Qualification Programme

Module A: Financial Reporting

FOURTH EDITION

CPA Hong Kong Institute of Certified Public Accountants
香港會計師公會

Hong Kong's CPA Qualification
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Qualification Programme

Module A

Financial Reporting

Flashcards

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Welcome to the HKICPA Flashcards for **Module A Financial Reporting**.

- They concentrate on the key topics you need for your exam preparation.
- They include **diagrams** to assist your memory.
- They follow the overall **structure** of HKICPA Learning Packs, but these Flashcards are not just a summarised book. Each card has been separately designed for clear presentation. Topics are self contained and can be grasped visually.
- The Flashcards are **just the right size** for pockets, briefcases and bags.

Run through the **Flashcards** as often as you can during your final revision period. The day before the exam, try to go through the **Flashcards** again! You will then be well on your way to passing your exams.

Good luck!

Overall structure of Module A

Part A Legal Environment

Part B Financial Reporting Framework

Part C
Accounting for Business Transactions

I. Statements of Financial Position and Profit or Loss and Other Comprehensive Income

II. Statements of Cash Flows

III. Disclosure & Reporting

Part D
Group Financial Statements

1: Legal environment

Topic List

You should be aware of the legal framework and related implications for business activities.

Forms of organisation

Advantages

Sole trader

- Quick and easy to set up
- No filing of accounts

Partnerships

- No filing of accounts
- Greater access to capital
- Spread of partners' skills
- Shared risk

Companies

- Limited liability
- Separated ownership/management
- Better access to finance
- Ownership easily transferred

Joint ventures

- Shared risk
- Necessary for entry into some overseas markets

Disadvantages

Sole trader:

- Sole trader is personally liable for losses

Partnerships:

- Disputes
- Partners are jointly and severally liable for losses

Companies:

- Costs of formalities, e.g. audit
- Public reporting
- Legal requirements

Establishing a company

Companies are established under the Companies Ordinance:

- private limited company, or
- public limited company

Corporate governance

The system by which companies are directed and controlled.

↓

In 2001 HKICPA published 'Corporate Governance disclosure in annual reports – a guide to current requirements and recommendations for enhancement'. This made recommendations to increase disclosure requirements, improve communication and increase transparency.

Directors

Duties and responsibilities

- Fiduciary duties
- Duty to exercise skill and care
- Responsibilities re financial reporting

Powers and obligations

Powers:

- Power to manage company
- No power to act individually as agents of company unless board delegate powers to individual directors

Obligations:

- Must comply with the duties and responsibilities identified above. If not, he may face civil/criminal proceedings and may be disqualified from being a director

Officers

Company secretary = chief administrative officer

- Link between company and Companies Registry
- Responsible for submitting returns and registering documents
- Arranges board meetings
- Arranges AGMs and EGMs
- Records minutes of meetings
- Maintains company's records
- Deals with liaison with members

Share issues

- Issued by allotment in private company
- Issued by renounceable allotment letter in public company

A public company seeking to raise money from general public must issue a prospectus.

Registration of charges

- Fixed and floating charges must be registered within 1 month of execution or they are void
- A fixed charge on land and buildings must be registered within 1 month
- Registration secures the position of the creditor
- On liquidation fixed charges rank ahead of floating

Auditors

- Appointed at AGM by members
- Special notice must be served where new auditors are appointed at the general meeting
- Auditors are removed by ordinary resolution
- Auditor can resign in writing at any time

Restructuring: Debt or capital may be restructured to reduce risk, reduce the cost of capital and increase liquidity

Liquidation: 'Winding up' – the end of the road for a company

Receivership: A receiver is appointed by creditors if a company has broken the conditions of a debenture in order to get their money back

2: Financial reporting framework

Topic List

The HKICPA's Conceptual Framework is vital as it underpins all HKFRS. When an accounting standard does not appear to provide guidance on a topic you may be required to fall back on the basic principles of the Conceptual Framework.

Regulatory bodies

HKICPA: statutory body which issues accounting and auditing standards and guidelines and administers and regulates HK accountants.

- HKFRSs (mandatory)
- HK(Int)s (mandatory)
- Accounting Guidelines (advisory)
- Accounting Bulletins (advisory)

SEHK: provides a fair, orderly and efficient market for the trading of securities.

- Main Board — The Listing Rules
- GEM Board — The GEM rules

SFC: independent body responsible for regulating and developing HK securities and futures markets.

FRC: independent body responsible for investigating listed entities, possible auditing and reporting irregularities and requiring them to remedy an identified non-compliance.

HKIA: regulatory body responsible for promoting the stability of the insurance industry and ensuring that policy holders' interests are protected.

HKMA: government authority responsible for maintaining monetary and banking stability in HK.

Sources of regulation

Companies Ordinance – legal requirements

HKFRSs
- converged with IFRSs
- HKAS 1-41
- HKFRS 1-13
- HKFRS for PEs

Conceptual Framework
- underlying concepts
- assist development of standards

Accounting Guidelines – guidance statements and indicators of best practice (AG1, 5, 7)

Accounting Bulletins – informative publications on subjects of topical interest (AB1, 3, 4)

Development
- Identify issues
- Examine existing guidance (eg industry practice)
- Consult SSSB about adding to the agenda
- Form an advisory group
- Issue discussion document
- Issue an exposure draft and basis for conclusions
- Consider comments
- Consider final standard
- Publish HKFRS with basis for conclusions

True and fair override If compliance with an HKFRS is misleading, it may be departed from and disclosure made of the fact.

Fundamental principles

All CPAs must comply with the following principles.

- **Integrity** – straightforward
  – honest
  – fair dealing
  – truthful
- **Objectivity** – unbiased
  – without conflict of interest
  – not unduly influenced by others
- **Professional competence and due care** – knowledge and skill at required level
- **Confidentiality** – respect the confidentiality of information
- **Professional behaviour** – comply with laws and regulations

Financial statements must meet the following criteria:

- Technical compliance
- Economic substance
- Full disclosure and transparency

Conceptual framework – a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

Advantages

- Avoids 'haphazard' or firefighting approach
- Less open to criticism of political/external pressure
- Some standards may concentrate on the statement of comprehensive income, others on the valuation of net assets

Disadvantages

- Financial statements are intended for a variety of users – single framework may not suit all
- May need different standards for different purposes
- Preparing and implementing standards is still difficult with a framework

GAAP signifies all the rules, from whatever source, which govern accounting.

Sources for individual countries

National company law, eg Companies Ordinance

National accounting standards, eg HKFRS

Local stock exchange requirements, eg HK Listing Rules

Non-mandatory sources

IFRSs

Other countries' statutory requirements

In many countries, such as the UK, GAAP does not have any statutory or regulatory authority or definition. GAAP is a dynamic concept.

Objective of financial statements

= to provide financial information that is useful to existing and potential investors, lenders and other creditors.

Useful information relates to:

Entity's economic resources **Claims against the entity**	**Changes in resources and claims**
Help users to assess: ■ Liquidity & solvency ■ Need for additional financing ■ Success in obtaining financing	Resulting from ■ Financial performance ■ Other events e.g. issuing debt/equity

Qualitative characteristics

FUNDAMENTAL

- **Relevance**

  Capable of making a difference in decisions made by users

  Materiality impacts relevance

- **Faithful representation**

  – complete
  – neutral
  – free from error

ENHANCING

- **Comparability**

  – including consistency

- **Verifiability**
  Direct or indirect agreement of faithful representation

- **Timeliness**
  Information should be available in time to be capable of influencing decisions

- **Understandability**
  Complex transactions are not excluded from financial statements

Underlying assumption: going concern

Elements

Position

- Assets
- Liabilities + Equity

Performance

- Income
- Expenses

Recognition

Probable that any future economic benefit associated with the item will flow to or from the entity

The item has a cost or value that can be measured with reliability

Probability = a degree of uncertainty that the future economic benefits will flow to or from the entity.

Measurement

Historical cost
(acquisition value)

Current cost (amount if acquired currently)

How should an item be valued?

Present value (present discounted value of future net cash inflows item expected to generate)

Realisable (settlement) value
(amount selling in current state)
– relevant to break-up basis accounts

Financial capital maintenance

Profit is earned if the financial amount of the net assets at the end of a period exceeds the financial amount of net assets at the beginning of a period after excluding any distributions to, and contributions from, owners during period.

Can be measured in either nominal monetary units or units of constant purchasing power.

Physical capital maintenance

Profit is earned if the physical productive capacity (or operating capacity) of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to and contributions from, owners during the period. This concept requires the current cost basis of measurement.

The selection of the measurement basis and concept of capital maintenance together determine the accounting model used.

Improved conceptual framework

- Project reactivated in 2012
- Discussion paper expected 2013; final chapters by 2015
- Outstanding topics:
  - Elements
  - Measurement
  - Reporting entity
  - Presentation and Disclosure

Management commentary

- Practice Statement has been issued
- Not an HKFRS and so non-binding
- Provides principles and characteristics which govern the preparation and presentation of management commentary

3: Small company reporting

Topic List

Hong Kong reporting system

SME–FRF and SME–FRS

HKFRS for private entities

Comparison with full HKFRSs

Smaller unlisted companies in Hong Kong have two simplified reporting options: the SME–FRS and the HKFRS for PEs.

	Can apply
Non-listed companies which meet criteria to use SME–FRF & FRS	– SME-FRF & FRS – HKFRS for PEs – Full HKFRS
Non-listed companies which do not meet criteria to use SME-FRF & FRS	– HKFRS for PEs – Full HKFRS
Publicly listed companies	– Full HKFRS

SME-FRF & SME-FRS

Entities that qualify for reporting under the SME-FRF and preparing financial statements in accordance with the SME-FRS include:

New Companies Ordinance Hong Kong companies

- Apply Reporting Exemption
- Meet size test
- All members agree to apply Reporting Exemption (s. 359 (1)(b))

Overseas companies

- No public accountability
- Meet size test
- All owners agree to apply the SME-FRS

Hong Kong companies

- Apply s.359 of new Companies Ordinance

Size test: Should meet any two of the following size criteria for two consecutive periods as determined by reference to new CO Schedule 3 section 1:

- annual revenue $\leq$ \$100 million
- total assets $\leq$ \$100 million
- employees $\leq$ 100 employees

For a company applying the new Hong Kong Companies Ordinance (New Companies Ordinance), compliance with the SME-FRF and SME-FRS is necessary in order for financial statements to give a true and correct view.

Switching between the full HKFRS and the SME-FRS

The transition from the Full HKFRS to the SME-FRS is treated as a change of accounting policies under the SME-FRS. When switching from the SME-FRS to the Full HKFRS, for the first set of financial statements prepared after switching, HKFRS 1 "First time adoption of Hong Kong Financial Reporting Standards" is to be applied. As switching between the Full HKFRS and the SME-FRS would involve restatement of opening balances and comparative amounts, frequent switching will cause extra cost and effort. Accordingly, before deciding to switch to the SME-FRS, an entity should consider the likelihood that it could adopt the SME-FRS for a sufficiently long period.

