Student Notes

Module A (June 2013)

Workshop Outline and Learning Methodologies

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Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Property related standards	• Case study • Group discussion	Ch. 5, 6, 10, 12	Pg. 1 – 23
3. Resolving accounting issues	• Case study • Group discussion	Ch. 11, 14, 21	Pg. 24 – 45
4. Wrap up	• Presentation • Group discussion		
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5. Reboot	• Presentation • Group discussion		
6. Financial instruments	• Case study • Group discussion	Ch. 18	Pg. 1 – 13
. Consolidation	• Case study • Group discussion	Ch. 15, 27, 28, 30	Pg. 14 – 38
8. Leading a team and teamwork	• Group discussion		
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Financial instruments

Case study 1

Casson Voss Company (CVC) manufactures component parts for motor vehicles. It has a financial year end of 31 March.

CVC borrowed HK$20 million from another entity on 1 April 2011 in order to help finance geographical expansion. No transaction costs were incurred. The loan matures on 31 March 2015 and carries an interest rate of HIBOR + 1%. Interest is payable annually in arrears on 31 March.

As CVC expects interest rates to rise, it entered into an interest rate swap on 1 April 2011 in order to fix interest payable at 5% on a notional amount of HK$20 million. CVC will therefore pay fixed interest at 5% and receive variable interest at HIBOR for a four-year period.

The swap has no initial cost and has a fair value of HK$900,000 at 31 March 2012 and HK$725,000 at 31 March 2013. Net settlement is made annually on 31 March and the swap is re-priced on this date.

HIBOR is 5% at 31 March 2012 and 6.5% at 31 March 2013.

All criteria for cash flow hedge accounting are met and since the notional HK$20 million subject of the swap is equal to the loan principal, the loan and swap term are both four years and cash flows arise on the same dates, the hedging relationship is expected to be 100% effective at inception and on an ongoing basis.

Required:

(i) **Discuss how the loan and swap should initially be accounted for in CVC's financial statements.**

(ii) **Calculate the amounts to be recognised in CVC's financial statements in the years ended 31 March 2012 and 2013 in respect of the loan and associated swap.**

(iii) **State what further disclosures are required in respect of the loan and swap arrangement.**

Discussion points

Financial instruments – Interest rate swap

Case Study 1 – CVC

What are the issues?

CVC has taken out a HK$20 million loan with interest of HIBOR + 1% and on the same date entered into an interest rate swap to pay fixed 5% payments and receive variable interest at HIBOR on a nominal HK$20 million. Students are required to:

1. Discuss how the swap should initially be accounted for in CVC's financial statements
2. Calculate amounts to be recognised in CVC's financial statements in the years ended 31 March 2012 and 2013 in respect of the loan and associated swap
3. Outline the relevant disclosures required.

Which accounting standards should be used?

HKAS 32	*Financial instruments: Presentation*
HKAS 39	*Financial instruments: Recognition and measurement*
HKFRS 7	*Financial instruments: Disclosures*
HKFRS 9	*Financial instruments*

What are the requirements of the accounting standards?

Financial assets and liabilities

Definitions

The definition of a *financial asset* includes the following: "a contractual right to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity."

(HKAS 32 paragraph 11, LP chapter 18 section 1.2)

The definition of a *financial liability* includes the following: "a contractual obligation to deliver cash or another financial asset to another entity".

(HKAS 32 paragraph 11, LP chapter 18 section 1.2)

Initial recognition

An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument.

(HKFRS 9 paragraph 3.1.1, LP chapter 18 section 3.2)

At initial recognition, an entity shall measure a financial asset or financial liability at its fair value, plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

(HKFRS 9 paragraph 5.1.1, LP chapter 18 section 4.1)

The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received).

(HKFRS 9 paragraph B5.1.1, LP chapter 18 section 4.1)

Subsequent measurement

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.

Otherwise it is measured at fair value. Therefore all derivatives are measured at fair value.

(HKFRS 9 paragraph 5.2.1, LP chapter 18 section 3.2.1)

An entity shall classify all financial liabilities as subsequently measured at amortised cost using the effective interest method unless they are:

(a) held for trading, or
(b) designated at fair value through profit or loss.

In this case financial liabilities are measured at fair value through profit or loss. Derivatives are always measured at fair value through profit or loss.

(HKFRS 9 paragraph 4.2.1, LP chapter 18 section 3.2.2)

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition less any principal repayments plus or minus the cumulative amortisation of any difference between that initial amount and the maturity amount minus any impairment.

(HKAS 39 paragraph 9, LP chapter 18 section 4.2.2)

Disclosure

An entity must disclose the carrying amounts of financial instruments by HKFRS 9 category.

(HKFRS 7 paragraph 8, LP chapter 18 section 7.3)

An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes: total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss.

(HKFRS 7 paragraph 20, LP chapter 18 section 7.4)

An entity should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments.

(HKFRS 7 paragraph 31, LP chapter 18 section 7.6)

Hedge accounting

Definitions

In a cash flow hedge, a hedging instrument is a designated derivative whose cash flows are expected to offset changes in the cash flows of a designated hedged item.

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to the risk of changes in fair value or future cash flows and (b) is designated as being hedged.

(HKAS 39 paragraph 9, LP chapter 18 section 6.2)

A cash flow hedge is a hedge of the exposure to variability of cash flows that is attributable to a particular risk associated with a recognised asset or liability or highly probable forecast transaction and could affect profit or loss. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt ie a hedge of a future transaction where the future cash flows being hedged are the future interest payments.

(HKAS 39 paragraphs 86, AG103, LP chapter 18 section 6.5.2)

Accounting

Where a cash flow hedge meets the conditions for hedge accounting, it is accounted for as follows:

(a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in other comprehensive income and

(b) The ineffective portion is recognised in profit or loss.

(HKAS 39 paragraph 95, LP chapter 18 section 6.5.2)

If a hedge of a forecast transaction results in the recognition of a financial asset or liability, any gains or losses that had been recognised in other comprehensive income (because they are the result of an effective hedge) are reclassified to profit or loss in the same period as the hedged forecast cash flows affect profit or loss.

(HKAS 39 paragraph 97, LP chapter 18 section 6.5.2)

Disclosure

An entity shall disclose the following separately for each type of hedge:

(a) A description of each type of hedge

(b) A description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period

(c) The nature of the risks being hedged.

(HKFRS 7 paragraph 22, LP chapter 18 section 7.5.1)

For cash flow hedges, an entity shall disclose:

(a) The periods when the cash flows are expected to occur and when they are expected to affect profit or loss

(b) A description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur

(c) The amount that was recognised in other comprehensive income during the period

(d) The amount that was reclassified from equity to profit or loss for the period, showing the amount included in each line item in the statement of comprehensive income

(e) The amount that was removed from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.

(HKFRS 7 paragraph 23, LP chapter 18 section 7.5.1)

How to apply the standards to the case

(i) Initial recognition

Loan

The HK$20 million loan meets the definition of a financial liability in the accounts of CVC. According to HKFRS 9, the amount of the loan should be recognised initially at fair value ie the proceeds of HK$20 million.

The entry would be recorded as follows (HK$'000):

DEBIT	Cash	20,000	
CREDIT	Loan		20,000

Swap

The swap is a derivative financial instrument however it is not initially recognised on 1 April 2011 as it has no cost.

(ii) Subsequent accounting treatment – years ended 31 March 2012 and 2013

Loan

The loan is classified as measured at amortised cost using the effective interest method. As there is no difference between the initial amount of the loan and the maturity amount, amortised cost is HK$20 million throughout the term of the loan.

