Workshop Outline and Learning Methodologies

<table>
<tr><th>Session</th><th>Methodologies</th><th>Chapters covered</th><th>Student Notes</th></tr>
<tr><td colspan="4">Workshop 1</td></tr>
<tr><td>1. Introduction</td><td>• Presentation
• Group discussion</td><td></td><td rowspan="4">Please refer to Workshop 1 Student Notes</td></tr>
<tr><td>2. Property related standards</td><td>• Case study
• Group discussion</td><td>Ch. 4, 5, 6 and 8</td></tr>
<tr><td>3. Resolving accounting issues</td><td>• Case study
• Group discussion</td><td>Ch. 11, 14, 15 and 22</td></tr>
<tr><td>4. Wrap up</td><td>• Presentation
• Group discussion</td><td></td></tr>
<tr><td colspan="4">Workshop 2</td></tr>
<tr><td>5. Reboot</td><td>• Presentation
• Group discussion</td><td></td><td></td></tr>
<tr><td>6. Financial Instruments</td><td>• Case study
• Group discussion</td><td>Ch. 18</td><td>Pg. 1 – 12</td></tr>
<tr><td>7. Consolidation</td><td>• Case study
• Group discussion</td><td>Ch. 19, 27, 28, 29 and 30</td><td>Pg. 13 – 39</td></tr>
<tr><td>8. Leading a team and teamwork</td><td>• Group discussion</td><td></td><td></td></tr>
<tr><td>9. Conclusion</td><td>• Presentation
• Group discussion</td><td></td><td></td></tr>
</table>

Financial instruments

Case study 1

Grandstay Hotels is a Hong Kong based company which runs luxury hotels throughout Southeast Asia. The company is about to embark on an expansion strategy, and will raise the necessary funding through a mixture of debt and equity instruments.

On 1 July 2010, the company issues 1 million HK$40 5% redeemable preference shares at par. The dividend is paid annually on 30 June. Holders have the option to convert one preference share into 3 ordinary HK$10 shares between 30 June 2013 and 30 June 2015. Any shares which are not converted will be redeemed at par on 30 June 2015.

The market rate on interest paid on similar shares without the conversion option is 7%. The effective rate of interest on the preference shares is 7%.

A quarter of the shares are converted on the earliest option date, with a further 25% of the original issue converted on 30 June 2015.

At 1 July 2010 Grandstay Hotels had 2 million HK$10 ordinary shares in issue with a balance on the share premium account of HK$15 million.

Required:

Using the information provided:

(i) determine the relevant accounting standards,

(ii) determine the appropriate accounting treatment of the convertible preference shares in Grandstay Hotels' financial statements, and

(iii) calculate the amounts which should be recognised in Grandstay Hotels' statement of financial position at 30 June in each of the years 2011 to 2015, and prepare extracts from the company's statement of comprehensive income at the same dates.

(iv) List the HKFRS 7 requirements applicable to Grandstay Hotels.

Discussion points

Financial instruments

Case Study 1 – Grandstay Hotels

What are the issues?

Grandstay Hotels has issued HK$40million convertible redeemable preference shares. The term to redemption is 5 years, and the holder may convert each preference share to 3 HK$10 ordinary shares at any time during the last two years of this term. A quarter of shareholders convert at the earliest opportunity (after 3 years); the same amount convert on the last possible date; the remainder redeem.

(a) How is the initial issue of the convertible redeemable preference shares recognised in the financial statements of Grandstay Hotels?
(b) How is the liability balance measured subsequent to initial recognition?
(c) How is the conversion after 3 years recognised?
(d) How is the conversion / redemption of the preference shares at maturity recognised?

Which accounting standards are relevant?

HKAS 32: Financial Instruments: Presentation

HKFRS 9: Financial Instruments

HKFRS 7: Financial Instruments: Disclosures

What are the requirements of the accounting standards?

Initial presentation and measurement

A bond or similar instrument convertible by the holder into a fixed number of ordinary shares of an entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).
The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately in its statement of financial position.

(HKAS 32.29, LP Chapter 18 Section 2.4.4)

The issuer of a bond convertible into ordinary shares should first determine the carrying amount of the liability component by measuring the fair value of a similar liability that is not convertible. The carrying amount of the equity instrument is then the difference between the fair value of the compound instrument as a whole and the carrying amount of the liability.

(HKAS 32.32, LP Chapter 18 Section 2.4.4)

Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability are recognised as income or expense in profit or loss.

(HKAS 32.35, LP Chapter 18 Section 2.6)

Subsequent measurement
Other than financial liabilities at fair value through profit or loss (such as derivatives) and limited other exceptions, all financial liabilities are subsequently measured at amortised cost using the effective interest method.

(HKFRS 9 4.2.1, LP Chapter 18 Section 4.3)

A gain or loss on a financial liability that is measured at amortised cost is recognised in profit or loss through the amortisation process.

(HKFRS 9 5.7.2, LP Chapter 18 Section 4.3)

Conversion
On conversion of a convertible instrument at maturity, the entity should derecognise the liability component and recognise it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

(HKAS 32.AG32, LP Chapter 18 Section 4.3)

Disclosure

Information that enables users of the financial statements to evaluate the significance of financial instruments for financial position and performance should be disclosed, including:

- The carrying amount of financial liabilities measured at amortised cost **(HKFRS 7.8)**
- Net gains or net losses on financial liabilities measured at amortised cost **(HKFRS 7.20)**
- Total interest expense calculated using the effective interest method **(HKFRS 7.20)**
- The fair value of each class of financial assets and liabilities **(HKFRS 7.25)**
- Qualitative and quantitative data which enables users to assess the nature and extent of risks arising from financial instruments **(HKFRS 7.31-32A)**

(HKFRS 7, LP Chapter 18 Section 7)

How to apply the standards to the case?

Initial presentation and measurement

The convertible redeemable preference shares are a compound instrument in accordance with HKAS 32 and must be split into a liability and equity component for initial recognition in Grandstay Hotels' financial statements.

The liability component is measured first, assuming that the instrument has no conversion rights, and so applying the market rate of interest (7%) as a discount factor:

Date of cash flow	Cash flow HK$000		Discount factor	Present value HK$000
30 June 2011	2,000 (40,000 x 5%)	x	1/1.07 = 0.935	1,870
30 June 2012	2,000	x	$1/1.07^2$ = 0.873	1,746
30 June 2013	2,000	x	$1/1.07^3$ = 0.816	1,632
30 June 2014	2,000	x	$1/1.07^4$ = 0.763	1,526
30 June 2015	42,000 (2,000 + 40,000)	x	$1/1.07^5$ = 0.713	29,946
				36,720

The initial carrying value of the liability element is therefore HK$36,720,000

Therefore the initial carrying amount of the equity element is HK$3,280,000 (40,000 – 36,720).

Measurement

Throughout the life of the preference shares the carrying value of the equity component remains unchanged.

The liability component is amortised in accordance with HKFRS 9. Using the amortised cost model, effective interest is charged on the liability component of the instrument at 7%. This has the effect of recognising the interest (dividend) paid and unwinding the liability, so that over the 5 year term of the shares the carrying value of the liability will increase to the redemption value.

