable to ordinary shareholders

The profit or loss attributable to ordinary shareholders for a period is calculated as:

- profit after **all items of income and expense** (including tax and non-controlling interests), *less*
- profit after tax attributable to irredeemable **preference shareholders**, including preference dividends and differences arising on the settlement of preference shares.

Note that the adjustment above only related to irredeemable preference shares since amounts relating to preference shares classified as debt (redeemable preference shares) are included in profit or loss for the period.

Preference dividends deducted from profit consist of the following:

(a) Preference dividends on non-cumulative preference shares declared in respect of the period.

(b) Preference dividends for cumulative preference shares required for the period, *whether or not* they have been declared (*excluding* those paid/declared during the period in respect of previous periods).

If an entity purchases its own preference shares for more than their carrying amount the excess should be treated as a return to the preference shareholders and deducted from profit or loss attributable to ordinary equity holders.

Example: Profit attributable to ordinary shareholders

Sunwin Co. is a listed company with the following shares in issue at 31 December 20X0:

	Number of shares
Ordinary shares	100 million
Irredeemable cumulative preference shares	10 million
Redeemable preference shares	20 million

On 30 June 20X0, 5 million irredeemable cumulative preference shares of the same class as the 10 million remaining were cancelled and shareholders paid 67c per share. At this date the shares had a carrying amount of 50c each.

Fixed dividends on preference shares are as follows:

- Irredeemable cumulative preference shares: 3c per annum
- Redeemable preference shares: 5c per annum

Profit after tax reported for the year ended 31 December 20X0 was $36,900,000.

Required

What are profits attributable to ordinary shareholders for the purposes of calculating basic EPS?

Solution

	$
Profit after tax	36,900,000
Redeemable preference share dividend does not need adjustment as it will already have been accounted for as a finance cost within the calculation of profit	
Irredeemable preference dividend:	
1.1.X0 – 30.6.X0 15m shares × 3c	(450,000)
1.7.X0 – 31.12.X0 10m shares × 3c	(300,000)
Excess paid to cancel shares (67c – 50c) × 5m	(850,000)
Profits attributable to ordinary shareholders	35,300,000

HKAS 33.19-24

1.4.2 Weighted average number of ordinary shares

The number of ordinary shares used should be the weighted average number of ordinary shares outstanding during the period. This figure therefore reflects changes in capital during the period due to new share issues and so on.

The **time-weighting factor** is the number of days the shares were outstanding compared with the total number of days in the period. A reasonable approximation is usually adequate.

Shares are usually included in the weighted average number of shares from the **date consideration is receivable** which is usually the date of issue. HKAS 33 does provide the following guidance on the application of this rule:

Consideration	Start date for inclusion
In exchange for cash	When cash is receivable
On the voluntary reinvestment of dividends on ordinary or preference shares	The dividend payment date
As a result of the conversion of a debt instrument to ordinary shares	Date interest ceases accruing
In place of interest or principal on other financial instruments	Date interest ceases accruing
In exchange for the settlement of a liability of the entity	The settlement date
As consideration for the acquisition of an asset other than cash	The date on which the acquisition is recognised
For the rendering of services to the entity	As services are rendered

Ordinary shares issued as **purchase consideration** in an acquisition should be included as of the date of acquisition because the acquired entity's results will also be included from that date.

Where a **uniting of interests** takes place the number of ordinary shares used for the calculation is the aggregate of the weighted average number of shares of the combined entities, adjusted to equivalent shares of the entity whose shares are outstanding after the combination.

Ordinary shares that will be issued on the **conversion** of a mandatorily convertible instrument are included in the calculation from the **date the contract is entered into**.

If ordinary shares are **partly paid**, they are treated as a fraction of an ordinary share to the extent they are entitled to dividends relative to fully paid ordinary shares.

Contingently issuable shares (including those subject to recall) are included in the computation when all necessary conditions for issue have been satisfied.

1.4.3 Required basic EPS

Basic EPS should be calculated for **profit or loss attributable to ordinary equity holders** of the parent entity and **profit or loss from continuing operations** attributable to those equity holders (if this is presented).

1.5 Weighted average number of ordinary shares: the effect of changes in capital

Where there is a change in the share capital structure of an entity, the issue with regard to earnings per share is ensuring that like is compared with like. This will become more clear as you read through sections 1.5.1 to 1.5.3 and work the examples within them.

1.5.1 New share issues and share buy backs

Where new shares are issued at market price the number of shares will increase and there is a corresponding increase in resources which may be utilised to generate profits.

Where **ordinary shares** are issued but not fully paid, they are treated in the calculation of basic earnings per share as a fraction of an ordinary share to the extent that they were entitled to participate in dividends during the period relative to a fully paid ordinary share. Therefore, if 2 million shares are issued, but only half of the issue price is paid and therefore the shareholder is entitled to only 50% of a dividend, then only 1 million shares (i.e. 50% $\times$ 2 million) are included in the calculation of weighted average number of shares.

Where a share buy back takes place, there is a reduction in the number of shares and a corresponding decrease in resources available to generate profits (as cash is paid by the entity to the selling shareholders).

In both of these cases, therefore, EPS after the share issue or buy back can be compared on a like for like basis with EPS before the event as the increase (or decrease) in the numerator of the EPS fraction corresponds to the increase (or decrease) in the denominator of the fraction.

Example: Issue of ordinary shares at full market price

The profit after tax of AB Co. for the year ended 31 December 20X5 was $3,000,000.

At 31 December 20X4 the company had in issue 1,000,000 ordinary shares.

On 1 July 20X5, AB Co. issued 400,000 ordinary shares at the full market price for cash.

What is the basic EPS for the year ended 31 December 20X5?

Solution

Weighted average number of ordinary shares outstanding for year 20X5:

$$1{,}000{,}000 + 400{,}000 \times \frac{6\text{ months}}{12\text{ months}} = 1{,}200{,}000$$

$$\text{Therefore, EPS for year 20X5} = \frac{\$3{,}000{,}000}{1{,}200{,}000} = \$2.50$$

HKAS 33.28,29

1.5.2 Bonus issues, share splits and reverse share splits

Events such as bonus issues change the number of shares outstanding, **without a corresponding change in resources**.

Here it is necessary to make adjustments so that the current and prior period EPS figures are comparable.

Bonus issues and share splits can be considered together as they have a similar effect.
In both cases, ordinary shares are issued to existing shareholders for **no additional consideration**. The number of ordinary shares has increased without an increase in resources.

Therefore, **the number of ordinary shares outstanding before the event** must be adjusted for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Reverse share splits are a consolidation of ordinary shares which generally reduces the number of ordinary shares outstanding without a corresponding reduction in resources. However, when the overall effect is a share repurchase at fair value, the reduction in the number of ordinary shares outstanding is the result of a corresponding reduction in resources. The weighted average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognised.

Example: Issue of ordinary share by bonus issue

The profit of CD Co. for the year ended 31 December 20X6 was $5,600,000. For the year ended 31 December 20X7 this increased to $7,000,000.

The company had issued share capital of 1,000,000 ordinary shares as at 31 December 20X6.

On 1 July 20X7, CD Co. issued 400,000 ordinary shares fully paid by way of capitalisation of reserves in the proportion of 2 for 5.

What is the basic EPS of CD Co. for both years?

Solution

Weighted average number of ordinary shares outstanding for year 20X7:

$1{,}000{,}000 + 1{,}000{,}000 \times {}^{2}/_{5} = 1{,}400{,}000$

An alternative calculation of this amount is as follows:

1 Jan 20X7 – 30 June 20X7	1,000,000	× 7/5	× 6/12 months	700,000
Bonus issue	400,000			
1 July 20X7 – 31 Dec 20X7	1,400,000		× 6/12 months	700,000
				1,400,000

Calculation using the tabular approach may prove easier to use in examples where there is more than one issue in the year.

Note that the bonus fraction of 7/5 is calculated as the number of shares post bonus issue/number of shares pre bonus issue, and is applied to all periods in the table **before** the bonus issue.

EPS (20X7) $= \dfrac{\$7{,}000{,}000}{1{,}400{,}000} = \$5.00$

Original EPS (20X6) $= \dfrac{\$5{,}600{,}000}{1{,}000{,}000} = \$5.60$

Restated EPS (20X6) $= \dfrac{\$5{,}600{,}000}{1{,}400{,}000} = \$4.00$

The restated EPS for 20X6 may alternatively be calculated using the reciprocal of the bonus fraction ($\$5.60 \times 5/7 = \$4.00$).

Note. Number of shares for all earlier accounting periods should be adjusted by the new issue as the reserves used for the bonus issue are carried down from prior periods.

HKAS 33, Appendix A.A2

1.5.3 Rights issues

A rights issue of shares is an issue of new shares to existing shareholders **at a price below the current market value**. The offer of new shares is made on the basis of x new shares for every y shares currently held, e.g. a 1 for 3 rights issue is an offer of one new share at the offer price for every three shares currently held.

As the issue price is below market value, a rights issue is treated as a combination of an issue at fair value and a bonus issue.

In order to calculate the weighted average number of shares when there has been a rights issue, an adjustment factor is required:

$$\text{Adjustment factor} = \frac{\text{Pre rights issue price of shares}}{\text{Theoretical ex-rights price (TERP)}}$$

The TERP is the theoretical price at which the shares would trade after the rights issue and takes into account the diluting effect of the bonus element in the rights issue. It is calculated as:

$$\text{TERP} = \frac{\text{Total market value of original shares pre rights issue} + \text{Proceeds of rights issue}}{\text{Number of shares post rights issue}}$$

The adjustment factor is used to increase the number of shares in issue **prior to** the rights issue for the bonus element.

The comparative EPS for the previous period is adjusted by the reciprocal of the rights adjustment factor.

Example: Theoretical ex-rights value

The following information is provided for an entity which is making a rights issue.

	20X2	*20X3*
Profit attributable to ordinary equity holders of the parent entity	$600,000	$720,000

Shares outstanding before rights issue: 100,000 shares
Rights issue: One new share for each five outstanding shares (20,000 new shares total)
Exercise price: $5.00
Date of rights issue: 1 March 20X3
Market price of one ordinary share immediately before exercise on 1 March 20X3: $8.00
Reporting date 31 December

Required

Calculate the theoretical ex-rights value per share and the basic EPS for each of the years 20X2 and 20X3.

Solution

1 Theoretical ex-rights price is calculated as:

$$\frac{(100{,}000 \times \$8.00) + (20{,}000 \times \$5.00)}{120{,}000} = \frac{900{,}000}{120{,}000} = \$7.50$$

An alternative calculation is:

		$
Old shares	5 @ $8.00 =	40.00
New shares	1 @ $5.00 =	5.00
	6	45.00 therefore $45.00/6 = $7.50

2 The adjustment factor is therefore $8.00/$7.50

3 The weighted average number of ordinary shares for 20X3 is therefore calculated as:

1 January – 28 February	100,000 shares × $\frac{\$8.00}{\$7.50}$	× 2/12	17,778
1 March – 31 December	120,000 shares	× 10/12	100,000
Weighted average			117,778

1 Basic EPS for 20X3 is therefore $720,000/117,778 shares = $6.11

2 Basic EPS for 20X2 as originally reported is $600,000/100,000 shares = $6.00

3 Basic EPS for 20X2 as adjusted is $6.00 × $7.50/$8.00 = $5.63

Self-test question 1

Random Co., a listed company, had 5 million ordinary shares in issue at 1 January 20X1. Between this date and 31 December 20X2, the following share issues took place:

1 May 20X1	1 for 5 bonus issue
1 October 20X1	Cash issue: 1 million shares were issued at $3.50. $2.10 has been paid in respect of each share and accordingly holders of these 1m shares are entitled to 60% dividends until such time as the share is fully paid on 31 December 20X1.
1 August 20X2	1 for 7 rights issue at $3.55. The issue was fully subscribed and the market price of a share immediately prior to the issue was $3.65.

Profits for the years ended 31 December 20X1 and 20X2 are $4,981,500 and $6,165,200 respectively.

Required

(a) What is the basic earnings per share as reported in 20X1 and 20X2?

(b) What is the restated 20X1 basic earnings per share figure for inclusion in the 20X2 financial statements?

(The answer is at the end of the chapter)

1.6 Diluted EPS

Topic highlights

Diluted EPS is calculated by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

Like basic EPS, diluted EPS provides a measure of the interest of each ordinary share in the profits of an entity. Unlike basic earnings per share, diluted EPS takes into account **dilutive potential ordinary shares** outstanding during the period.

Diluted EPS is therefore the calculation of what the EPS would have been if all the dilutive potential ordinary shares had been actual shares in issue during the period.

HKAS 33.41-44

1.6.1 Dilutive potential ordinary shares

Dilutive potential ordinary shares are **securities** which do not (at present) have any "claim" to a share of equity earnings, but **may be converted to ordinary shares and so give rise to such a claim in the future**. They include:

- **options** or **warrants**
- **convertible loan stock** or **convertible preference shares**
- **equity shares** which at present are not entitled to any dividend, but will be entitled after some future date.

If these instruments are converted into ordinary shares, the number of shares ranking for dividend will increase, however the profits figure will generally not increase proportionately. Therefore, such a conversion will reduce the profits attributable to each share. In other words they will have a dilutive effect on EPS.

Diluted EPS is therefore calculated to indicate to investors the possible effects of a future dilution.

Note that only **dilutive potential ordinary shares** form part of the diluted EPS calculation. Potential ordinary shares may also be **anti-dilutive**. In this case a conversion would increase the number of ordinary shares but increase earnings to a greater extent, meaning that EPS increases overall.

In determining whether potential ordinary shares are dilutive or antidilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate.

HKAS 33.44

1.6.2 Calculation of diluted earnings per share

Diluted earnings per share is calculated as:

$$\frac{\text{Profits in basic EPS + effect on profit of dilutive potential ordinary shares}}{\text{Number of shares in basic EPS + dilutive potential ordinary shares}}$$

This calculation is achieved in steps, with each group of potentially dilutive ordinary shares added in turn from the most dilutive to the least dilutive. Options and warrants are generally included first as they do not affect the profits part of the calculation.

After each addition, diluted EPS is calculated and the diluted earnings per share is the lowest figure calculated at any stage in the sequence.

HKAS 33.33,35

1.6.3 Impact of potential ordinary shares on profits

The earnings calculated for basic EPS should be adjusted by the **post-tax** (including deferred tax) effect of converting potential ordinary shares.

Adjustments may include:

- any **dividends** on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS.
- **interest recognised** in the period for the dilutive potential ordinary shares.
- any **other changes in income or expenses** (fees and discount, premium accounted for as yield adjustments) that would result from the conversion of the dilutive potential ordinary shares.

The conversion of some potential ordinary shares may lead to changes in **other income or expenses**. For example, the reduction of interest expense related to converting some convertible loan stock and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit-sharing plan. When calculating diluted EPS, the profit or loss for the period is adjusted for any such consequential changes in income or expense.

HKAS 33.36,39,40

1.6.4 Impact of potential ordinary shares on weighted average number of shares

The number of shares calculated for basic EPS should be increased by the weighted average number of ordinary shares that would be issued on the conversion of all the **dilutive potential ordinary shares** into actual ordinary shares in issue.

It should be assumed that dilutive ordinary shares were converted into ordinary shares at the **beginning of the period** or, if later, at the actual date of issue.

There are two other points:

(a) The computation assumes the most **advantageous conversion rate** or exercise rate from the standpoint of the holder of the potential ordinary shares.

(b) A **subsidiary, joint venture or associate** may issue potential ordinary shares that are convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the reporting entity. If these potential ordinary shares have a dilutive effect on the consolidated basic EPS of the reporting entity, they are included in the calculation of diluted EPS.

HKAS 33.45-47A

1.6.5 Share options

Share options are potential ordinary shares which will not impact future profits. Therefore only the denominator (i.e. number of shares) is affected in the diluted earnings per share calculation.

The exercise price of share options is generally lower than the market value of a share, and therefore any exercise of options is viewed as an issue of shares at full (average) market value and an issue of "free" shares. It is these "free" shares which are dilutive. The denominator of the DEPS calculation is increased by the number of "free" shares issuable to reflect this.

Note that where the exercise price of share options exceeds average market value in a period, the options are not dilutive.

Example: A listed company has issued share options

The profit after tax of XY Ltd for the year ended 31 December 20X3 was $3,000,000.

Capital structure

Issued share capital as at 31 December 20X2: 2,000,000 ordinary shares.

On 1 January 20X3, XY Ltd issued 50,000 share options each of which entitled the holder to one ordinary share on payment of $2. The average fair value of one ordinary share during 20X3 was $4.

Solution

Discussion: A company should assume the exercise of options in calculating diluted EPS. The assumed proceeds from these issues should be considered to have been received from the issues of shares at fair value. The difference between the number of shares issued and the number of shares that would have been issued at fair value should be treated as an issue of ordinary shares for no consideration.

The exercise of options has no impact on profits.

Basic EPS (20X3) = $\frac{\$3,000,000}{2,000,000}$ = \$1.50

For calculation of Diluted EPS (20X3)

	Shares
Number of ordinary shares in issue during 20X3	2,000,000
Number of shares under share options 50,000	
Number of shares that would have been issued at fair value = $(50,000 \times {}^{\$2}/_{\$4})$	
Therefore, number of shares issued for no consideration	25,000
	2,025,000

Therefore, diluted EPS (20X3) = $\frac{\$3,000,000}{2,025,000}$ = \$1.48

Where expenses related to employee share options have not yet been recognised in profit or loss in accordance with HKFRS 2, a further adjustment is required to the calculation of diluted earnings per share.

Here, the expense which has not yet been recognised is calculated as a per share option amount. This is then added to the exercise price, before the number of "free" shares is calculated.

Example: Share options (continued)

Assume that in the above example, the share options in issue have been awarded to employees and \$15,000 expense has not yet been recognised in accordance with HKFRS 2.

Therefore:

Exercise price per share = \$2 + (\$15,000/50,000) = \$2.30

Proceeds raised on exercise of options = \$2.30 × 50,000 = \$115,000

\$115,000 / \$4 = 28,750 shares would be issued at fair value, therefore 50,000 − 28,750 = 21,250 "free" shares would be issued

Diluted EPS is therefore based on 2,021,250 shares:

Diluted EPS (20X3) = $\frac{\$3,000,000}{2,021,250}$ = \$1.48

HKAS 33.49-50

1.6.6 Convertible instruments

Convertible loan stock may be dilutive or anti-dilutive. In order to ascertain which the case is, a stand-alone earnings per share amount should be calculated as:

$$\frac{\text{Post tax interest saved on conversion of loan stock}}{\text{Maximum number of potential ordinary shares in respect of the stock}}$$

If the amount calculated is less than basic earnings per share, the loan stock is dilutive and should be included in diluted earnings per share.

Example: Loan stock

Ollivander Co. has a basic earnings per share of 45c for the year ended 30 April 20X1, based on 30 million shares.

The company has in issue $4 million 5% loan stock convertible into ordinary shares at a rate of 20 per $100 in 20X9.

Ollivander pays tax at a rate of 26%.

What is Ollivander's diluted earnings per share for the year ended 30 April 20X1?

Solution

The increase in profits on conversion is:	$4 million × 5% × 74%	=	$148,000
The number of potential ordinary shares is	$4 million / $100 × 20	=	800,000

Earnings per share is therefore $148,000/800,000 = 18.5c. As this is lower than the basic earnings per share of 45c, the convertible loan stock is dilutive and should be considered in the calculation of diluted earnings per share:

Diluted earnings per share

Profits for the year attributable to ordinary shareholders: 45c × 30million = $13.5 million.

$$\text{DEPS } \frac{\$13{,}500{,}000 + \$148{,}000}{30{,}000{,}000 + 800{,}000} = 44.31\text{c}$$

Convertible preference shares are antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per **ordinary share** obtainable on conversion exceeds basic earnings per share.

In this case the instrument should be ignored for the purposes of calculating diluted EPS.

Self-test question 2

Lytton Co. has calculated amounts for basic earnings per share for the year ended 28 February 20X5 in accordance with HKAS 33 as:

Profit attributable to ordinary shareholders	$29,295,000
Weighted average number of ordinary shares	46,500,000

The following is also relevant at 28 February 20X5:

1 There are 100,000 vested employee share options outstanding with an exercise price of $3.20

2 Lytton is also financed via $10 million 6% loan stock convertible into ordinary shares at a rate of:

 18 per $100 in 20X6
 20 per $100 in 20X7
 22 per $100 in 20X8

3 The average market value of a Lytton ordinary share in the year ended 28 February 20X5 was $4.20

4 Lytton pays tax at a rate of 25%

What is diluted earnings per share for the year ended 28 February 20X5?

(The answer is at the end of the chapter)

HKAS 33.52 1.7 Diluted EPS: contingently issuable ordinary shares

Contingently issuable shares may form:

- part of the consideration for the acquisition of another entity. In this case they will only be issued if certain targets are met in the future.
- a performance reward for senior staff members, payable if certain targets are met.

With regard to the calculation of EPS, the following apply in respect of contingently issuable shares:

(a) Until such time as the shares are issued they should not be taken into account when calculating basic EPS.

(b) They should be taken into account when calculating diluted EPS if the conditions leading to their issue have already been satisfied. If the conditions are not satisfied, the number of contingently issuable shares used in the diluted EPS calculation is the number of shares if the end of the period were the end of the contingency period.

(c) Contingently issuable shares are included from the beginning of the period (or from the date of the contingent share agreement, if later).

Restatement is not permitted if the conditions are not met when the contingency period expires.

For example, Company A issued contingently issuable ordinary shares (CIOS) on 1 July 20X7. The conditions are satisfied on 1 July 20X9.

Year ended	Basic EPS	Diluted EPS
31 December 20X7	Do not include the CIOS since the conditions were not satisfied as at that date.	Include, from 1 July 20X7 to 31 December 20X7, the CIOS shares that would be issuable if 31 December 20X7 was the end of the contingency period.
31 December 20X8	Do not include the CIOS since the conditions were not satisfied as at that date.	Include, from 1 January 20X8 to 31 December 20X8, the CIOS that would be issuable if 31 December 20X8 was the end of the contingency period.
31 December 20X9	Include the CIOS from 1 July 20X9.	Include, from 1 January 20X9 to 30 June 20X9, the CIOS that would be issuable at 30 June 20X9.

Restatement of 20X7 and 20X8's diluted EPSs is not permitted.

HKAS 33.53 1.7.1 Contingent on future earnings

The condition for contingent issue may be achieving or maintaining a specified level of earnings for a particular period.

In this case, if the effect is dilutive, the calculation of diluted EPS is based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period.

Because earnings may change in future periods, the calculation of basic EPS does not include such CIOS until the end of the contingency period because not all necessary conditions have been satisfied.

HKAS 33.54 1.7.2 Contingent on future market price of the ordinary shares

The number of ordinary shares contingently issuable may depend on the future market price of the ordinary shares.

In that case, if the effect is dilutive, the calculation of diluted EPS is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period.

If the condition is based on an average of market prices over a period of time that extends beyond the end of the reporting period, the average for the period of time that has lapsed is used.

Because the market price may change in a future period, the calculation of basic EPS does not include such CIOS until the end of the contingency period because not all necessary conditions have been satisfied.

HKAS 33.55

1.7.3 Contingent on both future earnings and future market price of the ordinary shares

The number of ordinary shares contingently issuable may depend on future earnings and future prices of the ordinary shares. In such cases, the number of ordinary shares included in the diluted EPS calculation is based on both conditions (i.e. earnings to date and the current market price at the end of the reporting period).

CIOS are not included in the diluted EPS calculation unless both conditions are met.

Example: Contingently issuable shares

QQ Co. had 20,000,000 ordinary shares outstanding as at 1 January 20X6. On 1 July 20X6, it acquired a business from YY Co.. In accordance with the agreement, the initial consideration of $20 million is to be satisfied by the issue of 1,000,000 ordinary shares in QQ Co. and, if the average annual profit of the business acquired for the following three financial years ending 31 December 20X8 is more than $8 million, additional shares should be issued to YY Co. at 1 July 20X9. The number of shares to be issued will be calculated as follows:

$$\frac{\text{Average annual profit} - \$8{,}000{,}000}{20}$$

The audited financial statements of the business for the year ended 31 December 20X6, 20X7 and 20X8 report a profit of $12,000,000, $5,000,000 and $4,000,000 respectively.

Required

Calculate the weighted average number of shares (WANOS) to use when calculating basic and diluted EPS of QQ Co. for each of the three years ended 31 December 20X6, 20X7 and 20X8.

Solution

Year ended 31 December 20X6

As the conditions for the issue of the additional ordinary shares to YY Co. have not been satisfied as at 31 December 20X6, no contingently issuable shares were considered outstanding for inclusion in the computation of basic EPS for the year ended 31 December 20X6. The denominator of basic EPS was calculated as follows:

$20{,}000{,}000 + (1{,}000{,}000 \times {}^{6}/_{12}) = 20{,}500{,}000$ shares

The original contingency period is the three-year period ending 31 December 20X8. Assuming the contingency period ended at 31 December 20X6, the average annual profit was $12,000,000 and according to the agreement 200,000 ordinary shares should be issued to YY Co.:

$$\frac{\$12{,}000{,}000 - \$8{,}000{,}000}{20} = 200{,}000 \text{ shares}$$

The denominator of the diluted EPS was calculated as follows:

$20{,}500{,}000 + (200{,}000 \times {}^{6}/_{12}) = 20{,}600{,}000$ shares

Year ended 31 December 20X7

As the conditions for the issue of the additional ordinary shares to YY Co. have not been satisfied as at 31 December 20X7, no contingently issuable shares were considered outstanding for inclusion in the computation of basic EPS for the year ended 31 December 20X7. The denominator of basic EPS was 21,000,000 shares.

Assuming the contingency period ended at 31 December 20X7, the average annual profit was:

$$\frac{\$12,000,000 + \$5,000,000}{2} = \$8,500,000$$

and according to the agreement 25,000 ordinary shares should be issued to YY Co.:

$$\frac{\$8,500,000 - \$8,000,000}{20} = 25,000 \text{ shares}$$

The denominator of the diluted EPS was calculated as follows:

21,000,000 + 25,000 = 21,025,000 shares

Restatement of diluted EPS for the year ended 31 December 20X6 previously reported is not permitted.

Year ended 31 December 20X8

As the conditions for the issue of the additional ordinary shares to YY Co. have not been satisfied as at 31 December 20X8, no contingently issuable shares were considered outstanding for inclusion in the computation of basic EPS for the year ended 31 December 20X8. The denominator of basic EPS was 21,000,000 shares.

Assuming the contingency period ended at 31 December 20X8, the average annual profit was:

$$\frac{\$12,000,000 + \$5,000,000 + \$4,000,000}{3} = \$7,000,000$$

and according to the agreement no ordinary shares should be issued to YY Co..

HKAS 33.66,68,69

1.8 Presentation

An entity should present on the face of the **statement of profit or loss and other comprehensive income** the basic and diluted EPS for profit and loss:

- from continuing operations
- for the period

for each class of ordinary share that has a different right to share in the net profit for the period.

The basic and diluted EPS should be presented with **equal prominence** for all periods presented.

If an entity is reporting a discontinued operation, the basic and diluted EPS for the **discontinuing operation** must also be presented.

Disclosure must still be made where the EPS figures (basic and/or diluted) are **negative** (i.e. a loss per share).

1.9 Significance of earnings per share

EPS is one of the most frequently quoted statistics in the financial analysis of listed companies. Because of the widespread use of the price/earnings **(P/E) ratio** as a yardstick for investment decisions, it has become increasingly important. Since the P/E ratio is calculated as the market price per share divided by the EPS, it is important that a standard method of calculating EPS is used by all quoted companies.

It seems that reported and forecast EPS can, through the P/E ratio, have a **significant effect on a company's share price**. Thus, a share price might fall if it looks as if EPS is going to be low. This is not very rational, as EPS can depend on many, often subjective, assumptions used in preparing the statement of profit or loss and other comprehensive income. It does not necessarily bear any relation to the value of a company, and of its shares. Nevertheless, in practice the market is sensitive to EPS.

EPS is commonly used as a means of assessing the **stewardship and management** role performed by company directors and managers. Remuneration packages are often linked to EPS growth, thereby increasing the pressure on management to improve EPS. The danger of this, however, is that management effort may go into distorting results to produce a favourable EPS.

1.10 Limitations of EPS

Although EPS is an important ratio, it does have a number of limitations. Users of the ratio should be aware of these limitations and the opportunities for manipulation:

- Its calculation is complex and may not be understood by non-accountants.
- It is based on historic profits, which may not be indicative of future profits.
- It is affected by accounting policy and changes in policy.
- It ignores risk; the maximisation of EPS does not guarantee benefits or capital growth to shareholders.
- It does not take account of the capital structure of an entity, so is not directly comparable between two companies.
- It is open to manipulation by share buy-backs which increase EPS, but also increase a company's risk by increasing its borrowings.

Topic recap

HKAS 33 *Earnings Per Share*

Earnings per share is a measure of the amount of profits earned by a company for each ordinary share

Basic EPS

$$\frac{\text{Profit/loss attributable to ordinary shareholders}}{\text{Weighted average ordinary shares}}$$

Profit/loss attributable to ordinary shareholders

Profit	X
Amounts attributable to irredeemable preference share holders	(X)
	X

Weighted average ordinary shares

Time apportion calculation for new share issues

Bonus issue: Adjust number of shares before issue by:

$$\frac{\text{No of shares after issue}}{\text{No of shares before issue}}$$

Rights issue: Adjust number of shares before issue by:

$$\frac{\text{Pre-rights issue share price}}{\text{Theoretical ex-rights price}}$$

Theoretical ex-rights price:

$$\frac{\text{Market value of ordinary shares pre rights issue + proceeds of rights issue}}{\text{No of shares post rights issue}}$$

Diluted EPS

$$\frac{\text{Basic EPS profit + effect on profit of dilutive potential ord shares}}{\text{No of shares in basic EPS + dilutive potential ordinary shares}}$$

Options:
- No effect on profit
- Increase no of shares by "free" shares

Convertible loan stock/preference shares:
- Increase profit by post-tax interest saved
- Increase no of shares

Contingently issuable ordinary shares are only taken into account if conditions leading to their issue are satisfied.

1 Check if potential ordinary shares are individually dilutive or anti-dilutive
2 Add in dilutive potential ordinary shares one at a time starting with the most dilutive
3 Diluted EPS is the lowest calculated EPS figure at any stage.

Disclose basic and diluted EPS from continuing and discontinued (where relevant) operations on the face of the statement of profit or loss and other comprehensive income.

Answers to self-test questions

Answer 1

(a) **20X1**

1 Jan 20X1 – 30 April 20X1	5,000,000	× 6/5 × 4/12 months	2,000,000
Bonus issue 5m/5	1,000,000		
1 May 20X1 – 30 Sept 20X1	6,000,000	× 5/12 months	2,500,000
Part paid cash issue 1m × 60%	600,000		
1 Oct 20X1 – 31 Dec 20X1	6,600,000	× 3/12 months	1,650,000
			6,150,000

Therefore, earnings per share is $\dfrac{4{,}981{,}500}{6{,}150{,}000}$ = 81.00c

20X2

NB the part paid shares are now fully paid and therefore the opening balance of shares is 7m rather than 6.6m

1 Jan 20X2 – 31 July 20X2	7,000,000	× 3.65/3.64 × 7/12 months	4,094,551
Rights issue 7m/7	1,000,000		
1 August 20X2 – 31 Dec 20X2	8,000,000	× 5/12 months	3,333,333
			7,427,884

Computation of theoretical ex-rights price

$$\frac{\text{Fair value of all outstanding shares} + \text{total received from exercise of rights}}{\text{Number of shares outstanding prior to exercise} + \text{number of shares issued in exercise}} = \frac{(\$3.65 \times 7) + (\$3.55 \times 1)}{8} = \$3.64$$

Therefore earnings per share is $\dfrac{6{,}165{,}200}{7{,}427{,}884}$ = 83.00c

(b) **Restated 20X1 basic EPS**

$81\text{c} \times \dfrac{3.64}{3.65} = 80.78\text{c}$

Answer 2

Basic EPS = $\frac{\$29,295,000}{46.5\,\text{million}}$ = 63 cents

Consider dilutive effects of options:

Proceeds raised on exercise:	100,000 × \$3.20	=	\$320,000
Therefore, shares issued at market value:	\$320,000/\$4.20	=	76,190
"Free" shares: 100,000 – 76,190		=	23,810

Consider dilutive effect of loan stock:

Post tax interest saving (\$10m × 6% × 75%)	=	\$450,000
Additional shares (\$10m/\$100 × 22)	=	2,200,000

(note that the worst case conversion scenario is assumed)

EPS of this instrument is therefore 20.45 cents. As this is less than basic EPS, the instrument is dilutive and should be taken into account in the calculation of diluted EPS.

Diluted EPS is therefore 61.05c:

Basic	$\frac{29,295,000}{46,500,000}$	63.00c
With options	$\frac{29,295,000}{46,500,000 + 23,810}$	62.97c
With loan stock	$\frac{29,295,000 + 450,000}{46,500,000 + 23,810 + 2,200,000}$	61.05c

Exam practice

Silver Coin Holdings Limited

23 minutes

Silver Coin Holdings Limited reported the following information in relation to the results and equity structure for each of the years ended 30 June 20X8 and 20X9:

Year ended 30 June	*20X8*	*20X9*
Profit for the year (before interest expense)	$32,800,000	$8,000,000
Equity structure:		
Ordinary shares ("OS")	220,000,000	228,500,000
Redeemable, convertible preference shares ("PS") issued on 1 July 20X7	3,000,000	2,000,000
Cumulative annual dividend of $0.30 per share		
Convertible into eight ordinary shares per preference share		
Outstanding share options	1,000,000	1,000,000
Average market price of one ordinary share during the year	$1.80	$1.65

The PS were issued at $10 which represented the then market price on the date of issue. 1,000,000 PS were converted into OS on 1 January 20X9. 500,000 ordinary shares were issued to new investors at $1.40 per share on 1 October 20X8. No dividend was declared by the company during the year ended 30 June 20X8, $0.45 dividend was declared to PS holders on 31 December 20X8.

All 1,000,000 share options, with exercise price for one ordinary share at $1.50 per option, were granted to employees on 1 July 20X6. Each grant is conditional upon the employee working for the company over two years.

The company did not have other borrowings outstanding during both the two years ended 30 June 20X9.

Required

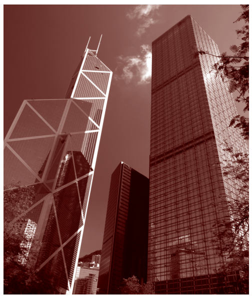
(a) Calculate the basic earnings per share for each of the years ended 30 June 20X8 and 20X9. **(7 marks)**

(b) Calculate the diluted earnings per share for the year ended 30 June 20X9. **(6 marks)**

(Total = 13 marks)

(**Note.** Tax effect is ignored and a reasonable approximation of the weighted average number of shares by the number of months that the shares are outstanding as a proportion of the total months in a year is adequate.)

HKICPA February 2010 (amended)



chapter 23

Operating segments

Topic list

1 HKFRS 8 *Operating Segments*

1.1 Objective of HKFRS 8
1.2 Scope of HKFRS 8
1.3 Definitions
1.4 Identifying reportable segments
1.5 Disclosures
1.6 Key criticisms of HKFRS 8
1.7 Summary of HKFRS 8

Learning focus

Listed companies are required to apply HKFRS 8 *Operating Segments* and you must be able to identify reportable operating segments and the required disclosures.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.23	**Operating segments**	3
3.23.01	Identify and discuss the nature of segmental information to be disclosed in accordance with HKFRS 8	
3.23.02	Explain when operating segments should be aggregated and disaggregated	
3.23.03	Disclose the relevant information for operating segments and appropriate entity-wide information	

1 HKFRS 8 *Operating Segments*

Topic highlights

HKFRS 8 *Operating Segments* requires that a listed entity identifies reportable operating segments and discloses financial information in respect of them.

Many entities now operate on a multinational basis in a number of different geographical and product markets. These distinct markets may operate very differently from one another and be subject to different levels of risks and returns, and differing future prospects.

The reason for segment reporting is to provide users of accounts with information on such segments so that they can make a better assessment of an entity's past performance and position, and identify which segments of an entity are successful and which are less so.

1.1 Objective of HKFRS 8

An entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

HKFRS 8.2

1.2 Scope of HKFRS 8

HKFRS 8 applies only to entities:

- whose equity or debt securities are traded in a public market (i.e. on a stock exchange); or
- which is in the process of listing securities in a public market.

It also applies to group financial statements where the parent meets the above criteria. In group accounts, only **consolidated** segmental information needs to be shown.

HKFRS 8.5,7

1.3 Definitions

HKFRS 8 provides one definition:

Key term

An **operating segment** is a component of an entity:

(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),

(b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(c) for which discrete financial information is available. *(HKFRS 8)*

The term "chief operating decision maker" identifies a function, not necessarily a manager with a specific title. That function is to allocate resources and to assess the performance of the entity's operating segments.

1.4 Identifying reportable segments

Topic highlights

Reportable segments are **operating segments** or aggregation of operating segments that meet the "10% test".

HKFRS 8 requires entities within its scope to report financial and descriptive information about its **reportable segments**, so the first task is to understand which segments are reportable. Reportable segments are either individual operating segments or aggregations of operating segments (see below) that meet the specified criteria (the "10% test" explained below).

HKFRS 8.12

1.4.1 Aggregation of operating segments

Two or more operating segments **below** the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in:

- the **nature of the products and services**
- the **nature of the production processes**
- the **type or class of customer for their products and services**
- the **methods used to distribute their products or provide their services**
- if applicable, the **nature of the regulatory environment** (e.g. banks).

HKFRS 8.13,15,19

1.4.2 Quantitative thresholds

An entity should report separate information about **each operating segment** that:

(a) has been identified as meeting the **definition of an operating segment**, and

(b) segment total is **10% or more of total**:

(i) **revenue** (internal and external)
(ii) **profits** for all segments reporting a profit (or all segments in loss if greater), or
(iii) **assets**

At least **75% of total external revenue** must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

Operating segments that do not meet **any of the quantitative thresholds** may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

HKFRS 8 suggests that there may be a limit to the number of reportable segments that an entity separately discloses before information becomes too detailed. It suggests that when the number of reportable segments increases above ten, the entity should consider whether a practical limit has been reached.

Self-test question 1

Styledesign, a listed clothing manufacturer, trades in five business areas which are reported separately in its internal accounts provided to the chief operating decision maker. The results of these segments for the year ended 31 December 20X1 are as follows.

OPERATING SEGMENT INFORMATION AS AT 31 DECEMBER 20X1

	Revenue					
	External $m	*Internal* $m	*Total* $m	*Segment profit/(loss)* $m	*Segment assets* $m	*Segment liabilities* $m
Ladies' fashion: Asia	14	7	21	1	31	14
Rest of world	56	3	59	13	78	34
Mens' fashion	59	8	67	9	104	35
Childrens' fashion	22	0	22	(2)	30	12
Sportswear	12	3	15	2	18	10
Uniforms	18	24	42	(1)	54	19
	181	45	226	22	315	124

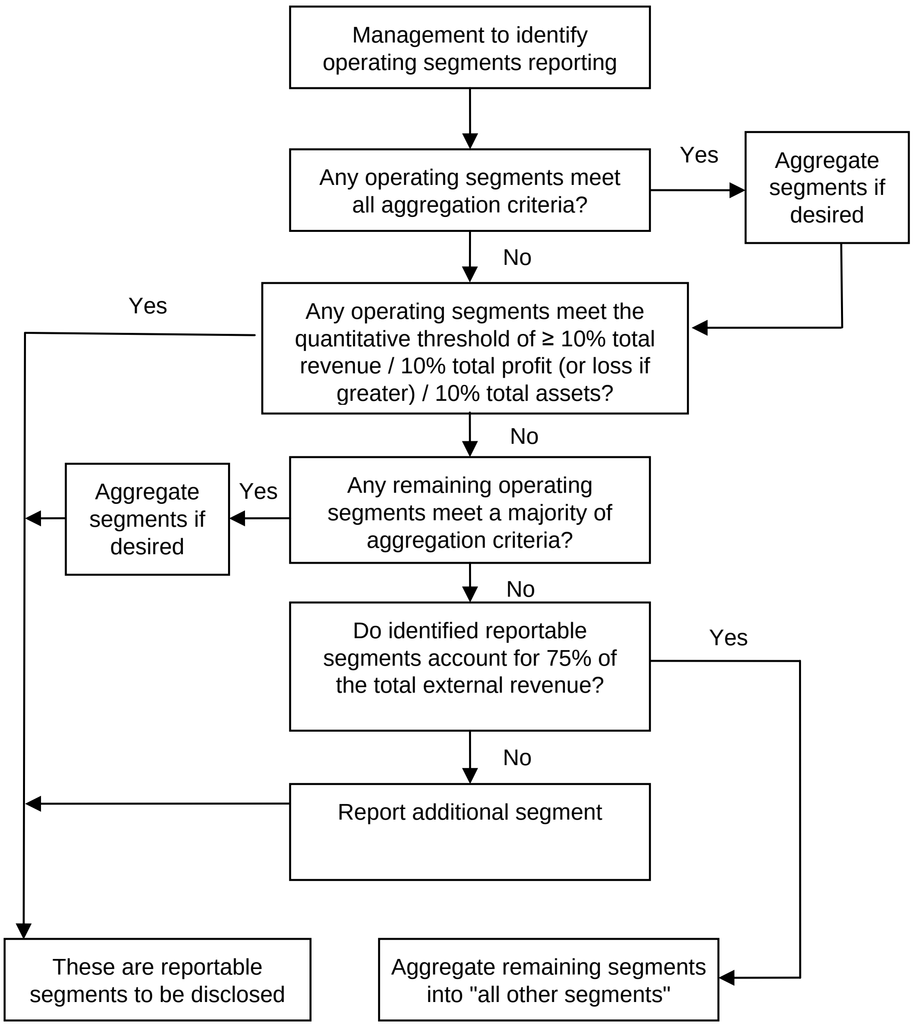
Required

Which of the operating segments of Styledesign constitute a "reportable" operating segment under HKFRS 8 *Operating Segments* for the year ending 31 December 20X1?

(The answer is at the end of the chapter)

1.4.3 Decision tree to assist in identifying reportable segments

The following decision tree will assist in identifying reportable segments.



HKFRS 8.29,30

1.4.4 Restatement of previously reported information

If an entity **changes the structure of its internal organisation** in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, shall be **restated** unless the information is not available and the cost to develop it would be excessive. The determination of whether the cost is excessive shall be made for each individual item of disclosure. Following a change in the composition of its reportable segments, an entity shall **disclose** whether it has restated the corresponding items of segment information for earlier periods.

If an entity has **changed the structure of its internal organisation** in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is **not restated** to reflect the change, the entity shall disclose in the year in which the change occurs segment information for the current period on both the **old basis and**

the new basis of segmentation, unless the necessary information is not available and the cost to develop it would be excessive.

HKFRS 8.20-24,28,33,34

1.5 Disclosures

Topic highlights

HKFRS 8 disclosures are of:

- general information about segments
- financial information about segments
  - segment profit or loss
  - segment assets
  - segment liabilities
  - basis of measurement

Disclosures are also required about the revenues derived from products or services and about the countries in which revenues are earned or assets held, even if that information is not used by management in making decisions.

Disclosures required by the HKFRS are extensive, and best learned by looking at the example and proforma, which follow the list.

(a) General information

(i) Factors used to identify the entity's reportable segments

(ii) **Types of products and services** from which each reportable segment derives its revenues

(b) Financial information; for each reportable segment the entity must disclose:

(i) profit or loss
(ii) total assets
(iii) total liabilities

The following further items must also be disclosed if they are reported to the chief operating decision maker:

Profit, assets and liabilities

- Revenue
  - External
  - Inter-co segment
- Interest revenue
- Interest expense
- Depreciation and amortisation
- Other material non-cash items
- Material items of income/expense (HKAS 1)
- Share of profit of associates/joint ventures equity accounted
- Profit or loss (as reported to chief operating decision maker)
- Income tax expense
- Non-current assets[(1)]
- Investments in associates/joint ventures

A **reconciliation** of the total of each of the above material items to the entity's reported figures is required.

(c) **External revenue** from external customers for each product and service (unless the cost of developing this information would be excessive).

(d) **Geographical information**

Geographical areas → External revenue[2] / Non-current assets[1]

By:
- Entity's country of domicile, and
- All foreign countries (subdivided if material)

Notes

1 Non-current assets excludes financial instruments, deferred tax assets, post-employment benefit assets, and rights under insurance contracts.

2 External revenue is allocated based on the customer's location.

(e) Information about **reliance on major customers** (i.e. those who represent more than 10% of external revenue).

1.5.1 Disclosure example from HKFRS 8

The following example is adapted from the HKFRS 8 *Implementation Guidance*, which emphasises that this is for illustrative purposes only and that the information must be presented in the most understandable manner in the specific circumstances.

The hypothetical company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration, denominated in thousands of dollars, are assumed to be the amounts in reports used by the chief operating decision maker.

Illustration: Disclosure example from HKFRS 8

	Car parts $'000	*Software* $'000	*Finance* $'000	*All other* $'000	*Totals* $'000
Revenues from external customers	8,000	21,500	5,000	1,000[a]	35,500
Intersegment revenues	–	4,500	–	–	4,500
Interest revenue	1,250	2,500	–	–	3,750
Interest expense	950	1,800	–	–	2,750
Net interest revenue[b]	–	–	1,000	–	1,000
Depreciation and amortisation	300	1,550	1,100	–	2,950
Reportable segment profit	270	3,200	500	100	4,070
Other material non-cash items:					
Impairment of assets	200	–	–	–	200
Reportable segment assets	7,000	15,000	57,000	2,000	81,000
Expenditure for reportable segment non-current assets	1,000	1,300	600	–	2,900
Reportable segment liabilities	4,050	9,800	30,000	–	43,850

Notes

(a) Revenues from segments below the quantitative thresholds are attributable to four operating segments of the company. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.

(b) The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, as permitted by HKFRS 8, only the net amount is disclosed.

1.5.2 Suggested proforma

Information about profit or loss, assets and liabilities

	Segment A	*Segment B*	*Segment C*	*All other segments*	*Inter segment*	*Entity total*
Revenue – external customers	X	X	X	X	–	X
Revenue – inter segment	X	X	X	X	X	–
	X	X	X	X	(X)	X
Interest revenue	X	X	X	X	(X)	X
Interest expense	(X)	(X)	(X)	(X)	X	(X)
Depreciation and amortisation	(X)	(X)	(X)	(X)	–	(X)
Other material non-cash items	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Material income/expense (HKAS 1)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)	X/(X)
Share of profit of associate/JVs	X	X	X	X	–	X
Segment profit before tax	X	X	X	X	(X)	X
Income tax expense	(X)	(X)	(X)	(X)	–	(X)
Unallocated items						X/(X)
Profit for the year						X
Segment assets	X	X	X	X	(X)	X
Investments in associate/JVs	X	X	X	X	–	X
Unallocated assets						X
Entity's assets						X
Expenditures for reportable assets	X	X	X	X	(X)	X
Segment liabilities	X	X	X	X	(X)	X
Unallocated liabilities						X
Entity's liabilities						X

Information about geographical areas

	Country of domicile	*Foreign countries*	*Total*
Revenue – external customers	X	X	X
Non-current assets	X	X	X

1.6 Key criticisms of HKFRS 8

(a) Some commentators have criticised the "managerial approach" as leaving segment identification **too much to the discretion of the entity**.

(b) The managerial approach may mean that financial statements of different entities are **not comparable**.

(c) The segments may include operations with **different risks and returns**.

(d) There is **no defined measure** of segment profit or loss.

1.7 Summary of HKFRS 8

HKFRS 8 is a **disclosure standard** which applies only to **listed companies**:

- **Segment reporting** is necessary for a better understanding and assessment of:
  - past performance
  - the economic environment
  - informed judgments
- HKFRS 8 adopts the **managerial approach** to identifying segments.
- The standard gives guidance on how segments should be **identified** and **what information should be disclosed** for each.

It also sets out **requirements for related disclosures** about products and services, geographical areas and major customers.

Topic recap

HKFRS 8 Operating Segments

Requires that a listed entity identifies reportable operating segments and discloses financial information in respect of them

Operating segment is a component of an entity:

- That engages in business activities from which it may earn revenues and incur expenses
- Whose results are regularly reviewed by the entity's chief operating decision maker
- For which discrete financial information is available

Reportable segments

A segment is reportable if:

1. it meets the definition of an operating segment
2. the segment total ≥ 10% of total:
   - revenue
   - profits (for all segments in profit, or all in loss if greater), or
   - assets

If reportable segments do not make up ≥ 75% total external revenue, additional segments not meeting the 10% test are reported.

Disclosures

- General information about segments
- Financial information for each segment:
  – Profit or loss
  – Total assets
  – Total liabilities
  – Other items reported to the chief operating decision maker
- External revenue
- Geographical information
- Reliance on major customers

Answer to self-test question

Answer 1

	Revenue as % of total revenue ($226m)	*Profit or loss as % of profit of all segments in profit ($25m)*	*Assets as % of total assets ($315m)*
Ladies' fashion *	35.4%	56%	34.6%
Mens' fashion	29.6%	36%	33.0%
Childrens' fashion	9.7%	8%	9.5%
Sportswear	6.6%	8%	5.7%
Uniforms	18.6%	4%	17.1%

* The ladies' fashion segments are aggregated due to their similar economic characteristics

At 31 December 20X1 three of the five operating segments are reportable operating segments:

Ladies' fashion

All size criteria are met

Mens' fashion

All size criteria are met

Children's fashion

The children's fashion segment is not separately reportable as it does not meet the quantitative thresholds. It can, however, still be reported as a separate operating segment if management believes that information about the segment would be useful to users of the financial statements. Alternatively, the group could consider amalgamating it with another segment, providing the two operating segments have similar economic characteristics and share a **majority** of the "aggregation" criteria, which may be the case, particularly if "uniforms" refers to school uniforms. Otherwise it would be disclosed in an "All other segments" column.

Sportswear

The sportswear segment does not meet the quantitative thresholds and therefore is not separately reportable. It can also be reported separately if management believes the information would be useful to users. Alternatively, the group may be able to amalgamate it with another segment, providing the operating segments have similar economic characteristics and share a majority of the "aggregation" criteria. Otherwise, it would also be disclosed in an "All other segments" column.

Uniforms

The uniforms segment meets the quantitative threshold in respect of revenue and assets and so is reported separately.

Note. HKFRS 8.15 states that at least 75% of total external revenue must be reported by operating segments. This condition has been met as the reportable segments (excluding children's wear and sportswear) account for 81% of total external revenue (147/181).

Exam practice

HKFRS 8

18 minutes

Ms. Li, the finance manager of a company listed on The Stock Exchange of Hong Kong Limited, is assessing the segment reporting requirements under HKFRS 8 *Operating Segments* included in the financial statements of the company and has tentatively concluded that:

(a) the company has a free choice in determining a business activity or business activities as an operating segment;

(b) the company can have 12 reportable segments;

(c) segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the company; and

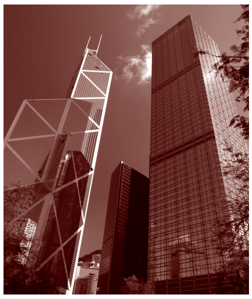
(d) during the financial year, the company disposed of the businesses of one of its reportable segments. The company is required to restate the comparatives segment information in the financial statements for the current year.

Required

Please comment on the above conclusions with reference to HKFRS 8 *Operating Segments*.

(10 marks)

HKICPA May 2007



chapter 24

Interim financial reporting

Topic list

1 **HKAS 34 *Interim Financial Reporting***
- 1.1 Objective
- 1.2 Scope
- 1.3 Definitions
- 1.4 Minimum components
- 1.5 Form and content
- 1.6 Periods covered
- 1.7 Materiality
- 1.8 Recognition and measurement principles
- 1.9 Applications of the recognition and measurement principles
- 1.10 Use of estimates
- 1.11 HK(IFRIC) Int-10 *Interim Financial Reporting and Impairment*

Learning focus

The preparation of interim financial statements is relevant for evaluating the performance of a listed entity. Therefore, the application of accounting standards is very important to measure the performance in a consistent manner.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.24	**Interim financial reporting**	3
3.24.01	Identify the circumstances in which interim financial reporting is required in accordance with HKAS 34	
3.24.02	Explain the purpose and advantages of interim financial reporting	
3.24.03	Explain the recognition and measurement principles of interim financial statements and apply them	
3.24.04	Disclose the relevant information for interim financial statements including seasonality	

1 HKAS 34 *Interim Financial Reporting*

Topic highlights

HKAS 34 does not mandate which entities should publish an interim financial report. For entities that do publish such reports, it lays down principles and guidelines for their production. However, it is up to government and regulators to decide what specific rules should apply to Hong Kong.

1.1 Objective

The objective of HKAS 34 is to **prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period**.

Relevant and reliable interim financial reporting enhances users' understanding of the performance and position of an entity. In addition, it may be a requirement for some companies.

The advantages of interim reporting are:

(a) financial information is more useful if provided more frequently and in a timely manner.

(b) it provides up to date information, since investors do not only make investment and divestment decisions at period ends.

(c) investors can see the impact of events soon after they occur.

(d) interim information may help to project financial amounts for the full year.

(e) interim results can provide evidence of trends and seasonality which is not evident from annual results.

HKAS 34.1

1.2 Scope

The standard does not make the preparation of interim financial reports **mandatory** for any company, taking the view that this is a matter for governments, securities regulators, stock exchanges or professional accountancy bodies to decide within each country. HKICPA encourages publicly traded entities to provide interim financial reports that conform to the recognition, measurement, and disclosure principles set out in this standard.

The standard recommends that in respect of public listed companies,

(a) an interim financial report should be produced by such companies for **at least the first six months of their financial year** (i.e. a half year financial report)

(b) the report should be **available no later than 60 days** after the end of the interim period.

Thus, a company with a year ending 31 December should prepare an interim report for the half year to 30 June and this report should be available before the end of August.

HKAS 34.4

1.3 Definitions

The following definitions are used in HKAS 34.

Key terms

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements (as described in HKAS 1) or a set of condensed financial statements (as described in this standard) for an interim period. *(HKAS 34)*

HKAS 34.6,8

1.4 Minimum components

The standard specifies the **minimum component elements** of an interim financial report:

- Condensed statement of financial position
- Condensed statement of profit or loss and other comprehensive income
- Condensed statement of changes in equity
- Condensed statement of cash flows
- Selected explanatory notes

The rationale for requiring only condensed statements and selected note disclosures is that entities need not duplicate information in their interim report that is contained in their report for the previous financial year. Interim statements should **focus more on new events, activities and circumstances**.

HKAS 34. 9-11

1.5 Form and content

HKAS 1 should be followed when full financial statements are given as interim financial statements, otherwise HKAS 34 states the minimum contents that should be disclosed.

Where condensed financial statements are given instead, they should include, at least, those headings and subtotals that appeared in its most recent annual financial statements and selected explanatory notes. Additional items or notes should be presented if their omission results in misleading condensed interim financial statements.

Where an entity is within the scope of HKAS 33 *Earnings Per Share* it should present basic and diluted EPS for the interim period.

HKAS 34.15,15A, 16A,19

1.5.1 Selected explanatory notes

According to HKAS 34, an entity should include in its interim report an explanation of events and transactions that are **significant** to an understanding of changes in financial position and performance since the end of the last reporting period. Information disclosed in relation to those events and transactions should update the relevant information presented in the most recent annual financial report.

It is not necessary for the notes to the interim accounts to provide relatively insignificant updates to the information provided in the most recent annual financial report.

In addition to disclosing significant events and transactions, an entity should include the following in its interim financial statements:

(a) A statement that the **same accounting policies and methods of computation** are followed in the interim statements as compared with the most recent annual financial statements. If any policy or method has changed, a description of the nature and effect of the change is required.

(b) Explanatory comments on the **seasonality or "cyclicality"** of operations.

(c) The **nature and amount** of items affecting assets, liabilities, equity, net income or cash flows, that are unusual, because of their nature, size or incidence.

(d) Nature and amount of **changes in estimates** of amounts reported in earlier interim reports of the same financial year, or prior financial years.

(e) The **issue, repayment and repurchase** of equity or debt securities.

(f) **Dividends paid** on ordinary shares and dividends paid on other shares.

(g) Where segment information is provided in the annual financial statements, the following should be disclosed in the interim financial statements:

  (i) Revenues from external customers (if included in the measure of profit reviewed by the chief operating decision maker);

  (ii) Intersegment revenues (if included in the measure of profit reviewed by the chief operating decision maker);

  (iii) A measure of segment profit or loss;

  (iv) A measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there has been a material change from the amount disclosed in the last financial statements for that reportable segment;

  (v) A description of differences in the basis of segmentation or measurement of profit or loss from the last annual financial statements;

  (vi) A reconciliation of total profit or loss of reportable segments to the entity's profit or loss before tax and discontinued operations.

(h) Events after the interim period that have not been reflected in the financial statements for the interim period;

(i) The effect of the acquisition or disposal of subsidiaries during the interim period.

(j) For financial instruments, the disclosures about fair value required by HKFRS 13 *Fair Value Measurement* and HKFRS 7 *Financial Instruments: Disclosures*.

(k) For entities becoming or ceasing to be investment entities, the relevant HKFRS 12 disclosures.

The kinds of disclosure required may include corrections of prior period errors, inventory write downs and the acquisition and disposal of items of property, plant and equipment.

Except as required above, the disclosures required by other HKFRS are not required if an entity's interim financial report includes only condensed financial statements and selected explanatory notes rather than a complete set of financial statements.

The entity should also disclose the fact that the interim report has been produced **in compliance with HKAS 34** on interim financial reporting.

Self-test question 1

Give some examples of the type of disclosures required according to the above list of explanatory notes.

(The answer is at the end of the chapter)

HKAS 34.20

1.6 Periods covered

As required by the standard, financial information for the following periods or as at the following dates should be provided in interim financial reports:

(a) **Statement of financial position data** as at the end of the current interim period, and comparative data as at the end of the most recent financial year.

(b) **Statement of profit or loss and other comprehensive income data** for the current interim period and cumulative data for the current year to date, together with comparative data for the corresponding interim period and cumulative figures for the previous financial year.

(c) **Statement of changes in equity data** should be for both the current interim period and for the year to date, together with comparative data for the corresponding interim period, and cumulative figures, for the previous financial year.

(d) **Statement of cash flows data** should be cumulative for the current year to date, with comparative cumulative data for the corresponding interim period in the previous financial year.

HKAS 34.23

1.7 Materiality

In deciding how to account for an item in an interim financial report, materiality should be assessed in relation to the interim period financial data. It should be recognised that interim measurements may **rely to a greater extent on estimates** than annual financial data.

HKAS 34.28

1.8 Recognition and measurement principles

HKAS 34 strongly emphasises the recognition and measurement principles and the guidelines for their practical application. The guiding principle is that identical recognition and measurement principles should be used in an entity's interim and annual financial statements.

To illustrate, a cost that is not regarded as an asset in the year-end statement of financial position should not be treated so in the statement of financial position for an interim period, Likewise, an accrual of income or expense for a transaction that has not been incurred (or a deferral of income or expense) is not suitable for interim reporting, just as it is for year-end reporting.

A remeasurement of the amounts that were reported in a financial statement of a previous interim period may have to be carried out in a later interim period or at the year-end because of the application of this recognition and measurement principle. Disclosure of the nature and amount of any significant reassessments is required.

HKAS 34.37

1.8.1 Revenues received occasionally, seasonally or cyclically

The revenue recognition principle should be applied consistently in both interim and year-end reports. Revenue which is not recurring i.e. received as an occasional item, or of seasonal or cyclical nature, should not be anticipated or deferred in the annual financial statements, as well as in the interim financial statements.

HKAS 34.39

1.8.2 Costs incurred unevenly during the financial year

Anticipation or deferral of these costs (i.e. recorded as accruals or prepayments) is done only if it would be appropriate to do so in the annual financial statements.

To illustrate, it would not be appropriate to anticipate expenses which have not yet been incurred e.g. part of the cost of a major advertising campaign happening later in the reporting year, where no expenses have been incurred. On the other hand, it would be necessary to anticipate a rental cost of a property where the rental is paid in arrears.

HKAS 34 Illustrative examples Section B

1.9 Applications of the recognition and measurement principles

Specific applications of the recognition and measurement principles are provided in an appendix to the standard. Some of these examples are explained below, by way of explanation and illustration.

1.9.1 Payroll taxes and insurance contributions paid by employers

The assessment of these costs is done annually in some countries, though they are paid at an uneven rate during the year. A large portion of the taxes is paid in the earlier phase of the year while a much smaller portion is paid in the later part of the year. This situation thus entails the use of an estimated average annual tax rate in an interim statement, not the actual tax paid since the taxes are assessed on an annual basis, even though the payments pattern is uneven.

1.9.2 Cost of a planned major periodic maintenance or overhaul

In the absence of a legal or constructive obligation to carry out major periodic maintenance or overhaul, the cost of this kind of work in the later phase of the year must not be anticipated in an interim financial statement. The fact that a maintenance or overhaul is planned and is carried out annually is not a justification for the anticipation of the cost in an interim financial report.

1.9.3 Other planned but irregularly-occurring costs

Likewise, no accrual is to be made in an interim report for costs such as charitable donations or employee training costs which are planned to be incurred later in the year. These costs are considered as discretionary, even if they occur regularly and are planned.

1.9.4 Year-end bonus

Unless there is a legal or constructive obligation to pay a year-end bonus (e.g. a contractual obligation, or a regular past practice) and a reliable measure on the size of the bonus, such a bonus should not be provided for in an interim financial statement.

Example: Bonus

BlueBear's year end is 31 December and it is currently preparing interim financial statements for the six months to 30 June 20X1. It has a contractual agreement with its staff that it will pay them an annual bonus equal to 8% of their annual salary if the full year's output exceeds 5,000,000 units.

Budgeted output is 5,500,000 units and the entity has achieved budgeted output during the first six months of the year. Annual salaries are estimated to be $80 million, with the salary cost in the first half year to 30 June being $35 million.

Required

How should the bonus be reflected in the interim financial statements?

Solution

It is probable that the bonus will be paid, given that the actual output already achieved in the year is in line with budgeted figures, which exceed the required level of output. So a bonus of $2.8 million (8% × $35m) should be recognised in the interim financial statements at 30 June 20X1.

1.9.5 Holiday pay

The same principle is to be applied to holiday pay. An accrual must be made for any unpaid accumulated holiday pay in the interim financial report if the holiday pay is an enforceable obligation on the employer.

1.9.6 Non-monetary intangible assets

Expenses might be incurred during an interim period on items that might or will generate non-monetary intangible assets. According to HKAS 38 *Intangible Assets*, with the exception of those costs that constitute part of the cost of an identifiable intangible asset, other costs relating to the generation of non-monetary intangible assets (e.g. development expenses) should be recognised as an expense when incurred. Costs that were initially recognised as an expense cannot be treated as part of the cost of an intangible asset in a later period. The same approach should be adopted in interim financial statements as mentioned in HKAS 34. That is to say, unless a cost will eventually be part of a non-monetary intangible asset that has not yet been recognised, it would not be appropriate to have it "deferred"; it should be expensed in the interim report.

1.9.7 Depreciation

Depreciation and amortisation should be calculated and charged in an interim statement only on non-current assets already acquired. No such calculation is required for those non-current assets to be acquired later in the financial year.

1.9.8 Foreign currency translation gains and losses

HKAS 21 should be applied and the amounts should be computed based on the same principles as at the financial year end.

1.9.9 Tax on income

An income tax expense (tax on profits), calculated based on an estimated average annual tax rate for the year, should be included in the interim statements of an entity. To illustrate, suppose a tax rate of 20% is to be applied on the first $500,000 of a company's profit and 22% on profits above $500,000. A company which makes a profit of $500,000 in its first half year, and expects to make $500,000 in the second half year should apply an expected annual average tax rate of 21% in the interim financial report, not 20%. Since income tax on company profits is charged on an annual basis, an effective annual rate is therefore considered as appropriate for each interim period.

Suppose a company earns pre-tax income of $300,000 in the first quarter of the year, but expects a loss of $100,000 in each of the following three quarters, so that net income before tax for the whole year is zero. Assume also that the tax rate for the current year is 20%. The loss will not be anticipated in this case and thus a tax charge of $60,000 should be recorded for the first quarter of the year (20% of $300,000) and a negative tax charge of $20,000 for each of the next three quarters, if actual losses are the same as anticipated.

Where the tax year and the financial year of a company do not coincide, a separate estimated weighted average annual tax rate should be used in the interim periods that fall within the tax year.

Tax credits are given, based on amounts of capital expenditure or research and development and so on, to set off against the tax payable in some countries. If these credits are calculated and granted annually, it is appropriate to include anticipated tax credits within the calculation of the estimated average tax rate for the year. This average tax rate is then applied to calculate the income tax for interim periods. However, in the case of a tax benefit relating to a specific one-time event, it should be recognised within the tax expense for the interim period in which the event occurs.

Self-test question 2

Flyman is currently preparing interim financial statements for the six months to 30 June 20X1. Its profit before tax for the six-month period to 30 June 20X1 is $5 million. The business is seasonal and the profit before tax for the six months to 31 December 20X1 is almost certain to be $9 million. Income tax is calculated as 14% of reported annual profit before tax if it does not exceed $10 million. If annual profit before tax exceeds $10 million the tax rate on the whole amount is 16%.

Required

Under HKAS 34 what should the taxation charge be in the interim financial statements?

(The answer is at the end of the chapter)

1.9.10 Inventory valuations

Inventories should be valued in the same manner in both interim reports and final accounts, though the valuation in interim reports may rely more heavily on estimates.

The net realisable value of inventories should be estimated from selling prices and the related costs to complete and dispose of at interim dates.

Example: Inventory valuation

Callcut is currently preparing interim financial statements for the half year to 30 June 20X1. The price of its products tends to vary. At 30 June 20X1, it has inventories of 500,000 units, at a cost per unit of $5.00. The net realisable value of the inventories is $4.50 per unit at 30 June 20X1. The expected net realisable value of the inventories at 31 December 20X1 is $5.10 per unit.

Required

How should the value of the inventories be reflected in the interim financial statements?

Solution

The value of the inventories in the interim financial statements at 30 June 20X1 is the lower of cost and NRV at 30 June 20X1. This is:

500,000 × $4.50 = $2.25m

HKAS 34.41

1.10 Use of estimates

It is vital that accounting information must be reliable and free from material error. However, a certain degree of accuracy and reliability might have to be sacrificed for the sake of timeliness and cost-benefits. This is particularly true where much less time can be devoted to the preparation of interim financial statements than at the financial year end. The standard therefore recognises that estimates for assessing values or even some costs will have to be used, to a greater extent, in interim financial reporting than in year-end reporting.

An appendix to HKAS 34 gives some examples of the use of estimates.

(a) **Inventories**. An entity might not need to carry out a full inventory count at the end of each interim period. Instead, it may be sufficient to estimate inventory values using sales margins.

(b) **Provisions**. An entity might employ outside experts or consultants to advise on the appropriate amount of a provision, as at the year end (for example, a provision for environmental or site restoration costs). It will probably be inappropriate to employ an expert to make a similar assessment at each interim date. Similarly, an entity might employ a professional valuer to revalue non-current assets at the year end, whereas at the interim date(s) the entity will not rely on such experts.

(c) **Income taxes**. The rate of income tax (tax on profits) will be calculated at the year end by applying the tax rate in each country/jurisdiction to the profits earned there. At the interim stage, it may be sufficient to estimate the rate of income tax by applying the same "blended" estimated weighted average tax rate to the income earned in all countries/jurisdictions.

The principle of **materiality** applies to interim financial reporting, as it does to year-end reporting. In assessing materiality, it needs to be recognised that interim financial reports will rely more heavily on estimates than year-end reports. Materiality should be assessed in relation to the interim financial statements themselves, and should be independent of "annual materiality" considerations.

If an estimate of an amount reported in an interim period changes significantly during the second period of the financial year but a separate financial report is not published for that second period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

1.11 HK(IFRIC) Int-10 *Interim Financial Reporting and Impairment*

There is a prominent conflict about the recognition and reversal in financial statements of impairment losses on goodwill and certain financial assets between the requirements of HKAS 34 *Interim Financial Reporting* and those in other standards. HK(IFRIC) Int-10 concludes the following:

(a) An entity **must not reverse an impairment loss** recognised in a previous interim period in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost.

(b) An entity **must not extend this consensus** by analogy to other areas of potential conflict between HKAS 34 and other standards.

Topic recap

HKAS 34 Interim Financial Reporting

- Lays down the principles and guidelines for production of interim financial statements
- Does not mandate which entities should produce them

Minimum components:

- Condensed statement of financial position
- Condensed statement of profit or loss and other comprehensive income
- Condensed statement of changes in equity
- Condensed statement of cash flows
- Selected notes
- Basic and diluted EPS if within scope of HKAS 33

The same headings and sub-totals as those in the most recent annual financial statements should be used.

Notes should include an explanation of significant events and transactions in the interim period and comments on seasonality.

Recognition and measurement principles:

- Should be identical to those applied in the annual financial statements
- Seasonal revenue is not anticipated/deferred
- Unevenly incurred costs are not anticipated/ deferred unless appropriate.

Example applications of recognition and measurement principles:

- No accrual made for planned costs in second half of year e.g. maintenance or overhaul
- No accrual made for year-end bonus unless there is a legal or constructive obligation to pay
- Include an income tax expense based on an estimated average annual tax rate for the year

Estimates for assessing values or costs will have to be used to a greater extent in interim financial reporting than in year-end financial reporting, e.g.

- Estimation of inventory values in the place of a full inventory count
- Using management estimates in interim reports to measure revaluations or provisions rather than external experts.

Answers to self-test questions

Answer 1

HKAS 34 provides the following list of events and transactions for which disclosures would be required if they were significant:

(a) The write down of inventories to net realisable value and the reversal of such a write-down

(b) Recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, or other assets, and the reversal of such a loss

(c) Reversal of any provisions for the costs of restructuring

(d) Acquisitions and disposals of items of property, plant and equipment

(e) Litigation settlements

(f) Corrections of prior period errors

(g) Changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets and liabilities are recognised at fair value or amortised cost

(h) Any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period

(i) Related party transactions

(j) Transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments.

(k) Changes in the classification of financial assets as a result of a change in the purpose or use of those assets, and

(l) Changes in contingent liabilities or contingent assets.

This list is not exhaustive.

Individual HKFRS provide guidance regarding disclosure requirements for many of the items listed above. When the events or transactions listed are significant, the interim report should provide an explanation of and update to the relevant information included in the financial statements of the last annual reporting period.

Answer 2

The taxation charge in the interim financial statements is based upon the weighted average rate for the year. In this case the entity's tax rate for the year is expected to be 16%. The taxation charge in the interim financial statements will be $5m × 16% = $800,000.

Exam practice

Hintrim

18 minutes

Hintrim's accounting year ends on 31 December each year and it is currently preparing interim financial statements for the half year to 30 June 20X4.

The financial controller is unsure about how to deal with three issues relating to HKAS 34 *Interim Financial Reporting*, and has asked for your help.

(a) Hintrim has a contractual agreement with its staff that it will pay them an annual bonus equal to 10% of their annual salary if the full year's output exceeds one million units. Budgeted output is 1.4 million units and the entity has achieved budgeted output during the first six months of the year. Annual salaries are estimated to be $100 million, with the cost in the first half year to 30 June being $45 million.

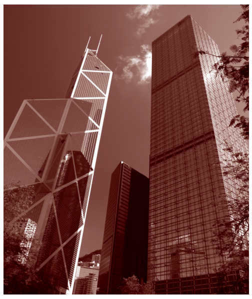
How should the bonus be reflected in the interim financial statements?

(b) The price of Hintrim's products tends to vary. At 30 June 20X4, it has inventories of 100,000 units, at a cost per unit of $1.40. The net realisable value of the inventories is $1.20 per unit at 30 June 20X4. The expected net realisable value of the inventories at 31 December 20X4 is $1.55 per unit.

How should the value of the inventories be reflected in the interim financial statements?

(c) Hintrim's profit before tax for the six-month period to 30 June 20X4 is $6 million. The business is seasonal and the profit before tax for the six months to 31 December 20X4 is almost certain to be $10 million. Income tax is calculated as 25% of reported annual profit before tax if it does not exceed $10 million. If annual profit before tax exceeds $10 million the tax rate on the whole amount is 30%.

Advise the financial controller. **(10 marks)**



chapter 25

Presentation of financial statements

Topic list

Learning focus

HKAS 1 affects all entities and you must be familiar with the requirements of the standard.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Prepare the financial statements for an individual entity in accordance with Hong Kong Financial Reporting Standards and statutory reporting requirements		
4.01	**Primary financial statement preparation**	3
4.01.01	Prepare the statement of financial position, the statement of profit or loss and other comprehensive income, the statement of changes in equity and the statement of cash flows of an entity in accordance with Hong Kong accounting standards	
4.01.02	Explain the minimum line items that should be presented in the financial statements and criteria for additional line items	
4.02	**Financial statement disclosure requirements**	3
4.02.01	Disclose accounting policy and items required by the HKFRS, Companies Ordinance and other rules and regulations	
4.02.02	Explain the importance to disclose significant judgment and estimates	

1 Reporting financial performance

Topic highlights

HKAS 1 (Revised) provides guidance on the content and format of a set of financial statements.

HKAS 1.10

1.1 HKAS 1 *Presentation of Financial Statements*

HKAS 1 (Revised) states that a complete set of financial statements includes the following:

(a) A statement of financial position as at the end of the period.

(b) A statement of profit or loss and other comprehensive income for the period.

(c) A statement of changes in equity for the period.

(d) A statement of cash flows for the period.

(e) Notes, comprising a summary of significant accounting policies and other explanatory information.

(f) Comparative information in respect of the preceding period.

(g) A statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

These financial statements must be clearly identified and distinguished from other information in the same published document.

The statement of cash flows is dealt with in Chapter 19 of this Learning Pack; the statements of financial position, profit or loss and other comprehensive income and changes in equity are considered in more detail in later sections of this chapter.

1.1.1 Terminology

HKAS 1 was revised in 2007 and some of the names of the main financial statements were changed. The title 'statement of comprehensive income' was further changed to be 'statement of profit or loss and other comprehensive income' by a 2011 amendment to the standard.

The use of the new terms listed above is not mandatory; and in practice, an entity may continue to use the 'old' titles such as "balance sheet" instead of "statement of financial position". The following table lists the old names alongside the new:

Old	New
Balance sheet	Statement of financial position
Income statement	Statement of profit or loss and other comprehensive income
Cash flow statement	Statement of cash flows

1.1.2 Performance reporting

HKAS 1 (Revised) focuses on aggregating transactions with similar characteristics and therefore requires that changes in equity are classified as one of two types, and reported accordingly:

(a) Changes in equity arising from transactions with owners in their capacity as owners (e.g. dividends and share issues) are reported in the **statement of changes in equity**.

(b) Changes in equity arising from all other transactions are reported in the **statement of profit or loss and other comprehensive income**.

The statement of profit or loss and other comprehensive income therefore includes both:

- the profit or loss for the period and
- other comprehensive income.

HKAS 1.7

Other comprehensive income is defined by HKAS 1 (Revised) as **income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other HKFRS**. The standard goes on to list the components of other comprehensive income as:

(a) changes in the revaluation surplus

(b) those actuarial gains and losses on defined benefit plans not recognised in profit or loss

(c) gains and losses arising from translating the financial statements of a foreign operation

(d) gains and losses from investments in equity instruments measured at fair value through other comprehensive income

(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge

HKAS 1.38, 38A

1.1.3 Comparative information

Other than where HKFRS permit otherwise, comparative information should be presented for the preceding period for all amounts reported in the current period's financial statements. Comparative narrative information should also be provided where this is relevant to an understanding of the current period's financial statements.

As a minimum, an entity should present:

- Two statements of financial position
- Two statements of profit or loss and other comprehensive income
- Two statements of cash flows
- Two statements of changes in equity, and
- Related notes.

HKAS 1.40A, 40B

1.1.4 Additional statement of financial position

HKAS 1 (Revised) requires that a statement of financial position is presented as at the beginning of the preceding period when an entity:

(i) applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements, and

(ii) the retrospective application or restatement or the reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period.

In effect, this will result in the presentation of three statements of financial position when there is a material prior period adjustment: one at the end of the current period, one at the end of the preceding period and one at the start of the preceding period.

1.2 Statement of financial position

1.2.1 Proforma

The HKAS 1 (Revised) format is given below.

ABC GROUP – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER

	20X9	*20X8*
	$'000	$'000
ASSETS		
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity investments measured at fair value through other comprehensive income	142,500	156,000
	901,620	945,460
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	564,880	578,740
Total assets	1,466,500	1,524,200
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	903,700	782,900
Non-controlling interests	70,050	48,600
Total equity	973,750	831,500
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	177,650	238,280
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	315,100	454,420
Total liabilities	492,750	692,700
Total equity and liabilities	1,466,500	1,524,200

HKAS 1.54,55,58,59

1.2.2 Disclosure requirements

As a minimum HKAS 1 (Revised) requires that the statement of financial position (balance sheet) includes the following:

(a) Property, plant and equipment

(b) Investment property

(c) Intangible assets

(d) Financial assets (excluding amounts shown under (e), (h) and (i))

(e) Investments accounted for using the equity method

(f) Biological assets

(g) Inventories

(h) Trade and other receivables

(i) Cash and cash equivalents

(j) The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

(k) Trade and other payables

(l) Provisions

(m) Financial liabilities (excluding amounts shown under (k) and (l))

(n) Liabilities and assets for current tax, as defined in HKAS 12 *Income Taxes*

(o) Deferred tax liabilities and deferred tax assets, as defined in HKAS 12

(p) Liabilities included in disposal groups classified as held for sale in accordance with HKFRS 5

(q) Non-controlling interests, presented within equity, and

(r) Issued capital and reserves attributable to owners of the parent

Additional line items should be presented when they are relevant to an understanding of an entity's position. In deciding whether additional items should be presented separately, HKAS 1 (revised) requires that assessment is made of:

- the nature and liquidity of assets
- the function of assets within the entity, and
- the amounts, nature and timing of liabilities.

Where different measurement bases are used for different classes of assets (e.g. historic cost or revalued amount), the standard suggests that their nature or function differs and they should be presented separately.

In addition, HKAS 1 (revised) requires that the line items presented in the statement of financial position are further sub-classified in a manner appropriate to the entity's operations either in the statement of financial position or in the notes.

HKAS 1.60,66,69,72, 74,75

1.2.3 Current / non-current classification

An entity must present **current** and **non-current assets**, and **current** and **non-current liabilities**, as **separate classifications** in the statement of financial position except where a presentation based on liquidity provides more relevant and reliable information. In this case, all assets and liabilities should be presented broadly in order of liquidity.

