Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Property related standards	• Case study • Group discussion	Ch. 4, 5, 8, 9 and 16	Pg. 1 – 20
3. Resolving accounting issues	• Case study • Group discussion	Ch. 7, 10, 21 and 22	Pg. 21 – 39
4. Wrap up	• Presentation • Group discussion		
Workshop 2			
5. Reboot	• Presentation • Group discussion		
6. Financial Instrument	• Case study • Group discussion	Ch. 17	Pg. 40 – 51
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8. Leading a team and teamwork	• Group discussion		
9. Conclusion	• Presentation • Group discussion		

Property related standards – recognition

Case study 1

DEF is a company with a large property portfolio, with a financial year ended 31 December 2010. One of its properties is a shopping centre which is split into 20 separate equally-sized retail units, which are rented out. DEF provides ancillary services in relation to the rental units, such as cleaning and security, but these costs are considered insignificant in the context of the rental arrangements.

DEF is a wholly owned subsidiary of HCO, a holding company with many subsidiaries. On 1 January 2010, HCO acquired 100% of the share capital of NSB.

NSB is a retail company, and on 1 January 2010 it entered into a rental arrangement with DEF. Under the terms of the arrangement, NSB would rent one of the retail units in DEF's shopping centre on a 5 year lease with a 3 month initial rent-free period. The lease can be extended at the end of the 5 year period, and rent payable to DEF comprises a fixed element, and a variable element which is related to the sales made by the lessee.

Information relevant to the shopping centre is as follows:

- Carrying value 1 January 2010 HK$125,000,000
- Fair value 31 December 2010 HK$155,000,000
- Costs of ancillary services HK$1,250,000

As all 20 units are of the same size and condition, both carrying value and fair value may be apportioned equally between them.

DEF also owns the following properties:

A leisure complex which comprises 15 units rented out to restaurants and bars. 8 of these units are currently vacant while new tenants are being sought.

An amusement park, which is rented out. The amusement park contains a number of further assets owned by DEF, including buildings, fairground rides, floodlight towers (which enable the park to stay open at night), and health and safety equipment.

Required

Using the information provided:

(i) determine which accounting standards are relevant,
(ii) determine the nature of each property, and
(iii) determine what recognition criteria should be used.

Discussion points

Property-related standards – recognition

Case study 1 – DEF

What are the issues?

DEF owns a shopping centre which is rented out in 20 separate retail units. One unit is now leased to a fellow subsidiary of DEF.

(a) Does the shopping centre qualify to be recognised as an investment property?
(b) What valuation bases are available for the property?
(c) How does recognition differ at group level?

DEF also owns 3 other properties.

(d) Do these properties qualify to be recognised as investment properties? If not, which accounting standards should be applied?

Which accounting standards should be used?

HKAS 40: Investment property

What are the requirements of the accounting standards?

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes
(b) sale in the ordinary course of business.

Owner-occupied property is property held by the owner (or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

(HKAS 40.5, LP Chapter 5, Section 1.1)

The standard provides the following examples of investment properties:

(a) Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

(b) Land held for a currently undetermined future use.

(c) A building owned by the reporting entity (or held by the entity under a finance lease) and leased out under an operating lease.

(d) A building that is vacant but held to be leased out under one or more operating leases.

(e) Property that is being constructed or developed for future use as investment property.

(HKAS 40.8, LP Chapter 5, Section 1.1)

(f) A building held by an entity and leased to a parent or another subsidiary. Note, however, that while this is regarded as an investment property in the individual entity's financial statements, in the consolidated financial statements this property will be regarded as owner-occupied (because it is occupied by the group) and will therefore be treated in accordance with HKAS 16.

(HKAS 40.15, LP Chapter 5, Section 1.1)

Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease) an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

(HKAS 40.10, LP Chapter 5, Section 1.1)

In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

(HKAS 40.11)

An entity does not recognise in the carrying amount of an investment property the costs of the day-to-day servicing of such a property. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the cost of labour and consumables, and may include the cost of minor parts. The purpose of these expenditures is often described as the repairs and maintenance of the property.

(HKAS 40.18)

An entity shall choose as its accounting policy either the fair value model or the cost model and shall apply that policy to all of its investment property.

(HKAS 40.30, LP Chapter 5, Section 1.4)

In determining the carrying amount of investment property under the fair value model of investment property, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment.

(HKAS 40.50)

How to apply the standards to the case?

Shopping Centre

<u>DEF financial statements</u>

The shopping centre meets the definition of an investment property, as it is held in order to earn rental incomes, and it is not owner-occupied. The fact that one unit is rented to a fellow group member is irrelevant in determining the accounting treatment at the individual company level.

DEF provides ancillary services to its lessees, but as long as these services are considered to be an insignificant component of the rental arrangement, the shopping centre will still qualify as an investment property. The ancillary costs represent only 1% of the carrying value of the shopping centre (based on its value at the start of the year) which is therefore not significant. The ancillary costs should be expensed as they represent maintenance costs and do not qualify for recognition as an asset.

DEF has a choice of accounting policy; according to HKAS 40 investment properties may be measured at cost or at fair value. If the fair value model is used, the asset must be remeasured each year end and depreciation is not charged. Changes in fair value of investment properties are taken to the income statement and form part of profit or loss for the year.

If the cost model is used, then the asset falls under the scope of HKAS 16 Property, Plant and Equipment, and depreciation should be charged.

The choice of accounting policy for investment properties must be consistently applied across all of DEF's investment properties.

HCO consolidated financial statements

From the group perspective, the shopping centre is partly owner-occupied because NSB, a member of the group, occupies one of the 20 retail units. Owner-occupied properties do not qualify as investment properties, and instead should be recognised under HKAS 16 Property, Plant and Equipment.

In this case the shopping centre can be separated into distinct portions, as each of the 20 retail units is leased separately. According to HKAS 40 if these portions could be sold separately (or leased out separately under a finance lease) an entity accounts for the portions separately.