Loan interest

Loan interest is payable annually at HIBOR + 1%. This is calculated as:

y/e 31 March 2012	(5+1)% x 20m	=	HK$1.2 million
y/e 31 March 2013	(6.5+1)% x 20m	=	HK$1.5 million

Interest expense is recorded by (HK$'000):

31 March 2012

DEBIT	Interest expense	1,200	
CREDIT	Cash		1,200

31 March 2013

DEBIT	Interest expense	1,500	
CREDIT	Cash		1,500

Swap – net settlement

Under the swap agreement, CVC pays 5% on a notional HK$20 million and receives HIBOR. Net settlement is made annually on 31 March:

	Paid HK$'000 (5% x 20m)	Received HK$'000	Net receipt HK$'000
31 March 2012	1,000	5% x 20m = 1,000	-
31 March 2013	1,000	6.5% x 20m = 1,300	300

Net settlement is nil in 2012 and therefore no accounting entry is required; at 31 March 2013, the accounting entry to record net settlement is (HK$'000):

DEBIT	Cash	300	
CREDIT	Other comprehensive income		300

This amount is immediately reclassified to profit or loss to be matched to the HK$1,500 interest payment cash flow which it hedges (HK$'000):

DEBIT	Other comprehensive income	300	
CREDIT	Interest expense		300

Swap – repricing

The swap is a derivative financial asset classified as measured at fair value in accordance with the HKAS 39 hedging rules.

As it is part of a cash flow hedging arrangement, changes in the fair value of the hedging instrument are recognised in other comprehensive income rather than in profit or loss.

The swap is repriced annually on 31 March. The fair value on 31 March 2012 is HK$900,000 and on 31 March 2013 is HK$725,000. The fair value is recorded by (HK$'000):

31 March 2012

DEBIT	Financial asset – swap	900	
CREDIT	Other comprehensive income		900

31 March 2013

DEBIT	Other comprehensive income	175	
CREDIT	Financial asset – swap (900 – 725)		175

(iii) **Disclosure requirements**

There are two relevant disclosure issues to discuss – those relating to the financial instruments (the loan and the derivative), and those relating to the hedge:

Disclosure relating to financial instruments

In the statement of financial position, or notes, HKFRS 7 requires disclosure of financial liabilities and assets by measurement classification. In this case, the requirement is met in the statement of financial position.

HKFRS 7 also requires disclosure, either on the face of the financial statements, or in the notes, of interest paid that has been calculated based on the effective interest method. This requirement is met in the statement of comprehensive income.

In addition disclosures are required in relation to the nature and extent of risks arising from financial instruments. In this case CVC has hedged interest cash flows which suggests that it perceives an interest rate risk. Therefore CVC must disclose within the notes to the accounts its exposure to risk and how it is managed (qualitative disclosures) and summary data about the exposure to risk at the end of the reporting period (quantitative disclosures).

Disclosure relating to the cash flow hedge

HKFRS 7 requires that an entity provides a description of each type of hedge together with a description of the hedging instruments and their fair values and the nature of the risks being hedged.

In addition, for cash flow hedges, disclosure is required of the periods when the cash flows being hedged are expected to occur and affect profit or loss, the amount that was recognised in other comprehensive income in the period and the amount that was reclassified from other comprehensive income to profit or loss in the period.

These requirements are met in the statement of comprehensive income and a cash flow hedge disclosure note.

Recommendation / Justification

CVC recognises the following in its financial statements:

	31 March 2012	*31 March 2013*
Statement of financial position	**HK$'000**	**HK$'000**
Non-current assets		
Financial asset derivatives designated and effective as hedging instruments: interest rate swap	900	725
Non-current liabilities		
Loan – Financial liabilities at amortised cost	20,000	20,000
Statement of comprehensive income		
Interest expense calculated using effective interest method	1,200	1,500
Reclassifications	-	(300)
Other comprehensive income		
Items that may be reclassified to profit or loss:		
Cash flow hedges		
Gains/losses arising in the year (300 – 175)	900	125
Less: reclassification adjustments for gains / losses included in profit or loss	-	(300)

Interest rate risk management

CVC is exposed to interest rate risk because it borrows funds at variable interest rates. The risk is managed by the Company by using interest rate swap contracts in hedging arrangements.

At 31 March 2013, CVC has an outstanding loan of HK$20 million with an interest rate of HIBOR + 1%. The loan matures on 31 March 2015.

Cash flow hedges

Under an interest rate swap contract the Company agrees to exchange the difference between interest paid at 5% and received at HIBOR on a notional amount of HK$20 million. This swap enables the Company to mitigate the risk of cash flow exposures on the issued variable debt. The fair value of the swap instrument at 31 March 2013 was HK$725,000. The swap is settled annually on 31 March on a net basis; the swap matures on the same date as the loan that it relates to on 31 March 2015.

Key learning points:

1. An interest rate swap is used to fix future interest payable / receivable on a loan. Where the HKAS 39 criteria are met this is classified as a cash flow hedge and accounted for in accordance with HKAS 39.
2. The future interest payments/receipts are the hedged item and the swap is the hedging instrument.
3. Where a swap instrument has no initial cost, it is not recognised immediately. Thereafter it is measured at fair value with gains and losses recognised in other comprehensive income. It may be a financial asset or financial liability.
4. On net settlement of the swap, the amount paid or received is recognised in other comprehensive income. This is reclassified to profit or loss in the same periods as the cash flows to which it relates are recognised.

Financial instruments

Case study 2

Fang Manufacturing Company (FMC) raises finance by issuing two financial instruments in the year to 31 March 2013:

1. On 1 April 2012, FMC issued 2,000,000 5% convertible redeemable preference shares for face value. Each share has a face value of HK$2.50, and they mature on 1 April 2015. The prevailing market rate of interest on 1 April 2012 is 6.5% for this type of financial instrument without the conversion option.
2. On 1 April 2012, FMC also issued 10,000 7% redeemable preference shares for face value of HK$1 each. Transaction costs of HK$100 were incurred. The preference shares will be redeemed for cash at face value on 1 April 2017. The effective interest rate for this type of financial instrument is 7.245%.

Required:

(i) **Explain the accounting treatment necessary for convertible and non-convertible redeemable preference shares.**

(ii) **Calculate the amounts to be recognised in the financial statements of FMC in the year ended 31 March 2013.**

Discussion points

Financial instruments

Case Study 2 – Preference shares

What are the issues?

On 1 April 2012, FMC issued two financial instruments, each being an issue of preference shares. One of the issues was an issue of convertible redeemable preference shares, the other non-convertible redeemable preference shares. The issues to consider are:

1. Are the preference shares financial liabilities or equity?
2. How should they be initially recognised and measured?
3. How should the finance charge for 2013 be calculated?
4. What figures will be recognised in the statement of financial position at 31 March 2013?

Which accounting standards should be used?

HKAS 32 *Financial Instruments: Presentation*

HKFRS 9 *Financial Instruments*

What are the requirements of the accounting standards?

Definitions

A financial liability is defined as any liability that is a contractual obligation to:

(i) Deliver cash or another financial asset to another entity, or

(ii) Exchange financial instruments with another entity under conditions that are potentially unfavourable

An instrument is an equity instrument only if there is no contractual obligation to deliver cash or another financial asset to another entity or to exchange another financial instrument with the holder under potentially unfavourable conditions to the issuer.

(HKAS 32 paragraph 11, LP chapter 18 sections 1.2 and 2.3.1)

Initial recognition

On initial recognition, HKFRS 9 requires that financial liabilities are classified as either:

(a) at fair value through profit or loss, or
(b) financial liabilities at amortised cost

A financial liability is classified at fair value through profit or loss if:

(a) it is held for trading, or
(b) upon initial recognition it is designated at fair value through profit or loss.