As some shares are converted at the earliest possible opportunity, these are removed from the calculation at the end of year 3:

Year	Amortised cost at beginning of year	Effective interest at 7%	Interest paid at 5%	Amortised cost at the end of the year
	HK$000	HK$000	HK$000	HK$000
2011	36,720	2,570	(2,000)	37,290
2012	37,290	2,610	(2,000)	37,900
2013	37,900	2,653	(2,000)	38,553

At this stage, 250,000 (25% x 1million) of the redeemable preference shares are converted. Therefore:

- HK$9,638,000 (25% x 38,553,000) is removed from the liability balance.
- HK$820,000 (25% x 3,280,000) is also removed from the equity component balance.
- 750,000 (3 x 250,000) new ordinary shares are issued with a nominal value of HK$7.5million (750,000 x HK$10)
- The difference of 9,638 + 820 - 7,500 = HK$2,958,000 is credited to share premium.

The liability table continues from a balance of HK$28,915,000 (38,553 – 9,638):

Year	Amortised cost at beginning of year	Effective interest at 7%	Interest paid at 5%	Amortised cost at the end of the year
	HK$000	HK$000	HK$000	HK$000
2014	28,915	2,024	(1,500)	29,439
2015	29,439	2,061	(31,500)	-

Within the liability table:

- The effective interest is charged in the statement of comprehensive income as a finance cost
- The amortised cost at the end of each year forms the balance of the liability in the statement of financial position.

The HK$31,500,000 liability on 30 June 2015 includes the interest (dividend) paid for the year of HK$1.5million and HK$30million principal (relating to the remaining 75% of preference shareholders).

Of the remaining shareholders:

- A further 25% of the original shareholders (so 1/3 of the remaining preference shareholders) convert, therefore:
  - HK$10million of the liability balance at 30 June 2015 relates to the shares converted
  - HK$820,000 of the equity balance relates to the shares converted

- o 750,000 (250,000 x 3) new ordinary shares are issued, with a nominal value of HK$7.5million (750,000 x HK$10)
- o The difference between these entries of 10,000,000 + 820,000 – 7,500,000 = HK$3,320,000 is credited to share premium

- The remaining shareholders redeem their preference shares, therefore:
  - o HK$20million of the liability balance at 30 June 2015 relates to the shares redeemed
  - o This HK$20 million is paid out as cash on redemption
  - o The remaining equity reserve balance of HK$1.64million remains within equity in the statement of financial position.

Recommendation / justification

Grandstay Hotels' financial statements journals

1 July 2010:	HK$000	
DR cash	40,000	
CR liability	36,720	
CR equity	3,280	being initial recognition of the preference shares

30 June 2011:

DR finance cost	2,570
CR cash	2,000
CR liability	570

being interest paid on the preference shares for 2011 and the amortisation of the liability for the same period.

30 June 2012:

DR finance cost	2,610
CR cash	2,000
CR liability	610

being interest paid on the preference shares for 2012 and the amortisation of the liability for the same period.

30 June 2013:

DR finance cost	2,653
CR cash	2,000
CR liability	653

being interest paid on the preference shares for 2013 and the amortisation of the liability for the same period.

DR liability	9,638
DR equity	820
CR share capital	7,500
CR share premium	2,958

being the conversion of 25% of the convertible redeemable preference shares

30 June 2014:

DR finance cost	2,024
CR cash	1,500
CR liability	524

being interest paid on the preference shares for 2014 and the amortisation of the liability for the same period.

30 June 2015:

DR finance cost	2,061	
CR cash	1,500	
CR liability	561	

being interest paid on the preference shares for 2015 and the amortisation of the liability for the same period.

DR liability	10,000	
DR equity	820	
CR share capital	7,500	
CR share premium	3,320	being the conversion of 250,000 preference shares
DR liability	20,000	
CR cash	20,000	being the redemption of 500,000 preference shares

Extracts from Financial Statements

Statement of financial position of Grandstay Hotels at 30 June

	2011	**2012**	**2013**	**2014**	**2015**
	HK$000	HK$000	HK$000	HK$000	HK$000
Non-current liabilities					
Financial liabilities measured at amortised cost: 5% convertible redeemable preference shares	37,290	37,900	28,915	-	-
Current liabilities					
Financial liabilities measured at amortised cost: 5% convertible redeemable preference shares	-	-	-	29,439	-
Share capital and reserves					
Share capital	20,000	20,000	27,500	27,500	35,000
Share premium	15,000	15,000	17,958	17,958	21,278
Equity reserve	3,280	3,280	2,460	2,460	1,640

Statement of comprehensive income for Grandstay Hotels for the year ended 30 June

	2011	**2012**	**2013**	**2014**	**2015**
	HK$000	HK$000	HK$000	HK$000	HK$000
Finance cost	2,570	2,610	2,653	2,024	2,061

Disclosure

In addition to the amounts disclosed in the financial statements and shown above, Grandstay Hotels should disclose the following in the notes to its financial statements:

- The fair value of the liability
- Qualitative data including:
  - Exposures to different types of risk and how they arise
  - Objectives, policies and processes for managing the risk
  - Methods for monitoring the risk
  - Any changes in these since the previous period

For example, Grandstay Hotels may suffer from liquidity problems if all the preference shareholders want their shares redeemed in cash after five years, rather than choosing to convert into new ordinary shares.

- Quantitative data including:
  - Summary quantitative data about the exposure to risk at the period end
  - A maturity analysis of financial liabilities
  - A description of how liquidity risk in relation to financial liabilities is managed
  - Concentrations of risk if not apparent from other disclosures.

Key Learning Points:

1. Compound instruments (such as convertible debt or convertible preference shares) which are convertible at the option of the holder are split into a liability and equity component when initially recognised. The liability component is calculated based on the fair value of a similar liability instrument with no conversion option. The equity component is the residual.
2. The liability component of a compound instrument is amortised over the period to redemption using the effective interest rate. The amount of interest charged to profit comprises both the interest paid out and the winding up element.
3. On conversion the liability and equity (or parts thereof) are derecognised, the nominal value of the newly issued ordinary shares is recognised in share capital and the balancing amount is recognised as share premium.

Financial instruments

Case study 2

The Ariel Group enters into a forward contract on 1 October 2010 to buy 10,000 tonnes of steel for HK$6,200 per tonne on 31 March 2011. The terms of the contract permit either party to settle net, and the Ariel Group intends to settle in this way rather than take delivery of the steel.

The market value of steel per tonne is as follows:

1 October 2010	HK$6,200
31 December 2010	HK$6,500
31 March 2011	HK$6,750

The Ariel Group has a year end of 31 December.

Required:

Using the information provided:

(i) determine the relevant accounting standards,

(ii) determine the appropriate accounting treatment of the contract at the inception of the contract, at 31 December 2010 and when the contract matures on 31 March 2011,

(iii) calculate the amount at which the forward contract should be recognised in the Ariel Group's statement of financial position at 31 December 2010 and 2011 and prepare extracts from the Group's statement of comprehensive income at the same dates.

Discussion points

Financial instruments

Case Study 2 – Ariel Group

What are the issues?

The Ariel Group enters into a forward contract on 1 October 2010 to buy steel at a fixed price on 31 March 2011. The terms of the contract permit either party to settle net. The issues to consider are:

(a) Whether the contract is within the scope of HKFRS 9

(b) How the forward contract should be accounted for initially, at the December 2010 year end and on maturity in accordance with HKFRS 9

(c) What disclosures are required in accordance with HKFRS 7.