The HKFRS for PEs can be used by companies that:

- do not have public accountability
- publish general purpose financial statements for external users

Public accountability

An entity is publicly accountable if:

- its debt/equity instruments are traded in a public market
- it holds assets in a fiduciary capacity as a primary business e.g. banks

Subsidiaries

Subsidiaries of a group applying full HKFRS can use the HKFRS for PEs if eligible

The HKFRS for PEs is
- self-contained
- < 10% volume of full HKFRSs
- organised by topic

Entities applying HKFRS for PEs may not use full HKFRSs other than the recognition and measurement rules of HKAS 39.

The HKFRS for PEs	Examples
1. Simplifies requirements	– R & D costs are expensed immediately – Borrowing costs are expensed immediately – All PPE is held using the cost model – There is no classification of non-current assets held for sale

2. Omits certain topics not relevant to private entities	– Earnings per share – Interim reporting – Segment reporting
3. Omits certain accounting options	– The revaluation model for PPE – Measurement of the NCI at fair value – Capitalisation of borrowing costs
4. Simplifies disclosure	– Majority of HKFRS 7 disclosures not required – No fair value disclosures for PPE – No disclosure of estimates used to measure recoverable amounts for CGUs including goodwill

Comparison with full HKFRSs

Property, plant and equipment	▪ Revaluation model not an option ▪ PPE carried at cost less acc. depn and impairment
Intangible assets	▪ Revaluation model not an option ▪ Intangible assets carried at cost less acc. amortisation and impairment
Borrowing costs	▪ Capitalisation model not allowed ▪ All borrowing costs to be expensed
Jointly controlled entities	▪ No proportionate consolidation*
Government grants	▪ Some options excluded ▪ Only single simplified method retained
Investment property	▪ Measurement driven by circumstances
Financial instruments	▪ Available-for-sale and held-to-market categories unavailable

Omitted topics

Earnings per share
Interim financial reporting
Segment reporting
Special accounting for assets held for sale

*Under HKFRS 11 *Joint Arrangements*, proportionate consolidation is no longer allowed

4: Non-current assets held for sale and discontinued operations

Topic List

- Non-current assets held for sale
- Discontinued operations

The measurement requirements for non-current assets held for sale are particularly important.

Non-current assets/disposal groups are held for sale when their carrying amount will be recovered principally through a sale rather than through continuing use.

- The asset (or disposal group) must be available for immediate sale in its present condition and
- The sale must be highly probable.
  For this to be the case:
  - **Management** must be **committed** to a plan to sell
  - An **active programme** to **locate a buyer** must have been initiated
  - The asset (or disposal group) must be **actively marketed** for sale at a price that is reasonable in relation to its current fair value
  - The sale should be expected to take place **within one year**
  - It is **unlikely** that **significant** changes to the plan will be made or that the plan will be withdrawn

Measurement

An entity must measure a non-current asset or disposal group classified as held for sale at the **lower of**:

- Carrying amount
- Fair value less costs to sell.

Immediately before initial classification, measure asset per applicable HKFRS. Any impairment loss accounted for as normal.

Non-current assets/disposal groups classified as held for sale are **not depreciated**.

Presentation

Assets and disposal groups (including associated liabilities) classified as held for sale are presented:

- On the face of the statement of financial position
- Separately from other assets and liabilities
- Normally as **current** assets and liabilities (not offset)
- Assets held for distribution to owners: when entity is committed
- Assets to be abandoned: not classified as held for sale

Definitions

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
Component of an entity	Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity

Presentation

- Single amount on SPLOCI comprising post tax profit/loss of discontinued operations plus post tax gain or loss on disposal of discontinued operations or on remeasurement to FV less costs to sell
- Analysis of single amount either in SPLOCI or in notes

Pro forma disclosure

XYZ GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1

	20X1	*20X0*
	$'000	$'000
Continuing operations		
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year from continuing operations	X	X
Discontinued operations		
Profit for the year from discontinued operations	X	X
Profit for the year	X	X
Profit attributable to		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

5: Property, plant and equipment

Topic List

HKAS 16

Non-current assets form a large part of many entities' financial statements. You may need to think critically and deal with controversial issues.

HKAS 16 *Property, plant and equipment* covers all aspects of accounting for tangible non-current assets.

Probable that future economic benefits associated with the assets will flow to the entity.

Recognition

Cost of asset can be reliably measured.

Initial measurement

Purchase price

Import duties

Non-refundable purchase taxes

LESS

Trade discounts/rebates

Directly attributable costs

Site preparation

Delivery/handling

Testing

Professional fees

Other costs

Estimate of unavoidable dismantling/removal costs and site restoration (HKAS 37)

Finance costs (HKAS 23)

Subsequent expenditure

Same criteria as initial costs. Otherwise do not capitalise but charge to statement of profit or loss.

Subsequent measurement

Cost model

- Cost less accumulated depreciation and accumulated impairment losses

Revaluation model

- Revalued amount (fair value at the date of revaluation) less subsequent accumulated depreciation and impairment losses
- Revalue sufficiently regularly so carrying amount not materially different from fair value
- All items of same class should be revalued

Depreciation

- Systematic basis over useful life reflecting pattern of use of asset's economic benefits
- Annual review of useful life and depreciation method and any change accounted for as change in accounting estimate

Revaluation model: Changes in value

- Surplus
  - Recognise as other comprehensive income and credit to revaluation surplus*
- Impairment
  - To extent of any revaluation surplus for same asset
    - Charge to other comprehensive income
  - Beyond revaluation surplus
    - Charge to profit or loss

*Unless reversing a previously recognised revaluation decrease of the same asset, in which case recognise as income to the extent of reversal of the previous decrease.

Disclosure

All PPE

- Depreciation methods
- Useful lives
- Reconciliation of gross carrying amount and accumulated depreciation at beginning and end of period
- Recoverable amounts of PPE
- Commitments to acquisitions
- Restrictions on title
- Accounting policy for restoration/dismantling costs

Revalued PPE

- Basis of revaluation
- Date of revaluation
- Whether an independent valuer was involved
- Carrying amount of assets if at historic cost
- Revaluation surplus + restrictions on distribution

Notes

6: Investment property

Topic List

HKAS 40

Land and buildings may be held as an investment to generate income and cash flows. HKAS 40 applies.

HKAS 40

An *investment property* is property (land or building) 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
- sale in the ordinary course of business

Accounting treatment

- Choice of *fair value model* or *cost model*
- *Fair value model*
  - Revalue to fair value at each accounting date
  - Do not depreciate
  - Gain or loss to profit or loss
- *Cost model*
  - Follow cost model of HKAS 16

Note. Leasehold investment properties are accounted for as finance leases

Exceptions

Owner-occupied property or property held for sale to or being constructed for third parties are not investment property (HKAS 16, HKAS 2, HKAS 11 respectively).

Disclosures

- Criteria for classification
- Assumptions in determining fair value
- Use of independent professional valuer
- Rental income and expenses
- Any restrictions or obligations

7: Government grants

Topic List

HKAS 20

We continue our study of non-current assets with a look at HKAS 20 dealing with government grants.

Grants related to income

Either show as credit in the statement of profit or loss (other income) or deduct in reporting the related expense.

Grants related to assets

Treat as deferred income and credit to profit or loss on systematic rational basis over useful life of asset OR deduct grant in arriving at carrying value of asset and recognise as income over asset’s life by means of reduced depreciation charge.

Disclose:

- Accounting policy
- Nature and extent of grants recognised & other government assistance
- Unfulfilled conditions and other contingencies relating to grants recognised

Recognise only when reasonable assurance that any conditions will be met and monies received.

8: Intangible assets and impairment of assets

Topic List

- HKAS 38
- Goodwill
- HKAS 36

Impairment of assets is relevant in the current economic climate and many companies are accounting for impairments.

Definition

An intangible asset is an identifiable non-monetary asset without physical substance which is:

- controlled by an entity due to past events
- something from which future economic benefits are expected to flow

Identifiable

- Separable, or
- Arises from contractual or other legal rights

Controlled

Skilled staff and market share are not controlled, so are not intangible assets in the SOFP

Future economic benefits

- Revenue
- Cost savings
- Other benefits

	Recognition	Initial measurement	Subsequent measurement
General rule	Recognise an intangible if: ■ probable economic benefits will flow to the entity ■ cost can be measured reliably	Cost	Either **COST MODEL** Cost less amortisation less impairment losses or **REVALUATION MODEL** Fair value at revaluation date less subsequent amortisation & impairment losses
Separately acquired intangibles	Meet recognition criteria	Purchase price + directly attributable costs	
Intangibles acquired as part of a business combination	Recognise separately if fair value can be reliably determined	Fair value at date of acquisition	
Internally generated intangibles	Apply R&D rules Never recognise goodwill, brands, mastheads, publishing titles, customer lists or similar	Cost	

INTERNALLY GENERATED INTANGIBLE ASSETS

Research phase

Recognise as expense when incurred

Development phase

Capitalise and amortise if following conditions are met:

- P robable future economic benefits
- I ntention to complete and use/sell
- R esources adequate to complete and use/sell
- A bility to use/sell
- T echnical feasibility
- E xpenditure can be reliably measured

Recognise as expense when incurred otherwise

Measure initially at cost; i.e. the sum of costs incurred from the date when recognition criteria were first met.

Amortisation

Should be charged on a systematic basis over the useful life of the asset. Should commence when asset available for use. Period and method to be reviewed at each year end.

Intangibles with indefinite useful life are not amortised, but reviewed at least annually for impairment.

Impairments

The recoverable amount of the asset should be determined at least at each financial year end and any impairment loss accounted for in accordance with HKAS 36.

Revaluations

Revalued amount is fair value at date of revaluation by reference to an active market.

All other assets in the same class should be revalued unless there is no active market for them, in which case the cost model value should be used for those assets.

Revaluations so that the carrying value does not differ materially from fair value.

Disclosures

- Useful lives of assets and amortisation methods
- Gross carrying amount and accumulated amortisation and impairment losses at start and end of period and a reconciliation between the two
- The carrying amount of internally generated intangibles
- Details of intangibles with an indefinite life
- Details of revalued intangibles (date of revaluation, historic cost, carrying amount, etc)

HKFRS 3: Purchased goodwill

Bargain purchase

Arises when acquiree's identifiable net assets exceed the cost of the combination. Results from **errors** or a **bargain**.

Reassess cost of combination and assets.

Recognise **any remaining** balance **immediately** in **profit or loss**.

Goodwill

Future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

Recognise as an asset and measure at excess of value of acquiree over book value of net assets.

Do **not amortise**.

Test at least annually for **impairment** (HKAS 36).

You may be asked for a complicated calculation of goodwill as part of a group accounts question.

Indicators of impairment

A review for impairment is carried out annually for goodwill, intangibles with indefinite useful lives and intangibles not yet available for use. Otherwise, a review should be carried out if events or changes in circumstances indicate that the carrying amount of the non-current asset or goodwill may not be recoverable.