HKAS 1 (Revised) provides the criteria for classification of an asset or liability as current. Any other items are classified as non-current:

	Current asset		Current liability
(a)	The entity expects to realise, sell or consume the asset in its normal operating cycle	(a)	The entity expects to settle the liability in its normal operating cycle
(b)	The asset is held primarily for trading	(b)	The liability is held primarily for trading
(c)	The entity expects to realise the asset within 12 months after the reporting period	(c)	The liability is due to be settled within 12 months after the reporting period
(d)	The asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least the 12 months after the reporting period	(d)	The entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect the classification

A **long-term financial liability** due to be **settled within 12 months** of the end of reporting period should be classified as a **current liability**, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.

End of reporting period	Agreement to refinance on long-term basis	Date financial statements authorised for issue	Settlement date <12 months after the reporting period

A **long-term financial liability** that is **payable on demand** because the entity **breached** a **condition** of its loan agreement should be classified as **current** at the end of reporting period even if the **lender** has agreed **after the reporting period**, and **before** the financial statements are **authorised for issue**, **not** to **demand payment** as a consequence of the breach.

Condition of loan agreement breached. Long-term liability becomes payable on demand	End of reporting period	Lender agrees not to enforce payment resulting from breach	Date financial statements approved for issue

However, if the **lender** has **agreed** by the **end of reporting period** to provide a **period of grace** ending **at least 12 months after the reporting period** within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as **non-current**.

HK Interpretation 5 was issued in November 2010. It sets out the conclusions of the HKICPA in relation to whether a term loan subject to a repayment on demand clause should be classified as current or non-current.

HKICPA concludes that the classification depends on the rights and obligations of the lender and borrower as contractually agreed and in force at the reporting date. Where a lender has an **unconditional right** to call the loan at any time, it must be classified by the borrower as **current**, regardless of the probability of the lender exercising their right within 12 months.

HKAS 1.79

1.2.4 Disclosure of share capital and reserves

HKAS 1 requires that the following information is disclosed either in the statement of financial position or statement of changes in equity or notes to the accounts:

(a) For each class of share capital:

(i) the number of shares authorised

(ii) the number of shares issued and fully paid, and issued but not fully paid

(iii) par value per share, or that the shares have no par value

(iv) a reconciliation of the number of shares outstanding at the beginning and end of the period

(v) the rights of each class of shares

(vi) shares held by the entity itself or a subsidiary or an associate, and

(vii) shares reserved for issue under options and contracts for the sale of shares, including terms and amounts, and

(b) A description of the nature and purpose of each reserve within equity.

Note that the new Companies Ordinance in Hong Kong abolishes the concepts of authorised share capital and par value per share from 2014.

HKAS 1.10,10A

1.3 Statement of profit or loss and other comprehensive income

HKAS 1 (Revised) allows the presentation of the statement of profit or loss and other comprehensive income in one of two ways:

(a) As a single statement ("the statement of profit or loss and other comprehensive income")

(b) As two statements:

(i) A statement of profit or loss
(ii) A statement which details other comprehensive income

1.3.1 Proforma: single statement

The following proforma shows the format of the statement of profit or loss and other comprehensive income where a single statement is used.

Illustration: Statement of profit or loss and other comprehensive income (single statement) given in HKAS 1

ABC GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9 (SINGLE STATEMENT)

	20X9	*20X8*
	$'000	$'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	933	3,367
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to items that will not be reclassified to profit or loss	(350)	(2,100)
Items that may be reclassified to profit or loss		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(24,667)	22,667
Income tax relating to items that may be reclassified to profit or loss	5,017	(7,234)
Other comprehensive income for the year, net of tax	14,000)	28,000
Total comprehensive income for the year	107,250	93,500
Profit attributable to		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Total comprehensive income attributable to		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500
Earnings per share (in currency units)		
Basic and diluted	0.46	0.30

1.3.2 Proforma: two statements

The two statement approach to the statement of profit or loss and other comprehensive income is shown in the following illustration:

Illustration: Statement of profit or loss and other comprehensive income (in two statements) given in HKAS 1

ABC GROUP – STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X9

	20X9	*20X8*
	$'000	$'000
Revenue	390,000	355,000
Other income	20,667	11,300
Changes in inventories of finished goods and work in progress	(115,100)	(107,900)
Work performed by the entity and capitalised	16,000	15,000
Raw material and consumables used	(96,000)	(92,000)
Employee benefits expense	(45,000)	(43,000)
Depreciation and amortisation expense	(19,000)	(17,000)
Impairment of property, plant and equipment	(4,000)	–
Other expenses	(6,000)	(5,500)
Finance costs	(15,000)	(18,000)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operation	–	(30,500)
PROFIT FOR THE YEAR	121,250	65,500
Profit attributable to		
Owners of the parent	97,000	52,400
Non-controlling interests	24,250	13,100
	121,250	65,500
Earnings per share (in currency units)		
Basic and diluted	0.46	0.30

ABC GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	20X9	*20X8*
	$'000	$'000
PROFITS FOR THE YEAR	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	933	3,367
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to items that will not be reclassified to profit or loss	(350)	(2,100)
Items that may be reclassified to profit or loss		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(24,667)	22,667
Income tax relating to items that may be reclassified to profit or loss	5,017	(7,234)
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	93,500

	20X9	20X8
	$'000	$'000
Total comprehensive income attributable to		
Owners of the parent	85,800	74,800
Non-controlling interests	21,450	18,700
	107,250	93,500

HKAS 1.81A, 82, 85-87,99

1.3.3 Disclosure requirements

In addition to the profit or loss section and other comprehensive income section, the following should be presented in the statement of profit or loss and other comprehensive income:

(a) Profit or loss

(b) Total other comprehensive income

(c) Comprehensive income for the period, being the total of profit or loss and other comprehensive income.

The profit or loss section should include line items that present the following amounts for the period:

(a) Revenue

(b) Gains and losses arising from the derecognition of financial assets measured at amortised cost

(c) Finance costs

(d) Share of the profit or loss of associates and joint ventures accounted for using the equity method

(e) If a financial asset is reclassified so that it is measured at fair value, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date

(f) Tax expense

(g) A single amount for the total of discontinued operations.

The following items must also be disclosed in the statement of profit or loss and other comprehensive income as allocations for the period:

(a) Profit or loss for the period attributable to:

(i) non-controlling interests
(ii) owners of the parent

(b) Total comprehensive income for the period attributable to:

(i) non-controlling interests
(ii) owners of the parent

Additional line items, headings and subtotals should also be presented when such presentation is relevant to an understanding of the entity's financial performance. In order to determine whether additional lines are necessary, an entity should consider materiality and the nature and function of items of income and expense.

When items of income or expense are material, their nature and amount must be disclosed separately, either in the statement of profit or loss and other comprehensive income or in the notes to the accounts.

An analysis of expenses by either nature or function, whichever provides information that is reliable and more relevant, should also be disclosed either in the statement of profit or loss and other comprehensive income or in the notes to the accounts.

HKAS 1 does not permit the following in the statement of profit or loss and other comprehensive income:

- The offsetting of income and expenses (unless required or permitted by an HKFRS)
- The presentation of any items of income or expense as extraordinary items.

HKAS 1. 82A, 90-91, 94

1.3.4 Presentation of other comprehensive income

Other comprehensive income items should be presented classified by nature and grouped into those items which, in accordance with other HKFRS,

(a) will not be reclassified subsequently to profit or loss, and
(b) will be reclassified subsequently to profit or loss when specific conditions are met.

Items of other comprehensive income should be presented either:

- net of related tax effects, or
- before related tax effects, with one amount shown for the aggregate amount of income tax relating to those items.

Where the second approach is adopted, the amount of tax should be allocated between those items which may be reclassified subsequently to profit or loss and those which will not.

Reclassification adjustments relating to components of other comprehensive income should be disclosed either in the statement of profit or loss and other comprehensive income or in the notes to the accounts. These are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in previous periods. Users can use this information to assess the impact of reclassifications on profit or loss.

HKAS 1.106,106A

1.4 Statement of changes in equity

The statement of changes in equity provides a reconciliation of the shareholders' funds brought forward and shareholders' funds carried forward. Shareholders' funds consist of ordinary share capital, share premium, revaluation reserve, retained earnings and any other components of equity.

The following should be disclosed:

(a) Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to the non-controlling interests.

(b) For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with HKAS 8, and

(c) For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:

 (i) profit or loss;

 (ii) other comprehensive income; and

 (iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners, and changes in ownership interests in subsidiaries that do not result in a loss of control.

An analysis of the other comprehensive income reported in the statement of changes in equity must be provided either:

- within the statement of changes in equity itself, or
- in the notes to the accounts.

The analysis should identify, for each balance within shareholders' funds, individual items of other comprehensive income aggregated within it. This enables users of the accounts to see in which reserve each type of other comprehensive income is accumulated.

1.4.1 Proforma

ABC GROUP – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X9

	Share capital	*Retained earnings*	*Translation of foreign operations*	*Financial assets at FV through OCI*	*Cash flow hedges*	*Revaluation surplus*	*Total*	*Non-controlling interests*	*Total equity*
Balance at	$'000	$'000	$'000	$'000	$'000	$'000	$'000	$'000	$'000
1 January 20X8	600,000	118,100	(4,000)	1,600	2,000	–	717,700	29,800	747,500
Changes in accounting policy	–	400	–	–	–	–	400	100	500
Restated balance	600,000	118,500	(4,000)	1,600	2,000	–	718,100	29,900	748,000
Changes in equity for 20X8									
Dividends	–	(10,000)	–	–	–	–	(10,000)	–	(10,000)
Total comprehensive income for the year	–	53,200	6,400	16,000	(2,400)	1,600	74,800	18,700	93,500
Balance at 31 December 20X8	600,000	161,700	2,400	17,600	(400)	1,600	782,900	48,600	831,500
Changes in equity for 20X9									
Issue of share capital	50,000	–	–	–	–	–	50,000	–	50,000
Dividends	–	(15,000)	–	–	–	–	(15,000)	–	(15,000)
Total comprehensive income for the year	–	96,600	3,200	(14,400)	(400)	800	85,800	21,450	107,250
Transfer to retained earnings	–	200	–	–	–	(200)	–	–	–
Balance at 31 December 20X9	650,000	243,500	5,600	3,200	(800)	2,200	903,700	70,050	973,750

Self-test question 1

The accountant of Chinatea Co. has returned to work after a sabbatical break of some years. She is unaware of the issue of HKAS 1 (revised) or the new Companies Ordinance and has prepared draft financial statements as follows in accordance with what she remembers of HKAS 1 prior to the revision:

BALANCE SHEET AT 31 DECEMBER 20X9

	$	$
Non-current assets		525,000
Long term receivable		10,000
		535,000
Current assets		
Inventories	31,200	
Receivables	56,450	
Cash	10,900	
		98,550
		633,550
Share capital and reserves		
Ordinary share capital (40,000 shares)		40,000
Profits reserve		379,540
		419,540
Liabilities		
Current liabilities	114,010	
Loan stock 20Y6	100,000	
		214,010
		633,550

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X9

	$
Turnover	1,235,000
Cost of sales	(740,000)
Administrative expenses	(267,020)
Distribution and other expenses	(115,230)
Operating profit	112,750
Interest payable	(7,400)
Profit before tax	105,350
Tax	(33,700)
Profit after tax	71,650
Dividends	(25,000)
Retained profit	46,650

The following information is also relevant:

(a) The accountant has prepared a working schedule of non-current assets as follows:

	Land and buildings	*Fixtures and fittings*	*Patent*	*Total*
	$	$	$	$
Cost b/f	700,000	200,000	30,000	930,000
Additions	–	15,000	–	15,000
Cost c/f	700,000	215,000	30,000	945,000
Depreciation b/f	337,500	60,000	2,500	400,000
Charge for year	12,500	5,000	2,500	20,000
Depreciation c/f	350,000	65,000	5,000	420,000
Carrying value	350,000	150,000	25,000	525,000

There have been no disposals of non-current assets in the period.

(b) A property was to be revalued at the end of the reporting period to $600,000. The property had cost $400,000 including $80,000 in respect of land. Depreciation on the property at the end of the reporting period was $180,000. This has not been reflected in the financial statements. Deferred tax relating to the revaluation amounts to $95,000.

(c) Current liabilities include a short-term provision of $20,000 and tax liability of $33,700.

(d) There was a 1 for 3 bonus issue of shares in the year which was funded by the proceeds of previous share issues.

(e) The long-term receivable balance relates to a customer who has been given an extended two-year credit period.

Required

Re-draft the financial statements of Chinatea Co., including a statement of changes in equity in accordance with HKAS 1 (revised). Comparatives are not required.

(The answer is at the end of the chapter)

1.5 Other aspects of HKAS 1

As well as prescribing the format and content of the financial statements, HKAS 1 provides guidance on the general features of financial statements.

HKAS 1.15,16,18,19, 20,23

1.5.1 True and fair view and compliance with HKFRS

Financial statements must present a true and fair view of the financial position, performance and cash flows of an entity. In other words, they must faithfully represent the effects of transactions and other events in accordance with the basic principles of the *Conceptual Framework*.

The application of HKFRS and additional disclosure where necessary is presumed to result in a true and fair view, and an entity which complies with HKFRS should state this fact in the notes to the accounts. Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

In extremely rare circumstances, compliance with a requirement of an HKFRS or HK(IFRIC) may be so misleading that it would conflict with the objective of financial statements set out in the *Conceptual Framework*, in which case the entity shall depart from that specific requirement.

In the case of such a departure, the entity must disclose the following:

1 That management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows.

2 That it has complied with applicable HKFRS except that it has departed from a particular requirement to achieve a true and fair view.

3 Full details of the departure, and

4 The impact on the financial statements for each item affected and for each period presented.

If the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:

1 The relevant HKFRS, the nature of the requirement and the reason why complying with the requirement is misleading.

2 For each period presented, the adjustments to each item in the financial statements that would be necessary to achieve a true and fair view.

HKAS 1.25

1.5.2 Going concern

As part of the process of preparing financial statements, the management of an entity should assess the entity's ability to continue as a going concern.

Where doubt exists as to this ability, any uncertainties should be disclosed.

Where an entity is not a going concern, the financial statements should not be prepared on a going concern basis and this fact should be disclosed together with:

- the basis on which the financial statements have been prepared
- the reason why the entity is not regarded as a going concern.

HKAS 1.29,30

1.5.3 Materiality and aggregation

HKAS 1 provides the following definition of material:

Key term

Material. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

(HKAS 1 (revised))

The standard requires that:

(a) each material class of similar items is presented separately

(b) items of a dissimilar nature or function should be presented separately unless they are immaterial

If a line item in the financial statements is not individually material, it is aggregated with other items; an item which is not sufficiently material to warrant separate presentation in an individual statement may warrant separate presentation in the notes.

HKAS 1.117,122

1.5.4 Disclosure of accounting policies

An entity must provide a summary of accounting policies and within it disclose the following:

(a) The measurement basis (or bases) used in preparing the financial statements, and

(b) The other accounting policies used that are relevant to an understanding of the financial statements.

An entity must disclose, in the summary of significant accounting policies and/or other notes, the **judgments** made by management in **applying** the **accounting policies** that have the **most significant effect** on the amounts of items recognised in the financial statements.

HKAS 1.125

1.5.5 Estimation uncertainty

An entity must disclose in the notes information regarding **key assumptions** about the **future**, and other sources of **measurement uncertainty**, that have a significant **risk of** causing a **material adjustment** to the carrying amounts of assets and liabilities within the **next financial year**.

HKAS 1.107,137

1.5.6 Dividends

Entities may not present dividends on equity instruments in the statement of profit or loss. **Equity dividends must be presented on the face of the statement of changes in equity or in the notes**.

This reflects the fact that an equity dividend distribution is an owner change in equity, which must be presented separately from non-owner changes in equity.

Equity dividends declared after the reporting date but before the financial statements are authorised for issue should be considered as a non-adjusting event after the reporting period. HKAS 1 permits an entity to make this disclosure either:

1 on the face of the statement of financial position as a separate component of equity
2 in the notes to the financial statements

1.5.7 Other matters

As well as those matters covered above, HKAS 1 (Revised) also requires the following:

(a) The accrual basis of accounting is used in the preparation of all financial statements except for the statement of cash flows.

(b) Assets and liabilities and income and expenses are not offset unless permitted or required by another HKFRS.

(c) A complete set of financial statements including comparative is presented at least annually.

(d) The presentation and classification of items in the financial statements is consistent from one period to the next unless another presentation or classification becomes more appropriate or an HKFRS requires another presentation or classification.

(e) Except when HKFRS permit or require otherwise, an entity shall disclose comparative information in respect of the previous period for all amounts reported in the current period's financial statements.

2 Current developments

In 2004, together with FASB, the IASB started a project to develop a standard to replace both IAS 1 *Presentation of Financial Statements* and IAS 7 *Statement of Cash Flows*. The Boards' goal is to reassess the layout of the main financial statements, together with how information is aggregated in order to improve the usefulness of the information provided in an entity's financial statements to help users make decisions in their capacity as capital providers.

The project is currently on hold while the Boards engage in outreach activities to ascertain constituents' requirements from such a standard.

Topic recap

HKAS 1 Presentation of Financial Statements

A complete set of financial statements includes:
- Statement of financial position at the end of the period
- Statement of profit or loss and other comprehensive income for the period
- Statement of changes in equity for the period
- Statement of cash flows for the period
- Notes to the financial statements
- Comparative information in respect of the preceding period
- Statement of financial position at the start of the preceding period when material retrospective adjustment has taken place

Statement of financial position

Minimum disclosure requirements

Separately classified current and non-current assets and liabilities

Current include assets and liabilities expected to be realised/settled in the normal operating cycle or expected to be realised/settled within 12 months

All other items are classified as non-current

Shares and reserves disclosures including:
- number of shares in issue
- rights of each class of shares
- nature and purpose of each reserve

Statement of profit or loss and other comprehensive income

Minimum disclosure requirements

Other comprehensive income and related tax effects must be grouped into:
- amounts that will not be reclassified to profit or loss
- amounts that may be reclassified to profit or loss

Statement of changes in equity

Reconciliation of each component of equity b/f and c/f

Disclose:
- Total comprehensive income attributable to parent/NCI
- Retrospective adjustments
- Transactions with owners in their capacity as owners

Other aspects of HKAS 1:
- Financial statements must present a true and fair view; this is presumed to result when an entity complies with HKFRS
- In extremely rare circumstances the requirements of an HKFRS may be departed from; disclosure of the departure is required
- Any uncertainties regarding going concern should be disclosed
- A summary of accounting policies must be disclosed
- Key assumptions and measurement uncertainty should be disclosed

Answer to self-test question

Answer 1

STATEMENT OF FINANCIAL POSITION OF CHINATEA CO. AT 31 DECEMBER 20X9	$
ASSETS	
Non-current assets	
Property, plant and equipment (905,000 – 25,000 (W1))	880,000
Other intangible assets (W1)	25,000
	905,000
Current assets	
Inventories	31,200
Trade receivables (56,450 + 10,000)	66,450
Cash and cash equivalents	10,900
	108,550
Total assets	1,013,550
EQUITY AND LIABILITIES	
Share capital	40,000
Retained earnings	379,540
Revaluation surplus	285,000
	704,540
Non-current liabilities	
Loan notes	100,000
Deferred tax (on revaluation)	95,000
	195,000
Current liabilities	
Trade and other payables (114,010 – 33,700 – 20,000)	60,310
Current tax payable	33,700
Short term provisions	20,000
Total current liabilities	114,010
Total liabilities	309,010
Total equity and liabilities	1,013,550

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR CHINATEA CO. FOR THE YEAR ENDED 31 DECEMBER 20X9

	$
Revenue	1,235,000
Cost of sales	(740,000)
Gross profit	495,000
Distribution costs	(115,230)
Administrative expenses	(267,020)
Finance costs	(7,400)
Profit before tax	105,350
Income tax expense	(33,700)
Profit for the year	71,650
Other comprehensive income that will not be reclassified to profit or loss	
Gains on property revaluation (W1)	380,000
Income tax relating to components of other comprehensive income	(95,000)
Other comprehensive income for the year, net of tax	285,000
Total comprehensive income for the year	356,650

STATEMENT OF CHANGES IN EQUITY FOR CHINATEA CO. FOR THE YEAR ENDED 31 DECEMBER 20X9

	Share capital	*Retained earnings*	*Revaluation surplus*	*Total*
	$	$	$	$
At 1 January 20X9	40,000	332,890	-	372,890
Dividends	-	(25,000)	-	(25,000)
Total comprehensive income	-	71,650	285,000	356,650
At 31 December 20X9	40,000	379,540	285,000	704,540

WORKINGS

1 *Non-current assets*

	Land and buildings	*Fixtures and fittings*	*Patent*	*Total*
	$	$	$	$
Cost b/f	700,000	200,000	30,000	930,000
Additions	–	15,000	–	15,000
Revaluation	200,000	–	–	200,000
Cost c/f	900,000	215,000	30,000	1,145,000
Depreciation b/f	337,500	60,000	2,500	400,000
Charge for year	12,500	5,000	2,500	20,000
Revaluation	(180,000)	–	–	(180,000)
Depreciation c/f	170,000	65,000	5,000	240,000
Carrying value	730,000	150,000	25,000	905,000

The revaluation surplus recognised as other comprehensive income is therefore $380,000 ($200,000 + $180,000).

2 *New share issue*

As the new share issue is made from the proceeds of previous share issues (ie share capital), no reserves transfer is necessary. This transaction is therefore not evident in the statement of changes in equity.

Within the financial statements, however, the company must disclose the number of shares in issue at the current and previous year ends, being:

– 40,000 at 31 December 20X9

– 30,000 (3/4 × 40,000) at 31 December 20X8.

Exam practice

AZ

27 minutes

AZ is a listed manufacturing company. Its finished products are stored in a nearby warehouse until ordered by customers. AZ has performed very well in the past, but has been in financial difficulties in recent months and has been re-organising the business to improve performance.

The trial balance for AZ at 31 March 20X3 was as follows:

	$'000	$'000
Sales		124,900
Cost of goods manufactured in the year to 31 March 20X3 (excluding depreciation)	94,000	
Distribution costs	9,060	
Administrative expenses	16,020	
Restructuring costs	121	
Interest received		1,200
Loan interest paid	639	
Land and buildings (including land $20,000,000)	50,300	
Plant and equipment	3,720	
Accumulated depreciation at 31 March 20X2:		
Buildings		6,060
Plant and equipment		1,670
Investment properties (at market value)	24,000	
Inventories at 31 March 20X2	4,852	
Trade receivables	9,330	
Bank and cash	1,190	
Ordinary shares, fully paid		20,430
6% redeemable preference shares		1,000
Revaluation surplus		3,125
Retained earnings at 31 March 20X2		27,137
Ordinary dividends paid	1,000	
Preference dividends paid	60	
7% loan stock 20X7		18,250
Trade payables		8,120
Proceeds of share issue		2,400
	214,292	214,292

Additional information provided:

(i) The property, plant and equipment are being depreciated as follows:

Buildings 5% per annum straight line

Plant and equipment 25% per annum diminishing balance

Depreciation of buildings is considered an administrative cost while depreciation of plant and equipment should be treated as a cost of sale.

(ii) On 31 March 20X3 the land was revalued to $24,000,000.

(iii) Income tax for the year to 31 March 20X3 is estimated at $161,000. Ignore deferred tax.

(iv) The closing inventories at 31 March 20X3 were $5,180,000. An inspection of finished goods found that a production machine had been set up incorrectly and that several production batches, which had cost $50,000 to manufacture, had the wrong packaging. The goods cannot be sold in this condition but could be repacked at an additional cost of $20,000. They could then be sold for $55,000. The wrongly packaged goods were included in closing inventories at their cost of $50,000.

(v) The preference shares will be redeemed for $1,000,000 in 20X9. Preference dividends are paid on 31 March each year.

(vi) The 7% loan is a 10-year loan due for repayment by 31 March 20X7. Interest on this loan needs to be accrued for the six months to 31 March 20X3.

(vii) The restructuring costs in the trial balance represent the cost of a major restructuring of the company to improve competitiveness and future profitability.

(viii) No fair value adjustments were necessary to the investment properties during the period.

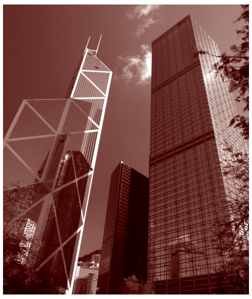
(ix) During the year the company issued 2 million new ordinary shares for cash at $1.20 per share. The proceeds have been recorded as "Proceeds of share issue".

Required

Prepare the statement of profit or loss and other comprehensive income and statement of changes in equity for AZ for the year to 31 March 20X3 and a statement of financial position at that date.

Notes to the financial statements are not required, but all workings must be clearly shown.

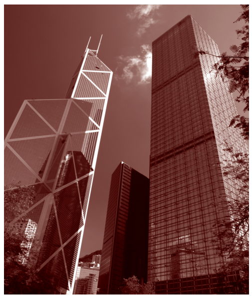
(15 marks)



Part D

Group financial statements

The emphasis in this section is on the application of accounting standards relating to consolidation. As prospective certified public accountants, it is important for you to be equipped with sound professional knowledge and skills in resolving consolidation issues. The purpose of this section is to develop your knowledge about the application of the relevant accounting standards to prepare consolidated financial statements, to account for associates and joint ventures and to handle difficult situations like acquisitions and the disposal of subsidiaries.



chapter 26

Principles of consolidation

Topic list

Learning focus

You are very likely to come across groups of companies in practice and in your exam. It is important that you can identify different types of group companies and know how to account for them.

The goodwill calculation (including gain on bargain purchase) and the related treatment are also vital for the preparation of group financial statements.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Prepare the financial statements for a group in accordance with Hong Kong Financial Reporting Standards and statutory reporting requirements		
4.03	**Principles of consolidation**	3
4.03.01	Identify and describe the concept of a group as a single economic entity	
4.03.02	Define a subsidiary and when a group should start and stop consolidating a subsidiary	
4.03.03	Explain what constitutes control and the impact of potential voting rights	
4.03.04	Describe the reasons why the directors of a company may not want to consolidate a subsidiary and the circumstances in which non-consolidation is permitted	
4.03.05	Explain the purpose of consolidated financial statements	
4.03.06	Explain the importance of eliminating intra-group transactions	
4.03.07	Explain the importance of uniform accounting policies and coterminous year ends in the preparation of consolidated accounts	
4.03.08	Apply the appropriate accounting treatment of consolidated goodwill	
4.06	**Business combinations**	3
4.06.01	Explain the scope of business combinations in accordance with HKFRS 3 (revised)	
4.06.02	Identify business combination and the difference between acquisition of asset and business	
4.06.03	Determine the acquisition date of an acquisition	
4.06.04	Identify the identifiable assets (including intangibles) and liabilities acquired in a business combination	
4.06.05	Explain the recognition principle and measurement basis of identifiable assets and liabilities and the exception	
4.06.06	Explain what contingent consideration is and how to account for it initially and subsequently	
4.06.07	Explain how to account for acquisition-related costs, including those related to issue debt or equity securities	
4.06.08	Determine what is part of the business combination transaction and the consideration	
4.06.09	Calculate goodwill (including bargain purchase) and account for it	
4.06.11	Account for non-controlling interest when the subsidiary has negative equity balance	
4.06.12	Explain and account for measurement period adjustments	
4.10	**Financial statement disclosure requirement**	3
4.10.01	Disclose the relevant information for business combinations occurred during and subsequent to the reporting period	

1 Introduction to group accounting

Topic highlights

A group of companies develops when a parent company buys one or more subsidiaries. The group should be regarded as a single economic entity for the purposes of accounting.

A group of companies is the result of one company (the parent company) buying a controlling share in one or more other companies (subsidiaries). This situation is very common where a parent company:

- buys a customer in order to secure custom
- buys a supplier in order to secure supplies
- buys a competitor in order to increase market share
- buys an overseas company in order to gain entry to a new geographical market, or
- buys another company in order to diversify.

1.1 Single economic entity and purpose of consolidated accounts

As groups grow, there is likely to be a very high level of buying and selling activity between group companies (intra-group sales). Often such sales do not take place at market prices. Similarly one group company may lend to another without charging interest or one company may provide management services to another free of charge.

These group transactions distort the individual financial statements of each group company, making it difficult for a user of the accounts to understand the performance and position of the group as a whole.

Furthermore, where there are a large number of group companies, there may be many individual sets of financial statements. Shareholders in the parent company (and so, by definition, the group) cannot be expected to digest each individual set of financial statements in order to gain an understanding of the group overall.

Therefore, financial statements are prepared for the group as a **single economic entity**. In other words a single statement of financial position is prepared which combines the position of the parent and all its subsidiaries and a single statement of profit or loss and other comprehensive income is prepared which combines the performance of the parent and all its subsidiaries. Since a single entity cannot transact with itself, the effects of any intra-group transactions are stripped out of these consolidated financial statements.

Users of the accounts are therefore able to understand the position and performance of the group as a result only of its transactions with parties outside the group.

The single economic entity concept and production of consolidated accounts is an example of the concept of substance over form, whereby the commercial substance of the group of companies as a whole has more relevance from an accounting perspective than the position of the individual companies as legal entities.

1.2 Group companies

Above we have considered a **group of companies** to consist of a **parent company** and one or more **subsidiary companies** which are controlled by the parent company. It is true that consolidated financial statements are only prepared where a parent company has at least one subsidiary, however other investments, including associates and joint arrangements may also be identified and must be represented in the consolidated financial statements.

HKAS 28.3, HKFRS 10, Appendix A, HKFRS 11, Appendix A

1.3 Definitions

A number of definitions are given in the relevant standards, including the following relating to group entities:

Key terms

Group. A parent and its subsidiaries. *(HKFRS 10)*

Parent. An entity that controls one or more entities. *(HKFRS 10)*

Subsidiary. An entity that is controlled by another entity. *(HKFRS 10)*

Control. An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee. *(HKFRS 10)*

Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. *(HKFRS 10)*

Power. Existing rights that give the current ability to direct the relevant activities. *(HKFRS 10)*

Relevant activities. Activities of the investee that significantly affect the investee's returns. *(HKFRS 10)*

Associate. An entity over which the investor has significant influence. *(HKAS 28)*

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies. *(HKAS 28)*

Joint arrangement. An arrangement of which two or more parties have joint control. *(HKFRS 11)*

Joint operation. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. *(HKFRS 11)*

Joint venture. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. *(HKFRS 11)*

Some of these definitions are considered in more detail later in this and subsequent chapters.

1.4 Levels of investment

Before we move on to discuss the principles of consolidation, the following table is useful in summarising different types of group investment and how they are accounted for.

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control	Full consolidation (HKFRS 3 (revised)/HKFRS 10)
Associate	Significant influence	Equity accounting (HKAS 28)
Joint arrangement (joint venture)	Contractual arrangement	Equity accounting (HKFRS 11/HKAS 28)
Investment which is none of the above	Asset held for accretion of wealth	As for single company accounts per HKFRS 9

We will be looking at six accounting standards in this and the next three chapters. HKFRS 10 to 12 and the revised versions of HKAS 27 and 28 (known as HKAS 27 (2011) and HKAS 28 (2011)) were issued in June 2011 as a "package of five" standards. They are applicable together and must be applied to periods beginning on or after 1 January 2013:

- HKFRS 3 (revised) *Business Combinations*
- HKFRS 10 *Consolidated Financial Statements*
- HKFRS 11 *Joint Arrangements*
- HKFRS 12 *Disclosure of Interests in Other Entities*
- HKAS 27 (2011) *Separate Financial Statements*
- HKAS 28 (2011) *Investments in Associates and Joint Ventures*

HKFRS 9 was covered in Chapter 18.

Note that this chapter includes mention of HKAS 27 (revised). Before 2011, HKAS 27 was entitled *Consolidated and Separate Financial Statements*, and HKAS 27 (revised) refers to this standard rather than HKAS 27 (2011) *Separate Financial Statements.* The "old" HKAS 27 is included in order to provide some detail of the original definition of control, now superseded by that provided in HKFRS 10.

2 Principles of consolidation

Topic highlights

Consolidated financial statements are prepared where a parent **controls** another entity. The definition of control includes three elements.

HKFRS 10 *Consolidated Financial Statements* is applied in the preparation and presentation of consolidated financial statements. It provides guidance on establishing a parent-subsidiary relationship and prescribes the principles of consolidation.

2.1 Control

As we have already seen, a parent-subsidiary relationship is established when one entity **controls** another. The definition of control provided in HKAS 27 (revised) has now been superseded by that provided in HKFRS 10.

HKAS 27.14-15

2.1.1 HKAS 27 (revised) definition of control

Control is defined in HKAS 27 (revised) as **the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities**.

The standard expanded on this definition to state that a control relationship is presumed to exist where **the parent owns, directly or indirectly through subsidiaries, more than half the voting power of an entity, unless it can be demonstrated that such ownership does not constitute control**. In other words a company which holds more than 50% of voting shares in another company controls that company.

The standard also lists the following situations where control exists, even when the parent owns only 50% or less of the voting power of an entity.

(a) The parent has power over more than 50% of the voting rights by virtue of agreement with other investors.

(b) The parent has power to govern the financial and operating policies of the entity by statute or under an agreement.

(c) The parent has the power to appoint or remove a majority of members of the board of directors (or equivalent governing body).

(d) The parent has power to cast a majority of votes at meetings of the board of directors (or equivalent governing body).

HKFRS 10.6, 8

2.1.2 HKFRS 10 definition of control

HKFRS 10, issued in June 2011 provides an amended definition, and identifies three separate elements of control.

HKFRS 10 states that an investor controls an investee if and only if it has all of the following:

(a) Power over the investee (see below)

(b) Exposure, or rights, to variable returns from its involvement with the investee (see below), and

(c) The ability to use its power over the investee to affect the amount of the investor's returns (see below).

If there are changes to one or more of these three elements of control, then an investor should reassess whether it controls an investee.

HKFRS 10.10-12, 14, B11, B15, B18

2.1.3 Power

Power is defined as **existing rights that give the current ability to direct the relevant activities of the investee**. There is no requirement for that power to have been exercised.

Relevant activities may include:

- selling and purchasing goods or services
- managing financial assets
- selecting, acquiring and disposing of assets
- researching and developing new products and processes
- determining a funding structure or obtaining funding.

In some cases assessing power is straightforward, for example, where power is obtained directly and solely from having the majority of voting rights or potential voting rights, and as a result the ability to direct relevant activities.

In other cases, assessment is more complex and more than one factor must be considered. HKFRS 10 gives the following examples of **rights**, other than voting or potential voting rights, which individually, or alone, can give an investor power:

- Rights to appoint, reassign or remove key management personnel who can direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities
- Rights to direct the investee to enter into, or veto changes to transactions for the benefit of the investor
- Other rights, such as those specified in a management contract.

HKFRS 10 suggests that the **ability** rather than contractual right to achieve the above may also indicate that an investor has power over an investee.

An investor can have power over an investee even where other entities have significant influence or other ability to participate in the direction of relevant activities.

HKFRS 10.15, B57

2.1.4 Returns

An investor must have exposure, or rights, to variable returns from its involvement with the investee in order to establish control.

This is the case where the investor's returns from its involvement have the potential to vary as a result of the investee's performance.

Returns may include:

- dividends
- remuneration for servicing an investee's assets or liabilities
- fees and exposure to loss from providing credit support
- returns as a result of achieving synergies or economies of scale through an investor combining use of their assets with use of the investee's assets

HKFRS 10.17, B59

2.1.5 Link between power and returns

In order to establish control, an investor must be able to use its power to affect its returns from its involvement with the investee. This is the case even where the investor delegates its decision making powers to an agent.

HKFRS 10.19

2.2 Consolidated accounts

Where a parent controls one or more subsidiaries, HKFRS 10 requires that consolidated financial statements are prepared to include **all subsidiaries, both foreign and domestic** other than:

- those held for sale in accordance with HKFRS 5
- those held under such long-term restrictions that control cannot be operated.

The rules on exclusion of subsidiaries from consolidation are necessarily strict, because this is a common method used by entities to manipulate their results. If a subsidiary which carries a large amount of debt can be excluded, then the gearing of the group as a whole will be improved. In other words, this is a way of taking debt **out of the consolidated statement of financial position**.

HKFRS 10 is clear that a subsidiary should not be excluded from consolidation simply because it is loss making or its business activities are dissimilar from those of the group as a whole. HKFRS 10 rejects the latter argument: exclusion on these grounds is not justified because better information can be provided about such subsidiaries by consolidating their results and then giving additional information about the different business activities of the subsidiary, e.g. under HKFRS 8 *Operating Segments*.

HKFRS 10.4

2.2.1 Exemption from preparing group accounts

A parent **need not present** consolidated financial statements in the following circumstances:

(a) If all of the following apply:

(i) It is a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements

(ii) Its securities are **not publicly traded**

(iii) It is **not in the process of issuing securities** in public securities markets, and

(iv) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards.

(b) If the parent is an investment entity which is required to measure its subsidiaries at fair value through profit or loss (see below).

A parent that does not present consolidated financial statements must comply with the HKAS 27 (2011) rules on separate financial statements.

HKFRS 10.27-33

2.2.2 Investment entities

HKFRS 10 was amended in December 2012 to address the issue of investment entities. An investment entity is defined as an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investors with investment management services;

(b) commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

Investment entities therefore include private equity organisations, venture capital organisations, pension funds and other investment funds.

Prior to the amendment, entities such as these were required to apply HKFRS 10 and consolidate all subsidiaries which they control. Investors and other users of the accounts felt, however, that this did not result in useful information; the most useful and relevant information would be to recognise investments at fair value.

As a result, HKFRS 10 is amended to require that investment entities measure subsidiaries at fair value through profit or loss rather than consolidate them.

This requirement applies only to the subsidiaries of an investment entity which do not provide services which relate to the investment entity's activities. Subsidiaries which provide investment-related services are consolidated as normal.

2.3 Consolidation procedures

Topic highlights

Consolidated financial statements are prepared by combining the assets; liabilities, income and expenses of a parent and its subsidiaries on a line by line basis and cancelling any intra-group amounts.

Financial statements prepared to the same date should be used.

HKFRS 10 does not deal with methods of accounting for business combinations and the calculation of goodwill (this is covered by HKFRS 3 (revised)), but it does provide guidance on consolidation procedures.

HKFRS 10.22, B86

2.3.1 Preparation of consolidated financial statements

Consolidated financial statements are prepared by combining the financial statements of the parent and its subsidiaries on a line by line basis. Practically, this involves adding together the parent's and its subsidiaries' assets, liabilities, income and expenses. In addition:

- the carrying amount of the parent's investment in each subsidiary and the parent's proportion of equity in each subsidiary are eliminated.
- non-controlling interests representing the equity of subsidiaries which does not belong to the parent are recognised.

The application of these procedures is considered in more detail in the next chapter.

HKFRS 10.B86

2.3.2 Intra-group transactions

As the consolidated financial statements are prepared for a group as a single economic entity, intra-group balances and transactions should be eliminated as part of the consolidation process. As we have already said, these amounts may be distorted due to the group relationship, and so may result in the presentation of misleading group performance or position.

To take an example, assume that a group company bought an asset from a non-group company paying the market price of $100 and sold this to another group company for $300, so making a $200 profit. The second company then sold the asset to a third group company for $600, so making a $300 profit. If the effects of this intra-group transaction were not eliminated from the consolidated accounts, assets and profits would both be overstated by $500.

HKRS 10, B92,93

2.3.3 Coterminous year end

In most cases, all group companies will prepare accounts to the same reporting date. One or more subsidiaries may, however, prepare accounts to a different reporting date from the parent and the bulk of other subsidiaries in the group.

In such cases the subsidiary may prepare additional statements to the reporting date of the rest of the group, for consolidation purposes. If this is not possible, the subsidiary's accounts may still be used for the consolidation, *provided that* the gap between the reporting dates is **three months or less**.

Where a subsidiary's accounts are drawn up to a different accounting date, **adjustments should be made** for the effects of significant transactions or other events that occur between that date and the parent's reporting date.

HKFRS 10.B87

2.3.4 Uniform accounting policies

Consolidated financial statements should be prepared using **uniform accounting policies for like transactions and other events in similar circumstances**.

Adjustments must be made where members of a group use different accounting policies, so that their financial statements are suitable for consolidation.

HKFRS 10.20, B88, HKFRS 3, Appendix A

2.3.5 Date of inclusion/exclusion

The results of subsidiary undertakings are included in the consolidated financial statements from the acquisition date, defined as **the date on which the investor obtains control of the investee**. Income and expenses of the subsidiary should be based on the asset and liability values recognised in the consolidated financial statements at this date. For example, future depreciation should be calculated based upon the fair value of the related asset at the acquisition date.

The results of subsidiary undertakings should cease to be included within the consolidated financial statements on the date on which the parent ceases to control the subsidiary. From this date the investment is accounted for as an associate in accordance with HKAS 28 or a financial asset in accordance with HKFRS 9.

HKAS 27(2011).10

2.3.6 Accounting for subsidiaries, joint ventures and associates in the parent's separate financial statements

A parent company will usually produce its own, single company financial statements. HKAS 27 (2011) *Separate Financial Statements* provides accounting guidance to be applied in the preparation of these single company statements. In these statements, investments in subsidiaries, joint ventures and associates included in the consolidated financial statements should be *either*:

(a) accounted for at **cost**, or
(b) in accordance with **HKFRS 9**

Where subsidiaries are **classified as held for sale** in accordance with HKFRS 5 they should be accounted for in accordance with HKFRS 5 in the parent's separate financial statements.

3 Disclosure of interests in other entities

HKFRS 12.7

HKFRS 12 *Disclosure of Interests in Other Entities* was issued in June 2011 as part of the "package of five standards" relating to consolidation. It removes all disclosure requirements from other standards relating to group accounting and provides guidance applicable to consolidated financial statements.

The standard requires disclosure of:

(a) the significant judgments and assumptions made in determining the nature of an interest in another entity or arrangement, and in determining the type of joint arrangement in which an interest is held

(b) information about interests in subsidiaries (including those which are not consolidated as a result of the investment entity exception), associates, joint arrangements and structured entities that are not controlled by an investor.

Disclosures requirements in respect of associates and joint arrangements are given in Chapter 28.

HKFRS 12.10-19

3.1 Disclosure of consolidated subsidiaries

An entity should disclose information which enables users of the consolidated financial statements:

(a) to understand:

- (i) the composition of the group
- (ii) the interest that non-controlling interests have in the group's activities and cash flows.

(b) to evaluate:

- (i) the nature and extent of significant restrictions on its ability to access or use assets and settle liabilities of the group
- (ii) the nature of, and changes in, the risks associated with interests in subsidiaries
- (iii) the consequences of changes in its ownership interest in a subsidiary where control is not lost
- (iv) the consequences of losing control in a subsidiary in the reporting period.

3.1.1 Non-coterminous year ends

Where the financial statements of a subsidiary used to prepare consolidated financial statements are prepared to a date different from that of the consolidated financial statements, the following must be disclosed:

(a) The date of the end of the reporting period of the financial statements of the subsidiary.
(b) The reason for using a different date.

3.1.2 Non-controlling interests

The following should be disclosed for each of a group's subsidiaries that have non-controlling interests that are material to the reporting entity:

(a) The name of the subsidiary.

(b) The principal place of business/country of incorporation of the subsidiary.

(c) The proportion of ownership interests held by non-controlling interests.

(d) The proportion of voting rights held by non-controlling interests if different from the proportion of ownership interests held.

(e) The profit or loss allocated to non-controlling interests of the subsidiary during the reporting period.

(f) Accumulated non-controlling interests of the subsidiary at the end of the reporting period.

(g) Summarised financial information about the subsidiary.

3.1.3 The nature and extent of significant restrictions

The following must be disclosed:

(a) Significant restrictions on the group's ability to access or use the assets and settle the liabilities of the group, such as:

 (i) those that restrict the ability of a parent or subsidiaries to transfer cash or other assets to or from other entities in the group.

 (ii) guarantees or other requirements that may restrict dividends and other capital distributions being paid or loans and advances being made or repaid to or from other entities in the group.

(b) The nature and extent to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the group.

(c) The carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

3.1.4 Nature of the risks associated with an entity's interests in subsidiaries

The terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a subsidiary should be disclosed, including events or circumstances that could expose the reporting entity to a loss.

If during the reporting period a parent or any of its subsidiaries has, without being contractually required to do so, provided financial support to a subsidiary, it should disclose:

(a) the type and amount of support provided
(b) the reasons for providing the support.

If during the reporting period a parent or any of its subsidiaries has, without being contractually required to do so, provided financial support to a previously unconsolidated entity and that provision of support resulted in a controlling relationship, an explanation of the relevant factors in reaching that decision must be disclosed.

Any current intentions to provide support to a subsidiary including providing assistance in obtaining financial support should be disclosed.

3.1.5 Changes in ownership which do not result in the loss of control

A schedule must be presented that shows the effects on equity attributable to owners of the parent of any changes in its ownership interest in a subsidiary that do not result in the loss of control.

3.1.6 Loss of control

If control of a subsidiary has been lost during a reporting period, the following should be disclosed:

(a) The gain or loss on disposal.

(b) The portion of the gain or loss attributable to measuring any retained investment at fair value on the date on which control is lost.

(c) The line items in profit or loss in which the gain or loss is recognised.

HKFRS 12.19A-G

3.2 Disclosure of unconsolidated subsidiaries (investment entities)

An investment entity is required to disclose:

(a) the fact that the exception to consolidation is applied and that subsidiaries are instead measured at fair value through profit or loss

(b) details of each unconsolidated subsidiary including name, place of business and proportion of ownership interest held

(c) the nature and extent of any significant restrictions on the ability of an unconsolidated subsidiary to transfer funds to the investment entity

(d) any current commitments or intentions to provide support to an unconsolidated subsidiary

(e) details of non-contractual support provided to an unconsolidated subsidiary in the period

(f) the terms of any contractual arrangements that may require the provision of financial support to an unconsolidated subsidiary

(g) details of non-contractual support provided in the period to an unconsolidated structured entity that the investment entity did not control but which resulted in control being achieved.

4 HKFRS 3 (revised) *Business Combinations*

Topic highlights

HKFRS 3 (revised) provides guidance on the measurement of net assets acquired in a business combination, the non-controlling interest and goodwill arising on a business combination.

We have seen that HKFRS 10 defines control and prescribes procedures for the preparation of consolidated financial statements. HKFRS 3 *Business Combinations*, revised in 2008, is the second relevant standard on group accounting, and provides guidance on the following:

(a) The recognition and measurement of the assets and liabilities acquired when a parent company achieves control over a subsidiary or other business

(b) The recognition and measurement of any non-controlling interest in the subsidiary or business

(c) The recognition and measurement of goodwill arising on the acquisition of a subsidiary or business

(d) Necessary disclosures to provide information to evaluate a business combination

HKFRS 3.2

4.1 Scope of HKFRS 3 (revised)

HKFRS 3 (revised) applies to business combinations, defined as transactions **in which an acquirer obtains control of one or more businesses**. It does not apply to:

- the formation of a joint venture
- the acquisition of an asset or group of assets that does not constitute a business
- a combination between entities or businesses under common control
- the acquisition of a subsidiary that is required to be measured at fair value through profit or loss by an investment entity.

Where a group of assets and liabilities is purchased which does not constitute a business, the assets and liabilities are recognised in the purchaser's financial statements in accordance with relevant standards including HKAS 16 and HKAS 38. The cost of the group is allocated to the individual identifiable assets and liabilities on the basis of their fair values at the date of acquisition. Goodwill does not arise on such a purchase.

HKFRS 3, Appendix A

4.2 Definitions

In addition to those definitions seen earlier in the chapter, HKFRS 3 (revised) provides the following:

Key terms

Acquirer is the entity that obtains control of the acquiree.

Acquiree is the business or businesses that the acquirer obtains control of in a business combination.

Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

Contingent consideration. Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met.

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually indentified and separately recognised.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Identifiable. An asset is identifiable if it either:

(a) is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so, or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

(HKFRS 3 (revised))

HKFRS 3.4-5 and B7-B12

4.3 Accounting for a business combination

An entity shall determine whether a transaction or other event is a business combination which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition.

Definition of a business

A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:

(a) **Input:** Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

(b) **Process:** Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

(c) **Output:** The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements – inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.

The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have assets, but a business need not have liabilities.

An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:

(a) has begun planned principal activities;

(b) has employees, intellectual property and other inputs and processes that could be applied to those inputs;

(c) is pursuing a plan to produce outputs; and

(d) will be able to obtain access to customers that will purchase the outputs.

HKFRS 3 (revised) requires that business combinations are accounted for by applying the **acquisition method**. This involves:

(a) identifying the acquirer

(b) determining the acquisition date

(c) recognising and measuring the identifiable assets acquired, liabilities assumed and non-controlling interests in the acquiree

(d) recognising and measuring goodwill.

HKFRS3.6-7

4.3.1 Identifying the acquirer

For each business combination, one of the combining entities must be identified as the acquirer, in other words a business combination is not considered to be a merger.

HKFRS 3.8-9

4.3.2 Determining the acquisition date

The acquisition date is the date on which the acquirer gains control of the acquiree. This is normally the date on which consideration is transferred and assets and liabilities are acquired. The date may, however, be earlier or later, for example where written agreement provides for this.

HKFRS 3.10,11,18

4.3.3 Recognising and measuring assets, liabilities and the non-controlling interests

The acquirer should recognise at the acquisition date:

- Identifiable assets acquired
- Liabilities assumed
- Non-controlling interest
- Goodwill

In doing so, the acquirer should apply the recognition criteria of the *Conceptual Framework*. This may result in the acquirer recognising some assets and liabilities that the acquiree had not previously recognised, for example intangible assets generated internally by the acquiree.

The identifiable assets recognised should be measured at fair value at the acquisition date.

The application of these principles is seen in more detail in section 5 of this chapter.

HKFRS 3.32

4.3.4 Recognising and measuring goodwill

Goodwill is measured as the excess of the **fair value of consideration transferred** plus the **amount of non-controlling interests** over **the fair value of identifiable net assets of the acquiree on the acquisition date**.

In some cases this will result in a positive amount of goodwill; in others a negative amount is calculated, referred to as a gain on a bargain purchase.

The elements of the calculation of goodwill are considered in more detail in the next section of this chapter.

Where an acquisition is achieved in steps, there may be an extra element to the calculation; step acquisitions are considered in a later chapter.

5 Goodwill

Topic highlights

Goodwill is calculated as the excess of consideration plus the non-controlling interests over the fair value of identifiable net assets acquired.

The non-controlling interests can be measured as a proportion of the net assets of the acquiree or at fair value.

As we saw in Chapter 8, goodwill is **created by good relationships** between a business and its customers, a good reputation, customer base, and other intangible elements. It is not usually valued in the accounts of a business at all, however it is likely to arise in:

- the financial statements of an individual company where that company buys an unincorporated business
- consolidated financial statements where a parent company buys a subsidiary.

As we saw earlier, goodwill arising on a business combination is calculated as:

		$
Consideration transferred		X
Amount of any non-controlling interests		X
Less:	net acquisition-date fair value of identifiable assets acquired and liabilities assumed	(X)
		X

We shall consider each of the elements of the calculation in turn.

HKFRS 3.37 5.1 Consideration transferred

Consideration or payment transferred to achieve a controlling share in another business may take a number of forms including:

- cash
- other assets
- ordinary or preference instruments
- debt instruments

Consideration may be immediate or deferred. Where it is deferred, payment may be contingent upon an event, or upon the acquiree attaining certain financial or non-financial goals.

The basic principle of HKFRS 3 (revised) is that consideration transferred in a business combination should be measured at fair value.

HKFRS 3.39-40

5.1.1 Contingent consideration

Contingent consideration is defined by HKFRS 3 (revised) as:

- an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met, or
- the right of the acquirer to the return of previously transferred consideration if specified conditions are met.

Therefore, contingent consideration may be a liability/equity (in the first case) or an asset (in the second case) of the acquirer.

Contingent consideration is a part of many transactions where there are substantial uncertainties about how the acquired business will perform post-transaction.

A common example of a contingent consideration liability is an earn-out clause, with future additional payments of consideration conditional on reaching milestones, or on the level of sales or profitability.

A contingent consideration asset may arise if the acquiree fails to meet targets, fails to pass regulatory reviews or fails to meet covenants and the former owners are therefore required to return to the acquirer consideration already paid.

Under HKFRS 3 (revised), contingent consideration is to be recognised at acquisition-date fair value as part of the consideration transferred. Fair value may be estimated through the use of a number of different methods.

Example: Contingent consideration (1)

Anderson Co. acquires all of the ordinary share capital of Potter Co. for $100m on 1 January 20X1. In addition, the purchase agreement stipulates that a further payment will be required dependent on the earnings of Potter Co. post acquisition. The terms of the contract call for additional cash consideration to be paid two years after the acquisition in the event that Potter Co.'s earnings exceed $5m in each of the next two years subject to an earnings cap of $7m. For earnings in excess of $5m, Anderson Co. is required to pay 20% of the excess to the previous shareholders. In this situation, the minimum amount that could be paid is nil and the maximum is $0.4m (($7m – $5m) × 20%).

Management have used a simulation model to ascertain the fair value of the contingent consideration and estimated it to be $0.25 million.

On the acquisition date the fair value of the identifiable net assets of Potter Co. was $96m.

(a) What goodwill arises on the acquisition of Potter Co.?

(b) State how the investment in Potter Co. is recorded in the individual financial statements of Anderson Co. in the year ended 31 October 20X1.

Solution

(a)

	$'000
Cash consideration	100,000
Fair value of contingent consideration	250
Fair value of identifiable net assets of acquiree	(96,000)
Goodwill	4,250

(b) Anderson Co. records the investment in Potter Co. by:

		$'000	$'000
DEBIT	Investment	100,250	
CREDIT	Cash		100,000
	Liability for contingent consideration		250

Contingent consideration may be payable in the form of equity, a debt instrument or (as in the above example) cash. In the case of equity or debt, it is classified in the acquirer's financial statements in accordance with HKAS 32.

The subsequent accounting for contingent consideration will depend on the type of contingent consideration, how it is classified and why a change in the fair value of the consideration arose:

(a) If the change in fair value is due to additional information obtained within the measurement period (see section 5.4) that affects the position at the acquisition date, goodwill should be remeasured.

(b) If the change is due to events which took place after the acquisition date, for example, meeting earnings targets:

  (i) Account for the change under HKFRS 9 if the consideration is in the form of a financial instrument, for example loan notes.

  (ii) Account for the change under HKAS 37 if the consideration is in the form of cash.

  (iii) An equity instrument is not remeasured.

Example: Contingent consideration (2)

To continue with the above example, assume the following:

(a) Further information has been received by the management of Anderson Co. on 1 June 20X1 which has led them to re-assess the acquisition date fair value of the contingent consideration to be $0.2m.

(b) At the end of the first year of the earnout period, Potter Co. reports earnings of $8 million. The fair value of contingent consideration in relation to the second year at this stage is estimated to be $0.1m.

Considering each of these separately, how are the calculation of goodwill and Anderson Co.'s journal to recognise the investment in Potter Co. affected?

Solution

(a) In this instance the goodwill arising in Potter Co. is remeasured:

	$'000
Cash consideration	100,000
Fair value of contingent consideration	200
Fair value of identifiable net assets of acquiree	(96,000)
Goodwill	4,200

Anderson Co. should therefore have recorded the investment in Potter Co. by:

		$'000	$'000
DEBIT	Investment	100,200	
CREDIT	Cash		100,000
	Liability for contingent consideration		200

Adjustment to the original acquisition journal made is therefore required:

		$'000	$'000
DEBIT	Liability for contingent consideration	50	
CREDIT	Investment		50

(b) In this instance, goodwill is not remeasured because the change in the estimated fair value of contingent consideration is due to events which took place after the acquisition date; it remains at the acquisition date amount of $4.25m. The liability in Anderson's financial statements is, however adjusted to reflect the new estimate of the amount of contingent consideration payable:

Payable in respect of:	$'000
Year 1 (($7m – $5m) × 20%)	400
Year 2	100
	500

Therefore:

		$'000	$'000
DEBIT	Profit or loss (500 – 250)	250	
CREDIT	Liability for contingent consideration		250

HKFRS 3.51

5.1.2 Pre-existing relationships

All consideration transferred will need to be carefully analysed to determine whether it is really part of the business combination transaction. **Pre-existing relationships** between the acquirer and the acquiree will need to be accounted for separately from the business combination. For example, the acquirer may have a payable balance due to the acquiree, which is effectively settled through the business combination. Where the former owners or employees receive payments, a number of factors have been included to assist the identification of whether this is for future services or not, and should be accounted for as compensation.

HKFRS 3.53

5.1.3 Acquisition-related costs

Under HKFRS 3 (revised) **costs relating to an acquisition must be recognised as an expense** at the time of the acquisition. They are not regarded as an asset or as part of the cost of acquisition. Costs of issuing debt or equity are to be accounted for under the rules of HKFRS 9 (Chapter 18, sections 2.6 and 4).

HKFRS 3.19

5.2 Non-controlling interests

The revised HKFRS 3 views the **group as an economic entity**. This means that it treats **all providers of equity including non-controlling interests as shareholders in the group**, even if they are not shareholders in the parent. It is for this reason that the non-controlling interests form part of the calculation of goodwill.

The question now arises as to how it should be valued.

HKFRS 3 (revised) applies a different rule to the measurement of the non-controlling interest depending on whether or not the relevant shareholders are entitled to a proportionate share of the entity's net assets in the event of liquidation.

Where holders of the non-controlling interest are entitled to a proportionate share of the net assets on a liquidation, HKFRS 3 (revised) requires that **the non-controlling interest in the acquiree is measured either at:**

- fair value or
- the non-controlling interests' proportionate share of the acquiree's identifiable net assets.

Where holders of the non-controlling interest are not entitled to a proportionate share of the net assets on a liquidation, the non-controlling interest should be measured at fair value.

The non-controlling interests measured at **fair value** will be different from the non-controlling interests measured at **proportionate share of the acquiree's net assets**. The difference is goodwill attributable to the non-controlling interests. This will become more apparent when we see some examples.

HKFRS 3.B44-45

5.2.1 Measurement at fair value

The non-controlling interest is measured at its fair value, determined on the basis of a quoted price in an active market for equity shares not held by the acquirer or, if this is not available, by using another valuation technique.

The amount of consideration transferred by an acquirer is not usually indicative of the fair value of the non-controlling interests, because consideration transferred by the acquirer will generally include a control premium. Therefore, it is not normally appropriate to determine the fair value of the acquired business as a whole or that of the non-controlling interests by extrapolating the fair value of the acquirer's interest. Hence, adopting this option means that additional time and expertise may be needed to determine the fair value of the non-controlling interests.

The result of the application of the fair value method is that recognised goodwill represents all of the goodwill of the acquired business, not just the acquirer's share.

Example: Fair value option

Entity B has 40% of its shares publicly traded on an exchange. Entity A purchases the 60% non-publicly traded shares in one transaction, paying $630,000. Based on the trading price of the shares of entity B at the date of gaining control, a fair value of $400,000 is assigned to the 40% non-controlling interests, indicating that entity A has paid a control premium of $30,000. The fair value of entity B's identifiable net assets is $700,000.

Calculate goodwill measuring the non-controlling interests

(a) as a proportion of the net assets of the acquiree
(b) at fair value

Solution

(a) **Non-controlling interests measured as a proportion of the net assets of the acquiree**

Goodwill:

	$'000
Consideration	630
Non-controlling interests ($700 × 40%)	280
	910
Fair value of identifiable net assets (100%)	(700)
Goodwill	210

(b) **Non-controlling interests measured at fair value**

Goodwill:

	$'000
Consideration	630
Non-controlling interests	400
	1,030
Fair value of identifiable net assets (100%)	(700)
Goodwill	330

The first method calculates only the amount of goodwill associated with the controlling interests. The second method calculates goodwill to be $120,000 higher. This $120,000 is the goodwill associated with the non-controlling interests. The second calculation could be stripped out into the two elements as:

	Controlling interests	*Non-controlling interests*
	$'000	$'000
Consideration/fair value	630	400
Share of identifiable net assets (60%/40%)	(420)	(280)
Goodwill	210	120

Note that goodwill is not proportionate. If the total goodwill were split proportionately in the ratio 60:40, then the controlling interests would be allocated $198,000 and the non-controlling interests $132,000. This is not the case due to the control premium associated with a controlling interest. The premium to acquire control may reflect the value of synergies between the parent and subsidiary.

5.2.2 Choice of method

Where available, the choice of measurement method for the non-controlling interests is made for each business combination (rather than being an accounting policy choice).

It will require management to carefully consider their **future intentions** regarding the acquisition of the non-controlling interests, as, where less than 100% of the acquired business is purchased, the two methods will potentially result in significantly different amounts of goodwill.

Measuring the non-controlling interest at fair value may prove to be a difficult exercise, however there are benefits:

- This method will increase reported net assets in the statement of financial position
- Testing goodwill for impairment will be easier as there is no need to gross up part-owned subsidiaries.

It should, however be noted that since goodwill as initially measured will be greater in the statement of financial position, there is a greater likelihood of an impairment arising and any impairment losses will be greater than those arising if the non-controlling interest had been measured as a proportion of net assets.

Another consideration when deciding how to measure the non-controlling interest is whether an entity intends to acquire more shares in the subsidiary at a future date.

As you will see in Chapter 29, where an existing interest in a subsidiary is increased, goodwill is not recalculated and instead the parent's equity is adjusted (normally reduced) by the difference between consideration paid for the additional interest and the change in the non-controlling interest's net assets (including any goodwill).

This adjustment to the parent's equity is less where non-controlling interest goodwill is recognised than where the non-controlling interest is simply measured as a proportion of net assets.

The following table summarises the impact at various stages of the two methods of measuring the non-controlling interest:

	Fair value	Proportion of net assets
NCI in statement of financial position at acquisition date	Higher as the NCI balance includes NCI goodwill.	Lower as the NCI balance is the proportion of net assets of the subsidiary owned by the NCI.
Goodwill in statement of financial position at acquisition date	Higher as goodwill includes both group and NCI goodwill.	Lower as the balance includes only the group goodwill.
NCI in statement of financial position at subsequent dates	There is a lower risk of the NCI balance being negative if the subsidiary is loss-making since the starting position was higher.	Higher risk of the NCI balance becoming negative as losses are allocated.
Impairment testing	Less complex as the carrying value of goodwill is compared with recoverable amount.	More complex: the carrying amount of goodwill must be grossed up prior to comparing with recoverable amount.
Impairment of goodwill	Goodwill impairment related to 100% of the acquiree is recognised.	Goodwill impairment related to the parent's interest is recognised.
Allocation of impairment losses at the reporting date	Any impairment losses to date are allocated between the parent and NCI based on ownership interests.	The impairment losses are allocated to the parent.
Subsequent acquisition	Lower impact on parent's equity because the NCI has a higher carrying value prior to the acquisition.	Higher impact on parent's equity as a result of the lower carrying value of the NCI prior to the acquisition.

HKFRS 3.11,12,18, HKFRS 13. 9-33,76, 81, 86

5.3 Fair value of identifiable assets acquired

HKFRS 3 (revised) requires that the net assets of the acquiree on the acquisition date are measured at fair value for inclusion within the consolidated financial statements and the goodwill calculation except in **limited, stated cases**. The assets and liabilities must:

(a) meet the definitions of assets and liabilities in the *Conceptual Framework*.

(b) be part of what the acquiree (or its former owners) exchanged in the business combination rather than the result of separate transactions.

HKFRS 13 *Fair Value Measurement* provides extensive guidance on how the fair value of assets and liabilities should be established.

This standard requires that the following are considered in determining fair value:

1 The asset or liability being measured

2 The principal market (i.e. that where the most activity takes place) or where there is no principal market, the most advantageous market (i.e. that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability.

3 The highest and best use of the asset or liability and whether it is used on a standalone basis or in conjunction with other assets or liabilities.

4 Assumptions that market participants would use when pricing the asset or liability.

Having considered these factors, HKFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that level 1 inputs are used where possible:

Level 1 Quoted prices in active markets for identical assets that the entity can access at the measurement date.

Level 2 Inputs other than quoted prices that are directly or indirectly observable for the asset.

Level 3 Unobservable inputs for the asset.

Fair values may be incorporated into the books of the acquiree in either of the following ways:

(a) The **subsidiary company** might **incorporate any necessary revaluations** in its own books of account. In this case, we can proceed directly to the calculation of goodwill and in turn the consolidation, taking asset values and reserves figures straight from the subsidiary company's statement of financial position.

(b) The **revaluations** may be made as a **consolidation adjustment without being incorporated** in the subsidiary company's books. In this case, we must make the necessary adjustments to the subsidiary's statement of financial position as a working. Only then can we proceed to the consolidation. Such adjustments are normally incorporated into the goodwill working, as shown in the following example.

Example: Fair value adjustments

Polly Co. acquired 75% of the 20,000 ordinary shares of Surrey Co. on 1 September 20X8 for $51,000. At that date the fair value of Surrey Co.'s non-current assets was $23,000 greater than their carrying amount, and the balance of retained earnings was $21,000. The non-controlling interests are measured as a proportion of the net assets of the acquiree.

Calculate the goodwill arising on the business combination.

Solution

Goodwill

	$	$
Consideration transferred		51,000
Non-controlling interests (64,000 (below) × 25%)		16,000
		67,000
Share of net assets acquired as represented by		
Ordinary share capital	20,000	
Retained earnings	21,000	
Fair value adjustment	23,000	
		(64,000)
Goodwill		3,000

Self-test question 1

Large Co. acquired 90% of the ordinary shares in Small Co. on 31 May 20X8, transferring $300,000 cash immediately, $100,000 in one year's time and 20,000 Large Co. shares to the shareholders of Small Co.. Large Co. also agreed to issue a further 10,000 shares in one year's time if Small Co. achieved an increase in profits of 5% over that year. At the acquisition date the equity and reserves section of Small Co.'s statement of financial position included the following balances:

	$
Share capital (100,000 shares)	100,000
Retained earnings	249,000
Revaluation reserve	50,000

The following information is also relevant:

1 The fair value of Small Co.'s land was $60,000 in excess of its book value, however Small Co. had not yet completed a revaluation exercise for the year.

2 Small Co. had not included a provision for legal costs of $40,000 in the accounts, despite the recognition criteria of HKAS 37 being met.

3 The share price of Large Co. shares on the acquisition date was $1.60

4 The share price of Small Co. shares on the acquisition date was $1.25

5 An appropriate discount rate is 6%

6 The fair value of the contingent consideration is estimated to be 90% of the value of the share price on the acquisition date.

7 In the year following the acquisition, Small Co. increased profits by 8%.

What goodwill arises on the acquisition of the controlling interests in Small Co., assuming that the non-controlling interests is measured at fair value?

(The answer is at the end of the chapter)

The following sections consider specific guidance on establishing the fair value of specific assets and liabilities in the case of a business combination.

HKFRS 3.11

5.3.1 Restructuring and future losses

An acquirer **should not recognise liabilities for future losses** or other costs expected to be incurred as a result of the business combination.

HKFRS 3 (revised) explains that a plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore an acquirer **should not recognise a liability for** such **a restructuring plan** as part of allocating the cost of the combination unless the subsidiary was already committed to the plan before the acquisition.

This **prevents creative accounting**. An acquirer cannot set up a provision for restructuring or future losses of a subsidiary and then release this to profit or loss in subsequent periods in order to reduce losses or smooth profits.

HKFRS 3.B31

5.3.2 Intangible assets

The acquiree may have **intangible assets**, such as development expenditure. These can be recognised separately from goodwill only if they are **identifiable**. An intangible asset is identifiable only if it:

(a) is **separable**, i.e. capable of being separated or divided from the entity and sold, transferred, or exchanged, either individually or together with a related contract, asset or liability

(b) arises from **contractual or other legal rights**

HKFRS 3.23,56

5.3.3 Contingent liabilities

Contingent liabilities of the acquiree are **recognised** if their **fair value can be measured reliably**. A **contingent liability** must be recognised even if the outflow is not probable, provided there is a present obligation.

This is a departure from the normal rules in HKAS 37; contingent liabilities are not normally recognised, but only disclosed.

After their initial recognition, the acquirer should measure contingent liabilities that are recognised separately at the higher of:

(a) the amount that would be recognised in accordance with HKAS 37
(b) the amount initially recognised

HKFRS 3.29

5.3.4 Reacquired rights

If the acquirer reacquires a right that it had previously granted to an acquiree (for example, the use of a trade name), the right will be recognised as an identifiable intangible asset, separately from goodwill.

HKFRS 3.27

5.3.5 Indemnification assets

Indemnification assets, such as an indemnity for an uncertain tax position or contingent liability, are recognised and measured based on the same measurement principles and assumptions as the related liability.

HKFRS 3.24,26,30,31

5.3.6 Other exceptions to the recognition or measurement principles

HKFRS 3 (revised) requires that the relevant standard is applied in measuring and recognising the following:

(a) **Deferred tax**: use HKAS 12 values.
(b) **Employee benefits**: use HKAS 19 values.
(c) **Share-based payment**: use HKFRS 2 values.
(d) **Assets held for sale**: use HKFRS 5 values.

HKFRS 3.45-50

5.4 Measurement period adjustments

Sometimes elements of the goodwill calculation such as the fair value of a particular asset or contingent consideration can only be determined provisionally by the end of the reporting period in which an acquisition takes place.

Where this is the case, goodwill is initially calculated based on those provisional values, and management will then continue to work to identify actual values after the reporting date for as long as the **measurement period** lasts.

The measurement period is that period of time immediately after the acquisition date when the acquirer may still be obtaining the information needed to identify and measure each element of the goodwill calculation:

- Consideration transferred
- The non-controlling interest
- The fair value of the net assets of the acquiree.

During this period the acquirer may adjust any provisional amounts to reflect new information obtained about facts and circumstances that existed as of the acquisition date. Amounts are adjusted retrospectively i.e. as if the actual amount had always been known. This means that the amount of goodwill initially calculated and the fair value of net assets or consideration initially recognised may change.

The measurement period ends on the earlier of:

- the date by which the acquirer has received all the information it was seeking or learns that the information cannot be obtained, or
- 12 months after the acquisition date.

Any further adjustments after the measurement period should be **recognised only to correct an error** in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Any subsequent changes in estimates are dealt with in accordance with HKAS 8 (i.e. the effect is recognised in the current and future periods). HKAS 8 requires an entity to account for an error correction retrospectively, and to present financial statements as if the error had never occurred by restating the comparative information for the prior period(s) in which the error occurred.

Example: Measurement period adjustments

Yeltsin Co. acquired 100% of Johnson Co. on 1 March 20X1, agreeing to pay cash consideration of $78 million. The provisional fair value allocated to the net assets of Johnson Co. at the acquisition date was $71 million, however the management of Yeltsin Co. have engaged third party experts in order to reliably measure the fair value of the intangible assets of Johnson Co. at this date.

The reporting date of Yeltsin Co. is 30 June 20X1, and at this date the third party experts have not yet concluded their work.

On 18 August 20X1, the experts report to management that the fair value of one of Johnson's intangible assets is $2m greater than the provisional value allocated to it. They also confirm the presumption that the asset has an indefinite useful life.

Required

Calculate the value of goodwill recognised in the financial statements of the Yeltsin Group on 30 June 20X1 and 30 June 20X2.

Solution

30 June 20X1

	$m
Consideration transferred	78
Provisional fair value of net assets acquired	(71)
Goodwill	7

30 June 20X2

	$m
Consideration transferred	78
Actual fair value of net assets acquired (71m + 2m)	(73)
Goodwill	5

Therefore goodwill is initially recognised at $7m in the consolidated financial statements at 30 June 20X1, however at 30 June 20X2 the amount is reduced to $5m with a corresponding increase of $2m to group intangible assets:

		$m	$m
DEBIT	Intangible assets	2	
CREDIT	Goodwill		2

As the adjustment is made retrospectively the 20X1 comparative financial statements provided in 20X2 are adjusted to reflect the lower value of goodwill.

Self-test question 2

Ariadne Co. acquired all of the share capital of Rebecca Co. on 30 September 20X7. At the Ariadne Group's year end of 31 December 20X7, management have still not ascertained the fair value of an item of property, plant and equipment held by Rebecca Co. at the acquisition date. A provisional value of $300,000 is allocated to the asset, which had a remaining useful life of five years at the acquisition date.

On 1 March 20X8, Ariadne received an independent valuer's report which allocated the asset a fair value of $400,000 on the acquisition date.

Required

What amounts are reported in the group accounts in the year ended 31 December 20X7 and 31 December 20X8 in respect of the asset? You should provide comparative information as at 31 December 20X8.

(The answer is at the end of the chapter)

5.5 Subsequent accounting

Topic highlights

Purchased positive goodwill is retained in the statement of financial position as an intangible asset under the requirements of **HKFRS 3 (revised)**. It must then be reviewed for impairment annually.

A bargain purchase is reassessed. If a bargain purchase remains, it is recognised as a gain in profit or loss.

5.5.1 Positive goodwill

Positive goodwill acquired in a business combination is **recognised as an asset** and is initially measured at **cost**. Cost is the excess of the cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities, and contingent liabilities.

After initial recognition goodwill acquired in a business combination is measured **at cost less any accumulated impairment losses**. It is **not amortised**. Instead it is tested for impairment at least annually, in accordance with HKAS 36 *Impairment of Assets*.

HKFRS 3.34-36

5.5.2 Bargain purchase

A bargain purchase arises when the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed exceeds the consideration transferred. It may also be referred to as negative goodwill.

Before recognising a gain on a bargain purchase, the acquirer must reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and must recognise any additional assets or liabilities that are identified in that review. The acquirer must then review the procedures used to measure the amounts this HKFRS requires to be recognised at the acquisition date for all of the following:

(a) The identifiable assets acquired and liabilities assumed
(b) The non-controlling interests in the acquiree, if any
(c) The consideration transferred

The purpose of this review is to ensure that the measurements appropriately reflect all the available information as at the acquisition date.

5.5.3 Non-controlling interests at the end of reporting period

It is important to realise that the measurement of the non-controlling interests (NCI) only applies **at the date of acquisition**. Subsequent to acquisition, the fair value of the subsidiary's net assets will have changed. The non-controlling interests at a given reporting date can therefore be calculated either by:

(a) calculating the NCI proportion of the net assets of the acquiree at the reporting date. Where the fair value method is used the NCI goodwill must be added to this, or

(b) calculating the NCI share of post-acquisition reserves movement and adding this to NCI as measured at the acquisition date.

Example: Goodwill

On 1 January 20X9, Flatley Co. acquired 70% of the ordinary shares of Gringo Co. at a cost of $700,000. The net assets of Gringo Co. at this date were $740,000. The non-controlling interests had a fair value of $250,000.

In the year to 31 December 20X9, Gringo retained profits of $100,000.

What goodwill arises on the acquisition of Gringo, and what is the value of the non-controlling interests at 31 December 20X9 assuming that the non-controlling interests is measured:

(a) as a proportion of the net assets of the acquiree
(b) at fair value?

Solution

Goodwill

	Proportion of net assets method	*Fair value method*
	$	$
Consideration	700,000	700,000
NCI (30% × $740,000)/fair value	222,000	250,000
	922,000	950,000
Net assets of acquiree	(740,000)	(740,000)
Goodwill	182,000	210,000
Non-controlling interests at 31 December 20X7		
Non-controlling interests at acquisition	222,000	250,000
Share of retained profits (30% × $100,000)	30,000	30,000
	252,000	280,000

	Proportion of net assets method	*Fair value method*
	$	$
Or		
Share of net assets at reporting date		
30% × ($740,000 + $100,000)	252,000	252,000
Goodwill ($250,000 – (30% × $740,000))	–	28,000
	252,000	280,000

In rare cases a subsidiary may have a negative equity balance. In this case the non-controlling interests is reported as a deficit balance in the consolidated statement of financial position in accordance with HKFRS 10. In other words, a group does not cease to allocate the non-controlling interests' share of losses to them simply because this would result in a negative balance.

Self-test question 3

Abacus prepares accounts to 31 December. On 1 September 20X7 Abacus acquired 6 million shares in Knowledge Co. (KC) at $2.00 per share. At that date KC produced the following interim statement of financial position:

Non-current assets	$m	$m
Property, plant and equipment (Note 1)		16.0
Current assets		
Inventories (Note 2)	4.0	
Receivables	2.9	
Cash in hand	1.2	
		8.1
Current liabilities		
Trade payables	3.2	
Provision for taxation	0.6	
Bank overdraft	3.9	
		(7.7)
Non-current liabilities		
Long-term loans		(4.0)
Net assets		12.4
Equity		
Share capital (8m shares)		8.0
Reserves		4.4
		12.4

Notes

1 The following information relates to the property, plant and equipment of KC at 1 September 20X7.

	$m
Gross replacement cost	28.4
Net replacement cost	16.6
Economic value	18.0
Net realisable value	8.0

The property, plant and equipment of KC at 1 September 20X7 had a total purchase cost to KC of $27.0 million. They were all being depreciated at 25% per annum pro rata on that cost. This policy is also appropriate for the consolidated financial statements of Abacus. No non-current assets of KC which were included in the interim financial statements drawn up as at 1 September 20X7 were disposed of by KC prior to 31 December 20X7. No non-current asset was fully depreciated by 31 December 20X7.

2 The inventories of KC which were shown in the interim financial statements are raw materials at cost to KC of $4 million. They would have cost $4.2 million to replace at 1 September 20X7. Of the inventory of KC in hand at 1 September 20X7, goods costing KC $3.0 million were sold for $3.6 million between 1 September 20X7 and 31 December 20X7.

3 On 1 September 20X7 Abacus took a decision to rationalise the group so as to integrate KC. The costs of the rationalisation were estimated to total $3.0 million and the process was due to start on 1 March 20X8. No provision for these costs has been made in any of the financial statements given above.

4 The non-controlling interests are measured as a proportion of the net assets of the acquiree.

Required

Compute the goodwill on consolidation of KC that will be included in the consolidated financial statements of the Abacus group for the year ended 31 December 20X7, explaining your treatment of the items mentioned above. You should refer to the provisions of relevant accounting standards.

(The answer is at the end of the chapter)

HKFRS 3.59-63

5.6 Disclosures

HKFRS 3 (revised) requires that an acquirer discloses information to enable the users of its financial statements to evaluate the nature and financial effect of a business combination that occurs during the current period or after the end of the period but before the financial statements are authorised for issue. This information should include:

- the name and a description of the acquiree
- the acquisition date
- the percentage of voting equity interests acquired
- the reasons for the business combination
- a qualitative description of the factors that make up the goodwill recognised
- the acquisition date fair value of the total consideration transferred and each major class of consideration
- for contingent consideration:
  - the amount recognised at acquisition
  - a description of the arrangement
  - an estimate of the range of outcomes
- details of acquired receivables
- amounts recognised for each class of assets and liabilities acquired
- disclosure in accordance with HKAS 37 for contingent liabilities recognised
- the amount of a gain in a bargain purchase and a description of reasons why the transaction resulted in a gain
- the amount of any non-controlling interests and the measurement basis applied
- valuation techniques used to determine the fair value of the non-controlling interests where relevant.