Which accounting standards are relevant?

HKAS 32: Financial Instruments: Presentation

HKFRS 9: Financial Instruments

HKFRS 7: Financial Instruments: Disclosures

What are the requirements of the accounting standards?

Scope

The financial instruments accounting standards are applied to contracts to buy or sell a non-financial item that can be settled net in cash with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with an entity's expected purchase, sale or usage requirements.

(HKAS 32.8, LP Chapter 18, Section 1.2)

Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item such as a forward contract on silver are not financial instruments. Nevertheless, some contracts to buy or sell non-financial items that can be settled net are within the scope of the Standard as if they were financial instruments.

(HKAS 32.AG20, LP Chapter 18, Section 1.2)

Definition

A derivative is a financial instrument with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

(c) it is settled at a future date.

(HKFRS 9, Appendix A, LP Chapter 18 Section 1.2)

Classification

On recognition, HKFRS 9 requires that financial assets are classified as measured at either:

- amortised cost, or
- fair value

This classification is made on the basis of both:

(a) the entity's business model for managing the financial asset, and
(b) the contractual cash flow characteristics of the financial asset.

(HKFRS 9.4.1, LP Chapter 18 Section 3.2.1)

A financial asset is classified as measured at amortised cost where:

(a) the objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

(HKFRS 9.4.2, LP Chapter 18 Section 3.2.1)

Measurement

HKFRS 9 requires that financial assets are initially measured at the fair value of consideration given.

(HKFRS 9.5.1, LP Chapter 18 Section 4.1)

How to apply the standards to the case?

Scope

The Ariel Group has entered into a forward contract to purchase steel, with the intention that the contract will be settled net and no delivery of steel will be taken. In other words, the forward contract is a speculative investment. The intention to settle net should be formally recorded, for example by a Board minute, so that there is no doubt that the intention is genuine.

The forward contract meets the definition of a derivative, since:

1. its value at a given time is dependent on the market price of steel (a traded commodity) at that date
2. no initial investment is required
3. the forward contract is settled at a future date, being 31 March 2011.

Therefore the forward contract is a derivative within the scope of HKAS 32 / HKFRS 9.

Classification

A derivative financial instrument may be a financial asset or a financial liability depending on the value of the underlying item.

In this case, the contract provides a fixed price for the purchase of steel for HK$6,200 per tonne. At 31 December 2010 the market price of steel is HK$6,500 per tonne and therefore the forward contract is 'in the money' ie it allows the Ariel Group to purchase steel for less than market price. This is still the case at the maturity date. The forward contract is therefore *a financial asset.*

A financial asset is classified as measured at amortised cost where:

(a) the objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

In this case, the forward contract does not meet these HKFRS 9 criteria that the asset is held to collect contractual cash flows and therefore the asset is measured at fair value through profit or loss.

Measurement

A financial asset is initially recorded at its fair value, normally cost. As no consideration is transferred in the case of the forward contract, and the contract has no intrinsic value, the instrument is not recognised in the financial statements on 1 October 2010.

At 31 December 2010, the forward contract has a value as follows:

	HK$000
Contracted purchase price of 10,000 tonnes of steel (@HK$6,200)	62,000
Market price of 10,000 tonnes of steel (@ HK$6,500)	65,000
Intrinsic value of forward contract	3,000

HK$3million is therefore recognised as a financial asset, with the corresponding credit made to profit or loss.

By the maturity date the fair value of the forward contract is:

	HK$000
Contracted purchase price of 10,000 tonnes of steel (@HK$6,200)	62,000
Market price of 10,000 tonnes of steel (@ HK$6,750)	67,500
Intrinsic value of forward contract	5,500

The fair value of the financial asset has therefore increased by HK$2.5million; this is recognised in profit or loss.

On maturity, the contract is settled net, therefore the Ariel Group receive HK$5.5million cash from the provider of the forward contract.

Recommendation / justification

Journal entries		HK$000	
At 31 December 2010			
DR	Financial asset	3,000	
CR	Investment income	3,000	being the recognition of the forward contract at fair value at 31 December 2010
At 31 March 2011			
DR	Financial asset	2,500	
CR	Investment income	2,500	being the remeasurement of the forward contract to fair value at 31 March 2011
DR	Cash	5,500	
CR	Financial asset	5,500	being the recognition of the net settlement of the forward contract.

Extracts from financial statements

Statement of financial position at 31 December

	2010 **HK$000**	**2011** **HK$000**
Forward contract	3,000	-

Statement of comprehensive income for the year ended 31 December

	2010 **HK$000**	**2011** **HK$000**
Investment income	3,000	2,500

Key Learning Points

1. A forward contract for purchase of a commodity is only a financial instrument within the scope of HKAS 32 / HKFRS 9 when it is not intended to result in delivery of the commodity, but will be settled net.
2. A forward contract for the purchase of a commodity which is intended to result in delivery of the commodity is not a financial instrument within the scope of HKAS 32 / HKFRS 9 and is not recognised in the financial statements.
3. A derivative is a financial asset or financial liability, depending on the value of the underlying item. In either case, the financial instrument is measured at fair value through profit or loss.

Discussion points

Group accounting

What are the issues?

Pioneer starts the year with a 90% interest in a Hong Kong subsidiary, Crescent, and a 75% interest in a PRC subsidiary, Grove.

Grove reports in RMB and therefore its financial statements must be translated into HK$ prior to being consolidated.

The consolidated statement of financial position and statement of comprehensive income must be prepared for the group, and the following issues considered:

(a) The non-controlling interest is to be measured as a proportion of net assets.

(b) Goodwill in Crescent was impaired by 50% four years ago.

(c) An item of plant held by Crescent requires a fair value uplift for consolidation purposes.

(d) Part of the holding in Crescent is disposed of mid way through the year. This disposal does not result in a loss of control.

Which accounting standards should be used?

HKFRS 3 (Revised) Business Combinations

HKFRS 10 Consolidated Financial Statements

HKAS 21 The Effects of Changes in Foreign Exchange Rates

What are the requirements of the accounting standards?

The results and position of an entity recorded in their functional currency are translated into a different presentation currency using the following procedures:

1. assets and liabilities are translated using the closing rate at the reporting date
2. income and expenses are translated at exchange rates at the dates of the transactions
3. all resulting exchange differences are recognised in other comprehensive income.

(HKAS 21.39, LP Chapter 19, Section 3.2.1)

An average rate for the period may be used to translate income and expenditure, providing that exchange rates do not fluctuate significantly.

(HKAS 21.40, LP Chapter 19, Section 3.2.1)

Any goodwill arising on the acquisition of a foreign operation is treated as an asset of that operation. It is therefore translated at each reporting date at the closing rate.

(HKAS 21.47, LP Chapter 19, Section 3.3.1)

Exchange differences are accumulated in a separate component of equity until disposal of the foreign operation. When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognised as part of, non-controlling interests in the consolidated statement of financial position.

(HKAS 21.41, LP Chapter 19, Section 3.3.3)

A parent that controls one or more subsidiaries should present consolidated financial statements.

(HKFRS 10.2, LP Chapter 27, Section 1.4)

The assets and liabilities of parent and subsidiary are added together on a line by line basis, eliminating the investment in subsidiary shown in the parent's statement of financial position and any intercompany items.