External indicators

- Fall in market value
- Change in technological, legal or economic environment
- Increase in market interest rate likely to affect discount rates
- Carrying amount of entity's net assets > market capitalisation

Internal indicators

- Obsolescence or physical damage
- Adverse changes in use
- Adverse changes in asset's economic performance

An impairment review involves determining recoverable amount and comparing this with carrying amount.

Recoverable amount = higher of

FV less costs to sell

Amount obtainable from the sale of an asset in arm's length transaction less cost of disposal

Value in Use (VIU)

PV of estimated future cash flows expected to arise from the continuing use of an asset and its disposal at the end of its useful life

Cash flows

- Based on reasonable assumptions
- Maximum period of 5 years
- Apply steady or declining growth rate

Discount rate

Use current pre-tax rate that reflects time value of money and risks specific to the asset

Where a single asset cannot be tested, test a cash generating unit.

Impairment loss =

Carrying amount - Recoverable amount

- For an asset held at historic cost, recognise in profit or loss
- For an asset held at revalued amount, recognise against revaluation surplus with excess in profit or loss
- For a CGU allocate to:

  (1) Goodwill, then
  (2) Other assets on pro rata basis

Reversal of an impairment loss =

only where there has been a change in estimates used to determine recoverable amount.

- Increase carrying amount of asset to new recoverable amount and recognise as income
- Carrying amount cannot be higher than carrying amount had no impairment taken place

Allocate reversal to assets in a CGU pro rata to their carrying amount, except for goodwill.

Disclosure

- The amount of impairment losses recognised in the statement of profit or loss and other comprehensive income during the period and the line items affected
- The amount of impairment loss reversals recognised in the statement of profit or loss and other comprehensive income during the period and the line items affected
- For each material loss recognised or reversed in period:
  - The events and circumstances
  - The amount
  - The nature of the asset or cash generating unit
  - For initial losses whether recoverable amount is FV less costs to sell or VIU (and details of basis of selling price or discount rate as appropriate)

Notes

9: Leases

Topic List

Leasing transactions are common in practice and you may come across them in both a business and personal capacity.

HKAS 17: A lease is an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time.

At inception a lease is classified as:

Finance lease
A lease that transfers substantially all the risks and rewards of ownership to the lessee

Operating lease
A lease other than a finance lease

Risks: Losses from idle capacity, technological obsolescence or changing economic conditions

Rewards: Profitable operation of asset over its life, unrestricted access, gain from appreciation in value

LAND & BUILDINGS: Classify each element separately.

	Accounting treatment	**Disclosure**
Operating leases	Total rentals net of any incentive charged to profit or loss on straight line basis over lease term unless another systematic/ rational basis is justified	■ Future minimum lease payments under non-cancellable operating leases split < 1 yr, 2–5 yrs, > 5 yrs ■ Lease payments recognised as expense in period
Finance leases	1 Recognise asset & liability at lower of FV and PV of minimum lease payments 2 Depreciate asset over shorter of lease term and useful life 3 Record lease payments allocated between interest & repayment of capital using actuarial method	■ Net carrying amount of leased assets at year end ■ Reconciliation of minimum lease payments and PV ■ Total minimum lease payments & PV for < 1 yr, 2–5 yrs, > 5 yrs ■ Contingent rents recognised as expense ■ Future minimum sublease payments

	Accounting treatment	Disclosure
Operating leases	1 Asset recorded in SOFP and depreciated over useful life 2 Income net of incentives recognised in profit or loss on straight line basis unless another systematic basis is more representative	■ Gross carrying amount, accumulated depreciation and impairment losses at year end ■ Amounts recognised in income for: depreciation, impairment losses and reversals, contingent rents ■ Future minimum lease payments under non-cancellable leases split < 1 yr, 2–5 yrs, > 5 yrs
Finance leases	1 Recognise receivable equal to net investment in lease 2 Recognise finance income to reflect constant periodic rate of return on net investment outstanding	■ Reconciliation of gross investment in lease & PV of minimum lease payments receivable at year end ■ Total gross investment in lease & PV of minimum lease payments for < 1 yr, 2–5 yrs, > 5 yrs ■ Unearned finance income, unguaranteed residual values, allowance for uncollectible receivables, contingent rents in income

Sale and leaseback transactions

- If leaseback is a finance lease, defer book profit/ loss and amortise over lease term

Interpretations

- HK(SIC)Int-27: Accounting for lease arrangements should reflect substance – a sale and finance leaseback may be a secured loan in substance
- HK(IFRIC)Int-4: Provides criteria which indicate when the substance of an arrangement is a lease even where legally it is not

- If leaseback transaction is an operating lease; where SP = sales proceeds; FV = fair value:
  - If SP = FV (an arm's length transaction), recognise any profit/loss immediately
  - If SP < FV, recognise profit/loss immediately *unless* the apparent loss is compensated by future rentals at below market price, in which case defer and amortise
  - If SP > FV, defer the excess over FV and amortise over lease term (ie only recognise FV minus Book Value immediately)

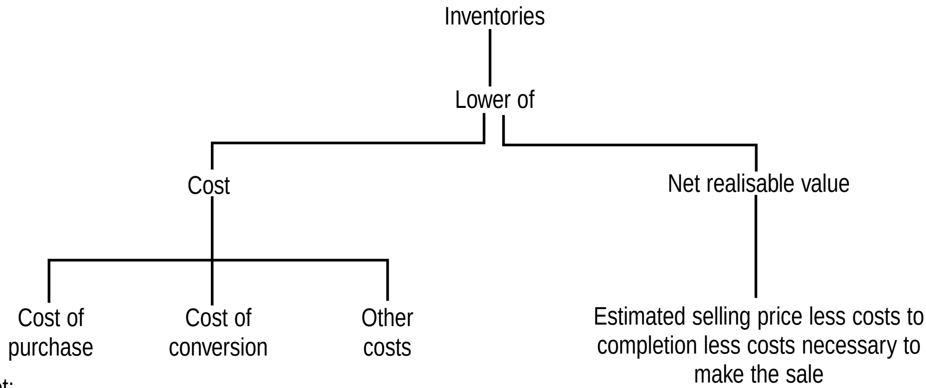
Notes

10: Inventories

Topic List

Accounting for inventories

Inventory has a direct impact on a company's gross profit. It is therefore an important subject area.



Not:

- Abnormal amounts
- Storage costs
- Admin overheads
- Selling costs

Measurement of cost

HKAS 2 suggests 2 techniques:

1. Standard cost
2. Retail method (selling price – profit margin)

Cost formulae

- Non-interchangeable items: identify specific cost
- Interchangeable items: use FIFO or weighted average. LIFO is not allowed

Disclosure

- Accounting policies for measuring inventories
- Carrying amount of inventories, subclassified as appropriate
- Carrying amount of inventories measured at FV less costs to sell
- Inventories recognised as an expense/write down of inventories recognised as an expense
- Reversals of previous writedowns of inventories
- Circumstances leading to reversals of write downs
- Carrying amount of inventories pledged as security

Notes

11: Provisions, contingent liabilities and contingent assets

Topic List

HKAS 37

You must learn the recognition criteria for provisions and be able to apply them.

HKAS 37

A provision is recognised when:

(1) Entity has legal or constructive present obligation

(2) Transfer of benefits is *probable*

(3) Reliable estimate can be made of amount
- For a single obligation use best estimate
- For a large population of items use expected values

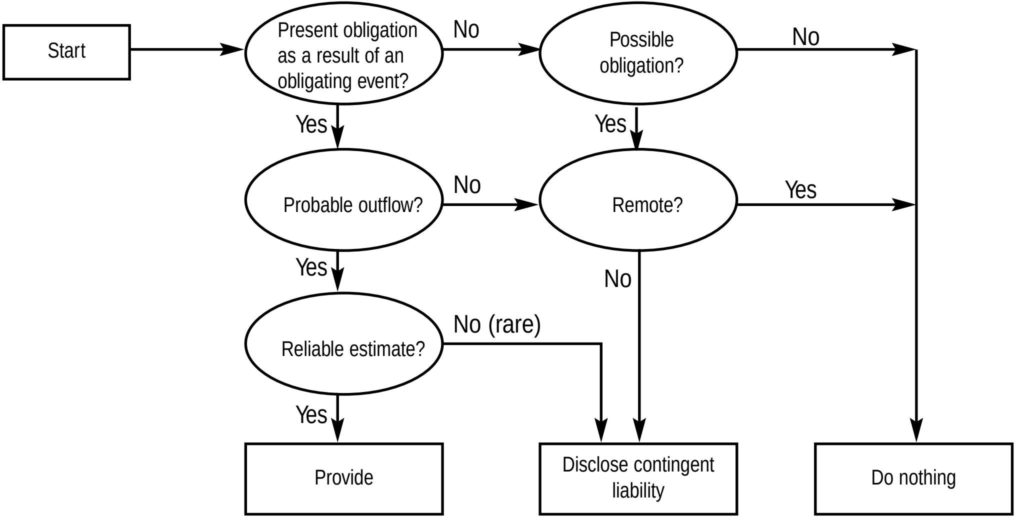
Provision = liability of uncertain timing or amount

Examples

- Future operating losses – do not provide
- Onerous contracts – provide
- Restructuring costs – provide for direct expenditure if present obligation

Contingent liability
should be disclosed unless the possibility of any outflow of economic benefits to settle it is remote

Contingent asset
should be disclosed where an inflow of economic benefits is probable


Start
Present obligation as a result of an obligating event?
No
Possible obligation?
No
Yes
Yes
Probable outflow?
No
Remote?
Yes
Yes
No
Reliable estimate?
No (rare)
Yes
Provide
Disclose contingent liability
Do nothing

Notes

12: Construction contracts

Topic List

Long term construction contracts are an everyday part of business in many industry sectors. You should be able to advise a client how this type of contract is accounted for.

Construction contracts

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 use

Cost plus contract
Contract price = defined costs plus percentage of costs or fixed fee

Fixed price contract
Contract price agreed; may be subject to cost escalation clauses

Contract revenue

- amount in contract
- variations, claims & incentive payments which will probably be paid & can be reliably measured

Contract costs

- direct costs of contract
- general contract costs allocated
- other costs chargeable to customer

Reliable estimate of outcome

When:

- Probable that economic benefits will flow
- Contract costs can be measured reliably
- Contract revenue can be measured reliably (fixed cost contracts)
- Stage of completion and costs to completion can be reliably measured (fixed cost contracts)

Profitable contracts

Contract revenue & costs are recognised in profit or loss by reference to stage of completion, calculated as:

- $\dfrac{\text{costs to date}}{\text{total estimated costs}} \times 100\%$
- $\dfrac{\text{work certified}}{\text{contract price}} \times 100\%$
- physical proportion completed

No reliable estimate of outcome

- Recognise costs as incurred
- Recognise revenue to extent costs are recoverable
- No profit no loss

Loss making contracts

Recognise loss in full as soon as foreseen.