(HKFRS 9 paragraph 4, LP chapter 18 section 3.2.2)

At initial recognition, an entity shall measure a financial asset or financial liability at its fair value, plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

(HKFRS 9 paragraph 5.1.1, LP chapter 18 section 4.1)

Subsequent measurement of financial liabilities

Except for financial liabilities at fair value through profit or loss, all financial liabilities should be recognised and measured at amortised cost.

(HKFRS 9 paragraph 5.3.1, LP chapter 18 section 4.3)

Compound instruments are split into equity and liability parts and presented accordingly in the statement of financial position.

(HKAS 32 paragraph 28, 29, 32, LP chapter 18 section 2.4.4)

How to apply the standards to the case

(i) **Initial recognition**

The first issue is to determine the nature of the financial instruments that have been issued, which then determines the amount at which the instruments will be initially recognised, and whether they are recognised as debt or equity.

Convertible preference shares

The convertible preference shares are a compound financial instrument. On the issue of such shares, the holder is granted an option to convert them into equity of the issuer rather than redeem the shares for cash. This is the economic equivalent of the issue of conventional preference shares plus an option to acquire equity shares in the future.

The financial instrument is presented as part liability, part equity, with the amounts recognised as each element being calculated as follows:

(a) calculate the present value for the liability component using a market interest rate based on similar instruments with no conversion element, and

(b) deduct this from the instrument as a whole to leave a residual value for the equity component.

For FMC's convertible preference shares the following calculation is performed:

Working 1

	HK$
Present value of the principal:	
5,000,000 payable at the end of three years (5m $\times$ 1/1.065^3)	4,139,245
Present value of the interest:	
Payable annually in arrears for three years (5m $\times$ 5% $\times$ (1/1.065 + 1/1.065^2 + 1/1.065^3)	662,119
Total liability component	4,801,364
Equity component (balancing figure)	198,636
Proceeds of the bond issue	5,000,000

The entry would be recorded as follows (HK$):

DEBIT	Cash	5,000,000	
CREDIT	Financial liability		4,801,364
CREDIT	Equity		198,636

Non-convertible preference shares

The non-convertible preference shares are a simple financial liability because there is no option to convert the preference shares to equity. HKFRS 9 requires that financial liabilities are initially recognised at fair value, which in this case is equivalent to the proceeds raised on the share issue. In addition, the amount initially recognised is reduced by the transaction costs incurred on the issue of the shares.

Therefore the amount initially recognised is the cash proceeds of HK$10,000 less HK$100 transaction costs i.e. HK$9,900 (Working 2).

The entry would be recorded as follows(HK$):

DEBIT	Cash	9,900	
CREDIT	Financial liability		9,900

(ii) **Subsequent measurement**

Subsequent to initial measurement, the financial liabilities should be measured at amortised cost, using the effective interest method. This is in accordance with HKFRS 9 which requires that financial liabilities that are not measured at fair value should be measured at amortised cost.

Fair value is only used where financial liabilities are classified as held for trading, which is not the case for either of FMG's instruments, which are going to be held to maturity.

Amortised cost involves charging an effective interest rate on the outstanding liability in order to calculate the finance cost for the year, and the liability outstanding at the year end.

Working 3: Convertible preference shares (HK$)

	Financial liability b/d	6.5% effective interest	Interest paid (5% x 5m)	Financial liability c/d
y/e 2013	4,801,364 (W1)	312,089	(250,000)	4,863,453
y/e 2014	4,863,453	316,124	(250,000)	4,929,577
y/e 2015	4,929,577	320,423	(250,000)	5,000,000

Working 4: Non-convertible preference shares (HK$)

	Financial liability b/d	7.245% effective interest	Interest paid (7% x 10,000)	Financial liability c/d
y/e 2013	9,900 (W2)	717	(700)	9,917
y/e 2014	9,917	719	(700)	9,936
y/e 2015	9,936	720	(700)	9,956
y/e 2016	9,956	721	(700)	9,977
y/e 2017	9,977	723	(700)	10,000

Recommendation / Justification

FMC recognises the following in its financial statements as at 31 March 2013:

	HK$
Statement of comprehensive income:	
Finance costs (312,089 (W3) + 717 (W4)	312,806
Statement of financial position	
Financial liabilities (4,863,453 (W3) + 9,917 (W4)	4,873,370
Equity (W1)	198,636

Student Notes

Key learning points:

1. Calculation of amounts to be recognised as a finance charge in the income statement for different types of redeemable preference shares.
2. Amortised cost calculations including the use of effective interest rate and prevailing market rate.
3. Treatment of transaction costs incurred on issuing financial instruments.

Discussion points

Pre-workshop case study

What are the issues?

Wheatley acquired 90% of Fleece in the previous accounting period. The consolidated statement of financial position must be prepared for the Wheatley group, and the following issues considered:

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

(b) HK$10 million of the purchase consideration is allocated to a brand name held by Fleece, but unrecognised in its statement of financial position.

(c) Fleece has sold goods to Wheatley during the period, resulting in a year end intercompany balance and inventory balance.

(d) The deferred tax impact of the consolidation adjustments must be considered.

Which accounting standards should be used?

HKAS 12	*Income Taxes*
HKAS 38	*Intangible Assets*
HKFRS 3 (Revised)	*Business Combinations*
HKFRS 10	*Consolidated Financial Statements*

What are the requirements of the accounting standards?

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

(HKFRS 10 paragraph 4, LP chapter 27 section 2.2)

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 paragraph 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 paragraph 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 paragraph 19, LP chapter 27 section 5.2)

An acquirer should recognise, separately from goodwill, an intangible asset of the acquire, irrespective of whether that asset had been recognised by the acquire before the business combination, when it meets the definition of an asset and is identifiable (ie separable or arising from contractual or other legal rights).

(HKAS 38 paragraph 34, LP chapter 27 section 5.3.2)

The identifiable assets acquired in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets are not affected by the business combination or are affected differently. For example when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, there is a taxable temporary difference which results in a deferred tax liability. The resulting deferred tax liability affects goodwill.

(HKAS 12 paragraph 19, LP chapter 15, section 10.1.1)

Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference. However, HKAS 12 does not permit the recognition of the resulting deferred tax liability because goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill.

(HKAS 12 paragraph 21, LP chapter 15, section 10.4)

Temporary differences arise when the carrying amount of investments in subsidiaries (being the parent's share of the net assets of subsidiaries) is different from the tax base of the investments (usually the cost). A deferred tax liability should be recognised for all taxable temporary differences associated with investments in subsidiaries except to the extent that the parent company is:

(i) Able to control the timing of the reversal of the temporary difference, which is the case where it controls the dividend policy, and

(ii) It is probable that the temporary difference will not reverse in the foreseeable future.

(HKAS 12 paragraph 38 & 39, LP chapter 15, section 10.2.1)

A deductible temporary difference arises where unrealised profits arising from intragroup transactions are eliminated from the carrying amount of assets such as inventory, but no equivalent adjustment is made for tax purposes.