(HKFRS 10.B86, LP Chapter 27 Section 2.3.1, 2.3.2)

Goodwill arising in a subsidiary acquired in a single transaction is calculated as the excess of consideration transferred plus the non-controlling interest at the acquisition date over the fair value of the net assets of the subsidiary on the acquisition date. It is included in the consolidated statement of financial position as an intangible asset.

(HKFRS 3.32, LP Chapter 27, Section 4.3.4)

The non-controlling interest is measured at the acquisition date either at fair value or as a proportion of the fair value of the net assets of the acquiree. It is subsequently measured at this amount plus the non-controlling interest share of post acquisition movement in reserves and is included in the equity section of the consolidated statement of financial position.

(HKFRS 3.19, LP Chapter 27, Section 5.2)

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

(HKFRS 10.23, LP Chapter 30, Section 1.3)

In such circumstances the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent.

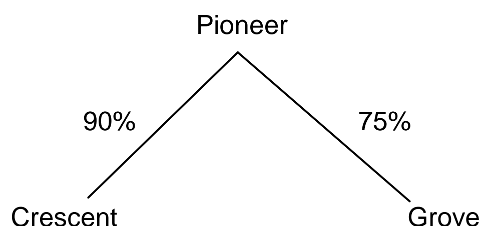
(HKFRS 10.B96, LP Chapter 30, Section 1.3.1)

How to apply the standard(s) to the case

Consolidation

The following workings show how the relevant accounting standards are applied to the case.

(W1) Group structure at start of year



(W2) Net asset working - Crescent

The fair value of the net assets of the subsidiaries is calculated at the acquisition date for inclusion in the goodwill calculation and at the reporting date in order to calculate:

– post acquisition movements in reserves (group share) for inclusion in group retained earnings

– post acquisition movements in reserves (NCI share) for inclusion in NCI

In the case of Crescent, there is a mid-year disposal of 10% of the shareholding, and therefore net assets are also calculated at this date in order to facilitate disposal and non-controlling interest calculations.

Crescent	Net assets at acquisition	Net assets at partial disposal date	Net assets at reporting date
	HK$000	HK$000	HK$000
Share capital	5,000	5,000	5,000
Retained earnings*	15,500	18,547	21,200
Fair value adjustment	2,000	2,000	2,000
Depreciation thereon 4.5/40 / 5/40 x 2m	-	(225)	(250)
	22,500	25,322	27,950

*retained earnings accrue evenly and therefore at the date of disposal are HK$18.547million ie HK$21.200m – (6/12 x HK$5.306m)

(W3) Goodwill on acquisition - Crescent

	Total HK$000
Cost of investment	24,000
Non-controlling interest 10% x HK$22.5m (W2)	2,250
	26,250
Net assets at acquisition (W2)	(22,500)
Goodwill	3,750
Impairment in 2007 (50%)	(1,875)
Carrying value at 30 April 2011	1,875

(i) Journal for initial recognition of goodwill (HK$000)

DR	Share capital	5,000	
DR	Retained earnings	15,500	
DR	Property, plant and equipment	2,000	
DR	Goodwill	3,750	
CR	Cost of investment in Crescent		24,000
CR	Non-controlling interest		2,250

(ii) Journal for impairment of goodwill (HK$000)

DR	Retained earnings	1,875	
CR	Goodwill		1,875

As the impairment arose a number of years ago, this does not affect the statement of comprehensive income for 2011.

(W4) Partial disposal of Crescent

The partial disposal takes place on 31 October 2010 ie exactly half way through the year.

Before considering the disposal, the NCI should be allocated its share of post acquisition reserves movements between the acquisition date and the partial disposal date.

(i) Journal to recognise profits between acquisition and disposal attributable to the NCI (HK$000)

		DR	CR
DR	Retained earnings [10%x(21,200 - 5,306 - 15,500)]	40	
DR	Non-controlling interest – IS (10% x 5,306 x 6/12)	265	
CR	Non-controlling interest - SOFP		305

The extra depreciation on the fair value adjustment up to the disposal date should also be recognised and allocated between the group and NCI as follows:

(ii) Journal to record extra depreciation on the fair value adjustment between acquisition and disposal (HK$000)

		DR	CR
DR	Non-controlling interest - SOFP (10% x 200)	20	
DR	Retained earnings (90% x 200)	180	
CR	Property, plant and equipment		200

Additionally, HK$25,000 relates to the current year (HK$2m/40 years x ½) and this is recognised in cost of sales in the statement of comprehensive income. It is attributable to the group and non-controlling interest in the proportion 90:10.

		DR	CR
DR	Cost of sales - Depreciation	25	
CR	Property, plant and equipment		25
DR	Non-controlling interest - SOFP	3	
CR	Non-controlling interest – IS (10% x 25)		3

On disposal, the difference between the increase in value of the NCI and sales proceeds is recognised in shareholders' equity.

		HK$000
NCI at 31 October 2010 pre disposal	Share of net assets 10% x 25,322 (W2) or, 2,250 (W3(i)) + 305 (W4(i)) – (20 + 3) (W4(ii))	2,532
NCI at 31 October 2010 post disposal	Share of net assets 20% x 25,322 (W2)	5,064
Increase in NCI		2,532

(iii) Journal to record the part disposal of Crescent (HK$000)

DR	Cash	3,600	
CR	Non-controlling interest - SOFP		2,532
CR	Retained earnings - Owners' equity		1,068

(W5) Profits since disposal

20% of profits made by Crescent since 31 October 2010 must be allocated to the non-controlling interest, and a further 6 months of extra depreciation on the fair value adjustment should be recognised:

(i) Journal to allocate profits since partial disposal attributable to the NCI (HK$000)

DR	Non-controlling interest – IS (20% x 5,306 x 6/12)	531	
CR	Non-controlling interest - SOFP		531

(ii) Journal to record extra depreciation on the fair value adjustment since partial disposal (HK$000)

DR	Cost of sales - Depreciation	25	
CR	Property, plant and equipment		25
DR	Non-controlling interest - SOFP	5	
CR	Non-controlling interest – IS (20% x 25)		5

In the statement of comprehensive income for the current period, the total debit entry of HK$25,000 is recognised in cost of sales and (as shown above) attributed proportionately to retained earnings and the non-controlling interest as before.