Disclosure

Statement of profit or loss

Revenue (x% × total contract revenue)	X
Expenses (x% × total contract cost)	(X)
	X
Expected loss	(X)
Recognised profit/loss	X

Statement of financial position

Gross amount due from/to customers	
Contract costs incurred	X
Recognised profits less recognised losses	X
	X
Less progress billings to date	(X)
	X/(X)
Trade receivables	
Progress billings to date	X
Less cash received	(X)
	X

The following, not covered above, must also be disclosed under HKAS 11:

- Methods used to determine contract revenue
- Methods used to determine stage of completion of contracts in progress
- Amount of advances received
- Amount of any retentions (progress billings not paid until the satisfaction of certain conditions)

Notes

13: Share-based payment

Topic List

Types of share-based payments

Accounting

Further issues

HKFRS 2 is relevant as share option schemes are common, and this is a controversial topic.

Share-based payments

are transactions whereby entities purchase goods and services from other parties, such as suppliers and employees, and provide payment by issuing shares or share options.

HKFRS 2 deals with three types of share-based payment transactions.

- **Equity-settled** share-based payment transactions: the entity receives goods or services as consideration for **equity instruments** of the entity (including shares or share options).
- **Cash-settled** share-based payment transactions: the entity acquires goods or services in exchange for an amount of cash based on the price (or value) of the entity's shares or other equity instruments.
- **Choice of equity/cash settled**: entity or supplier can choose whether to settle the transaction in cash or equity instruments.

Equity-settled

Measurement

- Transaction with employees — Fair value of instruments granted at grant date
- Transaction with other parties — Fair value of goods/services received if reliable estimate available
  — Fair value of instruments granted at grant date otherwise

Recognition

- Instruments vest immediately — Account for transaction in full on grant date
- Instruments vest after a vesting period — Account for transaction over vesting period. Expense in each year is based on the best available estimate of the number of instruments expected to vest

Dr Expense/asset
Cr Equity

Cash-settled

Cash-settled share based payment transactions include share appreciation rights (SARs).

Measurement

- Measure goods/services acquired at fair value of liability
- Re-measure fair value of liability at each reporting date until settlement
- Recognise changes in fair value in profit or loss

Recognition

- Recognise transaction as entity receives services; this may be over a vesting period.

Choice of settlement

Counterparty has choice

Liability + equity component are identified and accounted for as cash settled/equity settled respectively

Entity has choice

- Recognise liability to extent there is present obligation to deliver cash
- otherwise treat as equity settled

Group cash-settled SBP transactions

Where one group entity (A) receives goods/services and another group entity (B) settles the SBP transaction, the transaction is recognised as equity settled by A only if:

- the awards granted are its own equity instruments
- it has no obligation to settle the transaction

The transaction is recognised as equity settled by B only if the transaction is settled in its own equity instruments.

Disclosure

Disclose information that enables users of the financial statements to

- understand the nature & extent of SBP arrangements
- understand how the fair value of the transaction was determined
- understand the effect of SBP transactions on performance and position

SBP transactions and deferred tax

A tax deduction is available when share options are exercised. If this is not in the same period as the accounting expense is recognised, a deferred tax asset arises.

Notes

14: Revenue

Topic List

You should be able to explain the recognition and measurement criteria of HKAS 18 and apply them in practice.

Revenue is the inflow of benefits which arises in the course of ordinary activities such as that from sales, services provided, interest, royalties and dividends.

Measurement

- **Fair value** of consideration received/receivable. Deferred amounts discounted
- In a sale financed by the seller, any difference between the fair value of the item and the nominal sales value should be accounted for as interest revenue
- In exchanges of similar goods there is no revenue
- In exchanges of dissimilar goods revenue is measured at fair value of goods/services received

Includes only those amounts receivable by the entity on its own account.

Revenue is recognised when the following criteria are met:

Goods

1 Transfer of significant risks and rewards of ownership (usually legal title)
2 No more control over goods sold
3 Amount of revenue can be reliably measured
4 Probable that economic benefits will flow
5 Transaction costs can be reliably measured

Services

- Conditions 3 to 5 as for goods, plus
- The stage of completion of the transaction at the year end can be measured reliably and a proportion applied to the revenue

- Interest – time proportion basis (effective yield)
- Royalties – accrual basis
- Dividends – when the right to the dividend is established

Disclosure

Accounting policy; the amount of each significant category of revenue; amount of revenue from exchange of goods or services.

Consignment sales →	One entity sells goods to another and the purchaser undertakes to sell the goods to a third party →	The first entity does not generally record a sale until the goods are sold to the third party
Bill and hold sales →	Purchaser of goods accepts legal title & billing but requests delivery is delayed →	Revenue is recognised when purchaser takes title provided that delivery is probable & normal payment terms apply
Sale & repurchase →	One entity sells an asset to another but the terms of sale provide for the asset to be repurchased at a later date →	Account for in accordance with commercial substance which is a secured loan if repurchase is probable

HK(IFRIC)Int-12 Service concession arrangements

Arrangements where a body (e.g. government) grants contracts for the supply of public services.

The operator has a financial asset where there is an unconditional guarantee of payment. This is recognised at fair value.

The operator recognises an intangible asset at fair value to the extent it has a right to charge users of the service.

HK(IFRIC)Int-13 Customer loyalty programmes

Programmes where customers buying goods receive credits, e.g. reward points.

Proceeds of sale is split into

- revenue
- deferred revenue measured at the FV of the credits awarded

The deferred revenue is recognised when the entity has supplied the awards associated with the credits/reward points.

HK(IFRIC)Int-15 Agreements for the construction of real estate

Applies where real estate developers sell units off plan.

Where the buyer can specify key elements of the design before and during construction, apply HKAS 11.

Where buyers can only influence limited elements of the design, apply HKAS 18.

Notes

15: Income taxes

Topic List

- Current tax
- Deferred tax
- Deferred tax & business combinations

Tax is relevant to all organisations and you must understand its operation in the financial statements.

Current tax: the amount payable to the tax authorities in relation to the trading activities of an entity.

HKAS 12 requires the following treatment of *current tax*.

- Recognise a liability for amount unpaid, relating to current and prior periods
- Recognise an asset for amounts overpaid/tax losses

If a transaction or event is charged or credited to other comprehensive income, the related tax should be also.

SPLOCI disclosure

Current tax	X
Under/(over) statement of prior periods	X/(X)
Deferred tax expense/(income)	X/(X)
	X

SOFP disclosure

- Tax assets and liabilities are shown separately from other assets and liabilities
- Tax assets and liabilities are only offset where there is a legally enforceable right and the amounts will be settled on a net basis

Taxable profits ≠ Accounting profits

Temporary differences
Revenue/expense items are included in both accounting and taxable profits but in different periods

Permanent differences
Revenue/expense items are excluded from computation of taxable profits

Deferred tax is attributable to temporary differences

Taxable temporary difference ↓ Carrying value of asset/liability > tax base ↓ Deferred tax liability	*Examples* ■ Accelerated tax depreciation ■ Capitalised development costs ■ Revaluations
Deductible temporary difference ↓ Tax base of asset/liability > carrying value ↓ Deferred tax asset	*Examples* ■ Retirement benefits costs ■ Unrelieved tax losses carried forward

Measurement

- Full provision method used (DT provided for on *all* temporary differences)
- Liability method applied, i.e. tax rates *enacted at year end* are applied to temporary differences in order to calculate deferred tax assets/liabilities
- Tax rate used may depend on intended manner of recovery of carrying amount of asset or liability (i.e. through sale or continued use)
  HKAS 12 includes a rebuttable presumption that the carrying value of investment properties held at fair value is recovered through sale
- DT assets and liabilities are not discounted

Recognition

- DT is recognised in profit or loss except where it relates to transactions recognised in other comprehensive income or equity. Here DT is also recognised in other comprehensive income or equity
- DT asset is recognised only to extent it is recoverable

Presentation in SOFP

- DT asset/liability broken down by type of temporary difference
- DT asset/liability offset in limited circumstances

Taxable temporary differences

- Unrealised losses on intra-group transactions
- Retained earnings of subsidiaries, branches, associates & JVs
- From changes in foreign exchange rates

Recognise DT liability unless

(1) Parent can control timing of reversal of temporary difference, and

(2) Probable that temporary difference will not reverse in foreseeable future

Deductible temporary differences

- Unrealised profits on intra-group transactions
- From changes in foreign exchange rates

Recognise DT asset provided that

(1) Temporary difference will reverse in foreseeable future, and

(2) Taxable profit will be available against which temporary difference can be utilised

Notes

16: Employee benefits

Topic List

HKAS 19

Post-employment benefits

It is important that there is a standard best practice for the way in which employee benefit costs are accounted for.

HKAS 19 was amended in 2011 to simplify the accounting for defined benefit plans.

HKAS 19

HKAS 19 *Employee Benefits* deals with all employee benefits, not just pensions.

Objectives

An entity should recognise an expense as it consumes the economic benefits of employee service in exchange for employee benefits and a liability where these are to be paid in the future.

Short term employee benefits

The cost of these benefits is recognised in the period in which the employee provides service on an accrual basis.

Termination benefits

Recognise as a liability and an expense at the earlier of:

(i) when the entity can no longer withdraw the offer of termination benefits

(ii) when the entity recognises costs for a restructuring that is within the scope of HKAS 37 and involves the payment of termination benefits.

Defined contribution plans

- A fixed contribution is paid to the plan each year
- The resultant benefit is unguaranteed and depends on how investments have performed

- Contributions are recognised as an expense in the period payable
- Accrual/prepayment may arise

Disclosure
- Description of plan
- Expense in period

Defined benefit plans

- A fixed benefit is paid on retirement
- Contributions will vary and are set at a level which is expected to result in sufficient returns to meet the obligation to pay a fixed benefit

Net defined benefit liability/asset is shown in SOFP:

PV of defined benefit obligation	X
Less: FV of plan assets	(X)
Net defined benefit liability (asset)	X/(X)

Changes in the PV of obligation and FV of plan assets are accounted for individually.

Defined benefit plans – accounting steps

(1) Determine the deficit or surplus	– use actuarial technique to estimate future obligation – discount obligation to present value – deduct fair value of plan assets.
(2) Determine amount of net defined benefit liability (asset)	– if surplus calculated in Step 1, may require adjustment for asset ceiling
(3) Determine amounts to be recognised in profit or loss	– current service cost – past service cost – gains or losses on settlements – net interest on net defined benefit liability (asset)
(4) Determine remeasurements to be recognised in other comprehensive income	– actuarial gains and losses – return on plan assets not included in net interest – change in effect of asset ceiling excluding amounts included in net interest.

Discount rate	In all cases the appropriate discount rate is determined by reference to market yields on high quality corporate bonds.
Asset ceiling	Where a plan is in surplus, the defined benefit asset is limited to the present value of future economic benefits in relation to the plan.
Current service costs	Increase in pension obligation due to employee service in the current period. Advised by actuary.
Past service costs	Change in pension obligation relating to employee service in prior periods due to amendments/curtailments. Advised by actuary.
Gains or losses on settlement	Arise where an employer eliminates all or part of its employee benefit obligations. Calculated as the difference between: (1) The present value of the obligation being settled on settlement date (2) The settlement price
Net interest on net defined benefit liability (asset)	Net defined benefit liability (asset) b/f × discount rate (see above).
Remeasurements	Calculated as a balancing figure to reconcile opening net defined benefit liability (asset) to closing. Arise due to changes in actuarial assumptions and experience adjustments.