Topic recap

Principles of consolidation

Levels of investment

Subsidiary
- control
- consolidate

Associate
- significant influence
- equity account

Chapter 28

Joint arrangement
- contractual arrangement
- equity account

Chapter 28

Investment
- accretion of wealth
- financial asset

Chapter 18

HKFRS 10 Consolidated Financial Statements

Control is established where an investor has:
1 power over the investee
2 exposure to variable returns from its involvement with the investee
3 the ability to use the power to affect returns

Consolidated financial statements must be prepared for all subsidiaries under the control of a parent other than those held for sale.

In certain circumstances a parent company which is itself a subsidiary is exempt from preparing consolidated financial statements.

Investment entities must measure subsidiaries at fair value through profit or loss rather than consolidate them unless they provide services relating to investment activities.

Consolidation procedures:
- The parent's and subsidiaries' financial statements are combined on a line by line basis.
- Intra-group balances and transactions are eliminated.
- Adjustments must be made where a subsidiary has a different year-end from a parent.
- Uniform accounting policies are applied.
- A subsidiary is included from the date on which control is obtained.

HKFRS 3 Business Combinations

Goodwill:

Consideration transferred	X
Non-controlling interests	X
Fair value of net assets of acquiree	(X)
	X

Consideration:
- Contingent consideration included at fair value
- Payment in respect of pre-existing relationships is not part of consideration
- Acquisition-related costs are recognised as an expense

Non-controlling interest is measured at either fair value or as a proportion of the net assets of the acquiree.

Net assets of the acquiree are measured at fair value:
- Fair value adjustments are either recognised by the acquiree or made as a consolidation adjustment.
- Provisions for future losses/ restructuring are not recognised
- Intangible assets are recognised if identifiable
- Contingent liabilities are recognised at fair value if reliable

- Positive goodwill is recognised as an asset and tested for impairment annually
- Negative goodwill is reviewed and is then recognised as a gain on bargain purchase.

Answers to self-test questions

Answer 1

	$	$
Cash consideration		300,000
Deferred cash consideration ($100,000 × 1/1.06)		94,340
Equity consideration (20,000 × $1.60)		32,000
Contingent equity consideration (10,000 × $1.60 × 90%)		14,400
		440,740
Non-controlling interests (10,000 × $1.25)		12,500
		453,240
Fair value of net assets		
Book value	399,000	
Land	60,000	
Provision	(40,000)	
		(419,000)
Goodwill		34,240

Note that Small's actual 8% increase to profits in the year following acquisition does not affect the measurement of the contingent equity consideration (and so the calculation of goodwill). This contingent consideration is measured at its estimated fair value at the acquisition date. Subsequent changes to this fair value are only made where information becomes available during the measurement period which affects the fair value at the acquisition date.

Answer 2

STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X7 – EXTRACT	$
Property, plant and equipment (W)	285,000
WORKING	
Provisional value of asset	300,000
Depreciation (300,000 / 5 years) × 3/12	(15,000)
	285,000

STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X8 – EXTRACT	20X8 $	20X7 $
Property, plant and equipment (W)	300,000	380,000
WORKING		
Fair value of asset		400,000
Depreciation to 31 Dec 20X7 (400,000 / 5 years) × 3/12		(20,000)
		380,000
Depreciation for y/e 31 Dec 20X8 (400,000 / 5 years)		(80,000)
		300,000

The property, plant and equipment balance in the 20X7 comparative financial statements as reported in 20X8 is increased by $95,000. This increase is balanced by the following adjustments also made to the 20X7 figures:

The carrying value of goodwill is decreased by $100,000 being the difference between the acquisition date provisional value and fair value. The depreciation expense is increased by $5,000 being the difference between the depreciation charge as recognised in the 20X7 financial statements, based on the provisional value and the depreciation charge for 20X7 based on the fair value (HK$'000):

		$'000	$'000
DEBIT	Property, plant and equipment	95	
DEBIT	Depreciation expense	5	
CREDIT	Goodwill		100

Answer 3

Goodwill on consolidation of Knowledge Co.

	$m	$m
Consideration ($2.00 × 6m)		12.0
Non-controlling interests ($13.2m × 25%)		3.3
		15.3
Group share of fair value of net assets acquired		
Share capital	8.0	
Pre-acquisition reserves	4.4	
Fair value adjustments		
Property, plant and equipment ($16.6m – $16.0m)	0.6	
Inventories ($4.2m – $4.0m)	0.2	
		(13.2)
Goodwill		2.1

Notes on treatment

1 Share capital and pre-acquisition profits represent the book value of the net assets of KC at the date of acquisition. Adjustments are then required to this book value in order to give the fair value of the net assets at the date of acquisition. For short-term monetary items, fair value is their carrying value on acquisition.

2 The fair value of property, plant and equipment should be determined by market value or, if information on a market price is not available (as is the case here), then by reference to depreciated replacement cost, reflecting normal business practice. The net replacement cost (i.e. $16.6m) represents the gross replacement cost less depreciation based on that amount, and so further adjustment for extra depreciation is unnecessary.

3 Raw materials should be valued at replacement cost. In this case that amount is $4.2 million.

4 The rationalisation costs cannot be reported in pre-acquisition results under HKFRS 3 (revised) as they are not a liability of KC at the acquisition date.

Exam practice

XYZ — 18 minutes

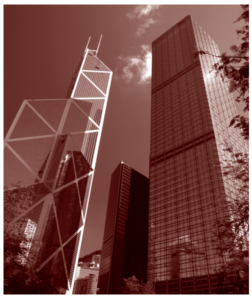
XYZ is a listed entity engaged in the provision of recruitment services, preparing financial statements to 30 June each year. Part of the directors' long term strategy is to identify opportunities for the takeover of other related businesses. In 20X1, the directors decided to expand their operations into the second major city of the country in which XYZ operates by taking over an existing recruitment agency. On 1 July 20X1, XYZ paid $14,700,000 for 800,000 of the 1,000,000 shares in the successful AB Agency. At that date, AB had share capital of $1,000,000 and retained earnings of $2,850,000. At the date of acquisition, AB's brand name was valued by specialists at $2,900,000 and following the acquisition it has been recognised in the consolidated financial statements of XYZ. Apart from retained earnings, AB has no other reserves.

AB has continued to be very successful and, therefore XYZ's directors have been seeking further acquisitions. On 1 April 20X7, XYZ gained control of a small online recruitment business, paying $39.60 per share to acquire 60,000 out of 100,000 issued shares in the CD Agency. CD's share capital is $100,000 and retained earnings at 1 July 20X6 were $700,000; at 30 June 20X7, they were $780,000. CD paid no dividends during the year ended 30 June 20X7. CD's profits can be assumed to accrue evenly over time. Since acquisition CD has continued to produce growth in both profit and market share.

The directors follow the accounting treatment required for goodwill arising on consolidation by HKFRS 3 *Business Combinations (revised)*. It is group policy to measure NCI at acquisition at full fair value. The fair value of the NCI shares at acquisition was $17 per share for AB and $35 per share for CD. XYZ has no investments other than those in AB and CD.

Required

Calculate the balance of goodwill on acquisition to be included in the consolidated financial statements of XYZ for the year ended 30 June 20X8. **(10 marks)**


chapter 27

Consolidated accounts: accounting for subsidiaries

Topic list

1 Consolidated financial statements
- 1.1 Mechanics of consolidation

2 Consolidated statement of financial position
- 2.1 Goodwill
- 2.2 Group reserves
- 2.3 Non-controlling interests
- 2.4 Fair value adjustments
- 2.5 Intra-group transactions

3 Consolidated statement of profit or loss and other comprehensive income
- 3.1 Non-controlling interests
- 3.2 Intra-group transactions
- 3.3 Mid-year acquisitions

4 Recap of simple consolidation techniques

5 Complex groups
- 5.1 Vertical groups
- 5.2 D-shaped groups

Learning focus

Group accounting is relevant to many entities. You should be able to perform a simple consolidation.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
4.04	**Acquisition of subsidiaries**	3
4.04.01	Prepare a consolidated statement of financial position for a simple/complex group structure including pre and post acquisition profits, non-controlling interests and goodwill	
4.04.02	Prepare a consolidated statement of profit or loss and other comprehensive income for a simple/complex group structure, dealing with an acquisition and the non-controlling interest	
4.09	**Consolidated financial statement preparation**	3
4.09.01	Prepare a consolidated statement of financial position in compliance with HKFRS 10	
4.09.02	Prepare a consolidated statement of profit or loss and other comprehensive income	

1 Consolidated financial statements

Topic highlights

Consolidated financial statements are prepared by adding together the parent and subsidiary's assets, liabilities, income and expenses and eliminating the cost of the investment in the subsidiary against the parent's equity in the subsidiary.

As we saw in the last chapter, HKFRS 10 requires a parent to present consolidated financial statements, in which the accounts of the parent and subsidiary (or subsidiaries) are combined and presented **as a single entity**.

1.1 Mechanics of consolidation

The basic mechanics of consolidation seen in the last chapter were as follows:

(a) Add together the parent's and subsidiaries' assets, liabilities, income and expenses on a line by line basis, eliminating any intra-group balances or transactions.

(b) Eliminate the carrying amount of the parent's investment in each subsidiary and the parent's proportion of equity in each subsidiary.

(c) Recognise non-controlling interests representing the equity of subsidiaries which does not belong to the parent where relevant.

In this chapter we shall apply these rules to both the consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income in turn.

2 Consolidated statement of financial position

Topic highlights

The consolidated statement of financial position includes only the parent's share capital.

The basic principles of the consolidated statement of financial position require that the assets and liabilities of a parent and subsidiary company are added together, and the parent's investment in the subsidiary is eliminated against the equity of that subsidiary. Therefore, only the parent company's share capital is shown in the consolidated accounts. In the simplest case the journal required to achieve this is:

DEBIT	Share capital of subsidiary
DEBIT	Pre-acquisition reserves of subsidiary
CREDIT	Parent's investment in subsidiary

The following example illustrates this.

Example: Consolidated statement of financial position

Let us assume that the parent company buys all of the ordinary shares in the subsidiary for $100,000:

STATEMENTS OF FINANCIAL POSITION AT ACQUISITION DATE

	Parent	*Subsidiary*	*Adjustments*	*Consolidated*
	$	$	$	$
Non-current assets	160,000	90,000		250,000
Investment in subsidiary	100,000	-	(100,000)	-
Current assets	58,000	30,000		88,000
	318,000	120,000		338,000

Share capital	100,000	30,000	(30,000)	100,000
Retained earnings	180,000	70,000	(70,000)	180,000
Liabilities	38,000	20,000		58,000
	318,000	120,000		338,000

The adjustments column shows the effect of the consolidation adjustment journal:

		$	$
DEBIT	Share capital of subsidiary	30,000	
DEBIT	Pre-acquisition reserves of subsidiary	70,000	
CREDIT	Parent's investment in subsidiary		100,000

To recognise the acquisition of subsidiary.

In this instance the $70,000 retained earnings of the subsidiary must have been made **pre-acquisition** and they are therefore eliminated and not available to the group.

2.1 Goodwill

Topic highlights

Goodwill is recognised as an asset in the consolidated statement of financial position and tested for impairment annually.

In the example above, the 100% investment in the subsidiary was purchased for $100,000 on a date when the net assets of the subsidiary were $100,000. Therefore no goodwill arose. As we saw in the last chapter, however, this is an unusual situation.

We shall now introduce goodwill into the consolidation process.

Example: Goodwill

The following statement of financial position relates to A Co. and B Co. as at 31 December 20X7.

	A Co.	*B Co.*
	$	$
Non-current assets	4,000	3,200
Investment in B Co.	3,800	–
Current assets	2,400	500
	10,200	3,700
Represented by:		
Share capital	8,000	3,000
Reserves	1,900	500
	9,900	3,500
Current liabilities	300	200
	10,200	3,700

A Co. acquired all of the share capital of B Co. on 31 December 20X7.

The consolidation process now involves:

1 adding together the assets and liabilities of A and B
2 eliminating the investment in B shown in A's books against B's equity
3 calculating and including goodwill in the consolidated statement of financial position

Goodwill is calculated as:

	$
Consideration	3,800
Net assets of B Co.	(3,500)
	300

CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF A CO AS AT 31 DECEMBER 20X7

	A Co.	*B Co.*	*Adjustments*	*Consolidated A Co.*
	$	$	$	$
Non-current assets	4,000	3,200	–	7,200
Investment in B Co.	3,800	–	(3,800)	–
Goodwill	–	–	300	300
Current assets	2,400	500	–	2,900
	10,200	3,700		10,400
Represented by:				
Share capital	8,000	3,000	(3,000)	8,000
Reserves	1,900	500	(500)	1,900
	9,900	3,500		9,900
Current liabilities	300	200	–	500
	10,200	3,700		10,400

Note. Consolidation adjustments are memoranda only, they are not part of bookkeeping procedures in the individual company's accounting records.

Consolidation adjustment

		$	$
DEBIT	Share capital	3,000	
	Pre-acquisition reserves (B Co.)	500	
	Goodwill on consolidation	300	
CREDIT	Cost of investment		3,800

To recognise the acquisition of B Co and goodwill arising

2.2 Group reserves

Topic highlights

Group reserves are calculated as all of the parent company's reserves plus the group share of the post-acquisition reserves in the subsidiary.

In both of the examples seen so far, the consolidation is performed on the date of the acquisition and therefore group reserves are equal to the parent company's reserves.

In the following example, we shall see how the post-acquisition profits of a subsidiary are taken into account in calculating group reserves.

Example: Group retained earnings

This example continues from the previous example (Goodwill) but has moved on a year, during which time B Co. has made post-acquisition profits of $200.

STATEMENTS OF FINANCIAL POSITION OF A CO. AND B CO. AT 31 DECEMBER 20X8

	A Co.	*B Co.*
	$	$
Non-current assets	5,000	3,500
Investment in B Co.	3,800	–
Current assets	2,000	800
	10,800	4,300
Represented by:		
Share capital	8,000	3,000
Reserves	1,900	700
	9,900	3,700
Current liabilities	900	600
	10,800	4,300

CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF A CO AS AT 31 DECEMBER 20X8

	A Co.	*B Co.*	*Adjustments*	*Consolidated A Co.*
	$	$	$	$
Non-current assets	5,000	3,500	–	8,500
Investment in B Co.	3,800	–	(3,800)	–
Goodwill	–	–	300	300
Current assets	2,000	800	–	2,800
	10,800	4,300		11,600
Represented by:				
Share capital	8,000	3,000	(3,000)	8,000
Reserves	1,900	700	(500)	2,100
	9,900	3,700		10,100
Current liabilities	900	600	–	1,500
	10,800	4,300		11,600

The acquisition journal in this case is the same as that in the example before. The difference is that in removing $500 of B's reserves, $200 post acquisition reserves remain to be carried across to form part of group reserves.

This example shows how group retained earnings comprise all of the parent company's retained earnings plus the group share (100% in this case) of the subsidiary's post acquisition retained earnings.

2.3 Non-controlling interests

Topic highlights

The non-controlling interests are shown in the equity and liabilities section of the consolidated statement of financial position. The acquisition date measurement (fair value or a proportion of net assets) increases by the non-controlling interest's share of post-acquisition reserves.

So far we have only dealt with situations where the parent company owns all of the share capital in the subsidiary. As we saw in the last chapter, however, there may be a non-controlling interest in the subsidiary. This may be measured at fair value or as a proportion of the net assets in the subsidiary, and the next two examples consider each of these situations.

Example: Non-controlling interests (1)

This example is based on the same information as that previously, but we shall assume that A Co. acquires only 2,400 of the 3,000 shares of B Co., and that the non-controlling interests are measured as a proportion of the net assets of the subsidiary.

Note that in this example the statement of financial position is being prepared at the acquisition date.

	A Co.	*B Co.*
	$	$
Non-current assets	4,000	3,200
Investment in B Co.	3,800	–
Current assets	2,400	500
	10,200	3,700
Represented by:		
Share capital	8,000	3,000
Reserves	1,900	500
	9,900	3,500
Current liabilities	300	200
	10,200	3,700

Goodwill working

Consideration		3,800
Non-controlling interests at date of acquisition ($3,500 × 20%)		700
		4,500
Less: net assets of B Co.		
Share capital	3,000	
Reserves	500	
		(3,500)
Goodwill		1,000

CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF A CO AS AT 31 DECEMBER 20X7

	A Co.	*B Co.*	*Adjustments*	*Consolidated A Co.*
	$	$	$	$
Non-current assets	4,000	3,200	–	7,200
Investment in B Co.	3,800	–	(3,800)	–
Goodwill	–	–	1,000	1,000
Current assets	2,400	500	–	2,900
	10,200	3,700		11,100
Represented by:				
Share capital	8,000	3,000	(3,000)	8,000
Reserves	1,900	500	(500)	1,900
	9,900	3,500		9,900
Non-controlling interests	–	–	700	700
Current liabilities	300	200		500
	10,200	3,700		11,100

Consolidation adjustment

		$	$
DEBIT	Share capital	3,000	
	Pre-acquisition reserves (B Co.)	500	
	Goodwill on consolidation	1,000	
CREDIT	Cost of investment		3,800
	Non-controlling interests		700

To recognise the acquisition of B Co and resulting goodwill and non-controlling interests

The non-controlling interests in net assets are shown within the equity and liabilities section of the statement of financial position. This amount represents the net assets of the subsidiary which legally belong to its non-controlling shareholders.

Example: Non-controlling interests (2)

Again, this example is based on the same information as previous worked examples but this time we'll assume that A Co. acquires only 2,400 of the 3,000 shares of B Co. and the fair value of the 20% non-controlling interests was $950. The non-controlling interest is measured at fair value at the acquisition date.

	A Co.	*B Co.*
	$	$
Non-current assets	4,000	3,200
Investment in B Co.	3,800	–
Current assets	2,400	500
	10,200	3,700
Represented by:		
Share capital	8,000	3,000
Reserves	1,900	500
	9,900	3,500
Current liabilities	300	200
	10,200	3,700

GOODWILL WORKING			
Consideration			3,800
Non-controlling interests (at fair value)			950
			4,750
Less:	Net assets of B Co.		
	Share capital	3,000	
	Reserves	500	
			(3,500)
Goodwill			1,250

CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF A CO. AS AT 31 DECEMBER 20X7

	A Co.	*B Co.*	*Adjustments*	*Consolidated A Co.*
	$	$	$	$
Non-current assets	4,000	3,200	–	7,200
Investment in B Co.	3,800	–	(3,800)	–
Goodwill	–	–	1,250	1,250
Current assets	2,400	500	–	2,900
	10,200	3,700		11,350

	A Co.	*B Co.*	*Adjustments*	*Consolidated A Co.*
	$	$	$	$
Represented by:				
Share capital	8,000	3,000	(3,000)	8,000
Reserves	1,900	500	(500)	1,900
	9,900	3,500		9,900
Non-controlling interests	–	–	950	950
Current liabilities	300	200		500
	10,200	3,700		11,350

Consolidation adjustment

		$	$
DEBIT	Share capital	3,000	
	Pre-acquisition reserves (B Co.)	500	
	Goodwill on consolidation	1,250	
CREDIT	Cost of investment		3,800
	Non-controlling interests		950

To recognise the acquisition of B Co and resulting goodwill and non-controlling interests

Again, the non-controlling interests is represented in the bottom half of the consolidated statement of financial position, however this time at fair value.

The goodwill calculated in this example of $1,250 is "full goodwill" being the goodwill attributable to both A Co. and the non-controlling interests.

2.3.1 Non-controlling interests and post acquisition profits

Now we shall consider how a non-controlling interest impacts the mechanics of the consolidation when we also have post acquisition retained earnings to consider.

Example: NCI and post acquisition profits (1)

This example is based on the same information as previous worked examples but now assume that:

- A Co. acquires only 2,400 of the 3,000 shares of B Co.
- The non-controlling interests are measured as a proportion of the net assets of the subsidiary
- B Co. has made post-acquisition profits of $200.

On 31 December 20X8, the statements of financial position of A Co. and B Co. are as follows:

	A Co.	*B Co.*
	$	$
Non-current assets	5,000	3,500
Investment in B Co.	3,800	–
Current assets	2,000	800
	10,800	4,300
Represented by:		
Share capital	8,000	3,000
Reserves	1,900	700
	9,900	3,700
Current liabilities	900	600
	10,800	4,300

CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF A CO. AS AT 31 DECEMBER 20X8

	A Co.	*B Co.*	*Adjustment (i)*	*Adjustment (ii)*	*Consolidated A Co.*
	$	$	$	$	$
Non-current assets	5,000	3,500	–	–	8,500
Investment in B Co.	3,800	–	(3,800)	–	–
Goodwill	–	–	1,000	–	1,000
Current assets	2,000	800	–	–	2,800
	10,800	4,300			12,300
Represented by:					
Share capital	8,000	3,000	(3,000)	–	8,000
Reserves	1,900	700	(500)	(40)	2,060
	9,900	3,700			10,060
Non-controlling interests	–	–	700	40	740
Current liabilities	900	600	–	–	1,500
	10,800	4,300			12,300

(i) Goodwill working

	$	$
Consideration		3,800
Non-controlling interests at date of acquisition ($3,500 × 20%)		700
		4,500
Less: net assets of B Co.		
Share capital	3,000	
Reserves	500	
		(3,500)
Goodwill		1,000

(ii) Post-acquisition profits in B Co.

Post-acquisition profits of B Co.	200
NCI share of post acquisition profits of B Co. (20% × $200)	40

Consolidation adjustments

		$	$
(i)			
DEBIT	Share capital	3,000	
	Pre-acquisition reserves (B Co.)	500	
	Goodwill on consolidation	1,000	
CREDIT	Cost of investment		3,800
	Non-controlling interests		700

To recognise the acquisition of B Co. and the resulting goodwill and non-controlling interest

(ii)

DEBIT	Reserves	40	
CREDIT	Non-controlling interests		40

To allocate the NCI share of B Co.'s post-acquisition profits

The following example again includes post-acquisition profits in the subsidiary, but this time the non-controlling interest is measured at fair value at the acquisition date.

Example: NCI and post acquisition profits (2)

Use the same information as the previous examples but this time assume that:

- A Co. acquires only 2,400 of the 3,000 shares of B Co.
- the non-controlling interest at acquisition is measured at fair value of $950
- B Co. has made a post-acquisition profit of $200.

On 31 December 20X8, the statements of financial position of A Co. and B Co. are as follows:

	A Co.	*B Co.*
	$	$
Non-current assets	5,000	3,500
Investment in B Co.	3,800	–
Current assets	2,000	800
	10,800	4,300
Represented by:		
Share capital	8,000	3,000
Reserves	1,900	700
	9,900	3,700
Current liabilities	900	600
	10,800	4,300

CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF A CO. AS AT 31 DECEMBER 20X8

	A Co.	*B Co.*	*Adjustment (i)*	*Adjustment (ii)*	*Consolidated A Co.*
	$	$	$	$	$
Non-current assets	5,000	3,500	–	–	8,500
Investment in B Co.	3,800	–	(3,800)	–	–
Goodwill	–	–	1,250	–	1,250
Current assets	2,000	800	–	–	2,800
	10,800	4,300			12,550

	A Co.	*B Co.*	*Adjustment (i)*	*Adjustment (ii)*	*Consolidated A Co.*
	$	$	$	$	$
Represented by:					
Share capital	8,000	3,000	(3,000)		8,000
Reserves	1,900	700	(500)	(40)	2,060
	9,900	3,700			10,060
Non-controlling interest	–	–	950	40	990
Current liabilities	900	600	-		1,500
	10,800	4,300			12,550

(i) Goodwill working

	$	$
Cost of investment		3,800
Non-controlling interests (fair value)		950
		4,750
Less: net assets of B Co.		
Share capital	3,000	
Reserves	500	
		(3,500)
Goodwill		1,250

(ii) Post-acquisition profits in B Co.

Post-acquisition profits in B Co.	200
NCI share of post acquisition profits of B Co. (20% × $200)	40

Consolidation adjustments

		$	$
(i)			
DEBIT	Share capital	3,000	
	Pre-acquisition reserves (B Co.)	500	
	Goodwill on consolidation	1,250	
CREDIT	Cost of investment		3,800
	Non-controlling interests		950

To recognise the acquisition of B Co. and resulting goodwill and NCI

(ii)			
DEBIT	Reserves	40	
CREDIT	Non-controlling interests		40

To allocate the NCI share of post-acquisition profits in B Co.

2.4 Fair value adjustments

Topic highlights

Where the book value of the subsidiary's assets and liabilities at the acquisition date is not equal to fair value, adjustment must be made on consolidation.

As we saw in the last chapter, HKFRS 3 (revised) requires that for the purposes of consolidation and the calculation of goodwill the assets and liabilities of the subsidiary are measured at fair value.

This may mean that adjustments are required as part of the consolidation process.

Example: Fair value adjustments

A Co. acquired 800 shares of B Co. representing 80% of the share capital on 1 January 20X7 when B Co.'s reserves were $300. The statements of financial position of A Co. and B Co. as at 31 December 20X7 were as follows:

	A Co.	*B Co.*
	$	$
Non-current assets, at cost	3,200	1,500
Less: Accumulated depreciation	(1,000)	(400)
	2,200	1,100
Investment in B Co.	1,300	–
Current assets	800	500
	4,300	1,600
Represented by:		
Share capital	3,000	1,000
Reserves	700	400
	3,700	1,400
Current liabilities	600	200
	4,300	1,600

The non-current assets of B Co. were valued at $1,400 on 1 January 20X7, and were estimated to have a remaining useful life of seven years. The revaluation was not recorded in the books of B Co..

B Co. provides depreciation at 10% per annum on cost of non-current assets. There have been no additions or disposal of non-current assets since 1 January 20X7.

The non-controlling interests are measured as a proportion of the net assets of the subsidiary.

APPROACH TO QUESTION AND WORKINGS

1 Set up a consolidation schedule

2 Calculate the acquisition date fair value adjustment:

	$
Carrying amount at 31 December 20X7	1,100
Add back 1 year's depreciation (10% × 1,500)	150
	1,250
Fair value of non-current assets at date of acquisition	(1,400)
Fair value adjustment at date of acquisition	(150)

Consolidation journal		$	$
DEBIT	Non-current assets	150	
CREDIT	Reserves		150

To recognise fair value adjustment on consolidation

3 Calculate goodwill on consolidation:

	$	$
Consideration		1,300
Non-controlling interests at date of acquisition ($1,450 × 20%)		290
		1,590
Less: net assets of B Co.		
Share capital	1,000	
Reserves	300	
Fair value adjustment	150	
		1,450
Goodwill		140

Consolidation journal

		$	$
DEBIT	Goodwill	140	
DEBIT	Share capital	1,000	
DEBIT	Reserves (300 + 150)	450	
CREDIT	Investment		1,300
CREDIT	Non-controlling interest		290

To recognise the acquisition of B Co. and resulting goodwill and non-controlling interest.

4 Calculate additional depreciation required in respect of the fair value adjustment

	$
Depreciation provided in the books of B Co. ($1,500 × 10%)	150
Depreciation based on fair value $\frac{\$1,400}{7 \text{ years}}$	(200)
Depreciation adjustment on consolidation	(50)

Consolidation journal

		$	$
DEBIT	Reserves	50	
CREDIT	Non-current assets		50

To record additional depreciation on fair value adjustment.

5 Allocate non-controlling interest share of post acquisition profit in B Co.

	$
Post acquisition profits in B Co.	
Per B Co.'s statement of financial position	400
Fair value adjustment at acquisition (W2)	150
Pre-acquisition reserves (W3)	(450)
Post-acquisition additional depreciation (W4)	(50)
	50
NCI share of post acquisition reserves (20% × 50)	10

Consolidation journal

		$	$
DEBIT	Reserves	10	
CREDIT	Non-controlling interest		10

To allocate the non-controlling interest share of B Co.'s post-acquisition profits

CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF A CO. AS AT 31 DECEMBER 20X7

				Adjustments			*Consolidated*
	A Co.	*B Co.*	2	3	4	5	*A Co.*
	$	$	$	$	$	$	$
Non-current assets	3,200	1,500	150				4,850
Accumulated depreciation	(1,000)	(400)			(50)		(1,450)
	2,200	1,100					3,400
Investment in B Co.	1,300	-		(1,300)			-
Goodwill				140			140
Current assets	800	500					1,300
	4,300	1,600					4,840
Represented by:							
Share capital	3,000	1,000		(1,000)			3,000
Reserves	700	400	150	(450)	(50)	(10)	740
Non-controlling interests				290		10	300
Current liabilities	600	200					800
	4,300	1,600					4,840

Note that there is no revaluation reserve in the consolidated statement of financial position since there is none in A Co.'s books, and that in B Co.'s books is a fair value adjustment on acquisition with no post-acquisition movement.

2.5 Intra-group transactions

Topic highlights

Intra-group balances and any unrealised profits must be eliminated on consolidation.

One of the basic principles underlying consolidation is that of viewing a group as a single economic entity. Therefore any intra-group (intercompany) transactions must be eliminated on consolidation so that the consolidated financial statements show only transactions with third parties outside the group.

Common intra-group transactions include:

- one company lending money to another group company
- trading between group companies
- one company selling a non-current asset to another company.

We shall consider each of these in turn.

2.5.1 Intra-group lending

As a result of intra-group lending one group company will show a loan in their statement of financial position and another group company will show an investment (or receivable).

On consolidation these should be eliminated against each other and are therefore not added across to form part of group borrowings or group investments.

2.5.2 Intra-group trading

Intra-group trading may result in one group entity recognising a receivable at the period end and another recognising a payable. These may be referred to as "current accounts". Again they should be cancelled against each other prior to the consolidation.

Where the amounts outstanding are not equal due to cash in transit, the recipient company should account for the cash in transit as if it had been received prior to the period end. The receivable and payable amounts will then be equal and may be cancelled.

A further result of intra-group trading is that of unrealised profits in stock. These are profits made by one group company selling to another. Until such time as the inventory in question is sold outside the group, the profit is not realised. Therefore, on consolidation, the unrealised profit in closing stock should be eliminated from the selling company's profits as part of the consolidation, and the closing inventory of the group should be recorded at cost to the group.

Example: Unrealised profit in stock

A Co. acquired 100% of the share capital of B Co. on 1 January 20X7 when the reserves of B Co. were $40. During the year ended 31 December 20X7, B Co. sold goods to A Co. at a price of $40 to include a 25% margin.

At 31 December 20X7, A Co. had half of these goods in stock. The inventory and reserves reported in the accounts of A Co. and B Co. as at 31 December 20X7 were:

	A Co.	*B Co.*
	$	$
Inventory	54	42
Reserves	100	50

The profit recorded by B Co. on sale of the goods to A Co. is $40 × 25% = $10. From the viewpoint of the group, $5 is unrealised and should be eliminated from B Co's profits prior to consolidation.

Consolidation adjustment

		$	$
DEBIT	B Co.'s Reserves	5	
CREDIT	Inventory		5

To eliminate the unrealised profit in inventory.

Consolidated inventory = $54 + $42 – $5 = $91
Consolidated reserves = $100 + ($50 – $40– $5) × 100% = $105

Note that in this case there is no non-controlling interest. If there had been, the group share of unrealised profits is deducted from group reserves and the non-controlling interests share is deducted from the non-controlling interests in the statement of financial position.

Had A Co. been the selling company, this is not an issue, and all of the unrealised profit is deducted from group reserves.

2.5.3 Intra-group transfers of non-current assets

It is common for group companies to transfer non-current assets from one to another depending on where they are needed. Often the transferor makes a profit on such a transaction. As above, this profit is unrealised until such time as the non-current asset is sold outside the group and therefore it must be eliminated on consolidation.

Here there is also the extra complication of depreciation, which must, for the purpose of the consolidated accounts, be based on the original cost of the asset to the group.

Example: Intra-group transfers of non-current assets

A Co. acquired 80% of the share capital of B Co. on 1 January 20X6. On 1 January 20X8, A Co. sold non-current assets which were acquired on 1 January 20X7 at $80,000 to B Co. for $90,000. Both A Co. and B Co. provide depreciation at 10% on cost per annum.

	$
Original cost	80,000
Less: accumulated depreciation	(8,000)
Carrying amount at date of transfer	72,000
Selling price to B Co.	(90,000)
Profit recorded in A Co. books	18,000

On 31 December 20X8, the consolidation adjustment on excess depreciation charge by B Co. from the viewpoint of the group is:

	$
Accumulated depreciation provided in the books of B Co. ($90,000 × 10%)	9,000
Accumulated depreciation since transfer based on cost of non-current assets of the group ($80,000 × 10%)	(8,000)
Excess depreciation charge	1,000

Therefore, relevant consolidation adjustments are:

		$	$
DEBIT	Consolidated reserves	18,000	
CREDIT	Consolidated non-current assets		18,000

To eliminate the unrealised profit on sale of non-current assets.

DEBIT	Consolidated accumulated depreciation	1,000	
CREDIT	Consolidated reserves		1,000

To eliminate excess depreciation charged as a result of intra-group transfer of non-current asset.

3 Consolidated statement of profit or loss and other comprehensive income

Topic highlights

A consolidated statement of profit or loss and other comprehensive income is prepared by adding across income and expenses on a line by line basis. Profit and total comprehensive income are allocated to the non-controlling interests and owners of the group.

A consolidated statement of profit or loss and other comprehensive income is prepared by adding all the individual items in the subsidiary's statement of profit or loss and other comprehensive income to those in the parent company's accounts.

Similar complications as those seen in relation to the statement of financial position are relevant.

3.1 Non-controlling interests

Where a subsidiary is partially owned, the relevant proportion of its profits and other comprehensive income must be allocated to the non-controlling interests.

Both the profit or loss and total comprehensive income attributable to the non-controlling interests and the owners of the parent should be shown separately at the end of the consolidated statement of profit or loss and other comprehensive income.

3.2 Intra-group transactions

Topic highlights

Intra-group income and expenditure is cancelled on consolidation. Any unrealised profits must also be eliminated.

The effects of intra-group lending, trading and transfers of assets will all need to be eliminated from the consolidated statement of profit or loss and other comprehensive income.

In the case of intra-group lending, interest receivable in the lender's books is cancelled against interest payable in the borrower's books prior to consolidation.

In the case of intra-group trading, sales in one group company's books is cancelled against cost of sales in another group company's books prior to consolidation. Where there is an unrealised profit in inventory this must also be eliminated. The following example illustrates this.

Example: Intra-group trading

The following information relates to A Co. and its 70% owned subsidiary, B Co., for the year ended 31 December 20X7.

	A Co.	*B Co.*
	$	$
Revenue	300	200
Cost of sales	(180)	(120)
Gross profit	120	80

During the year 20X7, B Co. sold goods to A Co. for $40, making a profit of $10. At the year end half of the goods remained in inventory, therefore there is an unrealised profit of $5.

Consolidation adjustments:

(i)		$	$
DEBIT	Revenue	40	
CREDIT	Cost of sales		40

To cancel intra-group sales.

(ii)		$	$
DEBIT	Cost of sales	5	
CREDIT	Inventory (SOFP)		5

To eliminate the unrealised profit in inventory.

The consolidated statement of profit or loss should be:

	A Co.	*B Co.*	*Adjustment (i)*	*Adjustment (ii)*	*Consolidated A Co.*
	$	$	$	$	$
Revenue	300	200	(40)		460
Cost of sales	(180)	(120)	40	(5)	(265)
Gross profit	120	80			195

In the case of intra-group transfers of non-current assets, any profit or loss arising in the year must be eliminated from the consolidated profit or loss. In addition, in the year of transfer and subsequent years, adjustment must be made so that the depreciation charge recorded in the consolidated statement of profit or loss and other comprehensive income is based on the cost of the asset to the group.

Example: Intra-group transfer of assets

The following information relates to A Co. and its 70% owned subsidiary, B Co., for the year ended 31 December 20X7.

	A Co.	*B Co.*
	$	$
Revenue	500	400
Cost of sales	(220)	(140)
Gross profit	280	260
Other income	90	30
Operating expenses	(270)	(180)
Operating profit	100	110

During the year, A Co. transferred an asset used for administrative purposes to B Co. making a profit of $80. As a result of the transfer depreciation has increased by $8 per annum.

Consolidation adjustments:

(i)		$	$
DEBIT	Other income	80	
CREDIT	Non-current assets (SOFP)		80

To eliminate the unrealised profit in non-current assets.

(ii)		$	$
DEBIT	Non-current assets (SOFP)	8	
CREDIT	Operating expenses		8

To eliminate the additional depreciation charged as a result of the intra-group transfer of a non-current asset.

The consolidated statement of profit or loss should be:

	A Co.	*B Co.*	*Adjustment (i)*	*Adjustment (ii)*	*Consolidated A Co.*
	$	$	$	$	$
Revenue	500	400			900
Cost of sales	(220)	(140)			(360)
Gross profit	280	260			540
Other income	90	30	(80)		40
Operating expenses	(270)	(180)		8	(442)
Operating profit	100	110			138

3.3 Mid-year acquisitions

Topic highlights

Where a subsidiary is acquired mid-year, its results must be pro-rated prior to consolidation.

Where a subsidiary is acquired mid-year, care must be taken to ensure that the subsidiary's results are included in the consolidation only from the date of acquisition. Practically, this will involve pro-rating the subsidiary's results prior to adding across.

Example: Mid-year acquisitions

The statements of profit or loss of A Co. and B Co. for the year ended 31 December 20X7 are given below:

	A Co.	*B Co.*
	$	$
Revenue	300	200
Cost of sales	(180)	(120)
Gross profit	120	80
Administrative and distribution expenses	(40)	(30)
Profit before taxation	80	50
Taxation	(15)	(8)
Profit after tax	65	42

A Co. acquired 70% of the ordinary share capital of B Co. on 1 April 20X7.

The consolidated statement of profit or loss for the year ended 31 December 20X7 is:

	A Co.	*B Co.*	*Calculation*	*Consolidated A Co.*
	$	$		$
Revenue	300	200	($300 + $200 × $^9/_{12}$)	450
Cost of sales	(180)	(120)	($180 + $120 × $^9/_{12}$)	(270)
Gross profit	120	80		180
Administrative and distribution expenses	(40)	(30)	($40 + $30 × $^9/_{12}$)	(63)
Profit before taxation	80	50		117
Taxation	(15)	(8)	($15 + $8 × $^9/_{12}$)	(21)
Profit after taxation	65	42		96

Available to:	
Owners of the parent (bal. fig.)	87
Non-controlling interests ($42 × $\frac{9}{12}$ × 30%	9
	96

4 Recap of simple consolidation techniques

The summary given below is very brief but it encompasses all the major rules which must be applied when preparing consolidated financial statements.

Approach to consolidated statement of financial position

1 Prepare a consolidation working schedule

2 Calculate and record in the schedule, as a consolidation adjustment, any fair value adjustment at the acquisition date. Recognising or increasing a liability will result in a debit to reserves; recognising or increasing an asset will result in a credit to reserves.

3 Calculate goodwill and record the adjustment journal in the schedule:

DEBIT	Goodwill
DEBIT	Share capital
DEBIT	Reserves
CREDIT	Investment
CREDIT	NCI

4 Calculate and record in the schedule any post-acquisition depreciation resulting from an acquisition date fair value adjustment.

DEBIT	Reserves
CREDIT	Property, plant and equipment

5 Calculate and record in the schedule any unrealised profit in inventory or non-current assets:

DEBIT	Reserves
CREDIT	Inventory / Non-current asset

6 Eliminate any intra-group balances such as loans, current accounts and cash in transit.

7 Calculate the NCI share of post-acquisition profits in the subsidiary and allocate these to the NCI.

DEBIT	Reserves
CREDIT	NCI

8 Add across the consolidation schedule.

The balances which are left should represent:

- **Assets** 100% P plus 100% S +/- adjustments
- **Share capital**: P only.
- **Reserves**: 100% P plus group share of post-acquisition retained reserves of S less consolidation adjustments.
- **Non-controlling interests**:

  Proportion of net assets method: NCI share of S's consolidated net assets

  Fair value method: NCI share of S's consolidated net assets plus NCI share of goodwill
- **Liabilities** 100% P plus 100% S +/- adjustments

Approach to consolidated statement of profit or loss and other comprehensive income

1 Set up a consolidation working schedule, pro-rating the subsidiary's results in the case of a mid-year acquisition.

2 Eliminate intra-group sales and purchases

3 Eliminate unrealised profits in inventory

4 Eliminate any intragroup dividends received and paid

5 Allocate profits between the parent and non-controlling interest.

Note:

Pre-acquisition dividends

There are two ways to calculate the pre-acquisition element of a dividend:

- To the extent that post-acquisition profits are **insufficient** to cover the dividend, the distribution must be out of pre-acquisition profits. This method is more commonly used in practice.
- **Apportion** the dividend on a time basis between the pre- and post-acquisition periods, so that only post-acquisition dividends are taken to P's reserves.
  - For **pre-acquisition dividends**: *Debit* Dividend receivable/cash, *Credit* Cost of investment.
  - For **post-acquisition dividends**: *Debit* Dividend receivable/cash, *Credit* Reserves.

Now try the following questions to practise the topics listed above.

Self-test question 1

Bootie Co. has owned 80% of Goose Co.'s equity since its incorporation. On 31 December 20X8 it despatched goods which cost $80,000 to Goose, at an invoiced cost of $100,000. Goose received the goods on 2 January 20X9 and recorded the transaction then. The two companies' draft accounts as at 31 December 20X8 are shown below:

STATEMENTS OF PROFIT OR LOSS

	Bootie	*Goose*
	$'000	$'000
Revenue	5,000	1,000
Cost of sales	2,900	600
Gross profit	2,100	400
Other expenses	1,700	320
Net profit	400	80
Income tax	130	25
Profit for the year	270	55

STATEMENT OF CHANGES IN EQUITY

	$'000	$'000
Opening balance	2,260	285
Total comprehensive income (profit) for the year	270	55
Dividends	(130)	(40)
Closing balance	2,400	300

STATEMENTS OF FINANCIAL POSITION

	Bootie		*Goose*	
	$'000	$'000	$'000	$'000
ASSETS				
Non-current assets				
Property, plant and equipment		1,920		200
Investment in Goose		80		–
		2,000		200
Current assets				
Inventory	500		120	
Trade receivables	650		40	
Bank and cash	390		35	
		1,540		195
		3,540		395
EQUITY AND LIABILITIES				
Equity				
Share capital		2,000		100
Retained earnings		400		200
		2,400		300
Current liabilities				
Trade payables	910		30	
Dividend payable	100		40	
Tax	130		25	
		1,140		95
		3,540		395

Required

Prepare draft consolidated financial statements (ignoring tax).

(The answer is at the end of the chapter)

Self-test question 2

The draft statements of financial position of Okay and its subsidiary Chestnut at 30 September 20X8 are as follows:

	Okay		*Chestnut*	
	$	$	$	$
Non-current assets				
Tangible assets, carrying amount				
Land and buildings		225,000		270,000
Plant		202,500		157,500
		427,500		427,500
Investment				
Shares in Chestnut at cost		562,500		
Current assets				
Inventory	255,000		180,000	
Receivables	375,000		90,000	
Bank	112,500		22,500	
		742,500		292,500
		1,732,500		720,000

	Okay	Chestnut
	$	$
Equity		
Share capital	1,125,000	450,000
Retained earnings	450,000	202,500
	1,575,000	652,500
Current liabilities	157,500	67,500
	1,732,500	720,000

The following information is also available:

(a) Okay purchased 360,000 of the 450,000 shares in Chestnut some years ago when that company had a credit balance of $105,000 in retained earnings. The goodwill had been impaired and was fully written off through profit or loss by 30 September 20X7.

(b) For the purpose of the acquisition, the land of Chestnut was revalued at $120,000 in excess of its book value. This was not reflected in the accounts of Chestnut. Land is not depreciated.

(c) At 30 September 20X8 Chestnut owed Okay $15,000 for goods purchased.

(d) The inventory of Chestnut includes goods purchased from Okay at a price which includes a profit to Okay of $10,500.

(e) It is the group's policy to value the non-controlling interests at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required

Prepare the consolidated statement of financial position for Okay as at 30 September 20X8 (ignoring tax).

(The answer is at the end of the chapter)

Self-test question 3

You are provided with the following statements of financial position for Shakier and Minoa.

STATEMENTS OF FINANCIAL POSITION AS AT 31 OCTOBER 20X0

	Shakier		Minoa	
	$'000	$'000	$'000	$'000
Non-current assets, at carrying amount				
Plant		325		70
Fixtures		200		50
		525		120
Investment				
Shares in Minoa at cost		200		
Current assets				
Inventory at cost	220		70	
Receivables	145		105	
Bank	100		–	
		465		175
		1,190		295
Equity				
Ordinary shares		700		170
Retained earnings		215		50
		915		220
Current liabilities				
Payables	275		55	
Bank overdraft	–		20	
		275		75
		1,190		295

The following information is also available:

(a) Shakier purchased 70% of the issued ordinary share capital of Minoa four years ago, when the retained earnings of Minoa were $20,000. There has been no impairment of goodwill.

(b) For the purposes of the acquisition, plant in Minoa with a book value of $50,000 was revalued to its fair value of $60,000. The revaluation was not recorded in the accounts of Minoa. Depreciation is charged at 20% using the straight line method.

(c) Shakier sells goods to Minoa at a mark up of 25%. At 31 October 20X0, the inventories of Minoa included $45,000 of goods purchased from Shakier.

(d) Minoa owes Shakier $35,000 for goods purchased and Shakier owes Minoa $15,000.

(e) It is the group's policy to value the non-controlling interests at fair value.

(f) The market price of the shares of the non-controlling shareholders just before the acquisition was $1.50.

Required

Prepare the consolidated statement of financial position of Shakier as at 31 October 20X0 (ignoring tax).

(The answer is at the end of the chapter)

5 Complex groups

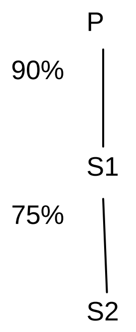
A parent company must prepare consolidated financial statements for all subsidiaries within its control, whether that control is direct or indirect.

So far, we have considered only direct control, for example a situation where P owns 80% of S. This section of the chapter considers two types of complex groups in which indirect control is also evident:

- Vertical groups
- D-shaped groups

5.1 Vertical groups

Vertical groups are those where there is a sub-subsidiary, for example:



Here:

- P owns 90% of S1, and therefore S1 is a subsidiary of P
- S1 owns 75% of S2 and therefore S2 is a subsidiary of S1
- As P controls S1 which in turn controls S2, S2 is within the control of P (referred to as a sub-subsidiary)

In this case the consolidated financial statements of P should include the assets, liabilities and results of both S1 and S2.

The consolidation is performed in the same way as the simple consolidations seen earlier in the chapter, however the calculation of goodwill becomes more complex, and is based on:

- an effective group interest of P in S2 of 67.5% (90% × 75%)
- an effective non-controlling interest in S2 of 32.5%, being
  25% owned directly by other shareholders in S2
  7.5% (10% × 75%) owned indirectly by other shareholders in S1

5.1.1 Goodwill calculation

Goodwill in the sub-subsidiary is calculated from the perspective of the parent company, and therefore includes only the parent's share of the cost of the investment in the sub-subsidiary and calculations based on the effective shareholdings.

Example: NCI as proportion of net assets

Tremendous owns 80% of the shares in Fabulous, and has done for many years. On 1 January 20X1, Fabulous acquired a 70% holding in Excellent at a cost of $9 million. On that date the fair value of the net assets of Excellent was $8 million (made up of $3m ordinary shares and $5m retained earnings).

What goodwill arises in the Tremendous consolidated financial statements at 31 December 20X1 on the acquisition of Excellent, assuming that the non-controlling interest is measured as a proportion of net assets of the acquiree?

Solution

- The group effective shareholding is 56% (80% × 70%)
- Therefore the effective non-controlling interest is 44%

	$'000
Cost of investment (80% × $9m)	7,200
NCI (44% × $8m)	3,520
Net assets of acquiree	(8,000)
Goodwill	2,720

Note that the goodwill arising on the acquisition of Fabulous would be calculated in the normal way, separately from the goodwill arising on the acquisition of Excellent.

Example: NCI at fair value

The facts are as for the example above, however the NCI in Excellent is now measured at fair value based on a share price of $3.50.

Solution

	$'000
Cost of investment (80% × $9m)	7,200
NCI (44% × 3m × $3.50)	4,620
Net assets of acquiree	(8,000)
Goodwill	3,820

In both of these examples the sub-subsidiary is acquired after the subsidiary. It may be the case that a vertical group develops where a parent company buys a subsidiary which itself already holds a sub-subsidiary. In this case separate calculations are still required for the goodwill arising in both the subsidiary and sub-subsidiary, but the acquisition date for both is the same, being the date on which the parent company acquired the subsidiary (and so the sub-subsidiary). The date on which the subsidiary acquired the sub-subsidiary is irrelevant.

5.1.2 Non-controlling interest and group reserves

Both non-controlling interests and group reserves are based on the respective effective shareholdings of the non-controlling interest and group.

Example: Non-controlling interest

The facts are as in the first example above (NCI measured as a proportion of net assets), and the retained earnings of Excellent as at 31 December 20X1 are $6.2 million.

(a) What is the non-controlling interest in respect of Excellent in both the statement of financial position at 31 December 20X1 and statement of profit or loss then ended?

(b) What share of Excellent's retained earnings are included in the group retained earnings balance?

Solution

(a)	*Statement of financial position*	$'000
	Non-controlling interest at acquisition	3,520
	Share of post acquisition profits 44% (6.2m – 5m)	528
	Non-controlling interest	4,048
	Statement of profit or loss	
	Non-controlling interest in profit	528
(b)	*Retained earnings*	
	Share of Excellent's retained earnings 56% (6.2m – 5m)	672

Self-test question 4

Below are the statements of financial position of three companies, Alpha, Beta and Gamma as at 31 December 20X5:

	Alpha	*Beta*	*Gamma*
	$'000	$'000	$'000
Investments			
300,000 shares in Beta	450		
240,000 shares in Gamma		320	
Current assets	890	610	670
	1,340	930	670
Share capital	600	400	300
Reserves	400	300	100
	1,000	700	400
Current liabilities	340	230	270
	1,340	930	670

1 Alpha acquired its interest in Beta on 1 January 20X2. Beta acquired its interest in Gamma on 1 January 20X3.

2 The retained earnings of Beta and Gamma were:

	1 January 20X3	*1 January 20X2*
	$'000	$'000
Beta	100	80
Gamma	60	50

Beta has 400,000 shares in issue and Gamma has 300,000 shares in issue.

3 Alpha Group's policy is to value non-controlling interests at the date of acquisition at the proportionate share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed. The fair values of the identifiable net assets of Beta and Gamma were equivalent to their book values at the respective date of acquisition.

4 Beta and Gamma form separate cash generating units. An impairment review carried out at 31 December 20X5 revealed that Beta had a recoverable amount of $780,000 (including its investment in Gamma) and that no impairment losses were required in respect of the group's investment in Gamma.

Required

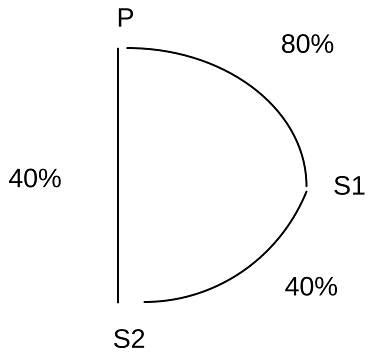
(a) Prepare the consolidated statement of financial position of Alpha and its subsidiary companies as at 31 December 20X5.

(b) Calculate the goodwill and consolidated reserves at 31 December 20X5 on the assumption that Alpha acquired Beta on 1 January 20X3 and that Beta had acquired Gamma on 1 January 20X2 (ignoring impairment losses).

(The answer is at the end of the chapter)

5.2 D-shaped groups

D-shaped groups are those where a parent company controls a subsidiary and the parent company and subsidiary together control a further subsidiary:



Here:

- P owns 80% of S1 and therefore S1 is a subsidiary of P
- P owns 40% of S2 directly and another 40% indirectly through S1. S2 is therefore a sub-subsidiary of P.

As with vertical groups, an effective interest is calculated in S2 and the consolidation is based on this percentage. In this case the relevant percentage is 72% (being a 40% direct holding and a

32% indirect holding calculated as 80% × 40%). The non-controlling interest effective percentage is therefore 28%.

5.2.1 Goodwill, non-controlling interest and retained earnings

The calculations for goodwill, the non-controlling interest and retained earnings are the same as those seen in the case of vertical groups, with one exception. Goodwill arising in the sub-subsidiary must include two elements to cost, being:

- the cost of the parent's direct holding
- the parent's share of the subsidiary's holding in the sub-subsidiary (i.e. the indirect holding)

Example: Goodwill

Goose acquired 90% of Duck a number of years ago. On 1 January 20X1, Duck and Goose both acquired 30% of Gander, each paying $4 million for their 30% share. On this date the net assets of Gander amounted to $10 million.

Required

What goodwill arises on the acquisition assuming that the non-controlling interest is measured as a proportion of net assets?

Solution

- Group effective holding is 57% (30% + (90% × 30%))
- Therefore the NCI share is 43%

	$'000
Cost of direct holding	4,000
Cost of indirect holding ($4m × 90%)	3,600
NCI (43% × $10m)	4,300
Net assets of acquiree	(10,000)
Goodwill	1,900

Self-test question 5

Below are the statements of financial position of Sigma, Pi and Delta as at 31 December 20X5.

	Sigma	*Pi*	*Delta*
	$'000	$'000	$'000
Investments			
300,000 shares in Pi	450		
25,600 shares in Delta	35		
230,400 shares in Delta		316	
Current assets	869	660	574
	1,354	976	574
Share capital	600	400	320
Retained earnings	400	356	180
	1,000	756	500
Current liabilities	354	220	74
	1,354	976	574

1 Sigma acquired its interest in Pi on 1 January 20X2 when the balance on the retained earnings was $140,000.

2 Sigma and Pi acquired their respective interests in Delta on 1 January 20X4 when the balance on the retained earnings was $80,000.

3 It is group policy to value the non-controlling interests at fair value at the date of acquisition. The fair value of the non-controlling interests in Pi on 1 January 20X2 was $145,000. The fair value of the 38% non-controlling interests in Delta on 1 January 20X4 was $160,000.

4 Sigma, Pi and Delta constitute separate cash generating units. The year end impairment test revealed impairment losses of $15,000 re Delta's recognised goodwill, but none of the other CGUs were affected.

5 Pi has 400,000 shares in issue and Delta has 320,000 shares in issue.

Required

Prepare the consolidated statement of financial position as at 31 December 20X5.

(The answer is at the end of the chapter)

Topic recap

Accounting for subsidiaries – basic groups

Consolidated statement of financial position

Mechanics:
1 add assets and liabilities on a line by line basis
2 eliminate P's investment in S against the equity of S
3 recognise the non-controlling interest
4 include P's share capital only

Calculate goodwill:

FV of consideration paid	X
NCI at acquisition	X
FV of net assets of acquiree	(X)
	X

Recognise as an asset and test for impairment annually.

Calculate NCI:

NCI at acquisition date	X
NCI share post acq'n reserves	X
	X

NCI at acquisition is either:
- proportion of net assets in subsidiary, or
- fair value

Calculate group reserves:

P's reserves	X
Group share of S's post acq'n reserves	X
Adjustments	X/(X)
	X

Adjust subsidiary's net assets at acquisition/in SOFP for fair value adjustments at acquisition

Intra-group balances are eliminated

Unrealised profits are eliminated against the selling company's reserves

Consolidated statement of profit or loss and other comprehensive income

Mechanics:
1 add income and expenditure on a line by line basis (pro rate for mid-year acquisition)
2 eliminate dividend income from S in P's SOCI
3 recognise the non-controlling interest in profits

Goodwill impairment charge

NCI in profits:

Profits of subsidiary	X
Adjustments	X/(X)
	X
	× NCI%

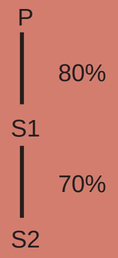
Fair value adjustments may result in additional depreciation on consolidation

Intra-group income and expenditure is eliminated

Unrealised profits are eliminated against the selling company's profits

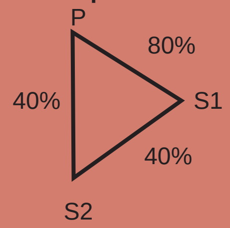
Complex groups

Vertical



- Consolidated financial statements include assets, liabilities and results of P, S1 and S2
- Goodwill calculation in S1 is as normal
- Goodwill calculation in S2 based on group effective holding of 56%; cost = 80% of the cost of S1's investment in S2
- NCI and group reserves calculations in respect of S2 are also based on group effective holding

D-shaped



- Consolidated financial statements include assets, liabilities and results of P, S1 and S2
- Goodwill calculation in S1 is as normal
- Goodwill calculation in S2 based on group effective holding of 72%; cost = 80% of the cost of S1's investment in S2
- NCI and group reserves calculations in respect of S2 are also based on group effective holding

Answers to self-test questions

Note: Although we have used a consolidation schedule in the chapter, these answers are prepared in a variety of ways in order to display that there is flexibility in how you prepare a consolidation.

Answer 1

BOOTIE GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X8

	$'000
Revenue (5,000 + 1,000 – 100)	5,900
Cost of sales (2,900 + 600 – 100 + 20)	3,420
Gross profit	2,480
Other expenses (1,700 + 320)	2,020
Net profit	460
Income tax (130 + 25)	155
Profit for the year	305
Profit attributable to:	
Owners of the parent	294
Non-controlling interests (55 × 20%)	11
	305

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X8

	$'000
Opening balance (balancing figure)	2,408
Group profit for the year	294
Dividends	(130)
Closing balance	2,572

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X8

	$'000	$'000
Assets		
Non-current assets (1,920 + 200)		2,120
Current assets		
Inventory (500 + 120 + 80)	700	
Trade receivables (650 – 100 + 40)	590	
Bank and cash (390 + 35)	425	
		1,715
		3,835

	$'000	$'000
EQUITY AND LIABILITIES		
Equity		
Share capital (Bootie only)		2,000
Retained earnings (W)		572
Shareholders' funds		2,572
Non-controlling interests (20% × 300)		60
		2,632
Current liabilities		
Trade payables (910 + 30)	940	
Dividend payable: Bootie Co.	100	
to non-controlling interests in Goose Co. (40 × 20%)	8	
Income tax (130 + 25)	155	
		1,203
		3,835

WORKING

Group retained earnings

	Bootie $'000	*Goose* $'000
Per question	400	200
Closing inventory in transit (at cost)	80	
Inter company sale	(100)	
Dividend receivable ($40 × 80%)	32	
Share of Goose's profit ($200 × 80%)	160	
Group net owned profits	572	

This working is, of course, only necessary when you are not required to prepare the consolidated statement of profit or loss and other comprehensive income. Here, it serves as a proof of the consolidated statement of profit or loss and other comprehensive income as well as of the reserves figure in the statement of financial position.

Answer 2

OKAY

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

	Okay	*Chestnut*	*W2*	*W3*	*W4*	*W5*	*W6*	*Consol'd*
	$'000	$'000	$'000	$'000	$'000	$'000	$'000	$'000
Land and buildings	225	270	120					615
Plant	202.5	157.5						360
Goodwill			22.5	(22.5)				-
Inventory	255	180				(10.5)		424.5
Receivables	375	90			(15)			450
Bank	112.5	22.5						135
								1,984.5
Share capital	1,125	450	(450)					1,125
Retained earnings	450	202.5	(105)	(22.5)	(15)	(10.5)	(19.5)	495
NCI			135				19.5	154.5
Current liabilities	157.5	67.5			(15)			210
								1,984.5

WORKINGS

1 Group structure: $\frac{360,000}{450,000}$ = 80%

2 *Goodwill*

	$	$
Consideration transferred		562,500
Non-controlling interests (675,000 × 20%)		135,000
		697,500
Less: net assets acquired		
Share capital	450,000	
Retained earnings	105,000	
Revaluation reserve	120,000	
		(675,000)
Goodwill		22,500

Consolidation adjustment

		$	$
DEBIT	Goodwill	22,500	
DEBIT	Share capital	450,000	
DEBIT	Reserves	105,000	
DEBIT	Revaluation reserve	120,000	
CREDIT	Investment		562,500
CREDIT	NCI		135,000

To recognise the acquisition of Chestnut and resulting goodwill and NCI.

3 *Goodwill impairment*

Goodwill is fully impaired, therefore:

		$	$
DEBIT	Retained earnings	22,500	
CREDIT	Goodwill		22,500

To record the goodwill impairment.

4 *Intra-group balances*

Intra-group balances are eliminated by:

DEBIT	Payables	15,000	
CREDIT	Receivables		15,000

To cancel intra-group balances.

5 *Unrealised profit*

DEBIT	Retained earnings	10,500	
CREDIT	Inventory		10,500

To eliminate the unrealised profit in inventory.

6 *Post-acquisition profits*

	$'000
Post acquisition profits (202.5 – 105)	97.5
Attributable to NCI (20%)	19.5

DEBIT	Retained earnings	19,500	
CREDIT	NCI		19,500

To allocate the NCI share of post-acquisition profits.

Answer 3

SHAKIER
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 OCTOBER 20X0

	$'000	$'000
Non-current assets		
Plant (W4)	397	
Fixtures (200 + 50)	250	
		647
Intangible asset: goodwill (W1)		77
		724
Current assets		
Inventory (W5)	281	
Receivables (W6)	200	
Bank	100	
		581
		1,305
Equity and liabilities		
Share capital		700
Retained earnings (W2)		221
		921
Non-controlling interests (W3)		84
		1,005
Current liabilities		
Payables (W7)	280	
Bank overdraft	20	
		300
		1,305

WORKINGS

1 *Goodwill*

	$'000	$'000
Consideration transferred		200.0
Fair value of the non-controlling interest (30% × 170,000 × $1.50)		76.5
		276.5
Net assets acquired		
Share capital	170	
Retained earnings	20	
Revaluation surplus (60 – 50)	10	
		(200.0)
Goodwill in parent		76.5

2 *Retained earnings*

	$'000	$'000
Shakier		215.0
PUP (W5)	9.0	
Additional depreciation on plant (8 (W4) × 70%)	5.6	
		(14.6)
		200.4
Minoa: 70% × (50 – 20)		21.0
		221.4

3 *Non-controlling interests*

	$'000	$'000
Share capital		170
Revaluation	10	
Less: excess depreciation	(8)	
		2
Retained earnings		50
		222
Non-controlling interest in subsidiary's identifiable net assets: 30% × $222,000		67
Goodwill attributable to NCI (76.5 – (200 × 30%))		17
Non-controlling interests		84

4 *Plant*

	$'000	$'000
Shakier		325
Minoa		
Per question	70	
Revalued (60 – 50)	10	
Depreciation on revalued plant (10 × 20% × 4)	(8)	
		72
		397

5 *Inventory*

	$'000	$'000
Shakier		220
Minoa	70	
Less: PUP (45 × $^{25}/_{125}$)	(9)	
		61
		281

6 *Receivables*

	$'000	$'000
Shakier		145
Less: intragroup		35
		110
Minoa	105	
Less: intragroup	15	
		90
		200

7 *Payables*

	$'000	$'000
Shakier		275
Less: intragroup		15
		260
Minoa	55	
Less: intragroup	35	
		20
		280

Answer 4

(a) ALPHA GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$'000
Goodwill (W2)	84
Current assets (890 + 610 + 670)	2,170
	2,254
Share capital	600
Reserves (W3)	559
	1,159
Non-controlling interests (W4)	255
	1,414
Current liabilities (340 + 230 + 270)	840
	2,254

WORKINGS

1 *Group structure*

Alpha

1.1.X2 $\frac{300,000}{400,000} = 75\%$

Beta → Non-controlling interests 25%

1.1.X3 $\frac{240,000}{300,000} = 80\%$

Gamma → Group effective interest (80% × 75%) 60%

∴ Non-controlling interests 40%

100%

2 *Goodwill*

	Beta		*Gamma*	
	$'000	$'000	$'000	$'000
Consideration transferred		450	(320 ×	240
Non-controlling interests (480 × 25%)/(360 × 40%)		120	75%)	144
Fair value of identifiable net assets at acquisition:				
Share capital	400		300	
Reserves at 1.12.20X2/1.12.20X3	80		60	
		(480)		(360)
		90		24
Impairment losses (see below)		(30)		
		60		24

$\underbrace{60 \qquad 24}_{84}$

Impairment losses – Beta	$'000
"Notional" goodwill (gross*) ($90 \times {}^{100}/_{75}$)	120
Net assets	700
	820
Recoverable amount	(780)
∴ Impairment loss (gross)	40
Impairment loss recognised (net) ($40 \times 75\%$)	30

* Where non-controlling interests are measured at the date of acquisition at the proportionate share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed (i.e. not at "full" fair value), part of the calculation of the recoverable amount of the CGU relates to the **unrecognised** non-controlling interest share of the goodwill.

For the purpose of calculating the impairment loss, the carrying amount of the CGU is therefore **notionally adjusted** to include the non-controlling interests in the goodwill by grossing it up.

The resulting impairment loss calculated is only recognised to the **extent of the parent's share**.

This adjustment is **not required** where non-controlling interests are measured at fair value at acquisition.

3 *Consolidated reserves*

	Alpha	*Beta*	*Gamma*
	$'000	$'000	$'000
Per question	400	300	100
Reserves at acquisition (W2)		(80)	(60)
		220	40
Group share of post acquisition reserves:			
Beta ($220 \times 75\%$)	165		
Gamma ($40 \times 60\%$)	24		
Group impairment losses to date (W2)	(30)		
	559		

4 *Non-controlling interests*

	Beta	*Gamma*
	$'000	$'000
NCI at acquisition (W2)	120	144
NCI share of post acquisition reserves:		
Beta ((W3) $220 \times 25\%$)	55	
Gamma ((W3) $40 \times 40\%$)		16
Less: NCI share of investment in Gamma ($320 \times 25\%$)	(80)	
	95	160
	255	

(b) Alpha acquired Beta on 1 January 20X3 and Beta acquired Gamma on 1 January 20X2

Revised workings:

2 *Goodwill*

	Beta		*Gamma*	
	$'000	$'000	$'000	$'000
Consideration transferred		450	(320 × 75%)	240
Non-controlling interests (500 × 25%)/(360 × 40%)		125		144
FV of identifiable net assets at acq'n:				
Share capital	400		300	
Reserves at 1.12.20X3	100		60	
		(500)		(360)
		75		24
			99	

3 *Consolidated reserves*

	Alpha	*Beta*	*Gamma*
	$'000	$'000	$'000
Per question	400	300	100
Reserves at acquisition (W2)		(100)	(60)
		200	40
Group share of post acq'n reserves:			
Beta (200 × 75%)	150		
Gamma (40 × 60%)	24		
	574		

Note. All other figures in the consolidated statement of financial position would be the same as in part (a). The consolidated statement of financial position would appear as follows:

ALPHA GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$'000
Goodwill (from above)	99
Current assets (890 + 610 + 670)	2,170
	2,269
Share capital	600
Reserves (from above)	574
	1,174
Non-controlling interests (W4)	255
	1,429
Current liabilities (340 + 230 + 270)	840
	2,269

Non-controlling interests working – same result, figures in bold have changed

	Beta	*Gamma*
	$'000	$'000
NCI at acquisition (W2)	**125**	144
NCI share of post acquisition reserves:		
Beta ((W3) **200** × 25%)	**50**	
Gamma ((W3) 40 × 40%)		16
Less: NCI share of investment in Gamma (320 × 25%)	(80)	
	95	160
	255	

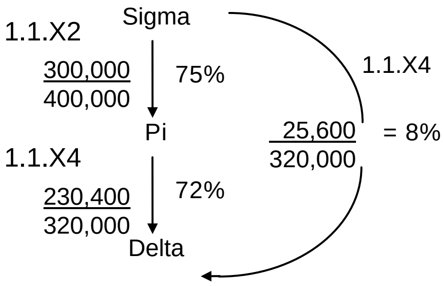
Answer 5

SIGMA CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$'000
Goodwill (W2)	72
Current assets (869 + 660 + 574)	2,103
	2,175
Share capital	600
Retained earnings (W3)	615
	1,215
Non-controlling interests (W4)	312
	1,527
Current liabilities (354 + 220 + 74)	648
	2,175

WORKINGS

1 *Group structure*



Sigma's effective interest in Delta [(75% × 72% = 54%) indirect + 8% direct]	62%
∴ Non-controlling interests	38%
	100%

2 *Goodwill*

	Pi		*Delta*	
	$'000	$'000	$'000	$'000
Consideration transferred – Sigma		450		35
Consideration transferred – Pi			(316 × 75%)	237
Non-controlling interests (at "full" fair value)		145		160
Fair value of identifiable NA at acq'n:				
Share capital	400		320	
Retained earnings	140		80	
		(540)		(400)
		55		32
Impairment losses to date		(-)		(15)
		55		17
Total goodwill		72		

3 *Retained earnings*

	Sigma	*Pi*	*Delta*
	$'000	$'000	$'000
Per question	400	356	180
Retained earnings at acquisition (W2)		(140)	(80)
		216	100
Group share of post acquisition retained earnings:			
Pi (216 × 75%)	162		
Delta (100 × 62%)	62		
Group share of impairment losses to date (W2) (15 × 62%)	(9)		
	615		

4 *Non-controlling interests*

	Pi	*Delta*
	$'000	$'000
NCI at acquisition (W2)	145	160
NCI share of post acquisition retained earnings:		
Pi ((W3) 216 × 25%)	54	
Delta ((W3) 100 × 38%)		38
Less: NCI in investment in Delta (316 × 25%)	(79)	
NCI share of impairment losses to date (W2) (15 × 38%)		(6)
	120	192
	312	

Exam practice

Smart Computer Limited — 22 minutes

On 1 October 20X9, Smart Computer Limited (SCL) acquired an 80% interest in Breakthrough Disc Company (BDC) at a consideration of HK$72 million. Fair value of BDC shares at that date was HK$45 each.

The carrying amount of identifiable net assets of BDC reported on its statement of financial position at the date of acquisition was HK$42 million. Other than the property, plant and equipment with a carrying amount of HK$60 million and fair value of HK$76 million, there were no differences between the carrying amount and the fair value for all other reported assets and liabilities. An internally generated intangible asset with fair value of HK$8 million was identified. Both the property, plant and equipment and the intangible asset have an estimated useful life of 10 years from the date of acquisition.

Post-acquisition profit reported by BDC before adjustment of depreciation and amortisation attributable to fair value up to 1 April 20Y0 was HK$8 million.

SCL adopts the accounting policy to measure any non-controlling interests in the acquiree at fair value.

Required

Assuming that BDC is not subject to income tax in any jurisdiction,

(a) calculate the amount of goodwill recognised for the acquisition. **(7 marks)**

(b) calculate the amount of non-controlling interests in BDC as at 1 April 20Y0 to be reflected in the consolidated statement of financial position of SCL.

(5 marks)

(Total = 12 marks)

HKICPA December 2010 (amended)

Bailey — 45 Minutes

Bailey, a public limited company, has acquired shares in two companies. The details of the acquisitions are as follows:

Company	*Date of acquisition*	*Ordinary share capital* $m	*Reserves at acquisition* $m	*Fair value of net assets at acquisition* $m	*Cost of investment* $m	*Ordinary share capital acquired* $m
Hill	1 January 20X6	500	440	1,040	720	300
Campbell	1 May 20X9	240	270	510	225	72

The draft financial statements for the year ended 31 December 20X9 are as follows:

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	Bailey	*Hill*	*Campbell*
Non-current assets	$m	$m	$m
Property, plant and equipment	2,300	1,900	700
Investment in Hill	720	–	–
Investment in Campbell	225	–	–
	3,245	1,900	700
Current assets	3,115	1,790	1,050
	6,360	3,690	1,750
Equity			
Share capital	1,000	500	240
Reserves	3,430	1,800	330
	4,430	2,300	570
Non-current liabilities	350	290	220
Current liabilities	1,580	1,100	960
	6,360	3,690	1,750

STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

	Bailey	*Hill*	*Campbell*
	$m	$m	$m
Revenue	5,000	4,200	2,000
Cost of sales	(4,100)	(3,500)	(1,800)
Gross profit	900	700	200
Distribution and administrative expenses	(320)	(175)	(40)
Dividend income from Hill and Campbell	36	-	-
Profit before tax	616	525	160
Income tax expense	(240)	(170)	(50)
PROFIT FOR THE YEAR	376	355	110
Other comprehensive income:			
Gain on revaluation of property (net of deferred tax)	50	20	10
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	426	375	120
Dividends paid in the year (from post-acquisition profits)	250	50	20

The following information is relevant to the preparation of the group financial statements of the Bailey group:

1 The fair value difference in Hill relates to property, plant and equipment being depreciated through cost of sales over a remaining useful life of 10 years from the acquisition date.

2 During the year ended 31 December 20X9, Hill sold $200 million of goods to Bailey. Three quarters of these goods had been sold by the year end. The profit on these goods was 40% on sales price. There were no opening inventories of intragroup goods nor any intragroup balances at the year end.

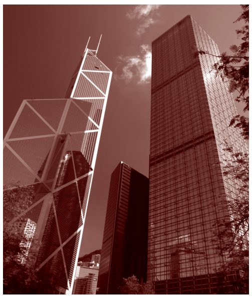
3 It is the group's policy to value non-controlling interests at fair value at the date of acquisition. The fair value of the non-controlling interests in Hill at 1 January 20X6 was $450 million.

4 Cumulative impairment losses on recognised goodwill in Hill at 31 December 20X9 amounted to $20 million, of which $15 million arose during the year. It is the group's policy to recognise impairment losses on positive goodwill in administrative expenses. No impairment losses have been necessary on the investment in Campbell.

Required

Prepare the consolidated statement of financial position for the Bailey group as at 31 December 20X9 and the consolidated statement of profit or loss and other comprehensive income for the year then ended.

(25 marks)


chapter 28

Consolidated accounts: accounting for associates and joint arrangements

Topic list

Learning focus

This chapter builds on the basic principles of consolidated accounts seen in the previous chapters. Associates and joint arrangements are common and you should know how to account for them.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
4.07	**Investments in associates**	3
4.07.01	Define an associate in accordance with HKAS 28 (2011)	
4.07.02	Explain what significant influence is and apply the principle	
4.07.03	Explain the reasons for and impact of equity accounting, including notional purchase price allocation on initial acquisition, fair value adjustments, upstream and downstream transactions, and uniform accounting policies	
4.07.04	Account for investors' share of losses of an associate in excess of its investments in associates	
4.07.05	Explain the impairment test and related treatments for investments in associates	
4.07.07	Prepare the disclosure in respect of associates	
4.08	**Joint arrangements**	3
4.08.01	Define a joint arrangement	
4.08.02	Explain the difference among joint operations and joint ventures	
4.08.03	Explain how an entity should account for a joint venture	
4.08.04	Account for the transactions between a venturer and a joint venture	
4.08.05	Disclose the relevant information in the venturer's financial statements	

1 Associates

Topic highlights

An associate is an entity over which an investor has significant influence. This is assumed where at least 20% of the voting power is held by an investor but may be achieved in other ways.

As we saw in Chapter 26, an associate is something less than a subsidiary, but more than a simple investment. HKAS 28 (2011) provides guidance on which entities meet the definition of an associate and how they should be accounted for within the consolidated financial statements.

HKAS 28 (2011) does not apply to investments in associates or joint ventures held by venture capital organisations, mutual funds, unit trusts, and similar entities that are measured at fair value in accordance with HKFRS 9.

Note that in the separate financial statements of the investor, an interest in an associate is accounted for either:

- at **cost**, or
- in accordance with HKFRS 9

HKAS 28(2011).3

1.1 Definitions

HKAS 28 (2011) provides a number of definitions:

Key terms

Associate. An entity, including an unincorporated entity such as a partnership, over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

Equity method. A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the profit or loss of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

(HKAS 28 (2011))

HKAS 28 (2011).5-6

1.1.1 Significant influence

Significant influence is defined as the "power to participate", but *not* to "control" (which would make the investment a subsidiary).

Significant influence can be determined by the holding of voting rights (usually attached to shares) in the entity. HKAS 28 (2011) states that if an investor holds **20% or more** of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, *unless* it can be clearly shown that this is not the case.

Significant influence can be presumed *not* to exist if the investor holds **less than 20%** of the voting power of the investee, unless it can be demonstrated otherwise.

The **existence of significant influence** is evidenced in one or more of the following ways:

(a) Representation on the **board of directors** (or equivalent) of the investee
(b) Participation in the **policy making process**
(c) **Material transactions** between investor and investee
(d) Interchange of **management personnel**
(e) Provision of **essential technical information**

HKAS 28 (2011).17

1.2 Excluded associates

HKAS 28 (2011) applies to all investments in associates *unless* the investment is classified as "held for sale" in accordance with HKFRS 5 in which case it should be accounted for under HKFRS 5.

An investor is exempt from applying HKAS 28 (2011) accounting procedures under the following circumstances:

(a) If it is a parent exempt from preparing consolidated financial statements under HKFRS 10

(b) All of the following apply:

(i) The investor is a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method.

(ii) Its securities are **not publicly traded**.

(iii) It is **not in the process of issuing securities** in public securities markets.

(iv) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with HKFRS.

Even where an investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor, the accounting requirements of HKAS 28 (2011) must be applied. Significant influence must be lost before the equity method ceases to be applicable.

HKAS 28 (2011).10-11, 22, 27,33

1.3 The equity method

HKAS 28 (2011) requires that associates are accounted for using the equity method in consolidated financial statements. Note that consolidated financial statements will only be prepared where there is also at least one subsidiary.

Under the equity method:

(a) the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.

(b) the investor's share of the profit or loss of the investee is recognised in the investor's profit or loss and their share of the other comprehensive income of the investee is recognised in other comprehensive income.

Therefore, the investment in associate is shown in the consolidated financial statements in just one line in the statement of financial position and a maximum of two in the statement of profit or loss and other comprehensive income. This treatment reflects the fact that the associate and its income streams are not controlled.

The use of the equity method should be **discontinued** from the date that the investor **ceases to have significant influence**.

When preparing the consolidated financial statements, the most recent available financial statements of the associate should be used. Where practicable, these should be prepared to the same reporting date as the financial statements of the investor. Where this is not practicable, **the difference between the end of the reporting period of the associate and that of the investor shall be no more than three months,** and adjustment should be made for transactions during this time.

Uniform accounting policies should be applied in the investor's and associate's accounts and where this is not the case, the associate's accounts should be adjusted.