Therefore at group level, the shopping centre should be apportioned so that 19/20 is recognised as an investment property, with the remaining 1/20 recognised as property, plant and equipment because it is owner-occupied. At the inception of the lease, 1/20 of the fair value of the shopping centre should be reclassified as property, plant and equipment. The property's deemed cost for subsequent accounting in accordance with HKAS 16 is its fair value at the date of change in use. **(LP Chapter 5, Section 1.5.2).** Depreciation on the owner-occupied component should commence from the date of reclassification.

Leisure complex

The fact that more than half of the units of the leisure complex are vacant does not prohibit its recognition as investment property. According to HKAS 40.8, a building that is vacant but is held to be leased out under one or more operating leases qualifies as an investment property.

All investment property must be accounted for under the same model – cost or fair value. Therefore the model applied to the retail units will also apply here.

If the cost model is used, the lack of tenants could be an indicator of impairment, so DEF should consider conducting an impairment review of the leisure complex in order to compare its value in use with its fair value at the year end. This is not relevant if the fair value model is used.

Amusement park

This is a collection of assets which are rented out. The issue is whether it is just the park itself, or the group of assets which should be recognised as investment property. HKAS 40.50 implies that 'other assets' which are integral to the land and buildings which form the major component of the lease should be recognised as part of the investment property. Therefore if the 'other assets' are necessary for the land and buildings to be used by the lessee in the intended way, and are included in the lease terms, they should be treated as investment property, as it is the entire group of assets which is generating an income stream from the lease contract. It would seem that the amusement park could not operate without floodlights and health and safety equipment, so the whole collection of assets should be treated as investment property.

Recommendation / justification

DEF has three properties which should be recognised as investment properties:

- The shopping centre
- The leisure complex, and
- The amusement park (including 'other assets')

At group level the shopping centre is recognised partly as investment property, but 1/20 is recognised as property, plant and equipment as it is owner-occupied.

Property related standards – measurement

Case study 1 (DEF) – additional information

(a) Additional information is now provided on HCO's group accounting policies:

Investment properties are measured using the fair value model. Owner-occupied properties are measured using the cost model.

Estimated useful life for properties subject to depreciation is 30 years.

Required

(i) Determine the value of the shopping centre to be recognised in DEF's statement of financial position at 31 December 2010, and relevant extracts from the statement of comprehensive income.

(ii) Calculate the value of the shopping centre to be recognised in HCO's consolidated statement of financial position at 31 December 2010, and relevant extracts from the consolidated statement of comprehensive income.

(b) Information is now provided on the 5 year rental agreement between DEF and NSB which commenced on 1 January 2010.

The rental cost to NSB is HK$500,000 per annum with an initial 3 month rent-free period. Additional rental is payable to DEF six-monthly in arrears based on the revenue generated by the rental unit based on the increase in revenue compared to the revenue of the previous 6 month period at the following rates:

0% - 5%	no additional payment
5% - 10%	additional HK$20,000 payable
10%-15%	additional HK$30,000 payable
Over 15%	additional HK$40,000 payable

The first additional payment is due on 31 December 2010.

NSB's retail unit generated HK$4,500,000 revenue in the six months to 30 June 2010, and generated HK$4,815,000 in the six months to 31 December 2010.

Required

(i) Calculate the amount to be recognised in NSB's income statement in respect of its lease of a rental unit from DEF.

(ii) Determine the accounting treatment of the rental agreement in DEF's financial statements, and HCO's consolidated financial statements.

(iii) List the disclosure requirements required by HKAS 17 in respect of the shopping centre and lease arrangement in NSB's and DEF's financial statements.

Discussion points

Property-related standards – measurement

Case study 1 – DEF (continued)

What are the issues?

DEF's shopping centre is an asset recognised at both individual and group levels.

(a) How does the measurement of the asset differ at group level than in DEF's individual accounts?

NSB is paying rentals over a 5 year period to DEF.

(b) What is the accounting treatment for lease incentives such as a rent-free period?

(c) How should contingent rentals be accounted for?

(d) How does the accounting treatment differ in the individual accounts of the subsidiaries, and at group level?

Which accounting standards should be used?

HKAS 40: Investment property

HKAS 17: Leases

HK(SIC) Int-15: Operating leases - incentives

What are the requirements of the accounting standards?

(a) A building held by an entity and leased to a parent or another subsidiary can be recognised as an investment property. Note, however, that while this is regarded as an investment property in the individual entity's financial statements, in the consolidated financial statements this property will be regarded as owner-occupied (because it is occupied by the group) and will therefore be treated in accordance with HKAS 16.

(HKAS 40.15, LP Chapter 5, Section 1.1)

An entity shall choose as its accounting policy either the fair value model or the cost model and shall apply that policy to all of its investment property.

(HKAS 40.30, LP Chapter 5, Section 1.4)

Where the fair value model is chosen, the following rules apply:

(1) An entity that chooses the **fair value model** should measure all of its investment property at fair value, except in the extremely rare cases where this cannot be measured reliably. In such cases it should apply the HKAS 16 cost model.

(2) A gain or loss arising from a change in the fair value of an investment property should be recognised in net profit or loss for the period in which it arises.

(3) The fair value of investment property should reflect the actual market conditions at the end of the reporting period.

(b) Rentals under an operating lease should be charged as an expense over the period of the lease on a straight line basis. This is so even if unequal lease payments are made, unless another systematic and rational basis is justified by the circumstances.

(HKAS 17.33, LP Chapter 8, Section 2.1)

HK(SIC) Int-15 provides that all incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or the form or the timing of payments. The lessee should recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term, generally on a straight line basis.

(HK(SIC) Int 15.4-6, LP Chapter 8, Section 2.1.1)

How to apply the standards to the case?

(a) DEF financial statements – measurement of the property

The shopping centre meets the definition of an investment property, as it is held in order to earn rental incomes, and it is not owner-occupied.