Accounting summary - Defined benefit plans

	Obligation	Assets		
b/f	X	X		
Contributions made into the scheme		X	Dr Assets	Cr Cash
Benefits paid	(X)	(X)	Dr Obligation	Cr Assets
Current service cost	X		Dr Operating expense	Cr Obligation
Past service cost (increase benefits)	X		Dr Operating expense	Cr Obligation
Past service cost (decrease benefits)	(X)		Dr Obligation	Cr Operating expense
Loss on settlement	X		Dr Operating expense	Cr Obligation
Gain on settlement	(X)		Dr Obligation	Cr Operating expense
Net interest on net defined benefit liability (asset)	X	X	Dr Finance cost and Dr Assets	Cr Obligation Cr Finance cost
Remeasurements	X/(X)	X/(X)	Dr OCI and Dr Obligation/assets	Cr Obligation/assets Cr OCI
c/f	X	X		

17: Borrowing costs

Topic List

HKAS 23

Borrowing costs may be considered as a topic in its own right, or as part of non-current assets.

Directly attributable borrowing costs in relation to qualifying assets must be capitalised as part of the cost of those assets.

Borrowing costs

Interest and other costs incurred by an entity in connection with the borrowing of funds. Includes:

- Interest calculated using HKFRS 9's effective interest method
- Finance charges on finance leases
- Exchange differences as far as they are an adjustment to interest costs

If borrowings are general, calculate interest to be capitalised by applying the 'capitalisation rate'

Qualifying assets

An asset that necessarily takes a substantial period of time to get ready for its intended sale or use

Disclose

- Borrowing costs capitalised in period
- Capitalisation rate used to determine eligible borrowing costs

Commencement of capitalisation

- Expenditure on asset being incurred
- Borrowing costs being incurred, and
- Construction in progress

Suspension of capitalisation

Extended periods when active development is not taking place.

Cessation of capitalisation

When the asset is ready for intended use.

18: Financial instruments

Topic List

This is a controversial and complex topic. It is also the subject of ongoing change as HKFRS 9 replaces HKAS 39.

Financial instruments | HKAS 32 | HKAS 39/ HKFRS 9 | HKFRS 7

Relevant standards:

HKAS 32 deals with the classification of instruments as debt or equity.

HKAS 39 dealt with the recognition & measurement of financial instruments, however it is gradually being replaced by HKFRS 9.

HKFRS 7 provides disclosure requirements for financial instruments.

HKFRS 9 has replaced HKAS 39 in respect of classification and measurement of financial assets and liabilities and derecognition and will eventually replace it all.

Financial instrument:

Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another.

Financial asset:

Cash; equity instrument of another entity; contractual right to receive cash/other financial assets; contract that can be settled in the entity's own equity instruments and may be either a derivative or a non-derivative.

Financial liability:

Contractual obligation to deliver cash/other financial asset; contractual obligation to exchange financial instruments under potentially unfavourable conditions.

Equity instrument:

Contract that evidences a residual interest in the assets of an entity after deducting all its liabilities.

HKAS 32 presentation

- Financial instruments issued should be classified as either
  - Liability (debt) or
  - Equity
- Compound instruments (exhibiting characteristics of both) must be split into their debt and equity components
- Substance rather than legal form applies (e.g. redeemable preference shares are a financial liability)
- Interest, dividends, loss or gains relating to a financial instrument classified as a liability are reported in the statement of P/L, while distributions to holders of equity instruments are debited directly to equity (in the SOCE)
- Offset of a financial asset and liability is only allowed where there is a legally enforceable right and the entity intends to settle net or simultaneously

Recognise financial instruments in the SOFP when the entity becomes a party to the contractual provisions of the instrument

Financial assets are classified as at:

- Fair value, or
- Amortised cost

on the basis of the business model for managing the asset and its contractual cashflow characteristics [HKFRS 9]

Reclassify debt instruments when an entity changes its business model for managing financial assets.

Derecognise when

- contractual rights to cashflows expire, or
- substantially all risks and rewards of ownership are transferred to another party

Financial liabilities are classified as at:

- FV through profit or loss (if held for trading or designated as such), or
- Amortised cost [HKFRS 9]

HKFRS 9 prohibits the reclassification of financial liabilities.

Derecognise when financial liability is extinguished.

	Initial measurement	Subsequent measurement	Related income/expense
Financial assets at amortised cost	FV of consideration given + transaction costs	Initial measurement - principal repayments +/- cumulative amortisation - impairments	Interest income (received + 'winding up') is recognised in profit or loss
Financial assets at fair value	FV of consideration given	Remeasured to FV at each period end	Changes in FV are recognised in – profit or loss – OCI if asset is equity instrument not held for trading and election made
Financial liabilities at amortised cost	FV of consideration received - transaction costs	Initial measurement - principal repayments +/- cumulative amortisation - impairments	Interest expense (paid + 'winding up') is recognised in profit or loss
Financial liabilities at FVTPL	FV of consideration received	Remeasured to FV at each period end	Changes in FV of financial liabilities held for trading are recognised in profit or loss

The change in FV of a financial liability DESIGNATED as FVTPL is split into two elements:

– Gain or loss from credit risk ⟶ recognise in OCI

– Other gain or loss ⟶ recognise in profit or loss

Amortised cost – Example

The method used in the following example applies to deep discount bonds and other similar instruments (including zero coupon bonds).

Debt issued for $400,000 (nominal) on 1.1.20X1 for proceeds of $315,526; redeemed for $400,000 (i.e. par) on 31.12.20X5

Coupon rate = 4%

IRR = 9.5%

	$
Annual interest payments (4% × $400,000 × 5)	80,000
Deep discount $(400,000 – 315,526)	84,474
	164,474

At inception	DEBIT	Cash	$315,526	
	CREDIT	Liability		$315,526

Year	*P/L charge*	*Actual interest payable*	*Winding up interest charged to P/L*	*Liability in closing SOFP*
	*$	$	$	$
20X1	29,975	16,000	13,975	329,501
20X2	31,303	16,000	15,303	344,804
20X3	32,756	16,000	16,756	361,560
20X4	34,348	16,000	18,348	379,908
20X5	36,092	16,000	20,092	400,000
	164,474	80,000	84,474	

*9.5% × opening liability in SOFP

Fair value is measured as quoted market price in an active market where possible.

Impairment [HKAS 39]

- Impairment review where evidence of financial asset being impaired
- Original effective interest rate should be used when discounting future cash flows to calculate the impairment
- Impairment loss is charged to P/L
- Where financial asset suffers impairment loss, cumulative losses on fair value adjustments previously recognised in equity are recycled in P/L as well as impairment loss
- Reversal: P/L

Embedded derivatives [HKFRS 9]

= Derivatives embedded within a host contract, eg construction contract in foreign currency

HOST ≠ FINANCIAL ASSET
Separate derivative from host and account for as a derivative when conditions are met.
Account for host contract as normal, e.g. HKAS 11

HOST = HKFRS 9 FINANCIAL ASSET
Account for hybrid contract in accordance with HKFRS 9

Hedging [HKAS 39]

Hedge accounting is mandatory where a transaction qualifies as a hedge (all three criteria met):

- Designated at inception as a hedge
- ‘Highly effective’
- Hedge effectiveness can be reliably measured

HKAS 39 identifies three types of hedges which determines their accounting treatment.

TYPE	HEDGES AGAINST	ACCOUNTING TREATMENT
Fair value hedge	Changes in fair value of a recognised asset or liability or an unrecognised firm commitment* (or portion of either) that could affect profit or loss	■ Gain or loss on instrument is recognised in P/L ■ Gain or loss on hedged item also recognised in P/L (and adjusts the carrying value of hedged item)
Cash flow hedge	Exposure to variability in cash flows attributable to a risk associated with a recognised asset or liability that could affect profit or loss	■ Gain or loss on effective portion of instrument is recognised in other comprehensive income (and recognised in P/L when asset or liability affects profit or loss, e.g. by interest income) ■ Gain or loss on ineffective portion is recognised in P/L
Hedge of net investment in a foreign operation	Variability in value of the net investment in a foreign operation or monetary items accounted for as part of that net investment	As for cash flow hedge

*HKAS 39 allows the hedge of a foreign currency firm commitment to be accounted for as a cash flow hedge.

The main disclosures required are:

Statement of financial position

- Carrying amount of financial assets and liabilities by HKFRS 9 category
- Reasons for any reclassification between fair value and amortised cost
- Details of assets and exposure to risk where transfers of assets have taken place
- Carrying amount of financial assets pledged as collateral
- Allowance for credit losses
- Multiple embedded derivatives
- Defaults and breaches

Statement of profit or loss and other comprehensive income

- Net gains/losses by HKFRS 9 category
- Interest income/expense
- Impairment losses by class of financial asset

Hedge accounting

- Description of hedge
- Description of financial instruments designated as hedging instruments
- Nature of risks being hedged
- Cash flow hedges: when cash flows will occur
- FV hedges: gains or losses on hedged item and hedging instrument
- Ineffectiveness recognised in profit or loss

Fair value

- By class
- Methods and assumptions

Risk

- Qualitative disclosure: management's objectives, policies and processes for managing those risks
- Quantitative disclosure:
  - Extent of exposure to risk
  - Credit risk
  - Liquidity risk
  - Market risk

Notes

19: Statement of cash flows

Topic List

The statement of cash flows is a required element of a set of financial statements and provides useful information with regard to liquidity.

Advantages of cash flow information

- Cash flow is objective, unlike profit
- Provides indicator of liquidity and solvency
- Companies need cash to survive
- Comparing cash flows with other entities may be more meaningful than comparing profits
- Cash flow reporting satisfies needs of all users, eg creditors can assess ability to pay
- Cash flow can be audited more easily
- Cash flows are easy to understand
- Cash flow forecasts may be produced and used to assess future expectations

Indirect method

STATEMENT OF CASH FLOWS FOR YEAR ENDED 31.12.X1

Cash flows from operating activities	
Profit before taxation	X
Adjustments for	
Depreciation	X
Investment income	(X)
Interest expense	X
	X
Increase in trade and other receivables	(X)
Decrease in inventories	X
Decrease in trade payables	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Net cash from operating activities	X

Think carefully about what you are adding and subtracting.

Net cash from operating activities brought forward		X
Cash flows from investing activities		
Purchase of property, plant and equipment	(X)	
Proceeds from sale of equipment	X	
Interest received	X	
Dividends received	X	
Net cash used in investing activities		(X)
Cash flows from financing activities		
Proceeds from issuance of share capital	X	
Proceeds from long-term borrowings	X	
Payment of finance lease liabilities	(X)	
Dividends paid	(X)	
Net cash used in financing activities		(X)
Net increase in cash and cash equivalents		X
Cash and cash equivalents at beginning of period		X
Cash and cash equivalents at end of period		X

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.