1.4 Application of the equity method

Topic highlights

The **equity method** should be applied in the consolidated accounts:

- **Statement of financial position**: include investment in associate at cost plus (or minus) the group's share of the associate's post-acquisition retained total comprehensive income
- **Statement of profit or loss and other comprehensive income**: include group share of associate's profit after tax and other comprehensive income

The application of the equity method results in the following line items being included in the consolidated financial statements:

Statement of financial position

- Investment in associate shown as a non-current asset

Statement of profit or loss and other comprehensive income

- Share of profit (loss) of associate
- Share of associate's other comprehensive income

1.4.1 Consolidated statement of financial position

The **investment in associates** recognised in the consolidated statement of financial position is initially measured at cost. This amount will increase (decrease) each year by the amount of the group's share of the associate's total comprehensive income retained for the year.

The group share of the associate's reserves is also included within the group reserves figure in the equity section of the consolidated statement of financial position.

Example: Associate

Panda Co. acquires 30,000 of the 120,000 ordinary shares in Aardvark for $100,000 cash on 1 January 20X1. In the year to 31 December 20X1, Aardvark earns profits after tax of $80,000, from which it declares a dividend of $20,000. Aardvark reports no other comprehensive income.

How will Aardvark's results be accounted for in the individual and consolidated accounts of Panda Co. for the year ended 31 December 20X1?

Solution

Individual accounts

1 record at cost on 1 January 20X1

		$	$
DEBIT	Investment in associate	100,000	
CREDIT	Cash		100,000

2 record dividend income

		$	$
DEBIT	Cash (25% × $20,000)	5,000	
CREDIT	Investment income from shares in associates		5,000

Unless there is an impairment the investment remains held at cost of $100,000 in Panda’s statement of financial position permanently.

Consolidated accounts

In the **consolidated accounts** of Panda Co. equity accounting principles will be applied, and therefore:

- in the consolidated statement of financial position the investment is carried at cost plus Panda's share of Aardvark's retained profits
- Panda's share of Aardvark's profits is included in the consolidated statement of profit or loss and other comprehensive income (25% × $80,000 = $20,000)
- Panda's share of the dividend paid by Aardvark (25% × $20,000 = $5,000) is already included in Panda's profits and therefore only $15,000 is brought in as a consolidation adjustment by:

		$	$
DEBIT	Investment in associates	15,000	
	Investment income	5,000	
CREDIT	Share of profits of associates		20,000

The asset "Investment in associates" is then stated at $115,000, being cost plus the group share of post-acquisition retained profits.

On acquisition of the associate shareholding, although the investment is always initially carried at cost, the consideration paid is notionally allocated to the fair value of the net assets acquired.

(a) Where the cost of the investment exceeds the fair value of net assets acquired, notional goodwill exists within the carrying value of the investment in the statement of financial position. This is not recognised separately as goodwill and is not amortised.

(b) Where the cost of the investment is less than the fair value of net assets acquired, the difference is included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.

1.4.2 Consolidated statement of profit or loss and other comprehensive income

Under equity accounting, the associate's revenue, cost of sales and so on are ***not* aggregated** with those of the group. Instead, the consolidated statement of profit or loss and other comprehensive income will only include the group share of the associate's profit after tax and other comprehensive income for the year.

In effect, this is the corresponding treatment to the associate's parent company's treatment: the investing company is the non-controlling interests here.

PRO-FORMA CONSOLIDATED STATEMENT OF PROFIT OR LOSS (FOR ILLUSTRATION)

	$'000
Revenue	2,000
Cost of sales	800
Gross profit	1,200
Distribution costs and administrative expenses	500
	700
Interest and similar income receivable	50
	750
Finance costs	(40)
	710
Share of profit (after tax) of associate	30
Profit before taxation	740
Income tax expense – parent company and subsidiaries	240
Profit for the year	500

	$'000
Profit attributable to:	
Owners of the parent	480
Non-controlling interests	20
	500

Self-test question 1

Set out below are the draft accounts of Parent Co. and its subsidiaries and of Associate Co.. Parent Co. acquired 20% of the equity capital of Associate Co. five years ago when the latter's retained earnings stood at $60,000.

SUMMARISED STATEMENT OF FINANCIAL POSITION

	Parent Co. and subsidiaries	*Associate Co.*
	$'000	$'000
Property, plant and equipment	400	180
Investment in Associate at cost	80	–
Loan to Associate Co.	30	–
Current assets	190	70
Loan from Parent Co.	–	(30)
	700	220
Share capital	200	100
Retained earnings	500	120
	700	220

SUMMARISED STATEMENTS OF PROFIT OR LOSS

	Parent Co. and subsidiaries	*Associate Co.*
	$'000	$'000
Profit before tax	120	100
Taxation	30	20
	90	80

Required

Prepare the summarised consolidated accounts of Parent Co..

Note. Assume that there are no non-controlling interests in the subsidiary companies.

(The answer is at the end of the chapter)

Self-test question 2

Peter Co. bought 30,000 ordinary shares representing 30% of the share capital on 31 December 20X6 in Agnes Co. at a cost of $60,000 when the statement of financial position of Agnes was as follows:

AGNES CO.
DRAFT STATEMENT OF FINANCIAL POSITION AT DATE OF SHARE PURCHASE

ASSETS	$
Non-current assets	
Goodwill	50,000
Tangible assets	200,000
	250,000
Current assets	80,000
Total assets	330,000
EQUITY AND LIABILITIES	
Equity	
Share capital	100,000
Retained earnings	110,000
Non-current liabilities: 7% loan notes	120,000
Total equity and liabilities	330,000

During the year to 31 December 20X7 Agnes Co. made a profit before tax of $90,000 and the taxation charge on the year's profits was $20,000. A dividend of $30,000 was paid on 31 December out of these profits.

The statement of financial position of Agnes Co. on 31 December 20X7 was as follows:

ASSETS	$
Non-current assets	
Goodwill	50,000
Tangible assets	210,000
	260,000
Current assets	110,000
Total assets	370,000
EQUITY AND LIABILITIES	
Equity	
Share capital	100,000
Retained earnings	150,000
Non-current liabilities: 7% loan notes	120,000
Total equity and liabilities	370,000

Calculate the entries for the associate which would appear in the consolidated accounts of the Peter group, in accordance with the requirements of HKAS 28 (2011).

(The answer is at the end of the chapter)

1.5 Consolidation adjustments

Topic highlights

Intra-group transactions with an associate are not cancelled but the group share of any unrealised profit is eliminated. Fair value adjustments may also be required.

An associate is not deemed to be part of the single economic entity that is the group. That is because its assets and liabilities and therefore resulting income and expenditure are not controlled within the group.

Since an associate is not considered to be part of the group, there is no need to eliminate intra-group transactions.

Certain consolidation adjustments do, however, remain relevant, in particular unrealised profits, referred to by HKAS 28 (2011) as the effect of upstream and downstream transactions, and fair value adjustments.

HKAS 28 (2011).28

1.5.1 "Upstream" and "downstream" trading transactions

"Upstream" transactions are sales made by an associate to the parent company or a group subsidiary. "Downstream" transactions are sales made by the parent company or a group subsidiary to an associate.

The group share of unrealised profits and losses resulting from "upstream" and "downstream" transactions are eliminated.

The double entry is as follows, where A% is the parent's holding in the associate, and PUP is the provision for unrealised profit.

DEBIT	Cost of sales of parent	PUP × A%	
CREDIT	Group inventories		PUP × A%

For upstream transactions (associate sells to parent/subsidiary) where the parent holds the inventories.

OR

DEBIT	Cost of sales of parent/subsidiary	PUP × A%	
CREDIT	Investment in associate		PUP × A%

For downstream transactions (parent/subsidiary sells to associate) where the associate holds the inventory.

Example: Downstream transaction

P Co., a parent with subsidiaries, holds 30% of the equity shares in A Co. During the year, P Co. makes sales of $100,000 to A Co. at cost plus a 25% mark-up. At the year-end, A Co. has all these goods still in inventories.

P Co. has made an unrealised profit of $20,000 ($100,000 × $^{25}/_{125}$) on its sales to the associate A. The group's share of this is 30%, i.e. $6,000. This must be eliminated.

The double entry is:

		$	$
DEBIT	P: Cost of sales	6,000	
CREDIT	Investment in associate (A)		6,000

Because the sale was made to the associate, the group's share of the unsold inventories forms part of the investment in associate at the year end. If the sale had been from the associate A to P, i.e. an upstream transaction, the double entry would have been:

		$	$
DEBIT	P: Cost of sales	6,000	
CREDIT	P: Inventories		6,000

If preparing the consolidated statement of profit or loss, you would deduct the $6,000 from the group share of the associate's profit.

Note. In the examples above, the debit could be to items other than cost of sales, depending on the subject of the intra-group transaction.

HKAS 28 (2011).28-29

1.5.2 Transfers of non-current assets

Where a parent company transfers a non-current asset to an associate (a downstream transaction) or an associate transfers a non-current asset to its parent company (an upstream transaction), again only the group share of the unrealised profit (including any additional depreciation charge related to the asset) is eliminated.

Where downstream transactions provide evidence of an impairment loss to an asset, such a loss is recognised in full by the group. Where upstream transactions provide evidence of an impairment loss to an asset, the investor recognises its share of the loss.

HKAS 28 (2011).32

1.5.3 Fair value adjustments

As we have already said, on acquisition of an associate, the cost of the investment is notionally allocated to the fair value of the net assets acquired.

Where a fair value adjustment is made for the purposes of this exercise, appropriate adjustments to the investor's share of the associate's profits or losses after acquisition are also made to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date.

HKAS 28 (2011).38-39

1.6 Losses in an associate

Where an investor is loss making and the parent company's share of losses equals or exceeds its interest in the associate, the parent must discontinue recognising its share of further losses.

For this purpose the investment in the associate includes:

- initial cost
- the group share of the associate's post-acquisition retained total comprehensive income
- other long term interests such as long-term loans or preference shares.

After the interest in the associate is reduced to zero, additional losses are provided for and a liability recognised to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate.

Should the associate return to profit, the parent may resume recognising its share of profits only after they equal the share of losses not recognised.

Example: Carrying amount

The Letters Group has a 40% associate investment in Alpha Co which cost $500,000 on 1 January 20X2, including a premium representing notional goodwill. The results of Alpha Co. in recent years have been as follows:

Year ended 31 December	*Retained total comprehensive income*
	$
20X2	100,000
20X3	(1,000,000)
20X4	(500,000)
20X5	100,000
20X6	500,000

What is the carrying amount of the investment in Alpha Co. in each of these years in the consolidated financial statements of the Letters Group?

Solution

31 December 20X2	\$500,000 + (40% × \$100,000)	\$540,000
31 December 20X3	\$540,000 + (40% × (\$1m))	\$140,000
31 December 20X4	\$140,000 + (40% × (\$500,000))	Nil (\$60,000 losses unrecognised)
31 December 20X5	–\$60,000 + (40% × \$100,000)	Nil (\$20,000 losses unrecognised and unrecovered)
31 December 20X6	–\$20,000 + (40% × \$500,000)	\$180,000

1.7 Impairment losses

HKAS 39 sets out a list of indications that a financial asset (including an associate) may have become impaired (see Chapter 18). Any impairment loss is recognised in accordance with HKAS 36 *Impairment of Assets* for each associate individually. An impairment loss is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in associate. Accordingly, any reversal of that impairment loss is recognised in accordance with HKAS 36 to the extent that the recoverable amount of the investment subsequently increases.

1.8 Indirect investment in an associate

Where the investment in an associate is held by a subsidiary in which there is a non-controlling interest, the non-controlling interests shown in the consolidated financial statements of the group should include the **non-controlling interests of the subsidiary's interest** in the results and net assets of the associated company.

This means that the group accounts must include the "gross" share of net assets and total comprehensive income in accounting for the **non-controlling interests separately**. For example, we will suppose that P Co. owns 80% of S Co. which owns 25% of A Co., an associate of P Co.. The relevant amounts for inclusion in the consolidated financial statements would be as follows:

CONSOLIDATED STATEMENT OF PROFIT OR LOSS

Operating profit (P 100% + S 100%)

Share of profit after tax of associate (A 25%)

Tax (P 100% + S 100%)

Non-controlling interests (S 20% + A 5%*)

Retained profits (P 100% + S 80% + A 20%)

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Investment in associated company (figures based on 25% holding)

Non-controlling interests

((20% × shareholders' funds of S) + (5%* × post-acquisition retained earnings of A))

Group retained earnings ((100% × P) + (80% × post-acquisition of S) + (20% × post-acquisition of A))

* 20% × 25% = 5%

2 Joint arrangements

Topic highlights

A joint venture is a contractual arrangement where two or more parties jointly control an economic activity.

When two or more entities wish to enter into a business arrangement together, however do not want to create a formal long-term partnership, it is common to form a joint venture. This type of business vehicle generally exists to fulfil short term projects, such as the construction of a building or structure. When the project is complete, the joint venture ceases to exist.

There are different forms of joint venture, as we shall see, but essentially, entities which form the joint venture (venturers) contribute assets, expertise and in some cases equity to the venture. In return they are entitled to a share of the profits of the joint venture.

HKFRS 11 *Joint Arrangements* was issued in June 2011 and replaced HKAS 31 *Interests in Joint Ventures.* HKFRS 11 considers the different forms of joint venture which may be undertaken and how each form should be accounted for.

This section of the chapter considers definitions in relation to joint arrangements and then explains the requirements of HKFRS 11.

HKFRS 11, Appendix A

2.1 Definitions

Before thinking about the different types of joint venture and how they are accounted for, we must consider the definitions provided by HKFRS 11.

Key terms

Joint arrangement. An arrangement of which two or more parties have joint control.

Joint control. The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Joint operation. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

Joint venture. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

(HKFRS 11)

HKFRS 11.7-13

2.1.1 Joint control

The definition above specifically refers to a **contractually** agreed sharing of control and states that this exists only when decisions about the relevant activities require the **unanimous consent** of the parties sharing control. Where there is no contractual arrangement to establish joint control, or where there is a contractual arrangement but unanimous consent is not required to make decisions, then there is no joint control.

HKFRS 11 makes additional points about joint control:

- No single party controls the arrangement on its own
- A party with joint control of an arrangement can prevent any of the other parties from controlling the arrangement
- An arrangement can be a joint arrangement even if not all parties have joint control; some parties to a joint arrangement may participate but not have joint control
- Judgment should be applied when assessing whether a party has joint control of an arrangement.

Example: Joint control

Three parties establish an arrangement. Abacus has 50% of the voting rights in the arrangement, Bacchus has 30% and Cornelius has 20%. The contractual arrangement between the parties specifies that at least 75% of votes are required to make decisions about relevant activities of the arrangement.

In this case, Abacus can block a decision, however does not control the arrangement alone as it needs the agreement of Bacchus. Therefore, Abacus and Bacchus have joint control of the arrangement as decisions about relevant activities cannot be made without them agreeing. Cornelius is a participating party to the arrangement, however does not have joint control.

Contractual arrangement

HKFRS 11, B2, B4

HKFRS 11 states that the contractual arrangement may be evidenced in a number of ways including:

- a written contract between the controlling parties
- minutes of discussions between controlling parties
- incorporation of the arrangement in the articles or by-laws of the joint arrangement.

The contractual arrangement will deal with issues such as:

(a) the purpose, activity and duration of the joint venture
(b) the appointment of the board of directors and voting rights of the controlling parties
(c) capital contributions by the controlling parties
(d) the sharing by the controlling parties of the output, income, expenses or results of the joint venture.

One party may be identified in the contractual arrangement as the operator or manager of the joint venture. This does not indicate that that party controls the joint arrangement, simply that they are acting within the financial and operating policies agreed by the controlling parties in accordance with the contractual arrangement.

If it is evident that the operator does have control of the activity then the arrangement is a subsidiary of the operator rather than a joint operation or venture.

2.2 HKFRS 11 *Joint Arrangements*

Topic highlights

Joint arrangements are classified as either joint operations or joint ventures.

HKFRS 11 classes joint arrangements as either joint operations or joint ventures. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

A joint operation is a joint arrangement whereby the parties that have joint control (the joint operators) have rights to the assets, and obligations for the liabilities, of that joint arrangement. A joint arrangement that is not structured through a separate entity is always a joint operation.

A joint venture is a joint arrangement whereby the parties that have joint control (the joint venturers) of the arrangement have rights to the net assets of the arrangement.

A joint arrangement that is structured through a separate entity may be either a joint operation or a joint venture. In order to ascertain the classification, the parties to the arrangement should assess the terms of the contractual arrangement together with any other facts or circumstances to assess whether they have:

- rights to the assets, and obligations for the liabilities, in relation to the arrangement (indicating a joint operation)
- rights to the net assets of the arrangement (indicating a joint venture)

Detailed guidance is provided in the appendices to HKFRS 11 in order to help this assessment, giving consideration to, for example, the wording contained within contractual arrangements.

Self-test question 3

Can you think of any examples of situations where the following may occur?

(a) Joint operation not structured through a separate entity
(b) Joint venture structured through a separate entity

(The answer is at the end of the chapter)

HKFRS 11.20, 26

2.2.1 Accounting for joint operations

HKFRS 11 requires that a joint operator recognises line-by-line the following in relation to its interest in a joint operation:

(a) Its assets, including its share of any jointly held assets
(b) Its liabilities, including its share of any jointly incurred liabilities
(c) Its revenue from the sale of its share of the output arising from the joint operation
(d) Its share of the revenue from the sale of the output by the joint operation, and
(e) Its expenses, including its share of any expenses incurred jointly.

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.

HKFRS 11.24, 26

2.2.2 Accounting for joint ventures

In its consolidated financial statements, HKFRS 11 requires that a joint venturer recognises its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with HKAS 28 (2011) *Investments in Associates and Joint Ventures* unless the entity is exempted from applying the equity method (see section 1.2 which is also applicable to joint ventures).

In its separate financial statements, a joint venturer should account for its interest in a joint venture in accordance with HKAS 27 (2011) *Separate Financial Statements* (see Chapter 26 section 2.3.6).

2.2.3 Application of HKAS 28 (2011) to joint ventures

The consolidated statement of financial position is prepared by:

- including the interest in the joint venture at cost plus share of post-acquisition total comprehensive income
- including the group share of the post-acquisition total comprehensive income in group reserves

The consolidated statement of profit or loss and other comprehensive income will include:

- the group share of the joint venture's profit or loss
- the group share of the joint venture's other comprehensive income.

The use of the equity method should be **discontinued** from the date on which the joint venturer ceases to have joint control over, or have significant influence on, a joint venture.

HKAS 28 (2011), 28-29

2.2.3 Transactions between a joint venturer and a joint venture

Upstream transactions

A joint venturer may **sell or contribute assets** to a joint venture so making a profit or loss. Any such gain or loss should, however, only be recognised to the extent that it reflects the substance of the transaction.

Therefore:

- Only the **gain** attributable to the interest of the other joint venturers should be recognised in the financial statements.

- The full amount of any **loss** should be recognised when the transaction shows evidence that the net realisable value of current assets is less than cost, or that there is an impairment loss.

Downstream transactions

When a joint venturer purchases assets from a joint venture, the joint venturer should not recognise its share of the profit made by the joint venture on the transaction in question until it resells the assets to an independent third party, i.e. until the profit is realised.

Losses should be treated in the same way, *except* losses should be recognised immediately if they represent a reduction in the net realisable value of current assets, or a permanent decline in the carrying amount of non-current assets.

Self-test question 4

AB Co. contributes inventories to a 50:50 joint venture it has undertaken with CD Co.. The historical cost of the inventories is recorded in AB Co.'s books of account at $1m.

What gain or loss should AB Co. recognise in its financial statements when the fair value (net realisable value) of the inventories is estimated at the date of transfer and recorded by the joint venture as:

(a) $1.2 million?
(b) $0.8 million?

(The answer is at the end of the chapter)

2.3 HKAS 31 *Interests in Joint Ventures*

Topic highlights

HKAS 31 was the standard on joint ventures in force before HKFRS 11 was issued and HKAS 28 revised. It specified three types of joint venture: jointly controlled operations, jointly controlled assets and jointly controlled entities.

HKAS 31 specified three main types of joint venture:

- **Jointly controlled operations**
- **Jointly controlled assets**
- **Jointly controlled entities**

The following **characteristics** were common to all types of joint venture**:**

- Two (or more) venturers are bound by a **contractual arrangement**
- The contractual relationship establishes **joint control**

The following table summarises the differences between these types of joint venture, and details the accounting treatment required by HKAS 31 in each case:

Type of joint venture	Characteristics	Accounting treatment
Jointly controlled operations (JCOs)	• No separate entity established • Venturers provide own assets and resources and incur own expenses and liabilities • Revenues and expenses of the JCO are shared among the venturers.	In its own financial statements a venturer recognises: • assets it controls • liabilities it incurs • expenses it incurs • its share of income earned from the JCO.

Jointly controlled assets (JCAs)	• No separate entity established • Venturers jointly control assets purchased / contributed for use within the joint venture. • Each venturer may take a share of the output from the assets and each bears an agreed share of expenses.	In its own financial statements a venturer recognises its share of: • the jointly controlled assets • liabilities incurred with other venturers in relation to the JCA • income generated by the JCA and expenses incurred.
Jointly controlled entities (JCEs)	• Separate entity is established • This JCE controls the joint venture's assets, incurs liabilities and expenses and earns income • Venturers share the results and sometimes the output of the JCE	• Separate financial statements are maintained for the JCE • In venturers' separate financial statements the investment is accounted for in accordance with HKAS 27 (2011). • In venturers' consolidated financial statements, the investment is accounted for using either one of two methods: – equity accounting (HKAS 28 (2011)) – proportionate consolidation (see below)

2.3.1 Proportionate consolidation

Proportionate consolidation differs from normal consolidation in that only the **group share** of assets and liabilities, income and expenses are brought into the financial statements. There is therefore no non-controlling interest.

According to HKAS 31, this treatment reflects the **substance and economic reality** of the arrangement, being that the venturer has control over its share of future economic benefits through its share of the assets and liabilities of the venture.

2.3.2 Summary of changes between HKAS 31 and HKFRS 11/HKAS 28 (2011)

The main changes to the old rules are:

- The definitions have changed to reduce the 'types' of joint arrangements to two**: joint operations and joint ventures**
- The existing policy choice of **proportionate consolidation** for jointly controlled entities has been **eliminated**
- **Equity accounting** (as per HKAS 28 (2011)) is **mandatory for participants in joint ventures**

- **HKAS 28 now includes joint ventures** as well as associates, and was renamed accordingly.
- Joint operations will be accounted for much like joint assets or joint operations are currently.

3 Disclosure requirements

HKFRS 12.7, 20-23

An entity should disclose information about significant judgments and assumptions made in determining:

- that it has joint control of an arrangement or significant influence over another entity, and
- the type of joint arrangement (joint operation or joint venture) when the arrangement is structured through a separate vehicle.

It should also disclose information to allow users of the financial statements to evaluate:

- the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with other investors.
- the nature of, and changes in, risks associated with interests in joint ventures and associates.

3.1 Nature, extent and financial effects of an entity's interests in joint arrangements and associates

For each joint arrangement and associate that is material to the reporting entity the following should be disclosed:

(a) The name of the joint arrangement or associate.

(b) The nature of the entity's relationship with the joint arrangement or associate.

(c) The principal place of business/country of incorporation of the joint arrangement or associate.

(d) The proportion of ownership interest held by the entity/proportion of voting rights held.

For each joint venture and associate that is material to the reporting entity the following should be disclosed:

(a) Risks associated with an entity's interests in joint ventures and associates.

(b) Whether the investment in the joint venture or associate is measured using equity method or fair value.

An entity should disclose:

(a) commitments that it has relating to its joint ventures separately from the amount of other commitments

(b) contingent liabilities incurred relating to its interests in joint ventures or associates, separately from the amount of other contingent liabilities.

4 Current developments

The IASB issued two exposure drafts in relation to joint arrangements and associates in December 2012. These propose minor amendments to IFRS 11 (HKFRS 11) and IAS 28 (2011) (HKAS 28 (2011)):

- *Acquisition of an Interest in a Joint Operation* proposes to amend IFRS 11 (and so HKFRS 11) such that a joint operator would apply the relevant principles for business combination accounting in IFRS (HKFRS) 3 when acquiring an interest in a joint operation that constitutes a business. The relevant principles include measurement of identifiable net assets at fair value and recognition of acquisition related costs as expenses as incurred.

- *Sale or Contribution of Assets Between an Investor and its Associate or Joint Venture* proposes to amend IAS 28 (2011) (and so HKAS 28 (2011)) so that where an investor sells or contributes assets that constitute a business (per the IFRS (HKFRS) 3 definition), any gain or loss is recognised in full rather than in part as is currently required.

Topic recap

HKAS 28 Associates

An entity over which an investor has significant influence which is neither a subsidiary nor an interest in a joint venture.

Significant influence:
- Power to participate but not control
- Presumed where investor holds ≥ 20% voting shares
- Evidenced by:
  - board representation
  - participation in the policy making process
  - material transactions between investor and investee
  - interchange of management personnel
  - provision of essential technical information

HKFRS 11 Joint Arrangements

An arrangement of which at least 2 parties have joint control, i.e.:
- There is a contractual agreement to share control, and
- Decisions about relevant activities require the unanimous consent of the parties sharing control.

Joint Venture
A joint arrangement where the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

Joint Operation
A joint arrangement where parties that have joint control have rights to the assets and obligations for the liabilities relating to the arrangement.

Includes all joint arrangements not structured through a separate entity.

Recognise line by line the investor's share of:
- assets
- liabilities
- revenue
- expenses

In separate and consolidated financial statements.

Apply the **Equity method**

CSOFP: investment recognised at cost + the investor's share of post-acquisition total comprehensive income – impairment losses.

CSPLOCI: Investor's share of profit or loss and other comprehensive income recognised.

- Intra-group transactions are not cancelled
- Fair value adjustments may be required
- Gains and losses resulting from "upstream" and "downstream" transactions are recognised only to the extent of unrelated investors' interests in the associate or joint venture
- When downstream transactions provide evidence of a reduction in the net realisable value of assets/an impairment loss, losses shall be recognised in full by the investor.

Disclosures:
- How joint control or significant influence over another entity has been determined
- How the type of joint arrangement is determined when the arrangement is structured through a separate vehicle
- The nature, extent and financial effects of interests in joint arrangements and associates
- The nature of, and changes in, risks associated with interests in joint ventures and associates.

Answers to self-test questions

Answer 1

PARENT CO.
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	$'000
Net profit	120
Share of profits of associate (20% × 80)	16
Profit before tax	136
Income tax expense	30
Profit attributable to the owners of Parent Co.	106

PARENT CO.
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Parent and subsidiaries	*Adjustment 1*	*Adjustment 2*	*Group*
	$'000	$'000	$'000	$'000
Property, plant and equipment	400			400
Interest in associate	80	30	12	122
Loan to associate	30	(30)		-
Current assets	190			190
				712
Share capital	200			200
Retained earnings	500		12	512
				712

Consolidation adjustments

1 Loan to associate

DEBIT	Interest in associate	30	
CREDIT	Loan to associate		30

To transfer the loan to become part of the investment in associate

2 Post acquisition retained earnings

DEBIT	Interest in associate 20% x (120-60)	12	
CREDIT	Retained earnings		12

Answer 2

CONSOLIDATED STATEMENT OF PROFIT OR LOSS

	$
Group share of associate's profit after tax 30% × (90,000 – 20,000)	21,000

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$
Interest in associate	72,000

The asset "interest in associate" comprises:

Cost	60,000
Share of post-acquisition retained earnings 30% × (150,000 – 110,000)	12,000
	72,000

Answer 3

(a) An example of a joint operation may involve building an aircraft. Say that Boeing is to build the body of the aircraft and the engines are to be built by Rolls Royce as specified by the airline customer for the aircraft. You can see that different parts of the manufacturing process are carried out by each of the joint operators. In the Rolls Royce factory, workers will work on the engines for the Boeing plane alongside others working on engines for different aircraft.

Each operator, Boeing and Rolls Royce, bears its own costs and takes a share of revenue from the aircraft sale. That share is decided in the contractual arrangement between the venturers.

Other examples may arise in the oil, gas and mineral extraction industries. In such industries companies may, say, jointly control and operate an oil or gas pipeline. Each company transports its own products down the pipeline and pays an agreed proportion of the expenses of operating the pipeline (perhaps based on volume).

A further example is a property which is jointly controlled, each operator taking a share of the rental income and bearing a portion of the expense.

In each case, the key issue is that the joint controller is entitled to a share of assets and liabilities of the joint arrangement, rather than a share of net assets.

(b) A common situation is where two or more entities transfer the relevant assets and liabilities to a joint venture in order to combine their activities in a particular line of business.

In other situations, an entity wishing to start operations in a foreign country will set up a joint venture with the government of the foreign country (or an agency of it).

Answer 4

(a) AB Co. has made a profit of $0.2 million, but only 50% of this can be considered as realised, ie that part attributable to the other venturer. AB Co. should therefore recognise a gain of $0.1 million.

(b) A loss of $0.2 million has been made on the inventories, the entire amount of which should be recognised by AB Co.. It is known that the loss will be made, even though the inventories have not yet been sold, and the standard requires that the full loss should be recognised immediately when they represent a reduction in the net realisable value.

Exam practice

Asia Polyethylene

90 Minutes

Assume that you are Miss Charmaine Yuen, the accounting manager of Asia Polyethylene Limited (APE), which is a company incorporated in Hong Kong. APE and its subsidiaries (APE Group) are principally engaged in the production and distribution of high density polyethylene (HDPE) which is widely used for the production of plastic bags, bottle caps and fluid containers in Hong Kong. Now, APE intends to expand its business for the production and distribution of HDPE worldwide.

Brazil Polyethylene (BPE) and Curitiba Polyethylene (CPE)

On 1 April 20X2, APE, BPE and CPE (the parties), which are not related companies, signed an agreement in which they have agreed the terms according to which they will conduct the manufacturing and distribution of HDPE worldwide. The parties have agreed to conduct manufacturing and distribution activities according to the details described below:

Diadema Polyethylene (DPE)

The parties have agreed to undertake the manufacturing and distribution activity by establishing a new incorporated entity, DPE, in which APE has a 60% ownership interest and hence 60% voting rights, BPE has 20% and CPE has 20%. The contractual agreement specifies that at least 90% of the voting rights are required to make decisions about activities that significantly affect the returns of DPE. In accordance with the agreement, DPE would manufacture and distribute the HDPE in various overseas countries according to the needs of the various markets where DPE sells the product. The contractual arrangement among APE, BPE and CPE did not specify that the parties have rights to the assets, and obligations for the liabilities, relating to DPE.

Embu Polyethylene (EPE) and Fatima Polyethylene (FPE)

APE acquired 80% of the shares of EPE for HK$26.55 million on 1 April 20W9. At the acquisition date, EPE's reported retained earnings were HK$12.25 million. The excess of APE's acquisition cost over its share of EPE's book value was assigned to plant and equipment that had a fair value of HK$2.5 million greater than book value and a remaining life of five years at the acquisition date, and the balance to goodwill. Non-controlling interests are to be measured at their fair value at the acquisition date, i.e. HK$6 million. The investment in EPE is carried at cost. There has been no change in the share capital of EPE since the date of acquisition.

On 1 April 20X1, APE acquired 30% of the ordinary shares in FPE for HK$7.45 million. FPE should be accounted for as an associate. The book value of FPE's net assets was the same as their fair value as at the acquisition date. There has been no change in the share capital of FPE since the date of acquisition.

An extract of the financial statements of the three companies for the year ended 31 March 20X2 is shown below.

	APE	*EPE*	*FPE*
	HK$'000	HK$'000	HK$'000
Sales	80,000	35,750	18,000
Cost of sales	(55,000)	(24,500)	(12,000)
Other income (including gain on disposal and EPE's dividend)	3,700	–	–
Depreciation expense	(8,000)	(1,700)	(400)
Interest expense	(5,900)	(1,600)	(550)
Other expenses	(3,800)	(4,200)	(2,850)
Profit for the year	11,000	3,750	2,200
Retained earnings, 1 April 20X1	44,000	22,500	11,250
Dividends declared	(3,500)	(1,250)	–
Retained earnings, 31 March 20X2	51,500	25,000	13,450

Plant and equipment, net	43,000	19,000	10,800
Investment in EPE, cost	26,550	–	–
Investment in FPE, cost	7,450	–	–
Other investments	20,750	1,250	–
Inventory	41,250	20,000	10,400
Receivables	10,000	11,000	9,000
Cash and cash equivalents	7,500	8,750	5,800
	156,500	60,000	36,000
Share capital	30,000	15,000	7,500
Retained earnings	51,500	25,000	13,450
Payables	75,000	20,000	15,050
	156,500	60,000	36,000

On 1 April 20X1, APE held inventory of HK$2.5 million purchased from EPE during the year ended 31 March 20X1; these goods had been manufactured by EPE at a cost of HK$1.6 million. During the year ended 31 March 20X2, EPE sold goods costing HK$6 million to APE for HK$9 million. APE sold the inventory of HK$2.5 million on hand at the beginning of the year, but held 35% of its current year's purchases from EPE on 31 March 20X2.

APE sold plant and equipment at a transfer price of HK$10 million (with an original carrying amount of HK$8 million) to FPE on 1 April 20X1. On that date, that plant and equipment had a remaining useful life of five years.

Bankrupt Customer

APE has a financial year end of 31 March 20X2 and the financial statements are to be authorised for issue on 15 June 20X2. On 15 May 20X2, it was discovered that a customer owing HK$650,000 had gone into bankruptcy. The adjustments, if necessary, have not been recorded in the draft financial statements listed above.

Ms. Pindy Lee, a director of APE is concerned about the implications of the above transactions and information. She wonders if it is necessary for APE to take into account the results of the above investments, arrangements and events and if it may make a difference in the consolidation process.

Assume that you are Charmaine Yuen, the accounting manager, and you are required to draft a memorandum to Ms. Pindy Lee, a Director of APE. In your memorandum, you should:

(a) For the investment in DPE in the consolidated financial statements of APE, identify and justify the applicable financial reporting standard, and advise the appropriate classification and accounting treatment.

(You are not required to describe the detailed accounting method.) **(13 marks)**

(b) Discuss and advise as to the accounting treatments for the bankrupt customer in the consolidated financial statements of APE for the year ended 31 March 20X2. **(7 marks)**

(c) Prepare an annex to your memorandum, showing the worksheets for:

(i) the consolidated statement of profit or loss and other comprehensive income of APE for the year ended 31 March 20X2, **(10 marks)**

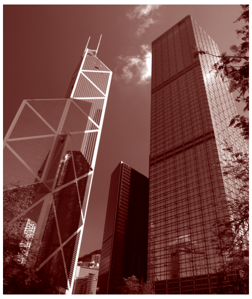
(ii) the consolidated statement of financial position of APE as at 31 March 20X2, and **(10 marks)**

(iii) the consolidated statement of changes in equity of APE for the year ended 31 March 20X2. **(10 marks)**

(Ignore the deferred tax implications. Consolidation adjustments are to be shown in the form of a worksheet. For part 1(c)(i) and (ii), you may use the template in green colour paper provided and/or the script booklet for Case Questions to prepare your answers. You are required to show the detailed calculations for each figure, journal entries are **not** required.)

(Total = 50 marks)

HKICPA December 2012 (amended)


chapter 29

Changes in group structures

Topic list

1 Disposals
- 1.1 Types of disposal
- 1.2 Full disposal of a subsidiary
- 1.3 Partial disposal of subsidiary: subsidiary to subsidiary
- 1.4 Partial disposal of subsidiary: subsidiary to associate
- 1.5 Partial disposal of subsidiary: subsidiary to financial asset
- 1.6 Reclassification adjustments
- 1.7 Full disposal of associate
- 1.8 Partial disposal of associate: associate to financial asset
- 1.9 Disclosure requirements on the disposal of an investment

2 Step acquisitions
- 2.1 Application of acquisition accounting
- 2.2 Calculation of goodwill when control is acquired
- 2.3 Preparation of the consolidated financial statements
- 2.4 Increased shareholding in subsidiary

3 Merger accounting for common control combinations
- 3.1 Introduction
- 3.2 The principles
- 3.3 The procedures
- 3.4 Accounting period covered by a newly formed parent
- 3.5 Disclosures in addition to those required by applicable HKFRS
- 3.6 Earnings per share

4 HK(IFRIC) Int-17 *Distributions of Non-cash Assets to Owners*
- 4.1 The issue
- 4.2 Key provisions

Learning focus

The acquisition and disposal of investments in group companies is a common occurrence in business. The "clean" transactions that we have already seen where a controlling shareholding is purchased on one date are not always how an acquisition is achieved. Gradual (or step) acquisitions are common and you must be able to deal with both these and disposals – either of a whole investment or part of an investment.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Prepare the financial statements for a group in accordance with Hong Kong Financial Reporting Standards and statutory reporting requirements		
4.03	**Principles of consolidation**	3
4.03.09	Explain how to account for changes in parent's ownership interest in a subsidiary without losing control	
4.05	**Disposal of subsidiaries**	3
4.05.01	Account for the disposal of a subsidiary by a group	
4.05.02	Account for the change of ownership in subsidiaries without loss of control	
4.06	**Business combinations**	3
4.06.10	Explain the accounting for step acquisition	
4.07	**Investments in associates**	3
4.07.06	Account for the disposal of an associate	
4.11	**Merger accounting for common control combinations**	2
4.11.01	Describe the principles and practices of merger accounting	
4.11.02	Apply merger accounting to a common control combination	

1 Disposals

Topic highlights

A subsidiary or associate may be disposed of in its entirety or in part, so that the status of the investment changes.

A parent company may choose to dispose of all or part of its investment in a subsidiary or associate. A gain or loss on disposal is normally calculated and included in the consolidated financial statements as well as the parent company's individual accounts.

The treatment of the disposal and calculation of any gain or loss depends upon the type of disposal.

1.1 Types of disposal

The type of disposal may be categorised as one of the following, each of which we shall deal with in turn in this chapter:

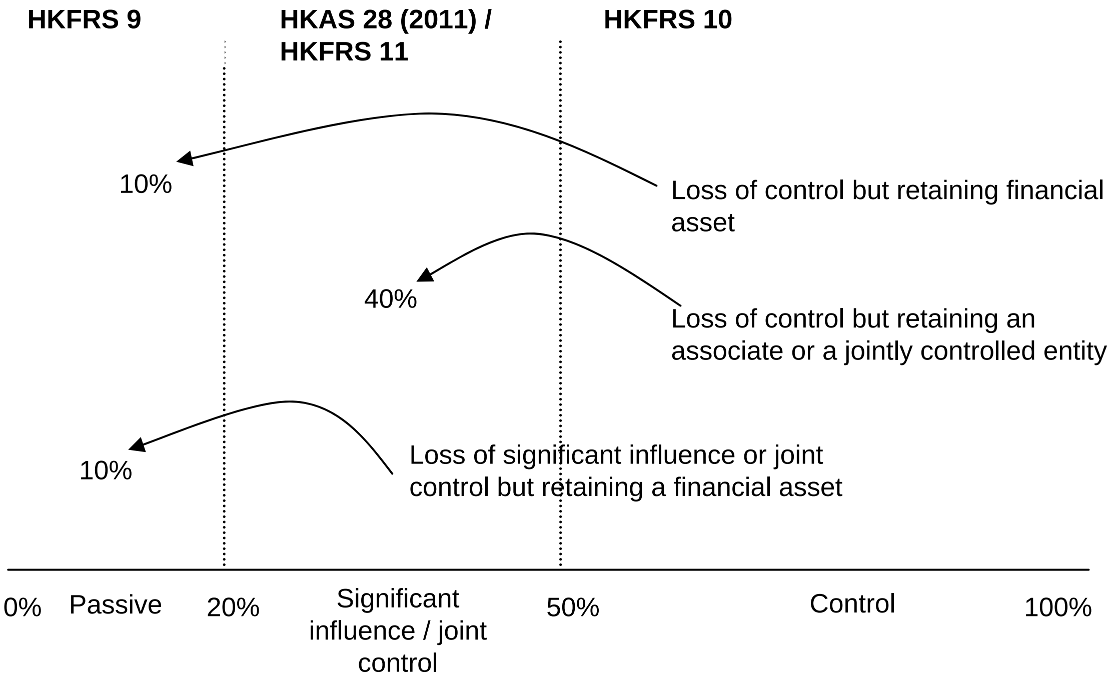
- Full disposal of a subsidiary
- Partial disposal of a subsidiary such that the investment remains a subsidiary
- Partial disposal of a subsidiary such that the investment becomes an associate
- Partial disposal of a subsidiary such that the investment becomes a financial asset
- Full disposal of an associate
- Partial disposal of an associate such that the investment becomes a financial asset

Before considering each type of disposal in turn, we must consider the issue of loss of control. HKFRS 3 (revised) and HKFRS 10 do not consider the second situation above to be a disposal, as control is not lost. This situation is therefore accounted for in a different way from other partial disposals.

1.1.1 Loss of control or significant influence

HKFRS consider a disposal to involve the loss of control or significant influence; this has been referred to as "crossing an accounting boundary". The date of disposal is therefore the date on which control or significant influence is lost.

The diagram below may help you visualise the boundary:



As you will see from the diagram, where an interest in a subsidiary is reduced from say 80% to 60%, this does not involve crossing that all-important 50% threshold.

HKAS 27(2011).10

1.1.2 Subsidiary held for sale

HKAS 27 (2011) requires that in the separate financial statements of the investor, a subsidiary, jointly controlled entity or associate is held either at cost or in accordance with HKFRS 9.

HKAS 27 (2011) is aligned with HKFRS 5 by clarifying that a parent entity that accounts for an investment in a subsidiary in accordance with HKFRS 9 (in its separate financial statements) and subsequently classifies the investment as held for sale (or held in a disposal group classified as held for sale) would continue to account for the investment in accordance with HKFRS 9.

HKFRS 5 measurement requirements only apply to investments that are held at cost.

HKFRS 10.25

1.2 Full disposal of a subsidiary

Topic highlights

Where a subsidiary is disposed of in full a gain or loss on disposal is recognised in the parent's individual and the consolidated accounts. The amount of the gain or loss will be different in the individual and the consolidated accounts. The results of the subsidiary are consolidated to the date of disposal.

Where a subsidiary is disposed of, a profit or loss on disposal will be recognised in both the parent's individual and the consolidated financial statements. The calculation of each of these amounts will be different.

1.2.1 Gain or loss in parent company's accounts

The gain or loss on disposal in the parent company's individual accounts is relatively straightforward. Proceeds are compared with the carrying value of the investment sold:

	$
Fair value of consideration received	X
Less: carrying value of investment disposed of	(X)
Profit/(loss) on disposal	X/(X)

The profit on disposal may be taxable and where it is, the **tax is based on the parent's gain** rather than the group's.

1.2.2 Gain or loss in consolidated accounts

The calculation of the gain or loss in the consolidated accounts is a little more complex:

	$	$
Fair value of consideration received		X
Less: net assets of subsidiary at disposal date	X	
goodwill at disposal date	X	
non-controlling interests at disposal date	(X)	
		(X)
Group profit/(loss)		X/(X)

This gain or loss may need to be disclosed separately if it is material.

1.2.3 Preparation of the consolidated financial statements

Where there has been a full disposal of a subsidiary during the accounting period:

(a) That subsidiary is not recognised in the statement of financial position at the period end, nor is any non-controlling interest

(b) The results of the subsidiary are included in the consolidated statement of profit or loss and other comprehensive income only until the date on which control is lost

(c) The non-controlling interests in profit and total comprehensive income represents the NCI share of these amounts only until control is lost

If the subsidiary is classified as a **discontinued operation** per HKFRS 5 the consolidated statement of profit or loss and other comprehensive income should include in one line "**Profit for the period from discontinued operations**", being the group profit on disposal plus the subsidiary's profit for the year to disposal.

Self-test question 1

Land Co. has owned 80% of the ordinary share capital in Rover Co. for a number of years. The investment cost $980,000 and goodwill of $45,000 arose on acquisition, $5,000 relating to the non-controlling interests which was measured at fair value. Goodwill has not been impaired. On 30 June 20X9 Land Co. disposed of the whole shareholding in Rover Co. for $1.2 million. At the date of disposal Rover Co. had net assets of $1 million and non-controlling interests of $205,000.

What gain is reported

(a) in Land Co.'s individual accounts?
(b) in the Land Group consolidated accounts?

(The answer is at the end of the chapter)

HKFRS 10.23

1.3 Partial disposal of subsidiary: subsidiary to subsidiary

Topic highlights

Where control is not lost on the disposal of shares there is no gain or loss in the consolidated accounts; instead the transaction results in an adjustment to shareholders' funds.

As we have already said, where a controlling shareholding is retained, the "accounting boundary" is not crossed and HKFRS 3 (revised) and HKFRS 10 do not consider the transaction to be a disposal.

In the parent company's individual accounts a profit or loss is recognised on the disposal of the investment calculated in the same way as we saw earlier, being proceeds less carrying amount of the investment.

In the consolidated financial statements, however:

- no gain or loss on disposal is calculated
- goodwill is not re-calculated
- the transaction is accounted for through shareholders' equity.

1.3.1 Adjustment to shareholders' equity

The adjustment to shareholders' equity is calculated as the difference between the proceeds received and the change in the non-controlling interests as a result of the transaction.

Example: Adjustment on disposal

Manta Co. acquired 90% of Ray Co. in 20X6 and at this time goodwill was calculated as $65,000 using the proportion of net assets method to value the non-controlling interests. Goodwill has been impaired by $15,000 since acquisition.

On 31 August 20X9 Manta Co. disposed of a 20% holding in Ray Co. for $120,000; on this date the net assets of Ray Co. were $560,000.

What adjustment is required as a result of the disposal?

Solution

1 Adjustment required to the non-controlling interests:

At disposal date:	$
NCI based on old shareholding (10% × $560,000)	56,000
NCI based on new shareholding (30% × $560,000)	168,000
Adjustment required	112,000

The non-controlling interests must be increased by $112,000.

2 Journal adjustment is therefore:

		$	$
DEBIT	Proceeds	120,000	
CREDIT	NCI		112,000
	Shareholders' equity ($120,000 – $112,000)		8,000

Self-test question 2

In 20X8, A acquired a 100% equity interest in B for cash consideration of $125,000.
B's identifiable net assets at fair value were $100,000. Goodwill of $25,000 was identified and recognised. In the subsequent years, B increased net assets by $20,000 to $120,000. This is reflected in equity attributable to the parent. A then disposed of 30% of its equity interest to non-controlling interests for $40,000.

What adjustment is required to shareholders' equity on the disposal?

(The answer is at the end of the chapter)

1.3.2 Preparation of the consolidated financial statements (subsidiary to subsidiary)

In the statement of financial position:

- the non-controlling interests are based on the year-end percentage
- goodwill on acquisition is unchanged as a result of the partial sale of the shareholding
- parent's equity is adjusted as above

In the statement of profit or loss and other comprehensive income:

- the subsidiary's results are included for the whole accounting period
- the non-controlling interests are based on pro-rated profits and total comprehensive income
- there is no profit or loss on disposal.

HKFRS 10.25

1.4 Partial disposal of subsidiary: subsidiary to associate

Topic highlights

Where a subsidiary becomes an associate or financial asset, a gain or loss is recognised in the consolidated accounts. This includes the gain on the shares disposed of and the revaluation of the shares retained.

In this instance control is lost and therefore a gain or loss on disposal must be calculated in both the parent company's and the consolidated financial statements.

The gain or loss in the parent company's accounts is again calculated as proceeds less carrying amount of investment, and any tax due will be based on this figure.

1.4.1 Gain in the consolidated accounts

Where control is lost, the gain in the consolidated accounts is calculated as:

	$	$
Proceeds		X
Fair value of interest retained		X
		X
Less: net assets of subsidiary recognised prior to disposal		
Net assets	X	
Goodwill	X	
Non-controlling interests	(X)	
		(X)
Profit / loss		X/(X)

It may seem odd that the fair value of the interest retained forms part of this calculation, but this is because the gain is essentially made up of two parts:

- A realised gain on the shares disposed of
- An unrealised gain on the revaluation of the shares retained to fair value.

The following example will help you to see this.

Example: Gain or loss

Ives Group acquired 95% holding in Hunt Co. in 20X6, which it held until 31 May 20X9 when a 55% shareholding was sold for $670,000, so reducing Ives Group's investment to 40%.

At the disposal date the net assets of Hunt Co. were $900,000, goodwill arising on acquisition had been fully impaired and the fair value of a 40% interest in Hunt was $390,000.

The non-controlling interests are valued using the proportion of net assets method.

Required

What gain or loss arises on the disposal?

	$	$
Proceeds		670,000
Fair value of interest retained		390,000
		1,060,000
Less: Amounts recognised prior to disposal		
Net assets of Hunt	900,000	
Goodwill (fully impaired)	–	
NCI at disposal (5% × $900,000)	(45,000)	
		(855,000)
Gain on disposal		205,000

The gain can be analysed as follows:

Gain on disposal	
	$
Proceeds	670,000
Net assets disposed of ($900,000 × 55%)	(495,000)
	175,000
Gain on revaluation of retained interest	
Fair value of retained interest	390,000
Net assets retained ($900,000 × 40%)	(360,000)
	30,000

1.4.2 Preparation of the consolidated financial statements (subsidiary to associate)

In the statement of financial position:

- The interest in the associate is equity accounted for based on the year-end shareholding. For this purpose, the cost of the investment is taken to be the fair value of the interest retained at the date the investment became an associate holding.

In the statement of profit or loss and other comprehensive income:

- The results of the investment are pro-rated and:
  - consolidated until the disposal date
  - equity accounted thereafter
- The gain or loss on disposal, calculated as above is recognised.

Example: Partial disposals

Linda Co. bought 100% of the voting share capital of Vivi Co. on its incorporation on 1 January 20X2 for $160,000. Vivi Co. earned and retained $240,000 from that date until 31 December 20X7. At that date the statements of financial position of the company and the group were as follows:

	Linda Co.	*Vivi Co.*	*Consolidated*
	$'000	$'000	$'000
Investment in Vivi	160	–	–
Other net assets	1,000	500	1,500
	1,160	500	1,500
Share capital	400	160	400
Reserve	560	240	800
Current liabilities	200	100	300
	1,160	500	1,500

It is the group's policy to value the non-controlling interests at its proportionate share of the fair value of the subsidiary's identifiable net assets.

On 1 January 20X8 Linda Co. sold 40% of its shareholding in Vivi Co. for $280,000. The profit on disposal (ignoring tax) in the financial statements of the parent company is calculated as follows:

	Linda
	$'000
Fair value of consideration received	280
Carrying value of investment (40% × 160)	(64)
Profit on sale	216

We now move on to calculate the adjustment to equity for the group financial statements.

Because only 40% of the 100% subsidiary has been sold, leaving a 60% subsidiary, **control is retained**. This means that there is **no group profit on disposal in profit or loss for the year**. Instead, there is an **adjustment to the parent's equity**, which affects group reserve.

Point to note

The adjustment to parent's equity is calculated as follows:

	$'000
Fair value of consideration received	280
Increase in non-controlling interests in net assets at the date of disposal (40% × 400*)	(160)
Adjustment to parent's equity	120
*Share capital	160
Reserve	240
	400

This increases group reserve and does not go through group profit or loss for the year. (**Note** that there is no goodwill in this example, as the subsidiary was acquired on incorporation.)

Solution: Subsidiary status

The statements of financial position immediately after the sale will appear as follows:

	Linda Co.	*Vivi Co.*	*Consolidated*
	$'000	$'000	$'000
Investment in Vivi (160 – 64)	96	–	–
Other assets	1,280	500	1,780
	1,376	500	1,780
Share capital	400	160	400
Retained earnings (Note)	776	240	920
Current liabilities	200	100	300
	1,376	500	1,620
Non-controlling interests			160
			1,780

Note. Linda's reserves are $560,000 + $216,000 profit on disposal. Group reserves are increased by the adjustment above: $800,000 + $120,000 = $920,000.

Solution: Associate status

Using the above example, assume that Linda Co. sold 60% of its holding in Vivi Co. for $440,000. The fair value of the 40% holding retained was $200,000. The gain or loss on disposal in the books of the parent company would be calculated as follows:

	Parent company
	$'000
Fair value of consideration received	440
Carrying value of investment (60% × 160)	(96)
Profit on sale	344

This time control is lost, so there will be a gain in group profit or loss, calculated as follows:

	$'000
Fair value of consideration received	440
Fair value of investment retained	200
Less: Net assets of Vivi Co. at date control lost	(400)
Group profit on sale	240

(**Note**. There was no goodwill arising on the acquisition, otherwise this goodwill would be deducted in the calculation.)

The statements of financial position would now appear as follows:

	Linda Co.	*Vivi Co.*	*Consolidated*
	$'000	$'000	$'000
Investment in Vivi (Note 1)	64		200
Other assets	1,440	500	1,440
	1,504	500	1,640
Share capital	400	160	400
Retained earnings (Note 2)	904	240	1,040
Current liabilities	200	100	200
	1,504	500	1,640

Notes

1 The investment in Vivi is at fair value in the group accounts. It is equity accounted based on the fair value at the date control was lost plus the share of post-acquisition retained earnings. As yet there are no retained earnings because control has only just been lost at 31 December 20X7.

2 Linda's reserves are $560,000 + the profit on sale of $344,000 i.e. $904,000. Group retained earnings are $800,000 (per question) plus group profit on the sale of $240,000, i.e. $1,040,000.

HKFRS 10.25

1.5 Partial disposal of subsidiary: subsidiary to financial asset

As in the case of a partial disposal which results in a subsidiary holding becoming an associate, where a subsidiary becomes a financial asset, control is lost. Therefore, a gain or loss on disposal is recognised in the consolidated financial statements.

This is calculated using the same method as that shown in section 1.4.1. In other words, the retained investment is revalued to fair value and the gain or loss on this revaluation forms part of the overall gain or loss on disposal.

Again, the gain or loss for inclusion in the parent company's own financial statements is the difference between the proceeds and the carrying amount of the investment sold.

1.5.1 Preparation of the consolidated financial statements (subsidiary to financial asset)

In the statement of financial position:

- the investment is recognised at its fair value at the date of disposal
- thereafter it is accounted for in accordance with HKFRS 9.

In the statement of profit or loss and other comprehensive income:

- the results of the investment are pro-rated and consolidated until the date of disposal
- thereafter only dividend income is included
- a gain or loss on disposal is recognised.

HKFRS 10.B98-99

1.6 Reclassification adjustments

Where control of a subsidiary is lost, any amounts recognised in other comprehensive income at the date of disposal in relation to the subsidiary should be accounted for in the same way as if the parent company had directly disposed of the assets that they relate to.

Therefore, where the subsidiary holds financial assets at fair value through other comprehensive income then on disposal, the amounts of other comprehensive income recorded in the consolidated accounts in relation to these are reclassified to profit or loss (recycled) and form part of the gain on disposal.

If the subsidiary holds revalued assets, the revaluation surplus previously recognised in consolidated other comprehensive income should be transferred to group retained earnings.

Example: Reclassification adjustments on loss of control

In 20X7, A acquired a 100% equity interest in B for cash consideration of $125,000. B's identifiable net assets at fair value were $100,000. Goodwill of $25,000 was identified and recognised.

In the subsequent years, B increased net assets by $20,000 to $120,000. Of this, $15,000 was reported in profit or loss and $5,000, relating to financial assets held at fair value through other comprehensive income, was reported within other comprehensive income. A then disposed of 75%

of its equity interest for cash consideration of $115,000. The resulting 25% equity interest is classified as an associate under HKAS 28 (2011) and has a fair value of $38,000.

The gain recognised in profit or loss on disposal of the 75% equity interest is:

	$
Fair value of consideration received	115,000
Fair value of residual interest	38,000
Gain previously reported in other comprehensive income	5,000
	158,000
Less: net assets and goodwill derecognised	(145,000)
Gain	13,000

Self-test question 3

Noel Co. bought 80% of the share capital of Fanny Co. for $324,000 on 1 October 20X5. At that date Fanny Co.'s retained earnings balance stood at $180,000. The statements of financial position at 30 September 20X8 and the summarised statements of profit or loss to that date are given below:

	Noel Co.	*Fanny Co.*
	$'000	$'000
Non-current assets	360	270
Investment in Fanny Co.	324	–
Current assets	370	370
	1,054	640
Equity		
Ordinary shares	540	180
Reserves	414	360
Current liabilities	100	100
	1,054	640
Profit before tax	153	126
Tax	(45)	(36)
Profit for the year	108	90

No entries have been made in the accounts for any of the following transactions.

Assume that profits accrue evenly throughout the year.

It is the group's policy to value the non-controlling interests at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Ignore tax on the disposal.

Required

Prepare the consolidated statement of financial position and statement of profit or loss at 30 September 20X8 in each of the following circumstances. (Assume no impairment of goodwill.)

(a) Noel Co. sells its entire holding in Fanny Co. for $650,000 on 30 September 20X8.

(b) Noel Co. sells one quarter of its holding in Fanny Co. for $160,000 on 30 September 20X8.

In the following circumstances you are required to calculate the gain on disposal, group retained earnings and carrying value of the retained investment at 30 September 20X8.

(c) Noel Co. sells one half of its holding in Fanny Co. for $340,000 on 30 June 20X8, and the remaining holding (fair value $250,000) is to be dealt with as an associate.

(d) Noel Co. sells one half of its holding in Fanny Co. for $340,000 on 30 June 20X8, and the remaining holding (fair value $250,000) is to be dealt with as a financial asset at fair value through other comprehensive income.

(The answer is at the end of the chapter)

1.7 Full disposal of associate

Topic highlights

Where an associate is fully or partially disposed of, a gain or loss is recognised in the consolidated financial statements. The gain or loss on a partial disposal includes the revaluation of the retained investment.

Where an associate is disposed of in full, a gain arises in both the parent and group financial statements.

The gain in the parent's financial statements is calculated in the same way as we have seen previously: proceeds less carrying amount of investment.

In the consolidated financial statements, the gain or loss is calculated as:

	$	$
Proceeds		X
Less: Cost of investment	X	
Share of post-acquisition profits retained by associate at disposal	X	
Impairment of investment to date	(X)	
		(X)
Profit/(loss)		X/(X)

In the consolidated financial statements in the year of disposal:

- no investment is recognised in the statement of financial position
- the group share of the associate's results is included in the statement of profit or loss and other comprehensive income to the date of disposal

1.8 Partial disposal of associate: associate to financial asset

Where part of an associate shareholding is disposed of such that it becomes a financial asset (for example, a 40% holding becomes a 10% holding), then significant influence is lost.

In this case a gain arises in the parent company's financial statements, calculated as before, and a gain is also calculated in the consolidated financial statements, calculated as:

	$	$
Proceeds		X
Fair value of interest retained		X
		X
Less: Cost of investment	X	
Share of post-acquisition profits retained by associate at disposal	X	
Impairment of investment to date	(X)	
		(X)
Profit/(loss)		X/(X)

Note that like the gain calculation in respect of part disposals of subsidiaries, this calculation includes the fair value of the financial asset retained. Therefore, once again, the gain is made up of two elements:

- A gain on disposal, and
- A gain on the revaluation of the financial asset.

1.8.1 Preparation of the consolidated financial statements (associate to financial asset)

In the statement of financial position:

- the investment is recognised at its fair value at the date of disposal
- thereafter it is accounted for in accordance with HKFRS 9.

In the statement of profit or loss and other comprehensive income:

- the group share of the associate's results is included to the date of disposal
- thereafter only dividend income is included
- a gain or loss on disposal is recognised.

1.9 Disclosure requirements on the disposal of an investment

HKFRS 12 *Disclosure of Interests in Other Entities* requires particular disclosures where there is a change in ownership of a subsidiary.

Where there is a change in ownership that does not result in a loss of control, a schedule must be presented that shows the effects on equity attributable to owners of the parent of the change in ownership interest.

If control of a subsidiary has been lost during a reporting period, the following should be disclosed:

(a) The gain or loss on disposal.

(b) The portion of the gain or loss attributable to measuring any retained investment at fair value on the date on which control is lost.

(c) The line items in profit or loss in which the gain or loss is recognised.

2 Step acquisitions

Topic highlights

The acquisition method is only applied when control is achieved. Therefore, goodwill only arises on the acquisition of a subsidiary, either in one or a number of transactions.

When a parent company gradually builds up an investment in another company to a stage where it controls that company, this is referred to as a step acquisition.

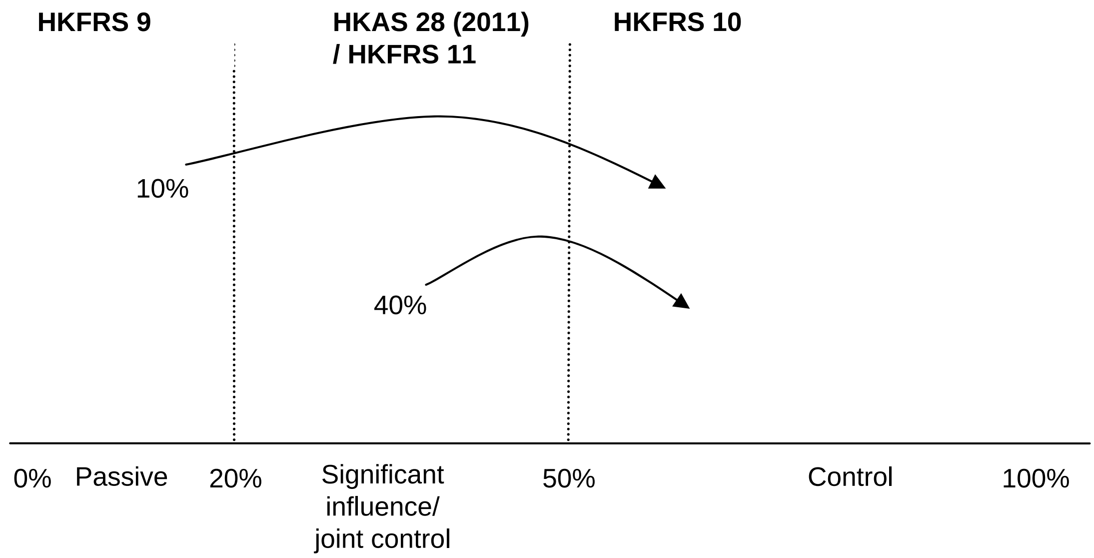
For example a company may

- initially purchase a 10% share in a company, so achieving a financial asset accounted for in accordance with HKFRS 9
- then increase the shareholding to 40%, so achieving an associate investment accounted for in accordance with HKAS 28 (2011)
- finally increase the shareholding to 75%, so achieving a subsidiary investment accounted for in accordance with HKFRS 10 and HKFRS 3 (revised).

2.1 Application of acquisition accounting

It is important to realise acquisition accounting is only applied on the date that **control** is achieved and therefore **goodwill does not arise until this time**. The date on which subsidiary status is achieved is therefore referred to as the acquisition date.

Earlier in the chapter we looked at "crossing the accounting boundary" in the context of disposals. The same "accounting boundary" principle applies to acquisition accounting:



Goodwill is identified and net assets remeasured to fair value only in respect of the transaction that achieved control, and not in respect of any earlier or subsequent acquisitions of equity interests. When more shares are acquired in an existing subsidiary, goodwill is not recalculated; we shall consider this situation later in the chapter.

HKFRS 3.32,41,42

2.2 Calculation of goodwill when control is acquired

Topic highlights

Where control is achieved any previously held interest is revalued to fair value; the gain or loss is recognised in profit or loss.

On the date on which control is achieved, previously held interests (measured in accordance with HKFRS 9 or HKAS 28 (2011)) are **remeasured** to **fair value** and this value is included in calculating goodwill.

Any gain or loss arising from the remeasurement will be recognised in **profit or loss**.

The calculation of goodwill now becomes:

	$
Consideration transferred	X
Non-controlling interests	X
Fair value of previously held interest	X
	X
Fair value of net assets of acquiree	(X)
Goodwill	X

Example: Financial asset under HKFRS 9 becomes a subsidiary

A acquired a 75% controlling interest in B in two stages.

1 In 20X3, A acquired a 15% equity interest for cash consideration of $10,000. A classified the interest as financial assets at fair value through other comprehensive income in accordance with HKFRS 9. From 20X3 to the end of 20X7, A reported fair value increases of $2,000 in other comprehensive income (OCI).

2 In 20X8, A acquired a further 60% equity interest for cash consideration of $60,000. A identified net assets of B with a fair value of $80,000. A elected to measure non-controlling interests at their share of net assets. On the date of acquisition, the previously-held 15% interest had a fair value of $12,500.

	$
In 20X8, A will include $2,500 in profit or loss, being:	
Gain on "disposal" re-measurement of 15% investment to fair value ($12,500 – $12,000)	500
Gain previously reported in OCI ($12,000 – $10,000)	2,000
Total	2,500

In 20X8, A will measure goodwill as follows:

Fair value of consideration given for controlling interests	60,000
Non-controlling interests (25% × $80,000)	20,000
Fair value of previously-held interest	12,500
	92,500
Less: fair value of net assets of acquiree	(80,000)
Goodwill	12,500

Example: Associate becomes a subsidiary

C acquired a 75% controlling interest in D in two stages.

1 In 20X3, C acquired a 40% equity interest for cash consideration of $40,000. C classified the interest as an associate under HKAS 28 (2011). At the date that C acquired its interest, the fair value of D's identifiable net assets was $80,000. From 20X3 to 20X7, C equity accounted for its share of undistributed profits totalling $5,000, and included its share of revaluation gain of $3,000 in other comprehensive income (OCI). Therefore, in 20X7, the carrying amount of C's interest in D was $48,000.

2 In 20X8, C acquired a further 35% equity interest for cash consideration of $55,000. C identified net assets of D with a fair value of $110,000. C elected to measure non-controlling interests at fair value of $30,000. On the date of acquisition, the previously-held 40% interest had a fair value of $50,000.

In 20X8 (ignoring any profits earned prior to the acquisition), C will include $2,000 in profit or loss, being:

	$
Fair value of previously-held interest	50,000
Less: carrying amount under HKAS 28 (2011)	48,000
Gain on disposal of investment in associate	2,000

The revaluation gain of $3,000 previously recognised in OCI is not reclassified to profit or loss because it would not be reclassified if the interest in D were disposed of.

In 20X8, C will measure goodwill as follows:

	$
Fair value of consideration given for controlling interests	55,000
Non-controlling interests (fair value)	30,000
Fair value of previously-held interest	50,000
Sub-total	135,000
Less: fair value of net assets of acquiree	(110,000)
Goodwill	25,000

2.3 Preparation of the consolidated financial statements

As we saw earlier in the chapter, a mid-year change in the status of an investment requires that its results are pro-rated and accounted for accordingly.

2.3.1 Financial asset to subsidiary

When a financial asset becomes a subsidiary:

- in the consolidated statement of financial position the investment is consolidated based upon the year-end shareholding; goodwill is recognised on the acquisition.
- in the consolidated statement of profit or loss and other comprehensive income:
  - Until the date on which control was achieved, only dividend income is shown
  - After the date on which control was achieved, results are consolidated.

2.3.2 Associate to subsidiary

When an associate becomes a subsidiary:

- again, in the consolidated statement of financial position the investment is consolidated based upon the year-end shareholding; goodwill is recognised on the acquisition.
- in the consolidated statement of profit or loss and other comprehensive income:
  - Until the date on which control was achieved, the investment's results are equity accounted
  - After the date on which control was achieved the results are consolidated.

HKFRS 10.B96

2.4 Increased shareholding in subsidiary

Topic highlights

An increase in shareholding in an existing subsidiary is treated as a transaction between owners with an adjustment made to reserves; goodwill is not recalculated.

Where an investment goes from, for example, a 60% subsidiary to an 80% subsidiary, the 50% threshold has not been crossed, so there is no re-measurement to fair value and no gain or loss to profit or loss for the year. The increase is treated as a **transaction between owners**. As with disposals, ownership has been **reallocated** between parent and non-controlling shareholders.

Accordingly the parent's equity is adjusted. HKFRS 10 does not give detailed guidance as to how to measure the amount to be allocated to the parent and non-controlling interests to reflect a change in their relative interests in the subsidiary. In most cases, however, the best approach is to recognise the change as the difference between the fair value of consideration paid and the decrease in non-controlling interests. (As the parent's share has increased, the NCI share has decreased.)

	$
Fair value of consideration paid	(X)
Decrease in NCI in net assets at date of transaction	X
Decrease in NCI in goodwill at date of transaction (Note)	X
Adjustment to parent's equity	(X)

Note. This line is only required where non-controlling interests are measured at fair value at the date of acquisition.

Example: Increase of shareholding in subsidiary

A parent owns an 80% interest in a subsidiary which has net assets of $4,000. The carrying amount of the non-controlling interests is $800. The parent acquires an additional 10% interest from the non-controlling interests for $500. The adjustment required is:

	$
Fair value of consideration paid	(500)
Decrease in NCI in net assets at date of transaction (10% × $4,000)	400
Adjustment to parent's equity	(100)

The parent accounts for this directly in consolidated equity as follows:

		$	$
DEBIT	Equity – non-controlling interests	400	
	Equity – controlling interests	100	
CREDIT	Cash		500

Example: Parent acquires non-controlling interest

In 20X8, A acquired a 75% equity interest in B for cash consideration of $90,000. B's identifiable net assets at fair value were $100,000. The fair value of the 25% non-controlling interests (NCI) was $28,000. Goodwill, on the two alternative bases for measuring non-controlling interests at acquisition, is calculated as follows:

	NCI at % of net assets	*NCI at fair value*
	$	$
Fair value of consideration	90,000	90,000
Non-controlling interests	25,000	28,000
	115,000	118,000
Fair value of net assets	100,000	100,000
Goodwill	15,000	18,000

In the subsequent years, B increased net assets by $20,000 to $120,000. This is reflected in the carrying amount within equity attributed to non-controlling interests as follows:

	NCI at % of net assets	*NCI at fair value*
	$	$
Non-controlling interests at acquisition	25,000	28,000
Increase (25% × $20,000)	5,000	5,000
Carrying amount	30,000	33,000

In 20X8, A then acquired the 25% equity interest held by non-controlling interests for cash consideration of $35,000. The adjustment to equity will be:

	NCI at % of net assets	*NCI at fair value*
	$	$
Fair value of consideration	35,000	35,000
Carrying amount of non-controlling interests	30,000	33,000
Negative movement in parent equity	5,000	2,000

As indicated in HKFRS 3 (revised 2008), the reduction in equity is greater where the option was taken to measure non-controlling interests at acquisition date as a proportionate share of the acquiree's identifiable net assets. The treatment has the effect of including the non-controlling interest's share of goodwill directly in equity. This outcome will always occur where the fair value basis is greater than the net asset basis at acquisition date.

Example: Parent acquires part of a non-controlling interest

The facts are as in the previous example: The parent acquires non-controlling interests above except that, rather than acquire the entire non-controlling interests, A acquires an additional 15% equity interest held by non-controlling interests for cash consideration of $21,000. The adjustment to the carrying amount of non-controlling interests will be:

	NCI at % of net assets	*NCI at fair value*
	$	$
Balance as in the previous example	30,000	33,000
Transfer to parent (15/25)	18,000	19,800
10% interest carried forward	12,000	13,200*
The adjustment to equity will be:		
Fair value of consideration	21,000	21,000
Change to non-controlling interests (as above)	18,000	19,800
Negative movement	3,000	1,200

* It is assumed that non-controlling interests are reduced proportionately. Under the fair value option, the closing balance represents $^{10}/_{25}{}^{th}$ of the acquisition date fair value (11,200) plus 10% of the change in net assets since acquisition (2,000).

Self-test question 4

Good, whose year end is 30 June 20X9 has a subsidiary, Will, which it acquired in stages. The details of the acquisition are as follows:

Date of acquisition	*Holding acquired*	*Retained earnings at acquisition*	*Purchase consideration*
	%	$m	$m
1 July 20X7	20	270	120
1 July 20X8	60	450	480

The share capital of Will has remained unchanged since its incorporation at $300 million. The fair values of the net assets of Will were the same as their carrying amounts at the date of the acquisition. Good did not have significant influence over Will at any time before gaining control of Will. The group policy is to measure non-controlling interests at its proportionate share of the fair value of the subsidiary's identifiable net assets. The fair value of a 20% interest on 1 July 20X8 was $130m.

Required

(a) Calculate the goodwill on the acquisition of Will that will appear in the consolidated statement of financial position at 30 June 20X9.

(b) Calculate the profit on the derecognition of any previously held investment in Will to be reported in group profit or loss for the year ended 30 June 20X9.

(The answer is at the end of the chapter)

Example: Step acquisition of a subsidiary

Happy acquired 25% of the 800,000 shares of Frankie on 1 January 20X8 for $2,020,000 when Frankie's reserves were standing at $5,800,000. The fair value of Frankie's identifiable assets and liabilities at that date was $7,200,000. Both Happy and Frankie are stock market listed entities.

At 31 December 20X8, the fair value of Happy's 25% stake in Frankie was $2,440,000.

A further 35% stake in Frankie was acquired on 30 September 20X9 for $4,025,000 (equivalent to the fair value of $14.375 per share acquired on that date) giving Happy control over Frankie. The fair value of Frankie's identifiable assets and liabilities at that date was $9,400,000, and Frankie 's reserves stood at $7,800,000.

For consistency with the measurement of other shares, Happy holds all investments in subsidiaries and associates as financial assets at fair value through other comprehensive income in its separate financial statements as permitted by HKAS 27 (2011).

At 31 December 20X9, the fair value of Happy's 60% holding in Frankie was $7,020,000 (and total cumulative gains recognised in other comprehensive income in Happy's separate financial statements amounted to $975,000).

Summarised statements of financial position of the two companies at that date show:

	Happy	*Frankie*
	$'000	$'000
Non-current assets		
Property, plant and equipment	38,650	7,600
Investment in Frankie	7,020	–
	45,670	7,600
Current assets	12,700	2,200
	58,370	9,800
Equity		
Share capital	10,200	800
Reserves	40,720	7,900
	50,920	8,700
Liabilities	7,450	1,100
	58,370	9,800

The difference between the fair value of the identifiable assets and liabilities of Frankie and their book value relates to the value of a plot of land. The land had not been sold by 31 December 20X9.

Income and expenses are assumed to accrue evenly over the year. Neither company paid dividends during the year.

Group policy is to measure non-controlling interests at the date of acquisition at their proportionate share of the net fair value of the identifiable assets acquired and liabilities assumed.

No impairment losses on recognised goodwill have been necessary to date.

Required

(a) Prepare the consolidated statement of financial position of Happy Group as at 31 December 20X9 in the following circumstances:

  (i) The 25% interest in Frankie allowed Happy significant influence over the financial and operating policy decisions of Frankie.

  (ii) The other 75% of shares were held by a single shareholder and Happy was allowed no influence in the running of Frankie until acquiring control.

(b) Show the consolidated current assets, non-controlling interests and reserves figures if Happy acquired an *additional* 10% interest in Frankie on 1 January 20Y0 for $1,200,000.

Solution

Parts (a)(i) and (a)(ii) to the example would generate the same overall answer.

(a) HAPPY GROUP

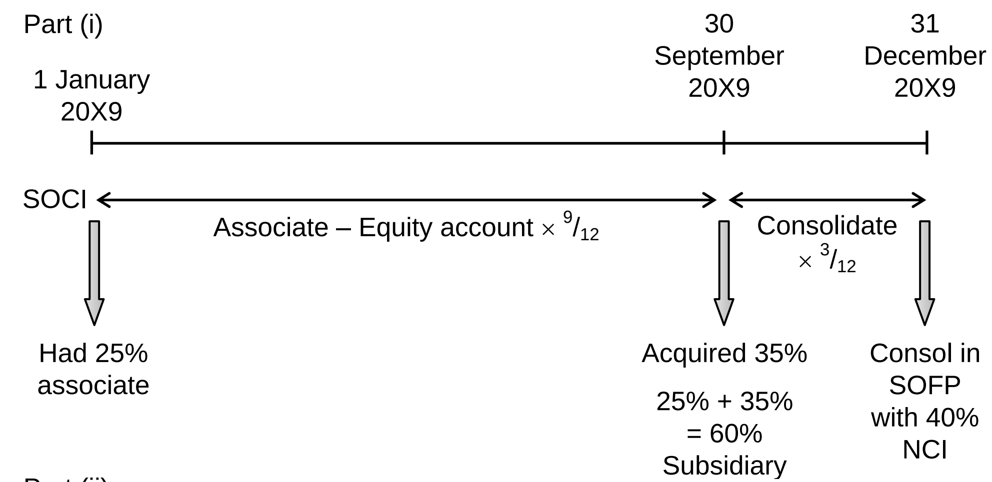
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	$'000
Non-current assets	
Property, plant and equipment (38,650 + 7,600 + (W6) 800)	47,050
Goodwill (W2)	1,260
	48,310
Current assets (12,700 + 2,200)	14,900
	63,210
Equity attributable to owners of the parent	
Share capital	10,200
Reserves (W3)/(W4)	40,660
	50,860
Non-controlling interests (W5)	3,800
	54,660
Liabilities (7,450 + 1,100)	8,550
	63,210

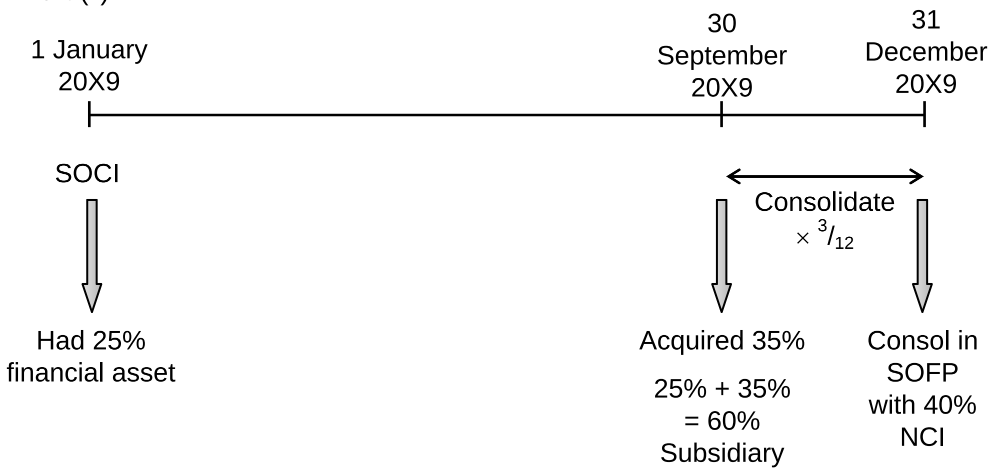
WORKINGS

1 *Group structure*

Part (i)



Part (ii)



2 *Goodwill*

	$'000	$'000
Consideration transferred		4,025
Non-controlling interests (9,400 × 40%)		3,760
FV of P's previously held equity interest (800,000 × 25% × $14.375)		2,875
		10,660
Less: Fair value of identifiable assets acq'd and liabilities assumed:		
Share capital	800	
Reserves	7,800	
Fair value adjustments (W6)	800	
		(9,400)
		1,260

3 *Consolidated reserves (if previously held as an associate) (i)*

	Happy	*Frankie*	*Frankie*
	$'000	$'000	$'000
		25%	60%
Per question	40,720	7,800	7,900
Profit on derecognition of investment (note)	355		
Fair value movement (W6)		-	-
Reserves at acquisition		(5,800)	(7,800)
		2,000	100
Share of post acqn reserves			
Frankie – 25% (2,000 × 25%)	500		
Frankie – 60% (100 × 60%)	60		
Less: Fair value gain recognised in Happy's separate FS	(975)		
	40,660		

Note. *Profit on derecognition of 25% associate*

	$'000
Fair value at date control obtained (200,000 shares × $14.375)	2,875
P's share of carrying value [2,020 + ((7,800 – 5,800) × 25%)]	(2,520)
	355

4 *Consolidated reserves (if previously held as an AFSFA) (ii)*

	Happy	*Frankie*
	$'000	$'000
Per question	40,720	7,900
Profit on derecognition of investment*	855	
Fair value movement (W6)	-	-
Reserves at acquisition		(7,800)
		100
Frankie – share of post acquisition reserves (100 × 60%)	60	
Less: Fair value gain recognised in Happy's separate FS	(975)	
	40,660	

* *Profit on derecognition of 25% investment*

	$'000
Fair value at date control obtained (200,000 shares × $14.375)	2,875
Cost	(2,020)
	855

Note. The profit would be the same whether the available-for-sale financial asset had been revalued or not, as any revaluation above original cost previously recognised in other comprehensive income is transferred to profit or loss.