DEF has a choice of accounting policy; according to HKAS 40 investment properties may be measured at cost or at fair value. It is group accounting policy to measure investment properties at fair value, so this is the valuation model that should be used for the shopping centre. Under HKAS 40's valuation model, the property should not be depreciated, and changes in fair value are recognised in the income statement. Maintenance costs should be expensed.

Therefore, DEF's financial statements will include the following for the year ending 31 December 2010:

Statement of financial position	HK$	
Investment property	155,000,000	(measured at fair value)
Income statement		
Operating expenses:		
Maintenance costs	1,250,000	
Other operating income:	30,000,000	(being the change in fair value of the property)

HCO consolidated financial statements – measurement of the property

Following on from the discussion in Handout 2.1 Case Study 1, at group level the shopping centre should be apportioned so that 19/20 is recognised as an investment property, with the remaining 1/20 recognised as property, plant and equipment. At the inception of the lease, 1/20 of the fair value of the shopping centre should be reclassified as property, plant and equipment.

Depreciation should commence from the inception of the lease to NSB, using the 30 year estimated useful life according to group accounting policy.

Statement of financial position:	HK$
Non-current assets	
Property, plant and equipment (w1)	6,041,667
Investment property (w1)	147,250,000
Income statement	
Operating expenses (w1):	
Depreciation	208,333
Maintenance costs	1,250,000
Other operating income (w1)	28,500,000

Working 1

Shopping centre carrying value at 1 January 2010 = HK$125,000,000

<u>Allocate 19/20 as investment property = HK$118,750,000</u>

This component is not depreciated.

Shopping centre fair value at 31 December 2010 = HK$155,000,000, of which 19/20 relates to this component = HK$ 147,250,000

Change in fair value of this component = HK$28,500,000 to be recognised in group income statement.

Note that from the perspective of performing the consolidation, the full amount of change in fair value of HK$30,000,000 (HK$155m – HK$125m) is already included in DEF's individual income statement. Therefore on consolidation, HK$1.5million of the change (ie the 1/20 relating to the owner-occupied property) should be reversed out as a consolidation adjustment.

<u>Allocate 1/20 as property, plant and equipment = HK$6,250,000</u>

This component is depreciated over 30 year useful life (group accounting policy for non-investment properties) 6,250,000/ 30 = HK$208,333, recognised in group income statement.

Carrying value of this component at 31 December 2010 = HK$6,041,667.

The full amount of maintenance costs remains recognised at group level, as these costs are incurred regardless of whether the property is classified as investment property or as property, plant and equipment.

(b) <u>Lease incentive</u>

The lease is an operating lease, and the cost to NSB should be recognised on a straight line basis over the 5 year lease period. This means that the benefit of the 3 month rent free period (HK$125,000) is spread over the entire lease period, rather than being recognised in the first year only.

Total amount payable (HK$500,000 × 5) - HK$125,000 = HK$2,375,000

Annual expense HK$2,375,000/5 years = HK$475,000

The difference between the annual expense (475,000) and the actual cash payable in the first year (375,000) of HK$100,000 should be recognised as an accrual, which represents the deferred benefit of the lease incentive to NSB.

<u>Contingent rent</u>

According to HKAS 17.25, contingent rents should be expensed in the period to which they relate.

No contingent rental is payable in respect of the first six month rental period. In the second six month rental period contingent rent is payable depending on the increase in revenue that has been generated by the rental unit.

Revenue increases by 7% in the second six month period, and therefore an additional payment of HK$20,000 is due to be paid to DEF on 31 December 2010. If this has not been paid in cash by the year end, it should be accrued for.

Therefore the total rental expense to be recognised in NSB's income statement is HK$495,000 for the year ending 31 December 2010.

This equates to rental income receivable in the financial statements of DEF. If DEF's main business activity involves investment property, this should be classified as revenue. DEF will recognise the incentive as a deferred cost of HK$100,000 at 31 December 2010.

At group level, the amount payable by NSB to DEF in respect of the lease would be cancelled out as an inter-company transaction, so would not be recognised in the consolidated financial statements.

Recommendation / justification

DEF financial statements

	HK$	
DR investment property	30,000,000	
CR income statement	30,000,000	being remeasurement of property to fair value
DR operating expenses	1,250,000	
CR cash	1,250,000	being maintenance costs
DR cash / receivables	395,000	being cash received from NSB
DR prepayment	100,000	being deferred cost of lease incentive
CR revenue	495,000	being rental income from NSB

NSB financial statements

DR operating expenses	495,000	
CR cash	20,000 + 375,000 = 395,000	
CR accrual	100,000	being accrued benefit of the lease incentive

HCO consolidated financial statements

DR PPE	6,250,000	
CR investment property	6,250,000	being transfer of owner occupied component
DR income statement	1,500,000	
CR investment property	1,500,000	being reversal of increase in FV of investment property which is classified as owner occupied at group level.
DR operating expenses	208,333	
CR PPE	208,333	being depreciation of owner occupied component
DR revenue	495,000	
CR operating expenses	495,000	being elimination of intragroup rental transaction
DR accrual	100,000	
CR prepayment	100,000	being elimination of intragroup accrual / prepayment in respect of lease agreement

Disclosure requirements

HKAS 17

The following HKAS 17 disclosure requirements are relevant to DEF's financial statements:

– The future minimum lease payments under non-cancellable operating leases in aggregate and split between not later than one year, later than one year but no later than 5 years and later than 5 years

– Total contingent rents recognised in income

– A general description of the lessor's leasing arrangements.

The following HKAS 17 disclosure requirements are relevant to NSB's financial statements:

– The total future minimum lease payments under non-cancellable operating leases split between not later than one year, later than one year but no later than 5 years and later than 5 years

– Lease payments recognised as an expense in the period with separate amounts for minimum lease payments and contingent rents

– A general description of significant leasing arrangements including the basis on which contingent rent payments are determined.