(HKAS 12, Illustrative Examples, paragraph 11, LP chapter 15, section 10.1.2)

How to apply the standards to the case

Consolidation

The following approach should be taken in answering the requirement:

1. Set up a working schedule and insert the individual company statement of financial position information provided in the case study
2. Add across each line item to produce totals for each in the third column of the working schedule
3. Ensure that you understand the group structure by drawing a structure diagram (W1)
4. Calculate the net assets of the subsidiary at the acquisition date and reporting date, taking into account any fair value adjustments, including the recognition of previously unrecognised intangible assets, and their deferred tax effects (W2)
5. Using the net assets at the acquisition date from (W2), calculate goodwill arising on the acquisition of the subsidiary (W3), and consider any deferred tax effects. Record the associated journals in the working schedule
6. Calculate the post acquisition profits in Fleece and reallocate the relevant proportion to the non-controlling interest (W4). Amortisation on the recognised brand and the associated movement in deferred tax should also be recognised and allocated between group retained earnings and the non-controlling interest

7. Cancel the intercompany balances (W5)
8. Adjust for the unrealised profit in inventory and consider the deferred tax effect of the adjustment (W5)
9. Cast the working schedule line by line in order to complete the consolidation.
10. Prepare the reconciliation of the non-controlling interest to ensure the accuracy of the consolidation (W6)

Workings

(W1) Group structure

Wheatley

90%

Fleece

(W2) Net assets at acquisition

The fair value of the net assets of the subsidiary 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 (NCI share) for inclusion in NCI:

	Net assets at acquisition	*Net assets at reporting date*
Fleece		
	HK$'000	HK$'000
Share capital	25,000	25,000
Retained earnings	39,000	45,000
Fair value of brand recognised at acquisition (note 1)	10,000	8,500
Deferred tax liability – brand (note 2)	(1,500)	(1,275)
	72,500	77,225

Notes

1 The Wheatley Group amortises brands over a 10 year period. Fleece was acquired 18 months prior to the reporting date, therefore the carrying amount of the brand at the reporting date is HK$8.5 million, being the original fair value of HK$10 million less amortisation of HK$1.5 million (1.5/10 × 10m).

2 A deferred tax liability arises in respect of the fair value adjustment since this results in the carrying amount of the brand exceeding its tax base of nil:

- At acquisition the deferred tax liability is 15% × HK$10m = HK$1.5m
- At the reporting date the deferred tax liability is 15% × HK$8.5m = HK$1.275m

(W3) Goodwill on acquisition - Fleece

	HK$'000
Cost of investment	70,000
Non-controlling interest 10% × HK$72,500 (W2)	7,250
	77,250
Net assets at acquisition (W2)	(72,500)
Goodwill	4,750

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

DEBIT	Share capital	25,000	
DEBIT	Retained earnings	39,000	
DEBIT	Intangible assets	10,000	
DEBIT	Goodwill	4,750	
CREDIT	Deferred tax liability		1,500
CREDIT	Cost of investment in Fleece		70,000
CREDIT	Non-controlling interest		7,250

(W4) Non-controlling interest in Fleece

(i) 10% of post-acquisition profits in Fleece must be allocated to the non-controlling interest in net assets. Post-acquisition profits are HK$6 million (45m – 39m (W2)), therefore (HK$'000):

DEBIT	Retained earnings (10% × 6m)	600	
CREDIT	Non-controlling interest		600

(ii) Amortisation since acquisition of HK$1.5 million (W2) on the brand and the HK$225,000 (W2) movement in the associated deferred tax liability must also be accounted for and allocated between group retained earnings and the non-controlling interest (HK$'000):

(a)

DEBIT	Retained earnings (90% × 1.5m)	1,350	
DEBIT	Non-controlling interest	150	
CREDIT	Intangible assets (1.5/10 × 10m)		1,500

(b)

DEBIT	Deferred tax liability (1,500 – 1,275)	225	
CREDIT	Retained earnings (90% × 225)		202
CREDIT	Non-controlling interest (10% × 225)		23

(W5) Intercompany trading

(i) The intercompany receivable account in Fleece and payable account in Wheatley must be cancelled (HK$'000):

DEBIT	Trade payables - Wheatley	900	
CREDIT	Trade receivables - Fleece		900

(ii) There is an unrealised profit in inventory of HK$300,000 (25/125 × HK$1.5m). This is eliminated from inventory of Wheatley and profit in Fleece, the selling company. The adjustment to profit is split between group retained earnings and the non-controlling interest (HK$'000):

DEBIT	Retained earnings 90% × 300	270	
DEBIT	Non-controlling interest 10% × 300	30	
CREDIT	Inventory		300

(iii) The adjustment for unrealised profit gives rise to a deductible temporary difference of HK$300,000, and so a deferred tax asset of HK$45,000 (300,000 × 15%). In this case the deferred tax asset reduces the existing deferred tax liability. The tax credit to profit is allocated between group retained earnings and the non-controlling interest (HK$'000):

DEBIT	Deferred tax liability	45	
CREDIT	Retained earnings 90% × 45		41
CREDIT	Non-controlling interest 10% × 45		4

(W6) Reconciliation of non-controlling interest

A reconciliation of the non-controlling interest should be prepared when the consolidation is completed to ensure the accuracy of the consolidation:

	Fleece HK$'000
Shareholders' funds at reporting date	70,000
Fair value adjustment – brand name	8,500
Deferred tax liability – brand name	(1,275)
Unrealised profit	(300)
Deferred tax asset – unrealised profit	45
	76,970
× 10%	7,697

Consolidated statement of financial position at 31 March 2012

	Wheatley	Fleece	Total	(W3)	(W4) (i)	(W4) (ii)(a)	(W4) (ii)(b)	(W5) (i)	(W5) (ii)	(W5)(iii)	Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
Property, plant and equipment	195,000	65,000	260,000								260,000
Intangible assets	30,500	-	30,500	10,000		(1,500)					39,000
Goodwill	-	-		4,750							4,750
Investment in Fleece	70,000	-	70,000	(70,000)							-
	295,500	65,000	360,500								303,750
Inventories	41,500	14,600	56,100						(300)		55,800
Trade receivables	32,000	10,150	42,150					(900)			41,250
Cash	-	2,250	2,250								2,250
	73,500	27,000	100,500								99,300
	369,000	92,000	461,000								403,050
Ordinary share cap	50,000	25,000	75,000	(25,000)							50,000
Revaluation reserve	38,000	-	38,000								38,000
Retained earnings	125,000	45,000	170,000	(39,000)	(600)	(1,350)	202		(270)	41	129,023
	213,000	70,000	283,000								217,023
Non controlling interest	-			7,250	600	(150)	23		(30)	4	7,697
											224,720
Deferred tax liability	21,500	7,600	29,100	1,500			(225)			(45)	30,330
Bank loan	82,000	-	82,000								82,000
	103,500	7,600	111,100								112,330
Trade payables	28,500	11,400	39,900					(900)			39,000
Income tax payable	3,250	2,000	5,250								5,250
Accrual	8,750	1,000	9,750								9,750
Overdraft	12,000	-	12,000								12,000
	52,500	14,400	66,900								66,000
	369,000	92,000	461,000								403,050

Key learning points:

1. Basic consolidation procedures involve adding assets and liabilities together on a line by line basis, eliminating the cost of the investment, share capital and pre-acquisition reserves of the acquiree and recognising goodwill.
2. The non-controlling interest can be measured at either fair value or as a proportion of the fair value of the net assets of the acquiree.
3. An intangible asset of the acquiree is recognised in the consolidated financial statements where it meets the definition of an asset and is identifiable, regardless of whether it is recognised in the individual financial statements of the acquiree.
4. Where the carrying amount of an asset or liability is adjusted for consolidation purposes but there is no corresponding adjustment to the asset or liability's tax base, a deferred tax asset or liability will result.
5. There is no deferred tax impact of the recognition of goodwill.
6. An unrealised profit adjustment for consolidation purposes results in a deferred tax asset.

Consolidation

Additional information 1

On 1 April 2012 Wheatley disposed of a 15% shareholding in Fleece for HK$12.8 million, so reducing its shareholding to 75%. The fair value of the shareholding retained is HK$69.5 million on the disposal date.

The shares are acquired by Farsyde, the existing non-controlling interest in Fleece.

In accordance with Hong Kong tax law, the resulting gain on disposal is not taxable.