5 *Non-controlling interests*

	$'000
Net assets at year end per question	8,700
Fair value adjustment (W6)	800
	9,500

× NCI share 40% = $3,800,000

6 *Fair value adjustments*

Measured at date control achieved (only)	*At acquisition 30 September 20X9* $'000	*Movement* $'000	*At year end 31 December 20X9* $'000
Land (9,400 – (800 + 7,800))	800	–	800

(b) (i) Current assets (14,900 – 1,200) = $13,700,000

(ii) Non-controlling interests

	$'000
Net assets at year end per question	8,700
Fair value adjustment (W8)	800
	9,500

× 30% = $2,850,000

Consolidated reserves

	$'000
Per part (a)	40,660
Adjustment to parent's equity on acq'n of 10% (W)	(250)
	40,410

Note. No other figures in the statement of financial position are affected.

WORKING

Adjustment to parent's equity on acquisition of additional 10% of Frankie

	$'000
Fair value of consideration paid	(1,200)
Decrease in NCI in net assets at acq'n (9,500 × 10%)	950
	(250)

Example: Step acquisition of a subsidiary with non-controlling interest at fair value

The facts are the same as in the previous example, except that group policy is to measure non-controlling interests at the date of acquisition at fair value. The fair value of the non-controlling interests at acquisition was $4,600,000.

Solution

Parts (a)(i) and (a)(ii) to the example would generate the same overall answer.

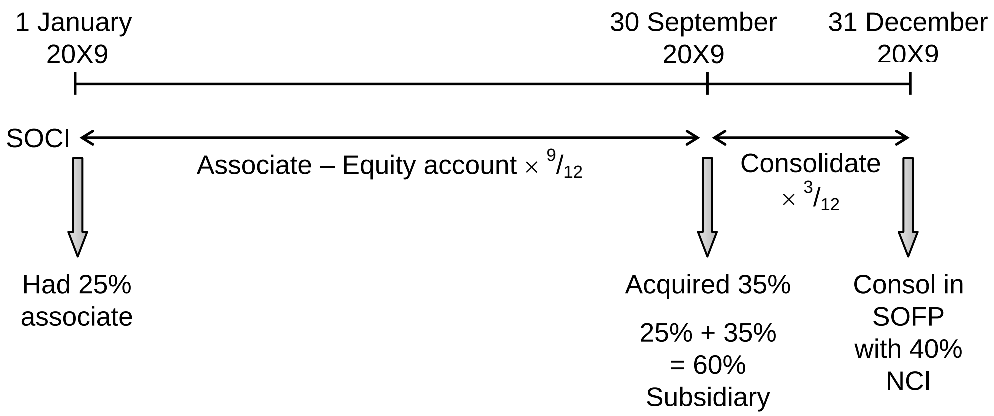
(a) HAPPY GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	$'000
Non-current assets	
Property, plant and equipment (38,650 + 7,600 + (W2) 800)	47,050
Goodwill (W2)	2,100
	49,150
Current assets (12,700 + 2,200)	14,900
	64,050
Equity attributable to owners of the parent	
Share capital	10,200
Reserves (W3)/(W4)	40,660
	50,860
Non-controlling interests (W5)	4,640
	55,500
Liabilities (7,450 + 1,100)	8,550
	64,050

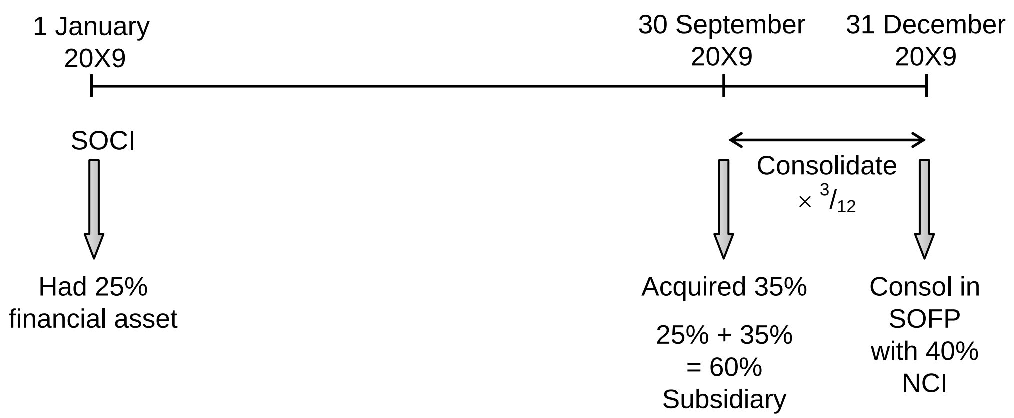
WORKINGS

1 *Group structure*

Part (i)



Part (ii)



2 *Goodwill*

		Group	*NCI*
	$'000	$'000	$'000
Consideration transferred		4,025	
FV NCI			4,600
FV P's previously held equity interest		2,875	
Fair value of identifiable assets acq'd and liabilities assumed:			
Share capital	800		
Reserves	7,800		
Fair value adjustments (W6)	800		
	9,400		
× 60%/40%		(5,640)	(3,760)
		1,260	840
		2,100	

3 *Consolidated reserves (if previously held as an associate) (i)*

	Happy	*Frankie*	*Frankie*
	$'000	$'000	$'000
		25%	60%
Per question	40,720	7,800	7,900
Profit on derecognition of investment (Note)	355		
Fair value movement (W6)		-	-
Reserves at acquisition		(5,800)	(7,800)
		2,000	100
Share of post acqn reserves			
Frankie – 25% (2,000 × 25%)	500		
Frankie – 60% (100 × 60%)	60		
Less: fair value gain recognised in Happy's separate FS	(975)		
	40,660		

Note. Profit on derecognition of 25% associate

	$'000
Fair value at date control obtained (200,000 shares × $14.375)	2,875
P's share of carrying value [2,020 + ((7,800 – 5,800) × 25%)]	(2,520)
	355

4 *Consolidated reserves (if previously held as financial assets) (ii)*

	Happy	*Frankie*
	$'000	$'000
Per question	40,720	7,900
Profit on derecognition of investment (Note)	855	
Fair value movement (W6)	-	-
Reserves at acquisition		(7,800)
		100
Frankie – share of post acquisition reserves (100 × 60%)	60	
Less: fair value gain recognised in Happy's separate FS	(975)	
	40,660	

Note. Profit on derecognition of 25% investment

	$'000
Fair value at date control obtained (200,000 shares × $14.375)	2,875
Cost	(2,020)
	855

Note. The profit would be the same whether the financial asset had been revalued or not, as any revaluation above original cost previously recognised in other comprehensive income is transferred to profit or loss.

5 *Non-controlling interests*

	$'000	$'000
Net assets at year end per question	8,700	
Fair value adjustment (W6)	800	
	9,500	
× 40%		3,800
NCI in goodwill (W2)		840
		4,640

6 *Fair value adjustments*

Measured at date control achieved (only)	*At acquisition 30 September 20X9*	*Movement*	*At year end 31 December 20X9*
	$'000	$'000	$'000
Land (9,400 – (800 + 7,800))	800	–	800

3 Merger accounting for common control combinations

3.1 Introduction

Topic highlights

A key issue involved in a business combination is to determine whether a particular arrangement should be classified as an acquisition or a merger (pooling of interests or uniting of interests).

HKFRS 3 (revised) *Business Combinations* applies to all business combinations except where a combination is specifically excluded from its scope. For those business combinations outside the scope of HKFRS 3 (revised), for example, business combinations involving entities or businesses under common control, there is no specific accounting standard addressing the appropriate accounting treatment.

HKFRS 3 (revised) defines a business combination involving entities or businesses under common control as "a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory". HKICPA has issued Accounting Guideline 5 (AG5) to give guidance on how such combinations should be accounted for, given that they fall outside the scope of HKFRS 3 (revised). AG5 refers to these combinations as "common control combinations" to distinguish them from other business combinations which fall within or outside the scope of HKFRS 3 (revised).

HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, contains requirements for the selection of accounting policies in the absence of a HKFRS that specifically applies to an issue. Common control combinations fall outside the scope of HKFRS 3 (revised). Accordingly, an entity selects an appropriate accounting policy in accordance with the requirements set out in HKAS 8 and many entities consider that merger accounting is an appropriate accounting policy for common control combinations.

AG5 sets out the basic principles and procedures of merger accounting when recognising a common control combination.

It should be noted that interspersing a shell entity between a parent entity and a single subsidiary does not represent the combination of two businesses and accordingly is not addressed in AG5. In practice, these transactions may be accounted for by applying a principle similar to that for a reverse acquisition.

An essential difference exists between a business combination effected by the purchase of a company's shares for cash and that executed by **an exchange of shares**.

A business combination involving a share exchange which is characterised by a continuity of ownership is regarded as a pooling of interests of both parties rather than an acquisition, and should be accounted for differently.

3.2 The principles

The concept underlying the use of merger accounting to account for a common control combination is that **no acquisition** has occurred and there has been a continuation of the risks and benefits to the controlling party (or parties) that existed prior to the combination. Use of merger accounting recognises this by accounting for the combining entities or businesses as though the separate entities or businesses were **continuing as before**.

In applying merger accounting, financial statement items of the combining entities or businesses for the reporting period in which the common control combination occurs, and for any comparative periods disclosed, are included in the consolidated financial statements of the combined entity as if the combination had occurred from the date when the combining entities or businesses first came under the control of the controlling party or parties.

Where the combining entities or businesses include an entity or a business previously acquired from a third party, the financial statement items of such entity or business are only included in the consolidated financial statements of the combined entity from the date of the previous acquisition using the acquisition values recognised at that date.

A **single uniform set of accounting policies** is adopted by the combined entity. Therefore, the combined entity recognises the assets, liabilities and equity of the combining entities or businesses at the carrying amounts in the consolidated financial statements of the controlling party or parties prior to the common control combination. If consolidated financial statements were not previously prepared by the controlling party or parties, the carrying amounts are included as if such consolidated financial statements had been prepared, including adjustments required for conforming the combined entity's accounting policies and applying those policies to all periods presented. These carrying amounts are referred to below as **existing book values from the controlling parties' perspective**. There is **no** recognition of **any additional goodwill** or excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of the common control combination to the extent of the continuation of the controlling party or parties' interests. Similarly, in accordance with HKFRS 10, the effects of all transactions between the combining entities or businesses, whether occurring before or after the combination, are **eliminated** in preparing the consolidated financial statements of the combined entity.

3.3 The procedures

In the consolidated financial statements under merger accounting:

1 No adjustment is required to the carrying values of the assets and liabilities of the acquired company on consolidation, except to achieve uniformity of accounting policies of the combining companies.

2 There is no distinction between pre- and post-acquisition reserves. The distributable reserves of the acquired company are not capitalised and remain distributable.

3 The consolidated statement of profit or loss includes the results of each of the combining entities or businesses from the earliest date presented (i.e. including the comparative period) or since the date when the combining entities or businesses first came under the control of the controlling party or parties, where this is a shorter period, regardless of the date of the common control combination. The consolidated statement of profit or loss also takes into account the profit or loss attributable to the non-controlling interests recorded in the consolidated financial statements of the controlling party.

4 **Comparative figures** should be presented as if the companies had been combined throughout the previous period and at the previous reporting date unless the combining entities or businesses first came under common control at a later date.

5 No amount is recognised as consideration for **goodwill** or excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of common control combination, to the extent of the continuation of the controlling party or parties' interests.

6 Expenditure incurred in relation to a common control combination that is to be accounted for by using **merger accounting** is recognised as an expense in the period in which it is incurred. Such expenditure includes professional fees, registration fees, costs of furnishing information to shareholders, and salaries and other expenses involved in achieving the common control combination. It also includes any costs or losses incurred in combining operations of the previously separate businesses.

7 Consolidation is performed in accordance with HKFRS 10. The principal consolidation entries are as follows:

   (a) The effects of all transactions between the combining entities or businesses, whether occurring before or after the common control combination, are eliminated; and

   (b) Since the combined entity will present one set of consolidated financial statements, a uniform set of accounting policies is adopted which may result in adjustments to the assets, liabilities and equity of the combining entities or businesses.

3.4 Accounting period covered by a newly formed parent

A common control combination may be effected by setting up a new parent which acquires the issued shares or equity of the combining entities or businesses in exchange for the issue of its own shares. In such cases, the first accounting period of the new parent will frequently be a period of less than a year, ending on the reporting date chosen for the group. This will normally be the existing reporting date of one or more of the combining entities or businesses.

Frequently, the date of formation of the new parent will not coincide with the beginning or end of the group's accounting periods. Strictly, if the parent is a Hong Kong incorporated company, the

Companies Ordinance requires the consolidated financial statements to cover the accounting period of the parent. It could be argued that this requirement prevents the disclosure of comparative information. In substance, however, where the combining entities or businesses are continuing to trade as before, but with a new legal parent, it is appropriate to prepare consolidated financial statements as if the parent had been in existence throughout the reported periods presented with a prominent footnote explaining the basis on which consolidated financial statements are prepared.

3.5 Disclosures in addition to those required by applicable HKFRS

Entities applying AG5 in accounting for a common control combination using the principles of merger accounting shall disclose in their consolidated financial statements the fact that this Guideline has been used.

Entities shall disclose the accounting policy applied in accounting for a common control combination by using the principles of merger accounting. Details of the accounting policy shall include, but not be limited to, a discussion of the specific principles and bases applied under merger accounting.

Bearing in mind the necessity of showing a true and fair view, entities applying AG5 shall disclose in their consolidated financial statements significant details of the common control combinations.

For each common control combination accounted for by using merger accounting, the following information shall be disclosed:

(a) The names of the combining entities (other than the reporting entity);

(b) The date of the common control combination;

(c) The composition of the consideration and fair value of the consideration other than shares issued;

(d) The nature and amount of significant accounting adjustments made to the net assets and net profit or loss of any entities or businesses to achieve consistency of accounting policies, and an explanation of any other significant adjustments made to the net assets and net profit or loss of any entity or business as a consequence of the common control combination; and

(e) A statement of the adjustments to consolidated reserves.

3.6 Earnings per share

Ordinary shares issued as part of a common control combination which is accounted for using merger accounting are **included in the calculation of the weighted average number of shares** for all periods presented because the consolidated financial statements of the combined entity are prepared as if the combined entity had always existed. Therefore, the number of ordinary shares used for the calculation of basic earnings per share in a common control combination which is accounted for using merger accounting is the aggregate of the weighted average number of shares of the entity whose shares are outstanding after the combination.

Example: Merger accounting

Pear has three subsidiaries, Xero, Yoho and Apex.

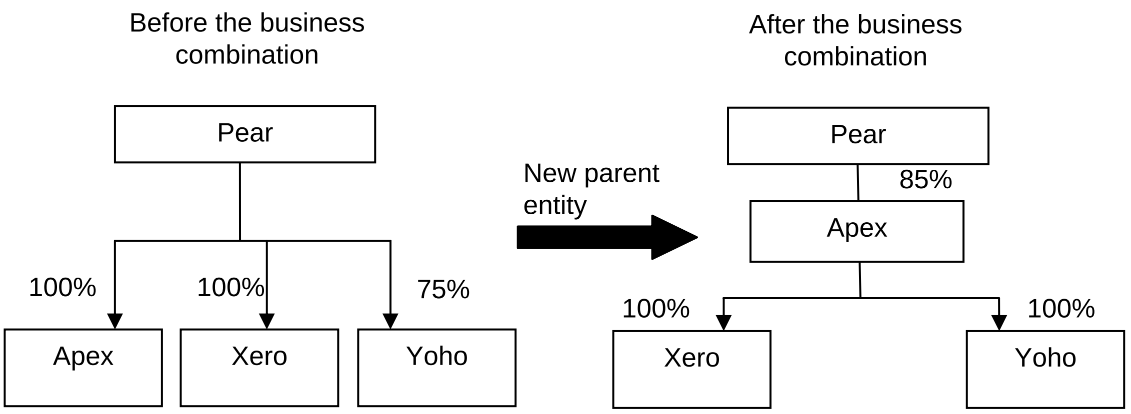
Pear acquired 100% of Xero for $28,000 many years ago. At that time, Pear recorded goodwill of $13,000 and fair value of identifiable assets acquired of $15,000 (which is equal to the then carrying amounts of the assets acquired).

Pear set up Yoho with a party outside the group, Shareholder S, many years ago. Pear's cost of investment in Yoho was $15,000, being 75% of the share capital of Yoho.

On 1 January 20X0, Pear formed a new entity, Apex, through share capital injection of $20,000.

On 31 December 20X1, Apex acquired 100% shareholdings in Xero and Yoho from Pear and Shareholder S. In return, Apex issued 14,000 and 6,000 ordinary shares to Pear and Shareholder S, respectively. Apex, Xero and Yoho have financial year ends of 31 December. The fair values of assets and liabilities of Yoho as at 31 December 20X1 are equal to their carrying values.

Ignore any tax effect arising from the business combination.



The statements of profit or loss of Apex, Xero and Yoho for the year ended 31 December 20X1 are:

	Apex $	*Xero* $	*Yoho* $
Revenue	3,000	40,000	50,000
Profit or loss	(5,000)	20,000	20,000

The statements of financial position of Apex, Xero and Yoho as at 31 December 20X1 are:

	Apex (before issue of shares) $	*Apex (after issue of shares*)* $	*Xero* $	*Yoho* $
Investment in subsidiaries	–	233,000	–	–
Other assets	13,000	13,000	100,000	120,000
Net assets	13,000	246,000	100,000	120,000
Capital	20,000	253,000	10,000	20,000
Accumulated profits (losses)	(7,000)	(7,000)	90,000	100,000
	13,000	246,000	100,000	120,000

* The 20,000 new shares issued by Apex as consideration are recorded at a value equal to the deemed cost of acquiring Xero and Yoho ($233,000). The deemed cost of acquiring Xero is $113,000, being the existing book values of net assets of Xero as at 31 December 20X1 ($100,000) plus remaining goodwill arising on the acquisition of Xero by Pear ($13,000). The deemed cost of acquiring Yoho is $120,000, being the existing book values of net assets of Yoho as at 31 December 20X1. The deemed cost used in this example is for illustrative purposes only and does not necessarily represent the value to be reported in the individual financial statements of Apex as the cost of acquiring the subsidiaries.

The statements of profit or loss of Apex, Xero and Yoho for the year ended 31 December 20X0 are:

	Apex	*Xero*	*Yoho*
	$	$	$
Revenue	2,000	38,000	45,000
Profit or loss	(3,000)	15,000	12,000

The statements of financial position of Apex, Xero and Yoho as at 31 December 20X0 are:

	Apex	*Xero*	*Yoho*
	$	$	$
Net assets	18,000	80,000	100,000
Capital	20,000	10,000	20,000
Accumulated profits (losses)	(2,000)	70,000	80,000
	18,000	80,000	100,000

Required

Prepare the consolidated financial statements of Apex for the year ending 31 December 20X1 (including the comparative figures, which would be presented for 20X0).

Solution

As Apex, Xero and Yoho are under the common control of Pear before and after the business combination, the business combination is specifically excluded from the scope of HKFRS 3 (revised).

The directors of Apex choose to account for the acquisition of the shareholdings in Xero and Yoho using the principles of merger accounting.

Under the principles of merger accounting, the assets and liabilities of Xero and Yoho are consolidated in the financial statements of Apex using the existing book values as stated in the consolidated financial statements of Pear immediately prior to the combination. This procedure requires recording of goodwill arising on the original acquisition of Xero by Pear and non-controlling interests in Yoho as stated in the consolidated financial statements of Pear immediately prior to the combination. There is no recognition of any additional goodwill or excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of this combination.

The consolidated statement of profit or loss of Apex for the year ended 31 December 20X1 is:

	Apex	*Xero*	*Yoho*	*Adjustments*		*Consolidated*
	$	$	$	$	Adj	$
Revenue	3,000	40,000	50,000			93,000
Profit or loss	(5,000)	20,000	20,000			35,000
Attributable to the former non-controlling interests in Yoho				5,000	(Y1)	(5,000)
Attributable to the equity holders of Apex						30,000

Adjustment

Y1 Being an adjustment to reflect the profit attributable to the non-controlling interests in Yoho prior to the combination. ($20,000 × 25%)

The consolidated statement of financial position of Apex as at 31 December 20X1 is:

	Apex	*Xero*	*Yoho*	*Adjustments*		*Consolidated*
	$	$	$	$	Adj	$
Goodwill				13,000	(X1)	13,000
Investment in				(113,000)	(X3)	–
Xero and Yoho	233,000	–	–	(120,000)	(Y5)	
Other assets	13,000	100,000	120,000			233,000
Net assets	246,000	100,000	120,000			246,000
Capital	253,000	10,000	20,000	(10,000)	(X3)	253,000
				(20,000)	(Y5)	
Other reserve	–	–	–	(85,000)	(X3)	(160,000)
				(75,000)	(Y5)	
Retained earnings	(7,000)	90,000	100,000	(5,000)	(X2)	153,000
				(25,000)	(Y4)	
	246,000	100,000	120,000			246,000

Adjustments

Relating to Xero:

X1 Being an adjustment to record goodwill arising on the original acquisition of Xero by Pear as stated in the consolidated financial statements of Pear immediately prior to the combination ($13,000).

X2 Being an adjustment to eliminate the accumulated profits of Xero generated prior to the original acquisition of Xero by Pear ($5,000).

X3 Being an adjustment to eliminate the share capital of Xero against the related investment cost of Apex. An adjustment of $85,000 has been made to a separate reserve in the consolidated financial statements of Apex ($113,000 – $28,000).

Relating to Yoho:

Y4 Being an adjustment to reflect the profits attributable to the non-controlling interests in Yoho prior to the combination ($100,000 × 25%).

Y5 Being an adjustment to eliminate the share capital of Yoho against the related investment cost of Apex. An adjustment of $75,000 has been made to a separate reserve in the consolidated financial statements of Apex ($120,000 × 75% – $15,000).

The consolidated statement of profit or loss of Apex for the year ended 31 December 20X0 is:

	Apex	*Xero*	*Yoho*	*Adjustments*		*Consolidated*
	$	$	$	$	Adj	$
Revenue	2,000	38,000	45,000			85,000
Profit or loss	(3,000)	15,000	12,000			24,000
Attributable to the non-controlling interests				3,000	(Y1)	(3,000)
Attributable to the equity holders of Apex						21,000

Adjustment

Y1 Being an adjustment to reflect the profit attributable to the non-controlling interests in Yoho prior to the combination ($12,000 × 25%).

The consolidated statement of financial position of Apex as at 31 December 20X0 is:

	Apex	*Xero*	*Yoho*	*Adjustments*		*Consolidated*
	$	$	$	$	Adj	$
Goodwill				13,000	(X2)	13,000
Investment in Xero				203,000	(1)	–
and Yoho	–	–	–	(113,000)	(X4)	
				(90,000)	(Y5)	
Other assets	18,000	80,000	100,000			198,000
Net assets	18,000	80,000	100,000			211,000
Capital						
	20,000	10,000	20,000	203,000	(1)	223,000
				(10,000)	(X4)	
				(20,000)	(Y5)	
Other reserve	–	–	–	(85,000)	(X4)	(160,000)
				(75,000)	(Y5)	
Non-controlling interests				25,000	(Y5)	25,000
Retained earnings	(2,000)	70,000	80,000	(5,000)	(X3)	123,000
				(20,000)	(Y5)	
	18,000	80,000	100,000			211,000

Note: The comparative figures are restated as if the entities had been combined at the previous end of reporting period. The consolidated share capital represents the share capital of Apex adjusted for the share capital issued for the purposes of the business combination.

Adjustments

1 Being an adjustment to push back the capital issued for the purposes of the business combination ($203,000, of which $113,000 relating to Xero and $90,000 relating to Yoho). The aim of the consolidated financial statements in merger accounting is to show the combining entities' results and financial positions as if they had always been combined. Consequently, the share capital in respect of 14,000 shares issued for the purposes of the business combination has to be shown as if it had always been issued.

Relating to Xero:

X2 Being an adjustment to record goodwill arising on the original acquisition of Xero by Pear as stated in the consolidated financial statements of Pear immediately prior to the combination ($13,000).

X3 Being an adjustment to eliminate the accumulated profits of Xero generated prior to the original acquisition of Xero by Pear ($5,000).

X4 Being an adjustment to eliminate the share capital of Xero against the related investment cost of Apex. An adjustment of $85,000 has been made to a separate reserve in the consolidated financial statements of Apex.

Relating to Yoho:

Y5 Being an adjustment to eliminate the share capital of Yoho against the related investment cost of Apex. Prior to the business combination, Pear only had 75% equity interest in Yoho. Non-controlling interests of $25,000 were recorded as at 31 December 20X0. An adjustment of $75,000 has been made to a separate reserve in the consolidated financial statements of Apex.

Earnings per share

Based on the same facts as per the above example, the calculation of basic earnings per share for each period presented in the consolidated financial statements of Apex is based on the consolidated profit (excluding the profit attributable to the non-controlling interests), and on the 40,000 shares (comprising 20,000 shares of Apex in issue throughout the two years ended 31 December 20X1 and 20,000 shares of Apex issued on 31 December 20X1 as consideration for the equity interests in Xero and Yoho).

4 HK(IFRIC) Int-17 *Distributions of Non-cash Assets to Owners*

4.1 The issue

Topic highlights

When an entity declares a distribution and has an obligation to distribute the assets concerned to its owners, it must recognise a liability for the dividend payable.

On declaring a distribution of non-cash assets, this Interpretation addresses the following issues:

(a) When should the entity recognise the dividend payable?

(b) How should an entity measure the dividend payable?

(c) When an entity settles the dividend payable, how should it account for any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable?

4.2 Key provisions

4.2.1 When to recognise a dividend payable

The liability to pay a dividend shall be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity, which is the date:

(a) when declaration of the dividend, e.g. by management or the board of directors, is approved by the relevant authority, e.g. the shareholders, if the jurisdiction requires such approval, or

(b) when the dividend is declared, e.g. by management or the board of directors, if the jurisdiction does not require further approval.

4.2.2 Measurement of a dividend payable

An entity shall measure a liability to distribute non-cash assets as a dividend to its owners at the fair value of the assets to be distributed.

If an entity gives its owners a choice of receiving either a non-cash asset or a cash alternative, the entity shall estimate the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative.

At the end of each reporting period and at the date of settlement, the entity shall review and adjust the carrying amount of the dividend payable, with any changes in the carrying amount of the dividend payable recognised in equity as adjustments to the amount of the distribution.

4.2.3 Accounting for any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable when an entity settles the dividend payable

When an entity settles the dividend payable, it shall recognise the difference, if any, between the carrying amount of the assets distributed and the carrying amount of the dividend payable in profit or loss.

4.2.4 Presentation and disclosures

An entity shall present the difference as a separate line item in profit or loss.

An entity shall disclose the following information, if applicable:

(a) The carrying amount of the dividend payable at the beginning and end of the period; and

(b) The increase or decrease in the carrying amount recognised in the period as result of a change in the fair value of the assets to be distributed.

If, after the end of a reporting period but before the financial statements are authorised for issue, an entity declares a dividend to distribute a non-cash asset, it shall disclose:

(a) the nature of the asset to be distributed;

(b) the carrying amount of the asset to be distributed as of the end of the reporting period; and

(c) the estimated fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount, and the information about the method used to determine that fair value required by HKFRS 7.

Topic recap

Changes in group structures

Disposals

Subsidiary

Full disposal:
- Gain/loss in parent's SPLOCI
- Gain/loss in consolidated SPLOCI
- Investment not included in CSOFP
- Consolidate subsidiary's results in CSPLOCI to disposal date

Part disposal: subsidiary → subsidiary:
- Gain/loss in parent's SPLOCI
- No gain/loss in consolidated SPLOCI
- Instead adjust equity by:

FV of consideration received	X
Change in NCI in net assets	(X)
	X/(X)

- NCI in CSOFP based on year end NCI%
- NCI in CSPLOCI calculated by pro-rating results of subsidiary

Part disposal: subsidiary → associate
- Gain/loss in parent's SPLOCI
- Gain/loss in consolidated SPLOCI
- Equity account for investment in CSOFP (cost = fair value of retained investment on disposal date)
- Pro-rate subsidiary's results and consolidate/equity account in CSPLOCI.

Part disposal: subsidiary → financial asset
- Gain/loss in parent's SPLOCI
- Gain/loss in consolidated SPLOCI
- Investment in CSOFP at fair value of retained investment on disposal date
- Consolidate results to disposal date then include dividend income.

Associate

Full disposal:
- Gain/loss in parent's SPLOCI
- Gain/loss in consolidated SPLOCI
- Investment not included in CSOFP
- Equity account associate's results in CSPLOCI to disposal date

Part disposal: associate → financial asset:
- Gain/loss in parent's SPLOCI
- Gain/loss in consolidated SPLOCI
- Investment in CSOFP at fair value of retained investment on disposal date
- Equity account for results to disposal date then include dividend income.

Group gain on disposal of subsidiary

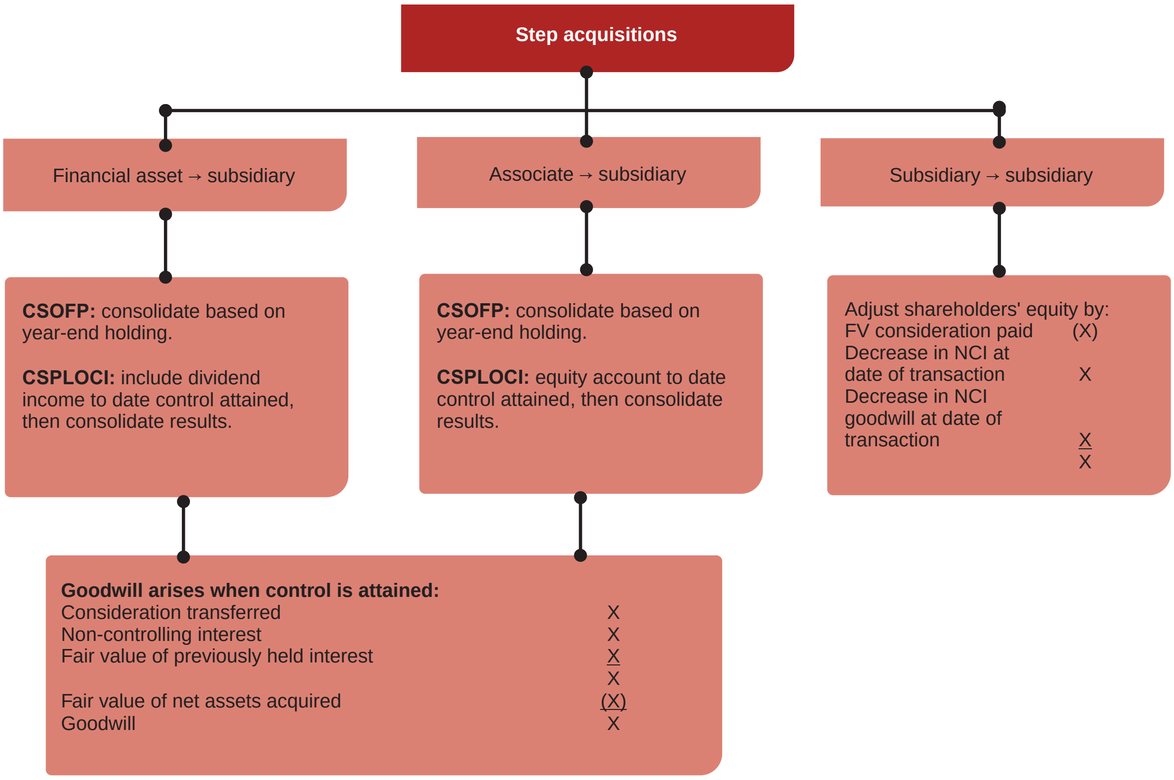
Consideration		X
FV ret'd interest		X
Net assets	X	
Goodwill	X	
NCI	(X)	
		(X)
		X/(X)

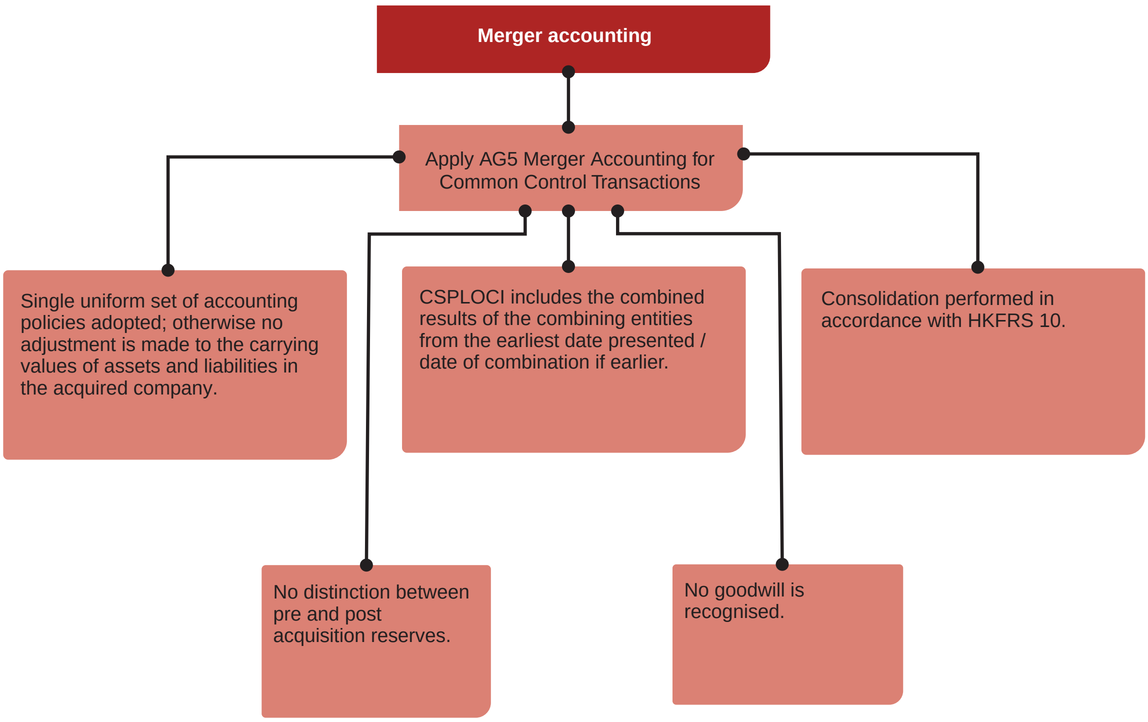
Parent company gain on disposal of investment

Consideration	X
Carrying value of investment disposed of	(X)
	X

Group gain on disposal of associate

Consideration		X
FV ret'd interest		X
Cost of inv't	X	
Post acq profits	X	
Impairment	(X)	
		(X)
		X/(X)


Step acquisitions
Financial asset → subsidiary
Associate → subsidiary
Subsidiary → subsidiary
CSOFP: consolidate based on year-end holding.
CSPLOCI: include dividend income to date control attained, then consolidate results.
CSOFP: consolidate based on year-end holding.
CSPLOCI: equity account to date control attained, then consolidate results.
Adjust shareholders' equity by:
FV consideration paid (X)
Decrease in NCI at date of transaction X
Decrease in NCI goodwill at date of transaction X
X
Goodwill arises when control is attained:
Consideration transferred X
Non-controlling interest X
Fair value of previously held interest X
X
Fair value of net assets acquired (X)
Goodwill X


Merger accounting
Apply AG5 Merger Accounting for Common Control Transactions
Single uniform set of accounting policies adopted; otherwise no adjustment is made to the carrying values of assets and liabilities in the acquired company.
CSPLOCI includes the combined results of the combining entities from the earliest date presented / date of combination if earlier.
Consolidation performed in accordance with HKFRS 10.
No distinction between pre and post acquisition reserves.
No goodwill is recognised.

Answers to self-test questions

Answer 1

Land Co.'s accounts	$'000
Fair value of consideration received	1,200
Less: carrying value of investment disposed of	(980)
Profit on disposal	220

Consolidated accounts	$'000	$'000
Fair value of consideration received		1,200
Less: net assets of subsidiary at disposal date	1,000	
goodwill at disposal date	45	
non-controlling interests at disposal date (20% × $1m) + $5,000	(205)	
		(840)
Group profit		360

Answer 2

The adjustment to equity will be:

	$
Fair value of consideration received	40,000
Amount recognised as non-controlling interests (30% × 120,000)	36,000
Positive movement in parent equity	4,000

		$	$
DEBIT	Cash	40,000	
CREDIT	Non-controlling interests		36,000
	Parent's equity		4,000

Note that there is no adjustment to the carrying amount of goodwill of $25,000 because control has been retained.

Answer 3

(a) **Complete disposal at year end (80% to 0%)**

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

	Noel	*Fanny*	*Adjustment 1*	*Adjustment 2*	*Disposal*	*Consolidated*
	$'000	$'000	$'000	$'000	$'000	$'000
Non-current assets	360	270			(270)	360
Investment	324		(324)			
Goodwill			36		(36)	
Current assets	370	370			(370)	} 1,020
					650	
						1,380
Share capital	540	180	(180)			540
Reserves	414	360	(180)	(36)	182	740
NCI			72	36	(108)	-
Current liabilities	100	100			(100)	100
						1,380

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X8

	Noel	*Fanny*	*Adjustment 1*	*Adjustment 2*	*Disposal*	*Consolidated*
	$'000	$'000	$'000	$'000	$'000	$'000
Profit before tax	153	126				279
Profit on disposal					182	182
Tax	(45)	(36)				(81)
	108	90				380
Owners of parent	108	90		(18)	182	362
NCI				18		18
						380

WORKINGS

1 *Goodwill*

	$'000
Consideration transferred	324
NCI: 20% × (180 + 180)	72
	396
Net assets (180 + 180)	(360)
	36

Consolidation adjustment journal		$'000	$'000
DEBIT	Goodwill	36	
DEBIT	Share capital	180	
DEBIT	Reserves	180	
CREDIT	Investment		324
CREDIT	Non-controlling interest		72

To recognise the acquisition and related goodwill and non-controlling interest.

2 *Allocate profits between acquisition date and disposal date to NCI*

	$
Post-acquisition profits (360 – 180)	180,000
NCI share (20%)	36,000

Of these, $18,000 (90,000 x 20%) relate to the current year

Consolidation adjustment journal (SOFP)		$'000	$'000
DEBIT	Reserves	36	
CREDIT	Non-controlling interest		36

To allocate the NCI share of post-acquisition profits

In addition 20% of the profits of Fanny Co arising in the year are allocated to the NCI:

Consolidation adjustment journal (SPL)		$'000	$'000
DEBIT	Profits attributable to owners of parent	18	
CREDIT	Non-controlling interest in profit		18

To allocate the NCI share of post-acquisition profits in the current year

3 *Profit on disposal of Fanny Co*

	$'000	$'000
Fair value of consideration received		650
Less: net assets at disposal	540	
Goodwill	36	
NCI (540 × 20%)	(108)	
		(468)
		182

Consolidation adjustment journal (SPL)		$'000	$'000
DEBIT	Cash	650	
DEBIT	NCI	108	
DEBIT	Disposal date liabilities of Fanny	100	
CREDIT	Goodwill		36
CREDIT	Disposal date current assets of Fanny		370
CREDIT	Disposal date non-current assets of Fanny		270
CREDIT	Reserves		182

To recognise the group gain on disposal of Fanny Co.

(b) **Partial disposal: subsidiary to subsidiary (80% to 60%)**

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X8

	Noel	*Fanny*	*Adjustment 1 (part (a)*	*Adjustment 2 (part (a)*	*Disposal*	*Consolidated*
	$'000	$'000	$'000	$'000	$'000	$'000
Non-current assets	360	270				630
Investment	324		(324)			
Goodwill			36			36
Current assets	370	370			160	900
						1,566
Share capital	540	180	(180)			540
Reserves	414	360	(180)	(36)	52	610
NCI			72	36	108	216
Current liabilities	100	100				200
						1,566

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X8

	Noel	*Fanny*	*Adjustment 1*	*Adjustment 2*	*Disposal*	*Consolidated*
	$'000	$'000	$'000	$'000	$'000	$'000
Profit before tax	153	126				279
Profit on disposal						–
Tax	(45)	(36)				(81)
	108	90				198
Owners of parent	108	90		(18)		180
NCI				18		18
						198

WORKING: Disposal

Adjustment is made to equity as control is not lost.	$'000
NCI before disposal 80% (360 + 180)	432
NCI after disposal 60% (360 + 180)	(324)
Required adjustment	108

Consolidation adjustment journal (SPL)		$'000	$'000
DEBIT	Current assets (cash)	160	
CREDIT	NCI		108
CREDIT	Reserves		52

(c) **Partial disposal: subsidiary to associate (80% to 40%)**

1 *Profit on disposal*

	$'000	$'000
Fair value of consideration received		340
Fair value of 40% investment retained		250
Less: Net assets when control lost		
((540 – (90 × $^3/_{12}$))	517.5	
Goodwill (part (a))	36	
NCI (517.5 × 20%)	(103.5)	
		(450)
		140

2 *Group reserves*

	Noel Reserves	*Fanny*	*Fanny 40% Reserve*
	$'000	$'000	$'000
At date of disposal	414		
Group profit on disposal (W1)	140		
Fanny: share of post acquisition earnings (157.5 × 80%)	126		
Fanny: share of post acquisition earnings (22.5 × 40%)	9		
	689		
At date of disposal (360 – (90 × $^{3}/_{12}$))/per question		337.5	360.0
Retained earnings at acquisition/ on disposal		(180.0)	(337.5)
		157.5	22.5

3 *Investment in associate*

	$'000
Fair value at date control lost (new "cost")	250
Share of post acquisition reserves (90 × $^{3}/_{12}$ × 40%)	9
	259

(d) **Partial disposal: subsidiary to financial asset (80% to 40%)**

1 *Profit on disposal* – as in part (c)

2 *Group reserves*

	$'000
Noel Co.'s reserves	414
Group profit on disposal (W1)	140
Fanny: share of post acquisition reserves (157.5 (see below) × 80%)	126
	680

	Fanny
	$'000
At date of disposal (360 – (90 × $^{3}/_{12}$))	337.5
Reserves at acquisition	(180.0)
	157.5

3 *Retained investment* – at $250,000 fair value.

Answer 4

(a) **Goodwill (at date control obtained)**

	$m	$m
Consideration transferred		480
Non-controlling interests (750 × 20%)		150
Fair value of previously held equity interest		130
		760
Less: Fair value of identifiable assets acquired and liabilities assumed		
Share capital	300	
Retained earnings	450	
		(750)
		10

(b) **Profit on derecognition of investment**

	$m
Fair value at date control obtained	130
Cost	(120)
	10

Exam practice

Most Capital Limited

54 minutes

Assume that you are Ms. Pindy Lee, the accounting manager of Most Capital Limited ("MCL"). MCL is a company incorporated and listed in Hong Kong and is principally engaged in the manufacturing of sanitary ware.

As at 1 April 20X7, MCL had two subsidiaries, First Successful Limited ("FSL") and Second Winning Limited ("SWL"). A summary of the acquisitions of these subsidiaries by MCL is as follows:

	Date of acquisition	*% acquired*	*Cost of investment*	*Retained earnings at acquisition date*	*Net assets at acquisition date*
			$'000	$'000	$'000
FSL	31 March 20X6	70	20,000	15,000	25,000
SWL	31 March 20X6	60	10,000	7,000	15,000

The fair value of the identifiable net assets of these subsidiaries at the respective date of acquisition was the same as the carrying amount of those assets. All goodwill arising on the acquisitions was found to be fully impaired so was written off in the consolidated financial statements for the year ended 31 March 20X7.

The retained earnings of MCL, FSL and SWL, as at 31 March 20X7, were $32 million, $20 million and $8 million respectively. The companies did not have any reserves other than retained earnings. The details of the issued share capital of MCL, FSL and SWL as at 31 March 20X7 are as follows:

	Issued capital	*Number of shares*
	$ million	million
MCL	60	10
FSL	10	5
SWL	8	8

MCL made a rights issue of one share for every two ordinary shares that was fully exercised on 1 January 20X8. The exercise price was $9 per share and the fair value of one ordinary share of MCL immediately before the rights issue was $12. The issued share capital of FSL and SWL has not changed since their acquisition by MCL.

The following table summarises information from the three companies' statements of profit or loss for the year ended 31 March 20X8:

	MCL	*FSL*	*SWL*
	$'000	$'000	$'000
Revenue	300,000	140,000	72,500
Cost of sales	(243,000)	(112,000)	(58,000)
Gross profit	57,000	28,000	14,500
Distribution costs	(15,000)	(7,500)	(4,000)
Administrative expenses	(10,000)	(5,000)	(2,500)
Depreciation and amortisation	(3,000)	(1,500)	(1,000)
Profit from operations	29,000	14,000	7,000
Finance costs	4,000	(2,000)	(1,000)
Profit before tax	25,000	12,000	6,000
Tax	(7,000)	(5,000)	(2,000)
Profit of the year	18,000	7,000	4,000

On 30 September 20X7, MCL sold 2.4 million shares in SWL for $8 million. The gain on this disposal has not been included in the above statements of profit or loss. The fair value of the remaining holding was $5 million at the date of disposal.

On 31 March 20X8, MCL sold all its plant and equipment, with an original purchase cost of $20 million and a carrying amount of $12 million, to a bank for its fair value of $16 million cash. MCL then leased the plant and equipment back from the bank under a finance lease over four years. The lease arrangement called for annual year-end payments of $1.6 million. At the end of the lease term, the bank is obligated to return the plant and equipment to MCL at an amount that has the overall effect, taking into account the lease payments, of providing the bank with a yield of the best lending rate minus 1% per annum. The remaining useful lives of the plant and equipment at 31 March 20X8 ranged from 8 to 10 years. No entries relating to the disposal have been recorded by MCL and the group.

During the year ended 31 March 20X8, FSL sold goods to MCL at an invoiced value of $1 million. FSL usually sold goods at cost plus 25%. Half of the goods were still held in MCL's inventory at 31 March 20X8.

MCL has adopted an accounting policy which depreciates plant and equipment using the straight line method over a 10-year life with no residual value. It is also the group's policy that interests in subsidiaries and associates are carried at cost in the separate financial statements and non-controlling interests are valued using the proportion of net assets method. SWL's results for the six months ended 30 September 20X7 were exactly half of its annual results in the year ended 31 March 20X8.

You have then added the gain on disposal of investment in SWL into MCL's financial statements and prepared draft consolidated financial statements of MCL for the year ended 31 March 20X8. After you sent these draft consolidated financial statements to MCL's directors for review, one of the directors, who is not a certified public accountant, sent you an email as follows:

To: Pindy LEE, Accounting Manager, MCL
From: Faria LEE (Director)
c.c.: Beverly CHOW, Emily WILSCON, Charmaine YUEN (Directors)

Date: 18 May 20X8

Consolidated financial statements of MCL as at 31 March 20X8

Could you please clarify the following points relating to MCL's draft consolidated financial statements which I have just reviewed.

(a) So far as I understand, we have already disposed of all our plant and equipment. I am not aware that we have purchased any new plant and equipment. Why is there still an amount of HK$12 million of plant and equipment in the consolidated statement of financial position?

(b) I find two new items, namely an "Investment in an associate" in the consolidated balance sheet and a "Share of profit of an associate" in the consolidated statement of profit or loss for the year ended 31 March 20X8. Why are these items with the consolidated financial statements?

(c) I note that the amount of gain on disposal of our investment in SWL as shown in our separate statement of profit or loss and that in the consolidated statement of profit or loss are different. Why is there such a difference?

(d) I note that MCL made a rights issue during the year. Will this have any impact on the EPS of MCL for the year?

I would appreciate your clarification in time for the upcoming board meeting.

Best regards,
Faria

Required

Prepare a memorandum in response to the issues raised by Ms. Faria Lee. In your memorandum, you should:

(a) discuss the reasons for the amount of HK$12 million of plant and equipment as shown in the consolidated statement of financial position; **(5 marks)**

(b) discuss how MCL should account for its interest in SWL before and after the disposal of the 2.4 million shares in SWL (no computation is expected in this part); **(10 marks)**

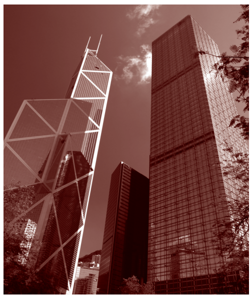
(c) discuss why the amount of the gain on disposal of the investment in SWL as shown in the separate statement of profit or loss and in the consolidated statement of profit or loss is different; and

(5 marks)

(d) discuss with appropriate calculation, the impact of the rights issue on the earnings per share of MCL for the year ended 31 March 20X8. **(10 marks)**

(Total = 30 marks)

HKICPA February 2008 (amended)


chapter 30

Consolidation of foreign operations

Topic list

1 HKAS 21 *The Effects of Changes in Foreign Exchange Rates*
- 1.1 Objective
- 1.2 Definitions

2 Foreign currency transactions in individual company accounts
- 2.1 Foreign currency transactions: initial recognition
- 2.2 Foreign currency transactions: settlement before the period end
- 2.3 Foreign currency transactions: settlement after the period end
- 2.4 Recognition of exchange differences

3 Consolidation of foreign operations
- 3.1 Introduction
- 3.2 Translation of financial statements to presentation currency
- 3.3 Exchange differences
- 3.4 Further matters relating to the consolidation of foreign operations

Learning focus

We conclude the coverage of group accounts with a chapter on consolidating foreign subsidiaries.

The issue of foreign currency, be it recording a few foreign currency transactions or consolidating several foreign currency subsidiaries, is relevant to a large number of companies. It is therefore important that you understand how transactions and financial statements are translated, and how the resulting exchange differences are recognised.

Once the translaton has been done, the general principles of consolidation apply.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.19	**The effects of changes in foreign exchange rates**	2
3.19.01	Determine the functional currency of an entity in accordance with HKAS 21	
3.19.02	Translate foreign operation financial statements to the presentation currency	
3.19.03	Account for foreign currency transactions within an individual company and in the consolidated financial statements	
3.19.04	Account for disposal or partial disposal of a foreign operation	

1 HKAS 21 *The Effects of Changes in Foreign Exchange Rates*

Topic highlights

HKAS 21 provides accounting guidance on the translation of foreign currency transactions and foreign currency financial statements. It prescribes which exchange rates should be used and how exchange differences are recognised.

HKAS 21.1-2

1.1 Objective

An entity may be involved in foreign activities in two ways:

(a) It may be involved in **transactions in foreign currencies**, such as buying or selling goods. For example, an Indian company might buy materials from Canada, pay for them in US dollars, and then sell its finished goods in Germany receiving payment in Euros, or perhaps in some other currency. If the company owes money in a foreign currency at the end of the accounting year, or holds assets which were bought in a foreign currency, those liabilities or assets must be translated into the local currency (in this Learning Pack $), in order to be shown in the books of account.

(b) It may have **foreign operations**, for example an overseas subsidiary. This subsidiary is likely to trade, and keep accounts, in its own local currency. However, in order to consolidate its results into the group accounts, its financial statements must be translated into the currency in which the group reports.

HKAS 21 provides guidance on how foreign currency transactions should be translated and accounted for, and how the financial statements of foreign operations should be translated into a presentation currency prior to consolidation.

In particular, the standard considers:

- which exchange rate to use, and
- how exchange differences should be recognised in the financial statements.

Sections 2 and 3 of this chapter deal with foreign currency transactions in individual companies and the translation of foreign currency financial statements. First, however, we must consider a number of important definitions.

HKAS 21.8

1.2 Definitions

The following definitions are given within HKAS 21:

Key terms

Foreign currency is a currency other than the functional currency of the entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

Presentation currency is the currency in which the financial statements are presented.

Exchange rate is the ratio of exchange for two currencies.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Spot exchange rate is the exchange rate for immediate delivery.

Key terms (cont'd)

Closing rate is the spot exchange rate at the end of the reporting period.

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation. *(HKAS 21)*

1.2.1 Functional and presentation currencies

As defined above, the functional currency of an entity is the currency of the primary economic environment in which the entity operates, in other words the currency in which it normally spends and receives cash.

Each entity should determine its functional currency and measure its results and financial position in that currency.

For most individual companies the functional currency will be the currency of the country in which they are located and in which they carry out most of their transactions.

Regardless of its functional currency, an entity can choose any currency to be its presentation currency i.e. the currency in which the financial statements are presented.

HKAS 21.9-10

1.2.2 Determining functional currency

HKAS 21 states that the following primary indicators should be considered in determining functional currency:

(a) The currency that mainly **influences sales prices** for goods and services (often the currency in which prices are denominated and settled)

(b) The currency of the **country whose competitive forces and regulations** mainly determine the sales prices of its goods and services

(c) The currency that mainly **influences labour, material and other costs** of providing goods or services (often the currency in which prices are denominated and settled)

The following secondary factors may also provide evidence of an entity's functional currency:

(d) The currency in which **funds from financing activities** (raising loans and issuing equity) are generated

(e) The currency in which **receipts from operating activities** are usually retained

HKAS 21.11

1.2.3 Determining whether a foreign operation has the same functional currency as the parent

Where a parent has a foreign operation a number of factors are considered in order to decide whether the functional currency is the same as that of the parent:

(a) Whether the activities of the foreign operation are carried out as an **extension of the parent**, rather than being carried out with a **significant degree of autonomy**.

(b) Whether **transactions with the parent** are a high or a low proportion of the foreign operation's activities.

(c) Whether **cash flows** from the activities of the foreign operation **directly affect the cash flows of the parent** and are readily available for remittance to it.

(d) Whether the activities of the foreign operation are **financed from its own cash flows** or by **borrowing from the parent**.

Where these indicators are mixed, management must use judgment, giving priority to factors (a) – (c) in section 1.2.2 above.

Example: Foreign operation

State in each of the following cases whether the foreign operation has the same functional currency as the parent:

(a) Lomas Co. operates in Thailand, selling goods manufactured by its parent company Real Co., based in Hong Kong. All sales proceeds are remitted to Real Co. on a monthly basis.

(b) Ariadne Co. operates in South Africa. It imports 30% of the goods it sells from its Australian parent company Thor Co.; the remainder come from third party suppliers. Ariadne usually maintains cash reserves in South African Rand, however as a result of expansion has recently utilised these and supplemented them with borrowings from the Bank of South Africa.

Solution

(a) Lomas operates as an extension of Real, therefore it can be concluded that its functional currency is the same as that of Real.

(b) Ariadne obviously has a significant degree of automony:

- 70% of purchases are from third party suppliers
- Cash reserves (when available) are maintained in local currency
- It is able to secure (and presumably service) borrowings in its own right rather than rely on the parent company

We can therefore conclude that the functional currency of Ariadne is the Rand.

HKAS 21.13, 35

1.2.4 Change in functional currency

The functional currency of an entity can be changed only if there is a change to the underlying transactions, events and conditions that are relevant to the entity. For example, an entity's functional currency may change if there is a change in the currency that mainly influences the sales price of goods and services.

Where there is a change in an entity's functional currency, the entity translates all items into the new functional currency **prospectively** (i.e., from the date of the change) using the exchange rate at the date of the change.

2 Foreign currency transactions in individual company accounts

Topic highlights

Foreign currency transactions are initially translated at the spot rate on the transaction date. Balances relating to monetary items are re-translated at the reporting date. An exchange gain or loss may be recognised on re-translation and settlement.

It is increasingly common for individual entities to engage in transactions denominated in a foreign currency. They may:

- sell to foreign customers
- buy from foreign suppliers
- borrow from foreign banks

In each of these instances the foreign currency transaction must be **translated** to the functional currency of the entity before it is recorded in the accounts. Where a balance denominated in foreign currency remains at the period end, this may require **re-translating**.

HKAS 21.21,22

2.1 Foreign currency transactions: initial recognition

HKAS 21 states that a foreign currency transaction should initially be translated to the functional currency, by applying the spot exchange rate between the reporting currency and the foreign currency **at the date of the transaction**.

An **average rate** for a period may be used if exchange rates do not fluctuate significantly.

For example, suppose a local company buys a large consignment of goods from a supplier in Singapore. The order is placed on 1 March and the agreed price is SG$124,000. At the time of delivery the rate of foreign exchange was SG$4 to $1. The local company would record the amount owed in its books as follows.

		$	$
DEBIT	Purchases (124,000 ÷ 4)	31,000	
CREDIT	Payables account		31,000

2.2 Foreign currency transactions: settlement before the period end

When the outstanding foreign currency balance is settled, an exchange difference is likely to arise. This is because exchange rates commonly fluctuate.

To consider the example given above, let's assume that the Singapore supplier is paid on 1 July, and on this date the rate of exchange was SG$5 to $1. The local company is obliged to pay SG$124,000, and can obtain this amount on 1 July for $24,800 (SG$124,000 ÷ 5). The company has therefore made an exchange gain of $6,200, being the difference between the amount of the payable in the books and the amount actually paid:

		$	$
DEBIT	Payables account	31,000	
CREDIT	Cash		24,800
	Exchange gain		6,200

HKAS 21.23

2.3 Foreign currency transactions: settlement after the period end

Where a foreign currency balance is not settled before the end of the reporting period, it may require re-translating for inclusion in the period end accounts.

HKAS 21 requires that foreign currency balances are classified as either monetary or non-monetary for this purpose. **Monetary items** are cash or amounts that will be settled in cash, for example receivables, payables and loans. **Non-monetary items** are balances such as non-current assets and inventories which do not involve a transfer of cash.

The following rules apply at each period end:

(a) Monetary items are re-translated using the closing rate.

(b) Non-monetary items which are carried at historical cost are not re-translated (i.e. they continue to be reported based on the spot exchange rate on the date of acquisition).

(c) Non-monetary items which are carried at fair value are not re-translated (i.e. they continue to be reported based on the exchange rates that existed when fair value was determined).

Example: Exchange

Silk Co. sells goods to a Japanese company on 1 May 20X9, and agrees that payment should be made in Japanese Yen at a price of ¥116,000 at the end of July 20X9. Silk Co. prepares its accounts to 30 June. Relevant exchange rates are:

1 May 20X9	¥10.75 to $1
30 June 20X9	¥11 to $1
31 July 20X9	¥11.6 to $1

Silk Co. would record the sale as follows:

		$	$
DEBIT	Receivables account (¥116,000 ÷ 10.75)	10,791	
CREDIT	Sales		10,791

At the period end, Silk Co must re-translate the receivable amount based on the spot rate on 30 June 20X9. The re-translated receivables balance will be $10,545 (¥116,000 ÷ 11). Therefore:

		$	$
DEBIT	Exchange loss	246	
CREDIT	Receivables account ($10,791 – $10,545)		246

An exchange loss arises as the receivables amount has lost value in $.

When the ¥116,000 are paid at the end of July, Silk Co. will convert them into $, to obtain (¥116,000 ÷ 11.6) $10,000. Therefore, a further loss arises:

		$	$
DEBIT	Cash	10,000	
	Exchange loss	545	
CREDIT	Receivables account		10,545

HKAS 21.28 - 29

2.4 Recognition of exchange differences

As we have seen, exchange differences arise where the exchange rate changes between the transaction date and the reporting and settlement date.

These exchange differences should be **recognised in profit or loss**:

- Exchange differences relating to items settled in the period in which they arise are recognised in that period.
- Exchange differences relating to items which are not settled in the period in which they arise are recognised in more than one period:
  - At each reporting date an exchange difference is recognised on re-translation
  - At the settlement date a further exchange difference is recognised.

Exchange differences relating to trading items (such as receivables and payables) are usually recognised as operating expenses or income, and exchange differences relating to financing are usually recognised as part of interest expense or income.

HKAS 12 *Income Taxes* should be applied when there are tax effects arising from gains or losses on foreign currency transactions. Where exchange losses are allowable expenses in a particular jurisdiction, tax relief will be given. Exchange gains may be treated as taxable income.

Self-test question 1

FineRt is a retailer of artworks and sculptures. The company has a year end of 31 December 20X1 and uses $ as its functional currency. On 28 October 20X1, FineRt purchased 10 paintings from a supplier for 920,000 pesas each, a total of 9,200,000 pesas.

Exchange rates were as follows:

28 October 20X1	$1:1.8 pesa
12 December 20X1	$1:1.9 pesa
31 December 20X1	$1:2.0 pesa
1 February 20X2	$1:2.4 pesa

FineRt sold seven of the paintings for cash on 12 December 20X1 with the remaining three paintings being sold on 1 February 20X2. All 10 of the paintings were paid for by FineRt on 1 February 20X2.

Required

What accounting entries are made in respect of the payable amount on each of the key dates?

(The answer is at the end of the chapter)

When a gain or loss on a non-monetary item is recognised **in other comprehensive income** (for example, where property is revalued), any **related exchange differences** should also be **recognised in other comprehensive income**.

3 Consolidation of foreign operations

Topic highlights

Individual group entities must translate their financial statements into a common group presentation currency prior to consolidation by applying the method specified in HKAS 21.

3.1 Introduction

Now that you have covered the main aspects of foreign currency translation in a single company context, you are ready to tackle consolidation of foreign operations (usually a subsidiary). Apart from the foreign currency aspects, the usual consolidation rules apply (intra-group transactions, non-controlling interest etc). Look back to Chapters 26 to 29 if unsure of any of these rules.

HKAS 21.38-40

3.2 Translation of financial statements to presentation currency

An individual entity may choose to present its financial statements in any currency, including one which is different from its functional currency.

Where a group contains individual entities with different functional currencies, each of their financial statements must be translated into a common presentation currency prior to consolidation.

Where financial statements are required to be translated into a presentation currency, and the functional currency of the reporting entity is not hyperinflationary, the following procedures are applied:

(a) Assets and liabilities in the statement of financial position are translated at the closing rate at the year end.

(b) Income and expenses in the statement of profit or loss and other comprehensive income are translated at the spot rates applicable on the dates of the transactions, although an average rate is usually used for practical purposes where the exchange rate does not fluctuate significantly.

(c) Resulting exchange differences are recognised in other comprehensive income.

Share capital is translated at the historical rate on the date of acquisition and reserves form a balancing figure to include the exchange difference.

HKAS 21.41

3.3 Exchange differences

The exchange difference arising on the translation of financial statements to the presentation currency is due to:

- translating **income/expense items** at the exchange rates at the date of transactions (or average rate), whereas **assets/liabilities** are translated at the closing rate
- translating the **opening net investment** (opening net assets) in the foreign entity at a closing rate different from the closing rate at which it was previously reported

The exchange difference for inclusion within other comprehensive income can therefore be calculated in the following way:

	$	$
Opening net assets at closing rate	X	
Opening net assets at opening rate	(X)	
Exchange gain/(loss)		X/(X)
Retained profits at closing rate	X	
Retained profits at average rate	(X)	
Exchange gain/loss		X/(X)
Overall exchange gain/loss		X/(X)

The gain or loss is accumulated in reserves in the consolidated statement of financial position. Where a subsidiary in which an exchange difference arises is not wholly-owned, a proportion of accumulated exchange differences is allocated to the non-controlling interest and therefore form part of the non-controlling interest in the consolidated statement of financial position.

HKAS 12 *Income Taxes* should be applied when there are tax effects arising on the translation of the financial statements of foreign operations.

Example: Exchange difference

Stockpot has a wholly-owned foreign subsidiary, Crockpot, with net assets at 1 January 20X1 of N$800 million. Crockpot made a profit for the year ending 31 December 20X1 of N$280 million. The functional currency of Crockpot is the N$.

Stockpot's consolidated financial statements were prepared to 31 December 20X1 and the presentation currency is Hong Kong dollars.

Exchange rates were as follows:

1 January 20X1	N$2.0:$1
31 December 20X1	N$3.0:$1
Average rate for 20X1	N$2.5:$1

Required

(a) How would the exchange gain or loss on the investment in Crockpot be recognised in the consolidated financial statements of Stockpot for the year ending 31 December 20X1 assuming that Stockpot maintains a foreign exchange reserve?

(b) How would your answer differ if Stockpot held 80% of the shares in Crockpot rather than 100%?

Solution

(a) Calculation of exchange difference

		$m	$m
Net assets at 1 January 20X1 at rate on 31.12.X0	N$800 @ 2.0	400	
Net assets at 1 January 20X1 at rate on 31.12.X1	N$800 @ 3.0	267	133 loss
Profit for the year at average rate	N$280 @ 2.5	112	
Profit for the year at 31 December 20X1 rate	N$280 @ 3.0	93	19 loss
			152 loss

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR STOCKPOT FOR THE YEAR ENDED 31 DECEMBER 20X1 (EXTRACT)

	$m
Other comprehensive income	
Items that may be reclassified to profit or loss	
Exchange difference on translating foreign operations	(152)

CONSOLIDATED STATEMENT OF FINANCIAL POSITION FOR STOCKPOT AT 31 DECEMBER 20X1 (EXTRACT)

Foreign exchange reserve	(152)

(b) If Stockpot owned 80% rather than 100% of Crockpot, the exchange difference is allocated between the group and non-controlling interest in proportion to their respective ownership interests.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR STOCKPOT FOR THE YEAR ENDED 31 DECEMBER 20X1 (EXTRACT)

	$m
Other comprehensive income	
Items that may be reclassified to profit or loss	
Exchange difference on translating foreign operations	(152)
Allocated to group (80%)	(122)
Allocated to non-controlling interest (20%)	(30)

CONSOLIDATED STATEMENT OF FINANCIAL POSITION FOR STOCKPOT AT 31 DECEMBER 20X1 (EXTRACT)

Foreign exchange reserve	(122)
Non-controlling interest	(30)

Example: Translation of foreign subsidiary financial statements

Mariol Co. operates in Rhineland and has identified the Gilder as its functional currency. The summarised financial statements of Mariol for the year ended 31 December 20X1 are as follows:

STATEMENT OF FINANCIAL POSITION	Gilder 000
Property, plant and equipment	1,400
Current assets	
Inventory	350
Receivables	500
Cash	160
	2,410
Share capital	600
Retained earnings	1,350
Liabilities	460
	2,410

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME	
Revenue	3,500
Cost of sales	(1,990)
Expenses	(1,150)
Tax	(170)
	190

At the start of December, Mariol issued an invoice for goods provided to a new customer, Blarney Co., based in Liffeland. The invoice was denominated in Punt, as agreed with the customer, and was for Pt 1.2 million. This invoice is not reflected in the financial statements above and at the period end remains unpaid.

100% of the share capital of Mariol was purchased by Rhonda Co. on 1 January 20X1 and Rhonda requires Mariol to translate its financial statements into $ before reporting its financial results.

Relevant exchange rates are:

	Gilder:$	Punt: Gilder
1 January 20X1	1:8.5	not known
1 December 20X1	1:9	5:1
31 December 20X1	1:10	5.5:1
Average for 20X1	1:8	not known

Required

Prepare the translated financial statements of Mariol ready for submission to its parent company.

Solution

First the transaction with Blarney must be reflected in the financial statements:

1 December 20X1		Gilder 000	Gilder 000
DEBIT	Receivables (1,200/5)	240	
CREDIT	Sales		240

To record the transaction at the point of sale.

31 December 20X1			
DEBIT	Exchange loss (240 – (1,200/5.5))	22	
CREDIT	Receivables		22

To measure the receivables at the year end.

Next the financial statements are translated:

STATEMENT OF FINANCIAL POSITION	Gilder 000	Gilder 000	Exch. rate	$'000
Property, plant and equipment		1,400	1:10	14,000
Current assets				
Inventory		350	1:10	3,500
Receivables	500 + 240 – 22	718	1:10	7,180
Cash		160	1:10	1,600
		2,628		26,280
Share capital		600	1:8.5	5,100
Retained earnings	1,350 + 240 – 22	1,568	β	13,124
Foreign exchange reserve			(W)	3,456
Liabilities		460	1:10	4,600
		2,628		26,280
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME				
Revenue	3,500 + 240	3,740	1:8	29,920
Cost of sales		(1,990)	1:8	(15,920)
Expenses		(1,150)	1:8	(9,200)
Exchange loss	(0+22)	(0+22)	1:8	(176)
Tax		(170)	1:8	(1,360)
		408		3,264
Other comprehensive income				
Exchange gain on translation (W)				3,456
Total comprehensive income				6,720

WORKING

Exchange gain

Opening net assets G1,760	At OR	8.5	14,960	
	At CR	10	17,600	
				2,640 gain
Retained profits G408	At AR	8	3,264	
	At CR	10	4,080	
				816 gain
Overall gain				3,456

3.4 Further matters relating to the consolidation of foreign operations

HKAS 21.47

3.4.1 Goodwill and fair value adjustments

Goodwill arising under HKFRS 3 *Business Combinations* from the acquisition of a foreign operation should initially be calculated in the functional currency of the subsidiary. It is then treated as an asset of the foreign operation and should be translated at the **closing rate** each year.

Similarly, any fair value adjustments made on consolidation are treated as an asset or liability of the foreign operation and are translated at closing rate each year.

The exchange differences arising are recorded as other comprehensive income in the consolidated accounts and accumulated in group equity.

Example: Goodwill

Surf Co. acquired 100% of Wave Co. for consideration of ¥78.6 million (foreign currency) on 1 April 20X8 when the net assets of Wave Co. were ¥66 million. Surf Co.'s presentation currency is the $ and relevant exchange rates are:

1 April 20X8	¥12:$1
31 March 20X9	¥11:$1

At what amount is goodwill recognised in the consolidated statement of financial position on 31 March 20X9 and what amount is recognised as an exchange difference on goodwill for the period?

Solution

Goodwill

	¥'000	*Rate*	$'000
Consideration transferred	78,600		
Net assets of Wave at 1 April 20X8	(66,000)		
At 1 April 20X8	12,600	12 *	1,050
Foreign exchange gain	–	Balance	95
At 31 March 20X9	12,600	11 **	1,145

* Historical rate
** Closing rate

Goodwill is therefore reported in the statement of financial position at $1,145,000 and an exchange gain of $95,000 is recognised in other comprehensive income.

HKAS 21.32,45

3.4.2 Intragroup balances and exchange differences

When a parent has a foreign subsidiary, consolidation procedures are applied as normal. Therefore, intra-group transactions and balances are eliminated.

However, transactions between parent and foreign subsidiary can lead to exchange gains and losses in the individual books and records of each entity. These exchange gains and losses are recognised in the profit or loss of each entity in accordance with the normal rules in transactions in foreign currencies.

On consolidation any exchange gains and losses in the individual profit or loss of parent and subsidiary which do not eliminate are reported in the consolidated profit or loss.

There is one exception to this rule: where exchange differences arise on a long term intra-group loan from parent to subsidiary that is not planned or likely to be received or paid in the foreseeable future.

In this case, the balance is regarded as part of the parent's investment in the foreign subsidiary. Therefore, the exchange gain or loss arising on the translation of this balance, which was recognised in the profit or loss **in the parent's separate financial statements**, is recognised in other comprehensive income **in the consolidated financial statements**. This will require a consolidation adjustment transferring the gain or loss from the parent's own profit or loss where it was initially recognised to other comprehensive income in the consolidated accounts.

3.4.3 Different reporting dates

Because of different laws in different countries, it can happen that the foreign operation's **reporting date** is different from that of the parent. In this case HKFRS 10 allows the use of the foreign operation's accounts as at its own reporting date to be consolidated with the accounts of the parent as at the parent's own reporting date as long as the foreign operation's reporting date is within three months of the parent's. However, adjustments are made for any significant changes in exchange rates which took place in the intervening period between the two dates.

HKAS 21.48-49

3.4.4 Disposal of foreign entity

A parent may dispose or part dispose of its foreign subsidiary. For this purpose, a full disposal includes:

- a disposal of all interests held in a subsidiary
- any disposal where control over the subsidiary is lost.

A part disposal is any other reduction in ownership in a foreign subsidiary i.e. where control is retained.

Full disposal

On disposal, a profit or loss on disposal is calculated as normal. In addition, historical cumulative exchange differences arising on consolidation and included in group reserves up to the date of disposal are reclassified to profit or loss.

Therefore the gain or loss on disposal is made up of two elements:

1 The actual gain or loss on disposal
2 The reclassified cumulative exchange differences

This means that these exchange differences are effectively recognised twice. The first time they are recognised in other comprehensive income as they arise each period on consolidation. They are then recognised for a second time, albeit in a different place, when they are transferred to the profit or loss on disposal. This double recognition is sometimes called recycling of profits or losses.

Note that the cumulative exchange differences that have been attributed to the non-controlling interests are derecognised as part of the non-controlling interest balance. They therefore have an impact on the gain or loss calculated on disposal, as discussed in Chapter 29.

Partial disposal

If the parent part disposes of a foreign subsidiary such that it still retains control after the disposal, the cumulative exchange differences previously recognised in other comprehensive income are re-allocated between the group and non-controlling interest in proportion to the new ownership interests.

Self-test question 2

Little was incorporated over 20 years ago, operating as an independent entity for 15 years until 20X1 when it was taken over by Large. Large's directors decided that the local expertise of Little's management should be utilised as far as possible, and since the takeover they have allowed the subsidiary to operate independently, maintaining its existing supplier and customer bases. Large exercises "arm's length" strategic control, but takes no part in day-to-day operational decisions.

The statements of financial position of Large and Little at 31 March 20X7 are given below. The statement of financial position of Little is prepared in francos (F), its reporting currency.

	Large		*Little*	
	$'000	$'000	F'000	F'000
Non-current assets				
Property, plant and equipment	63,000		80,000	
Investments	12,000		–	
		75,000		80,000

	Large		*Little*	
	$'000	$'000	F'000	F'000
Current assets				
Inventories	25,000		30,000	
Trade receivables	20,000		28,000	
Cash	6,000		5,000	
		51,000		63,000
		126,000		143,000
Equity				
Share capital		30,000		40,000
Retained earnings		35,000		34,000
Revaluation reserve		–		6,000
		65,000		80,000
Non-current liabilities				
Long-term borrowings	20,000		25,000	
Deferred tax	6,000		10,000	
		26,000		35,000
Current liabilities				
Trade payables	25,000		20,000	
Tax	7,000		8,000	
Bank overdraft	3,000		–	
		35,000		28,000
		126,000		143,000

NOTES TO THE STATEMENTS OF FINANCIAL POSITION

1 *Investment by Large in Little*

On 1 April 20X1 Large purchased 36,000,000 of the 40,000,000 shares in Little for 72 million francos. The accumulated profits of Little at that date were 26 million francos. There was no impairment of goodwill.

2 *Intra-group trading*

Little sells goods to Large, charging a mark-up of one-third on production cost. At 31 March 20X7, Large held $1 million (at cost to Large) of goods purchased from Little in its inventories. The goods were purchased during March 20X7 and were recorded by Large using an exchange rate of $1 = 5 francos. (There were minimal fluctuations between the two currencies during March 20X7.) At 31 March 20X6, Large's inventories included no goods purchased from Little. On 29 March 20X7, Large sent Little a cheque for $1 million to clear the intra-group payable. Little received and recorded this cash on 3 April 20X7.

3 *Accounting policies*

The accounting policies of the two companies are the same, except that the directors of Little have decided to adopt a policy of revaluation of property, whereas Large includes all properties in its statement of financial position at a depreciated historical cost. Until 1 April 20X6, Little operated from rented warehouse premises. On that date, the entity purchased a leasehold building for 25 million francos, taking out a long-term loan to finance the purchase. The building's estimated useful life at 1 April 20X6 was 25 years, with an estimated residual value of nil, and the directors decided to adopt a policy of straight line depreciation. The building was professionally revalued at 30 million francos on 31 March 20X7, and the directors have included the revalued amount in the statement of financial position. No other property was owned by Little during the year.

Large measures non-controlling interests at acquisition at the proportionate share of the fair value of the subsidiary's net assets.

4 *Exchange rates*

Date	*Exchange rate* Francos to $1
1 April 20X1	6.0
31 March 20X6	5.5
31 March 20X7	5.0
Average rate for the year to 31 March 20X7	5.2
Average rate for the dates of acquisition of closing inventory	5.1

Required

(a) Explain (with reference to relevant accounting standards to support your argument) how the financial statements (statement of financial position and statement of profit or loss) of Little should be translated into $ for the consolidation of Large and Little.

(b) Translate the statement of financial position of Little at 31 March 20X7 into $ and prepare the consolidated statement of financial position of the Large group at 31 March 20X7.

Note. Ignore any deferred tax implications of the property revaluation and the intra-group trading.

(The answer is at the end of the chapter)

Topic recap

HKAS 21 The Effects of Changes in Foreign Exchange Rates

Functional currency (FC) is the currency of the primary economic environment in which the entity operates
Presentation currency (PC) is the currency in which the financial statements are presented.

To determine functional currency, **primary factors**:
- Currency that influences sales prices
- Currency of country whose regulations/competition determines sales prices
- Currency that influences costs

Individual company accounts

Apply spot rate to transactions before recording in the accounts

At period end retranslate monetary items at closing rate → exchange difference

Record settlement at spot rate on settlement date → exchange difference

Recognise exchange differences in profit or loss

Consolidated accounts

Translate foreign subsidiary accounts to presentation currency

Statement of financial position:
all assets and liabilities at closing rate

Statement of profit or loss and other comprehensive income:
all income and expenditure at average rate

Exchange difference arises:

Opening net assets at opening rate	X	
Opening net assets at closing rate	<u>X</u>	
		X/(X)
Retained profit at average rate	X	
Retained profit at closing rate	<u>X</u>	
		<u>X/(X)</u>
		X/(X)

Recognise exchange difference in other comprehensive income of subsidiary.

Goodwill/FV adjustments are calculated in functional currency and translated at closing rate each year. Exchange differences are recognised in other comprehensive income of group.

Some exchange differences on intragroup balances will not be eliminated on consolidation; these are reported in group profit or loss.

On disposal of foreign subsidiary, cumulative exchange differences in reserves are reclassified to profit or loss.