Property related standards – recognition

Case study 2

(a) ABC is a property construction company with a financial year ended 31 December 2010. ABC has constructed a new head office for its own use. Construction commenced on 1 April 2008, and was completed on 30 September 2009, when the head office became available for use. ABC did not occupy the head office until 1 January 2010. The head office has an estimated useful life of 25 years.

Below summarised the costs and respective time incurred in constructing the head office:

Date amount incurred	Nature of the expenditure	HK$
1 April 2008	Legal fees regarding advice sought on planning permission	135,000
1 April 2008	External labour costs for site preparation	500,000
30 April 2008	Payment to supplier of building materials	3,000,000
30 June 2008	Interest payment on loan (note 1)	25,000
30 September 2008	Payment to supplier of building materials	3,500,000
31 December 2008	Interest payment on loan (note 1)	25,000
31 March 2009	Payment to supplier of building materials	6,000,000
30 June 2009	Interest payment on loan (note 1)	25,000
30 September 2009	Payment to supplier of building materials	3,000,000
30 September 2009	Installation of security system (note 2)	3,250,000
31 December 2009	Costs of relocating office furniture and computers to the new head office	350,000
31 December 2009	Interest payment on loan (note 1)	25,000

Notes:

Note 1 The loan was taken out specifically in relation to the construction on 1 January 2008. Interest is set at HK$25,000 per six months, and is payable six-monthly in arrears, starting 30 June 2008.

Note 2 The security system has an estimated useful life of 6 years.

In addition to the above, ABC's payroll expense includes staffs working exclusively on the head office construction with total salaries of HK$325,000 per month and a project manager with monthly salary of HK$75,000 in relation to who spends approximately one third of his time overseeing the head office construction.

Additional costs of HK$100,000 were incurred in March 2009 in relation to an industrial dispute which meant that external workers had to be brought in.

(b) ABC has a residential development division, which is converting the old head office into a block of apartments. It is anticipated that once the conversion is complete, the property will be sold to a housing association. The conversion commenced on 1 February 2010, and is expected to be complete by 31 March 2011.

Required

Using the information provided, determine:

(i) which accounting standards are relevant,

(ii) the nature of each property,

(iii) what recognition criteria should be used, and

(iv) List the disclosure requirements in respect of the properties.

Discussion points

Property-related standards – recognition

Case study 2 – ABC

What are the issues?

ABC has self-constructed a new head office and is redeveloping the old head office for sale. Many different costs were incurred in constructing the new head office. The asset was ready for use on 30 September 2009, and was occupied by ABC on 1 January 2010. The old head office is being converted for sale. In relation to the properties:

(a) Which costs should be recognised as part of the new head office or as a separate depreciable item, and which should be expensed?

(b) When should depreciation commence on the new head office?

(c) How should the old head office be recognised in the statement of financial position?

Which accounting standards should be used?

HKAS 16: Property, plant and equipment

HKAS 23 (Revised): Borrowing costs

HKAS 2: Inventories

What are the requirements of the accounting standards?

<u>HKAS 16</u>

The recognition of property, plant and equipment depends on two criteria:

(a) It is probable that future economic benefits associated with the asset will flow to the entity.

(b) The cost of the asset to the entity can be measured reliably.

(HKAS 16.7, LP Chapter 4, Section 2.3)

Once an item of property, plant and equipment qualifies for recognition as an asset, it will initially be measured at cost. The standard lists the components of the direct cost of an item of property, plant and equipment:

(a) Purchase price, less any trade discount or rebate

(b) Import duties and non-refundable purchase taxes

(c) Directly attributable costs of bringing the asset to working condition for its intended use, for example:

   (i) The cost of site preparation

   (ii) Initial delivery and handling costs

   (iii) Installation costs

   (iv) Testing

   (v) Professional fees (architects, engineers)

(d) Initial estimate of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located (HKAS 37 Provisions, Contingent Liabilities and Contingent Assets).

(e) Any borrowing costs incurred related to building the asset may be capitalised within the assets too (HKAS 23 Borrowing Costs).

(HKAS 16.17, LP Chapter 4, Section 2.4.1)

In addition, the capitalisation of costs must cease when an asset is in the location and condition necessary for it to be capable of normal operation. Therefore, the following may not be capitalised:

- Costs incurred when an item is capable of normal use however is operating at less than full capacity
- Initial operating losses
- The costs of relocating or reorganising the entity's operations.

(HKAS 16.20, LP Chapter 4, Section 2.4.1)

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see HKAS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. HKAS 23 Borrowing Costs establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

(HKAS 16.22, LP Chapter 4, Section 2.4.1)

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part.

(HKAS 16.43, LP Chapter 4, Section 2.5)

Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

(HKAS 16.55, LP Chapter 4, Section 2.5)

<u>HKAS 23 (Revised)</u>

Three events or transactions must be taking place for capitalisation of borrowing costs to be started:

(a) Expenditure on the asset is being incurred

(b) Borrowing costs are being incurred

(c) Activities are in progress that are necessary to prepare the asset for its intended use or sale

(HKAS 23.17, LP Chapter 16, Section 1.2.3)

<u>HKAS 2</u>

Inventories are assets:

- Held for sale in the ordinary course of business
- In the process of production for such sale
- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

(HKAS 2.6, LP Chapter 9, Section 1.2)

How to apply the standards to the case?

New head office

It is necessary to consider each component of the costs associated with the construction of the new head office to see if they meet the criteria for recognition as part of the asset, and if they were incurred prior to the asset becoming capable of normal operation.

Legal fees, external labour costs and payments to supplier of building materials – these are considered to be directly attributable to the property, and are incurred prior to the asset becoming capable of normal operation which was 30 September 2009. Therefore all of these costs should be recognised as part of the head office asset.

The security system should be treated as a separate component of the asset as it has a cost which is significant in relation to the total cost of the asset, according to HKAS 16.43. The security system should therefore be depreciated over its own estimated life of 6 years. The other capitalised costs should be depreciated over 25 years.