Note: Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money market instruments. Cash and cash equivalents included in the statement of cash flows comprise the following amounts.

	20X1	*20X0*
	$m	$m
Cash on hand and balances with banks	X	X
Short-term investments	X	X
Cash and cash equivalents	X	X

Direct method

The operating activities section of the statement of cash flows is different.

	$'000
Cash flows from operating activities	
Cash receipts from customers	X
Cash paid to suppliers and employees	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Net cash from operating activities	X

TAX PAID

		Deferred tax b/d	X
∴ Tax paid	X	Income tax b/d	X
		Charge for year	X
Deferred tax c/d	X		
Income tax c/d	X		
	X		X

FINANCE LEASE LIABILITY

∴ Finance lease payments	X	B/d liability	
		< 1 year	X
		> 1 year	X
C/d liability		New finance lease in year	X
< 1 year	X		
> 1 year	X		
	X		X

NON-CURRENT ASSETS

Bal b/d (carrying amount)	X	Depreciation	X
Revaluation	X		
∴ Addition	X		
		Bal c/d (carrying amount)	X
	X		X

Consolidated statement of cash flows

Includes extra line items for cash flows associated with:

- non-controlling interests
- associates and JVs
- the acquisition and disposal of subsidiaries

Non-controlling interests

Only the actual payment of cash, e.g. dividends, to non-controlling shareholders should be reflected in the consolidated statement of cash flows. Include under 'cash flows from financing activities'.

NON-CONTROLLING INTERESTS

Dividend paid (Bal. fig.)	X	Balance b/fwd	X
		Profit for the period	X
Balance c/fwd	X		
	X		X

Associates/JVs

Only the actual cash flows from sales or purchases between the group and the entity, and investment in and dividends from the entity should be included.

- Dividends received should be included as a separate item in 'cash flows from operating activities' where they are included within operating profit, otherwise in investing activities.

INVESTMENT IN ASSOCIATE

Balance b/fwd	X	Dividend from associate (Bal. fig.)	X
Profit after tax	X	Balance c/fwd	X
	X		X

Acquisition or disposal of a subsidiary

Present as a simple item of cash inflow or outflow

- Cash paid/received as consideration should be shown *net* of any cash transferred as part of the purchase/sale

When looking at movements in individual assets or liabilities:

- Deduct acquired assets & liabilities from the movement in the year
- Add disposed of assets & liabilities to the movement in the year

Foreign currency cash flows

Individual entity transactions in foreign currency (settled) — No adjustment to profit for exchange gains/losses

Individual entity transactions in foreign currency (unsettled) —

- Adjust exchange gain/loss as non-cash item
- Take exchange difference into account when calculating cash flows/working capital movements

Foreign subsidiary — Translate cash flows to functional currency for consolidation using average rate

20: Related party disclosures

Topic List

HKAS 24

You must be able to identify related parties and make the necessary disclosures.

Key elements: control, joint control, significant influence

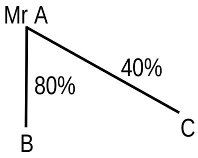
A **person** is related to an entity if:

(1) They control or jointly control the entity (Mr A & B)

(2) They have significant influence over the entity (Mr A & C)

(3) They are key management personnel of the entity or its parent

(4) They are a close family member of any individual in (1)-(3)



PLUS where an individual controls/jointly controls/has significant influence over two entities, they are related

An **entity** is related to another entity if:

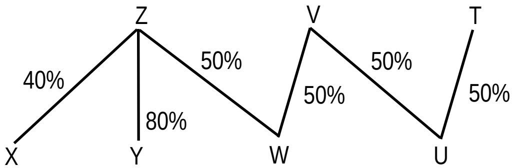
(1) They are members of the same group (Z & Y)

(2) One is an associate or JV of the other (Z & X)

(3) Both are JVs of a third party (W & U)

(4) One is an associate and the other a JV of a third party (X & W)

(5) One is a pension plan for employees of the other



KEY FACTOR: SUBSTANCE OF RELATIONSHIP

Not necessarily related parties

- Two entities simply because they have a director in common
- Two venturers simply because they share joint control of a joint venture
- Providers of finance, trade unions, public utilities, government departments and agencies in the course of their normal dealings with an entity by virtue only of those dealings
- A single customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business merely by virtue of the resulting economic dependence

Disclosure

Always

(1) Name of parent + ultimate controlling party

(2) Key management personnel compensation

Where RP transactions have occurred disclose for each category of related party

(1) Nature of relationship

(2) Amount of transactions

(3) Amount of outstanding balances

(4) Provision for doubtful debts

(5) Bad debt expense re related parties

Notes

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

Topic List

- Accounting policies
- Accounting estimates
- Errors
- HKAS 10

It is important that you understand how accounting policies should be selected and when they, and accounting estimates, can be changed. You should also know how to deal with events between the reporting date and authorising of the accounts.

HKAS 8

Accounting policies

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

An entity follows extant Standards and Interpretations when determining its accounting policies.

In the absence of a Standard or Interpretation covering a specific transaction, other event or condition, management uses its judgment to develop an accounting policy which results in information that is relevant and reliable, considering in the following order:

1. Standards or Interpretations dealing with similar and related issues
2. The *Conceptual Framework* definitions and recognition criteria
3. Other national GAAPs based on a similar conceptual framework (providing the treatment does not conflict with extant Standards, Interpretations or the *Conceptual Framework*)

Changes in accounting policy

Only allowed if:

- required by Standard or Interpretation
- the change will provide more relevant or reliable information about events or transactions

Accounting treatment:

Apply retrospectively unless impracticable:

- restate prior year SPLOCI and SOFP
- restate opening balance of retained earnings

Disclose:

- reasons for change
- amount of adjustment for each period presented
- amount of adjustment relating to periods prior to those presented

Accounting estimates involve judgment, e.g. useful lives of assets, amount of allowance for doubtful debts.

Change in accounting estimate

- Apply prospectively in period of change and future periods if relevant

Disclose:

- Nature of change
- Amount of change in current and future periods, unless impracticable

Prior period errors

Omissions from and misstatements in the entity's financial statements for one or more periods.

Correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery.

- Restate comparative amounts for each prior period presented in which the error occurred
- Restate the opening balances of assets, liabilities and equity for the earliest prior period presented

Disclose:

- The nature of the error and the amount of the correction to prior periods for each line item in each period affected
- The amount of the correction at the beginning of the earliest period presented

Where it is impracticable to determine the period-specific effects or the cumulative effect of the error, the entity corrects the error from the earliest period/date practicable (and discloses that fact).

Events after the reporting period (EARPs)

Events, both favourable and unfavourable, which occur between the end of the reporting period and the date on which the financial statements are approved for issue.

Adjusting events are EARPs which provide additional evidence of conditions existing at the reporting date, and therefore need to be incorporated into the financial statements. Events affecting going concern are always classified as adjusting.

Non-adjusting events are EARPs which concern conditions which did *not* exist at the reporting date. Do not adjust, but disclose if non-disclosure would affect the user's ability to make proper evaluations and decisions.

Disclosure – for significant non-adjusting events: nature of the event, estimate of financial effect (or statement that estimate cannot be made).

22: Earnings per share

Topic List

HKAS 33

Earnings per share (HKAS 33) is applicable to listed companies and is a useful measure of performance.

HKAS 33

EPS is a stock market indicator, so it is important that EPS is calculated on a comparable basis, year to year and company to company. *Drawback*: EPS relies on reported earnings; creative accounting can make a mockery of this.

HKAS 33 applies to all entities whose ordinary shares or potential ordinary shares are publicly traded.

Basic calculation

$$\frac{\text{Profit/loss attributable to ordinary shareholders}}{\text{Weighted average no. of shares outstanding during the period}}$$

The profit or loss used is after tax and all deductions in respect of non-equity shares.

Weighted average number of shares: changes in capital structure

It is necessary to match the earnings for the year against the capital base giving rise to those earnings.

Bonus issue

The earnings of the entity will not rise (no new funds injected); to calculate the number of shares:

Treat bonus shares as if in issue for the full year

Apply retrospectively, reducing the reported EPS for the previous year by applying the reciprocal of the bonus fraction

Issue at full market price

New capital is introduced therefore earnings would be expected to rise from date of new issue; to calculate the number of shares:

Use time weighted average number of shares for period

No retrospective effect

Part-paid shares included to extent provide entitlement to dividends

Rights issue

For purposes of calculating the number of shares, treat this as an issue at full market price followed by a bonus issue:

Use weighted average number of shares in issue for the period modified by the retrospective effect of the bonus element

Bonus element

$$\frac{\text{Actual cum-rights price}}{\text{Theoretical ex-rights price}}$$

$$\text{Diluted EPS} = \frac{\text{Profits in basic EPS} + \text{effect on profit of dilutive potential ordinary shares}}{\text{No of shares in basic EPS} + \text{dilutive potential ordinary shares}}$$

Potential ordinary shares

- Options or warrants
- Convertible loan stock/ preference shares
- Equity shares which will be entitled to a dividend at a future date

Effect on profit of potential ordinary shares

- Preference dividends saved
- Post tax interest saved
- Other changes to income or expense

Contingently issuable ordinary shares

- Do not take into account in calculation of basic EPS until issued
- Incorporate in calculation of DEPS only if conditions leading to issue are satisfied (treating period end as end of contingency period)

Only include dilutive potential ordinary shares in DEPS; ignore anti-dilutive potential ordinary shares

Presentation: Basic and diluted EPS should be disclosed with equal prominence in the SPLOCI for continuing and discontinued operations.

23: Operating segments

Topic List

Operating segments (HKFRS 8) is applicable to listed companies.

HKFRS 8 requires the disclosure of financial information by operating segment for a better understanding of past performance and risks and rewards.

Operating segment

Component of an entity

- which engages in business activities to earn revenue and incur expenses
- whose results are reviewed by the chief operating decision maker to make decisions
- for which discrete financial information is available

Reportable if segment total is 10% or more of total

- Revenue
- Segment profit
- Assets

If reportable segments represent < 75% external revenue of entity, additional segments are identified as reportable

Two or more segments below 10% threshold can be aggregated to form a reportable segment if they have similar economic characteristics.

Disclose for each segment:

- Operating segment profit or loss
- Segment assets
- Segment liabilities
- Certain income & expense items

Also disclose:

- Factors used to identify reportable segments
- Products & services from which each segment derives revenue
- External revenue by product & service
- Geographical information
- Reliance on major customers

Notes

24: Interim financial reporting

Topic List

HKAS 34

Interim financial reporting is relevant to assessing the performance of a listed company.