Translation of foreign currency financial statements - Grove

In the first case the financial statements of Grove should be translated into the presentation currency, HK$, and the resulting exchange difference arising in the year calculated for recognition as other comprehensive income. The cumulative exchange difference should be accumulated in a foreign exchange reserve or other separate component of equity:

(W6)

Statement of financial position	RMB000	Exchange rate	HK$000
Property, plant and equipment	91,200	0.84	108,571
Intangible assets	6,588	0.84	7,843
Inventories	17,050	0.84	20,298
Receivables	10,230	0.84	12,179
Cash	2,500	0.84	2,976
	127,568		151,867
Share capital	10,000	0.88	11,364
Retained earnings	90,740	β	103,478
Foreign exchange reserve (W8)			5,087
Deferred tax	9,438	0.84	11,236
Overdraft	1,650	0.84	1,964
Payables	12,340	0.84	14,690
Accrual	3,400	0.84	4,048
	127,568		151,867

(W7)

Statement of comprehensive income	RMB000	Exchange rate	HK$000
Revenue	182,240	0.86	211,907
Cost of sales	(73,690)	0.86	(85,686)
Distribution costs	(42,800)	0.86	(49,767)
Administrative expenses	(45,050)	0.86	(52,384)
Finance costs	(305)	0.86	(355)
Taxation	(6,655)	0.86	(7,738)
Profit for the year	13,740		15,977
Other comprehensive income			
Exchange difference (W8)			5,087
			21,064

(W8)

Opening net assets:	RMB000	HK$000
Share capital	10,000	
Retained earnings	77,000	
	87,000	
Opening net assets (RMB87,000,000) at opening rate (RMB0.88 /HK$1)		98,864
Opening net assets (RMB87,000,000) at closing rate (RMB0.84 /HK$1)		103,571
		Gain 4,707
Profit for the year at average rate (see above)		15,977
Profit for the year (13,740) at closing rate (RMB0.84 /HK$1)		16,357
		Gain 380

The overall gain on translation of Grove's financial statements is therefore HK$5.087 million (4,707 + 380). This is reported as other comprehensive income of Grove in its translated financial statements.

On consolidation the exchange difference arising in the year is allocated, in the statement of comprehensive income, between the group and the non-controlling interest in proportion to their shareholdings (see (W11)).

(W9) Net asset working - Grove

Grove	Net assets at acquisition	Net assets at acquisition	Net assets at reporting date	Net assets at reporting date
		(RMB0.88:HK$)		(W6)
	RMB000	HK$000	RMB000	HK$000
Share capital	10,000	11,364	10,000	11,364
Retained earnings	77,000	87,500	90,740	103,478
Foreign exchange reserve (W8)	-	-	-	5,087
	87,000	98,864	100,740	119,929

(W10) Goodwill on acquisition - Grove

	RMB000	Exchange rate	HK$000
Cost	80,000	0.88	90,909
NCI (25% x RMB 87m)	21,750	0.88	24,716
	101,750		115,625
Net assets at acquisition (W9)	(87,000)	0.88	(98,864)
Goodwill at acquisition date	14,750	0.88	16,761
Exchange difference (bal.fig.)			799
Goodwill at reporting date	14,750	0.84	17,560

(i) Journal for initial recognition of goodwill (HK$000)

DR	Share capital	11,364	
DR	Retained earnings	87,500	
DR	Goodwill	16,761	
CR	Cost of investment in Grove		90,909
CR	Non-controlling interest		24,716

(ii) Journal to record exchange movement on goodwill (HK$000)

DR	Goodwill	799	
CR	Foreign exchange reserve		799

The credit to the foreign exchange reserve in the statement of financial position is recognised as other comprehensive income in the statement of comprehensive income. This exchange gain is attributable to the parent only, as goodwill relating to the NCI is not recognised where the proportion of net assets method is used to measure the NCI.

(W11) Non-controlling interest in Grove

The non-controlling interest increases since acquisition by the NCI's share of post-acquisition reserves. In the translated financial statements there are two relevant reserves:

NCI share of increase in retained earnings: 25% (103,478 – 87,500(W9)) = HK$3.995m

NCI share of increase in foreign exchange reserve 25% x 5,087 (W9) = HK$1.272m

DR	Non-controlling interest - IS	3,995	
DR	Foreign exchange reserve	1,272	
CR	Non-controlling interest - SOFP		5,267

Recommendation / Justification

Statement of comprehensive income for the year ended 30 April 2011

	Pioneer	Crescent	Grove (W7)	Subtotal	W4(i)	W4 (ii)	W5 (i)	W5 (ii)	W10(ii)	W11	Consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
Revenue	154,748	58,950	211,907	425,605							425,605
Cost of sales	(62,348)	(23,580)	(85,686)	(171,614)		(25)		(25)			(171,664)
Gross profit											253,941
Distribution costs	(32,450)	(14,560)	(49,767)	(96,777)							(96,777)
Administrative expenses	(41,700)	(14,120)	(52,384)	(108,204)							(108,204)
Profit before interest and tax											48,960
Finance charge	(950)	(150)	(355)	(1,455)							(1,455)
Profit before tax											47,505
Taxation	(3,370)	(1,234)	(7,738)	(12,342)							(12,342)
Profit for the year	**13,930**	**5,306**	**15,977**	**35,213**							**35,163**
Other comprehensive income											
Surplus on revaluation	15,000	-	-	15,000							15,000
Exchange differences	-	-	5,087	5,087					799		5,886
Total comprehensive income	**28,930**	**5,306**	**21,064**	**55,300**		**(25)**		**(25)**	**799**		**56,049**
Profit for the year allocated to:											
Owners of the parent											30,381
NCI					265	(3)	531	(5)		3,994*	4,782
Total comprehensive income allocated to:											
Owners of the parent											49,995
NCI					265	(3)	531	(5)		5,266**	6,054

*NCI share of profits in Grove is 25% x 15.977m = 3.994m

**NCI share of TCI in Grove is 25% x 21.064m = 5.266m

Statement of financial position at 30 April 2011

	Pioneer	Crescent	Grove	Subtotal	W3 (i)	W3 (ii)	W4(i)	W4(ii)	W4(iii)	W5(i)	W5(ii)	W10 (i)	W10 (ii)	W11	Consolidated
	HK$000	HK$000	HK$000 (W6)	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
PPE	112,721	24,800	108,571	246,092	2,000			(225)			(25)				247,842
Intangibles	8,875	2,400	7,843	19,118											19,118
Goodwill	-	-	-	-	3,750	(1,875)						16,761	799		19,435
Investment (Crescent)	24,000	-	-	24,000	(24,000)										-
Investment (Grove)	90,909	-	-	90,909								(90,909)			-
															286,395
Inventories	13,450	7,750	20,298	41,498											41,498
Trade receivables	16,700	8,000	12,179	36,879											36,879
Cash	-	1,250	2,976	4,226					3,600						7,826
	266,655	44,200	151,867	462,722											372,598
Share capital	30,000	5,000	11,364	46,364	(5,000)							(11,364)			30,000
Retained earnings	143,025	21,200	103,478	267,703	(15,500)	(1,875)	(305)	(202)	1,068	(531)	(20)	(87,500)		(3,995)	158,843
Revaluation reserve	25,000	-	-	25,000											25,000
Foreign exchange reserve			5,087	5,087									799	(1,272)	4,614
Non-controlling interest	-	-	-		2,250		305	(23)	2,532	531	(5)	24,716		5,267	35,573
															254,030
Deferred tax liability	12,100	6,400	11,236	29,736											29,736
Loan	20,000	3,000	-	23,000											23,000
Overdraft	12,340	-	1,964	14,304											14,304
Trade payables	18,760	7,300	14,690	40,750											40,750
Accrual	5,430	1,300	4,048	10,778											10,778
	266,655	44,200	151,867	462,722											372,598

Key learning points

Foreign currency translation

1. The statement of financial position is translated as follows:

   Assets and liabilities – at closing rate

   Share capital – at exchange rate on date of acquisition of subsidiary

   Pre acquisition reserves – at exchange rate on date of acquisition of subsidiary

   A foreign exchange reserve is created to include the cumulative exchange difference on translation.