The interest (borrowing costs) should be recognised as part of the head office asset according to HKAS 23 (revised), but interest can only be capitalised from the point in time when activities are in progress that are necessary to prepare the asset for its intended use or sale. This means that even though the loan was taken out on 1 January 2008, interest must only be capitalised from 1 April 2008, as this is when construction activity commenced and expenditure was incurred on the asset. The interest from 1 January to 31 March 2008 must be treated as an expense (finance cost).

Capitalisation of costs, including borrowing costs, should cease once the asset is available for normal use. This occurs on 30 September 2009.

The costs of relocating office furniture and computers to the new head office are not allowed to be recognised as an asset, according to HKAS 16.20. These costs are not necessary for the asset to be ready for use by management.

The payroll costs should be included for the 18 month period of construction of the head office, as these are directly attributable costs. The project manager's payroll cost should be allocated on a one third basis to the head office.

The additional costs incurred due to industrial dispute should not be capitalised as they are abnormal costs. (HKAS 16.22)

Depreciation should commence from the date on which the building is ready for use ie 30 September 2009. The fact that the building is not occupied until 1 January 2010 is irrelevant for the purpose of determining when depreciation should commence.

Therefore as at 31 December 2010, accumulated depreciation on the property will represent 15 months of depreciation.

Old head office

From 1 January 2010, the old head office is no longer occupied by ABC for trading purposes. As the asset is being converted for potential sale, the property should be transferred to inventory until it is sold. It should be transferred at carrying value, and no longer depreciated once it has been reclassified.

Any costs of conversion should be added to the carrying value of the property in accordance with HKAS 2's requirement that cost includes all costs of conversion incurred in bringing inventory to its present location and condition.

Recommendation / justification

ABC's new head office should be capitalised in the financial statements and depreciation charged from 30 September 2009.

From 1 January 2010 the old head office should be reclassified as inventories.

Disclosure requirements

HKAS 16

The following HKAS 16 disclosure requirements are relevant to ABC:

– Measurement bases for determining gross carrying amount
– Depreciation methods used
– Useful lives or depreciation rates used
– Gross carrying amount and accumulated depreciation at the start and end of the period and a reconciliation between these amounts
– The amount of expenditure on assets in the course of construction

Further disclosure is also required where assets are pledged as security, there are commitments to acquire further assets and the revaluation model is applied.

HKAS 23

The following HKAS 23 disclosure requirements are relevant to ABC:

– The amount of borrowing costs capitalised in the period

HKAS 2

The following HKAS 2 disclosure requirements are relevant to ABC, and in particular the old head office:

– The accounting policies adopted in measuring inventories
– The carrying amount of the head office classified appropriately

Further disclosure is required where inventories are carried at fair value less costs to sell, where they are written down in a period, or where they are pledged as security for liabilities.

Property related standards – measurement

Case study 2 (ABC) – additional information

ABC's new head office continues to be occupied throughout 2010.The head office is used by the three business segments of ABC – residential property development, commercial property development and public sector property developments.

In 2010 the country suffers an economic recession, which particularly affects residential and commercial business segments. The government released statistics indicating that the recession is expected to last for a number of years, and that the property market will remain depressed for the foreseeable future. This prompted ABCs management to review the future expected performance of the business segments, and the value in use of each on 31 December 2010 was found to be:

Residential property:	HK$55,000,000
Commercial property:	HK$32,000,000
Public sector property:	HK$25,000,000

The three business segments have identifiable assets and goodwill attributable to them as follows:

	Residential property	Commercial property	Public sector property
Identifiable assets:	**HK$'000**	**HK$'000**	**HK$'000**
Goodwill	10,000	5,000	2,500
Property, plant and equipment	46,000	25,000	10,000
Other net assets	24,000	10,000	7,500
Total	**80,000**	**40,000**	**20,000**

Required

(i) **Calculate at what amount the new head office should initially be recognised**

(ii) **Calculate the annual depreciation charge on the new head office and its carrying value at 31 December 2010 before any impairment review.**

(iii) **Determine the relevant accounting standard in terms of the additional information provided above.**

(iv) **Allocate the head office to each segment based on the identifiable assets of each and calculate the impairment loss for each business segment**

(v) **Calculate the value of the head office to be recognised immediately after the impairment review on 31 December 2010, and**

(vi) **List the required disclosures in respect of the impairment of assets in according to HKAS 36.**

Discussion points

Property-related standards – measurement

Case study 2 – ABC (continued)

What are the issues?

ABC is operating three business segments which have identifiable cash generating assets. The economy is suffering a decline, indicating that an impairment review should be conducted. The issues are:

(a) At what value should the head office initially be measured?

(b) What is the carrying value of the head office (before any impairment) at 31 December 2010?

(c) How should the head office be allocated to the business segments?

(d) Are all of the business segments impaired?

(e) For the impaired business segments, how is the impairment calculated and allocated to the assets?

(f) What is the carrying value of the head office immediately subsequent to the impairment review?

Which accounting standard should be used?

HKAS 36: Impairment of assets

What are the requirements of the accounting standards?

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash generating unit should be measured instead. A cash generating unit is the smallest identifiable group of assets for which independent cash flows can be identified and measured. **(HKAS 36.66, LP Chapter 7, Section 4.8.1)**

Corporate assets include group and divisional assets that do not generate cash inflows independently from other assets and hence their carrying amount cannot be fully attributed to a cash generating unit under review. Head office building, equipment or a research centre are examples of corporate assets.

An entity should identify all the corporate assets that relate to a cash generating unit in an impairment test of that unit. An entity compares the carrying amount of the unit (including the portion of the asset) with its recoverable amount when a portion of the carrying amount of a corporate asset can be allocated to the unit on a reasonable and consistent basis.

(HKAS 36.100, LP Chapter 7, Section 4.10)

An impairment loss should be recognised for a cash generating unit if the recoverable amount for the cash generating unit is less than the carrying amount in the statement of financial position for all the assets in the unit. When an impairment loss is recognised for a cash generating unit, the loss should be allocated between the assets in the unit in the following order:

(a) First, to the goodwill allocated to the cash generating unit (if any).
(b) Then, to all other assets in the cash generating unit, on a pro rata basis.