Interim financial reporting

Aim of HKAS 34

(1) To prescribe minimum content of interim financial reports

(2) To prescribe principles for recognition & measurement in interim financial reports

Minimum contents

- condensed SOFP
- condensed SPLOCI
- condensed SOCE
- condensed statement of cash flows
- selected notes

Recognition & measurement

Basic principle: use same principles as in annual financial statements

Payroll taxes paid unevenly: use estimated annual average tax rate rather than actual tax paid

Cost of planned maintenance is not accrued as a liability unless an obligation exists

Year end bonus is not accrued unless an obligation exists and the amount can be reliably measured

Development costs not meeting the recognition criteria are expensed even if those criteria are expected to be met later in the year

Tax on income is included as an expense based on estimated average annual tax rate for the year

25: Presentation of financial statements

Topic List

It is important that you are familiar with the HKAS 1 formats.

A complete set of financial statements includes: ■ a statement of financial position	■ At the end of the period and at the end of the comparative period ■ Where there is a prior period adjustment a third SOFP at the start of the comparative period must be provided
■ a statement of profit or loss and other comprehensive income, in one or two statements	To include: ■ profit or loss ■ other comprehensive income, being income and expenses not recognised in profit or loss Dividends are not reported here
■ a statement of changes in equity	■ Focuses on transactions with owners in their capacity as owners ■ Other comprehensive income reported in the SOCE is analysed in the SOCE itself or in the notes to the accounts
■ a statement of cash flows	HKAS 7
■ notes to the accounts	Including a summary of accounting policies and other significant information

Statement of financial position (HKAS 1 revised)

	20X1		20X0	
	$'000	$'000	$'000	$'000
Assets				
Non-current assets				
Property, plant & equipment	X		X	
Goodwill	X		X	
Other intangible assets	X		X	
Investments in associates	X		X	
Investments in equity instruments measured at fair value through other comprehensive income	X		X	
	—	X	—	X
Current assets				
Inventories	X		X	
Trade receivables	X		X	
Other current assets	X		X	
Cash and cash equivalents	X		X	
	—	X	—	X
Total assets		X		X
Equity and liabilities				
Equity attributable to owners of the parent				
Share capital	X		X	
Other reserves	X		X	
Retained earnings	X		X	
	—	X	—	X
Non-controlling interests		X		X
Total equity		X		X
Non-current liabilities				
Long-term borrowings	X		X	
Deferred tax	X		X	
Long-term provisions	X		X	
Total non-current liabilities		X		X
Current liabilities				
Trade and other payables	X		X	
Short-term borrowings	X		X	
Current portion of long-term borrowings	X		X	
Current tax payable	X		X	
Short-term provisions	X		X	
Total current liabilities		X		X
Total equity and liabilities		X		X

Statement of profit or loss and other comprehensive income (HKAS 1 revised)

	20X1 $'000	*20X0* $'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	X	X
Income tax relating to items that will not be reclassified to profit or loss	(X)	(X)
Items that may be reclassified to profit or loss		
Cash flow hedges	(X)	X
Income tax relating to items that may be reclassified to profit or loss	X	(X)
Other comprehensive income for the year, net of tax	X	X
Total comprehensive income for the year	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interests	X	X
	X	X
Total comprehensive income attributable to:		
Owners of the parent	X	X
Non-controlling interests	X	X
	X	X

Statement of changes in equity (HKAS 1 revised)

	Share capital $'000	*Retained earnings* $'000	*Revaluation surplus* $'000	*Total* $'000	*Non-controlling interests* $'000	*Total equity* $'000
Balance at 1 January 20X0	X	X	X	X	X	X
Changes in accounting policy		X		X	X	X
Restated balance	X	X	X	X	X	X
Changes in equity for 20X0:						
Dividends		(X)		(X)		(X)
Total comprehensive income for the year		X	X	X	X	X
Balance at 31 December 20X0	X	X	X	X	X	X
Changes in equity for 20X1:						
Issue of share capital	X			X		X
Dividends		(X)		(X)		(X)
Total comprehensive income for the year		X	X	X	X	X
Transfer to retained earnings		X	(X)			
Balance at 31 December 20X1	X	X	X	X	X	X

HKAS 1 provides guidance on the general features of financial statements

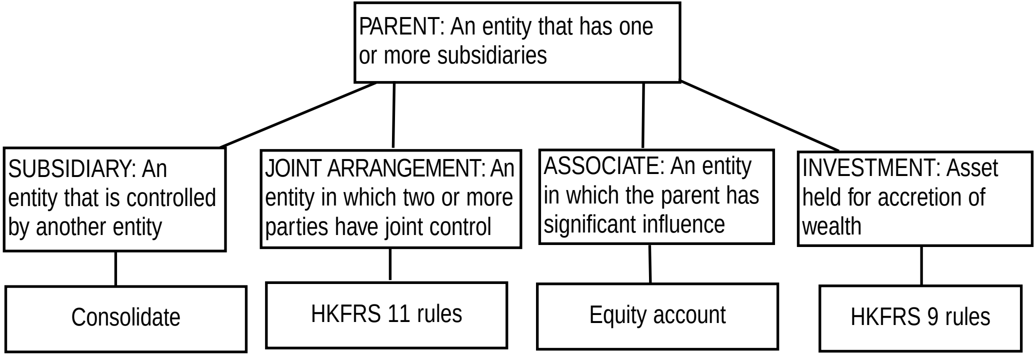
- Fair presentation
- Going concern
- Materiality & aggregation
- Accrual
- Offsetting

26: Principles of consolidation

Topic List

You are very likely to come across groups of companies in practice and in your exam. You must be able to identify different types of group companies and account for them.

Group accounts are prepared which show the group as a **single economic entity**.



Control

An investor controls an investee if it has:

- Power over the investee, and
- Exposure or rights to variable returns from involvement with the investee, and
- The ability to use its power over the investee to affect the amount of returns it receives

Power

Existing rights that give the current ability to direct the relevant activities of the investee.

Power may be achieved through holding a majority of voting rights or by other means.

Returns

May include:

- Dividends
- Remuneration for servicing investee's assets and liabilities
- Fees and exposure to loss from the provision of credit support.

Consolidated financial statements

Consolidated financial statements include all subsidiaries other than those held for sale or those which operate under long term restrictions and so are not controlled.

Exemption

1. A parent need not prepare group accounts if:
   - It is itself a wholly owned subsidiary
   - It is partially owned and the other owners do not object
   - Its securities are not publicly traded
   - The ultimate or intermediate parent publishes HKFRS-compliant consolidated accounts
2. It is an investment entity. In this case subsidiaries which do not provide services relating to investment activities must be held at FVTPL.

Preparation

- Different reporting dates – adjustments should be made
- Uniform accounting policies – if not, disclose why. Adjustments should be made on consolidation
- Intra-group transactions are eliminated

Parent's accounts
Subsidiaries are accounted for at cost or in accordance with HKFRS 9

HKFRS 12 Disclosure of Interests in Other Entities

Disclose:

- Significant judgements and assumptions made in determining the nature of an interest in another entity
- Information about subsidiaries, associates and joint arrangements and about structured entities that are not consolidated by an entity

↓

Disclosure of consolidated subsidiaries

- Interests of NCI in group activities and cash flows
- The nature and extent of restrictions on investor's ability to use group assets and liabilities
- The nature of risks associated with interests in consolidated structured entities
- Consequences of changes in ownership interest

↓

Disclosure of unconsolidated subsidiaries (investment entities)

- Details of unconsolidated subsidiaries
- Significant restrictions on ability of unconsolidated subsidiaries to transfer funds
- Support provided to unconsolidated subsidiaries

Acquisition method

1 Identify the acquirer → One entity acquires another in all business combinations

2 Determine acquisition date → Date on which control is gained

3 Recognise and measure

- assets and liabilities of acquiree → At fair value
- non controlling interest → At fair value or as a proportion of net assets

4 Recognise and measure goodwill →

Consideration transferred	X
Non controlling interest	X
	X
FV of net assets of acquiree	(X)
Goodwill	X

CONSIDERATION TRANSFERRED

- Cash/other assets
- Shares
- Debt instruments
  - record contingent consideration at fair value
  - exclude consideration relating to pre-existing relationships
  - exclude acquisition costs (which are expensed)

NON-CONTROLLING INTEREST

Measure at:

- fair value, or
- as proportion of net assets

Fair value should be determined based on market value of shares or valuation techniques. It is not extrapolated from consideration transferred for controlling interest. If the NCI is not entitled to a proportionate share of net assets on a winding up, the NCI must be measured at FV.

When fair value is used to measure the NCI, goodwill represents all of the goodwill of the business, not just the parent's share.

FV OF NET ASSETS ACQUIRED

All assets and liabilities are included at fair value in accordance with HKFRS 13

- Exclude liabilities for future losses
- Include identifiable intangible assets
- Include contingent liabilities if fair value can be measured reliably
- Include reacquired rights & indemnification assets
- Use relevant standards to measure deferred tax, pensions, share based payments & assets held for sale

Disclosures

- Name and description of acquiree and date of acquisition
- Share of voting rights acquired and reason for combination
- Description of factors making up goodwill
- Consideration transferred by type and details of contingent consideration
- Details of assets and liabilities acquired
- The gain in a bargain purchase and a description of why it arose
- The NCI and measurement basis applied plus details of techniques to determine fair value where relevant

27: Consolidated accounts: accounting for subsidiaries

Topic List

Group accounting is relevant to many entities. You should be able to perform a consolidation.

APPROACH

1. Draw group structure
2. Set up consolidation working schedule
3. Insert the statements of financial position of P & S
4. Calculate goodwill and record adjustment journal

Consideration		A	DEBIT	Goodwill	G
NCI		B	DEBIT	Share capital	C
Net assets acquired:			DEBIT	Retained earnings	D
Share capital	C		DEBIT/CREDIT	FV adjustment	E
Retained earnings	D		CREDIT	Investment in subsidiary	A
Fair value adjustment	E/(E)				
		(F)	CREDIT	Non-controlling interest	B
Goodwill		G			

APPROACH (continued)

5 Deal with Adjustments

■	Intra-group trading balances	DEBIT CREDIT	Payables Receivables	X X
■	Unrealised profit in Inventory/PPE (NCI % allocated if subsidiary is selling company)	DEBIT CREDIT	Retained earnings/NCI Inventory/PPE	X X
■	Goodwill impairment (NCI % allocated if NCI measured at FV)	DEBIT CREDIT	Retained earnings/NCI Goodwill	X X
■	Additional depreciation on FV adjustment (NCI % allocated to NCI only if subsidiary is selling company)	DEBIT CREDIT	Retained earnings/NCI PPE	X X

APPROACH (continued)

6 Allocate the NCI share of post acquisition profits to the NCI

Retained earnings @ Reporting date	A	DEBIT	Retained earnings	C
Retained earnings @ Acquisition date	(B)	CREDIT	NCI	C
Post-acquisition profits	C			

7 Add across consolidation schedule to calculate consolidated balances.

8 CHECK:

- Share capital = P only
- Goodwill = At acquisition – Impairment
- NCI = At acquisition + Share of post acquisition profits +/– adjustments
- Reserves = 100% P + Group % (S post acquisition +/– adjustments)

APPROACH

1. Draw group structure taking note of mid-year acquisitions
2. Set up consolidation working schedule
3. Insert the SPLOCIs of P and S, pro-rating S for a mid-year acquisition
4. Allocate S's profit and total comprehensive income to group and the NCI