Required:

(i) **Prepare the journal entries required to record the disposal of a 15% shareholding in Fleece Coin Wheatley's individual financial statements.**

(ii) **Prepare the journal entries required to record the disposal of the 15% shareholding in Fleece Co in the consolidated financial statements.**

(iii) **Discuss how the accounting treatment of the disposal may differ if Farsyde, as well as purchasing an additional 15% shareholding in Fleece, were able to appoint two additional directors to the Board of Fleece.**

Discussion points

Consolidation

Additional information 1

What are the issues?

Wheatley disposes of a 15% shareholding in Fleece on 1 April 2012, so reducing its shareholding from 90% to 75%. The purchaser is Farsyde, the existing non-controlling interest. Students are required to:

1. Prepare the journal entries to record the disposal in Wheatley's individual financial statements
2. Prepare the journal entries to record the disposal in the Wheatley Group consolidated financial statements
3. Consider whether the accounting treatment would be different if Farsyde acquired the right to appoint half of the board members of Fleece on the same date.

Which accounting standard should be used?

HKFRS 10 *Consolidated Financial Statements*

What are the requirements of the accounting standard?

Disposals

If a parent loses control of a subsidiary, the parent:

(a) Derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial position

(b) Recognises any investment retained at its fair value on the date when control is lost

(c) Recognises the gain or loss associated with the loss of control

(HKFRS 10 paragraph 25, LP chapter 30 section 1.2)

Changes in a parent's ownership interest that do not result in the parent losing control of the subsidiary are equity transactions.

When the proportion of equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes. The entity shall recognise directly in equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received and attribute it to the owners of the parent.

(HKFRS 10 paragraphs 23 & B96, LP chapter 30 section 1.3)

Control

An investor controls an investee when it has all of the following:

(i) Power over the investee

(ii) Exposure or rights to variable returns from its involvement with the investee

(iii) The ability to use its power over the investee to affect the amount of the investor's returns.

(HKFRS 10 paragraph 7, LP chapter 27 section 2.1.2)

An investor has power over an investee when the investor has rights that give it the current ability to direct the relevant activities ie the operating and financial activities that significantly affect the investee's returns, such as:

- Selling and purchasing goods and services
- Managing financial assets
- Acquiring and disposing of assets
- Researching and developing new products and processes
- Determining a funding structure and obtaining funding.

Power may be straightforward eg arising solely from the voting rights granted by shares, and can be assessed by considering the voting rights from shareholdings. In other cases the assessment is more complex and requires more than one factor to be considered.

An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities.

(HKFRS 10 paragraphs 10, 11, 14, B11 LP chapter 27 section 2.1.3)

Examples of rights that either individually or in combination can give an investor power include:

(a) Voting rights

(b) Rights to appoint or remove members of an investee's key management personnel who have the ability to direct the relevant activities

(c) Rights to direct the investee to enter into transactions for the benefit of the investor

(d) Other rights that give the holder the ability to direct the relevant activities.

(HKFRS 10 paragraph B15, LP chapter 27 section 2.1.3)

How to apply the standards to the case

(i) **Wheatley's individual financial statements**

In Wheatley's individual financial statements, the proceeds of disposal are recognised, the proportion of the cost of the investment relating to the shareholding disposed of is derecognised and any difference is recognised in profit or loss (HK$'000):

DEBIT	Cash	12,800	
CREDIT	Investment in Fleece (15/90 x 70m)		11,667
CREDIT	Gain on disposal		1,133

(ii) **Consolidated financial statements**

In the consolidated financial statements, the journal made to record the disposal in Wheatley's individual financial statements should be reversed and a consolidation level disposal journal recorded: the proceeds of disposal are recognised, the increase in the non-controlling interest is recognised and the difference is recognised in group retained earnings.

The 10% non-controlling interest on 31 March 2012 was HK$7,697,000 (pre-workshop case study). A 25% non-controlling interest on 1 April 2012 is therefore HK$19,243,000 (76,970,000 x 25%). This is an increase of HK$11,546,000.

The journal to record the disposal is therefore (HK$'000):

DEBIT	Cash	12,800	
CREDIT	Non-controlling interest		11,546
CREDIT	Retained earnings		1,254

(iii) **Control of Fleece**

Year ended 31 March 2012

Throughout the year ended 31 March 2012, Wheatley held 90% of the shares in Fleece and Farsyde held 10%. The two Board directors of Fleece were appointed by Wheatley. Therefore Wheatley clearly held power over Fleece by virtue of the fact that it held both the majority of voting rights and was able to appoint the two directors (key management personnel who direct relevant activities).

Wheatley was also entitled to a variable return in the form of a dividend, and due to its power could influence the amount of this dividend. Therefore for the year ended 31 March 2012, Wheatley controlled Fleece.

From 1 April 2012 – no Farsyde Board representation

After the disposal date, 1 April 2012, Wheatley holds 75% of the shares in Fleece and Farsyde holds 25%. The two Board directors are appointed by Wheatley and therefore, again, Wheatley has power over Fleece as it holds the majority of voting rights and has the ability to appoint the directors.

Wheatley continues to be entitled to a variable return in the form of a dividend, and due to its power can influence the amount of this dividend. Therefore Wheatley continues to control Fleece.

From 1 April 2012 – Farsyde appoints two Board members

Should Farsyde acquire the right to appoint two further directors on 1 April 2012 together with an additional 15% shareholding, the ability to appoint key management personnel is shared by Wheatley and Fleece. The majority of votes would still be held by Wheatley.

Therefore in order to establish whether Wheatley continues to control Fleece after 1 April 2012, it must be considered whether the relevant activities of Fleece are directed through voting rights or by appointed Board members.

If relevant activities are directed primarily through voting rights, Wheatley will continue to have power over Fleece, and assuming that Wheatley remains entitled to dividends and can influence the amounts of these dividends, it will retain control.

If relevant activities are directed primarily by appointed directors, then Wheatley loses control of Fleece at 1 April 2012. The investment is instead classified as an associate or joint arrangement.

Recommendation / Justification

Wheatley recognises the following in its individual company financial statements as at 31 March 2013:

Statement of financial position	**HK$'000**
Non-current assets	
Investment in Fleece (70,000 – 11,667)	58,333
Statement of comprehensive income	
Gain on disposal	1,133

In the consolidated financial statements for the year ended 31 March 2013:

- The individual company gain recognised in Wheatley's financial statements is reversed
- No group gain is recognised in profit or loss
- The non-controlling interest is increased by HK$11,546,000 at the disposal date
- Retained earnings are increased by HK$1,254,000 at the disposal date
- There is no adjustment to previously recognised goodwill.

Key learning points:

1. Where part of a subsidiary shareholding is disposed of, a gain or loss, calculated as proceeds less the cost of the shareholding disposed of, is recognised in the profit or loss of the parent company.
2. Where part of a subsidiary shareholding is disposed of, but control is not lost, no gain or loss on disposal is recognised in the consolidated financial statements. Instead the disposal is accounted for by adjusting the non-controlling interest and recognising any difference between this and proceeds in equity. There is no adjustment to previously recognised goodwill.
3. Where part of a subsidiary shareholding is disposed of and control is lost, a gain or loss is recognised in consolidated profit or loss. This is calculated as the difference between proceeds plus the fair value of any interest retained and the net assets of the subsidiary recognised prior to disposal.
4. Control is achieved where an investor has power over an investee, has the right or exposure to variable returns from an investee, and can use its power to influence the returns.

Consolidation

Additional information 2

At the start of the financial year ended 31 March 2013, Wheatley disposed of a 15% shareholding in Fleece (Additional information 1).