   Post-acquisition reserves – should be a balancing figure

2. Income and expenditure is translated at the spot exchange rate on the date of the transaction. Where exchange rates do not fluctuate significantly, an average rate for the year may be applied to all transactions.

3. Exchange differences are recognised in other comprehensive income and accumulated in a foreign exchange reserve until the foreign subsidiary is disposed of.

4. The exchange difference arising in any year is calculated as the difference between opening net assets translated at the opening rate and closing rate and the difference between profit for the year translated at the average rate and closing rate.

Consolidation

1. When the results of the foreign subsidiary have been translated to the presentation currency (HK$ in this case), they are then consolidated as normal.

2. Goodwill arising in the foreign subsidiary on consolidation must be retranslated with any exchange gain or loss recognised as other comprehensive income.

3. A fair value uplift of a depreciated asset results in additional depreciation being charged annually as a consolidation adjustment.

Disposal

1. Where part of a shareholding is disposed of but control is not lost, the transaction is dealt with through equity, with no gain or loss calculated.

   Disposal proceeds are recorded, and the NCI increased; any balancing amount is credited to shareholders' equity.

Group accounting

Additional information 1

The following additional information is provided in respect of the Pioneer Group:

1. On 1 November 2010, Pioneer transferred a machine used in production to Crescent for HK$600,000. The machine had cost HK$800,000 on 1 May 2005 and on that date was assessed as having a 16 year useful life and no residual value. Management do not believe that the useful life of the machine has changed. Depreciation is charged monthly.

2. Crescent sold goods to Pioneer during the year ended 30 April 2011 for HK$14m. Crescent sets a transfer price which includes a mark up of 20%. At 30 April 2011, goods purchased by Pioneer during the last quarter of the year which cost them HK$6million remain in inventory. Crescent's accounts show an intercompany balance with Pioneer at the year end of HK$750,000; Pioneer's accounts show an intercompany balance with Crescent of HK$710,000. The difference is due to cash in transit.

3. Grove sold goods to Crescent on 1 January 2011 for RMB2.6million, based on a 25% profit margin. At the period end, half of these goods remain in Crescent's inventory, however the intercompany balance *has been settled in full.*

4. Exchange rates are:

1 January 2011	RMB0.86:HK$1
30 April 2011	RMB0.84:HK$1
Average for year ended 30 April 2011	RMB0.86:HK$1

Required:

Prepare a revised consolidated statement of financial position as at 30 April 2011 and statement of comprehensive income to that date, based on the additional information, ignoring tax.

You should work to the nearest HK$000.

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

Discussion points

Group accounting

Additional information 1

What are the issues?

The consolidated financial statements prepared in the pre-workshop case study must be adjusted to take account of:

1. The transfer of a depreciated non-current asset from Pioneer to Crescent.
2. Intercompany sales from Crescent to Pioneer, with goods remaining in Pioneer's inventory at the year end and an outstanding intercompany balance in both companies' books.
3. Intercompany sales from Grove to Crescent denominated in RMB, with goods remaining in Crescent's inventory at the year end.

Which accounting standards should be used?

HKFRS 3 (Revised) Business Combinations

HKFRS 10 Consolidated Financial Statements

HKAS 21 The Effects of Changes in Foreign Exchange Rates

What are the requirements of the accounting standards?

The assets and liabilities of parent and subsidiary are added together on a line by line basis, eliminating the investment in subsidiary shown in the parent's statement of financial position and any intercompany items. **(HKFRS 10.B86, LP Chapter 27 Section 2.3.1, 2.3.2)**

Intragroup balances must be eliminated in full. Profits and losses resulting from intragroup transactions that are recognised in assets, such as inventory and non-current assets, are eliminated in full. **(HKFRS 10.B86, LP Chapter 28, Section 2.5)**

A foreign currency transaction is recorded by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. **(HKAS 21.21, LP Chapter 19, Section 2.1)**

At the end of each reporting period:

(a) foreign currency monetary items are retranslated using the closing rate

(b) foreign currency non-monetary items measured at historical cost are not retranslated ie the item remains translated using the spot rate on the date of the transaction

(c) foreign currency non-monetary items measured at fair value are translated using the exchange rate on the date when fair value was determined.

(HKAS 21.23, LP Chapter 19, Section 2.3)

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

(HKAS 21.8, LP Chapter 19, Section 2.3)

How to apply the standard(s) to the case

The following workings show how the additional information affects the consolidated statement of financial position.

(W1) Intercompany transfer of non-current asset

There are two issues to deal with in respect of the transfer of the non-current asset in the year:

- Any gain or loss on disposal is unrealised and so must be removed from the seller's profit or loss for the period and from the carrying value of the non-current asset
- The depreciation charge for the six months post transfer will differ from that before the transfer as the base cost to Crescent is different from that to Pioneer. The difference must be removed from profit or loss for the year and the carrying amount of the asset adjusted accordingly.

After adjusting for both of these items, the consolidated financial statements will reflect the position as if the intercompany transfer had not taken place.

(i) Gain or loss on disposal

	HK$000	HK$000
Proceeds		600
Carrying value at disposal:		
Cost	800	
Accumulated depreciation		
5.5/16 years x HK$800,000	(275)	
		(525)
Gain on disposal		75

To remove the gain from the consolidated financial statements (HK$000):

DR	Gain on disposal of machinery	75	
CR	Property, plant and equipment		75

This adjustment affects profits attributable to the owners of the parent company only, as the selling company is Pioneer.

The gain on disposal is also removed from retained earnings in the statement of financial position as a consolidation adjustment.

(ii) Increased depreciation charge	HK$	HK$
Annual depreciation charge prior to transfer (800/16yrs)	50,000	
So since transfer 6/12 x 50,000		25,000
Annual depreciation charge post transfer (600/10.5yrs)	57,143	
So since transfer 6/12 x 57,143		28,572
Extra depreciation charged in y/e 30 April 2011		3,572
Rounded to nearest thousand		4,000

To remove the effects of the extra depreciation charge from the consolidated financial statements (HK$000):

DR	Property, plant and equipment	4	
CR	Cost of sales		4

Again, this adjustment affects profits attributable to the owners of the parent company only.

The extra depreciation is also credited back to retained earnings in the statement of financial position as a consolidation adjustment.

(W2) Intercompany trading: Crescent and Pioneer

Three issues arise as a result of the intercompany trading between Crescent and Pioneer:

- intercompany sales in the statement of comprehensive income which must be cancelled
- unrealised profits in inventory
- intercompany balances in the statement of financial position which must be cancelled

(i) Intercompany sales – statement of comprehensive income

Intercompany sales of HK$14million have been made in the year; these must be eliminated from Crescent's sales revenue and Pioneer's cost of sales (HK$000):

DR	Revenue	14,000	
CR	Cost of sales		14,000

(ii) Unrealised profits in inventory

The unrealised profit is calculated as:

HK$6million x 20/120 = HK$1million

This amount must be removed from inventory and the cost of sales of the selling company:

DR	Cost of sales	1,000	
CR	Inventory		1,000

As the selling company is Crescent, the increase to cost of sales reduces the profits attributable to the owners of the parent and the NCI in proportion to their respective ownership interest at the period end.