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

(a) its fair value less costs to sell,
(b) its value in use (if determinable), or
(c) zero.

(HKAS 36.104, LP Chapter 7, Section 4.11)

How to apply the standards to the case?

Recognition and measurement of the head office

As discussed in the first part of the ABC case study, the head office should be initially recognised as follows at 30 September 2009:

	HK$
Legal costs	135,000
External labour	500,000
Payments to supplier of materials (3,000,000+3,500,000+6,000,000+3,000,000)	15,500,000
Borrowing costs (25,000/6 x 18 months)	75,000
Payroll costs (325,000 x 18 months)	5,850,000
Project manager costs (75,000/3 x 18 months)	450,000
Security system	3,250,000
	25,760,000

The security system is capitalised as part of the cost of the head office, however for depreciation purposes the property and security system are separate assets:

	HK$
Head office (25,760,000 – 3,250,000)	22,510,000
Security system	3,250,000

Depreciation per annum is calculated as follows:	HK$
Head office cost excluding security system (22,510,000/25 yrs)	900,400
Security system depreciation (3,250,000/ 6 yrs)	541,667
	1,442,067

At 31 December 2010, the property has been depreciated for 15 months and therefore its carrying value is:

Cost	25,760,000
Depreciation (15/12 x 1,442,067)	(1,802,584)
	23,957,416

Impairment

The three business segments each represent a cash generating unit (CGU), because they generate independent cash flows and each have directly attributable assets.

The economic recession is an indicator of impairment, and management has already forecast the value in use of each CGU for use in an impairment test. The head office represents a central asset, and its carrying value must be allocated to each CGU in order for the impairment test to be conducted. HKAS 36 requires that central assets are allocated on a reasonable and consistent basis, which is usually on the basis of the net assets of the CGUs.

The carrying value of the head office is allocated to the three CGUs on a pro-rata basis:

	Residential property	**Commercial property**	**Public sector property**
Identifiable assets:	**HK$000**	**HK$000**	**HK$000**
Goodwill	10,000	5,000	2,500
Property, plant and equipment	46,000	25,000	10,000
Other net assets	24,000	10,000	7,500
Total	**80,000**	**40,000**	**20,000**
Allocation of head office 23,957,000 (8:4:2)	**13,690**	**6,845**	**3,422**
Total carrying value of CGU	**93,690**	**46,845**	**23,422**

Next, each CGU should be tested for impairment by comparing its total carrying value with its value in use.

	Residential property	**Commercial property**	**Public sector property**
Identifiable assets:	**HK$000**	**HK$000**	**HK$000**
Total carrying value of CGU	93,690	46,845	23,422
Value in use	55,000	32,000	25,000
Impairment loss	**38,690**	**14,845**	**Not impaired**

The results of the impairment test show that residential property and commercial property CGUs are both impaired, as the value in use is less than carrying value. However, the public sector CGU is not impaired as its value in use exceeds carrying value.

For the impaired CGUs, the impairment loss must be allocated across the assets in the CGU, including the head office. HKAS 36 requires that impairment losses are allocated firstly to any goodwill in the CGU, and then allocated pro-rata over the remaining assets in the CGU.

For the residential property CGU, the impairment is allocated as follows:

Residential property	**Original carrying value**	**Impairment**	**Final carrying value**
Identifiable assets:	**HK$000**	**HK$000**	**HK$000**
Goodwill	10,000	(10,000)	-
Property, plant and equipment	46,000	*(15,769)	30,231
Other net assets	24,000	*(8,228)	15,772
Allocation of head office	13,690	*(4,693)	8,997
Total carrying value of CGU	**93,690**	**(38,690)**	**55,000**

*after allocating HK$10,000,000 impairment loss to goodwill, the remaining impairment loss of HK$28,690,000 is allocated pro-rata according to the carrying value of the remaining assets in the CGU.

For the commercial property CGU, the impairment is allocated as follows:

Commercial property	**Original carrying value**	**Impairment**	**Final carrying value**
Identifiable assets:	**HK$000**	**HK$000**	**HK$000**
Goodwill	5,000	(5,000)	-
Property, plant and equipment	25,000	*(5,882)	19,118
Other net assets	10,000	*(2,353)	7,647
Allocation of head office	6,845	*(1,610)	5,235
Total carrying value of CGU	**46,845**	**(14,845)**	**32,000**

*after allocating HK$5,000,000 impairment loss to goodwill, the remaining impairment loss of HK$9,845,000 is allocated pro-rata according to the carrying value of the remaining assets in the CGU.

We can now conclude that the head office should be measured at HK$17,654,000 after the impairment loss has been recognised. (Head office valued at HK$8,997,000 in residential CGU + HK$5,235,000 in commercial CGU + HK$3,422,000 in public sector CGU.) Its previous carrying value was HK$ 23,957,000, so an impairment loss of HK$6,303,000 should be recognised in respect of the head office.

Recommendation / justification

The head office has suffered an impairment loss, which should be recognised immediately in profit and loss:

	HK$	HK$
DR operating expenses	6,303,000	
CR head office asset		6,303,000

Depreciation must be recalculated based on the new, lower amount.

Disclosure requirements

HKAS 36 requires the following disclosures where an impairment has taken place in the year, and which are applicable to ABC:

– The amount of impairment loss recognised in profit or loss in the period and the line item where it is included

– The events and circumstances leading to the recognition of the impairment loss

– A description of each cash generating unit which is impaired and the amount of impairment loss recognised by class of assets

– Whether recoverable amount is fair value less costs to sell or value in use, and the basis used to determine this amount.

Further disclosures are required where impairment losses are recognised in other comprehensive income, losses are reversed in the period, losses relate to individual assets, or the make up of CGUs has changed.