Answers to self-test questions

Answer 1

28 October 20X1

The paintings are purchases and the purchase is translated into $ using the spot rate (i.e. the exchange rate on the date of the transaction):

		$	$
DEBIT	Purchases (9.2m/1.8)	5,111,111	
CREDIT	Payable		5,111,111

31 December 20X1

At the year end, the payable balance is re-translated using the closing rate (the exchange rate at the period end). The resulting gain is recognised in profit or loss for the year:

Retranslate payable to 9.2m/2 = $4.6m

DEBIT	Payable	511,111	
CREDIT	Exchange gain		511,111

1 February 20X2

On the settlement date, an exchange gain arises, being the difference between the cash required to purchase 9.2 million pesas and the carrying value of the payable extinguished:

DEBIT	Payable	4,600,000	
CREDIT	Cash (9.2m/2.4)		3,833,333
	Exchange gain		766,667

Answer 2

(a) From the information in the question it is clear that Little operates on a largely independent basis from Large with its own supplier and customer bases and no day-to-day part being played by Large in operational decisions. Therefore, the cash flows of Little will not have a day-to-day impact on those of Large. As such HKAS 21 *The Effects of Changes in Foreign Exchange Rates* requires that the financial statements of Little for consolidation purposes should be translated using the **presentation currency** or **closing rate method**. Under this method the statement of financial position assets and liabilities are translated at the **closing rate** of exchange on the **reporting date** and the statement of profit or loss is translated at an **average rate** of exchange for the year. Any exchange differences are not reported in the statement of profit or loss, as they have no impact on the cash flows of the group, but instead are reported in **other comprehensive income**.

(b) TRANSLATION OF LITTLE STATEMENT OF FINANCIAL POSITION INTO $

	F'000	Rate	$'000
Non-current assets			
Property, plant and equipment			
(80,000 – 6,000 revaluation adjustment)	74,000	5	14,800
Current assets			
Inventories	30,000	5	6,000
Trade receivables	28,000	5	5,600
Cash	5,000	5	1,000
	137,000		27,400
Equity			
Share capital	40,000	6	6,667
Revaluation surplus (6,000 – 6,000)			
Pre acquisition retained reserves	26,000	6	4,333
Post acquisition retained reserves			
(34,000 – 26,000)	8,000	Bal	3,800
	74,000		14,800
Non-current liabilities			
Long-term borrowings	25,000	5	5,000
Deferred tax	10,000	5	2,000
Current liabilities			
Trade payables	20,000	5	4,000
Tax	8,000	5	1,600
	137,000		27,400

WORKINGS

1 *Group structure*

Investment in Little = 36,000/40,000 = 90%

Large

1.4.X1 | $\frac{36,000}{40,000}$ 90%

Little

Pre-acquisition retained earnings 26 million francos

2 *Goodwill*

	F'000	F'000	Rate	$'000
Consideration transferred (12,000 × 6)		72,000	6	12,000
Non-controlling interest				
(66,000 × 10%)		6,600	6	1,100
Share capital	40,000			
Pre acquisition ret'd earnings	26,000			
		(66,000)		(11,000)
At 1.4.20X1		12,600	6	2,100
Foreign exchange gain		–	Bal	420
At 31.3.20X7		12,600	5	2,520

(i) Consolidation journal ($'000):

DEBIT	Share capital (40,000/6)	6,667	
DEBIT	Pre-acquisition retained earnings (26,000/6)	4,333	
DEBIT	Goodwill	2,100	
CREDIT	Non-controlling interest		1,100
CREDIT	Investment		12,000

(ii) Retranslation of goodwill:

DEBIT	Goodwill	420	
CREDIT	Retained earnings		420

3 *Post acquisition retained earnings*

	$'000
Little – post acquisition	3,800
Allocated to NCI (10%)	380

Consolidation journal ($'000):

DEBIT	Retained earnings	380	
CREDIT	NCI		380

4 *Cash in transit*

Cash in transit of $1m is treated as if received by Little, therefore ($'000):

DEBIT	Cash	1,000	
CREDIT	Trade receivables		1,000

5 *Unrealised profit*

As mark-up is one-third, this means that 25% of the cost to Large is profit. So the unrealised profit on the inventory of 1,000 is 25%, i.e. 250.

The seller is Little and therefore part of the unrealised profit is attributable to the NCI ($'000):

DEBIT	Retained earnings (90% × 250)	225	
DEBIT	NCI (10% × 250)	25	
CREDIT	Inventory		25

Consolidation schedule

	Large	*Little*	*W2(i)*	*W2(ii)*	*W3*	*W4*	*W5*	*Consolidated*
	$'000	$'000	$'000	$'000	$'000	$'000	$'000	$'000
Property, plant and equipment	63,000	14,800						77,800
Investment	12,000		(12,000)					-
Goodwill	-	-	2,100	420				2,520
Inventory	25,000	6,000					(250)	30,750
Trade receivables	20,000	5,600				(1,000)		24,600
Cash	6,000	1,000				1,000		8,000
	126,000	27,400						143,670
Share capital	30,000	6,667	(6,667)					30,000
Retained earnings								
Post-acqn	35,000	3,800		420	(380)		(225)	38,615
Pre-acqn	-	4,333	(4,333)					-
Non-controlling interest	-	-	1,100		380		(25)	1,455
Long term borrowings	20,000	5,000						25,000
Deferred tax	6,000	2,000						8,000
Trade payables	25,000	4,000						29,000
Tax	7,000	1,600						8,600
Overdraft	3,000	-						3,000
	126,000	27,400						143,670

Exam practice

Home

27 minutes

The statements of profit or loss for Home and its wholly owned subsidiary Foreign for the year ended 31 July 20X6 are shown below.

	Home	*Foreign*
	$'000	Crowns '000
Revenue	3,000	650
Cost of sales	(2,400)	(550)
Gross profit	600	100
Distribution costs	(32)	(41)
Administrative expenses	(168)	(87)
Finance costs	(15)	(10)
Profit (loss) before tax	385	(38)
Income tax	(102)	10
Profit (loss) for the year	283	(28)

Notes

1 The presentation currency of the group is the HK $ and Foreign's functional currency is the Crown.

2 Home acquired 100% of the ordinary share capital of Foreign on 1 August 20X4 for 204,000 Crowns. Foreign's share capital at that date comprised 1,000 ordinary shares of 1 Crown each, and its reserves were 180,000 Crowns. In view of its subsidiary's losses, Home's directors conducted an impairment review of the goodwill at 31 July 20X6. They concluded that the goodwill had lost 20% of its value during the year (before taking exchange differences into account). The impairment should be reflected in the consolidated financial statements for the year ended 31 July 20X6.

3 On 1 June 20X6, Home purchased an item of plant for 32,000 Florins. At the year end, the payable amount had not yet been settled. No exchange gain or loss in respect of this item is reflected in Home's statement of profit or loss above.

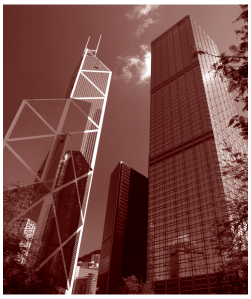
4 Exchange rates are as follows:

On 1 August 20X4:	1.7 Crowns = $1
On 31 July 20X6:	2.2 Crowns = $1
Average rate for year ended 31 July 20X6:	2.4 Crowns = $1
On 1 June 20X6:	1.5 Florins = $1
On 31 July 20X6:	1.6 Florins = $1

5 During the year, Foreign made sales of 50,000 Crowns to Home. None of the items remained in inventory at the year end.

Required

Prepare the consolidated statement of profit or loss for the Home group for the year ended 31 July 20X6. (Work to the nearest HK $100) **(15 marks)**



Answers to exam practice questions

Chapter 1 Legal environment

The statement given by the executive director is incorrect.

Section 123 of the Companies Ordinance requires every company to prepare a statement of financial position which gives a true and fair view of the state of affairs of the company as at the end of its financial year and a statement of profit or loss and other comprehensive income which gives a true and fair view of the company for the financial year.

Directors are responsible for ensuring that the financial statements are accurate and presented in accordance with the laws and regulations *(e.g. Companies Ordinance and Rules governing the Listing of Securities of The Stock Exchange of Hong Kong Limited)* that apply to the company.

Directors of a company must take all reasonable steps to ensure that proper books and accounts are kept so as to give a true and fair view of the state of affairs of the company, and explain its transactions.

The role of the directors carries a high level of responsibility in respect of financial reporting although they can employ a professional accountant and delegate the task to the professional accountant.

The statement given by the financial controller is incorrect.

The financial controller, being a professional accountant in business, involved in the preparation and reporting of the financial or management information made public and used by others inside or outside the listed company is expected to observe the same fundamental principles set out in the **Code of Ethics** for Professional Accountants (the *"Code"*) and the same standards of behaviour and competence as applied to other certified public accountants who work in practising offices.

Section 320.1 of the *Code* states that a professional accountant in business should prepare or present the financial information fairly, honestly and in accordance with relevant professional standards so that the information will be understood in its context.

Section 320.2 states that a professional accountant in business who has responsibility for the preparation or approval of the general purpose financial statements of an employing organisation should ensure that those financial statements are presented in accordance with the applicable financial reporting standards.

HKAS 36.10 requires that irrespective of whether there is any indication of impairment, an entity shall test goodwill acquired in a business combination for impairment annually. A failure to perform such impairment tests for the purpose of the preparation of the financial statements constitutes non-compliance with financial reporting standards.

If the failure was due to the threats to compliance with the fundamental principles, **section 320.6** of the *Code* states that where it is not possible to reduce the threat to an acceptable level, a professional accountant in business should refuse to remain associated with information they consider is, or may be, misleading.

Chapter 2 Financial reporting framework

Question 1

The statement is incorrect.

HKAS 1.15 states that financial statements shall present a true and fair view of the financial position, financial performance and cash flows of an entity. A true and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework for Financial Reporting* (the *"Conceptual Framework"*). The application of HKFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a true and fair view.

S.4.1 of the *Conceptual Framework* states that the financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity 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 should be disclosed.

HKAS 1.25 states that an entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so.

HKAS 10.14 states that an entity shall not prepare its financial statements on a going concern basis if management determine after the reporting period either that it intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

Under the historical cost basis, assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Under the current financial reporting standards, elements of financial statements can be / are required to be measured at a base other than historical cost. Fair value measurement is allowed/required for certain assets and liabilities, which may be above or below the value measured on historical cost basis. Furthermore, inventories should be measured at the lower of cost and net realisable value according to HKAS 2. Net realisable value is the estimated selling price of an item of inventory less estimated costs to complete and sell it.

For an entity which does not prepare financial statements on a going concern basis, assets and liabilities which are originally measured at historical cost may need to be measured on realisable (settlement) value.

When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

Question 2

Mr. Kong’s behaviour is unethical.

As a professional accountant he must comply with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour as set out in section 100.5 of the *Code of Ethics for Professional Accountants* (the "*Code*").

A professional accountant in business is expected to encourage an ethics-based culture in an employing organisation that emphasises the importance that senior management places on ethical behaviour (300.5 of the *Code*).

A professional accountant in business should not knowingly engage in any business, occupation, or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles (300.6 of the *Code*).

A professional accountant in business who has responsibility for the preparation or approval of the general purpose financial statements of an employing organisation shall be satisfied that those financial statements are presented in accordance with the applicable financial reporting standards.

Ms. Yuen has been threatened with dismissal if she does not comply with Mr. Kong's wishes. However, in complying with Mr. Kong's wishes, Ms. Yuen would become associated with fraudulent transactions and misleading information and be in direct breach of the fundamental principles laid out in the *Code*.

Safeguards should be applied to eliminate threats, such as consultation with superiors within the employing organisation, the audit committee or those charged with governance of the organisation or with a relevant professional body.

If Ms. Yuen believes that unethical behaviour or actions by Mr. Kong will continue to occur within the company, she may consider obtaining legal advice.

In the extreme situation where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, Ms. Yuen should refuse to be associated with information she determines is misleading and may conclude that it is appropriate to resign from the company (300.15 of the *Code*).

Chapter 3 Small company reporting

(a) Pursuant to paragraph 21 of the SME-FRF, when an entity has previously qualified for reporting under the SME-FRF it will only cease to qualify for reporting under the SME-FRF when the entity is not an SME for two consecutive reporting periods.

STL qualified for reporting under the SME-FRF from the date it was established up to the year ended 31 December 20W9.

STL failed to meet two out of three of the size test criteria for the year ended 31 December 20X0, as the total annual revenue was greater than HK$50 million and STL had over 50 employees. Despite this, it still qualified for reporting under SME-FRF for the year.

STL met two out of three of the size test criteria for the year ended 31 December 20X1 since, both total annual revenue and total assets were less than HK$50 million. Therefore it still qualified for reporting under the SME-FRF for the year.

(b) STL is eligible to prepare its financial statements under HKFRS for Private Entities as it does not have public accountability and publishes general purpose financial statements for external users.

(c) The statement is partially correct / incorrect.

Section 17.15 of the HKFRS for Private Entities requires that an entity measures all items of property, plant and equipment after initial recognition at cost less any accumulated depreciation and any accumulated impairment losses. Therefore, accounting for impairment is appropriate.

Only the cost model is allowed. The revaluation model is not an option for the subsequent measurement of property, plant and equipment.

(d) In accordance with paragraph 22 of the SME-FRF, and Section 1.3 of the HKFRS for Private Entities, an entity has public accountability for the purposes of the SME-FRF or HKFRS for Private Entities if it is in the process of issuing publicly traded equity or debt securities.

Accordingly, for the purpose of incorporation of the historical financial information of STL in its prospectus, STL is not qualified for reporting under either the SME-FRF or HKFRS for Private Entities.

Chapter 4 Non-current assets held for sale and discontinued operations

HKAS 36.18 defines the recoverable amount as the higher of an asset's or cash generating unit's fair value less costs to sell and its value in use.

Rocket Running Limited ("RR") as a disposal group with an estimated fair value less costs to sell of HK$85,000,000

HKFRS 5.23 requires an impairment loss recognised for a disposal group to reduce the carrying amount of the assets in the group that are within the scope of the measurement requirements of the HKFRS, in order of allocation set out in HKAS 36.104 and 122.

The allocation of the impairment loss is as follows:

	Carrying amount reported immediately before classification as held for sale	*Allocation of impairment loss*	*Carrying amount after allocation of impairment loss*
	HK$'000	HK$'000	HK$'000
Goodwill	2,400	(2,400)	–
Intangible assets	12,500	(1,007)	11,493
Property, plant and equipment	48,300	(3,893)	44,407
Inventories	16,600		16,600
Trade receivables	4,500		4,500
Financial assets held for trading	8,000		8,000
TOTAL	92,300	(7,300)	85,000

An impairment loss of HK$7,300,000 (HK$92,300,000 less HK$85,000,000) should be recognised when the group is initially classified as held for sale.

The impairment loss reduces the amount of goodwill first. The residual loss is allocated to other non-current assets to which the measurement requirements of HKFRS 5 are applicable pro rata based on the carrying amounts of these assets (i.e. intangible assets and property, plant and equipment).

Closure of the retailing operation of Soft Walking Limited ("SW") and abandonment of non-current assets

Super Shoes Limited should not classify the non-current assets of SW as held for sale that are to be abandoned as their carrying amount would be recovered principally through continuing use.

There is an indication that the assets of SW may be impaired and the recoverable amount should be estimated in accordance with HKAS 36.18 to 23.

Irrespective of whether there is any indication of impairment, goodwill should be tested for impairment annually in accordance with HKAS 36.80 to 99.

The recognition of impairment loss is as follows:

	Carrying amount reported immediately before impairment	*Impairment loss recognised*	*Carrying amount after allocation of impairment loss*
	HK$'000	HK$'000	HK$'000
Goodwill	2,700	(2,700)	–
Property, plant and equipment	18,800	(18,800)	–
Inventories	6,400	(2,560)	3,840
Trade receivables	1,300		1,300
TOTAL	29,200	(24,060)	5,140

Goodwill and property, plant and equipment are considered fully impaired as both the fair value less costs to sell and value in use are nil.

Inventories are stated at net realisable value of 60% of the cost in accordance with HKAS 2.9.

Chapter 5 Property, plant and equipment

Hotel Property One

Land use right is accounted for as an operating lease under HKAS 17.

Carrying amount as at 31 December 20X5

= RMB45,000,000 × (1 – 2.5/75)
= RMB43,500,000.

An owner-managed hotel is owner-occupied property, rather than investment property. Accordingly, the building is treated as property, plant and equipment under HKAS 16 and measured by the cost model.

Cost of the building (capitalised the amortisation of land cost over the development period)

= RMB303,000,000 + [45,000,000 × 1.5/75]
= RMB303,900,000.

Accumulated depreciation up to 31 December 20X5 (1 full year)

= RMB303,900,000/ 50 × 1
= RMB6,078,000.

Carrying amount as of 31 December 20X5

= RMB303,900,000 – 6,078,000
= RMB297,822,000.

Hotel Property Two

The land use right is accounted for as an operating lease under HKAS 17.

Carrying amount as of 31 December 20X5

= RMB48,000,000 × (1 – 2.25/60)
= RMB46,200,000.

The building is held to earn rental without provision of any ancillary services to the occupant. Accordingly, the building is treated as investment property under HKAS 40 and stated at fair value as of 31 December 20X5.

Carrying amount = fair value = RMB340,000,000.

Under HKAS 17, separate measurement of the land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with HKAS 40 and the fair value model is adopted. Accordingly, there is an alternative treatment to state the whole property, i.e. both land and building, at RMB440,000,000 (RMB100,000,000 + 340,000,000).

Chapter 6 Investment property

Building A – Warehouse

As a warehouse for storage of inventories, it was accounted for as property, plant and equipment under HKAS 16 prior to the vacating of the warehouse.

At 31 December 20X7, this building should continue to be classified as property, plant and equipment after removal of the inventories to the new production plant in Shenzhen as CLL has no intention of selling it.

Accordingly, the building is carried at cost less any accumulated depreciation and any accumulated impairment loss.

Cost less accumulated depreciation: \$20 million × (1– (8/30)) = \$14.67 million.

As the fair value of the building (\$28 million) is higher than the cost less accumulated depreciation (\$14.67 million), no impairment is recognised.

Building B – Director's quarter

As a director's quarter, it was formerly accounted for as property, plant and equipment under HKAS 16 prior to being vacated.

At 31 December 20X7, this building should be classified as a non-current asset held for sale under HKFRS 5 as its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

The building was available for immediate sale in its present condition subject only to the terms that are usual and customary for sales of such assets as it had already been vacated.

Also, as the management of CLL had made the decision to sell the building in a board meeting and appointed a property agent to actively identify potential buyers, it can assume that a sale is highly likely.

At 31 December 20X7, the building should be measured at the lower of carrying amount and fair value less costs to sell.

Carrying amount = \$36 million × (1 – (10/30)) = \$24 million.

Fair value less costs to sell = \$22 million × (1 – 0.5%) = \$21.89 million.

Accordingly, Building B is stated at \$21.89 million on the statement of financial position as at 31 December 20X7.

Building C – Earning rental income

As a building held for earning rental income, it was accounted for as investment property under HKAS 40 prior to being vacated.

As in the case of Building B, this building should be classified as a non-current asset held for sale under HKFRS 5.

According to HKFRS 5.5, the measurement provisions of HKFRS 5 do not apply to the non-current assets that are accounted for in accordance with the fair value model in HKAS 40.

Since CLL accounts for investment property at fair value model, Building C will continue to be measured in accordance with HKAS 40.

The fair value of Building C at 31 December 20X7 is $22 million.

Chapter 7 Government grants

The $10,000,000 government grant falls under the requirements of HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, which defines government grants as assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

According to HKAS 20, PMT should not recognise the grant until there is reasonable assurance that it will comply with the conditions attaching to them and the grants will be received.

That is, if PMT has no plan, or it is unlikely that PMT will meet the employment targets within the next four years, PMT should not recognise the government grant.

If there is reasonable assurance that PMT will comply with the conditions, PMT should recognise the government grant as income over the periods necessary to match the grant with the related costs which it is intended to compensate, i.e. the $25,000,000 acquisition cost of the equipment, on a systematic basis.

PMT may either set up the government grant as deferred income of $10,000,000 and amortise it over eight years on a straight line basis; or

PMT may deduct the government grant of $10,000,000 in arriving at the carrying amount of the equipment for its research and development centre, i.e. the initial carrying amount of the equipment would be $15,000,000.

Chapter 8 Intangible assets and impairment of assets

YM is required to assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, YM must estimate the recoverable amount of the asset.

The closure of the production plant and return of the leasehold land to the government is considered as an indicator of possible impairment of assets for YM, i.e. a significant change with an adverse effect on the entity has taken place in the period or is expected to in the near future with the result that the asset's expected use or useful life will change.

An impairment test of assets, other than inventories in this case, involves comparing the carrying amount of the asset with its recoverable amount.

HKAS 36.2a specifies that inventories are outside the scope of the standard. Instead the requirements of HKAS 2 are applied. This requires inventories to be measured at the lower of cost and net realisable value.

Net realisable value is the estimated selling price of an item of inventory less estimated costs to complete and sell it.

Building and infrastructure:

This should be presented as property, plant and equipment rather than an asset available for sale, as it is to be abandoned.

The recoverable amount at 31 May 20Y1 is the higher of:

- fair value less costs to sell = nil
- value in use = the present value of the future cash flows expected to be derived from the operation from June to end of August 20Y1.

An impairment loss must be recognised calculated as the excess of $23.8 million over the estimated value in use.

The provision for dismantling must be increased to $3 million by September 20Y1. Assuming the time value of money for the four months from June to September 20Y1 is ignored, an additional $1.5 million is therefore recognised.

Production equipment:

This is presented as property, plant and equipment as YM do not plan to dispose of it.

The recoverable amount at 31 May 20Y1 is equal to the carrying amount of $48 million.

No impairment loss is recognised as YM can continue to use the equipment in another manufacturing plant.

No provision for relocation and installation cost is recognised as there is no present obligation at 31 May 20Y1.

Electricity generator:

This is presented as property, plant and equipment, as YM intend to continue manufacturing until the end of August 20Y1 and it is expected that the electricity generator would not be available for immediate sale as at 31 May 20Y1.

It is measured at the lower of carrying amount and recoverable amount.

The recoverable amount is the higher of:

- fair value less costs to sell = $4 million
- value in use = the present value of the future cash flows expected to be derived from the operation from June to end of August 20Y1.

Assuming the value in use is less than the fair value less costs to sell of $4 million, the impairment loss recognised is $1.2 million ($5.2 million – $4 million).

Land under operating lease:

This is presented as a prepaid lease payment as YM intends to continue manufacturing and so use the land until the end of August 20Y1 and therefore the land would not be available for immediate sale as at 31 May 20Y1. It is measured at the lower of carrying amount and recoverable amount.

The recoverable amount is the higher of:

- fair value less costs to sell = not less than $35 million (assuming the costs to sell is minimal)
- value in use = the present value of the future cash flows expected to be derived from the operation from June to end of August 20Y1.

No impairment is recognised as the recoverable amount is expected to be greater than the carrying amount of $13 million.

Inventories – raw material:

These are measured at the lower of cost and net realisable value.

The cost is $8.4 million.

As it is expected that all the raw materials will be consumed for the production of tiles and sales at a profit, the net realisable value is higher than the cost.

Therefore the inventories are measured at $8.4million.

Inventories – finished products:

Again these are measured at the lower of cost and net realisable value.

The cost is $6.4million.

Net realisable value is

- $3.2 million × 100/80 = $4 million for that half of the goods made to order
- $3.2 million × 40% = $1.28 million for the remaining half of the goods

The goods are therefore measured at $4.48 million, being:

- $3.2 million (cost) for that half of the goods made to order
- $1.28 million (NRV) for the remaining half of the goods.

Chapter 9 Leases

(a) *Purchase option regarding classification of the lease by SRC*

According to HKAS 17.10, if the lessee (SRC) has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, it would normally lead to a lease being classified as a finance lease.

The option price is $10,000. In view of the fact that SRC estimated the economic useful life of the leased equipment to be eight years while the lease term is just five years, plus the fair value of the leased equipment at 1 January 20X7 is $227,500, it is reasonable to expect that the option price is sufficiently lower than the then fair value after five years. Therefore, SRC should classify the lease as a finance lease.

(b) 12.93% is the implicit rate that, at the inception of the lease, causes the aggregate present value of the minimum lease payment and the unguaranteed residual value to be equal to the fair value of the leased asset:

Date	*Annual lease payment*	*Unguaranteed residual value*	*Present value at implicit rate 12.93%*	
	$	$	$	
01/01/20X7	53,069		53,069	
01/01/20X8	53,069		46,993	$= 53,069 / (1.1293)^1$
01/01/20X9	53,069		41,612	$= 53,069 / (1.1293)^2$
01/01/20Y0	53,069		36,848	$= 53,069 / (1.1293)^3$
01/01/20Y1	53,069		32,629	$= 53,069 / (1.1293)^4$
31/12/20Y1		30,000	16,333	$= 30,000 / (1.1293)^5$
			227,484	

Year	*Balance of lease net investment at 1 Jan*	*Annual lease payment at 31 Dec*	*Interest 12.93%*	*Balance of lease net investment at 31 Dec*
	$	$	$	$
20X7	227,500	53,069	22,554	196,985
20X8	196,985	53,069	18,608	162,524
20X9	162,524	53,069	14,153	123,608
20Y0	123,608	53,069	9,121	79,660
20Y1	79,660	53,069	3,438	30,029

(c) Journal entries that TMI should make for each of the years ended 31 December 20X7 and 20X8:

		$	$
20X7			
DEBIT	Lease payment receivable	227,500	
CREDIT	Revenue		227,500
To *record the revenue and the lease payment receivable for the finance lease of the equipment.*			
DEBIT	Cost of sales	200,000	
CREDIT	Inventory		200,000
To *record the cost of sales for the finance lease of the equipment.*			
DEBIT	Cash	53,069	
CREDIT	Lease payment receivable		53,069
To *record the receipt of the lease payment.*			
DEBIT	Lease payment receivable	22,554	
CREDIT	Interest income		22,554
To *record the interest income for the year recognised at the implicit rate.*			
20X8			
DEBIT	Cash	53,069	
CREDIT	Lease payment receivable		53,069
To *record the receipt of the lease payment.*			
DEBIT	Lease payment receivable	18,608	
CREDIT	Interest income		18,608
To *record the interest income for the year recognised at the implicit rate.*			

Chapter 10 Inventories

		Adjustment	
Item	*Explanation*	*Add to inventory value* $	*Subtract from inventory value* $
(a)	Cost $2,885. Net realisable value $(3,600 – 921) = $2,679. The inventory should be valued at the lower of cost and NRV. Since NRV is lower, the original valuation of inventories (at cost) will be reduced by $(2,885 – 2,679)		206

(b)	Inventory issued on sale or return and not yet accepted by the customer should be included in the valuation and valued at the lower of cost and NRV, here at $5 each (cost)	1,500	
(c)	The cost ($7.30) is below the current and foreseeable selling price ($10 or more) which is assumed to be the NRV of the item. Since the current valuation is at the lower of cost and NRV, no change in valuation is necessary	-	-
		1,500	206

	$	$
Original valuation of inventories, at cost		153,699
Adjustments and corrections:		
To increase valuation	1,500	
To decrease valuation	(206)	
		1,294
Valuation of inventories for the annual accounts		154,993

Chapter 11 Provisions, contingent liabilities and contingent assets

(a) Under HKAS 37, a provision should be recognised when and only when:

An entity has a present obligation (legal or constructive) as a result of a past event, and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

According to HKAS 37.19, it is only those obligations arising from past events that exist independently of the reporting entity's future actions that are recognised as provisions.

The provision for the late delivery penalty is a provision for future operating losses as the delivery date of the 7,000,000 units of rechargeable battery is 31 August 20X8.

Since the delivery will be expected on 10 September 20X8, the compensation per unit will be $0.1 per unit (10 days × $0.01) and the total compensation will be $700,000.

This compensation will reduce the expected gross profit, but will not result in an onerous contract for DCL.

Accordingly, no provision is required for this late delivery penalty as at 30 June 20X8.

(b) As at 30 June 20X8, DCL has no obligation to perform the safety inspection of the production line, accordingly no provision should be recognised.

The cost for the inspection should be recognised as expense when incurred.

OR

The information provided in the question has not stated whether DCL, by an established pattern of past practice, published policies or a sufficiently specific current statement, has indicated to other parties that it must carry out the safety inspection on an annual basis and therefore, it has created a valid expectation on the other parties in respect of this activity.

If there is evidence to prove the above, this can be considered as a constructive obligation and therefore a provision should be provided.

(c) Any future loss on sales of aged finished goods should be considered in the measurement of the net realisable value of the inventory under HKAS 2 instead of HKAS 37.

The net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Sales of finished goods at a price below the cost immediately after the date of the statement of financial position (July 20X8) is a strong indicator of the amount of net realisable value at 30 June 20X8.

Accordingly, this should be recorded as a write down of inventories and no separate provision should be recognised in the current liabilities.

(d) DCL has an obligation to pay the bonus to two executive directors in accordance with the directors' service contract.

It should be possible to make a reliable estimate of the provision amount based on the amount of profit before tax and the accrued bonus.

Accordingly, a provision should be recognised as at 30 June 20X8.

Chapter 12 Construction contracts

(a) The statement is incorrect.

HKAS 11.22 states that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of reporting period.

HKAS 11.25 states that the recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.

This method provides useful information on the extent of contract activity and performance during a period.

Even when the outcome of a construction contract cannot be estimated reliably, revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable and contract costs shall be recognised as an expense in the period in which they are incurred. **(HKAS 11.32)**

Under both circumstances, an expected loss on the construction contract shall be recognised as an expense immediately when it is probable that total contract costs will exceed total contract revenue. **(HKAS 11.22, 32 and 36)**

(b) It is considered that the outcome of the Waterfall Golf Villa construction contract can be estimated reliably as:

(i) 1 the total contract revenue can be measured reliably.

2 evidence/indicator: contract sum has been agreed upfront between VC and the employer.

(ii) 1 it is probable that the economic benefits associated with the contract will flow to the entity.

2 evidence/indicator: VC has collected the contracted instalment from the employer on time.

(iii) 1 both the contract costs to complete the contract and the stage of contract completion at the end of reporting period can be measured reliably.

2 evidence/indicator: the information given indicated that VC has reassessed the total costs against with the original bid estimate and forecast that the total cost would increase because the price of construction material has been 15% higher than the price in the budget. Besides, it is stated that 60 units have been

completed and the remaining 20 units are expected to be completed in the last quarter of 20X9.

(iv) 1 the contract costs attributable to the contract can be clearly identified and measured reliably so that actual costs incurred can be compared with prior estimates.

2 evidence/indicator: same as (iii).

The stage of completion of the contract may be determined by reference to:

(i) the proportion that contract costs incurred for work performed to date bear to the revised estimated total contract costs.

(ii) completion of a physical proportion of the contract work (i.e. 60 units completed and 20 units in progress).

For the year ended 30 June 20X9, the contract revenue and contract costs shall be recognised as revenue and expenses respectively by reference to the stage of completion as determined above at 30 June 20X9 less the contract revenue and contract costs that were recognised in the prior year.

For the year ended 30 June 20X8, revenue should have been recognised only to the extent of contract costs incurred that it is probable will be recoverable and contract costs should have been recognised as an expense in the prior year in which they were incurred.

For financial statements presentation, where contract costs incurred to 30 June 20X9 plus recognised profits exceed (less than) progress billings, the surplus is shown as amounts due from (to) customers for contract work. Amounts billed for work performed but not yet settled by the customer are included in the statement of financial position as receivable, while amounts received before the related work is performed are included as a liability, as advances received.

Chapter 13 Share-based payment

(a)

On 1 July 20X1

DEBIT	Staff expense	HK$960,000	
CREDIT	Equity – share-based payment		HK$960,000

{240 × 8,000 × HK$(8 – 7.50)}

On 30 April 20X2

DEBIT	Equity – Share-based payment	HK$40,000	
DEBIT	Cash	HK$600,000	
CREDIT	Capital/Equity		HK$640,000

(10 × 8,000 × HK$0.5) and (10 × 8,000 × HK$7.5)

On 30 June 20X2

DEBIT	Staff expense	HK$1,836,000	
CREDIT	Equity – share-based payment		HK$1,836,000

(240 × 85% × 12,000 × HK$1.5 / 2)

(b) Managerial staff who leave during the two-year period will forfeit their rights to the share options. Accordingly, those staff who left during the vesting period will not be entitled to any share-based benefit.

Under HKFRS 2, the share-based payment expense recognised in each year of the vesting period should be based on the best available estimate of the number of equity instruments expected to vest.

The estimate should be revised if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates.

On the vesting date, the entity should revise the estimate to equal the number of equity instruments that actually vest.

Chapter 14 Revenue

(a) (i) Counter sales at department stores:

NFL has the primary responsibility for providing the goods to the customers of department stores with its sales team.

NFL retains inventory risk as the ownership of the goods has not been transferred to department stores.

NFL has latitude in establishing prices while the department stores will only share 20% of the invoice amounts for the service provided.

Customers' credit risk is borne by the department stores but it is considered as a weak indicator for department store operation.

Taking into consideration the features listed above, it is considered that NFL acts as a principal because it has exposure to the significant risks and rewards associated with the sale of goods while the department stores act as an agent and service provider rather than customers of NFL.

Significant risks and rewards of ownership are transferred to the department store customers when they acquire possession of the goods and invoices are issued by the department store.

The return or exchange offered to the customers represents only an insignificant risk of ownership as past history demonstrates that the return rate is insignificant.

Revenue is therefore recognised at the time of sale to the department store customers.

The amount recognised as revenue of NFL is the gross selling price charged to the customers.

The 20 per cent of the retail prices retained by the department stores is a selling and distribution expense of NFL and is not offset against the revenue.

(ii) Distributors:

NFL has no primary responsibility for providing the goods to their retail store customers.

NFL does not bear inventory risk after the delivery of goods to distributors as the goods are non-returnable unless there are quality problems.

Although NFL has latitude in establishing price charges for the goods to be sold by the distributors at their own retail store, it is the distributors to bear their customers’ credit risk.

Taking into consideration the features listed above, we can conclude that the distributors are acting as principal rather than agent of NFL as they have exposure to the significant risks and rewards associated with the sales of goods at their own retail stores. The distributors are therefore considered to be the customers of NFL.

Revenue is recognised by NFL when the goods are delivered and accepted by the distributors either after their quality inspection or after the 7 days return period has elapsed.

The amount recognised as the revenue of NFL is the invoice price, i.e. 50% of the pre-determined retail price of the items delivered and accepted by the distributors.

(b) HKAS 18.10 states that the amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

NFL should estimate the distributors to whom the company is likely to give the volume discount, i.e. annual quantity delivery will be above 100,000 pieces, at the time of sale on a monthly basis, and recognise revenue net of the amount of volume discount.

The final discount will be true up to the end of the year for the actual amount of discount given. The discount should be presented as a reduction in revenue.

Chapter 15 Income taxes

(a) Current tax computation

Current tax for the year: HK$43,122,000 × 18% = HK$7,761,960

Current tax payable at 30 September 20X2: HK$7,761,960 – HK$4,600,000
= HK$3,161,960

(b) Deferred tax computation

Deferred tax charge for the year:

Temporary difference on plant and equipment:

Carrying amount = HK$94,334,000 – HK$15,933,000

= HK$78,401,000

Tax base = HK$(94,334,000 – 4,388,000 – 38,500,000) + (HK$4,388,000 × (1–10%))

= HK$51,446,000 + HK$3,949,200

= HK$55,395,200

Taxable temporary difference = HK$78,401,000 – 55,395,200 = HK$23,005,800

Alternative method for calculation of temporary difference:

Depreciation allowance of HK$38,500,000

Less: Deprecation charged to P/L of HK$15,933,000

Add: Depreciation charged to P/L attributable to non-deductible item of HK$438,800 (HK$4,388,000 × 10%)

= HK$23,005,800

Deductible temporary difference on government grant: HK$9,600,000 – HK$1,200,000

= HK$8,400,000

Deductible temporary difference on warranty provision: HK$4,200,000 – HK$1,248,000

= HK$2,952,000

Net taxable temporary difference: HK$23,005,800 – HK$8,400,000 – HK$2,952,000

= HK$11,653,800

Deferred tax charge and liabilities recognised = HK$11,653,800 × 20%

= HK$2,330,760

(c) Tax reconciliation for the year ended 30 September 20X2:

	Reconciliation at 18%	*Reconciliation at 20%*
Profit before tax	HK$54,018,000	HK$54,018,000
	HK$	HK$
Tax thereon	9,723,240	10,803,600
Tax effect on non-taxable income [HK$1,039,000]	(187,020)	(207,800)
Tax effect on non-deductible expense [HK$1,358,000 + (HK$4,388,000 × 10%)]	323,424	359,360
Tax effect on 2% tax rate deduction [HK$43,122,000 × 2%]	N/A	(862,440)
Deferred tax recognised at different tax rate [HK$11,653,800 × 2%]	233,076	N/A
Tax charge for the year (HK$7,761,960 + 2,330,760)	10,092,720	10,092,720

Chapter 16 Employee benefits

(a) **New treatment of actuarial gains and losses**

Statement of financial position

On moving to the new standard, an entity which currently defers actuarial gains and losses may have to recognise a higher pension deficit (or lower surplus) in the statement of financial position. This may impact those entities practically in terms of compliance with debt covenants.

On an ongoing basis, the amount reported in the statement of financial position will be more volatile, as the smoothing effects of deferring a proportion of gains/losses is disallowed.

Statement of profit or loss and other comprehensive income

Total comprehensive income will also become more volatile when the new rules are adopted, as there is no option to defer a proportion of actuarial gains and losses.

The change will be more marked for those entities which previously recognised actuarial differences in profit or loss, since not only will the amounts recognised increase, but they will also be recognised in other comprehensive income rather than profit or loss. This should result in **less** volatile profits but **more** volatile total comprehensive income.

(b) (i)

	Obligation $'000	*Assets* $'000	*Net (SOFP)* $'000	*Net (SPLOCI)* $'000
20X8 b/f	20,000	20,000	-	
Net interest at 8%	1,600	1,600		-
Current service cost	1,250			1,250
Past service cost	1,000			1,000
Benefits paid	(987)	(987)		
Contributions paid in		1,000		
	22,863	21,613		
Remeasurement losses	137	(113)		250
20X8 c/f	23,000	21,500	1,500	

20X9 b/f	23,000	21,500		
Net interest at 9%	2,070	1,935		135
Current service cost	1,430			1,430
Settlement	(5,700)	(5,400)		See below
Benefits paid	(1,100)	(1,100)		
Contributions paid in		1,100		
	19,700	18,035		
Remeasurement losses	700	(195)		895
20X9 c/f	20,400	17,840	2,560	

- During 20X8, there is an improvement in the future benefits available under the plan and as a result there is a past service cost of $1million, being the increase in the present value of the obligation as a result of the change.
- During 20X9, Rhodes sells part of its operations and transfers the relevant part of the pension scheme to the purchaser. This is a settlement. The overall gain on settlement is calculated as:

	$'000
Present value of obligation settled	5,700
Fair value of plan assets transferred on settlement	(5,400)
Cash transferred on settlement	(200)
Gain	100

(ii) STATEMENT OF FINANCIAL POSITION

	20X8	20X9
	$'000	$'000
Net defined benefit liability	1,500	2,560

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	20X8	*20X9*
Profit or loss	$'000	$'000
Current service cost	1,250	1,430
Past service cost	1,000	-
Gain on settlement	-	(100)
Net interest	-	135
Other comprehensive income		
Remeasurement loss on defined pension plan	250	895

Chapter 17 Borrowing costs

(a)

For the year ending 31 December 20X3:

	HK$
HK$40 million × 10/12 × 6.5%	2,166,667
HK$40 million × 6/12 × 6.5%	1,300,000
HK$40 million × 2/12 × 6.5%	433,333
Total borrowing cost capitalised	3,900,000

For the year ending 31 December 20X4:

	HK$
HK$120 million × 6/12 × 6.5%	3,900,000
HK$40 million × 4/12 × 6.5%	866,667
Total borrowing cost capitalised	4,766,667

(b) Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. In order to comply with the requirements of HKAS 16 relating to deprecation, it is necessary to identify:

- The parts (components) of each item of property, plant and equipment that are to be depreciated separately, such as the structure of the hotel building, furniture and fixtures and equipment that can be considered as significantly different components.
- The cost of each separately depreciable component.
- The amount eligible for capitalisation.
- The estimated residual value of each separately depreciable component, which is likely to be immaterial in most instances.
- The length of time during which the component will be commercially useful to the entity taking into consideration the expected physical wear and tear, obsolescence, and legal or other limits on the use of the assets, for example the length of the operating lease term.
- The time when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management, and therefore deprecation of an asset begins. For the hotel property of RHE, it should start for depreciation at the date of the pre-opening activities start, i.e. 1 July 20X4.
- The most appropriate depreciation method, which reflects the pattern in which the assets' future economic benefits are expected to be consumed by the entity, for each separately depreciable component.

(c) The equipment and furniture in the hotel rooms at a cost of HK$40 million and the corresponding borrowing cost capitalised are considered as separately depreciable components with a useful life of 5 years.

The remaining cost of the hotel construction of HK$160 million and the corresponding borrowing cost capitalised are depreciated over 30 years.

Total borrowing costs capitalised : HK$8,666,667 (HK$3,900,000 + HK$4,766,667)

Allocated to equipment and furniture: HK$1,733,333 (40/200 x HK$8,666,667)

Allocated to hotel building structure: HK$6,933,334 (160/200 x HK$8,666,667)

Depreciation for 6 months from 1 July to 31 December 20X4:

[(HK$40,000,000 + HK$1,733,333) / 5 × 6/12] + [(HK$160,000,000 + HK$6,933,334) /

30 x 6/12]

= HK$4,173,333 + HK$2,782,222

= HK$6,955,555

Chapter 18 Financial instruments

(a) (i) A fixed rate bank loan exposes the borrower to fair value interest rate risk, i.e. the change in market interest rate will affect the fair value of the bank loan.

A variable rate bank loan exposes the borrower to cash flow interest rate risk, i.e. the change in market interest rate will affect the cash flow of the bank loan with an increase or decrease in payment of loan interest.

(ii) A hedging instrument is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

A hedged item is a recognised asset, liability, unrecognised firm commitment, highly probable forecast transaction or net investment in a foreign operation that exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged.

Hedge accounting recognises the offsetting effect on profit or loss of changes in the fair values of the hedging instrument and the hedged item. The objective is to ensure that the gain or loss on the hedging instrument is recognised in profit or loss in the same period when the item that is being hedged affects profit or loss.

Without adopting the hedge accounting, the hedging instrument, if it is a derivative, will normally be measured at fair value through profit or loss. The hedged item may adopt a different accounting treatment under HKFRS which results in a mis-match of the effects of changes in the fair value.

If a cash flow hedge meets the conditions for hedge accounting during the period, it shall be accounted for as follows:

(a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income and

(b) The ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss

If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, the amount that had been recognised in other comprehensive income shall be:

(a) reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged forecast cash flows affect profit or loss or

(b) included in the initial cost or other carrying amount of the asset or liability.

(iii) The variable rate bond of SC has a cash flow exposure to changes in the market rate of interest.

An increase in the market interest rate, assuming other variables affecting the valuation of the bond are unchanged, theoretically means that the fair value of a variable rate bond will not change while a fixed rate bond will decrease.

Since SC measures the bond at amortised cost, the increase in the market interest rate of 0.5% will not result in any adjustment to the carrying amount of the bond.

The interest rate swap, as a derivative, is measured at fair value through profit or loss, if hedge accounting is not adopted.

An increase in the market interest rate of 0.5 per cent will result in SC receiving more under the variable rate interest amount in exchange for paying 2 per cent fixed interest amount.

Theoretically, the fair value of the interest rate swap should be increased and a gain will be recognised in profit or loss.

(b) If SC designates the hedge as a fair value hedge, the non-cancellable purchase order in Yen is considered as a firm commitment to be hedged (hedged item) in connection with the spot foreign currency risk.

The Yen forward contract is considered to be as the hedging instrument.

As a financial derivative, the Yen forward contract will have been reported at fair value on each reporting date, with gains or losses reported in profit or loss.

Under a fair value hedge, the change in fair value of the firm commitment related to the hedged risk will also be recognised in profit or loss and adjusts the carrying amount of the hedged item. This applies if the hedged item is otherwise measured at cost. For SC's hedged item which is an unrecognised firm commitment, its cumulative change in the fair value attributable to the hedged risk is recognised as an asset or liability.

Chapter 19 Statements of cash flows

(a) **Chong Co.**

EXTRACT FROM THE STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 OCTOBER 20X7

	$'000
Cash flows from operating activities	
Profit before tax (W1)	266
Depreciation charge for the year (W2)	76
Loss on disposal of assets (W3)	4
Finance charge	15
Redemption penalty	8
Operating profit before changes in working capital	369
Increase in receivables	(61)
Increase in payables	66
Cash generated from operations	374
Interest paid	(12)
Income tax paid (W4)	(52)
Net cash flow from operating activities	310

(b) To examine whether the net cash flow from operating activities is sufficient to support the proposed relocation and expansion we must first consider the other uses to which the cash flow has been put:

	$'000
Net capital expenditure (W5)	260
Bond repayment (W6)	171
	431
Extent to which financed by new issue of shares (740-460)	280
Net cash requirement to finance capital expenditure and bond	151
Dividend	40
Overall net cash requirement	191
Net cash flow from operating activities	310
Increase in cash at bank	119

The above shows that the company's overall net cash requirement during the year was easily met by available cash flow from operations. However, the company would have to forecast future cash flow and consider relocation costs and any likely future capital commitments before deciding whether future cash flows would be sufficient to fund the relocation.

Also, the above shows that net capital expenditure was financed by a new issue of shares and that much of the net cash flow from operating activities was used to repay part of the bond. The company would have to balance the likelihood of these events recurring* with the need to fund the above relocation costs.

* The company would also need to consider the likely impact of this on the equity/debt ratio (up from 1.95:1 to 8:1).

W1 *Calculation of "profit before tax"*

	$'000
Retained profit at 31.10.X7	224
Retained profit at 31.10.X6	86
Increase in retained profit during the year	138
Add dividend paid	40
Profit for the year	178
Tax charge in statement of profit or loss	88
Profit for the year before tax	266

W2 *Calculation of depreciation charge for the year*

		$'000
Accumulated depreciation:	at 31.10.X7	276
	at 31.10.X6	232
Net increase for the year		44
Depreciation on disposals		32
Depreciation charge for the year		76

W3 *Calculation of profit or loss on disposal*

		$'000
Proceeds from disposal		16
Cost of assets	52	
Less depreciation	32	
		20
Loss on disposal		4

W4 *Tax paid calculation*

	$'000
Opening balances:	
Deferred tax	44
Income tax	32
	76
Tax charge	88
	164
Closing balances:	
Deferred tax	72
Income tax	40
	112
Tax paid	52

W5 *Calculation of net capital expenditure*

	$'000
Closing balance 31.10.X7	1,240
Opening balance 31.10.X6	1,016
	224
Cost of disposals	52
Capital expenditure during year	276
Less proceeds from disposal of assets	16
	260

W6 *Calculation of bond repayment*

	$'000
Liability at start of year	280
Add amortised interest (Finance charge $15,000 – cash paid $12,000)	3
	283
Redemption penalty	8
	291
Liability at year end	120
	171

Chapter 20 Related party disclosures

(a) Company B: (Yes) Mrs. Kwok, a joint venturer of Company B, is:
a member of the key management personnel of Company A [HKAS 24.9 (b) (vi)] OR a close member of the family of Mr. Kwok who controls Company A [HKAS 24.9 (b) (vi)]

(b) Company C: (Yes) A wholly owned subsidiary of GIL. Company A is an associate of GIL [HKAS 24.9(b)(ii)]

(c) Company D: (Yes) Being wholly owned by Mr. Ma, a member of the key management personnel of Company A [HKAS 24.9 (b) (vi)]

(d) Company E: (Yes) Mr. Kwok, the controlling shareholder of Company A, is the husband of Mrs. Kwok, who is a key management personnel of Company E. [HKAS 24.9 (b) (vii)]

(e) GIL: (Yes) Company A is an associate of GIL [HKAS 24.9 (b) (ii)]

(f) Mr. Ma: (Yes) A member of the key management personnel of Company A [HKAS 24.9 (a)(iii)]

(g) Ms. Chan: (No) Not a person or a close member of the family of a person as set out in HKAS 24.9 (a)

(h) Mr. Wang: (No) Not a person or a close member of the family of a person as set out in HKAS 24.9 (a)

Chapter 21 Accounting policies, changes in accounting estimates and errors; events after the reporting period

(a) This is an adjusting event under HKAS 10. SW should reverse the recognition of the HK$8 million sales during the year ended 31 March 20X2 and record the inventory as the lower of cost and net realisable value after considering the rework cost.

The notice from the customer on 3 April 20X2 has indicated that the goods received on 25 March 20X2 were not accepted. This is an event after the reporting period that provides evidence of circumstances (the condition of goods) that existed at the end of reporting period.

SW accepted the complaint of the customer and has replaced the goods shipped after the reporting period.

The customer confirmed only the acceptance of the replaced goods, which was after the reporting period.

(b) This is a non-adjusting event under HKAS 10. SW should recognise the HK$3 million (20% of HK$15 million) compensation for the breach of contract in the period subsequent to 31 March 20X2.

The sales orders were received and the sales contracts were signed before the end of the reporting period. At the reporting date there was no indication that SW would fail to fulfil the sales orders.

The failure in the production and delivery of orders was due to the suspension of production from 15 April 20X2, and therefore not a condition that existed at 31 March 20X2.

If this event is considered to be material, SW should disclose the nature of the event and its financial effect in the notes to the financial statements.

(c) This is a non-adjusting event under HKAS 10. SW should not recognise the HK$5 million subsidy as government grant in the year ended 31 March 20X2. It should however recognise the subsidy as government grant in the period subsequent to 31 March 20X2.

It is possible to argue that there is reasonable assurance that SW would comply with the conditions attached (HKAS 20.7 (a)). The relevant employment period of local workers was the six months ended 31 December 20X1 and the application for the subsidy was on 8 March 20X2, which is during the year ended 31 March 20X2.

However, there was no reasonable assurance that the subsidy would be received (HKAS 20.7 (b)) at 31 March 20X2, as the subsidy is discretionary and subject to approval by the local government which was not obtained until 8 April 20X2.

If this event is considered to be material, SW should disclose the nature of the event and its financial effect in the notes to the financial statements.

Chapter 22 Earnings per share

(a) **Year ended 30 June 20X8:**

Profit attributable to ordinary shareholders =

$32,800,000 – (3,000,000 × $0.3) = $31,900,000

Weighted average number of ordinary shares outstanding for the year = 220,000,000

Basic earnings per share = $31,900,000 / 220,000,000 = 14.5 cents

Year ended 30 June 20X9:

Profit attributable to ordinary shareholders =

$8,000,000 – (3,000,000 × $0.15 + 2,000,000 × $0.15) = $7,250,000

(Or

Profit attributable to ordinary shareholders =

$8,000,000 – (1,000,000 × $0.15 + 2,000,000 × $0.3) = $7,250,000)

Weighted average number of ordinary shares outstanding for the year =

(220,000,000 × 3/12) + (220,500,000 × 3/12) + (228,500,000 × 6/12)

= 224,375,000

(Or

Weighted average number of ordinary shares outstanding for the year =

(220,000,000 × 12/12) + (500,000 × 9/12) + (8,000,000 × 6/12)

= 224,375,000)

Basic earnings per share = $7,250,000 / 224,375,000 = 3.231 cents

(b) **Year ended 30 June 20X9:**

The potential impact of preference share conversion on earnings:

$750,000/ (1,000,000 × 8 × 6/12 + 2,000,000 × 8) = $0.0375

No adjustment to the preference share dividend as the earnings per incremental share is higher than the basic earnings per share (3.231 cents) and therefore considered anti-dilutive.

Adjusted profit attributable to ordinary shareholders = $7,250,000

Adjusted weighted average number of ordinary shares:

No adjustment for the conversion of the preference shares

Weighted average number of shares under option = 1,000,000

Weighted average number of shares that would have been issued at average market price: (1,000,000 × $1.5) / $1.65 = 909,091

Weighted average number of shares assumed to be issued for nil consideration: (1,000,000 – 909,091) = 90,909

Weighted average number of ordinary shares used to calculate diluted earnings per share: 224,375,000 + 90,909 = 224,465,909

Diluted earnings per share = $7,250,000 / 224,465,909 = 3.230 cents

Chapter 23 Operating segments

(a) The conclusion is incorrect. The entity does not have a free choice. HKFRS 8.5 states an operating segment is a component of an entity:

(i) that engages in business activities from which it may earn revenue and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),

(ii) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(iii) for which discrete financial information is available.

(b) A reportable segment consists of an operating segment, or an aggregation of two or more operating segments, that exceed the quantitative thresholds specified in HKFRS 8.13.

In general, an entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

(i) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.

(ii) The absolute amount of its reporting profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss.

(iii) Its assets are 10% or more of the combined assets of all operating segments.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

HKFRS 8.19 states that there may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed. Although no precise limit has been determined, as the number of segments that are reportable increases above 10, the entity should consider whether a practical limit has been reached. An evaluation should be made of the criteria adopted by the management for aggregation to determine if an appropriate aggregation of operating segments has been performed.

Accordingly, it is possible for an entity to report 12 reportable segments.

(c) The conclusion is incorrect. HKFRS 8 does not require that segment information be provided in accordance with the same generally accepted accounting principles used to prepare the financial statements.

According to HKFRS 8.25, the amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance.

Adjustments and elimination made in preparing an entity's financial statements and allocations of revenues, expenses and gains or losses shall be included in determining reported segment profit or loss only if they are included in the measure of the segment profit or loss that is used by the chief operating decision maker.

Similarly, only those assets and liabilities that are included in the measures of the segment assets and segment liabilities that are used by the chief operating decision maker shall be reported for that segment.

(d) The conclusion is incorrect. The company is not required to remove from the prior year amounts the portion of the operating segment that was disposed of prior to the end of the current year.

The disposal of a portion of an operating segment is not considered a change of the structure of an entity's internal organisation in a manner that causes the composition of its reportable segments to change, which would require restatement of prior periods in accordance with HKFRS 8.29.

Furthermore, if management judges that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment shall continue to be reported separately in the current period even if it no longer meets the criteria for reportability in HKFRS 8.13.

Chapter 24 Interim financial reporting

(a) It is probable that the bonus will be paid, given that the actual output already achieved in the year is in line with budgeted figures, which exceed the required level of output. So a bonus of $4.5 million should be recognised in the interim financial statements at 30 June 20X4.

(b) The value of the inventories in the interim financial statements at 30 June 20X4 is the lower of cost and NRV at 30 June 20X4. This is:

100,000 × $1.20 = $120,000

(c) The taxation charge in the interim financial statements is based upon the weighted average rate for the year. In this case the entity's tax rate for the year is expected to be 30%. The taxation charge in the interim financial statements will be $1.8 million.

Chapter 25 Presentation of financial statements

AZ CO. STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20X3

	$'000
Revenue	124,900
Cost of sales (W1)	(94,200)
Gross profit	30,700
Distribution costs (W1)	(9,060)
Administrative expenses (W1)	(17,535)
Other expenses (W1)	(121)
Finance income	1,200
Finance costs [60 + (18,250 × 7%)]	(1,338)
Profit before tax	3,846
Income tax expense	(161)
Profit for the year	3,685
Other comprehensive income:	
Items that will not be reclassified to profit or loss	
Gain on land revaluation	4,000
Total comprehensive income for the year	7,685

Other expenses represent the cost of a major restructuring undertaken during the period.

AZ CO.
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X3

	$'000
Non-current assets	
Property, plant and equipment (W2)	48,262
Investment properties	24,000
	72,262
Current assets	
Inventories (5,180 – (W3) 15)	5,165
Trade receivables	9,330
Cash and cash equivalents	1,190
	15,685
	87,947
Equity	
Share capital (20,430 + (W4) 2,400)	22,830
Retained earnings (27,137 – 1,000 + 3,685)	29,822
Revaluation surplus (3,125 + 4,000)	7,125
	59,777
Non-current liabilities	
Redeemable preference shares	1,000
7% debentures 20X7	18,250
	19,250
Current liabilities	
Trade payables	8,120
Income tax payable	161
Interest payable (1,278 – 639)	639
	8,920
	87,947

AZ CO.
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 20X3

	Share capital $'000	*Retained earnings* $'000	*Revaluation surplus* $'000	*Total* $'000
Balance at 1 April 20X2	20,430	27,137	3,125	50,692
Issue of share capital	2,400			2,400
Dividends		(1,000)		(1,000)
Total comprehensive income for the year		3,685	4,000	7,685
Balance at 31 March 20X3	22,830	29,822	7,125	59,777

WORKINGS

1 *Expenses*

	Cost of sales $'000	*Distribution* $'000	*Admin* $'000	*Other* $'000
Per TB	94,000	9,060	16,020	121
Opening inventories	4,852			
Depreciation on buildings (W2)			1,515	
Depreciation on P&E (W2)	513			
Closing inventories (5,180 – (W3) 15)	(5,165)			
	94,200	9,060	17,535	121

2 *Property, plant and equipment*

	Land	*Buildings*	*P&E*	*Total*
	$'000	$'000	$'000	$'000
Cost b/d	20,000	30,300	3,720	54,020
Acc'd depreciation b/d	–	(6,060)	(1,670)	(7,730)
	20,000	24,240	2,050	46,290
Depreciation charge for year:				
$30,300 × 5%	–	(1,515)		(1,515)
($3,720 – $1,670) × 25%			(513)	(513)
	20,000	22,725	1,537	44,262
Revaluation (balancing figure)	4,000	–	–	4,000
CV c/d	24,000	22,725	1,537	48,262

3 *Inventories*

	$'000
Defective batch:	
Selling price	55
Cost to complete: repackaging required	(20)
∴NRV	35
Cost	(50)
∴Write off required	(15)

4 *Share issue*

The proceeds have been recorded separately in the trial balance. This requires a transfer to the appropriate accounts:

		$'000	$'000
DEBIT	Proceeds of share issue	2,400	
CREDIT	Share capital (2,000 × $1.20)		2,400

To transfer the proceeds of the share issue to the share capital account.

Chapter 26 Principles of consolidation

Consolidated goodwill

	$'000
AB (W1)	11,350
CD (W2)	2,916
	14,266

WORKINGS

1 *Goodwill on acquisition of AB*

	$'000	$'000
Purchase consideration		14,700
NCI share (W3)		3,400
Less: Net fair value of identifiable assets and liabilities acq'd:		
Net tangible assets (1,000 + 2,850)	3,850	
Brand name	2,900	
		(6,750)
Goodwill on acquisition		11,350

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2 *Goodwill on acquisition of CD*

	$'000
Purchase consideration (39.6 × 60,000)	2,376
NCI share (W4)	1,400
Net assets acquired at 1 April 20X3 (100 + (700 + (80 × 9/12)))	(860)
Goodwill on acquisition	2,916

3 *NCI at acquisition of AB*

Number of shares = 200,000

Fair value = 200,000 × $17
= $3,400,000

4 *NCI at acquisition of CD*

Number of shares = 100,000 – 60,000
= 40,000

Fair value = 40,000 × $35
= $1,400,000

Chapter 27 Consolidated accounts: accounting for subsidiaries

Smart Computer Limited

(a) The amount of goodwill is calculated as follows:

Consideration transferred: HK$72 million

Amount of non-controlling interests: HK$45 × 2,000,000 × 20% = HK$18 million

Identifiable net assets of BDC acquired:

Net carrying amount in the books of BDC = HK$42 million

Fair value adjustments:

Property, plant and equipment = HK$76 – HK$60 million = HK$16 million

Intangible asset = HK$8 million

Net of the acquisition date amounts of the identified assets acquired and the liabilities assumed = HK$[42 + 16 + 8] million = HK$66 million

Goodwill acquired = HK$[72 + 18 – 66] million = HK$24 million

(b) Non-controlling interests in BDC as at 1 April 20Y0 to be reflected in the consolidated statement of financial position of SCL:

Net of the acquisition date amounts of the identified assets acquired and the liabilities assumed (as above) = HK$66 million

Post acquisition profit reported by BDC before adjustment of depreciation and amortisation attributable to fair value up to 1 April 20Y0 = HK$8 million

Additional depreciation for the period from 1 October 20X9 to 31 March 20Y0:
= HK$16 million / 10 × 0.5
= HK$0.8 million
Additional amortisation for the period from 1 October 20X9 to 31 March 20Y0:
= HK$8 million / 10 × 0.5
= HK$0.4 million
Adjusted post acquisition profit of BDC incorporated into the consolidated financial statements of SCL up to 1 April 20Y0 = HK$[8 – 0.8 – 0.4] million = HK$6.8 million

Non-controlling interest of 20% = HK$18 million + [HK$6.8 million × 20%]
= HK$19.36 million

Bailey

BAILEY GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

Non-current assets	$m
Property, plant and equipment (2,300 + 1,900 + (W2) 100 – (W6) 40)	4,260
Goodwill (130 – 20 (W2))	110
Investment in associate (225 + (W3) 18)	243
	4,613
Current assets (3,115 + 1,790 – (W4) 20)	4,885
	9,498
Equity attributable to owners of the parent	
Share capital	1,000
Reserves (3,430 + 1,800 - (W2) 440 – (W2) 12 + (W3) 18 – (W4) 12 – (W5) 544 - (W6) 24)	4,216
	5,216
Non-controlling interests ((W2) 450 – (W2) 8 – (W4) 8 + (W5) 544 – (W6) 16)	962
	6,178
Non-current liabilities (350 + 290)	640
Current liabilities (1,580 + 1,100)	2,680
	9,498

BAILEY GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

	$m
Revenue (5,000 + 4,200 – (W4) 200)	9,000
Cost of sales (4,100 + 3,500 + (W6) 10 – (W4) 200 + (W4) 20)	(7,430)
Gross profit	1,570
Distribution costs and administrative expenses (320 + 175 + (W2) 15)	(510)
Share of profit of associate (W3)	22
Profit before tax	1,082
Income tax expense (240 + 170)	(410)
Profit for the year	672
Other comprehensive income:	
Gain on revaluation of property (net of deferred tax) (50 + 20)	70
Share of other comprehensive income of associate (W3)	2
Other comprehensive income, net of tax	72
Total comprehensive income for the year	744
Profit attributable to:	
Owners of the parent	548
Non-controlling interests ((40% x 355) – (W2) 6 – (W4) 8 – (W6) 4)	124
	672
Total comprehensive income attributable to:	
Owners of the parent	612
Non-controlling interests ((40% x 375) – (W2) 6 – (W4) 8 – (W6) 4)	132
	744

WORKINGS

1 *Group structure*

Bailey

1.1.X6 (4 years ago) — $\frac{300}{500}$ = 60% — Hill

1.5.X9 (current year) — $\frac{72}{240}$ = 30% — Campbell

Hill: Pre-acqn reserves $440m

Campbell: $270m

2 (i) *Goodwill (Hill)*

	$m	$m
Consideration transferred		720
Non-controlling interests (at "full" fair value)		450
Fair value of net assets at acquisition		
Share capital	500	
Reserves	440	
Fair value adjustment (W6)	100	
		(1,040)
		130

Consolidation adjustment journal ($m)

DEBIT	Goodwill	130
DEBIT	Share capital	500
DEBIT	Reserves	440
DEBIT	Property, plant and equipment	100
CREDIT	Investment in H	720
CREDIT	NCI	450

To recognise the acquisition of Hill and associated goodwill and NCI.

(ii) Impairment losses to date

Consolidation adjustment journal ($m):

DEBIT	Reserves (60%)	12
DEBIT	NCI (40%)	8
CREDIT	Goodwill	20

To recognise the cumulative goodwill impairment

$15m of the debit entry relates to the impairment loss arising in the year and therefore this is reported in the SPLOCI as part of administrative expenses. 40% of this is attributable to the NCI ($6m).

3 *Post acquisition reserves of associate (Campbell)*

	$m
Share of post acquisition retained reserves ((330-270) × 30%)	18

Consolidation adjustment journal ($m)

DEBIT	Investment in Campbell	18	
CREDIT	Reserves		18

To recognise the group share of Campbell's post acquisition reserves.

In the SPLOCI, the group share of Campbell's profit and OCI in the year is recognised by ($m):

CREDIT	Share of profit of associate (110 × 30% × 8/12)	22
CREDIT	Share of OCI of associate (10 × 30% × 8/12)	2

These two credit entries together total $24million. The group share of the post-acquisition dividend paid by Campbell (30% x $20m = $6m) is deducted from this amount to give the total credit entry made to reserves in the SOFP in the journal above.

4 *Intragroup sales and URP*

Intragroup sales are $200m and the resulting URP is $20m (1/4 x 200m x 40%)

Consolidation adjustment journal ($m)

DEBIT	Revenue	200	
CREDIT	Cost of sales		200

To eliminate intragroup sales in the SPLOCI

And

DEBIT	Cost of sales	20	
CREDIT	Inventory		20

To eliminate the URP.

The debit entry is split between the NCI and group and therefore in the SOFP the debit entries are:

DEBIT	Reserves (60% x 20)	12
DEBIT	NCI (40% x 20)	8

The $8m attributable to the NCI also reduces NCI profits in the SPLOCI.

5 *Post acquisition reserves of subsidiary (Hill)*

	Hill
	$m
Per question	1,800
Pre-acquisition	(440)
	1,360
NCI share of post-acquisition reserves:	
1,360 × 40%	544

6 *Fair value adjustment (Hill)*

	At acquisition 1/1/X6	Movement X6, X7, X8, X9	Year end 31/12/X9
	$m	$m	$m
Property, plant and equipment (W2) (1,040 – 500 – 440)	100	* (40)	60
	↓	↓	↓
	Goodwill (W2)	Reserves (W4) Add 1 year to cost of sales	Add to PPE

* additional depreciation = 100 × 4/10 = 40

Consolidation adjustment journal ($m)

DEBIT	Reserves (60% x 40)	24	
DEBIT	NCI (40% x 40)	16	
CREDIT	PPE		40

To recognise depreciation on the fair value adjustment in the SOFP.

In the SPLOCI the current year depreciation of $10m is recognised by debiting cost of sales. 40% ($4m) is allocated to the NCI.

Chapter 28 Consolidated accounts: accounting for associates and joint arrangements

To : Ms. Pindy Lee, Director of APE

From : Charmaine Yuen, Accounting Manager

Date : dd/mm/yyyy

Subject : Various investments, bankrupt customer and consolidated financial statements of APE

I refer to your queries regarding the various investments and the bankrupt customer and their impact on the consolidated financial statements of APE.

(a) **Applicable financial reporting standard**

The arrangement for the investment in DPE has three parties: APE has 60% of the voting rights in DPE, BPE has 20% and CPE has 20%. The contractual arrangement among APE, BPE and CPE specifies that at least 90% of the voting rights are required to make decisions about the relevant activities of DPE. Even though APE can block any decision, APE cannot control DPE because it needs the agreement of both BPE and CPE.

Since we cannot control DPE, it is not a subsidiary of APE.

The terms of the contractual arrangement requiring at least 90% of the voting rights to make decisions about the relevant activities imply that APE, BPE and CPE have joint control of DPE because decisions about the relevant activities of DPE cannot be made without APE, BPE and CPE agreeing. Thus it has implicitly specified that APE, BPE and CPE are required to agree unanimously to decisions about the relevant activities of the arrangement.

HKFRS 11 defines joint control as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities (i.e. activities that significantly affect the returns of the arrangement) require the unanimous consent of the parties sharing control.

In this case, DPE shall be considered as a joint arrangement as it is an arrangement of which two or more parties have joint control. The agreement sets up the terms under which APE, BPE and CPE conduct the manufacturing and distribution of HDPE. These activities are undertaken through joint arrangements whose purpose is either the manufacturing or the distribution of HDPE.

Therefore, HKFRS 11 *Joint Arrangements* is to be applied by all entities (APE, BPE and CPE) that are a party to this joint arrangement.

General principles

HKFRS 11 requires a party to a joint arrangement to determine the type of joint arrangement in which it is involved by assessing its rights and obligations arising from the arrangement.

HKFRS 11 classifies joint arrangements into two types - joint operations and joint ventures. APE should determine the type of joint arrangement in which it is involved by considering its rights and obligations.

Diadema Polyethylene (DPE)

APE, BPE and CPE carry out the manufacturing and distribution activities through DPE, whose legal form confers separation between the parties and the entity.

In addition, the contractual arrangement dealing with the manufacturing and distribution activity did not specify that the parties have rights to the assets, and obligations for the liabilities, relating to DPE.

There are no contractual arrangements and no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to DPE or that the parties have an obligation for the liabilities relating to that arrangement. DPE is a joint venture.

A joint venture is defined in HKFRS 11 as a joint arrangement whereby the parties that have joint control of the arrangement (i.e. APE, BPE and CPE as joint venturers) have rights to the net assets of the arrangement.

HKFRS 11 requires a joint venturer to recognise an investment and to account for that investment using the equity method in accordance with HKAS 28 *Investments in Associates and Joint Ventures*, unless the entity is exempted from applying the equity method as specified in that standard.

Therefore, the parties (APE, BPE and CPE) should recognise their rights to the net assets of DPE as investments in joint ventures and account for them using the equity method.

(b) **Bankrupt customer**

HKAS 10 *Events after the Reporting Period* defines events after the reporting period as those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Two types of events can be identified:

- those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and
- those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

HKAS 10 specifies that the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period is an adjusting event after the reporting period that requires an entity to adjust the amounts recognised in its financial statements.

The bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period on an accounts receivable and therefore APE needs to adjust the carrying amount of the accounts receivable. Therefore, it is an adjusting event.

On the basis of this objective evidence about the existence of impairment in the account receivable, APE should recognise the impairment (bad debt) losses for the year ended 31 March 20X2.

DEBIT	Other expenses (impairment)	HK$650,000	
CREDIT	Receivables		HK$650,000

I hope the above explanation has answered your questions. For further details, please refer to the annex. Please feel free to contact me if you have further queries.

Best regards,

Charmaine Yuen

(c) (i) **APE – Worksheet for the Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 March 20X2**

	APE	*EPE*	*DEBIT*	*Ref*	*CREDIT*	*Consolidated*
	HK$'000	HK$'000	HK$'000		HK$'000	HK$'000
Sales	80,000	35,750	9,000	6		106,750
Cost of sales	(55,000)	(24,500)		5	900	(70,650)
				6	7,950	
Other income (including gain on disposal and EPE's dividend)	3,700	–	1,000	3		2,100
			600	E2		
Depreciation expense	(8,000)	(1,700)	500	2		(10,200)
Interest expense	(5,900)	(1,600)				(7,500)
Other expenses	(3,800)	(4,200)	650	1(c)		(8,650)
Share of profits of FPE				E1	660	780
				E2	120	
Profit for the year	11,000	3,750				12,630
Profit attributable to:						
Owners of the parent						12,010
Non-controlling interests			620	7		620
						12,630

(c) (ii) **APE – Worksheet for the Consolidated Statement of Financial Position as at 31 March 20X2**

	APE	*EPE*	*DEBIT*	*Ref*	*CREDIT*	*Consolidated*
	HK$'000	HK$'000	HK$'000		HK$'000	HK$'000
Plant and equipment, net	43,000	19,000	2,500	1,2	1,500	63,000
Investment in EPE, cost	26,550	–		1	26,550	–
Investment in FPE	7,450	–	660	E1, E2	480	7,630
Goodwill	–	–	2,800	1		2,800
Other investments	20,750	1,250				22,000
Inventory	41,250	20,000		6	1,050	60,200
Receivables	10,000	11,000		1(c)	650	20,350
Cash and cash equivalents	7,500	8,750				16,250
	156,500	60,000				192,230
Share capital	30,000	15,000	15,000	1		30,000
Retained earnings	51,500	25,000				59,190
Non-controlling interests	–	–				8,040
Payables	75,000	20,000				95,000
	156,500	60,000				192,230

(c) (iii) **APE – Worksheet for the Consolidated Statement of Changes in Equity for the year ended 31 March 20X2**

	Share capital	*Retained earnings*	*Total*	*Non-controlling interest*	*Total equity*
	HK'000	HK'000	HK'000	HK'000	HK'000
Balance at 1 April 20X1	30,000	50,680*	80,680	7,670**	88,350
Changes in equity					
Dividends		(3,500)	(3,500)		(3,500)
Dividend paid to NCI				(250)	(250)
Total comprehensive income for the year		12,010	12,010	620	12,630
Balance at 31 March 20X2	30,000	59,190	89,190	8,040	97,230

Workings:

W1

Retained earnings, 1 April 20X1	44,000	22,500	12,250	1		50,680*
			800	2		
			2,050	4		
			720	5		

W2

Non-controlling interests, 1 April 20X1	200	2,1	6,000	7,670**
	-	4	2,050	
	180	5		

*Journal entries and reconciliations are **not** required*

			HK$'000	HK$'000
CJE 1	Elimination of investment in EPE			
DEBIT	Share capital		15,000	
DEBIT	Retained earnings		12,250	
DEBIT	Goodwill		2,800	
DEBIT	Plant and equipment		2,500	
	CREDIT	Investment in EPE		26,550
	CREDIT	Non-controlling interests (SOFP)		6,000
CJE 2	Past and current depreciation on undervalued plant and equipment			
DEBIT	Opening retained earnings =2,500k/5 × 2 × 80%		800	
DEBIT	Non-controlling interests (SOFP) = 2,500k/5 × 2 × 20%NCI		200	
DEBIT	Depreciation=2,500/5 years		500	
	CREDIT	Accumulated depreciation		1,500
CJE 3	Eliminate dividend income			
DEBIT	Dividend income (1,250k x 80%)		1,000	
DEBIT	Non-controlling interests (SOFP) (1,250k × 20% NCI)		250	
	CREDIT	Dividends declared		1,250
CJE 4	Assign post-acquisition RE to NCI			
DEBIT	Opening retained earnings (1/4/20W9 to 31/3/20X1)		2,050	
	CREDIT	Non-controlling interests (SOFP)		2,050
Assign post-acquisition RE to NCI	20% × (RE 31/3/20X1 22,500k – pre-acq 12,250k)			
CJE 5	Realisation of opening unrealised profit in inventory			
DEBIT	Opening retained earnings 80%		720	
DEBIT	Non-controlling interests (SOFP) 20% NCI		180	
	CREDIT	Cost of sales (2,500k – 1,600k)		900
CJE 6	Elimination of intercompany sale of inventory			
DEBIT	Sales		9,000	
	CREDIT	Cost of sales		7,950
	CREDIT	Inventory 35% unsold x (9,000k – 6,000k)		1,050
CJE 7	Allocate current profit for the year to non-controlling interests			
DEBIT	Non-controlling interests (PL)		620	
	CREDIT	Non-controlling interests (SOFP)		620

	HK$'000	**20%**
Profit for the year before adjustment	3,750	**750**
Less: depreciation on undervalued plant and equipment CJE 2	(500)	**(100)**
Add: previous year's unrealised profit now realised CJE 5 (2,500k – 1,600k)	900	**180**
Less: current year's unrealised profit CJE 6 [35% × (9,000k-6,000k)]	(1,050)	**(210)**
Adjusted profit	*3,100*	
NCI's share 20%	**620**	**620**

NCI = 6,000k – 200k – 250k + 2,050k – 180k + 620k = 8,040k

EA1	Share of FPE's current year post-acquisition profits		
DEBIT	Investment in FPE (2,200k × 30%)	660	
	CREDIT Share of profits of FPE		660

EA2 Elimination of intercompany sales of PPE (10,000k–8,000k) × **4 years / 5 years** unrealised × 30% Associate

DEBIT	Gain on disposal*	600	
	CREDIT Investment in FPE		480
	CREDIT Share of profits of associates		120

Reconciliation of NCI as at 31 March 20X2

	HK$'000
NCI's share of EPE's net assets at book value (15,000k + 25,000k) × 20%	8,000
NCI's share of EPE's FV adjustment (unamortised) (2,500k × 2/5) × 20%	200
NCI's share of implicit goodwill (6,000k – 20% × 29,750k)	50
Less: NCI's share of unrealised profit of upstream sale (9,000k – 6,000k) × 35% unsold × 20% NCI	(210)
	8,040

Reconciliation of Investment in FPE as at 31 March 20X2

	HK$'000
Share of FPE's net assets at book value (7,500k + 13,450k) × 30%	6,285
Share of implicit goodwill (7,450k – 30% × (7,500k+11,250k))	1,825
Less: unrealised profit on intercompany sales of PPE	(480)
	7,630

*Alternatively, share of profits of associates may be debited instead of gain on disposal, i.e. EA2 Elimination of intercompany sales of PPE (10,000k–8,000k) × 4 years / 5 years unrealised × 30% Associate

DEBIT	Share of profits of FPE*	480	
	CREDIT Investment in FPE		480

Chapter 29 Changes in group structures

To: Faria LEE (Director), MCL
From: Pindy LEE, Accounting Manager, MCL
c.c.: Beverly CHOW, Emily WILSCON, Charmaine YUEN (Directors)

Date: dd/mm/yyyy

I refer to your email dated 18 May 20X8 regarding your queries about the draft consolidated financial statements for MCL as at 31 March 20X8.

(a) **Plant and equipment**

In accordance with HK(SIC)-Int 27, we are required to evaluate the substance of the transaction with the bank which involves the legal form of a lease.

Since the overall economic effect of the transactions cannot be understood without reference to the series of transactions as a whole, it is concluded that the series of the sale and the lease is linked and shall be accounted for as one transaction.

The sale and leaseback arrangement with the bank does not, in substance, involve a sale as MCL retains substantially all the risks and rewards incident to ownership of the underlying asset and enjoys substantially the same rights to its use as before the arrangement.

If the legal form is ignored, the substance of the arrangement is a financing arrangement in which the seller-lessee (MCL) borrows money from the lessor (the bank) using the asset as security.

Since MCL's risks and rewards incident to owning the plant and equipment have not substantively changed, the amount of $12 million of plant and equipment should remain in the consolidated statement of financial position.

(b) **The investment in SWL from 31 March 20X7 to 31 March 20X8**

1 **Status before and after the disposal**

Before the disposal, MCL held 60% of the issued shares of SWL.

In accordance with HKFRS 10, control is presumed to exist:

- power is achieved through holding the majority of votes
- MCL has exposure to variable returns from the investment (such as dividends)
- it is assumed that voting power can be used to affect these returns.

Therefore, SWL was a subsidiary of MCL at 31 March 20X7, and MCL was a parent at that date.

After the disposal of 2,400,000 shares in SWL, MCL held a 30% interest in SWL in total.

MCL had significant influence, but not control, over SWL from the date of the disposal, i.e. 30 September 20X7.

Thereafter, SWL was classified as an associate under HKAS 28 *Investments in Associates and Joint Ventures* from the date that it ceased to be a subsidiary.