The following further information is relevant to the year ended 31 March 2013:

1. Wheatley sold goods to Fleece for HK$6 million, charging a margin of 25%. At the year end, a third of these remained unsold by Fleece. At 31 March 2013, Wheatley's accounts show a balance of HK$1 million due from Fleece; Fleece's accounts show a balance of HK$800,000 due to Wheatley. The difference is due to cash in transit.
2. Wheatley paid a dividend of HK$22 million during the year. In May 2013, it declared a final dividend for the year ended 31 March 2013 of HK$24 million.
3. Fleece paid a dividend of HK$8.5 million in the year.
4. During the year, Wheatley transferred HK$2 million from the revaluation reserve to retained earnings in respect of excess depreciation charged on the carrying amount of revalued assets.

You should assume that all inventory held at 31 March 2012 by Wheatley Group companies is sold during the course of the year ended 31 March 2013.

There have been no impairments in the year ended 31 March 2013.

Required:

Prepare the consolidated statement of financial position, statement of comprehensive income and statement of changes in equity for the Wheatley Group for the year ended 31 March 2013, incorporating the deferred tax impact of any adjustments.

Proforma consolidation workings for the statement of financial position and statement of comprehensive income which include the results of Wheatley and Fleece for the year ended 31 March 2013 are included in the appendix.

You should work to the nearest HK$'000.

Appendix

Consolidated statement of financial position at 31 March 2013

	Wheatley	Fleece	Total										Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
Property, plant and equipment	214,000	69,500	283,500										
Intangible assets	28,000	-	28,000										
Goodwill	-	-	-										
Investment in Fleece	58,333	-	58,333										
	300,333	69,500	369,833										
Inventories	47,500	14,200	61,700										
Trade receivables	36,667	9,800	46,467										
Cash	-	3,500	3,500										
	84,167	27,500	111,667										
	384,500	97,000	481,500										
Ordinary share cap	50,000	25,000	75,000										
Revaluation reserve	50,000	-	50,000										
Retained earnings	136,000	48,500	184,500										
	236,000	73,500	309,500										
Non controlling interest													
Deferred tax	23,450	8,800	32,250										
Bank loan	69,500	-	69,500										
	92,950	8,800	101,750										
Trade payables	27,600	11,620	39,220										
Income tax payable	3,450	2,300	5,750										
Accrual	9,950	780	10,730										
Overdraft	14,550	-	14,550										
	55,550	14,700	70,250										
	384,500	97,000	481,500										

Student Notes

Module A (June 2013)
Workshop 2 – Handout 7.1
(Additional information 2)

Consolidated statement of comprehensive income for the year ended 31 March 2013

	Wheatley	Fleece	Total											Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
Revenue	395,000	165,000	560,000											
Cost of sales	(246,250)	(96,500)	(342,750)											
Gross profit	148,750	68,500	217,250											
Distribution costs	(62,450)	(28,520)	(90,970)											
Administrative expenses	(54,208)	(24,480)	(78,688)											
Gain on disposal of shares in Fleece	1,133	-	1,133											
Investment income	6,375	-	6,375											
Other gains and losses	-	-	-											
Profit before int and tax	39,600	15,500	55,100											
Finance charge	(3,200)	-	(3,200)											
Profit before tax	36,400	15,500	51,900											
Income tax	(5,400)	(3,500)	(8,900)											
Profit for the year	31,000	12,000	43,000											
Gain on property revaluation	14,000	-	14,000											
Total comp income	45,000	12,000	57,000											
Profit attributable to owners of parent (bal fig)														
Profit attributable to NCI														
TCI attributable to owners of parent (bal fig)														
TCI attributable to NCI														

-

Discussion points

Consolidation

Additional information 2

What are the issues?

Wheatley disposed of a 15% shareholding in Fleece on the first day of the accounting period, and therefore have a 75% holding throughout the year. The consolidated statement of financial position, statement of comprehensive income and statement of changes in equity must be prepared for the Wheatley Group, and the following issues considered:

(a) The disposal must be accounted for at a group level.

(b) There is an opening provision for unrealised profit which must be reversed.

(c) Wheatley has sold goods to Fleece resulting in a year end intercompany balance and inventory balance.

(d) Dividends have been paid by both Wheatley and Fleece and Wheatley has declared a final dividend in respect of the year ended 31 March 2013 after the year end.

(e) The deferred tax impact of the consolidation adjustments must be considered.

Which accounting standards should be used?

HKAS 12	*Income Taxes*
HKFRS 3 (Revised)	*Business Combinations*
HKFRS 10	*Consolidated Financial Statements*

What are the requirements of the accounting standards?

A parent that controls one or more subsidiaries should present consolidated financial statements.
(HKFRS 10 paragraph 4, LP chapter 27 section 2.2)

The assets and liabilities and income and expenses 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 paragraph 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 paragraph 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 paragraph 19, LP chapter 27 section 5.2)

A deductible temporary difference arises where unrealised profits arising from intragroup transactions are eliminated from the carrying amount of assets such as inventory, but no equivalent adjustment is made for tax purposes.

(HKAS 12, Illustrative Examples, paragraph 11, LP chapter 15, section 10.1.2)

How to apply the standards to the case

Consolidation

The following approach should be taken in answering the requirement:

1. Using the proforma consolidation schedules, reverse the journal entry made to record the disposal in Wheatley's accounts and replace it with the group level journal (W1).
2. The dividend income from Fleece recorded by Wheatley should be reversed for the purposes of the consolidation (W2).
3. Calculate the net assets of the subsidiary at the acquisition date, the partial disposal date and the reporting date, considering the recognition of the previously unrecognised intangible asset, and its deferred tax effects (W3).
4. Record the journal to recognise goodwill in the working schedule. This journal is the same as that in the pre-workshop case study (W4).
5. Calculate the post acquisition profits in Fleece and reallocate the relevant proportion to the non-controlling interest (W5). Amortisation on the recognised brand and the associated movement in deferred tax should also be recognised and allocated between group retained earnings and the non-controlling interest (W5).
6. Reverse the opening URP and associated deferred tax (W6).
7. Cancel the intercompany sales and purchases and outstanding balances (W7)(i) and (ii).
8. Adjust for the unrealised profit in inventory and consider the deferred tax effect of the adjustment (W7)(iii) and (iv).
9. Cast the working schedule line by line in order to complete the consolidated statement of financial position and statement of comprehensive income.
10. Feed the relevant consolidated balances into the consolidated statement of changes in equity and calculate dividends for inclusion in the statement (W8).

(W1) Group disposal journal

The disposal has been accounted for in Wheatley's individual financial statements, evidenced by the gain on disposal in the company's statement of comprehensive income.

The journal entry to record the disposal at a company level must be reversed and replaced with the group level disposal journal (Additional information 1).

The company journal already recorded is (HK$'000):

DEBIT	Cash	12,800	
CREDIT	Investment in Fleece		11,667
CREDIT	Gain on disposal / Retained earnings		1,133

The group level disposal journal is (HK$'000):

DEBIT	Cash	12,800	
CREDIT	Non-controlling interest		11,546
CREDIT	Retained earnings		1,254

Both debit entries are the same. Therefore the following journal is required to reverse the credit entries of the company journal and record the credit entries of the group journal (HK$'000):

DEBIT	Investment in Fleece	11,667	
DEBIT	Gain on disposal (SOCI)	1,133	
CREDIT	Non-controlling interest		11,546
CREDIT	Retained earnings		1,254

The reversal of the gain on disposal also affects retained earnings. For the purposes of entries in the consolidation schedule, this entry and the credit to retained earnings are netted off to make one credit entry of HK$121,000 (1,254,000 – 1,133,000).

(W2) Dividend income

Fleece has paid a dividend of HK$8.5 million during the year. Wheatley's share of the dividend of HK$6,375,000 (75% x 8.5m) has been recorded in Wheatley's individual company statement of comprehensive income. This income is reversed as it is replaced by the profits of Fleece in the consolidated statement of comprehensive income (HK$'000):

DEBIT	Investment income (Wheatley - SOCI)	6,375	
CREDIT	Retained earnings (Fleece)		6,375

The debit entry to Wheatley's investment income is also a debit to Wheatley's retained earnings, meaning that the net effect on group retained earnings of the debit and the credit is nil. Therefore no adjustment for HK$6,375,000 is made to the statement of financial position.