Therefore in the statement of financial position, HK$800,000 is charged against retained earnings, and HK$200,000 against the non-controlling interest (HK$000):

DR	Non-controlling interest - SOFP	200	
CR	Non-controlling interest - IS		200

(iii) Intercompany balances – statement of financial position

The outstanding intercompany balances between Crescent and Pioneer must be eliminated on consolidation. The cash in transit is treated as if received by Crescent, and Crescent's cash and receivable balances are therefore adjusted in the first instance (HK$000):

DR	Cash	40	
CR	Receivables - intercompany		40

The intercompany balance now matches in both Crescent and Pioneer's accounts, and may be eliminated (HK$000):

DR	Payables - intercompany	710	
CR	Receivables - intercompany		710

(W3) Intercompany trading: Grove and Crescent

Two issues arise as a result of the intercompany trading between Grove and Crescent:

- intercompany sales in the statement of comprehensive income which must be cancelled
- unrealised profits in inventory

(i) Intercompany sales – statement of comprehensive income

In Grove's accounts the sale was initially recorded in RMB. For the purposes of consolidation, Grove's statement of comprehensive income is translated at average rate for the year. Therefore the intercompany sale in Grove's accounts is:

RMB2.6m/0.86 = HK$3,023,256

In Crescent's accounts, the purchase price would have been translated in accordance with the requirements of HKAS 21, ie at the spot rate prevailing on the date of the transaction. Therefore the intercompany purchase in Crescent's accounts is:

RMB2.6m/0.86 = HK$3,023,256

These amounts are then eliminated in the consolidated statement of comprehensive income by (HK$000):

DR	Sales	3,023	
CR	Cost of sales		3,023

(ii) Unrealised profits in inventory

The unrealised profit is calculated as:

RMB2.6 million x ½ x 25%	=	RMB325,000
This is translated as RMB325,000/0.86	=	HK$377,907

This amount must be removed from inventory and the cost of sales of the selling company (HK$000) :

DR	Cost of sales	378	
CR	Inventory		378

The selling company is Grove, and therefore the debit to cost of sales is attributable to the owners of the parent and the NCI in proportion to the year end ownership interest.

Therefore in the statement of financial position, group retained earnings decreases by HK$284,000 (75% x 378,000) and the NCI by HK$94,000.

DR	Non-controlling interest - SOFP	94	
CR	Non-controlling interest - IS		94

Recommendation / Justification

Statement of comprehensive income for the year ended 30 April 2011

	Consolidated (per pre-workshop case study)	W1(i)	W1(ii)	W2(i)	W2(ii)	W3(i)	W3(ii)	Adjusted Consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
Revenue	425,605			(14,000)		(3,023)		408,582
Cost of sales	(171,664)		4	14,000	(1,000)	3,023	(378)	(156,015)
Gross profit	253,941							252,567
Distribution costs	(96,777)							(96,777)
Administrative expenses	(108,204)	(75)*						(108,279)
Profit before interest and tax	48,960							47,511
Finance charge	(1,455)							(1,455)
Profit before tax	47,505							46,056
Taxation	(12,342)							(12,342)
Profit for the year	**35,163**							**33,714**
Other comprehensive income								
Surplus on revaluation	15,000							15,000
Exchange differences	5,886							5,886
Total comprehensive income	**56,049**							**54,600**
Profit for the year allocated to:								
Owners of the parent	30,381							29,226
NCI	4,782				(200)		(94)	4,488
Total comprehensive income allocated to:								
Owners of the parent	49,995							48,840
NCI	6,054				(200)		(94)	5,760

*Assuming Pioneer previously included the gain on disposal under Administrative expenses. In normal situation, it should be grouped under other gain and loss.

Statement of financial position at 30 April 2011

	Consolidated (per pre workshop material)	(W1) (i)	(W1)(ii)	(W2)(ii)	(W2) (iii) a	(W2) (iii) b	(W3)(ii)	Adjusted consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
PPE	247,842	(75)	4					247,771
Intangibles	19,118							19,118
Goodwill	19,435							19,435
	286,395							286,324
Inventories	41,498			(1,000)			(378)	40,120
Trade receivables	36,879				(40)	(710)		36,129
Cash	7,826				40			7,866
	372,598							370,439
Share capital	30,000							30,000
Retained earnings	158,843	(75)	4	(800)			(284)	157,688
Revaluation reserve	25,000							25,000
Foreign exchange reserve	4,614							4,614
Non-controlling interest	35,573			(200)			(94)	35,279
	254,030							252,581
Deferred tax	29,736							29,736
Loan	23,000							23,000
Overdraft	14,304							14,304
Trade payables	40,750					(710)		40,040
Accrual	10,778							10,778
	372,598							370,439

Key learning points

The key learning points of this case study are:

1. Where a non-current asset has been transferred between group companies, the required adjustment includes two elements:

	Gain or loss on disposal	Extra depreciation due to disposal
Consolidated statement of financial position	- Remove from carrying value of asset - Remove from retained earnings (allocating a proportion to the NCI where a non-wholly owned subsidiary is the selling company)	- Add back cumulative amount to carrying value of asset - Add back cumulative amount to retained earnings (allocating a proportion to the NCI where relevant)
Consolidated statement of comprehensive income	- Remove from profit or loss only where transfer arose in the current accounting period.	- Add back extra depreciation charged in the current accounting period.

2. Where intercompany trading has occurred in the year:
   - Eliminate intercompany sales from revenue and cost of sales
   - Eliminate intercompany payable and receivable balances, first accounting for items in transit where necessary
   - Eliminate the unrealised profit from the carrying value of any intercompany inventory remaining in inventory at the period end. This amount is also eliminated from the retained earnings /cost of sales of the selling company.

Group accounting

Additional information 2

On 1 May 2011 Pioneer sold a further 40% holding in Crescent so reducing its investment to a 40% shareholding. The sale was agreed for cash at the holding's fair value of HK$15.54 million. No entries have been made in Pioneer's individual financial statements.

Required:

(a) Calculate the group gain or loss on disposal and prepare the consolidated statement of financial position as at 1 May 2011, ignoring tax.

(b) If Pioneer's holding in Crescent were reduced to 15%, under what circumstances should Pioneer equity account for this 15% shareholding?

Note. The information above leads on from the pre-workshop case study and the Additional information 1.

You should work to the nearest HK$000.

Discussion points

Group accounting

Additional information 2

What are the issues?

The disposal of shares in Crescent reduces Pioneer's shareholding from 80% to 40% and so results in a loss of control. Therefore:

1. The group gain or loss on disposal must be calculated for inclusion in consolidated retained earnings.
2. Crescent must be accounted for as an associate in the statement of financial position.

Grove remains a subsidiary and should be consolidated as before.

In the second part of the question, the issue is how significant influence can be established without holding 20-50% voting shares.

Which accounting standards should be used?

HKFRS 3 (Revised) Business Combinations

HKFRS 10 Consolidated Financial Statements

HKAS 28 Investments in Associates and Joint Ventures

What are the requirements of the accounting standards?

If a parent loses control of a subsidiary, it should:

- Derecognise:
  - the assets, liabilities and goodwill of the subsidiary at the date when control is lost
  - the carrying amount of any non-controlling interest in the subsidiary at the date when control is lost. This includes any components of other comprehensive income attributable to the NCI
- Recognise:
  - The fair value of consideration received
  - Any investment retained in the subsidiary at fair value on the date of loss of control
- Reclassify amounts recognised in other comprehensive income in relation to the subsidiary to profit or loss (or transfer them to retained earnings if required by another standard) as if the underlying assets to which they relate have been disposed of.