APPROACH (continued)

5 Adjustments

■ Intra group sales	DEBIT Revenue X CREDIT Cost of sales X
■ Unrealised profit in inventory	DEBIT Cost of sales X CREDIT Inventory (SOFP) X (Allocate NCI % if S is Selling Co)
■ Unrealised profit in PPE (Profit and Excess depreciation if transfer in year; otherwise excess depreciation only)	DEBIT/CREDIT Operating expenses X DEBIT/CREDIT PPE (SOFP) X (Allocate NCI % if S is Selling Co)
■ Goodwill impairment	DEBIT Admin expenses X CREDIT Goodwill (SOFP) X (Allocate NCI % if NCI measured at FV)
■ Additional depreciation on FV Adjustment	DEBIT Operating expenses X CREDIT PPE (SOFP) X

6 Add across consolidation schedule to calculate consolidated SPLOCI.

Recap of adjustments

(1) Mid year acquisition → Pro-rate S's results prior to consolidation

(2) Intra-group transactions → Eliminate as part of consolidation process

(3) Unrealised profit in inventory → Increase cost of sales of selling company prior to adding across line by line

(4) Unrealised profit in non-current assets

- sale in period → Adjust for profit or loss on sale and excess depreciation
- sale not in period → Adjust for excess depreciation only

(5) Fair value adjustments → Where relevant, charge extra depreciation on the fair value uplift

Vertical groups

P

90%

S1

70%

S2

– P controls S1 which controls S2, therefore S2 is a sub-subsidiary of P

– Group effective interest in S2 is 90% × 70% = 63%

– NCI in S2 is therefore 37%

- 30% direct NCI plus
- 7% (10% × 70%) indirect NCI

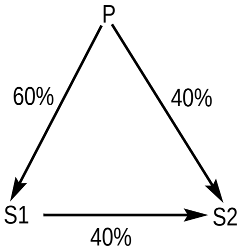
– Goodwill in S2:

90% × consideration transferred	X
NCI (based on 37% holding)	X
Net assets of S2	(X)
	X

– Group retained earnings include 63% of S2's post-acquisition profits

– NCI includes 37% of S2's post-acquisition profits.

D-shaped groups



– P has a direct 40% holding in S2 and also controls S1 which has a 40% holding in S2. Therefore S2 is a sub-subsidiary of P.

– Group effective interest is 40% + (60% × 40%) = 64%

– NCI interest is therefore 36%

– Goodwill in S2:

Cost of P's investment in S2	X
60% × cost of S1's investment in S2	X
NCI (based on 36% holding)	X
Net assets of S2	(X)
	X

– Group retained earnings include 64% of S2's post-acquisition profits

– NCI includes 36% of S2's post-acquisition profits.

Notes

28: Consolidated accounts: accounting for associates and joint arrangements

Topic List

Associates and joint arrangements occur often and you should know how to account for them.

HKAS 28

Significant influence	Presumed when 20%–50% voting shares are held Evidenced by: – Board representation – Participation in policy making – Material transactions between investor & investee – Interchange of management personnel – Provision of essential technical information
Equity method	Method of accounting for an associate. Applied where consolidated accounts are prepared, i.e. the parent also has a subsidiary. Also, where an investor has an associate but no subsidiaries, then the investor does not prepare consolidated accounts, but includes the associate in its own accounts using the equity method.

Consolidated statement of financial position – equity method

Investment in associate

	$
Cost of investment	X
Add share of post-acquisition profits	X
Add share of post-acquisition OCI	X
	X

Consolidated statement of profit or loss and other comprehensive income

- Share of profit after tax
- Share of other comprehensive income

Adjustments

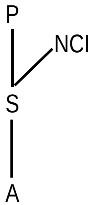
- Transactions between the group and the associate are not eliminated
- **Group share** of unrealised profits is eliminated
  - against inventories (where associate is seller)
  - against investment (where parent is seller)
- Excess depreciation on FV adjustments

Exception: use HKFRS 5 if investment acquired and held for sale.

Losses in associate

Parent discontinues recognising its share of losses when investment is reduced to nil.

Indirect investment in associate



NCI in consolidated accounts includes non-controlling interest of subsidiary’s interest in associate

HKFRS 11 Joint Arrangements

Joint control

The contractually agreed sharing of control which exists when decisions about relevant activities require unanimous consent of the parties sharing control.

Joint arrangement

An arrangement in which 2 or more parties have joint control.

Joint operations

Parties with joint control have rights to the assets and obligations for the liabilities of the joint arrangement.

Includes all joint arrangements not structured through a separate entity.

Joint ventures

Parties with joint control have rights to the net assets of the arrangement.

Accounting for Joint Arrangements

Joint operation

Joint operator should recognise:

- Its assets including its share of jointly-held assets
- Its liabilities including its share of jointly-incurred liabilities
- Revenue from the sale of its share of output from the joint operation
- Its share of revenue from the sale of output by the joint operation
- Its expenses including its share of expenses incurred jointly.

Joint venture

A joint venturer should recognise its interest in a joint venture as an investment and account for that investment using the equity method (HKAS 28).

Disclosure of associates / joint arrangements

HKFRS 12 requires disclosure of:

- The nature, extent and financial effects of an entity's interests in associates or joint arrangements
- Risks associated with an interest in an associate or joint arrangement

Notes

29: Changes in group structures

Topic List

Step acquisitions are common and you must be able to deal with these as well as full and partial disposals.

Gain or loss on disposal of a subsidiary or associate is calculated as follows:

In parent company

	$
FV of consideration received	X
Less carrying value of investment	(X)
Profit/(loss)	X/(X)

Note: if control is retained, the adjustment to parent's equity is:

	$
FV of consideration received	X
Increase in NCI in net assets at disposal	(X)
	X

In group accounts

		$
FV of consideration received		X
FV of investment retained		X
Less:		
NAs of S at disposal	X	
Goodwill at disposal	X	
NCI at disposal	(X)	
		(X)
Group profit/(loss)		X/(X)

Full disposal of subsidiary

- In SPLOCI
  - Consolidate results to date of disposal
  - Show group gain or loss separately before interest
- In SOFP: no subsidiary therefore no consolidation or NCI

Subsidiary to subsidiary

- NCI in SPLOCI will be based on % before and after disposal, i.e. time apportion
- NCI in SOFP based on year end %
- Goodwill is unchanged
- Parent's equity is adjusted

Subsidiary to associate

- SPLOCI: treat as subsidiary to date of disposal, consolidate for correct no. of months and show NCI in that amount. Treat as associate thereafter. Include gain or loss on disposal
- SOFP: Equity accounted with FV of interest retained substituting cost

Subsidiary to financial asset

- SPLOCI: treat as subsidiary to date of disposal. Show dividend income only thereafter. Include gain or loss on disposal
- SOFP: Investment at fair value at disposal date. Thereafter HKFRS 9 applies

Disclose separately if significant (HKAS 1) or if a discontinued operation (HKFRS 5).

Reclassification adjustments

Where control or significant influence is lost, cumulative other comprehensive income of the subsidiary/associate held in the group reserves is reclassified to profit or loss to become part of the gain or loss on disposal.

Full disposal of associate

- In SPLOCI
  - Equity account to date of disposal
  - Show group gain or loss on disposal
- In SOFP
  - No investment is shown

Associate to financial asset

- In SPLOCI
  - Treat as associate to disposal date
  - Show dividend income thereafter
  - Include gain or loss on disposal
- In SOFP recognise an investment at FV at disposal date and apply HKFRS 9 thereafter

A step acquisition is the achievement of control in stages, e.g. an investment becomes an associate and then a subsidiary.

Goodwill

is calculated only when control is achieved.

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

The gain or loss on remeasurement of the previously held interest to fair value is recognised in profit or loss.

Financial asset to subsidiary

- In SOFP consolidate based on year end holding
- In SPLOCI
  - Include dividend income to date control was achieved
  - Consolidate thereafter

Associate to subsidiary

- In SOFP consolidate based on year end holding
- In SPLOCI
  - Equity account to date control was achieved
  - Consolidate thereafter

Increase in subsidiary investment

- In SOFP consolidate based on year end holding
- NCI in SPLOCI is based on time apportioned results
- Adjust parent's equity by:

FV of consideration paid	X
Decrease in NCI in net assets at date of transaction	(X)
Decrease in NCI in goodwill at date of transaction	(X)
	X

A business combination involving a share exchange characterised by a continuity of ownership should be accounted for in consolidated financial statements using merger accounting:

- No adjustment is made to carrying values of net assets except to achieve uniformity of accounting policies
- No distinction between pre and post acquisition reserves
- No adjustment for mid-year acquisition
- Comparative figures are presented as if the companies were combined throughout the period prior to the combination

Notes

30: Consolidation of foreign operations

Topic List

The issue of foreign currency is relevant to a large number of companies. You should understand how transactions and financial statements are translated and how exchange differences are recognised.

Functional currency

- Currency of the primary economic environment in which an entity operates
- Considerations in determining functional currency
  - Influences sales prices
  - Influences labour, materials & other costs
  - Currency in which funds received
  - Currency in which receipts are retained
- Other currencies treated as a foreign currency

Presentation currency

- Currency in which the financial statements are presented
- Can be any currency
- Special rules apply to translation from functional currency to presentation currency

Does the foreign operation have the same functional currency as the parent?

Considerations

- Whether the activities of the foreign operation are carried out as an **extension of the parent** or with a significant degree of autonomy
- Whether **transactions with the parent** are a **high or low proportion** of the foreign operation's activities
- Whether **cash flows** from the activities of the foreign operation directly affect the cash flows of the parent
- Whether the activities are financed from the foreign operation's own cash flows or by **borrowing from the parent**

Foreign currency transactions are translated for inclusion in the accounts.

Initial recognition
Translate at spot rate on date of transaction

Settlement before period end
Translate cash at spot rate on settlement date

↓

An exchange difference will arise

Settlement after period end

1 Retranslate monetary items (payables, receivables, loans) at closing rate at period end
2 After period end when settlement occurs, translate cash at spot rate on settlement date

An exchange difference will arise for each of 1 and 2

Exchange differences are recognised in profit or loss

Where a group includes individual entities with different functional currencies, their financial statements must be translated to a common presentation currency.

Statement of financial position	Assets & liabilities – Closing rate Share capital – Historical rate Reserves – Balancing figure
Statement of profit or loss and other comprehensive income	Income & expenses – Average rate

Exchange differences are recognised in other comprehensive income

The exchange difference on translation is calculated as:

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)
Total exchange gain/(loss)		X/(X)

This is:

- reported as other comprehensive income
- included in post-acquisition reserves
- allocated between owners of the parent and the non-controlling interest where relevant

Additional points

- Goodwill is calculated in the functional currency and retranslated using the closing rate each year
- When a foreign operation is disposed of, the cumulative exchange differences in reserves are reclassified to profit or loss to form part of the gain or loss on disposal

Notes

Notes