The amount paid by Fleece to non-controlling interest of HK$2,125,000 (25% × 8.5m) serves to reduce the balance owing to the NCI (HK$'000):

DEBIT	Non-controlling interest (SOFP)	2,125	
CREDIT	Retained earnings		2,125

(W3) Net assets at acquisition

The fair value of the net assets of the subsidiary is calculated at the acquisition date for inclusion in the goodwill calculation and at the disposal date, the partial disposal date and reporting date in order to calculate post acquisition movements for inclusion in NCI:

Fleece	*Net assets at acquisition*	*Net assets at disposal date (Pre-workshop case study)*	*Net assets at reporting date*
	HK$'000	HK$'000	HK$'000
Share capital	25,000	25,000	25,000
Retained earnings	39,000	45,000	48,500
Fair value of brand recognised at acquisition (note 1)	10,000	8,500	7,500
Deferred tax liability – brand (note 2)	(1,500)	(1,275)	(1,125)
	72,500	77,225	79,875

Notes

1 The Wheatley Group amortises brands over a 10 year period. Fleece was acquired 2½ years prior to the reporting date, therefore the carrying amount of the brand at the reporting date is HK$7.5 million, being the original fair value of HK$10 million less amortisation of HK$2.5 million (2.5/10 x 10m).

2 A deferred tax liability arises in respect of the fair value adjustment since this results in the carrying amount of the brand exceeding its tax base of nil:

- At acquisition the deferred tax liability is 15% x HK$10m = HK$1.5m
- At the reporting date the deferred tax liability is 15% x HK$7.5m = HK$1.125m

(W4) Goodwill on acquisition – Fleece

When shares in a subsidiary are sold, however control is retained, goodwill is not recalculated. Therefore the journal to recognise goodwill is the same as that in the pre-workshop case study.

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

DEBIT	Share capital	25,000	
DEBIT	Retained earnings	39,000	
DEBIT	Intangible assets	10,000	
DEBIT	Goodwill	4,750	
CREDIT	Deferred tax liability		1,500
CREDIT	Cost of investment in Fleece		70,000
CREDIT	Non-controlling interest		7,250

(W5) Non-controlling interest in Fleece

(i) The non-controlling proportion of post-acquisition profits in Fleece must be allocated to the non-controlling interest in net assets. This is calculated using retained profits calculated in (W3) as:

		HK$'000
Pre disposal	10% (45,000 – 39,000)	600
Post disposal	25% ((48,500 – 45,000) + 8,500))	<u>3,000</u>
		3,600

The required journal entry is (HK$'000):

DEBIT	Profit attributable to NCI (SOCI)	3,000	
DEBIT	Retained earnings	600	
CREDIT	Non-controlling interest		3,600

The first debit entry is shown at the bottom of the statement of comprehensive income as an allocation of total profits; it must also be debited to group retained earnings in the statement of financial position, meaning that the total debit to retained earnings is HK$3.6 million.

(ii) Amortisation since acquisition on the brand (W3) and the movement in the associated deferred tax liability (W3) must also be accounted for and allocated between group retained earnings and the non-controlling interest. The relevant amounts are again calculated pre and post disposal.

(a) *Amortisation*

The total amortisation charge on the brand since acquisition is HK$2.5m (W3). The amount attributable to the non-controlling interest is calculated as:

		HK$'000
Pre disposal	10% (10m – 8.5m)	150
Post disposal	25% (8.5m – 7.5m)	250
		400

The required journal entry is (HK$'000):

DEBIT	Retained earnings	2,100	
DEBIT	Non-controlling interest	400	
CREDIT	Intangible assets		2,500

The amortisation charge arising on the brand in the year ended 31 March 2013 of HK$1 million (8.5m-7.5m) is also debited to profit or loss in the year. This is charged to administrative expenses and the NCI proportion of HK$250,000 is allocated to NCI.

(b) *NCI – Deferred tax*

The deferred tax liability relating to the brand has decreased by HK$375,000 since acquisition (1,500 – 1,125 (W3)). The amount attributable to the non-controlling interest is calculated as:

		HK$'000
Pre disposal	10% (1,500 – 1,275)	23
Post disposal	25% (1,275 – 1,125)	37
		60

The required journal entry is (HK$'000):

DEBIT	Deferred tax liability (1,500 – 1,125)	375	
CREDIT	Retained earnings		315
CREDIT	Non-controlling interest		60

The reduction in the deferred tax liability arising in the year ended 31 March 2013 of HK$150,000 is also credited to profit or loss in the year. This is credited to the income tax expense and the NCI proportion of HK$37,000 is allocated to NCI.

(W6) Intercompany trading – opening provision for unrealised profit

(i) *Provision for unrealised profit*

In the pre-workshop case study, an unrealised profit in inventory of HK$300,000 was calculated at 31 March 2012 on sales from Fleece to Wheatley. This amount was eliminated from the inventory value in the statement of financial position and also from profits to ensure that:

- inventory in the consolidated financial statements was shown at cost to the group
- the profit on the sale from Fleece to Wheatley was not reflected in earnings.

The journal entry for this was as follows (HK$'000):

DEBIT	Retained earnings	270	
DEBIT	Non-controlling interest	30	
CREDIT	Inventory		300

This elimination should now be reversed to reflect the fact that the inventory in question has been sold on to a third party, and therefore the profit realised. The required journal:

- reduces cost of sales (opening inventory) by the unrealised amount in order to increase the profit on sale of the inventory to be group profit (ie the difference between cost to Fleece and selling price from Wheatley to the third party)
- adjusts retained earnings to reflect the consolidation adjustment made in the previous year.

The required journal is (HK$'000):

DEBIT	Retained earnings	270	
DEBIT	Non-controlling interest	30	
CREDIT	Cost of sales		300

The credit to cost of sales is allocated between the owners of the parent and the non-controlling interest in the statement of comprehensive income.

Both the debit and the credit entry of the adjustment journal affect retained earnings – the debit entry directly, and the credit entry through its inclusion in profit for the year, and therefore in effect the adjustment is netted off to zero in the statement of financial position.

Note that there is no impact on inventory in the statement of financial position as the goods in question have now been sold.

(ii) *Deferred tax on opening provision for unrealised profit*

At 31 March 2012 a deferred tax asset (here a reduction to the deferred tax liability) was recognised in relation to the unrealised profit by (HK$'000):

DEBIT	Deferred tax liability	45	
CREDIT	Retained earnings		41
CREDIT	Non-controlling interest		4

As the inventory has now been sold and there is no longer an unrealised profit and therefore no associated deferred tax effect, the previous adjustment should be reversed. The required journal:

- Reverses the credit to the consolidated income tax expense recognised last year, as the temporary difference has now reversed
- Adjusts retained earnings to reflect the consolidation adjustment made in the previous year.

The required journal is (HK$'000):

DEBIT	Income tax (SOCI)	45	
CREDIT	Retained earnings		41
CREDIT	Non-controlling interest		4

The debit to income tax is allocated between the owners of the parent and the non-controlling interest in the statement of comprehensive income.

Once again, both the debit and the credit entry of the adjustment journal affect retained earnings – the credit entries directly, and the debit entry through its inclusion in profit for the year, and therefore in effect the adjustment is netted off to zero in the statement of financial position.

Note that no entry is made to the deferred tax liability as the asset is not included in either company's individual accounts and therefore the amount does not exist to reverse.