  Any resulting difference is a gain or loss attributable to the parent and should be recognised in profit or loss.

(HKFRS 10.B98, LP Chapter 30, Section 1.4)

Significant influence is the power of one company to participate in the financial and operating policy decisions of another company.

(HKAS 28.3, LP Chapter 29, Section 1.1)

If an investor holds, directly or indirectly, 20% or more of the voting power of another company, it is presumed that the investor has significant influence, unless it can be clearly

demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.

(HKAS 28.5, LP Chapter 29, Section 1.1.1)

The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

1. Representation on the board of directors or equivalent governing body of a company
2. Participation in policy-making processes, including participation in decisions about dividends or other distributions
3. Material transactions between the investor and the other company
4. Interchange of management personnel
5. The provision of essential technical information

(HKAS 28.6, LP Chapter 29, Section 1.1.1)

Under the equity method, the investment in an associate is initially recognised at cost (fair value where a controlling shareholding is reduced to an associate investment) and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income.

(HKAS 28.10, LP Chapter 29, Section 1.3)

How to apply the standard(s) to the case

In the revised consolidated statement of financial position, Grove is consolidated as before, whilst Crescent is reported as an associate.

(W1) Treatment of Grove

Grove is consolidated as in the pre-workshop case study and additional information 1. Therefore:

(i) Goodwill of HK$16,761,000 is initially recognised (W10(i) WFGN Pre-workshop case study)

(ii) Goodwill is retranslated at the closing rate giving rise to an exchange gain of HK$799,000 (W10(ii) WFGN Pre-workshop case study)

(iii) The non-controlling interest is allocated its share of profits and foreign exchange reserves since acquisition (W11 WFGN Pre-workshop case study)

(iv) The unrealised profit in inventory is eliminated (W3(ii) WFGN Additional information 1)

(W2) Initial disposal of 10% of Crescent

The initial disposal of Crescent is not reflected in Pioneer's individual financial statements, therefore the following adjustment is required to record this disposal (HK$000):

DR	Cash	3,600	
CR	Investment (24,000 x 10/90)		2,667
CR	Gain on disposal		933

(W3) Group gain on disposal

In order to prepare the revised consolidated financial statements, the group gain on disposal should be calculated:

	HK$000	HK$000
Proceeds		15,540
Fair value of retained holding		15,540
		31,080
Net assets of Crescent at disposal (27,950 (W2) WFGN pre workshop case study) – 1,000 (W2(ii) WFGN Additional information 1))	26,950	
Goodwill at disposal date (W3 WFGN pre workshop case study)	1,875	
NCI in Crescent at disposal date (20% x 26,950)	(5,390)	
		23,435
Gain on disposal		7,645

Where an interest is retained, HKFRS 10 requires that it is treated as disposed of and then re-acquired at fair value. Therefore the journal to record the disposal in the statement of financial position is as follows (HK$000):

DR	Cash	15,540	
DR	Investment in associate	15,540	
CR	Investment in Crescent (24,000 – 2,667)		21,333
CR	Retained earnings		9,747

The credit of HK$9,747,000 to retained earnings comprises four elements:

	HK$000
(i) the gain on disposal as calculated above	7,645
(ii) the recognition of the group share of profits in Crescent from acquisition to the disposal date (90% x (25,322 – 22,500)) + (80% x (26,950 – 25,322))(W5 WFGN Pre-workshop case study)	3,842
(iii) uplift of gain on initial disposal from treatment in individual accounts to treatment in consolidated accounts (1,068 (W4 (iii) pre-workshop) – 933 (W2 above))	135
(iv) the recognition of the goodwill impairment in Crescent in 2007	(1,875)
	9,747

The gain of HK$7,645,000 is recognised in the consolidated statement of comprehensive income as an exceptional operating item.

(b) **Equity accounting**

One company equity accounts for another company where it has significant influence but not control over that company.

Significant influence is the power of one company to participate in the financial and operating policy decisions of another company.

Significant influence is presumed to exist where an investor holds between 20% and 50% of the voting power in another company. In assessing the level of voting power held, financial

instruments (such as share options) which are convertible into voting shares should be considered.

If Pioneer's shareholding in Crescent were reduced to 15%, it would be presumed that Pioneer no longer had significant influence over Crescent, unless such influence could be clearly demonstrated.

Significant influence could be demonstrated in any of the following ways:

1. Pioneer had a representative on Crescent's board of directors, or equivalent governing body.
2. Pioneer could participate in Crescent's policy-making decisions including those regarding dividends and other distributions.
3. Material transactions existed between Pioneer and Crescent.
4. Management personnel of the two companies were interchanged.
5. Pioneer provided essential technical information to Crescent.

Recommendation / Justification

Statement of financial position at 1 May 2011

	Pioneer	Grove*	Subtotal	W1 (i)	W1 (ii)	W1 (iii)	W1 (iv)	W2	W3	Consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
PPE	112,721	108,571	221,292							221,292
Intangibles	8,875	7,843	16,718							16,718
Goodwill	-	-	-	16,761	799					17,560
Investment in associate	-	-	-						15,540	15,540
Investment (Crescent)	24,000	-	24,000					(2,667)	(21,333)	-
Investment (Grove)	90,909	-	90,909	(90,909)						-
										271,110
Inventories	13,450	20,298	33,748				(378)			33,370
Receivables	16,700	12,179	28,879							28,879
Cash	-	2,976	2,976					3,600	15,540	22,116
	266,655	151,867	418,522							355,475
Share capital	30,000	11,364	41,364	(11,364)						30,000
Retained earnings	143,025	103,478	246,503	(87,500)		(3,995)	(284)	933	9,747	165,404
Revaluation reserve	25,000	-	25,000							25,000
Foreign exchange reserve		5,087	5,087		799	(1,272)				4,614
NCI	-	-		24,716		5,267	(94)			29,889
										254,907
Deferred tax	12,100	11,236	23,336							23,336
Loan	20,000	-	20,000							20,000
Overdraft	12,340	1,964	14,304							14,304
Payables	18,760	14,690	33,450							33,450
Accrual	5,430	4,048	9,478							9,478
	266,655	151,867	418,522							355,475

*see (W6) of pre-workshop WFGN

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

Key learning points

Loss of control

When control of a subsidiary is lost:

1. a gain or loss on disposal is calculated.
   - In the parent's financial statements this is the difference between the proceeds and cost of the investment disposed of
   - In the consolidated financial statements this is the difference between proceeds plus the fair value of any investment retained and the net assets in the subsidiary prior to disposal (including any goodwill and non-controlling interest).

   The group gain or loss on disposal includes 2 elements:

   (i) a realised gain, being the difference between proceeds and the net assets disposed of

   (ii) an unrealised gain, being the uplift of the retained investment to fair value
2. the subsidiary should be consolidated to the date of disposal and where an interest is retained, accounted for in accordance with relevant accounting standards thereafter (HKAS 28 where an associate or joint venture holding is retained; HKFRS 9 where a financial asset investment is retained).

Identification of an associate

Although a 20%-50% shareholding is presumed to result in significant influence and so associate status, significant influence may be achieved where a smaller percentage of voting shares are owned, for example by board representation.