Resolving accounting issues

Case study 1

JKL is a manufacturer of domestic appliances, and has a financial year ended 31 December 2010, and four accounting issues need to be resolved prior to the finalisation of the financial statements.

1. Warranty

   JKL offers a warranty to customers if products are found to be defective within six months of purchase. If minor defects were found in all products sold in the six months prior to the year end, repair costs of HK$5 million would result. If major defects were found in all products sold, repair costs of HK$20 million would result. In previous years, JKL has provided for warranty costs based on an estimation that 20% of goods have minor defects, and 5% have major defects. Due to quality control improvements in the manufacturing process, it is now estimated that 17% of goods will have minor defects, and 3% major defects. A provision of HK$2 million was recognised at 31 December 2009.

2. Depreciation

   Machinery had a carrying value at 1 January 2010 of HK$50,250,000. In previous years, JKL charged depreciation on a reducing balance basis at 15% per annum. Owing to higher than anticipated production levels, it is now thought that a reducing balance of 18% is more appropriate.

3. Incorrect accounting treatment

   A machine was purchased for HK$8 million on 1 January 2009. The cost (which is material to the financial statements) was incorrectly treated as an administrative expense. The depreciation policy is as set out in note 2 above.

   Information from JKL's draft accounts is as follows:

	31.12.2009 HK$	31.12.2010 HK$
Net profit for the year	14,500,000	30,000,000
Opening retained earnings	150,000,000	164,500,000

   These figures for 2010 are before accounting for the warranty provision, depreciation or incorrect accounting treatment.

4. Investment property

   JKL purchased a property on 1 May 2008 for HK$2 million which was classified as an investment property. JKL has no other investment properties. The company applied the cost model to the investment property, depreciating it over 50 years, with a full year's depreciation charge in the year of acquisition and none in the year of disposal. At 31 December 2010, it has become apparent that the nature of the commercial property market means that the fair value model would result in more reliable and relevant information in the financial statements. The fair values of the property were as follows:

31 December 2008	HK$2.25 million
31 December 2009	HK$2.40 million
31 December 2010	HK$2.50 million

Required

Using the information provided:

(i) **determine which accounting standards are relevant,**

(ii) **discuss the appropriate accounting treatment for each of the four issues,**

(iii) **calculate the correct amounts to be recognised in JKL's financial statements as at 31 December 2010 in respect of the warranty provision, depreciation charge and investment property,**

(iv) **prepare extracts from JKL's statement of comprehensive income and statement of changes in equity as at 31 December 2010, and**

(v) **List the disclosure requirements of HKAS 8 relevant to JKL.**

Discussion points

Resolving accounting issues

Case study 1 – JKL

What are the issues?

JKL has the following issues to deal with in order to prepare financial statements as at 31 December 2010:

(a) Are changes in respect of the warranty, depreciation method and investment property measurement model changes in accounting policy or accounting estimate?

(b) At what value should the provision be recognised, and what adjustment is needed to the financial statements?

(c) What depreciation charge should be recognised this year?

(d) How should the accounting treatment of the machine be corrected and disclosed in the financial statements?

(e) At what value should the investment property be recognised, and what adjustment is needed to the financial statements?

Which accounting standards should be used?

HKAS 8: Accounting policies, Changes in accounting estimates and Errors

HKAS 37: Provisions, Contingent Liabilities and Contingent Assets

What are the requirements of the accounting standards?

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

A *change in accounting estimate* is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors. **(HKAS 8.5, LP Chapter 21, Section 1.2)**

The effect of a change in an accounting estimate shall be recognised prospectively by including it in profit or loss in:

(a) the period of the change, if the change affects that period only; or

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

To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

(HKAS 8.36, LP Chapter 21, Section 3.1)

An entity may change an accounting policy only if the change is required by an HKFRS or results in the financial statements providing more reliable and relevant information.

(HKAS 8.14, LP Chapter 21, Section 2.2)

When an entity changes an accounting policy voluntarily, it shall apply the change retrospectively.

(HKAS 8.19, LP Chapter 21, Section 2.2.1)

When a change in accounting policy is applied retrospectively, the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

(HKAS 8.22, LP Chapter 21, Section 2.2.1)

An entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

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

(HKAS 8.42, LP Chapter 21, Section 4.1)

The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting period.

Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is "expected value".

(HKAS 37.36-39, LP Chapter 10, Section 2.1)

How to apply the standards to the case?

Warranty provision

Provisions are based on estimates, and JKL is changing the estimation method used in determining its warranty provision. According to HKAS 8, changes in estimates are accounted for prospectively meaning that the effect of the change in estimate is in the current year financial statements. No adjustment is made to opening balances or to comparative figures.

The value of the new provision is calculated using expected values as follows: (80% x nil) + (17% x HK$5 million) + (3% x HK$20 million) = HK$1,450,000.

The provision previously recognised was HK$2 million, therefore a reduction in provision of HK$550,000 should be made.

Depreciation method

Depreciation is also based on estimates, including estimates of the residual value and estimated useful life of the asset. Any changes to depreciation method should be accounted for as a change in estimate, according to HKAS 8.38. This paragraph states that some changes to accounting estimates, eg a change in the estimate of bad debts, affect only the current period's profit or loss, and so are recognised in the current period. Other changes to accounting estimates, such as a change in the estimated useful life of an asset or the expected pattern of consumption of future economic benefits of an asset affect depreciation expense for the current and future periods. Therefore the effect of the change is recognised as income or expense in the current and future periods.

The depreciation adjustment for JKL's machinery should therefore be made prospectively, so that the assets' carrying value is written off using the new reducing balance of 18% per annum in current and future periods. No adjustment is made to opening balances or to comparative figures.

The carrying value of machinery at the start of the year (not including the machinery incorrectly accounted for which is discussed separately below) is HK$50,250,000. Applying the new depreciation rate of 18% results in a depreciation charge for the year of HK$9,045,000. This amount should be recognised as an operating expense, and included in accumulated depreciation of machinery.