2 **The effect of disposal on MCL's financial statements**

MCL's remaining 30% investment in SWL should be accounted for using the equity method in MCL's consolidated financial statements under which the investment would initially be recognised at cost as of 30 September 20X7.

The fair value of the investment at the date that SWL ceased to be a subsidiary, i.e. 30 September 20X7, shall be regarded as the cost on initial measurement.

During the period from 1 October 20X7 to 31 March 20X8 (after the disposal of the 2,400,000 shares), the investment in 30% equity interest in SWL shall be accounted for by the equity method.

Under the equity method, the investment should be initially recognised at cost and the carrying amount increased or decreased to recognise MCL's share of SWL's profit or loss after the date SWL became an associate. MCL's share of SWL's profit or loss will be recognised in MCL's consolidated profit or loss.

HKFRS 10 states that the income and expenses of a subsidiary are included in the consolidated financial statements from the acquisition date, i.e. the date on which the acquirer effectively obtains control of the acquiree, until the date on which the parent ceases to control the subsidiary. Thus, SWL's income and expenses from 1 April 20X7 to 30 September 20X7 should be included in the consolidated financial statements for the year ended 31 March 20X8.

The difference between the proceeds from the disposal of the subsidiary plus the fair value of the interest retained and the carrying amount of the net assets as of the date of disposal is recognised in the consolidated statement of profit or loss as the gain or loss on the disposal of the subsidiary.

In MCL's separate financial statements for the year ended 31 March 20X8, the investment in SWL would continue to be accounted for at cost.

(c) **Difference in gains on disposal at entity and consolidated level**

During the period from 1 April 20X7 to 30 September 20X7 (before the disposal of the 2,400,000 shares), the investment in 60% equity interest in SWL shall be accounted for as a subsidiary.

The difference between the proceeds from the disposal of a 30% equity interest in SWL plus the fair value of the 30% equity interest retained and the carrying amount of the net assets in the consolidated financial statements as of the date of disposal is recognised in the consolidated statement of profit or loss as the gain or loss on the disposal of the subsidiary.

The relevant carrying amount as of the date of disposal to be recognised in the consolidated statement of financial position should have already been increased or decreased to recognise MCL's share of SWL's profit or loss after the date of acquisition since MCL's share of SWL's profit or loss will be recognised in MCL's consolidated profit or loss.

However, when separate financial statements are prepared, investments in subsidiaries shall be accounted for either at cost, or in accordance with HKFRS 9.

In this case, MCL stated the investment at cost. Thus the calculation of gain or loss on disposal will be based simply on the difference between proceeds from the disposal and the cost of the investment.

(d) **Impact of rights issue on EPS of MCL for 20X8**

In this rights issue, the exercise price ($9) of the rights issue is less than the fair value of the shares ($12). Therefore such a rights issue includes a bonus element.

In calculating the basic EPS for the current year, the number of ordinary shares from 1 April 20X7 to 31 December 20X7 to be used in calculating basic earnings per share would be adjusted by the following bonus factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

Theoretical ex-rights price to identify the bonus factor:

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

- 2 shares at fair value of $12 prior to rights issue = $24
- 1 share at discounted rights issue price of $9 = $9
- Ex-rights price (3 shares at fair value of $33 after issue) = $33/3 = $11

The bonus factor = $12 / $11 = 1.09

Since the rights issue is made part way through the year (1 January 20X8), a time-apportionment is required.

Thus, weighted average number of ordinary shares outstanding:

- 10,000,000 shares × 12/11 × 9/12 = 8,181,818
- plus (10,000,000 + 5,000,000) shares × 3/12 = 3,750,000 = 11,931,818

The comparative basic EPS i.e. basic EPS for the year ended 31 March 20X7, should be adjusted accordingly by dividing by the factor of 1.09.

I hope the above explanation has answered your questions. Please feel free to contact me if you have further queries.

Best regards

Pindy Lee

Chapter 30 Foreign currency transactions

Question 1

HOME GROUP – CONSOLIDATED STATEMENT OF PROFIT OR LOSS
FOR YEAR ENDED 31 JULY 20X6

	$'000
Revenue (3,000 + 270.8 (W2) – (50/2.4))	3,250.0
Cost of sales (2,400 + 229.2 (W2) – (50/2.4))	(2,608.4)
Gross profit	641.6
Distribution costs (32 + 17.1 (W2))	(49.1)
Administrative expenses (168 + 36.3 (W2))	(204.3)
Impairment of goodwill (W3)	(1.9)
Exchange difference (W4)	1.3
Finance costs (15 + 4.2 (W2))	(19.2)
Profit before tax	368.4
Income tax (102 – 4.2 (W2))	(97.8)
Profit for year	270.6

Workings

1 *Group structure*

Home

1.8.X4 | 100%

Foreign Pre-acquisition reserves = 180,000 Crowns

2 *Translation of Foreign*

	Foreign Crowns 000	*Exchange rate*	*Foreign $'000*
Revenue	650	2.4	270.8
Cost of sales	(550)	2.4	(229.2)
Distribution costs	(41)	2.4	(17.1)
Administrative exp	(87)	2.4	(36.3)
Finance costs	(10)	2.4	(4.2)
Income tax (credit)	10	2.4	4.2

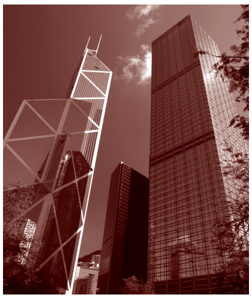
3 *Goodwill*

	Crowns	*Crowns*	*Rate*	$
Consideration transferred		204,000	1.7	120,000
Less fair value of net assets acquired				
Share capital	1,000			
Reserves	180,000			
		(181,000)	1.7	(106,471)
At 1 August 20X4		23,000	1.7	13,529
Impairment loss: 20%		(4,600)	2.4	(1,917)
Exchange difference			balance	(3,248)
At 31 July 20X6		18,400	2.2	8,364

4 *Exchange difference on plant*

As the payable is a monetary liability, it must be retranslated at the closing rate at the year end and the exchange difference recognised in profit or loss:

	$
Payable at closing rate (32,000 florins/1.6)	20,000
Original payable (32,000 florins/1.5)	(21,333)
Reduction in payable = exchange gain	(1,333)


Question bank – questions

SECTION A – Case questions

Question 1

90 minutes

Assume that you are Mr. Ricky Cheung, the accounting manager of Pacific Limited ("PCF"). PCF is a conglomerate listed on the Stock Exchange of Hong Kong with many subsidiaries. PCF acquired the equity interest in Sanata Limited ("SNT") by two successive purchases with details as follows:

Date	*Acquisition cost paid* HK$	*Fair value of SNT as an entity* HK$	*% acquired*
1 April 20X9	6,000,000	24,000,000	25%
31 March 20Y0	26,000,000	40,000,000	65%

The financial year of both PCF and SNT ends on 31 March. The fair value of non-controlling interests is measured as a proportionate interest in the fair value of the subsidiary as an entity. Information relating to SNT is as follows:

	1 April 20X9 *Book value* HK$	*1 April 20X9* *Fair value* HK$	*31 March 20Y0* *Book value* HK$	*31 March 20Y0* *Fair value* HK$
Intangibles	–	3,600,000	–	3,200,000
Inventory	2,000,000	2,400,000	4,000,000	4,800,000
Other net assets	18,000,000	18,000,000*	24,000,000	24,000,000*
Net identifiable assets	20,000,000	24,000,000*	28,000,000	32,000,000*
Share capital	8,000,000		8,000,000	
Retained earnings	12,000,000		20,000,000	
	20,000,000		28,000,000	

* The fair values of other net assets and net identifiable assets are stated before considering the impact of deferred tax. Following the business combination, the tax bases of the assets and liabilities of SNT remain unchanged.

The net profit of SNT for the year ended 31 March 20Y0 was HK$8,000,000. The intangibles of SNT had a remaining useful life of 6 years from 1 April 20X9 and all inventories were sold within two months from the year end. Both PCF and SNT did not declare any dividends during the year ended 31 March 20Y0. The accounting policy of PCF is to account for the investment in associates at cost in its separate financial statements.

Customer loyalty programme

SNT is a regional chain of convenience stores. It operates a customer loyalty programme and it grants programme members loyalty points when they spend a specified amount on foodstuffs. Programme members can redeem the points for further foodstuffs. The points have no expiry date. Before 1 April 20X8, the entity granted 200,000 points. Management expected 180,000 of these points to be redeemed. Management has measured the fair value of each loyalty point to be HK$1.

During the year ended 31 March 20X9, 81,000 of the points were redeemed in exchange for foodstuffs. In the year ended 31 March 20Y0, management revised its expectations. It expected 190,000 points to be redeemed altogether. During the year, 90,000 points were redeemed.

You have prepared the draft consolidated financial statements of PCF for the year ended 31 March 20Y0. After you sent these draft consolidated financial statements to PCF's directors for review, one of the directors, who is not a certified public accountant, sent you an email as follows:

To: Ricky Cheung, Accounting Manager, PCF
From: Emily Chen (Director)
c.c.: David Ip, Susan Tse, Richard Chung (Directors)

Date: 18 May 20Y0

Consolidated financial statements of PCF as at 31 March 20Y0

Could you please clarify the following points relating to PCF's draft consolidated financial statements which I have just reviewed.

(A) I find that there is an item called "gain on step acquisition" in the consolidated financial statements. You told me that it is somewhat related to the remeasurement of the previously held equity interest in SNT at its acquisition-date fair value. What is it all about?

(B) I find that there are intangibles in the consolidated financial statements that I cannot find in the financial statements of PCF and SNT.

(C) It seems to me that goodwill is the difference between the amount that I paid and the value that I obtained from the investment. However, I cannot obtain the goodwill figure that you computed in the consolidated financial statements.

(D) I know that there will be tax-effect entries for fair value adjustments. However, why is this tax effect affecting the value of the goodwill?

(E) I find that portion of the revenue from the sales of foodstuffs by SNT has not been recognised in the same period as the sales are made. You told me that it is due to the customer loyalty programme. What is it all about?

I would appreciate your clarification for the upcoming board meeting.

Best regards,

Emily

Required

Assume that you are the accounting manager, and you are required to draft a memorandum to Ms. Chen, a Director of PCF. In your memorandum, you should:

(a) discuss and calculate the effect of the business combination, at 31 March 20Y0, on the 25 per cent equity interests in SNT held by PCF in the separate financial statements of PCF and at consolidated level (ignore taxation); **(14 marks)**

(b) discuss the rationale for the recognition of the intangibles in the consolidated financial statements that are not recognised in the financial statements of SNT; **(10 marks)**

(c) calculate the amount of goodwill as at 31 March 20Y0 if deferred tax implications are ignored; **(5 marks)**

(d) discuss the rationale and calculate the effect on goodwill if deferred tax implications follow from recognising the difference between the fair values and book values of the identifiable net assets is taken into consideration (assuming a tax rate of 16 per cent); and **(10 marks)**

(e) discuss and calculate the amount of revenue in relation to 200,000 loyalty points, granted before 1 April 20X8, to be recognised for the year ended 31 March 20X9 and 31 March 20Y0. **(11 marks)**

(Total = 50 marks)

HKICPA February 2010

Question 2

90 minutes

Assume that you are Mr. David Li, the accounting manager of City Limited ("City"). City is a company incorporated and listed in Hong Kong and is principally engaged in the manufacturing of electronic products. The draft consolidated financial statements for the year ended 31 March 20X8 are shown as follows:

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20X8

	Notes	HK$'000
Revenue		2,348,314
Cost of sales		(2,044,510)
Gross profit		303,804
Interest income		5,306
Selling and distribution costs		(44,868)
Administrative expenses		(136,085)
Loss on disposal of an associate	(e)	(7,888)
Finance costs		(4,974)
Profit before tax	(a)	115,295
Income tax expense		(14,758)
Profit for the year		100,537
Other comprehensive income:		
Exchange differences on translating foreign operations	(g)	310
Total comprehensive income for the year		100,847

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X8

	Notes	*20X8* HK$'000	*20X7* HK$'000
Non-current assets			
Property, plant and equipment	(b)	115,568	114,170
Investment in an associate	(e)	–	11,748
Club membership	(d)	1,956	1,956
Pledged bank deposits	(f)	6,582	6,232
		124,106	134,106
Current assets			
Inventories		270,726	346,984
Trade receivables, deposits and prepayments		719,128	670,522
Pledged bank deposits	(f)	2,322	13,522
Bank balances and cash		234,026	143,472
		1,226,202	1,174,500
Current liabilities			
Trade payables and accrued charges		675,602	708,524
Amount due to a related party		48,634	37,862
Tax liabilities		7,898	10,580
Obligations under finance leases – due within one year		220	2,690
Bank borrowings – due within one year		76,482	83,006
		808,836	842,662
Net current assets		417,366	331,838
Total assets less Current liabilities		541,472	465,944
Equity			
Share capital and reserves	(c)	524,774	449,618
Total equity		524,774	449,618

Non-current liabilities

Obligations under finance leases – due after one year	–	216
Bank borrowings – due after one year	10,412	8,908
Deferred tax liabilities	6,286	7,202
	16,698	16,326
	541,472	465,944

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 20X8

	Share capital $'000	*Share premium* $'000	*Retained profits* $'000	*Translation of foreign operations* $'000	*Share option reserve* $'000	*Total equity* $'000
At 31 March 20X7	160,490	154,490	284,821	590	3,717	449,618
Total comprehensive income for the year	–	–	100,537	310	–	100,847
Exercise of share options	4,118	4,050	–	–	(4,050)	68
Recognition of equity-settled share-based payment	–	–	–	–	333	333
Final dividend paid in respect of 20X7	–	–	(16,990)	–	–	(16,990)
Interim dividend paid in respect of 20X8	–	–	(9,102)	–	–	(9,102)
At 31 March 20X8	164,608	158,540	359,266	900	–	524,774

Additional information

(a) **Profit before tax**

	20X8 HK$'000	*20X7* HK$'000
Profit before tax has been arrived at after charging:		
Depreciation	32,036	26,748
Equity-settled share-based payment expense	333	3,717
Loss on disposal of property, plant and equipment	802	436
Impairment loss recognised on trade receivables	210	–

(b) **Property, plant and equipment**

	HK$'000
Cost	
At 31 March 20X7	219,792
Additions	34,240
Disposals	(2,898)
At 31 March 20X8	251,134
Depreciation	
At 31 March 20X7	105,622
Charge for the year	32,036
Eliminated on disposals	(2,092)
At 31 March 20X8	135,566
Carrying amounts	
At 31 March 20X8	115,568
At 31 March 20X7	114,170

(c) Pursuant to the service agreement between City and a director of City dated 1 May 20X6, an option to subscribe for 6,800,000 shares in the Company at an exercise price equal to HK$0.01 per share (the "Pre-IPO Share Option") was granted to the director. The Pre-IPO Share Option, which serves as an incentive for the director, shall be exercised during the period from 1 May 20X7 to 31 December 20X8 and the option holder has to be in employment with City when he exercises the options. The estimated fair value of the Pre-IPO Share Option at the date of grant is HK$4,050,000.

(d) The club membership represents entrance fees paid to golf clubs held on a long-term basis. It is considered by the management of City as having an indefinite useful life.

(e) On 1 April 20X7, City disposed of its entire 20 per cent interest in an associate for a cash consideration of HK$3,860,000, resulting in a loss on disposal of HK$7,888,000.

(f) As at 31 March 20X8, bank deposits of HK$8,904,000 had been pledged to secure City's banking facilities in terms of short-term bank borrowings and long-term borrowings.

(g) Exchange differences arising on translation of foreign operations recognised directly in equity for the year ended 31 March 20X8 were made on the translation of the financial statements of the 100 per cent owned foreign subsidiaries. The exchange gains/(losses) were found to be made up as follows:

	HK$'000
Inventories	120
Trade receivables	140
Trade payables	(40)
Cash	90

After you sent these draft consolidated financial statements to City's directors for review, a new director who has just joined the board sent you an email as follows:

To: David LI, Accounting Manager
From: Janice CHEUNG (Director)
c.c.: Michelle CHOW, Julian LIN, Fiona MERRILL (Directors)

Date: 18 May 20X8

Consolidated financial statements of City as at 31 March 20X8

Could you please clarify the following points relating to City's draft consolidated financial statements which I have just reviewed?

(A) So far as I understand, cash is cash. Why is there a total of three items showing our bank deposits and cash in the consolidated statement of financial position? Also, I cannot find the consolidated statement of cash flows. Please send it to me again.

(B) I note that the amount of the item "Club membership" has remained the same throughout the two years in the consolidated statement of financial position. I believe that non-current assets should be subject to depreciation and amortisation. Why does the amount of this item remain the same?

(C) I have also found an item "Equity-settled share-based payment expense" in the note to profit before tax. As we are only issuing equity to the employees, how would it affect the profit before tax? Why is HK$333,000 recognised as an expense in 20X8 while the total estimated fair value is HK$4,050,000?

I would appreciate your clarification in time for the upcoming board meeting.

Best regards,
Janice

Required

(a) Prepare a memorandum in response to the issues raised by Ms. Janice Cheung. In your memorandum, you should:

(i) discuss the reasons for the classification of bank deposits and cash into three items as shown in the consolidated statement of financial position; **(8 marks)**

(ii) discuss the accounting treatment of the "Club membership"; and **(7 marks)**

(iii) discuss, with appropriate calculations, the accounting treatment of the "Equity-settled share-based payment expense". **(8 marks)**

(b) Prepare an annex to your memorandum showing the consolidated statement of cash flows for the year ended 31 March 20X8. **(27 marks)**

(Total = 50 marks)

HKICPA September 2008 (amended)

Question 3 — 90 minutes

Assume that you are Mr. Vincent Lee, the accounting manager of Peter Wong Equipment Group Limited (PWE). PWE is a company incorporated in Bermuda with limited liability. Its shares are listed on The Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange").

The consolidated financial statements are presented in Hong Kong dollars, which is the same as the functional currency of PWE. PWE has a number of subsidiary companies in various countries. On 1 April 20X1, PWE acquired an equity interest in Sandy Jolly Limited (SJL), a company incorporated in Hong Kong. The following are the extracts of the draft consolidated financial statements of PWE for the year ended 31 March 20X2 and the statement of financial position of SJL as at 1 April 20X1, the date of acquisition.

Consolidated statement of profit or loss and other comprehensive income of PWE (the Group) for the year ended 31 March 20X2 (extract)

	HK$'000
Revenue	853,000
Cost of sales	(800,350)
Gross profit	52,650
Administrative expenses	(35,100)
Finance costs	(2,300)
Share of profits of associates	1,650
Profit before tax	16,900
Tax expense	(1,050)
Profit for the year (Note 1)	15,850
Other comprehensive income:	
Exchange differences on translating foreign subsidiaries *(Note 6)*	5,000
Total comprehensive income for the year	20,850
Profit for the year attributable to:	
Owners of PWE	13,950
Non-controlling interests	1,900
	15,850
Total comprehensive income for the year attributable to:	
Owners of PWE	17,950
Non-controlling interests	2,900
	20,850

Statements of Financial Position (extract)

	PWE Consolidated 31 Mar 20X2 HK$'000	PWE Consolidated 31 Mar 20X1 HK$'000	SJL at acquisition HK$'000
ASSETS			
Non-current assets			
Property, plant and equipment (Note 3)	279,500	244,500	35,500
Prepaid land lease payment	21,600	22,200	–
Goodwill (Note 4)	9,000	7,500	–
Investment in associates	16,000	15,500	–
Certificate of deposit (Note 7)	7,500	–	–
Current assets			
Trade and other receivables	44,000	47,250	10,250
Cash and cash equivalents (Note 8)	1,000	9,000	1,250
Total assets	378,600	345,950	47,000
EQUITY AND LIABILITIES			
Share capital (Note 2)	95,000	65,000	13,000
Retained earnings	58,900	53,200	10,500
Other reserves (Note 5)	104,000	100,000	17,000
	257,900	218,200	40,500
Non-controlling interest	27,500	18,600	–
Total equity	285,400	236,800	40,500
Current liabilities			
Trade and other payables	34,900	56,650	4,500
Interest payable	1,250	500	–
Taxation payable	7,050	7,000	2,000
Non-current liabilities			
Bank loans	50,000	45,000	–
Total equity and liabilities	378,600	345,950	47,000

Additional information

1 Profit for the year has been arrived at after charging (crediting):

	HK$'000
Auditor's remuneration	1,000
Depreciation of property, plant and equipment	32,600
Exchange loss arising on translating the foreign currency bank deposits	500
Exchange loss arising on translating the foreign currency bank loans	1,260
Impairment loss recognised in respect of trade receivables	711
Loss on disposal of property, plant and equipment (Note 3)	2,500
Operating lease rentals	200
Release of prepaid land lease payments	600

2 PWE issued 3,000,000 new ordinary shares (in addition to 10,000,000 existing shares) at HK$10 each, which have a total fair value of HK$30,000,000 at the acquisition date, and paid cash of HK$4,000,000, in consideration for 80% of SJL's shares. At the date of acquisition, all of SJL's assets and liabilities were recorded at their fair values. The fair value of non-controlling interests of SJL was recorded as HK$8,000,000 on the acquisition date. During the year, PWE did not make any further issue of ordinary shares.

3 An analysis of the movement on the Group's property, plant and equipment during the year showed that the property, plant and equipment with a carrying amount of HK$29,000,000 was sold for HK$26,500,000.

4 During the year, no goodwill has suffered from any impairment and the Group has not repaid any bank loans.

5 The increase in the other reserves is solely attributed to the controlling shareholders' share of the translation reserve arising on the translation of foreign subsidiaries.

6 The exchange difference arising on the translation of foreign subsidiaries is summarised as below:

	HK$'000
Trade and other receivables	4,500
Trade and other payables	(1,500)
Cash and cash equivalents	2,000
	5,000

7 The certificate of deposit is a 5-year certificate of deposit that pays 4% compounded semi-annually with a maturity date of 31 December 20X6.

8 Included in cash and cash equivalents are foreign currency demand deposits. An exchange loss of HK$500,000 arises on the translation of these foreign currency demand deposits.

You have prepared the draft consolidated financial statements of PWE for the year ended 31 March 20X2. After you sent these draft consolidated financial statements to PWE's directors for review, one of the directors, who is not a certified public accountant, sent you an e-mail as follows:

To: Vincent Lee, Accounting Manager, PWE
From: Fatima Choi (Director)
c.c.: Jason Lam, Andy Cheng, Nick Chan (Directors)
Date: 16 May 20X2

Re: Consolidated financial statements of PWE as at 31 March 20X2

Could you please clarify the following points relating to PWE's draft consolidated financial statements which I have just reviewed.

(A) I find that you have deducted HK$7,500,000 from our cash and bank balances and separately included it as "certificate of deposit". The way you have done it reduces our reported cash and cash equivalents a lot. You should not do so! It is even worse that you included it as a non-current asset. The way you have done that not only significantly reduces our reported cash and cash equivalent but also results in net current liability. I don't want people to think that we have liquidity problems. I demand you adjust the cash and cash equivalent by adding back this "certificate of deposit".

(B) You told me that various HKFRSs have been issued but we have not applied them. Why don't we apply those HKFRSs as they have been issued? Do we need to tell our shareholders on this matter?

(C) I find that PWE have acquired a new subsidiary and therefore goodwill arises. How should we disclose this acquisition of a subsidiary in our consolidated financial statements? How do you calculate the amount of goodwill?

(D) I find that it is difficult to obtain the figures in the consolidated statement of cash flows. Can you tell me more about how you arrive at each figure?

Please clarify and adjust in time for the upcoming board meeting.

Best regards,
Fatima

Assume that you are the accounting manager, a certified public accountant, and you are required to draft a memorandum to Fatima Choi, a Director of PWE. In your memorandum, you should:

(a) discuss the appropriate treatment of the certificate of deposit with reference to:

(i) the accounting standards; and **(5 marks)**
(ii) the ethical issues **(6 marks)**

(b) discuss the disclosure requirements relating to the fact that various new HKFRSs have been issued but are not yet effective and are not early adopted; **(6 marks)**

(c) briefly describe the presentation requirement of the cash flow effects of the acquisition of SJL. Show the calculation of goodwill and the net cash flow arising on the acquisition of SJL; and **(10 marks)**

(d) prepare an annex to your memorandum showing the Consolidated Statement of Cash Flows, using the indirect method, for PWE for the year ended 31 March 20X2, beginning with profit before tax. All figures should be rounded to the nearest HK$'000. **(23 marks)**

(Total = 50 marks)

HKICPA June 2012 (amended)

Question 4 — 90 minutes

Assume that you are Mr. David Lee, the accounting manager of Ultimate Holdings Limited ("UHL"). UHL is a company incorporated in Hong Kong and is principally engaged in the trading of toys in Hong Kong.

On 31 March 20X5, UHL acquired 20 per cent of the issued share capital of Successful Toys Limited ("STL"), a retail chain store incorporated in Hong Kong. The cost of the investment was seven million Hong Kong Dollars (HK$7,000,000), which UHL paid all in cash. This 20 per cent shareholding enables UHL to exercise significant influence on STL. On 31 March 20X5, the fair value of STL's identifiable assets was HK$20,000,000, and the carrying amount of those assets was HK$15,200,000. STL had no liabilities or contingent liabilities at that date. The following shows STL's statement of financial position at 31 March 20X5 together with the fair values of the identifiable assets:

	Carrying amounts	*Fair values*
	HK$'000	HK$'000
Plant and equipment (net)	11,200	16,000
Net current assets	4,000	4,000
	15,200	20,000
Issued equity:		
1,000,000 ordinary shares	10,000	
Retained earnings	5,200	
	15,200	

During the year ended 31 March 20X6, STL reported a profit of HK$12,000,000 but did not pay any dividends. In addition, the fair value of STL's plant and equipment further increased to HK$20,000,000.

On 31 March 20X6 the fair value of the 20 per cent stake in STL was HK$10,000,000.

On 31 March 20X6, UHL acquired a further 50 per cent of the issued share capital of STL thereby obtaining control. The cost of investment was thirty million Hong Kong Dollars (HK$30,000,000), which UHL paid all in cash. At 31 March 20X6, STL had a contingent liability of HK$1,000,000 regarding a lawsuit with a supplier. STL expects to settle the case by March 20X7 by paying around the amount claimed.

The following shows the statements of financial position of UHL and STL at 31 March 20X6 together with the fair values of STL's identifiable assets at that date:

	UHL	*STL*	*STL*
		Carrying amounts	*Fair values*
	HK$'000	HK$'000	HK$'000
Land lease premium	10,000	–	–
Property, plant and equipment (net)	21,000	9,800	20,000
Investment in a subsidiary	37,000	–	–
Net current assets	9,000	17,400	17,400
	77,000	27,200	37,400
Issued equity:			
Ordinary shares	65,000	10,000	
Retained earnings	12,000	17,200	
	77,000	27,200	

UHL has adopted an accounting policy to depreciate and amortise plant and equipment using the straight line method over a 10-year life with no residual value. Non-controlling interests are measured using the proportion of net assets method.

UHL has no investment other than STL.

The fair values of STL's assets at 31 March 20X5 and subsequent changes in the fair values have not been reflected in STL's financial statements.

You have a draft set of consolidated financial statements of UHL for the year ended 31 March 20X6. After you have sent them to UHL's directors for review, one of the directors, who is not a certified public accountant, sends you an email as follows:

To: David Lee, Accounting Manager, UHL
From: Danielle Wong (Director)
c.c.: Crystal Ho, Stephen Lee, Christopher Yung (Directors)

Date: 18 May 20X6

Consolidated financial statements of UHL as at 31 March 20X6

Could you please clarify the following points relating to UHL's draft consolidated financial statements which I have just reviewed.

(A) So far as I understand, the company owns a warehouse in the New Territories and an office in Kowloon. I am not aware that we have purchased or leased any land. Why is there an item "Land lease premium" in the consolidated statement of financial position?

(B) In last year's financial statements, I see an item "Investment in an associate" of an amount of HK$7,000,000 in the statement of financial position. This item disappeared in the current year's "consolidated" statement of financial position as at 31 March 20X6. Interestingly, I find an item "Share of profit of an associate" in the "consolidated" statement of profit or loss for the current year. Is there something wrong with the financial statements? What does the term "consolidated" mean?

(C) In your notes to the consolidated statement of cash flows describing assets and liabilities acquired in business combination, there is an item "Provision for contingent liabilities" of HK$1,000,000 under current liabilities assumed. I recall that in the financial statements of some listed companies I have read, contingent liabilities are in fact not liabilities. They are only disclosed in the notes. Why do we treat them as a liability in our accounts?

(D) What is "Goodwill"?

I would appreciate your clarification in time for the upcoming board meeting.

Best regards,

Danielle

Required

(a) Prepare a memorandum in response to the issues raised by Ms. Danielle Wong. In your memorandum, you should:

(i) discuss the reasons for the item "Land lease premium" in the consolidated statement of financial position; **(5 marks)**

(ii) discuss how UHL should account for its interest in STL from 31 March 20X5 to 31 March 20X6. For this purpose, you should explain (1) the treatments of the 20 per cent interest in STL in UHL's statement of financial position at 31 March 20X5; (2) the effect of the 50 per cent interest acquired at 31 March 20X6 on the status of STL and (3) the meaning of "consolidated" financial statements; **(10 marks)**

(iii) determine the carrying amount of the 20 per cent interest in STL at 31 March 20X6 (i.e. before the acquisition of the 50 per cent interest at 31 March 20X6); **(5 marks)**

(iv) discuss why the "contingent liability" is recognised as a liability in UHL's consolidated statement of financial position; and **(5 marks)**

(v) discuss why goodwill is recognised in UHL's consolidated statement of financial position and its implications for financial statements in future. You should also demonstrate the calculation of the carrying amount of the goodwill as at 31 March 20X6. **(10 marks)**

(b) Prepare an annex to your memorandum showing the consolidated statement of financial position as at 31 March 20X6. Ignore deferred taxation. (Alternatively, you may list the consolidation journals necessary for the purpose of drafting the consolidated statement of financial position.) **(15 marks)**

(Total = 50 marks)

HKICPA September 2006 (amended)

Question 5 — 81 minutes

Assume that you are Mr. Tommy Lau, the accounting manager of Papaya Limited (PPY). PPY is a company incorporated in Hong Kong and is principally engaged in the manufacturing of consumer products. PPY acquired 80 per cent of the ordinary shares of Sheffield Limited (SFL) for HK$25,600,000 on 1 April 20X7.

At the acquisition date, SFL reported retained earnings of HK$12,000,000 and no revaluation reserve. The carrying amount of all assets and liabilities approximated the fair value except for intangible assets. The fair and book values of the intangible assets of SFL (with a remaining life of ten years), excluding deferred tax liability on fair value adjustments, is HK$18,500,000 and HK$16,000,000 respectively at the date of acquisition.

Non-controlling interests are measured as the non-controlling interest's proportionate share of the acquiree's net identifiable assets as at acquisition date. Investment in SFL was carried at cost. Both companies did not have any reserves other than retained earnings and revaluation reserves.

On 1 April 20X7, PPY commenced construction of a plant which was expected to take three years to complete. In the year ended 31 March 20Y0, HK$600,000 interest which qualified for capitalisation had not been capitalised in the draft accounts.

On 1 April 20X9, PPY held inventory purchased from SFL during the year ended 31 March 20X9 for HK$1,200,000 which had been manufactured by SFL at a cost of HK$800,000. During the year ended 31 March 20Y0, SFL sold goods costing HK$3,200,000 to PPY for HK$4,800,000. PPY sold the inventory on hand at the beginning of the year, but continued to hold 40 per cent of its 20X9 purchases from SFL on 31 March 20Y0. It is the group's accounting policy to allocate to non-controlling interests the adjustments to unrealised profits from upstream transactions. The tax rate for the years of assessment from 20X7/X8 to 20X9/Y0 was 16.5 per cent.

PPY holds an investment property which was let out, charging arm's length rentals, to a senior manager of SFL. PPY acquired this property on 1 April 20X9 at a price of HK$6,000,000. The estimated useful life of the property was 50 years from 1 April 20X9. The fair value of the property at 31 March 20Y0 remains at HK$6,000,000 and the rental income to PPY for the year ended 31 March 20Y0 amounts to HK$300,000. This property is included in PPY's statement of financial position at its fair value as an investment property. PPY adopts the revaluation model for property, plant and equipment, except for construction in progress, which is stated at cost. Intangible assets are carried at cost. Depreciation is provided using the straight line method.

The draft financial data of the two companies for the year ended 31 March 20Y0 are shown below:

	PPY	*SFL*
	HK$	HK$
Sales	80,000,000	38,400,000
Cost of sales*	(51,200,000)	(25,600,000)
Gross profit	28,800,000	12,800,000
Other income (Dividend income)	1,280,000	–
Distribution costs	(3,000,000)	(2,300,000)
Administrative expenses	(5,000,000)	(2,500,000)
Finance costs	(5,760,000)	(1,120,000)
Profit before tax	16,320,000	6,880,000
Income tax expense	(3,520,000)	(2,080,000)
Profit for the year	12,800,000	4,800,000
Other comprehensive income: revaluation surplus	6,000,000	1,200,000
Total comprehensive income for the year	18,800,000	6,000,000

*** Cost of sales includes the depreciation of the plant and amortisation of intangible assets**

	Share capital	*Retained earnings*	*Revaluation surplus*	*Total equity*
	HK$	HK$	HK$	HK$
PPY				
Balance, 1 April 20X9	32,000,000	36,400,000	4,000,000	72,400,000
Total comprehensive income	–	12,800,000	6,000,000	18,800,000
Dividends	–	(3,200,000)	–	(3,200,000)
Balance, 31 March 20Y0	32,000,000	46,000,000	10,000,000	88,000,000

	Share capital	*Retained earnings*	*Revaluation surplus*	*Total equity*
	HK$	HK$	HK$	HK$
SFL				
Balance, 1 April 20X9	16,000,000	21,800,000	1,000,000	38,800,000
Total comprehensive income	–	4,800,000	1,200,000	6,000,000
Dividends	–	(1,600,000)	–	(1,600,000)
Balance, 31 March 20Y0	16,000,000	25,000,000	2,200,000	43,200,000

	PPY	*SFL*
	HK$	HK$
Property, plant and equipment, net	40,000,000	7,600,000
Investment property	20,800,000	12,000,000
Investment in SFL, at cost	25,600,000	–
Intangible assets, net	–	11,200,000
Inventories	51,200,000	21,600,000
Trade and other receivables	25,000,000	14,000,000
Cash and cash equivalents	23,000,000	10,400,000
	185,600,000	76,800,000
Share capital	32,000,000	16,000,000
Retained earnings	46,000,000	25,000,000
Revaluation surplus	10,000,000	2,200,000
	88,000,000	43,200,000
Trade and other payables	47,600,000	13,600,000
Long-term loan	50,000,000	20,000,000
	185,600,000	76,800,000

You have prepared the draft consolidated financial statements of PPY for the year ended 31 March 20Y0. After you sent these draft consolidated financial statements to PPY's directors for review, one of the directors, who is not a certified public accountant, sent you an email as follows:

To: Tommy Lau, Accounting Manager, PPY
From: Gabriel Wong (Director)
c.c.: Renee Ho, Chris Wong, Adrian Cheung (Directors)
Date: 8 May 20Y0

Consolidated financial statements of PPY as at 31 March 20Y0

Could you please clarify the following points relating to PPY's draft consolidated financial statements which I have just reviewed.

(A) I am puzzled about the investment property. The figure that was found in the PPY's statement of financial position was not the same as that in the consolidated one.

(B) I find that it is difficult to obtain the figures in the consolidated statement of financial position. Can you tell me more about how you arrived at each figure?

I would appreciate your clarification for the upcoming board meeting.

Best regards,
Gabriel

Required

Assume that you are Tommy Lau, the accounting manager, and you are required to draft a memorandum to Gabriel Wong, a Director of PPY. In your memorandum, you should:

(a) discuss the reason for the different figures for the investment property in the consolidated financial statements and in the financial statements of PPY; and **(7 marks)**

(b) prepare an annex to your memorandum showing worksheets for:

(i) the consolidated statement of profit or loss and other comprehensive income, and **(12 marks)**

(ii) the consolidated statement of financial position. **(26 marks)**

(Total = 45 marks)

(Consolidation adjustments are to be shown in the form of a worksheet. You have to show the detailed calculations of each figure though journal entries are not required.)

HKICPA December 2010 (amended)

Question 6 — 54 minutes

Assume that you are Mr. Ricky Lam, the accounting manager of Sun Tech Limited ("STL"). STL is a company incorporated and listed in Hong Kong and is principally engaged in the manufacturing of electronic products.

In June 20X8, STL made an offer to the shareholders of Moon-night Limited ("MNL") to acquire a controlling interest in the 400 million shares of MNL. STL was prepared to pay $1.50 cash per share, provided that 70% of the shares could be acquired. The directors of MNL recommended that the offer be accepted. By 1 July 20X8, when the offer expired, 75% of the shares had changed hands and were now in the possession of STL.

STL also acquired 25% of the 400 million shares of Earth-ray Limited ("ERL") on 1 July 20X8 for a cash consideration of $145 million. A summary of the acquisition of the shares of MNL and ERL by STL is as follows:

	Date of acquisition	*% acquired*	*Cost of investment*	*Share capital at acquisition date*	*Retained earnings at acquisition date*	*Net assets at acquisition date*
			$'000	$'000	$'000	$'000
MNL	1 July 20X8	75	450,000	400,000	160,000	560,000
ERL	1 July 20X8	25	145,000	400,000	180,000	580,000

The following table summarises information from the three companies' statements of profit or loss for the year ended 30 June 20X9:

	STL	*MNL*	*ERL*
	$'000	$'000	$'000
Revenue	878,900	388,900	300,000
Cost of sales	(374,400)	(112,400)	(120,000)
Gross profit	504,500	276,500	180,000
Other income	14,000	16,000	15,000
Distribution and administrative costs	(216,200)	(115,800)	(120,000)
Depreciation and amortisation	(30,000)	(10,000)	(10,000)
Profit before tax	272,300	166,700	65,000
Tax	(112,400)	(50,000)	(24,000)
Profit for the year	159,900	116,700	41,000

The fair value of the identifiable net assets of MNL and ERL at the date of acquisition was the same as the carrying amount of those assets. Neither company had any reserves other than retained earnings.

During the year ended 30 June 20X9, STL sold goods to MNL and ERL at an invoiced value of $100 million and $15 million respectively. STL invoiced goods to its subsidiary and associated company at cost plus 20%. One-third (1/3) of the goods and half (1/2) of the goods were still held in MNL's inventory and in ERL's inventory respectively at 30 June 20X9.

On 1 July 20X8, MNL sold equipment to STL for $60 million. At that date, the carrying amount of the equipment was $52 million and the equipment was estimated to have a remaining useful life of 10 years. The resulting gain was recorded as other income by MNL. STL has adopted an accounting policy which depreciates plant and equipment using the straight line method with no residual value. It is also the group policy that non-controlling interest shall be measured at the non-controlling interest's proportionate share of the subsidiary's identifiable net assets.

Joint venture

STL is considering a joint venture with Johnson Limited ("JSL"). STL and JSL will have equal interests in the joint venture, which will be set up as a separate legal entity. JSL will contribute $10 million in cash while STL will contribute machinery which is stated in its statement of financial position at a cost of $12 million and a carrying amount of $8 million. The machinery has a fair value assessed as $10 million on the basis of its depreciated replacement cost. It is noted that the significant risks and rewards of ownership of the contributed machinery can be transferred to the joint venture and the resulting gain can be reliably measured.

You have prepared draft consolidated financial statements of STL for the year ended 30 June 20X9. After you sent these draft consolidated financial statements to STL's directors for review, one of the directors, who is not a certified public accountant, sent you an email as follows:

To: Ricky Lam, Accounting Manager, STL
From: Sunny Sun (Director)
c.c.: Susan Chow, Emily Tsim, Rachael Lau (Directors)

Date: 18 September 20X9

Consolidated financial statements of STL as at 30 June 20X9

Could you please clarify the following points relating to STL's draft consolidated financial statements which I have just reviewed.

(a) I have not found any goodwill in either of the financial statements of STL and MNL. Why is there such an item in the consolidated statement of financial position?

(b) It seems to be a good idea to invest in the joint venture. By contributing our machinery to the joint venture, a gain on disposal will be recorded. Do you agree?

(c) I note that you have made tax-effect entries for adjustments for intragroup transactions. As tax is charged on individual entities, why have these tax effect entries been made?

(d) I note that the amount of sales from STL to ERL has not been eliminated. Why don't we eliminate all these sales as ERL is our investee? Did we overstate our profit, particularly when ERL has not resold all the inventory transferred from STL?

I would appreciate your clarification in time for the next board meeting.

Best regards,
Sunny

Required

Prepare a memorandum in response to the issues raised by Mr. Sunny Sun. In your memorandum, you should:

(a) briefly discuss the reason for the goodwill and calculate the amount of goodwill as shown in the consolidated statement of financial position; **(5 marks)**

(b) discuss how STL should account for its contribution to the joint venture and prepare the relevant journal entries in STL's separate financial statements and in the consolidated financial statements; **(10 marks)**

(c) discuss why tax effects of adjustments for intragroup transactions are needed. Illustrate, with appropriate calculation, by using the intragroup sales of goods from STL to MNL as an example (assume a tax rate of 16%); **(7 marks)**

(d) explain why the amount of sales from STL to ERL has not been eliminated in the consolidated statement of profit or loss. Discuss and calculate the amount of ERL's profit that STL should share (assume a tax rate of 16%). **(8 marks)**

(Total = 30 marks)

HKICPA May 2009 (amended)

Question 7 — 90 minutes

Assume that you are Mr. John Chan, the accounting manager of Global Resources Limited ("GRL"), which is a company incorporated in Hong Kong and listed in the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited. GRL and its subsidiaries (GRL Group) are principally engaged in the natural resources business in the People's Republic of Bangladesh; and the provision of medical equipment services and related accessories, and the provision of medical research and development services in mainland China. Now, GRL intends to disinvest its investment in the medical research and development business.

Asia Medical Research Limited ("AMR")

On 1 April 20X8, GRL acquired 600,000 of the 1,000,000 ordinary shares issued by Asia Medical Research Limited ("AMR") for $7.5 million in cash. On that date, the fair value of the net identifiable assets of AMR was the same as their carrying amount, and the share capital and retained earnings of AMR were $1 million and $9 million respectively with no other components of equity. GRL is entitled to appoint three out of the five directors on the board. All board decisions are made by simple majority resolution. On 1 April 20Y1, AMR issued 500,000 shares to a new investor, Simon Firth Limited ("SFL"), for $8 million. As a result, GRL's shareholdings in AMR decreased to 40%. In addition, SFL has the right to appoint two new directors to the board making a total of seven directors on the board. The fair value of GRL's investment in AMR was valued at $9.6 million on 1 April 20Y1.

China Development Services Limited ("CDS")

On 1 April 20Y0, GRL acquired 2,640,000 ordinary shares in China Development Services Limited ("CDS") for $12 million in cash. Thus GRL owns 2,640,000 out of the 4,000,000 shares of CDS, giving it a 66% interest. On 1 April 20Y1, CDS issued 400,000 shares to a new investor, Michael Sun Limited ("MSL"), for $5.5 million. As a result, GRL's shareholdings in CDS decreased to 60 per cent. The carrying amount of CDS's net identifiable assets in the consolidated financial statements of GRL, as at 31 March 20Y1, was $12.9 million.

Other relevant information:

(i) At the date of acquisition, the fair values of CDS's assets were equal to their carrying amounts with the exception that the fair value of CDS's inventory was $500,000 below its carrying amount; and it was written down by this amount shortly after acquisition as an impairment loss and it has not changed in its fair value since then.

(ii) On 2 April 20Y0, GRL sold an item of plant to CDS at $2.5 million. Its carrying amount prior to the sale was $2 million. The estimated remaining useful life of the plant at the date of sale was five years. GRL, AMR and CDS depreciate their property, plant and equipment using the straight line method.

(iii) There were no intra-group payables or receivables at 31 March 20Y1. No dividends were paid during the year by any of the said companies.

(iv) It is the group's policy to measure non-controlling interests at its proportionate share of the subsidiary's net identifiable assets at the acquisition date. Goodwill arising from the acquisition of AMR and CDS has not subsequently been impaired. For the assets of both AMR and CDS, no gain or loss has been previously recognised in other comprehensive income.

Ms. Linda Ho, a director of GRL is concerned about the implications of the above transactions and information. She wondered if it may result in any gain or loss to be recognised and if it may make any difference in the consolidation process.

The draft statements of financial position of the companies at 31 March 20Y1 are:

	GRL	*AMR*	*CDS*	*Total*
	$'000	$'000	$'000	$'000
ASSETS				
Non-current assets				
Property, plant and equipment	18,400	9,000	10,400	37,800
Investment in AMR	7,500	-	-	7,500
Investment in CDS	12,000	-	-	12,000
Current assets				
Inventory	5,900	3,000	4,200	13,100
Accounts receivable	2,200	2,000	1,500	5,700
Cash	1,000	1,000	2,000	4,000
	47,000	15,000	18,100	80,100
EQUITY AND LIABILITIES				
Share capital	19,000	1,000	4,000	24,000
Retained earnings				
At 31 March 20Y0	16,000	10,000	6,500	32,500
For the year ended 31 March 20Y1	8,000	1,000	2,400	11,400
	43,000	12,000	12,900	67,900
Non-current liability				
Debenture	-	2,000	1,000	3,000
Current liability				
Accounts payable	4,000	1,000	4,200	9,200
	47,000	15,000	18,100	80,100

Required

Assume that you are John Chan, the accounting manager, and you are required to draft a memorandum to Ms. Linda Ho, a Director of GRL. In your memorandum, you should:

(a) discuss and advise, with calculations, the accounting treatments for the investment in AMR in the consolidated financial statements of GRL on 1 April 20Y1;

(14 marks)

(b) discuss and advise, with calculations, the accounting treatments for the investment in CDS in the consolidated financial statements of GRL on 1 April 20Y1; and

(10 marks)

(c) prepare an annex to your memorandum showing worksheets for the consolidated statement of financial position of GRL as at 1 April 20Y1 after considering the transactions and other information. Ignore the deferred tax implications.

(26 marks)

(Total = 50 marks)

(Consolidation adjustments are to be shown in the form of a worksheet. You have to show the detailed calculations of each figure, but journal entries are **not** required.)

HKICPA December 2011

SECTION B – Short / Essay questions

Question 8 — 18 minutes

(a) Mr. K. Chow is a member of the Hong Kong Institute of Certified Public Accountants ("HKICPA"). His brother, Mr. V. Chow, is also a member of HKICPA and acts as an independent non-executive director and the chairman of the audit committee of a company listed on the Stock Exchange of Hong Kong Limited. For the audit committee meeting to be held next week, Mr. V. Chow received a copy of draft audited annual financial statements for the year ended 30 June 20X9 (the "Accounts") which reported a significant increase in profit. They discussed the company's financial performance and position with reference to the information shown in the Accounts. Mr. K. Chow acquired shares in the company on the following day.

Required

Discuss the appropriateness of behaviours of both Mr. K. Chow and his brother, Mr. V. Chow in the context of *Code of Ethics for Professional Accountants of HKICPA*. **(5 marks)**

(b) "No goodwill is recognised in the financial statements prepared under merger accounting for a business combination under common control. However, goodwill can still appear in the consolidated financial statements after applying merger accounting for a business combination under common control." Discuss. **(5 marks)**

(Total = 10 marks)

HKICPA February 2010

Question 9 — 27 minutes

Howard Development Limited ("HDL") has financial difficulties and successfully renegotiated the contractual terms of a bank loan of principal HK$200 million on 30 June 20X9, the date of the statement of financial position:

	Original	*Modified*
Term of interest	8 per cent payable yearly in arrears	6 per cent payable yearly in arrears since 1 July 20X9
Date of repayment	30 June 20Y0	30 June 20Y3

The original effective interest rate is 8 per cent. No fees for renegotiating the finance are payable.

The holders of 100 units of HK$1 million, 4 per cent convertible bonds (the "Bonds") of HDL have agreed to convert the Bonds into 250 million ordinary shares on 30 June 20X9 and waive the payment of interest. Each unit of the Bonds was originally convertible into two million ordinary shares and with a maturity date of 30 June 20Y0. Interest is payable yearly in arrears.
The carrying amount of the Bonds as at 30 June 20X9 is as follows:

	HK$
Current liabilities:	
The Bonds (effective interest rate: 8 per cent)	96,296,296
Bonds interest payable	4,000,000
Equity:	
Convertible bonds equity reserve	7,133,058

The market price of the ordinary shares of HDL on 30 June 20X9 was HK$0.45.

Required

(a) Discuss the accounting treatment for HDL in relation to the modification of the terms of the bank loan. **(8 marks)**

(b) Prepare the journal entries that HDL should make on 30 June 20X9 in relation to the conversion of the Bonds. **(7 marks)**

(Total = 15 marks)

HKICPA February 2010

Question 10 — 25 minutes

Modern Department Store ("MDS") adopted a share option scheme which allows the board of directors of the company to award share options to employees at nil consideration. On 1 April 20X8, 2,000,000 share options were granted to the Chief Operating Officer ("the COO"). Subject to the continued employment of the COO with the company, one-fourth of the awarded share options shall become vested at the end of each anniversary from the date of grant. MDS expects that all the awarded share options will vest.

On 1 April 20Y0, MDS entered into an agreement with the COO to cancel the unvested awarded share options at a consideration of HK$5,500,000.

Fair value of the share options of MDS (assuming same for different vesting dates):

1 April 20X8	HK$8
31 March 20X9	HK$3
31 March 20Y0	HK$5
1 April 20Y0	HK$5

Required

(a) Calculate the amount of compensation expense in relation to the share options awarded by MDS for the years ended 31 March 20X9 and 31 March 20Y0 respectively. **(4 marks)**

(b) Explain the accounting implication of and calculate the compensation expense upon the cancellation of the unvested awarded share options on 1 April 20Y0 to the financial statements of MDS for the year ending 31 March 20Y1. **(7 marks)**

(c) Assuming that the share options were awarded to the director of Bargain Store (BS), a subsidiary of MDS, instead of the COO of the company, without any intra-group charge for such share-based payment arrangement, explain the accounting implication for the financial statements of BS for the year ended 31 March 20Y0. **(3 marks)**

(Total = 14 marks)

HKICPA December 2010

Question 11 — 25 minutes

Anna Manufacturing Limited ("AML"), a company listed on the Hong Kong Stock Exchange, had a convertible bond (CB) with a principal amount of HK$800 million issued on 1 December 20X8. Fixed interest at 6 per cent per annum is payable annually in arrears. The holders are entitled to convert the CB into 50 million ordinary shares of AML at any time before the redemption by AML at 30 November 20Y2 at principal amount.

On 1 April 20Y0, the holders of CB exercised their options to convert into shares in AML. On the same date, AML borrowed an interest-free loan of HK$500 million from its major shareholder for a term of two years.

Effective interest rate of AML's other external borrowings was 8 per cent and 6 per cent per annum on 1 December 20X8 and 1 April 20Y0 respectively.

The functional currency of AML is the Hong Kong dollar.

Required

(a) Prepare journal entries for the issue of CB on 1 December 20X8. **(5 marks)**

(b) Prepare journal entries for the conversion of CB into shares on 1 April 20Y0. **(5 marks)**

(c) Prepare journal entries for the recognition of the interest-free loan on 1 April 20Y0. **(4 marks)**

(Total = 14 marks)

(**Note.** Tax effect is ignored.)

HKICPA December 2010

Question 12 — 11 minutes

Cleantech Motor Limited ("CML") was an overseas company incorporated in the British Virgin Islands and registered under the Hong Kong Companies Ordinance in October 20X8 with a share capital of HK$60 million contributed by two shareholders in cash. During 20X9, CML incurred approximately HK$28 million for the development activities for an electrical vehicle project, out of which approximately HK$5 million is not yet paid at the end of financial period. A letter of intent has been signed with an automobile manufacturing company for licensing the technology from CML at a consideration of not less than HK$50 million if it is successfully developed. It was so far unable to complete the technical feasibility study on the computerised energy saving monitoring system and no module is available for testing. The other asset of the entity is cash kept at a bank. CML has 100 employees. The management does not have intention to raise funds publicly at this moment.

Required

You are the auditors of CML. Advise the directors of CML whether they can prepare the financial statements as at 31 December 20X9 in accordance with the *Small and Medium-sized Entity Financial Reporting Standard*.

(6 marks)

HKICPA December 2010

Question 13 — 31 minutes

(a) Paper Box Limited ("PBL") is a manufacturer of paper-based packaging products. Due to insufficient production capacity to meet the market demand for its products, PBL leased two new printing machines from United Machinery Corporation ("UMC") for a fixed term of four years. Monthly rental for the two machines is $200,000 for the first year and then increased by $10,000 annually. The lease is non-cancellable and there are no rights to extend the lease term or purchase the machines at the end of the term. The machines are required to be returned to UMC upon expiry of the lease term. UMC sells similar machines at a price of $12,000,000 per unit and the estimated useful life of each machine is 10 years.

Required

Discuss PBL's accounting treatment of the lease arrangement with UMC. **(5 marks)**

(b) PBL has three other printing machines which have been used for four years and their estimated useful life is ten years. The carrying amount and the estimated fair value of the machines are $15,000,000 and $18,000,000 respectively on 1 October 20Y1. On the same date, PBL entered into an agreement with Easy Finance Limited (EFL) to sell the three machines at $17,000,000 and lease them back for five years with an annual future lease payment of $4,500,000. At the end of the lease term, PBL has an option to buy the machines from EFL at $50,000.

Required

"As PBL has sold the machines to EFL, no amount should be reflected in the balance of plant and equipment on the statement of financial position of PBL" according to PBL's Chief Operating Officer.

(i) Do you agree with the Chief Operating Officer? Explain PBL's accounting treatment for the lease arrangement with EFL. (Discount rate of 8 per cent is used, if applicable) **(8 marks)**

(ii) Discuss the impact on the accounting treatment of PBL of shortening the lease term to three years with an annual future lease payment of $4,000,000 and cancellation of PBL's options to buy the machines from EFL. **(4 marks)**

(Total = 17 marks)

HKICPA December 2011

Question 14 — 27 minutes

Marsh Global Limited ("MG") is a company listed on The Stock Exchange of Hong Kong Limited with an issued capital of 1,000 million ordinary shares. The board of directors is considering the funding needs to finance the expansion of its businesses in mainland China, and two options are under discussion:

Option 1: A rights issue of 200 million ordinary shares at $5 per rights share.

Option 2: A four-year convertible bond of $1,000 million with semi-annual interest of 2 per cent payable on 1 April and 1 October. Every $8 bond can be converted into 1 ordinary share of MG from 1 July 20Y2 until 31 December 20Y5, the redemption date of the convertible bond.

The relevant fund raising exercise is planned to be completed by the end of December 20Y1.

Required

You are the Chief Financial Officer of MG and you are requested by the board of directors to prepare an analysis of the impact of these two options on:

(a) the financial position of MG as at 31 December 20Y1. **(5 marks)**

(b) the earnings per share of MG for the year ending 31 December 20Y2, assuming
  (i) the estimated profit before finance expenses is $800 million, and
  (ii) the funds raised and the expansion of business in mainland China will only affect the earnings of MG from 20Y3; and

(6 marks)

(c) the disclosure of financial risks under HKFRS 7. **(4 marks)**

(Total = 15 marks)

(Assume MG's bank borrowings are carried at an interest rate of 2.5 per cent semi-annually and ignore the tax effect.)

HKICPA December 2011

Question 15 — 27 minutes

On 1 July 20X8, Gibb Investment Inc. ("GII") entered into contracts for the following financial instruments:

(a) An investment in 300,000 units of mandatorily convertible bonds ("Bonds") issued by a listed company with a principal amount of in aggregate $15 million, carrying an interest rate of 6% per annum payable semi-annually in arrears on 30 June and 31 December up to and including 31 December 20Y0. On 31 December 20Y0, each unit of the Bonds will be mandatorily converted into one share in the listed company at the conversion price of $50 per share.

(b) A deposit of a principal amount of $10 million with a commercial bank carries an interest rate of 2.5% per annum and has a maturity date of 30 June 20Y0. Interest will be receivable at maturity together with the principal. In addition, an additional 3% interest per annum will be payable by the bank if the exchange rate of HKD against RMB exceeds or is equal to $1.15 to RMB 1.

GII's functional currency is Hong Kong dollars.

Required

Explain how GII shall account for the above financial instruments in the financial statements for the year ended 31 December 20X8. **(15 marks)**

HKICPA May 2009 (amended)

Question 16 — 22 minutes

Bestpoint Printing Limited ("BP"), established in the People’s Republic of China (PRC), is a wholly-owned subsidiary of Glory Publishing Group ("GP"). BP is entitled to a two-year exemption from foreign enterprise income tax (FEIT) from its first profit-making year, as computed under PRC accounting standards (PRC GAAP) and tax regulations. For the following three years, it enjoyed a 50% reduction in the rate of FEIT. 20X3 was BP's first profit-making year. The standard tax rate for BP was 24% for the periods up to 31 December 20X7. With the enactment of the new tax law during 20X7, BP will be subject to FEIT at 25% for the year beginning 1 January 20X8. GP is subject to Hong Kong profits tax at 17.5%.

BP acquired a printing machine on 1 July 20X3 at a cost of $20 million. For the purpose of FEIT calculations, the machine is depreciated over 10 years with a residual value of 10% of the cost from the corresponding date of acquisition, which is the same for the preparation of BP's PRC GAAP financial statements. In the preparation of GP's consolidated financial statements, the machine is depreciated over 16 years with nil residual value.

Required

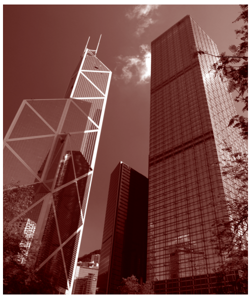
(a) Calculate the deferred tax asset or liability position in relation to the machine at 31 December 20X7 accounted for in GP's consolidated financial statements. **(5 marks)**

(b) Prepare the journal entry(ies) to record the deferred income taxes at 31 December 20X8 for GP's consolidated financial statements with calculations supporting the balances recorded. **(5 marks)**

(c) Assuming GP has a deferred tax asset of $500,000 in respect of its own plant and equipment at 31 December 20X8, explain how the deferred taxes will appear on the consolidated statement of financial position at that date. **(2 marks)**

(Total = 12 marks)

HKICPA February 2008 (amended)


Question bank – answers

SECTION A – Case questions

Answer 1

To: Ms. Chen, Director of PCF
From: Ricky Cheung, Accounting Manager, PCF
c.c.: David Ip, Susan Tse, Richard Chung (Directors)

Date: dd/mm/yyyy

Subject: Report on business combination

I refer to your email dated 18 May 20Y0 regarding your queries about the draft consolidated financial statements for PCF as at 31 March 20Y0.

(a) **Effect of business combination on the 25 per cent equity interest in SNT**

On 1 April 20X9, PCF acquired the 25 per cent equity interest in SNT at a cost of $6,000,000. Thus the investment in SNT would be stated initially at cost, i.e. $6,000,000.

On 31 March 20Y0, PCF obtained control of SNT in which it held an equity interest immediately before the acquisition date.

HKFRS 3 (revised) *Business Combinations* refers to such a transaction as a "business combination achieved in stages", sometimes also referred to as a "step acquisition".

In accordance with paragraph 42 of HKFRS 3 (revised), in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit and loss.

On consolidation, PCF should then remeasure this 25 per cent equity interest at its acquisition-date fair value and recognise the resulting gain or loss in profit and loss.

A business combination should not have any effect at the level of separate financial statements. The investment in SNT should simply be accounted for at cost in the separate financial statements of PCF, i.e. $6,000,000 + $26,000,000 = $32,000,000.

Gain on step acquisition at consolidation level

Since PCF had a 25 per cent equity interest in SNT during the year ended 31 March 20Y0, PCF had significant influence over SNT and thus PCF had to account for SNT's profit for the year ended 31 March 20Y0 using the equity method at consolidation level (HKAS 28 (2011) *Investments in Associates and Joint Ventures*):

	$
Net profit of SNT for the year ended 31 March 20Y0	8,000,000
Less: amortisation of intangibles ($3.6m / 6 years)	(600,000)
Less: cost of sales from revalued inventory	(400,000)
Adjusted net profit for SNT	7,000,000

The carrying amount of the previously held equity interests at consolidated level would be equal to:

	$
The original acquisition cost for the 25% interest	6,000,000
Plus: share of profit after acquisition (25% × $7,000,000)	1,750,000
The carrying amount of previously held interests at consolidated level	7,750,000

Gain on step acquisition on previously held interest at consolidated level would be equal to:

	$
The remeasured acquisition-date fair value of the 25% equity interest (25% × $40,000,000)	10,000,000
Less: carrying amount of the 25% equity interest at consolidated level	(7,750,000)
Thus, gain on step acquisition at consolidated level would be	2,250,000

(b) **Recognition of intangibles**

The recognition principle under HKFRS 3 (revised) states that "as of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree".

Accordingly, the acquirer should recognise an acquiree's intangible assets separately from goodwill, if the recognition criteria are met, i.e.:

- to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the *Conceptual Framework for Financial Reporting* at the acquisition date.
- in addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions.

Paragraph 13 of HKFRS 3 (revised) states that "the acquirer's application of the recognition principle and conditions may result in recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements".

For example, the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

An intangible asset is identifiable if it meets either the *separability criterion* or the *contractual-legal criterion*.

- An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.
- The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability.

An intangible asset that the acquirer would be able to sell, license or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license or otherwise exchange it.

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset or liability.

Since goodwill is a payment for anticipated benefits that are not capable of being individually identified and separately recognised, it is inappropriate for an identifiable intangible asset to be subsumed in goodwill.

Thus an acquirer should recognise an intangible asset of the acquiree in the consolidated financial statements if it meets the definition of an intangible asset and its fair value is included in the exchange transaction relating to the business combination.

(c) **Amount of goodwill as at 31 March 20Y0**

	$
Fair value of consideration transferred	26,000,000
Amount of non-controlling interest (10% × $40,000,000)	4,000,000
Fair value of the previously held interest (25% × $40,000,000)	10,000,000
	40,000,000
Less: Fair value of SNT's recognised net identifiable assets	(32,000,000)
Goodwill	8,000,000

(d) **Deferred tax**

HKAS 12 requires the recognition of deferred tax liabilities or deferred tax assets on taxable or deductible temporary differences. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently (paragraph 19).

Paragraph 18 of HKAS 12 states that temporary differences arise when the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with HKFRS 3 (revised) *Business Combinations*, but no equivalent adjustment is made for tax purposes.

When the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability increases goodwill.

In Hong Kong, the Inland Revenue Department does not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. Therefore, goodwill has a tax base of nil. Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference.

However, HKAS 12 does not permit the recognition of the resulting deferred tax liability because goodwill is measured as a residual.

In this case:

- the carrying amount of the inventory ($4,000,000) is increased to its fair value ($4,800,000) but the tax base will remain at cost,
- a taxable temporary difference ($800,000) arises,
- which results in a deferred tax liability of 16% × $800,000
- = $128,000 and this affects the amount of goodwill.

A temporary difference may also arise on initial recognition of an asset or liability, for example if part or all of the cost of an asset is not deductible for tax purposes (paragraph 22).

In this case:

- intangibles are recognised at $3,200,000 which will not be deductible for tax purposes,
- a taxable temporary difference of $3,200,000 arises.
- Thus in accounting for the business combination, a deferred tax liability of 16% × $3,200,000
- = $512,000 should be recognised and this affects the amount of goodwill.

Thus the goodwill, after considering the deferred tax implication of the fair value differences will be:

	$
Original goodwill amount	8,000,000
+ deferred tax liability for inventory	128,000
+ deferred tax liability for intangibles	512,000
	8,640,000

Or:

- In this case, the carrying amount of net identifiable assets ($28,000,000) is increased to its fair value ($32,000,000) but the tax base will remain at cost,
- a taxable temporary difference of $4,000,000 arises,
- which results in a deferred tax liability of 16% × $4,000,000
- = $640,000 and this affects the amount of goodwill.

	$
Original goodwill amount	8,000,000
+ deferred tax liability for inventory and intangibles	640,000
	8,640,000

Or:

	$
Total fair value	40,000,000
– Fair value of SNT's recognised net identifiable assets, after tax	
($32,000,000 – $128,000 – $512,000)	31,360,000
	8,640,000

(e) **Customer loyalty programme**

According to the HK(IFRIC)-Int 13, SNT should apply paragraph 13 of HKAS 18 and account for points of the loyalty programme as a separately identifiable component of the sales transactions in which they are granted (the "initial sales").

The fair value of the consideration received or receivable in respect of the initial sales shall be allocated between the award credits (the loyalty points) and the other component of the sale.

Since SNT supplies the awards itself, SNT shall recognise the consideration allocated to loyalty points as revenue only when loyalty points are redeemed and it fulfils its obligations to supply awards. In other words, a portion of the consideration shall be allocated to loyalty points and recognition of revenue thereof shall be deferred.

In this case, since SNT's management has measured the fair value of each loyalty point to be $1, SNT shall recognise $200,000 ($1 × 200,000) as revenue only when the loyalty points are redeemed and thus the recognition of revenue of this portion of consideration amounting to $200,000 has been deferred to a period after 1 April 20X8.

The amount of revenue recognised shall be based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

Year ended 31 March 20X9

As at 31 March 20X9, 81,000 of the points have been redeemed in exchange for foodstuffs. Thus the amount of revenue to be recognised for the year ended 31 March 20X9

= (number of points redeemed / total number of points expected to be redeemed) × $200,000

= (81,000 points / 180,000 points) × $200,000

= $90,000

Year ended 31 March 20Y0

In the year ended 31 March 20Y0, the management of SNT revised its expectations. It expected 190,000 points to be redeemed altogether. This revised estimate of the total number of points expected to be redeemed shall be used.

During this year, 90,000 points are redeemed, bringing the total number redeemed to 81,000 + 90,000 = 171,000 points.

The cumulative revenue to date = (cumulative number of points redeemed / revised estimate of total number of points expected to be redeemed) × $200,000.

Thus, the cumulative revenue that SNT recognises is (171,000 points / 190,000 points) × $200,000 = $180,000.

SNT has recognised revenue of $90,000 in the year ended 31 March 20X9, so the amount of revenue to be recognised in the year ended 31 March 20Y0

= cumulative revenue to date – cumulative revenue recognised to date

= $180,000 – $90,000

= $90,000

I hope the above explanation has answered your questions. Please feel free to contact me if you have further queries.

Best regards,

Ricky Cheung

Answer 2

To: Janice Cheung (Director)
From: David Li, Accounting Manager
c.c.: Michelle Chow, Julian Lin, Fiona Merrill (Directors)

Date: dd/mm/yyyy

I refer to your email dated 18 May 20X8 regarding your queries about the draft consolidated financial statements for City as at 31 March 20X8.

(a) (i) **Pledged bank deposits**

HKAS 1 requires the face of the statement of financial position to include a line item that presents the cash and cash equivalents.

HKAS 7 states that cash comprises cash on hand and demand deposits while cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Since pledged bank deposits are not readily convertible to known amounts of cash without an insignificant risk of changes in value, they are not included in the cash and cash equivalents.

HKAS 1 also specifies that additional line items, headings and subtotals shall be presented on the face of the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.

Paragraph 14 of HKFRS 7 requires an entity to disclose:

- the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with HKFRS 9; and
- the terms and conditions relating to its pledge.

Paragraph 31 of HKFRS 7 requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.

Pledged bank deposits and their relevant financial liability create a potentially significant exposure to risks and hence their terms and conditions warrant disclosure.

The amounts represent deposits pledged to banks to secure banking facilities granted to the Group. This denotes that as at 31 March 20X8, bank deposits of HK$8,904,000 (20X7: HK$19,754,000) had been pledged to secure City's banking facilities.

HKAS 1 requires that an asset shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is expected to be realised within 12 months after the end of the reporting period; or

(d) it is cash or a cash equivalent (as defined in HKAS 7 *Statement of Cash Flows*) unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the end of the reporting period.

All other assets shall be classified as non-current. Therefore, the bank deposits and cash should be classified into three items in accordance with the nature of the amount, i.e. cash and cash equivalents, pledged bank deposits classified as current assets and pledged bank deposits classified as non-current assets.

The amounts denote that deposits amounting to HK$2,322,000 (20X7: HK$13,522,000) have been pledged to secure short-term bank borrowings and are therefore classified as current assets; and the remaining deposits amounting to HK$6,582,000 (20X7: HK$6,232,000) have been pledged to secure long-term borrowings and are therefore classified as non-current assets.

The pledged bank deposits will be released and reclassified from "Pledged bank deposits" to "Bank balances and cash" upon settlement of the relevant bank borrowings.

(ii) **Club membership**

The club membership represents entrance fees paid to clubs held on a long-term basis. Typically, it is recognised as an intangible asset since it is an identifiable non-monetary asset without physical substance.

The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not. Therefore, an entity shall assess whether the useful life of an intangible asset is finite or indefinite.

HKAS 38 requires an intangible asset to be regarded as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

The term "indefinite" does not mean "infinite". The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level. A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.

Since there is no foreseeable limit to the period over which the club membership is expected to generate net cash inflows for City, the management of City considered the club membership as having an indefinite useful life.

An intangible asset with an indefinite useful life should not be amortised. Therefore, the club membership, which is considered by the management of the Group as having an indefinite useful life, will not be amortised until the useful life is determined to be finite upon reassessment of the useful life annually by the management.

The useful life of the club membership should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate.

As a result, the club membership with indefinite useful life is carried at cost less any identified impairment loss and is tested for impairment annually.

During the year ended 31 March 20X8, the club membership shall be tested for impairment by comparing its carrying amount with its recoverable amount. If the recoverable amount exceeds the carrying amount, the management can conclude that no impairment loss needed to be charged for the current year and hence the carrying amount of the club membership remains the same throughout the two years.

As an intangible asset assessed as having an indefinite useful life, HKAS 38 requires City to disclose the carrying amount of the club membership and the reasons supporting the indefinite useful life assessment.

(iii) **Equity-settled share-based payment transactions – Share options granted to employees of the Group**

HKFRS 2 defines equity-settled share-based payment transactions as transactions in which the reporting entity receives goods or services as consideration for equity instruments of the entity, which equity instruments can include shares or share options.

For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

There is a general assumption that transactions with employees cannot be reliably measured on the basis of the value of the services being provided. Therefore, transactions with employees are typically measured at the fair value of the equity instruments being granted.

The grant date is 1 May 20X6. The requirement for the holder to be in employment with City when he exercises the options is effectively a vesting condition.

The vesting date should be 1 May 20X7, which is the first date that the option holder is entitled to exercise the options. The options vest over the one year ending 1 May 20X7.

Since the options vest over the one year ending 1 May 20X7, it is presumed that the services to be rendered by the director as consideration for the options will be received in the one year vesting period.

Therefore, City should recognise 335/365 (335 days out of 365 days) of the services to be received as an expense during the year ended 31 March 20X7 with a corresponding increase in equity (share option reserve).

The amount should be measured by reference to the fair value of the options as at 1 May 20X6, i.e. the fair value of services received determined by reference to the fair value of share options granted at the grant date is expensed on a straight-line basis over the vesting period, with a corresponding increase in equity (share option reserve).

Therefore, City recognised the total expense of HK$333,000 (HK$4,050,000 × 30/365) for the year ended 31 March 20X8 (20X7: HK$3,717,000 (HK$4,050,000 × 335/365)) in relation to share options granted by the Company.

At the end of each reporting period, City should revise its estimates of the number of options that are expected to ultimately vest. The impact of the revision of the estimates is recognised in profit or loss, with a corresponding adjustment to share option reserve.

At the time when the share options are exercised, the amount previously recognised in share option reserve shall be transferred to share capital. Thus, HK$4,050,000 has been transferred from the share option reserve to the share capital account as shown in the consolidated statement of changes in equity.

I hope the above explanation has answered your questions. Please feel free to contact me if you have further queries.

Best regards

David LI

(b) CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 MARCH 20X8

	HK$'000
Operating activities	
Profit before tax	115,295
Adjustments for:	
Finance costs	4,974
Share-based payment expense	333
Depreciation	32,036
Impairment loss recognised on trade receivables	210
Interest income	(5,306)
Loss on disposal of property, plant and equipment	802
Loss on disposal of an associate	7,888
Operating cash flows before movements in working capital	156,232
Decrease in inventories	
(270,726 – exchange difference 120) – 346,984	76,378
Increase in trade receivables, deposits and prepayments	
(719,128 – exchange difference 140) + impairment 210 – 670,522	(48,676)
Decrease in trade payables and accrued charges	
(675,602 – exchange difference 40) – 708,524	(32,962)
Increase in amount due to a related party (48,634 – 37,862)	10,772
Cash generated from operating activities	161,744
Tax paid (current 10,580 + deferred 7,202 + expense 14,758 – closing current 7,898 – closing deferred 6,286)	(18,356)
Net cash from operating activities	143,388
Investing activities	
Purchases of property, plant and equipment	(34,240)
Proceeds on disposal of property, plant and equipment	
(2,898 – 2,092) – 802	4
Proceeds on disposal of an associate (Note e)	3,860
Decrease in pledged bank deposits (6,582 + 2,322) – (6,232 + 13,522)	10,850
Interest received	5,306
Net cash used in investing activities	(14,220)

	HK$'000
Financing activities	
Repayment of obligations under finance leases (2,690 + 216) – 220	(2,686)
Proceeds on issue of shares (note c)	68
Repayment of bank borrowings (83,006 + 8,908) – (76,482 + 10,412)	(5,020)
Dividends paid (16,990 + 9,102)	(26,092)
Interest paid	(4,974)
Net cash used in financing activities	(38,704)
Net increase in cash and cash equivalents	90,464
Effect of foreign exchange rate changes (Note g)	90
Cash and cash equivalents at the beginning of the year	143,472
Cash and cash equivalents at the end of the year representing bank balances and cash	234,026

Alternatively, candidates may present Statement of Cash Flows by using direct method:

	HK$'000
Cash generated from operating activities:	
Cash receipts from customers (670,522 + 2,348,314 – (719,128 – exchange gain 140 + impairment loss 210))	2,299,638
Cash paid to suppliers and employees (Note 1)	(2,137,894)
Cash generated from operating activities	161,744

Note 1 Cash paid to suppliers and employees

Opening inventories + purchases – closing inventories = cost of sales
346,984 + purchases – (270,726 – exchange gain 120) = 2,044,510
thus purchases = 1,968,132

	HK$'000
Opening trade payables and accrued charges	708,524
Opening amount due to a related party	37,862
Purchases	1,968,132
Selling and distribution costs	44,868
Administrative expenses	136,085
less: share-based payment expense	(333)
less: depreciation	(32,036)
less: impairment loss recognised on trade receivables	(210)
less: loss on disposal of property, plant and equipment	(802)
less: closing trade payables and accrued charges	(675,602)
add: exchange difference	40
less: closing amount due to a related party	(48,634)
	2,137,894

Answer 3

To	:	Ms. Choi, Director of PWE
From	:	Vincent Lee, Accounting Manager, PWE
c.c.	:	Jason Lam, Andy Cheng, Nick Chan (Directors)
Date	:	dd/mm/yyyy
Subject	:	Consolidated financial statements of PWE as at 31 March 20X2

I refer to your e-mail dated 16 May 20X2 regarding your queries about the draft consolidated financial statements of PWE as at 31 March 20X2.

(a) (i) **Certificate of deposit**

Paragraph 54 of HKAS 1 (Revised) *Presentation of Financial Statements* requires cash and cash equivalents to be presented as a line item in the statement of financial position.

Cash is defined by HKAS 7 *Statement of Cash Flows* as cash on hand and demand deposits while cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Since the certificate of deposit (HK$7,500,000) has a maturity more than three months from the date of acquisition, it cannot meet the definition of cash and cash equivalents.

Therefore, we cannot include the certificate of deposit amounting to HK$7,500,000 (20X1: nil) in the cash and cash equivalents.

Classified as non-current

HKAS 1 (Revised) *Presentation of Financial Statements* specifies the classification of an asset as current when:

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent (as defined in HKAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

All other assets should be classified as non-current. Since the certificate of deposit of HK$7,500,000 (20X1: nil) is not expected to be realised within twelve months after the reporting period, it cannot be classified as current and therefore it should be classified as a non-current asset.

(a) (ii) **Ethical issues**

A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. In acting in the public interest, a professional accountant shall observe and comply with the Code of Ethics for Professional Accountants.

With all the relevant facts discussed above, clearly we are not allowed to include the certificate of deposit into the cash and cash equivalents and it would violate fundamental principles such as integrity, objectivity, professional competence and due care as well as professional behaviour:

- Integrity - A professional accountant should be straightforward and honest in all professional and business relationships. It would not be honest if I misrepresent the certificate of deposit as cash and cash equivalents when in fact it is not.

- Objectivity - A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments. It would not be objective if I included the certificate of deposit as cash and cash equivalents with the mere intention to present a better financial position.
- Professional Competence and Due Care - A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services. I must act diligently in accordance with the accounting standards and thus I cannot allow the inclusion of the certificate of deposit as cash equivalents.
- Professional Behaviour - A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession. I cannot compromise with an action that discredits our profession. Thus I cannot include the certificate of deposit as cash equivalents.

Therefore, in this case, if the intention is merely for the purpose of increasing the amount of cash and cash equivalents to be presented in the statement of financial position, it would not be ethical and it would not be acceptable under the Code of Ethics for Professional Accountants.

Having considered all these issues, I would suggest, as an alternative course of action, that we may provide a disclosure note to show the total amount of cash and bank deposits and highlight the fact that the total amount of cash and bank deposits actually did not drop significantly (20X2: HK$8,500,000, 20X1: HK$9,000,000).

(b) **Disclosure requirement as various HKFRSs are not early adopted**

According to paragraph 30 of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, when an entity has not applied a new HKFRS that has been issued but is not yet effective, the entity shall disclose:

(a) this fact (i.e. PWE has not applied the new HKFRS because it has been issued but is not yet effective); and

(b) known or reasonably estimable information relevant to assessing the possible impact that application of the new HKFRS will have on the entity's financial statements in the period of initial application.

Therefore, PWE has to disclose:

(a) the title of the new HKFRS;

(b) the nature of the impending change or changes in accounting policy (e.g. HKFRS 9 *Financial Instruments (as issued in November 2009)* introduces new requirements for the classification and measurement of financial assets. HKFRS 9 *Financial Instruments (as revised in November 2010)* adds requirements for financial liabilities and for derecognition);

(c) the date by which application of the HKFRS is required (e.g. HKFRS 9 *Financial Instruments* is effective for annual periods beginning on or after 1 January 2015, with earlier application permitted);

(d) the date at which it plans to apply the HKFRS initially; and

(e) either:

  (i) a discussion of the impact that the initial application of the HKFRS is expected to have on the entity's financial statements; or

  (ii) if that impact is not known or reasonably estimable, a statement to that effect.