(W7) Intercompany trading

(i) *Intercompany sales and purchases*

During the year ended 31 March 2013, Wheatley has sold goods to Fleece for HK$6 million. This amount must be reversed from each company's statement of comprehensive income (HK$'000):

DEBIT	Revenue (Wheatley)	6,000	
CREDIT	Cost of sales (Fleece)		6,000

(ii) *Year-end intercompany balances*

The intercompany sales resulted in a year end receivable balance in Wheatley's accounts of HK$1m. The corresponding payable balance in Fleece's accounts is HK$800,000 with the difference being due to cash in transit.

(a) In the first instance Wheatley's accounts are adjusted as if the cash has been received by the company. As Wheatley has an overdraft, this is reduced by (HK$'000):

DEBIT	Overdraft – Wheatley	200	
CREDIT	Trade receivables – Wheatley		200

(b) The intercompany receivable account in Wheatley and payable account in Fleece are now equal and must be cancelled (HK$'000):

DEBIT	Trade payables – Fleece	800	
CREDIT	Trade receivables – Wheatley		800

These two journals can be merged to become (HK$'000):

DEBIT	Overdraft - Wheatley	200	
DEBIT	Trade payables – Fleece	800	
CREDIT	Trade receivables – Wheatley		1,000

(iii) *Unrealised profit*

There is an unrealised profit in inventory of HK$500,000 (25% x HK$6m x 1/3). This is eliminated from inventory of Fleece and profit in Wheatley, the selling company. The adjustment to profit is allocated to the owners of the parent company only (HK$'000):

DEBIT	Cost of sales	500	
CREDIT	Inventory		500

The debit to cost of sales also adjusts retained earnings in the statement of financial position.

(iv) The adjustment for unrealised profit gives rise to a deductible temporary difference of HK$500,000, and so a deferred tax asset of HK$75,000 (500,000 x 15%). As in the pre-workshop case study, the deferred tax asset reduces the existing deferred tax liability. The tax credit to profit is treated in the same way as the underlying temporary difference and is allocated to the owners of the parent company only (HK$'000):

DEBIT	Deferred tax liability	75	
CREDIT	Income tax (SOCI)		75

The credit to income tax also adjusts retained earnings in the statement of financial position.

(W8) Dividends

The dividends to be disclosed in the consolidated statement of changes in equity are those paid outside the group only. They therefore include:

(i) The whole of Wheatley's dividend
(ii) The non-controlling interest share of Fleece's dividend.

Dividends on ordinary shares which are declared after the reporting date are not adjusting events after the reporting period and therefore are not included.

Instead, dividends which are declared before the financial statements are authorised for issue but which are not recognised in the financial statements, together with the related amount per share, are disclosed in the notes to the financial statements.

The total dividend for inclusion in Wheatley Group's consolidated statement of changes in equity is HK$24,125,000 (Wheatley's dividend of HK$22m plus the 25% of Fleece's dividend of HK$8.5m).

Statement of changes in equity for the year ended 31 March 2013

	Share capital HK$'000	Revaluation reserve HK$'000	Retained earnings HK$'000	Total HK$'000	Non-controlling interests HK$'000	Total HK$'000
Balance at 1 April 2012	50,000	38,000	129,023	217,023	7,697	224,720-0
Dividends - Group	-	-	(22,000)	(22,000)	-	(22,000)
Dividends - NCI					(2,125)	(2,125)
Total comprehensive income for the year	-	14,000	31,659	45,659	2,813	48,472
Transfer to retained earnings	-	(2,000)	2,000	-	-	-
Disposal of shares in Fleece	-	-	1,254	1,254	11,546	12,800
Balance at 31 March 2013	50,000	50,000	141,936	241,936	19,931	261,867

Key learning points:

1. Basic consolidation procedures involve adding assets and liabilities and income and expenses together on a line by line basis. Then eliminating the cost of the investment, share capital and pre-acquisition reserves of the acquiree and recognising goodwill in the statement of financial position. Then eliminating dividends received from within the group from the statement of comprehensive income.

2. The non-controlling interest can be measured at either fair value or as a proportion of the fair value of the net assets of the acquiree. Profits in the year are allocated to the non-controlling interest in the statement of comprehensive income.

3. An unrealised profit adjustment for consolidation purposes results in a deferred tax asset. An opening unrealised profit and the associated deferred tax asset are reversed before consolidating the year's results.

4. Where a subsidiary has been disposed of or part-disposed of in the period, the parent company disposal journal is reversed and replaced with a group level disposal journal.

Consolidated statement of financial position at 31 March 2013

	Wheatley	Fleece	Total	(W1)	(W2)	(W4)	(W5)(i)	(W5)(ii) (a)	(W5)(ii) (b)	(W7)(ii) (a)	(W7)(ii) (b)	(W7)(iii)	(W7)(iv)	Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
Property, plant and equipment	214,000	69,500	283,500											283,500
Intangible assets	28,000	-	28,000			10,000		(2,500)						35,500
Goodwill	-	-	-			4,750								4,750
Investment in Fleece	58,333	-	58,333	11,667		(70,000)								-
	300,333	69,500	369,833											323,750
Inventories	47,500	14,200	61,700									(500)		61,200
Trade receivables	36,667	9,800	46,467							(200)	(800)			45,467
Cash	-	3,500	3,500											3,500
	84,167	27,500	111,667											110,167
	384,500	97,000	481,500											433,917
Ordinary share cap	50,000	25,000	75,000			(25,000)								50,000
Revaluation reserve	50,000	-	50,000											50,000
Retained earnings	136,000	48,500	184,500	121	2,125	(39,000)	(3,600)	(2,100)	315			(500)	75	141,936
	236,000	73,500	309,500											241,936
Non controlling interest				11,546	(2,125)	7,250	3,600	(400)	60					19,931
														261,867
Deferred tax	23,450	8,800	32,250			1,500			(375)				(75)	33,300
Bank loan	69,500	-	69,500											69,500
	92,950	8,800	101,750											102,800
Trade payables	27,600	11,620	39,220								(800)			38,420
Income tax payable	3,450	2,300	5,750											5,750
Accrual	9,950	780	10,730											10,730
Overdraft	14,550	-	14,550							(200)				14,350
	55,550	14,700	70,250											69,250
	384,500	97,000	481,500											433,917

Student Notes

Consolidated statement of comprehensive income for the year ended 31 March 2013

	Wheatley	Fleece	Total	(W1)	(W2)	(W5)(i)	(W5)(ii)(a)	(W5)(ii)(b)	(W6)(i)	(W6)(ii)	(W7)(i)	(W7)(iii)	(W7)(iv)	Consolidated
	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
Revenue	395,000	165,000	560,000								(6,000)			554,000
Cost of sales	(246,250)	(96,500)	(342,750)						300		6,000	(500)		(336,950)
Gross profit	148,750	68,500	217,250											217,050
Distrib costs	(62,450)	(28,520)	(90,970)											(90,970)
Admin expenses	(54,208)	(24,480)	(78,688)				(1,000)							(79,688)
Gain on disposal (Fleece)	1,133	-	1,133	(1,133)										-
Inv income	6,375	-	6,375		(6,375)									-
Profit before interest and tax	39,600	15,500	55,100											46,392
Finance charge	(3,200)	-	(3,200)											(3,200)
Profit before tax	36,400	15,500	51,900											43,192
Income tax	(5,400)	(3,500)	(8,900)					150		(45)			75	(8,720)
Profit for the year	31,000	12,000	43,000											34,472
Gain on property reval	14,000	-	14,000											14,000
Total comp income	45,000	12,000	57,000											48,472
Profit attrib to owners of parent (bal fig)														31,659
Profit attrib to NCI						3,000	(250)	37	30	(4)				2,813
TCI attrib to owners of parent (bal fig)														45,659
TCI attrib to NCI						3,000	(250)	37	30	(4)				2,813