(c) **Cash flow effects of the acquisition of SJL**

According to paragraph 39 of HKAS 7 *Statement of Cash Flows*, the aggregate cash flows arising from obtaining control of subsidiaries shall be presented separately and classified as investing activities.

In particular, PWE should disclose, in aggregate, in respect of obtaining control of SJL during the period each of the following:

(a) the total consideration paid (HK$34,000,000);

(b) the portion of the consideration consisting of cash and cash equivalents (HK$4,000,000);

(c) the amount of cash and cash equivalents in the subsidiary over which control is obtained (HK$1,250,000); and

(d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiary over which control is obtained, summarised by each major category.

The net cash outflow arising on the acquisition and the fair value of the assets acquired and liabilities assumed were as follows:

	HK$'000	HK$'000
Total consideration paid		34,000
Fair value of non-controlling interests (20%)		8,000
		42,000
Property, plant and equipment	35,500	
Trade and other receivables	10,250	
Cash and cash equivalents	1,250	
Trade and other payables	(4,500)	
Taxation payable	(2,000)	
Less: Fair value of identifiable net assets		40,500
Goodwill		1,500
Total consideration paid		34,000
Non-cash consideration – fair value of shares issued		(30,000)
Cash consideration paid		4,000
Less: Cash and cash equivalents of SJL		(1,250)
Cash outflow on acquisition, net of cash acquired		2,750

I hope the above explanation has answered your questions. For the details, please refer to the annex. Please feel free to contact me if you have further queries.

Best regards,
Vincent Lee

(d) **Consolidated Statement of Cash Flows of PWE for the year ended 31 March 20X2**

	HK$'000	HK$'000
Operating activities		
Profit before tax	16,900	
Adjustments for:		
Depreciation	32,600	
Impairment loss recognised in respect of trade receivables	711	
Loss on disposal of property, plant and equipment	2,500	
Release of prepaid land lease payments	600	
Finance costs	2,300	
Exchange loss arising on translating foreign currency bank loans	1,260	
Exchange loss arising on translating foreign currency bank deposits	500	
Share of profits of associate	(1,650)	

	HK$'000	HK$'000
Operating profits before working capital changes	55,721	
Decrease in trade and other receivables (44,000 – (47,250 – impairment 711) – exchange 4,500 – new 10,250)	17,289	
Decrease in trade and other payables (34,900 – 56,650 – exchange 1,500 – new 4,500)	(27,750)	
Cash generated from operations	45,260	
Interest paid (500 + SPLOCI 2,300 – 1,250)	(1,550)	
Tax paid (7,000 + SPLOCI 1,050 + new 2,000 – 7,050)	(3,000)	
Net cash from operating activities		40,710
Investing activities		
Acquisition of subsidiary, net of cash acquired (c) (4,000 – 1,250)	(2,750)	
Increase in certificate of deposit	(7,500)	
Dividend received from associate (W1)	1,150	
Purchase of property, plant and equipment (W2)	(61,100)	
Proceeds from disposal of property, plant and equipment	26,500	
Net cash used in investing activities		(43,700)
Financing activities		
New bank loans raised (W3)	3,740	
Dividend paid to non-controlling interest (W4)	(2,000)	
Dividend paid (W5)	(8,250)	
Net cash used in financing activities		(6,510)
Net decrease in cash and cash equivalents		(9,500)
Cash and cash equivalents at beginning of period		9,000
Effect of exchange rate changes on cash and cash equivalents (exchange gain on translation of foreign subsidiaries 2,000 – exchange loss on foreign currency bank deposits 500)		1,500
Cash and cash equivalents at end of period		1,000

Workings: (All figures in HK$'000)

W1 Opening investment in associates 15,500 + SPLOCI 1,650 – dividend = closing 16,000, thus dividend received from associates = 1,150

W2 Opening PPE 244,500 + addition – depreciation 32,600 – disposal 29,000 + new 35,500 = closing 279,500, thus addition = 61,100

W3 Opening bank loans 45,000 + new bank loans raised + translation loss 1,260 = closing bank loans 50,000, thus new bank loans raised = 3,740

W4 Opening NCI 18,600 + new 8,000 + SPLOCI 2,900 – dividend to NCI = closing 27,500, thus dividend to NCI = 2,000

W5 Opening retained earnings and other reserves (53,200+100,000) + SPLOCI 17,950 – dividend = closing (58,900+104,000), thus dividend paid = 8,250

Answer 4

To: Danielle WONG (Director), UHL
From: David LEE, Accounting Manager, UHL
cc: Crystal HO, Stephen LEE, Christopher YUNG (Directors)

Date: dd/mm/yyyy

I refer to your email dated 18 May 20X6 regarding your queries about the draft consolidated financial statements for UHL as at 31 March 20X6 and the proforma consolidated statement of financial position as at 31 March 20X5.

(a) (i) **Land lease premium**

The "Land lease premium" refers to the land element of our warehouse and office.

Although we have purchased the warehouse and the office, a significant amount of the purchase considerations was paid for the land element.

With very few exceptions, all lands in Hong Kong are owned by the Government and leased out for a limited period. That is, the warehouse and office were built on land under a government lease.

For the purpose of lease classification, the land and buildings elements of a lease of land and buildings are considered separately.

A characteristic of land is that it normally has an indefinite economic life.

Since the land title will not pass to the leasing company by the end of the lease term, the company normally does not receive substantially all of the risks and rewards incidental to ownership of the land.

When the land has an indefinite economic life, the land element is normally classified as an operating lease unless the title is expected to pass to the lessee by the end of the lease term. The lease of land is therefore classified as an operating lease.

The "Land lease premium" of HK$10,000,000, which represents a part of the payments made for the acquisition of the warehouse and office, is accounted for as an operating lease of the land, representing prepaid lease payments that are amortised over the lease term.

(ii) **The investment in STL from 31 March 20X5 to 31 March 20X6**

1 **At 31 March 20X5**

At 31 March 20X5, UHL held only 20 per cent of the issued shares of STL. UHL had significant influence, but not control over STL.

Therefore, STL was classified as an associate under HKAS 28 (2011) *Investments in Associates and Joint Ventures*.

UHL's 20 per cent investment in STL should be accounted for using the equity method under which the investment would initially be recognised at cost of HK$7,000,000 at 31 March 20X5.

2 **The effects of acquiring a further 50 per cent interest in STL at 31 March 20X6**

After the acquisition of a further 50 per cent interest in STL, UHL holds a total of 70 per cent interest in STL.

HKFRS 10 defines a subsidiary as an entity that is controlled by another entity. The key element is "control" which means power over the investee, exposure or rights to variable returns from the investee and the ability to use power to affect the returns.

In accordance with HKFRS 10, the elements of control are presumed to exist since UHL directly owns more than one half of the voting rights of STL.

Therefore, STL was a subsidiary of UHL at 31 March 20X6, and UHL was a parent at that date.

In accordance with HKFRS 10 and the Companies Ordinance, UHL, as a parent company, shall present consolidated financial statements for the year ended 31 March 20X6 in addition to its separate financial statements.

3 **The meaning of "consolidated" financial statements**

Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.

In preparing the consolidated financial statements, UHL combines the financial statements of UHL and STL line by line by adding together like items of assets, liabilities, equity, income and expenses.

In order that the consolidated financial statements present financial information about the group as that of a single economic entity, a number of consolidation adjustments are made to the combined financial statements.

For example, the carrying amount of UHL's investment in STL is eliminated against STL's equity at the date of acquisition, resulting in, among other items, a goodwill balance in the consolidated statement of financial position.

Moreover, UHL's 20 per cent investment in STL from 1 April 20X5 to 31 March 20X6 should be accounted for using the equity method in the consolidated financial statements for the year ended 31 March 20X6.

In UHL's separate financial statements for the year ended 31 March 20X6, the investment in STL would continue to be accounted for at cost.

(iii) **Carrying amount of the 20 per cent interest in STL in the consolidated statement of financial position of UHL at 31 March 20X6**

During the period from 1 April 20X5 to 31 March 20X6 (before the acquisition of the further 50 per cent), the investment in 20 per cent equity interest in STL shall be accounted for by the equity method.

Under the equity method, the investment should be initially recognised at cost and the carrying amount increased or decreased to recognise UHL's share of STL's profit or loss after the date of acquisition. UHL's share of STL's profit or loss will be recognised in UHL's consolidated profit or loss.

The carrying amount of the 20 per cent interest in STL at 31 March 20X6 was determined as follows:

	HK$'000
Cost of investment at 1 April 20X5	7,000
Share of profits for the year ended 31 March 20X6	
(20% × HKD12,000,000)	2,400
Depreciation adjustment for the year	
[20% × (HKD16,000,000 – HKD11,200,000)]/10 years	(96)
Carrying amount of investment in associate (STL) at 31 March 20X6	9,304*

* Alternatively:

	HK$'000
Share of net assets at 31 March 20X6	
(20% × HKD27,200,000)	5,440
Balance of fair value adjustment	
(20% × (HKD16,000,000 – HKD11,200,000) × 9 / 10)	864
Balance of goodwill at 31 March 20X6	
(HKD7,000,000 – 20% × HKD20,000,000)	3,000
Carrying amount of investment in associate (STL) at	
31 March 20X6	9,304

(iv) According to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a contingent liability is:

1. a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
2. a present obligation that arises from past events but is not recognised because:
   - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
   - the amount of the obligation cannot be measured with sufficient reliability.

It is right that, in accordance with HKAS 37, UHL should not recognise a contingent liability. A contingent liability should be disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

However, since the further acquisition of the 50 per cent of STL constitutes a business combination, which is defined by HKFRS 3 (revised) *Business Combinations* as the bringing together of separate entities or businesses into one reporting entity, UHL should also apply HKFRS 3.

In accordance with HKFRS 3 (revised), UHL (as the acquirer) should recognise STL's contingent liabilities separately at the acquisition date if, at that date, the fair value of the contingent liabilities can be measured reliably.

Although STL's contingent liability of HK$1,000,000 was not recognised by STL before the business combination, that contingent liability has a fair value, the amount of which reflects market expectations about any uncertainty surrounding the possibility that an outflow of resources embodying economic benefits will be required to settle the possible or present obligation. As a result, the existence of STL's contingent liabilities has the effect of lowering the price that UHL is prepared to pay for the controlling interest in STL. UHL has, in effect, been paid to assume an obligation in the form of a reduced purchase price for the controlling interest in STL.

(v) **Goodwill on consolidation**

The "goodwill" in the consolidated financial statements represents the payment made by UHL on acquisition of the controlling interest in STL in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised.

It is measured as the residual cost of the business combination after recognising STL's identifiable assets, liabilities and contingent liabilities.

In accordance with HKFRS 3, UHL should, at the acquisition date, recognise the goodwill acquired in the business combination with STL as an asset; and initially measure that goodwill at its cost.

The investment in STL is a business combination involving more than one exchange transaction since it occurred in stages by successive share purchases.

However, goodwill is only calculated when **control** is first achieved, in this case on 31 March 20X6.

After initial recognition at 31 March 20X6, UHL should measure goodwill at cost less any accumulated impairment losses.

UHL should test the goodwill for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with HKAS 36 *Impairment of Assets*. Since UHL acquired the goodwill at 31 March 20X6, no impairment loss need to be recognised as at that date.

The calculation of the goodwill at 31 March 20X6 is as follows:

	HK$'000
Cost of investment for the 50% acquired at 31 March 20X6	30,000
Non-controlling interest (30% × (37,400,000 – 1,000,000))	10,920
Fair value of previously held 20% stake	10,000
	50,920
Net assets at 31 March 20X6	(36,400)
Goodwill	14,520

I hope the above explanation has answered your queries. Please feel free to contact me if you have further queries.

Best regards

David Lee

(b) CONSOLIDATED STATEMENT OF FINANCIAL POSITION OF UHL AS AT 31 MARCH 20X6

	UHL	*STL*	*Adjust*	*Note*	*Consolidated*
	HK$'000	HK$'000	HK$'000		HK$'000
Net assets					
Land lease premium	10,000	–	–		10,000
Property, plant and equipment	21,000	9,800	10,200	1	41,000
Investment in a subsidiary	37,000	–	(37,000)		–
Goodwill	–	–	14,520	2	14,520
Net current assets	9,000	17,400	(1,000)		25,400
	77,000	27,200	(13,280)		90,920
Issued equity	65,000	10,000	(10,000)		65,000
Retained earnings	12,000	17,200	(14,200)	3	15,000
Non-controlling interest	–	–	10,920	4	10,920
	77,000	27,200	(13,280)		90,920

Notes

(1) HK$20,000,000 – 9,800,000

(2) Answer 4 (a)(v)

(3) – Pre-acquisition retained earnings of STL = HK$17,200,000
+ equity method profits HK$2,400,000
– HK$96,000
+ gain on fair value of 20% stake HK$696,000 (HK$10,000,000 – HK$9,304,000)

(4) 30% × (HK$37,400,000 – HK$1,000,000)

CJ 1

No consolidation adjustment is required at 31 March 20X5. However, it is possible to analyse the balance of investment in an associate by putting through a consolidation journal as follows:

		HK$'000	HK$'000
DEBIT	Investment in an associate – share of equity at date of acquisition	3,040	
	Investment in an associate – fair value adjustments (HK$16,000,000 – HK$11,200,000) × 20%	960	
	Investment in an associate – goodwill	3,000	
CREDIT	Investment in an associate – costs of acquisition		7,000

Being analysis of investment in an associate for consolidation purposes.

CJ 2

DEBIT	Investment in an associate – share of post acquisition profit of an associate (HK$12,000,000 × 20%)	2,400	
CREDIT	Profit or loss – share of post acquisition profit of an associate		2,400

Being recognition of UHL's share of STL's profit for the year.

CJ 3

DEBIT	Profit or loss – share of post acquisition profit of an associate (HK$960,000/10 years)	96	
CREDIT	Investment in an associate		96

Being recognition of depreciation adjustment for the year.

CJ 4

DEBIT	Share capital	10,000	
	Retained earnings	17,200	
	Property, plant and equipment (HK$20,000,000 – 9,800,000)	10,200	
	Goodwill	14,520	
CREDIT	Net current assets (Provision for STL's contingent liability)		1,000
	Non-controlling interests (HK$36,400,000 × 30%)		10,920
	Investment in an associate [See Answer 4 (a)(iii)]		9,304
	Retained earnings (HK$10,000,000 – HK$9,304,000)		696
	Investment in a subsidiary		30,000
DEBIT	Investment in an associate**	7,000	
CREDIT	Investment in a subsidiary**		7,000

Being elimination of share capital, pre-acquisition reserves against cost of investment and recognition of goodwill and non-controlling interest in assets and liabilities.

**This eliminates the effect of the transfer from the cost of the 20 per cent investment in STL as investment in an associate to an investment in a subsidiary made at the entity level of UHL.

Answer 5

To: Gabriel Wong (Director), PPY
From: Tommy Lau, Accounting Manager, PPY
c.c.: Renee Ho, Chris Wong, Adrian Cheung (Directors)
Date: dd/mm/yyyy

I refer to your email of 8 May 20Y0 concerning the draft consolidated financial statements of PPY as at 31 March 20Y0.

(a) **Investment property**

HKAS 40 defines an investment property as a property held to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes; or sale in the ordinary course of business.

From the perspective of PPY, the property is an investment property because it meets the definition stated above by leasing it to another party (a senior manager of SFL). Therefore, PPY correctly treats the property as an investment property in its separate financial statements.

However, PPY's property is leased to, and occupied by, an employee of its subsidiary (SFL).

Paragraph 9(c) of HKAS 40 specifies that owner-occupied property includes property occupied by employees (whether or not the employees pay rent at market rates) and it is one of the examples of items that are not investment property and are therefore outside the scope of HKAS 40.

From the perspective of the group, an employee of SFL is an employee of the group. Thus the property does not qualify as an investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group.

Therefore, the relevant investment property, with a fair value of HK$6 million, has to be reclassified as property, plant and equipment in the consolidated financial statements.

Nonetheless, the rent paid by the senior manager of SFL to PPY is not an intragroup income and expense and thus the relevant rental income is not eliminated in preparing the consolidated financial statements.

I hope the above explanation has answered your questions. For the details, please refer to the annex. Please feel free to contact me if you have further queries.

Best regards,
Tommy Lau

(b) **Annex**

(i) **Worksheet for the consolidated statement of profit or loss and other comprehensive income**

	PPY	*SFL*	*Eliminations*			*Consolidated*
			DEBIT		CREDIT	
	HK$	HK$	(HK$)	working(s)	(HK$)	HK$
Sales	80,000,000	38,400,000	4,800,000	W7		113,600,000
Cost of sales	(51,200,000)	(25,600,000)	640,000	W7	4,800,000	(72,490,000)
			250,000	W2/W6	400,000	
Gross profit	28,800,000	12,800,000				41,110,000
Other income (Dividend income)	1,280,000	–	1,280,000	W3		–
Distribution costs	(3,000,000)	(2,300,000)				(5,300,000)
Administrative expenses	(5,000,000)	(2,500,000)				(7,500,000)
Finance costs	(5,760,000)	(1,120,000)		(a)	600,000	(6,280,000)
Profit before tax	16,320,000	6,880,000				22,030,000
Income tax expense	(3,520,000)	(2,080,000)	66,000	W6/W7	105,600	(5,519,150)
				W2	41,250	
Profit for the year	12,800,000	4,800,000				16,510,850
Other comprehensive income: revaluation surplus	6,000,000	1,200,000				7,200,000
Total comprehensive income	18,800,000	6,000,000				23,710,850

Profit attributable to:			
Owners of the parent			15,632,680
Non-controlling interests	878,170	W4	878,170
			16,510,850
Total comprehensive income attributable to:			
Owners of the parent	878,170	W4	22,592,680
Non-controlling interests	240,000	W4a	1,118,170
			23,710,850

(ii) **Worksheet for consolidated statement of financial position**

	PPY	*SFL*	*Eliminations*			*Consolidated*
			DEBIT		CREDIT	
	HK$	HK$	(HK$)	working(s)	(HK$)	HK$
Property, plant and equipment, net	40,000,000	7,600,000	600,000	(a)		54,200,000
			6,000,000	(b)		
Investment properties	20,800,000	12,000,000		(b)	6,000,000	26,800,000
Investment in SFL, at cost	25,600,000	–		W1	25,600,000	–
Goodwill	–	–	1,530,000	W1		1,530,000
Other intangible assets, net	–	11,200,000	2,500,000	W1/W2	750,000	12,950,000
Deferred tax asset	–	–	105,600	W7		105,600
Inventories	51,200,000	21,600,000		W7	640,000	72,160,000
Trade and other receivables	25,000,000	14,000,000				39,000,000
Cash and cash equivalents	23,000,000	10,400,000				33,400,000
	185,600,000	76,800,000				240,145,600
Share capital	32,000,000	16,000,000	16,000,000	W1		32,000,000
Retained earnings	46,000,000	25,000,000				56,071,480
Revaluation surplus	10,000,000	2,200,000				11,760,000
	88,000,000	43,200,000				99,831,480
Non-controlling interests	–	–		W1	6,017,500	8,825,370
			100,000	W2	16,500	
			320,000	W3/W4	878,170	
				W4a	240,000	
				W5	1,960,000	
				W5a	200,000	
			80,000	W6	13,200	
Deferred tax liability			123,750	W2/W1	412,500	288,750
Trade and other payables	47,600,000	13,600,000				61,200,000
Long term loan	50,000,000	20,000,000				70,000,000
	185,600,000	76,800,000	49,816,020		49,816,020	240,145,600

WORKING:

Reconciling consolidated retained earnings and consolidated revaluation surplus

	PPY	*SFL*	*Eliminations*			*Consolidated*
			DEBIT		CREDIT	
	HK$	HK$	(HK$)	working	(HK$)	HK$
Retained earnings, 1 April 20X9	36,400,000	21,800,000	400,000	W2	66,000	43,638,800
			320,000	W6	52,800	
			12,000,000	W1		
			1,960,000	W5		
Profit for the year attributable to the owners of the parent	12,800,000	4,800,000				15,632,680
Dividends declared	(3,200,000)	(1,600,000)		W3	1,600,000	(3,200,000)
Retained earnings, 31 March 20Y0	46,000,000	25,000,000				56,071,480

	PPY	*SFL*	DEBIT	*Eliminations*	CREDIT	*Consolidated*
	HK$	HK$	(HK$)	working	(HK$)	HK$
Revaluation surplus, 1 April 20X9	4,000,000	1,000,000	200,000	W5a		4,800,000
Revaluation for the year	6,000,000	1,200,000				6,960,000
Revaluation surplus, 31 March 20Y0	10,000,000	2,200,000				11,760,000

Note. The journal entries are for illustrative purpose only. They are not required by the question.

			HK$	HK$
W1 - *Elimination of investment in subsidiary*				
DEBIT	Share capital		16,000,000	
	Retained earnings		12,000,000	
	Goodwill		1,530,000	
	Intangible assets		2,500,000	
CREDIT	Deferred tax liability			412,500
	Investment in SFL			25,600,000
	Non-controlling interests	(30,087,500 × 20%)		6,017,500
W2 - *Past and current amortisation on revalued intangible assets*				
DEBIT	Opening retained earnings	(2.5m/10 × 2 × 80%)	400,000	
	Non-controlling interests	(2.5m/10 × 2 × 20%)	100,000	
	Amortisation	(2.5m/10)	250,000	
CREDIT	Accumulated amortisation			750,000
DEBIT	Deferred tax liability	(750,000 × 16.5%)	123,750	
CREDIT	Opening retained earnings	(400,000 × 16.5%)		66,000
	Non-controlling interests	(100,000 × 16.5%)		16,500
	Tax expense	(250,000 × 16.5%)		41,250
W3 - *Eliminate dividend income*				
DEBIT	Dividend income	(1,600,000 × 80%)	1,280,000	
	Non-controlling interests	(1,600,000 × 20%)	320,000	
CREDIT	Dividends declared			1,600,000
W4 - *Current income to Non-controlling interests*				
DEBIT	Non-controlling interests (SPLOCI)		878,170	
CREDIT	Non-controlling interests (SOFP)			878,170

		HK$
Profit of SFL before adjustment		4,800,000
Add: previous year's unrealised profit now realised	(1.2m – 0.8m)	400,000
Tax effects on previous year's unrealised profit	(400,000 × 16.5%)	(66,000)
Less: current year's unrealised profit	(40% × (4.8m – 3.2m))	(640,000)
Tax effects on current year unrealised profit	(640,000 × 16.5%)	105,600
Less: amortisation on revalued intangible assets		(250,000)
Tax effects on amortisation on revalued intangible assets (250,000 × 16.5%)		41,250
Adjusted profit		4,390,850
Non-controlling interests' share (20%)		878,170

W4a - *Current revaluation surplus to Non-controlling interests*

		HK$	HK$
DEBIT	Non-controlling interests (SPLOCI) (1,200,000 × 20%)	240,000	
CREDIT	Non-controlling interests (SOFP)		240,000

W5 - *Assign post-acquisition Retained Earnings to Non-controlling interests*

DEBIT	Opening retained earnings (from 1 April 20X7 to 31 March 20X9) [20% × (21.8m-12m)]	1,960,000	
CREDIT	Non-controlling interests (SOFP)		1,960,000

W5a - *Assign post-acquisition revaluation surplus to Non-controlling interests*

DEBIT	Opening revaluation surplus (from 1 April 20X7 to 31 March 20X9) [20% × (1m-0m)]	200,000	
CREDIT	Non-controlling interests		200,000

W6 - *Realisation of opening unrealised profit in inventory*

DEBIT	Opening retained earnings	320,000	
	Non-controlling interests	80,000	
CREDIT	Cost of sales		400,000
DEBIT	Tax expense (400,000 × 16.5%)	66,000	
CREDIT	Opening retained earnings (320,000 × 16.5%)		52,800
	Non-controlling interests (80,000 × 16.5%)		13,200

W7 - *Elimination of intercompany sale of inventory*

DEBIT	Sales	4,800,000	
CREDIT	Cost of sales		4,800,000
DEBIT	Cost of sales (1.6m × 40%)	640,000	
CREDIT	Inventory		640,000
DEBIT	Deferred tax asset (640,000 × 16.5%)	105,600	
CREDIT	Tax expense		105,600

Reconciliation of Non-controlling interests in SOFP:

	HK$
Shareholders' equity of SFL at 31 March 20Y0	43,200,000
Fair value adjustment of intangible assets	2,500,000
Tax on fair value adjustment of intangible assets (2.5m × 16.5%)	(412,500)
Accumulated amortisation on fair value adjustment of intangible assets (2.5m/10 × 3)	(750,000)
Tax on acc. amortisation on fair value adjustment of intangible assets	123,750
Unrealised profit on upstream sale	(640,000)
Tax on unrealised profit on upstream sale	105,600
Adjusted shareholders' equity of SFL at 31 March 20Y0	44,126,850
NCI's share @ 20%	8,825,370

or

		20% NCI
Shareholders' equity of SFL at 31 March 20Y0	43,200,000	8,640,000
Fair value adjustment of intangible assets	2,500,000	500,000
Tax on fair value adjustment of intangible assets (2.5m × 16.5%)	(412,500)	(82,500)
Accumulated amortisation on fair value adjustment of intangible assets (2.5m/10 × 3)	(750,000)	(150,000)
Tax on acc. amortisation on fair value adjustment of intangible assets	123,750	24,750
Unrealised profit on upstream sale	(640,000)	(128,000)
Tax on unrealised profit on upstream sale	105,600	21,120
Adjusted shareholders' equity of SFL at 31 March 20Y0	44,126,850	8,825,370

Answer 6

To: Sunny Sun (Director), STL
From: Ricky Lam, Accounting Manager, STL
c.c.: Susan Chow, Emily Tsim, Rachael Lau (Directors)
Date: dd/mm/yyyy

I refer to your email dated 18 September 20X9 regarding your queries about the draft consolidated financial statements for STL as at 30 June 20X9.

Goodwill

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

HKFRS 3 (revised) requires the acquirer, having recognised the identifiable assets, the liabilities and any non-controlling interests, to identify any difference between:

- the aggregate of the consideration transferred, any non-controlling interest in the acquiree and, in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; and
- the net identifiable assets acquired.

The difference is generally recognised as goodwill.

The amount of goodwill is calculated as follows:

Consideration transferred ($1.50 × 75% × 400 million shares) = $450 million

Amount of non-controlling interest in MNL ($560 million × 25%) = $140 million

Total = $450 million + $140 million = $590 million

Identifiable net assets of MNL acquired = $560 million

Goodwill acquired = $30 million

Contribution to joint venture

In accordance with **HKAS 28 (2011)**, when a venturer contributes assets to a joint venture, recognition of any portion of a gain or loss from the transaction shall reflect the substance of the transaction.

In applying to non-monetary contributions to a joint venture in exchange for an equity interest in the joint venture, HKAS 28 (2011) states that a venturer shall recognise in profit and loss for the period the portion of a gain or loss attributable to the equity interests of the other venturers **except when** the contribution transaction lacks commercial substance.

If the above mentioned exception applies, the gain or loss is regarded as unrealised and therefore is not recognised in profit and loss.

In this case, it is reasonable to assume that the exception does not apply and therefore the gain should be recognised in profit or loss.

Therefore STL shall recognise that portion of the gain that is attributable to the interests of the other venturer, i.e. 50%.

The journal entries for STL, in its separate financial statements, to record its contribution to the joint venture, are:

		$m	$m
DEBIT	Interests in JV – capital contribution	10	
	Accumulated depreciation – machinery	4	
CREDIT	Interests in JV – unrealised gain on contribution of machinery		1
	Other income – gain on contribution of machinery to JCE		1
	Machinery		12

According to **HKAS 28 (2011)**, in the consolidated financial statements of the venturer, unrealised gains or losses on non-monetary assets contributed to joint ventures shall be eliminated against the investment under the equity method. Such unrealised gains or losses shall not be presented as deferred gains or losses in the venturer's consolidated statement of financial position.

It is not appropriate to present unrealised gains or losses on non-monetary assets contributed to joint ventures as deferred items since such items do not meet the recognition criteria for assets or liabilities as defined in the *Conceptual Framework*.

Therefore, STL shall make the following adjustment under the equity method, in addition to the above adjustment, in its consolidated financial statements:

		$m	$m
DEBIT	Interests in JV – unrealised gain on contribution of machinery	1	
CREDIT	Machinery held in JV		1

Tax effect of consolidation adjustments for intragroup transactions

Since taxes are being charged on the individual entities, the consolidation adjustments will not affect the current tax liability, i.e. the amount that is expected to be paid in tax.

However, tax-effect adjustments are necessary when, during the consolidation, adjustments are made to the carrying amounts of assets.

The consolidation adjustments relating to the carrying amount of assets will affect the differences between the tax base and the carrying amount of an asset. This then affects future tax (deferred tax amounts) rather than current tax payable.

HKAS 12 provides examples of circumstances that give rise to deductible temporary differences e.g.: "unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes".

In this case, to eliminate intragroup sales and unrealised profit on inventory on downstream sales, inventory is to be reduced by ($100,000,000 × 20/120 × $^1/_3$) = $5,555,555 as the cost to the consolidated group differs from that to the subsidiary (MNL).

In MNL's accounts, the inventory is carried at $100,000,000 and has a tax base of $100,000,000, giving rise to no temporary differences.

From the group's point of view, the inventory has a carrying amount of $94,444,445, giving a temporary difference of $5,555,555.

As the expected future deduction is greater than the assessable amount, a deferred tax asset exists for the group, though there is no effect on the amount of tax payable in the current period.

Deferred tax asset thereof = $5,555,555 × 16% = $888,888

STL's share of ERL's current year profit

According to HKAS 28 (2011), if an investor holds, directly or indirectly, 20% or more of the voting power of the investee, it is presumed that the investor has significant influence. Thus ERL would be regarded as an associate of STL.

The equity method would be applicable whereby the investment in ERL would be initially recognised at cost and adjusted thereafter for the post-acquisition change in STL's share of ERL's net assets. STL's profit or loss will include STL's share of the profit or loss of ERL.

Since STL has transferred the significant risks and rewards of ownership of the inventories to the associate, the transaction should be recognised as sales. Thus no elimination of sales is required.

Nonetheless, HKAS 28 (2011) requires that profits and losses resulting from "upstream" (sales of assets from an associate to the investor) and "downstream" (sales of assets from the investor to an associate) transactions between an investor (including its consolidated subsidiaries) and an associate are recognised in the investor's financial statements only to the extent of unrelated investors' interests in the associate.

Therefore, the investor's share in the profits and losses resulting from these transactions should be eliminated. When STL sells goods to ERL (an associate), STL should not recognise its share of the profit or loss from the transaction in its consolidated financial statements until the goods or assets have been resold to an independent party.

STL's share of any unrealised profit or loss in the inventories that were retained by ERL at the end of the reporting period is eliminated as follows:

ERL's profit for the year ended 30 June 20X9 = $41,000,000

STL's share = $41,000,000 × 25% = $10,250,000

Less: Elimination of unrealised profit (after tax) on intercompany transaction

Total unrealised profit:	$15,000,000 × 20/120 × 1/2 =	$1,250,000
STL's share =	$1,250,000 × 25% =	$312,500
Less: Tax effect	$312,500 × 16% =	$50,000
Elimination of unrealised profit (after tax)	$312,500 – $50,000 =	$262,500

Thus STL's share of ERL's adjusted profit = $10,250,000 – $262,500 = $9,987,500

I hope the above explanation has answered your questions. Please feel free to contact me if you have further queries.

Best regards

Ricky Lam

Answer 7

To : Ms. Linda HO, Director of GRL

From : John Chan, Accounting Manager

Date : dd/mm/yyyy

Subject : Investment in subsidiaries and consolidated financial statements of GRL as at 1 April 20Y1 after the transactions

I refer to your message regarding your queries about the investment in subsidiaries and the draft consolidated financial statements of GRL as at 1 April 20Y1 after the transactions.

(a) **Investment in AMR**

The issue of shares by AMR to SFL has reduced GRL's interest in AMR to 40 per cent, i.e. less than 50 per cent. Also, GRL is entitled to appoint only three out of the total seven seats in the board of directors. Therefore, GRL has lost control of AMR.

Since GRL holds 20 per cent or more of the voting power of AMR, there is a presumption that GRL has significant influence over AMR and hence AMR should be accounted for as an associate.

In this case, GRL should stop consolidating AMR from the date that control was lost, i.e. 1 April 20Y1.

Paragraph 25 of HKFRS 10 *Consolidated Financial Statements* states that if a parent loses control of a subsidiary, the parent should derecognise the assets and liabilities of the former subsidiary from the consolidated statement of financial position and recognise any investment retained in the former subsidiary at its fair value when control is lost.

A partial disposal of the investment in AMR, as a subsidiary, but retaining an interest as an associate creates the recognition of a gain or loss on the entire interest.

Since the loss of control of a subsidiary is a significant economic event, the retained interest, ie the new investor-investee relationship, is recognised and measured at fair value at the date when control is lost.

A gain or loss should be recognised on the part that has been disposed of and a further holding gain or loss is recognised on the investment retained, being the difference between the fair value of the investment and the carrying amount of the investment.

On 1 April 20Y1, the carrying amounts of AMR that should be derecognised =

100% of the net identifiable assets of AMR = $12 million

+ goodwill ($7.5 million + 40% × ($1 million + $9 million) – $10 million = $1.5 million)

= $13.5 million

GRL should derecognise the carrying amount of any non-controlling interests (NCI) in AMR (the former subsidiary) at the date when control is lost (including any components of other comprehensive income attributable to them).

On 1 April 20Y1, non-controlling interest, measured at its proportionate share of the AMR's net identifiable assets, should be 40% × $12 million = $4.8 million.

GRL should also recognise the fair value of the consideration received from the transaction. However, in this case, GRL has not received any consideration from the transaction.

Any investment retained in AMR (the former subsidiary) should be recognised at its fair value at the date when control is lost. Thus, GRL should recognise its investment in AMR at its fair value on 1 April 20Y1, i.e. $9.6 million.

GRL should also reclassify to profit or loss, or transfer directly to retained earnings any gain or loss previously recognised in other comprehensive income. However, for the assets of AMR, no gain or loss has been previously recognised in other comprehensive income.

The resulting difference, i.e.

Investment in AMR	=	$9.6 million
+ Non-controlling interest	=	$4.8 million
- Net identifiable assets of AMR	=	$12 million
- Goodwill	=	$1.5 million
	=	$0.9 million

should be recognised as a gain or loss in profit or loss attributable to the parent.

The corresponding consolidation journal entry is summarised as below:

		$m	$m
DEBIT	Investment in AMR	9.6	
DEBIT	Non-controlling interest	4.8	
DEBIT	Debenture of AMR	2	
DEBIT	Accounts payable of AMR	1	
CREDIT	PPE of AMR		9
CREDIT	Inventory of AMR		3
CREDIT	Accounts receivable of AMR		2
CREDIT	Cash of AMR		1
CREDIT	Goodwill		1.5
CREDIT	Gain on disposal		0.9

Alternatively, candidates may exclude AMR from the consolidation and prepare a terminal entry:

DEBIT	Investment in AMR	9.6	
CREDIT	Investment in AMR		7.5
CREDIT	Retained earnings (11m – 9m) × 60%		1.2
CREDIT	Gain on disposal		0.9

(b) **Investment in CDS**

The issue of shares by CDS to MSL has reduced GRL's interest in CDS from 66 per cent to 60 per cent. Since GRL holds more than 50 per cent of the voting power of CDS, there is a presumption that GRL has retained control of CDS and hence CDS should remain as a subsidiary.

Paragraph 23 of HKFRS 10 *Consolidated Financial Statements* states that "changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions'' (i.e. transactions with owners in their capacity as owners).

This means that no gain or loss from these changes should be recognised in profit or loss. It also means that no change in the carrying amounts of the subsidiary's assets (including goodwill) or liabilities should be recognised as a result of such transactions.

This adopted approach is consistent with the fact that non-controlling interests are treated as a separate component of equity.

In such circumstances, the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary.

Previously, the carrying amount of NCI = 34% of $12.9 million = $4,386,000

After the transaction, NCI = 40% of ($12.9 + $5.5) million = $7,360,000

Thus, NCI increases by $7,360,000 – $4,386,000 = $2,974,000

Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received shall be recognised directly in equity and attributed to the owners of the parent.

Thus the difference between the consideration received ($5,500,000) and the amount that NCI is adjusted ($2,974,000), amounting to $2,526,000, should be recognised directly in equity attributable to the owners of the parent.

The corresponding consolidation journal entry is summarised as below:

		$	$
DEBIT	Cash	5,500,000	
CREDIT	Non-controlling interest		2,974,000
CREDIT	Equity attributable to owners of the parent		2,526,000

Alternatively:

DEBIT	Cash	5,500,000	
DEBIT	Non-controlling interest	4,386,000	
CREDIT	Non-controlling interest		7,360,000
CREDIT	Equity attributable to owners of the parent		2,526,000

I hope the above explanation has answered your questions. For the details, please refer to the annex. Please feel free to contact me if you have further queries.

Best regards,

John Chan

(c)

GRL – CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 1 APRIL 20Y1

	GRL	*AMR*	*CDS*		Adjustment *DEBIT*	Adjustment *CREDIT*		*Group*
	$'000	$'000	$'000	ref	$'000	$'000	ref	$'000
ASSETS								
Non-current assets								
Property, plant and equipment	18,400	9,000	10,400	W3	100	500	W3	28,400
						9,000	(a)	
Goodwill				W1	5,400	1,500	(a)	5,400
				W5	1,500			
Investments in CDS	12,000	-	-			12,000	W1	-
Investment in AMR	7,500	-	-			7,500	W5	-
Investment in associate				(a)	9,600			9,600
Current assets								
Inventory	5,900	3,000	4,200	W2	500	500	W1	10,100
						3,000	(a)	
Accounts receivable	2,200	2,000	1,500			2,000	(a)	3,700
Cash	1,000	1,000	2,000	(b)	5,500	1,000	(a)	8,500
	47,000	15,000	18,100					65,700

EQUITY AND LIABILITIES

	GRL	*AMR*	*CDS*		*Adjustment DEBIT*	*CREDIT*		*Group*
	$'000	$'000	$'000	ref	$'000	$'000	ref	$'000
Share capital	19,000	1,000	4,000	W1	4,000			19,000
				W5	1,000			
Retained earnings	24,000	11,000	8,900	W1	6,500	500	W2	27,614
				W3	500	100	W3	
				W4	986	900	(a)	
				W5	9,000			
				W6	800			
Other components of equity	-	-	-			2,526	(b)	2,526
	43,000	12,000	12,900					49,140
Non-controlling interests	-	-	-	(a)	4,800	3,400	W1	7,360
						986	W4	
						2,974	(b)	
						4,000	W5	
						800	W6	
Non-current liability								
Debenture	-	2,000	1,000	(a)	2,000			1,000
Current liability								
Accounts payable	4,000	1,000	4,200	(a)	1,000			8,200
	47,000	15,000	18,100					65,700

Alternative

GRL – CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 1 APRIL 20Y1

	GRL	*CDS*		*Adjustment DEBIT*	*CREDIT*		*Group*
	$'000	$'000	ref	$'000	$'000	ref	$'000
ASSETS							
Non-current assets							
Property, plant and equipment	18,400	10,400	W3	100	500	W3	28,400
Goodwill			W1	5,400			5,400
Investment in AMR	7,500	-			7,500	(a)	-
Investments in CDS	12,000	-			12,000	W1	-
Investment in associate			(a)	9,600			9,600
Current assets							
Inventory	5,900	4,200	W2	500	500	W1	10,100
Accounts receivable	2,200	1,500					3,700
Cash	1,000	2,000	(b)	5,500			8,500
	47,000	18,100					65,700

	GRL	CDS		Adjustment DEBIT	Adjustment CREDIT		Group
	$'000	$'000		$'000	$'000		$'000
Share capital	19,000	4,000	W1	4,000			19,000
Retained earnings	24,000	8,900	W1	6,500	500	W2	27,614
			W3	500	100	W3	
			W4	986	1,200	(a)	
					900	(a)	
Other components of equity	-	-			2,526	(b)	2,526
	43,000	12,900					49,140
Non-controlling interests	-	-			3,400	W1	7,360
					986	W4	
					2,974	(b)	
Non-current liability							
Debenture	-	1,000					1,000
Current liability							
Accounts payable	4,000	4,200					8,200
	47,000	18,100					65,700

Goodwill calculations (not required by the question)

		Investment in AMR		Investment in CDS
		$'000		$'000
Purchase consideration		7,500		12,000
NCI	(10m × 40%)	4,000	(10m × 34%)	3,400
		11,500		15,400
Fair value of net identifiable assets	(1m + 9m)	10,000	(4m + 6.5m – 0.5m)	10,000
Goodwill		1,500		5,400

Journal entries not required by the question

(All figures in $'000)

W1 *Elimination of investment in CDS*

DEBIT	Share capital	4,000		
DEBIT	Retained earnings	6,500		
DEBIT	Goodwill	5,400		
CREDIT	Inventory		500	
CREDIT	Investment in CDS		12,000	
CREDIT	Non-controlling interests (NCI)		3,400	(4,000 + 6,500 – 500) × 34%

W2 *Impairment of inventory (fair value realisation)*

DEBIT	Inventory	500	
CREDIT	Retained earnings		500

W3 *Adjustment of 20Y0 unrealised profit in plant (downstream)*

DEBIT	Retained earnings	500		(2,500 – 2,000)
CREDIT	Plant		500	
DEBIT	Acc. depreciation	100		(500 / 5 years)
CREDIT	Retained earnings		100	

W4 *Allocation of post-acquisition profit to NCI of CDS*

DEBIT	Retained earnings	986		(2,400 + inventory 500) $\times$ 34%
CREDIT	NCI		986	

If AMR is included in the consolidation worksheet:

W5 *Elimination of investment in AMR*

DEBIT	Share capital	1,000		
DEBIT	Retained earnings	9,000		
DEBIT	Goodwill	1,500		
CREDIT	Investment in AMR		7,500	
CREDIT	NCI		4,000	(1,000 + 9,000) $\times$ 40%

W6 *Allocation of post-acquisition profit to NCI of AMR*

DEBIT	Retained earnings	800		(11,000 – 9,000) $\times$ 40%
CREDIT	NCI		800	

SECTION B – Short / Essay questions

Answer 8

(a) In accordance with the *Code of Ethics for Professional Accountants of HKICPA* (the "Code"):

Mr. V. Chow, as the independent non-executive director of the listed company, should consider the need to maintain confidentiality of information within the listed company.

Mr. V. Chow should not disclose the confidential information contained in the draft audited financial statements of the listed company to Mr. K. Chow without proper and specific authority.

Both Mr. K. Chow and Mr. V. Chow should not use confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

Both Mr. K. Chow and Mr. V. Chow should comply with relevant laws and regulations and should avoid any action that discredits the profession.

The trading of shares by Mr. K. Chow would constitute insider dealing under the Securities and Futures Ordinance.

Insider dealing in relation to the listed securities of a corporation takes place when, *inter alia*, a person who is "connected with the corporation" and who is knowingly in possession of "relevant information" deals in listed securities of the corporation or counsels or procures another person to do so knowing or having reasonable cause to believe that such person would deal in them. Relevant information is specific information about a corporation which is not generally known to persons accustomed or likely to deal in the listed securities of that corporation but which would materially affect the price of the securities if it were.

(b) Goodwill can still be recognised in the financial statements prepared under merger accounting for a business combination under common control.

The concept underlying the use of merger accounting to account for a common control combination is that no acquisition has occurred and there has been a continuation of the risks and benefits to the controlling party (or parties) that existed prior to the combination.

The net assets of the combining entities or businesses are consolidated using the existing book value from the controlling parties' perspective.

The assets and liabilities of the acquired entity or business should be recorded at the book values as stated in the financial statements of the controlling party.

That is, it will require recording of:

– the fair value of the identifiable assets and liabilities of the acquired entity or business at the date of original acquisition from third parties by the controlling party.

– any remaining goodwill arising on the previous acquisition and non-controlling interest recorded in the consolidated financial statements of the controlling party.

There is no recognition of any additional goodwill or excess of acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of common control combination to the extent of the continuation of the controlling party or parties' interest.

Answer 9

(a) HDL must determine whether the modification is considered to be an extinguishment of the original bank loan in accordance with HKFRS 9.

HKFRS 9, 3.3.2 requires an exchange between an existing borrower and lender of debt instruments with substantially different terms to be accounted for as extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

B3.3.6 of HKFRS 9 states that the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

The modified cash flow of the bank loan is as follows:

Year ended	*Payments*
	HK$ million
30 June 20Y0	12.00
30 June 20Y1	12.00
30 June 20Y2	12.00
30 June 20Y3	212.00

Present value at 30 June 20X9 discounting at original effective interest rate of 8% is HK$186.75 million.

As the difference between the amortised cost of the bank loan at the date of modification, 30 June 20X9 (HK$200 million) and the present value of the new bank loan, discounted by the original effective interest rate (HK$186.75 million), is less than 10 per cent ([HK$200 million – HK$186.75 million]/ HK$200 million × 100% = 6.625%), the modification is not considered as extinguishment of the original bank loan.

No gain or loss is recognised for the modification and the carrying amount of the bank loan is still HK$200 million.

The bank loan was originally repayable on 30 June 20Y0 and classified as current liability. The modification of the maturity date of the bank loan results in such liability to be settled more than 12 months after the reporting period. Accordingly, it is classified as non-current liability in the statement of financial position as at 30 June 20Y0.

(b) In accordance with AG35 of HKAS 32, an entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specific date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in profit or loss.

Journal entries that HDL should make on 30 June 20X9:

		HK$	HK$
DEBIT	Expense	18,500,000	
CREDIT	Convertible bonds equity reserve		18,500,000

To record the amendment of the terms of conversion (100 × (2,500,000 – 2,000,000) × HK$0.45) – HK$4,000,000.

DEBIT	Convertible bonds	96,296,296	
	Interest payable	4,000,000	
	Convertible bonds equity reserve	25,633,058	
CREDIT	Share capital		125,929,354

To record the conversion of the bonds under the amended terms of conversion and waive interest payable.

Answer 10

(a) Share-based compensation expense for the year ended 31 March 20X9:

= [(2,000,000 / 4 × HK$8)] + [(2,000,000 / 4 × HK$8) / 2] + [(2,000,000 / 4 × HK$8) / 3] + [(2,000,000 / 4 × HK$8) / 4]
= HK$4,000,000 + HK$2,000,000 + HK$1,333,333 + HK$1,000,000 = HK$8,333,333

Share-based compensation expense for the year ended 31 March 20Y0:

= [(2,000,000 / 4 × HK$8) / 2] + [(2,000,000 / 4 × HK$8) / 3] + [(2,000,000 /4 × HK$8) / 4]
= HK$2,000,000 + HK$1,333,333 + HK$1,000,000 = HK$4,333,333

(b) Accounting implication of cancellation of unvested awarded share options on 1 April 20Y0: According to HKFRS 2.28, if a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) The entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) Any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense.

Share-based compensation expense originally to be recognised from 1 April 20Y0 to 31 March 20Y2:
= [(2,000,000 / 4 × HK$8) / 3] + [(2,000,000 / 4 × HK$8) / 4 × 2]
= HK$1,333,334 + HK$2,000,000 = HK$3,333,334

OR

Accumulated compensation expense recognised up to 31 March 20Y0:
HK$8,333,333 + HK$4,333,333 = HK$12,666,666

[(2,000,000 × HK$8) – HK$12,666,666] = HK$3,333,334
Payment exceeds the fair value of the share options granted and cancelled, measured at 1 April 20Y0:
= HK$5,500,000 – [(2,000,000 / 4 × 2) × HK$5]
= HK$500,000

Total compensation expense recognised upon cancellation of unvested awarded share options on 1 April 20Y0 = HK$3,333,334 + HK$500,000 = HK$3,833,334

(c) According to HK(IFRIC) – Int 11 para. 8, provided that the share-based arrangement is accounted for as equity-settled in the consolidated financial statements of the parent, the subsidiary shall measure the services received from its employees in accordance with the requirements applicable to equity-settled share-based payment transactions, with a corresponding increase recognised in equity as a contribution from the parent.

The journal entries to be recorded by BS for the year ended 31 March 20Y0 were:

		HK$	HK$
DEBIT	Share compensation expense	4,333,333	
CREDIT	Contribution from MDS		4,333,333

Answer 11

(a) The value of the financial liability component of the CB at initial recognition:

[(6% × HK$800 / 1.08) + (6% × HK$800 / 1.08^2) + (6% × HK$800 / 1.08^3) + (6% × HK$800 / 1.08^4) + (HK$800 / 1.08^4)] million

= HK$[44.4 + 41.2 + 38.1 + 35.3 + 588] million
= HK$747 million

The initial carrying amount of the equity component of the CB:
= HK$(800 – 747) million = HK$53 million

Journal entries for the issue of the convertible bond (CB) on 1 December 20X8:

		HK$m	HK$m
DEBIT	Cash	800	
CREDIT	Convertible Bond – liability		747
	Equity – conversion option		53

(b) Carrying amount of the financial liability component of the CB at 1 April 20Y0:

HK$[(747 million × 1.08) – (800 million × 6%)] × [1 + (0.08 × 4/12)]
= HK$(806.76 – 48) million × 1.027
= HK$779 million

Journal entries for the conversion of CB into shares on 1 April 20Y0:

		HK$m	HK$m
DEBIT	Convertible Bond – liability	779	
	Equity – conversion option	53	
CREDIT	Share capital		832

(c) HKFRS 9 requires an entity to measure the financial liability at fair value, plus transaction costs that are directly attributable to the issue of the financial liabilities, at initial recognition.

Measurement of the fair value of the interest-free loan of HK$500 million based on the effective interest rate of other borrowings of AML, i.e. 6 per cent:
HK$500 million / 1.06^2 = HK$445 million

The journal entries for the recognition of the interest-free loan on 1 April 20Y0:

		HK$m	HK$m
DEBIT	Bank or Cash	500	
CREDIT	Loan from a shareholder		445
	Equity – contribution from a shareholder		55

Answer 12

CML did not have public accountability as it was not an issuer of securities and it was not in the process of issuing publicly traded equity or debt securities.

In terms of size test, CML met the following two quantitative conditions:

- The entity had no revenue, i.e. annual revenue did not exceed HK$50 million, for the year.
- The entity did not have assets in excess of HK$50 million at 31 December 20X9.

Under SME-FRS s.4 *Intangible assets*, an intangible asset arising from development phase of an internal project should be recognised if, and only if, an entity can demonstrate all the conditions set out in 4.7 are fulfilled.

One of these conditions is the technical feasibility of completing the intangible asset so that it will be available for use or sale. Based on the information stated, CML did not demonstrate that this condition has been met. Accordingly, the HK$28 million expenditure cannot be recognised as an intangible asset, but charged to profit or loss.

As a result, the total assets of CML at 31 December 20X9 were estimated to be approximately HK$37 million [= 60 – (28 – 5) million].

Provided that both shareholders of CML agree to prepare the financial statements in accordance with the SME-FRS, CML qualifies for reporting under the SME-FRS for the year ended 31 December 20X9.

Answer 13

(a) **Classification of lease**

PBL should account for the lease with UMC as an operating lease, since:

- there is no transfer of ownership of those two printing machines nor option to purchase the machines by PBL.
- the lease term of four years is not the majority of the ten-year economic life of the machines.
- the total gross rental over the lease term is [($200,000 × 12) + ($210,000 × 12) + ($220,000 × 12) + ($230,000 × 12)] = $10,320,000. The present value of the minimum lease payments is not substantially all of the fair value of the leased assets, i.e. $24,000,000 [$12,000,000 × 2].

Alternative:

The total gross rental over the lease term is [($200,000 × 12) + ($210,000 × 12) + ($220,000 × 12) + ($230,000 × 12)] = $10,320,000. Assuming a discount rate of 8 per cent is used, the present value of the above minimum lease payment amounts (calculated based on yearly basis at accrual) is approximately $8,507,000 which is not substantially all of the fair value of the leased assets, i.e. $24,000,000 [$12,000,000 × 2].

Accordingly, risks and rewards incidental to ownership of the machines are not transferred.

Accounting treatment

The lease payments shall be recognised as an expense on a straight line basis over the lease term.

Monthly expense recognised = $10,320,000 / 48 = $215,000.

(b) (i) **The chief operating officer of PBL is incorrect.**

In this case, PBL is entering into an arrangement with a finance house to sell three machines at a profit and then lease them back over a five-year term.

In order to establish the accounting treatment of this transaction, it is necessary to decide whether this is a sale and leaseback arrangement within the scope of HKAS 17. If so, it will be necessary to establish whether the lease arrangement is finance or operating in nature.

HK(SIC)-Int 27 deals with evaluating the substance of transactions involving the legal form of a lease. It states that HKAS 17 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time. It further states that the following indicators demonstrate that an arrangement may **not**, in substance, involve a lease under HKAS 17:

(a) An entity retains all of the risks and rewards incidental to ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement; and

(b) An option is included on terms that make its exercise almost certain.

Risks and rewards

- The remaining estimated useful life for the assets is six years while the lease term is five years, which can be interpreted as the major part of the economic life of the asset.
- PBL has an option to buy the machines from EFL for $50,000 at the end of the five-year lease term.

- Assuming the purchase option is exercised, gross payments in respect of the agreement over five years total $22,550,000. The present value of this minimum lease payment is approximately $18,010,000 at a discount rate of 8 per cent. This is considered to be substantially equal to the fair value of the leased assets.

The substance and economic reality are therefore that PBL has not transferred substantially all the risks and rewards incidental to ownership of the machines to the lessor.

Almost certainly exercisable option

As the current fair value of the machines (with a remaining six-year useful life) is $18,000,000, it is reasonable to consider that the $50,000 option price at the end of the lease is sufficiently lower than fair value at the date the option becomes exercisable that the option will be exercised by PBL.

It can therefore be concluded that the transaction is not within the scope of HKAS 17. Rather than a sale and leaseback transaction, it is a means whereby the finance house provides finance to PBL using the assets as security.

Accounting treatment

As the transaction is classified as a financing transaction, the $17 million proceeds received are recognised as a financial liability in accordance with HKFRS 9.

Tutorial note

If this transaction were within the scope of HKAS 17 (if, for example there were no repurchase option) it would be accounted for as a sale and finance leaseback. The original asset with carrying amount of $15 million would be derecognised and a finance lease asset and liability of $17 million would be recognised and accounted for in line with the requirements of HKAS 17.

The profit of $2 million would be deferred and amortised over the lease term.

(b) (ii) If the lease term is shortened to three years with an annual future lease payment of $4,000,000 and without PBL's option to buy the machines from EFL:

- The total lease payment would be $12,000,000, the present value of which would not be substantially equal to the fair value of the leased assets ($18,000,000) nor the proceeds received ($17,000,000).
- PBL would not retain the ownership of the machines nor have an option to purchase the machines at the end of the lease term.

In this case the transaction would be treated as a sale and operating leaseback. A $4 million operating lease expense would be recognised in each of the three years of the lease.

As the sale price of $17,000,000 is below fair value of $18,000,000, the profit, calculated as the difference between $17,000,000 and $15,000,000, would be recognised immediately in profit or loss.

Answer 14

(a) The financial position of MG as at 31 December 20Y1 is affected as follows:

Option 1

The rights issue is an equity transaction and will increase MG's net assets by $1,000 million.

Option 2

The convertible bond is a compound financial instrument which contains both a liability and an equity component.

- Liability component shown as a non-current liability:

  PV of eight semi-annual interest payments of $20 million and redemption of $1,000 million at 31 December 20Y5 (market interest rate 2.5 per cent per semi-annual) = $964.15 million.

- Equity component:

  $35.85 million [$1,000 – 964.15 million] (ignoring the tax effect).

(b) Calculation of the earnings per share of MG for the year ending 31 December 20Y2, assuming the estimated profit is $800 million, is as follows:

Rights issue

With the rights issue, the number of shares of MG used for the computation of EPS will increase to 1,200 million.

The EPS calculated based on an estimated profit of $800 million will decrease from $0.8 ($800/1,000) to $0.67 ($800/1,200) per share.

Convertible bond

The convertible bond will not affect the number of shares for the basic EPS calculation, but will decrease the profit for the year 20Y2 due to interest payments (ignoring the tax effect):

	$m
April 20Y2 interest $964.15 × 2.5%	24.10
October 20Y2 interest ($964.15 + 24.10 – 20) × 2.5%	24.21
	48.31

The basic EPS calculated based on an estimated profit of $751.69 million ($800 million – $48.31 million) will decrease from $0.8 ($800 / 1,000) to $0.752 ($751.69 / 1,000) per share.

The convertible bonds are dilutive with an individual EPS of $0.386 ($48.31 million / 125 million shares).

Diluted EPS is therefore calculated as $0.711 (($751.69 + $48.31) / (1,000 + 125))

(c) *The disclosure of financial risk under HKFRS 7*

HKFRS 7.33 requires MG to disclose the financial instruments'

(a) exposure to risk and how it arises,

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk and

(c) any changes of (a) and (b) from the previous period.

The convertible bonds are at a fixed rate and subject to fair value interest rate risk, as an increase / decrease of the market interest rate will increase/decrease the fair value of the convertible bonds.

HKFRS 7.39(a) requires the preparation of a maturity analysis for the convertible bonds that shows the remaining contractual maturities, analysed by time bands showing the contractual undiscounted cash payments and allocated to the earliest period in which MG can be required to pay.

HKFRS 7.39(c) requires MG to describe in the financial statements how the management of MG manages the liquidity risk inherent in the items disclosed in the maturity analysis.

Answer 15

Classification of financial assets

GII's investments are both financial assets. According to HKFRS 9, financial assets are classified as measured at either amortised cost or fair value depending on:

1 the entity's business model for managing the financial assets and
2 the contractual cash flow characteristics of the financial assets.

In particular, a financial asset is measured at amortised cost where:

1 the asset is held within a business model where the objective is to hold assets in order to collect contractual cash flows

2 the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

For this purpose, interest is consideration for the time value of money and for the credit risk associated with the principal amount.

Embedded derivatives

Derivatives embedded within a host which is a financial asset within the scope of HKFRS 9 are not separated out for accounting purposes; instead the entire hybrid contract is accounted for as one and classified as measured at amortised cost or fair value through profit or loss in accordance with the guidelines above.

Application: convertible bonds

For the holder, convertible bonds are a financial asset within the scope of HKFRS 9. The standard requires that the holder analyses the instrument in its entirety (rather than split it into the host contract and conversion option, as was required under HKAS 39).

GII will be entitled to receive a contracted interest payment of $450,000 ($15 million × 6% / 2) on 31 December 20X8, 30 June 20X9, 31 December 20X9, 30 June 20Y0 and 31 December 20Y0 from the listed company. These contractual interest payments are not only consideration for the time value of money and credit risk; they are also linked to the value of the equity of the issuer of the bonds.

Therefore, the bonds should be classified as at fair value through profit or loss.

At initial recognition at 1 July 20X8, the financial asset will be measured at fair value.

After initial recognition, the asset will be measured at fair value with gains or losses recognised in profit or loss.

Application: deposit with commercial bank

The deposit is considered a financial asset classified as held at amortised cost.

The additional 3% interest is an example of an embedded derivative, however, as the host contract is a financial asset, the derivative is not separated out for the purposes of accounting and the entire hybrid contract is accounted for together.

Answer 16

(a) Deferred tax position at 31 December 20X7 accounted for in GP's consolidated financial statements:

Carrying amount of the printing machine at 31 December 20X7:

$20,000,000 × [1 – (4.5 years/16 years)] = $14,375,000

Tax base at 31 December 20X7:

$20,000,000 × [1 – (1 – 0.1) × (4.5 years/10 years)] = $11,900,000

Taxable temporary difference:

Carrying amount – tax base

= $14,375,000 – $11,900,000 = $2,475,000

Deferred tax liability:

$2,475,000 × 25%[1] = $618,750

1 Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the reporting date. 20X3 is the first profit-making year for GP, the company will have full tax exemption for 20X3 and 20X4, and then be subject to 50% reduction for 20X5 to 20X7 (i.e. 12%). Afterward, the tax rate is 25%. As the taxable temporary difference will be reversed after 20X7, the tax rate applied for deferred tax computation is 25%.

(b) Journal entries to record the deferred income taxes at 31 December 20X8 for GP's consolidated financial statements:

		$	$
DEBIT	Deferred tax – Statement of profit or loss	137,500	
CREDIT	Deferred tax liability		137,500

Carrying amount of the printing machine at 31 December 20X8:

$20,000,000 × [1 – (5.5 years/16 years)] = $13,125,000

Tax base at 31 December 20X8:

$20,000,000 × [1 – (1 – 0.1) × (5.5 years/10 years)] = $10,100,000

Taxable temporary difference:

Carrying amount – tax base

= $13,125,000 – $10,100,000 = $3,025,000

Deferred tax liability:

$3,025,000 × 25% = $756,250

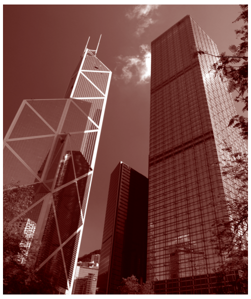
Increase in deferred tax liability in 20X8:

= $756,250 – $618,750 = $137,500

(c) Amount of deferred taxes to be shown on GP's consolidated statement of financial position at 31 December 20X8:

Deferred tax asset	$500,000
Deferred tax liability	$756,250

GP's deferred tax asset cannot be offset against the deferred tax liability of BP as the two entities' income taxes are NOT levied by the same taxation authority.


Glossary of terms

Accounting policies. The specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

Accounting profit. Profit or loss for a period before deducting tax expense.

Accrual basis. The effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

Acquiree. The business or businesses that the acquirer obtains control of in a business combination. Referred to in HKFRS 10 as the investee.

Acquirer. The entity that obtains control of the acquiree. Referred to in HKFRS 10 as the investor.

Active market. A market in which all the following conditions exist:

(a) The items traded in the market are homogenous
(b) Willing buyers and sellers can normally be found at any time; and
(c) Prices are available to the public.

Actuarial gains and losses comprise:

(a) Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred)

(b) The effects of changes in actuarial assumptions.

Amortised cost of a financial asset or financial liability. The amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

Antidilution. An increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of certain conditions.

Asset. Any tangible or intangible possession which has value. A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Asset ceiling is the present value of any economic benefits available in the form of refunds from a defined benefit pension plan or reductions in future contributions to the plan.

Assets. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.

Associate. An entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Borrowing costs. Interest and other costs incurred by an entity in connection with the borrowing of funds.

Break-up basis. Financial statements are prepared on the break-up basis where an entity is not assessed to be a going concern. Assets and liabilities may be measured and presented differently from in financial statements prepared on the going concern basis.

Carrying amount. The amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

Cash. Comprises cash on hand and demand deposits.

Cash equivalents. Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flow hedge. Hedge of the exposure to variability in cash flows that:

(a) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction (such as an anticipated purchase or sale), and that

(b) could affect profit or loss.

Cash flows. Inflows and outflows of cash and cash equivalents.

Cash generating unit. The smallest identifiable group of assets for which independent cash flows can be identified and measured.

Change in accounting estimate. An adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Close members of the family of a person. Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner
(b) children of that person's spouse or domestic partner; and
(c) dependants of that person or that person's spouse or domestic partner.

Closing rate. The spot exchange rate at the end of the reporting period.

Comparability. An enhancing qualitative characteristic. Information is more useful if it can be compared with similar information about other entities or the same entity for another period.

Consolidated financial statements. The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Construction contract. 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.

Constructive obligation. "An obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and

- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities."

Contingent asset. A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Contingent consideration. Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met.

Contingent liability

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or

(b) A present obligation that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) the amount of the obligation cannot be measured with sufficient reliability.

Contingent rent. That portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g. percentage of sales, amount of usage, price indices, market rates of interest).

Contingent share agreement. An agreement to issue shares that is dependent on the satisfaction of specified conditions.

Contingently issuable ordinary shares. Ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

Control. An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee.

Corporate governance. The system by which companies are directed and controlled.

Cost. The amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Cost plus contract. A **construction contract** in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

Costs to sell. The incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Current service cost. The increase in the present value of the defined benefit obligation resulting from employee service in the current period.

Current tax. The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Deferred tax assets. The amounts of income taxes recoverable in future periods in respect of:

- Deductible temporary differences
- The carry forward of unused tax losses
- The carry forward of unused tax credits

Deferred tax liabilities. The amounts of income taxes payable in future periods in respect of taxable temporary differences.

Defined benefit plans. Post-employment benefit plans other than defined contribution plans.

Defined contribution plans. Post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Depreciable amount. The cost of an asset, or other amount substituted for cost, less its residual value.

Depreciable assets. Assets which:

- are expected to be used during more than one accounting period.
- have a limited useful life.
- are held by an entity for use in the production or supply of goods and services, for rental to others, or for administrative purposes.

Depreciation. The systematic allocation of the depreciable amount of an asset over its useful life.

Derivative. A financial instrument or other contract with all three of the following characteristics:

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the "underlying")

(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

(c) It is settled at a future date.

Development. The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Dilution. A reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

Discontinued operation. A component of an entity that either has been disposed of or is classified as held for sale and:

(a) represents a separate major line of business or geographical area of operations

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) is a subsidiary acquired exclusively with a view to resale.

Disposal group. Group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. (In practice, a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

Dividends. Distributions of profit to holders of equity investments, in proportion with their holdings, of each relevant class of capital.

Economic life. Either the:

(a) Period over which an asset is expected to be economically usable by one or more users, or

(b) Number of production or similar units expected to be obtained from the asset by one or more users.

Effective interest method. A method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period. The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

Employee benefits. All forms of consideration given by an entity in exchange for service rendered by employees.

Entity specific value. The present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life, or expects to incur when settling a liability.

Equity. The residual interest in the assets of the entity after deducting all its liabilities.

Equity instrument granted. The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

Equity instrument. A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Equity method. A method of accounting whereby an interest in a jointly controlled entity is initially recorded at cost and adjusted thereafter for the post acquisition change in the venturer's share of net assets of the jointly controlled entity. The profit or loss of the venturer reflects the venturer's share of the profit or loss of the jointly controlled entity.

Event after the reporting period. Those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Exchange difference. The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate. The ratio of exchange for two currencies.

Expenses. Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Fair value. The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair value hedge. A hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and could affect profit or loss.

Fair value model. A property interest that is held by a lessee under an operating lease may be classified and accounted for as an investment property, if and only if the property would otherwise meet the definition of an investment property and the lessee uses the HKAS 40 fair value model. This classification is available on a property-by-property basis.

Fair value less costs to sell. The amount obtainable from the sale of an asset or cash generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Faithful representation. A fundamental qualitative characteristic. Financial information should faithfully represent the phenomena it purports to represent. To be a perfectly faithful representation, a depiction should be complete, neutral and free from error.

Finance lease. A lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

Financial asset. Any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is a:

  (i) non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

  (ii) derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Financial instrument. Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial liability. Any liability that is a:

(a) Contractual obligation to:

  (i) deliver cash or another financial asset to another entity

(ii) exchange financial instruments with another entity under conditions that are potentially unfavourable

(b) Contract that will or may be settled in the entity's own equity instruments and is a:

(i) non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Financing activities. Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Fixed price contract. A **construction contract** in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

Fixed production overheads. Defined by the standard as those indirect costs of production that remain relatively constant regardless of the volume of production such as depreciation and maintenance of factory buildings and equipment and the cost of factory management and administration. Fixed production overheads must be allocated to items of inventory on the basis of the normal capacity of the production facilities. Normal capacity is the expected achievable production based on the average over several periods/seasons, under normal circumstances, and taking into account the capacity lost through planned maintenance.

Foreign currency. A currency other than the functional currency of the entity.

Foreign operation. An entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Forgivable loans. Loans which the lender undertakes to waive repayment of under certain prescribed conditions.

Functional currency. The currency of the primary economic environment in which the entity operates.

Future economic benefit. The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

Gains. Increases in economic benefits. As such they are no different in nature from revenue.

Going concern. The entity is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Goodwill. An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually indentified and separately recognised.

Government. Government, government agencies and similar bodies whether local, national or international.

Government assistance. Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government grants. Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Grant date. The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the other party (the counterparty) the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

Grants related to assets. Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income. Government grants other than those related to assets.

Gross investment in the lease. The aggregate of:

(a) The minimum lease payments receivable by the lessor under a finance lease
(b) Any unguaranteed residual value accruing to the lessor

Group. A parent and all its subsidiaries.

Guaranteed residual value.

(a) For a lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable).

(b) For a lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Hedge effectiveness. The degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

Hedge of a net investment in a foreign operation. HKAS 21 defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation.

Hedged item. An asset, liability, firm commitment, or forecasted future transaction that:

(a) exposes the entity to risk of changes in fair value or changes in future cash flows, and that
(b) is designated as being hedged.

Hedging. For accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

Hedging instrument. A designated derivative or (in limited circumstances) another financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. (A non-derivative financial asset or liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.)

Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Identifiable. An asset is identifiable if it either:

(a) is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so.

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Impairment loss. The amount by which the carrying amount of an asset exceeds its recoverable amount.

Impracticable. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

Inception of the lease. The earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

(a) A lease is classified as either an operating lease or a finance lease

(b) In the case of a finance lease, the amounts to be recognised at the lease term are determined.

Income. Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Incremental costs. Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors. Examples of initial direct costs include amounts such as commissions, legal fees and relevant internal costs.

Initial direct costs. Incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors. Examples of initial direct costs include amounts such as commissions, legal fees and relevant internal costs.

Intangible asset. An identifiable non-monetary asset without physical substance.

Interest. The charge for the use of cash or cash equivalents or amounts due to the entity.

Interest cost. The increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

Interest rate implicit in the lease. The discount rate that, at the inception of the lease, causes the aggregate present value of the:

(a) minimum lease payments
(b) unguaranteed residual value

to be equal to the sum of:

(a) the fair value of the leased asset
(b) any initial direct costs.

Interim financial report. A financial report containing either a complete set of financial statements (as described in HKAS 1) or a set of condensed financial statements (as described in HKAS 34) for an interim period.

Interim period. A financial reporting period shorter than a full financial year.

Intrinsic value. The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the other party is (or will be) required to pay for those shares. For example, a share option with an exercise price of $15 on a share with a fair value of $20, has an intrinsic value of $5.

Inventories. Assets:

- held for sale in the ordinary course of business
- in the process of production for such sale
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Investing activities. The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Investment entity. An entity which:

- obtains funds from one or more investors for the purpose of providing those investors with investment management services
- commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both, and
- measures and evaluates the performance of substantially all of its investments on a fair value basis.

Investment property. Property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes
(b) sale in the ordinary course of business.

Joint arrangement. An arrangement of which two or more parties have joint control.

Joint control. The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Joint operation. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

Joint operator. A party to a joint operation that has joint control of that joint operation.

Joint venture. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

Joint venturer. A party to a joint venture that has joint control of that joint venture.

Key management personnel. Those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Lease. An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Lease term. The non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Lessee's incremental borrowing rate of interest. The rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Liability. A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Liquidation. The "end of the road" for the company. It occurs when it is certain that the life of the company will come to an end. The process by which this occurs is called winding up. You can use the terms "liquidation" and "winding up" to mean broadly the same thing. However, the company does not have to be in financial difficulties to be wound up. The members of the company may decide at any time to take such action, and in some cases are obliged to do so (for example, if the company were set up to achieve a specific purpose and this has been fully achieved, there is no reason for the company to go on trading).

Liquidity. The availability of sufficient funds to meet deposit withdrawals and other short-term financial commitments as they fall due.

Losses. Decreases in economic benefits. As such they are no different in nature from other expenses.

Material. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Measurement. The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of comprehensive income.

Measurement date. The date at which the fair value of the equity instruments granted is measured. For transactions with employees and others providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

Measurement period. The measurement period is that period of time immediately after the acquisition date when the acquirer may still be obtaining the information needed to identify and measure each element of the goodwill calculation. It ends on the earlier of the date when all information sought by the acquirer is either obtained or found to be unavailable and 12 months from the acquisition date.

Minimum lease payments. The payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and be reimbursable to the lessor, together with:

(a) For a lessee, any amounts guaranteed by the lessee or by a party related to the lessee.

(b) For a lessor, any residual value guaranteed to the lessor by one of the following:

  (i) The lessee
  (ii) A party related to the lessee
  (iii) An independent third party financially capable of meeting this guarantee.

Monetary items. Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Multi-employer plans. Defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

(a) pool the assets contributed by various entities that are not under common control

(b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

Net defined benefit liability (asset). The deficit or surplus when the fair value of pension plan assets is deducted from the present value of the defined benefit obligation, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

Net investment in a foreign operation. The amount of the reporting entity's interest in the net assets of that operation.

Net investment in the lease. The gross investment in the lease discounted at the interest rate implicit in the lease.

Net realisable value. The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Non-cancellable lease. A lease that is cancellable only in one of the following situations:

(a) Upon the occurrence of some remote contingency.

(b) With the permission of the lessor.

(c) If the lessee enters into a new lease for the same or an equivalent asset with the same lessor.

(d) Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

Non-controlling interest. The equity in a subsidiary not attributable, directly or indirectly, to a parent.

Non-current asset. An asset intended for use on a continuing basis in the entity's activities, i.e. it is not intended for resale.

Obligation. A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

Off-balance sheet finance. The funding or refinancing of a company's operations in such a way that, under legal requirements and traditional accounting conventions, some or all of the finance may not be shown in its statement of financial position.

Onerous contract. A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

Operating activities. The principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Operating lease. A lease other than a finance lease.

Operating segment. A component of an entity:

(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),

(b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(c) for which discrete financial information is available.

Options, warrants and their equivalents. Financial instruments that give the holder the right to purchase ordinary shares.

Ordinary share. An equity instrument that is subordinate to all other classes of equity instruments.

Other long-term employee benefits. Employee benefits (other than post-employment benefits and termination benefits) that are not due to be settled within 12 months after the end of the period in which the employees render the related service.

Owner-occupied property. Property held by the owner (or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

Parent. An entity that controls one or more entities.

Past service cost. The change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan).

Plan assets comprise:

(a) assets held by a long-term employee benefit fund
(b) qualifying insurance policies

Post-employment benefit plans. Formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.

Post-employment benefits. Employee benefits (other than termination benefits) which are payable after the completion of employment.

Potential ordinary share. A financial instrument or other contract that may entitle its holder to ordinary shares.

Power. Existing rights that give the current ability to direct the relevant activities.

Present value of a defined benefit obligation. The present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Present value. The present discounted value of the future net cash flows in the normal course of business.

Presentation currency. The currency in which the financial statements are presented.

Prior period errors. Omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Property, plant and equipment. Tangible items that are:

- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
- expected to be used during more than one period

Prospective application of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:

- applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed
- recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

Provision. A liability of uncertain timing or amount. A present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated.

Qualifying asset. An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Realisable (settlement) value

- **Realisable value**. The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
- **Settlement value**. The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Recognition. The process of incorporating in the statement of financial position or statement of comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

(a) It is probable that any future economic benefit associated with the item will flow to or from the entity.

(b) The item has a cost or value that can be measured with reliability.

Recoverable amount. The higher of an asset's fair value less costs to sell and its value in use.

Related party. is A person or entity that is related to the entity that is preparing its financial statements.

Related party transaction. A transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Relevance. 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.

Relevant activities. Activities of the investee that significantly affect the investee's returns.

Remeasurements of the net defined benefit liability (asset) comprise:

(a) actuarial gains and losses

(b) the return on plan assets, excluding amounts included in net interest on the defined benefit liability (asset); and

(c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Reporting entity. An entity for which there are users who rely on the financial statements as their major source of financial information about the entity.

Research. Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Residual value. The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Restructuring. A programme that is planned and controlled by management and materially changes either:

- the scope of a business undertaken by an entity, or
- the manner in which that business is conducted

Retrospective application. Applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Retrospective restatement. Correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

Return on plan assets. Interest, dividends and other revenue derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less any cost of administering the plan (other than those included in the actuarial assumptions used to measure the defined benefit obligation) and less any tax payable by the plan itself.

Revaluation. Restatement of assets and liabilities.

Revenue. The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Royalties. Charges for the use of non-current assets of the entity, e.g. patents, computer software and trademarks.

Service concession arrangements. Arrangements whereby a government or other body grants contracts for the supply of public services – such as roads, energy distribution, prisons or hospitals – to private operators.

Share option. A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

Share-based payment arrangement. An agreement between the entity (or another group entity) and another party (including an employee) that entitles the other party to receive:

(a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or

(b) equity instruments (including shares or share options) of the entity or another group entity provided the specified vesting conditions are met.

Share-based payment transaction. A transaction in which the entity:

(a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

Short-term employee benefits. Employee benefits (other than termination benefits) that are due to be settled within 12 months after the end of the period in which the employees render the related service.

Significant influence. The power to participate in the financial and operating policy decisions of an entity, but is not control or joint control over those policies. Significant influence may be gained by share ownership, statute or agreement.

Solvency. The availability of cash over the longer term to meet financial commitments as they fall due.

Spot exchange rate. The exchange rate for immediate delivery.

Subsidiary. An entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

Substance over form. The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Tax base of an asset or liability. The amount attributed to that asset or liability for tax purposes.

Tax expense/(tax income). The aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Taxable profit/(tax loss). The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Temporary differences. Differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

- **Taxable temporary differences,** which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

- **Deductible temporary differences,** which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Termination benefits. Employee benefits payable as a result of either an:

(a) entity's decision to terminate an employee's employment before the normal retirement date
(b) employee's decision to accept voluntary redundancy in exchange for those benefits

Timeliness. An enhancing characteristic which means having information available in time to be capable of influencing decisions.

Understandability. An enhancing qualitative characteristic. Classifying, characterising and presenting information clearly and concisely makes it understandable.

Unearned finance income. The difference between the:

(a) gross investment in the lease
(b) net investment in the lease

Unguaranteed residual value. That portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Useful life. One of two things:

- The period over which an asset is expected to be available for use by an entity.
- The number of production or similar units expected to be obtained from the asset by an entity.

Useful life. The estimated remaining period, from the beginning of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Value in use. The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Variable production overheads. Those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and labour.

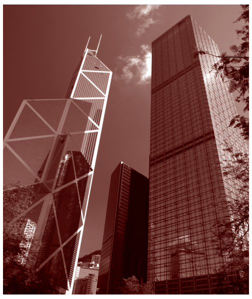
Verifiability. An enhancing qualitative characteristic. Different knowledgeable and independent observers could reach consensus that a depiction is a faithful representation.

Vest. To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets, or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any **vesting conditions**.

Vested employee benefits. Employee benefits that are not conditional on future employment.

Vesting conditions are the conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or **equity instruments** of the entity, under a **share-based payment arrangement**. Vesting conditions are either service conditions or performance conditions. Service conditions require the counterparty to complete a specified period of service. Performance conditions require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). A performance condition might include a market condition.

Vesting period. The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.


Index

Note: **Key Terms** and their page references are given in **bold**

A

B

C

D

I

J

Notes

Notes

Notes

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