Accounting error

The machinery has been incorrectly accounted for from 1 January 2009, meaning that a prior period error has been made. HKAS 8 requires that such errors are corrected on a retrospective basis, meaning that comparative amounts and opening balances are restated. The result of retrospective adjustment is to present the financial statements as if the error had not occurred.

In JKL's case, the error occurred in the previous accounting period, so opening balances of non-current assets and retained earnings will need to be adjusted, and the comparative statement of comprehensive income restated in order to include the asset and to recognise an appropriate amount of depreciation on the asset.

The necessary restatement is calculated as follows:

1.1.2009	depreciation	31.12.2009	depreciation	31.12.2010
HK$	HK$	HK$	HK$	HK$
8,000,000	(1,200,000)	6,800,000	(1,224,000)	5,576,000
Include asset in SOFP	@15% reducing balance	Carrying value 31.12.2009	@18% reducing balance	Carrying value 31.12.2010

Therefore, the comparative statement of comprehensive income should include an additional HK$1.2 million depreciation, and opening retained earnings adjusted to include the effect of the additional expense. In addition, the original accounting error must be corrected by removing HK$8 million from the prior year statement of comprehensive income and adjusting retained earnings by the same amount. The asset will be recognised on the comparative statement of financial position at HK$6.8 million, and on the current year statement of financial position at HK$5.576 million.

Investment property

Investment property may be measured using the cost model or the fair value model. A change from one model to the other constitutes a change in accounting policy.

(HKAS 40.30-31)

The necessary adjustments are calculated as follows:

	1 May 2008 HK$000	Profit or loss 2008 HK$000	31 Dec 2008 HK$000	Profit or loss 2009 HK$000	31 Dec 2009 HK$000	Profit or loss 2010 HK$000	31 Dec 2010 HK$000
Cost model	2,000	(40)	1,960	(40)	1,920	(40)	1,880
FV model	2,000	250	2,250	150	2,400	100	2,500
Adjustment		290		190		140	

These adjustments are dealt with as follows:

1. The HK$290,000 adjustment relating to 2008 must be dealt with by adjusting the retained earnings brought forward at 1 January 2009 in the statement of changes in equity.
2. The HK$190,000 adjustment relating to 2009 is dealt with by restating the comparative statement of comprehensive income and the comparative net profit within the statement of changes in equity.
3. The HK$140,000 adjustment relating to the current year is dealt with by adjusting the amounts recognised in the statement of comprehensive income.

The investment property is recognised at HK$2.5 million in the statement of financial position at 31 December 2010 and HK$2.4 million at 31 December 2009.

Recommendation / justification

The following journals should be posted to JKL's accounts in respect of the year ended 31 December 2010:

Warranty provision	HK$000	
DR warranty provision	550	
CR operating expenses	550	being reduction in provision
Depreciation method		
DR operating expenses	9,045	
CR accumulated depreciation	9,045	being current year depreciation on machinery
Accounting error		
DR non-current assets	8,000	
CR retained earnings	8,000	being correction of accounting error in prior year
DR retained earnings	1,200	
CR accumulated depreciation	1,200	being prior year depreciation on reinstated asset
DR operating expenses	1,224	
CR accumulated depreciation	1,224	being current year depreciation on the reinstated asset
Investment property		
DR investment property	480	
CR retained earnings	480	being application of new accounting policy prior to 1 January 2009 (290 + 190).
DR investment property	140	
CR profit or loss	140	being application of new accounting policy in 2010.

Extracts from the financial statements as at 31 December 2010 should be presented as follows:

Statement of comprehensive income

	31.12.2010	**31.12.2009** (as restated)
	HK$000	HK$000
Net profit	**20,421 (w)**	**21,490 (w)**

Working: Calculation of net profit

Net profit as given in case study	30,000	14,500
Correction of error	-	8,000
Additional depreciation on reinstated asset	-	(1,200)
Depreciation charge for 2010 (9,045+1,224)	(10,269)	-
Reduction in warranty provision	550	-
Change in accounting policy	140	190
	20,421	**21,490**

Statement of changes in equity (extract)

Retained earnings

	HK$000
Balance at 31 December 2008	150,000
Change in accounting policy	290
Balance at 31 December 2008 as restated	150,290
Profit for the year ended 31.12.09 as restated	21,490
Balance at 31 December 2009	171,780
Profit for the year ended 31.12.2010	20,421
Balance at 31 December 2010	192,201

Disclosure requirements

The following disclosure requirements are relevant:

Change in accounting policy

HKAS 8 requires the following disclosures where there is a change in accounting policy which is material:

– reasons for the change
– amount of the adjustment for the current period and for each period presented
– amount of the adjustment relating to periods prior to those included in the comparative information
– the fact that comparative information has been restated

Change in accounting estimate

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

Error

The following must be disclosed in relation to an error:

– nature of the prior period error.
– for each prior period, to the extent practicable, the amount of the correction for each financial statement line item affected
– the amount of the correction at the beginning of the earliest prior period presented.

Further disclosure is required where retrospective adjustment is impracticable (in the case of a change in policy or error).

Resolving accounting issues

Case study 2

X-treme is a manufacturer of clothing and equipment for extreme sports, including mountain climbing, skiing and deep sea diving. It currently operates primarily in Asia, however has a long term strategy to expand into the Australian and American markets. As part of this strategy, X-treme is developing its brand portfolio.

Deep Blue

On 1 October 2009, the company acquired a well established Australian brand, 'Deep Blue' at a cost of HK$2.6 million cash consideration. Included within this amount were patents on 'XZ3' performance fabric transferred by the vendor for HK$100,000.

As a result of this deal, X-treme was able to penetrate the multi-million dollar Australian wetsuit market. At the time of the acquisition of the brand, the fabric protected by the patent was expected to be a source of net cash inflows for 10 years. The directors of X-treme would, however, commit to continuous development of high performance wetsuit fabrics, such that the Deep Blue brand would result in net cash inflows for the foreseeable future.

During 2010, a competitor patented a new fabric with capabilities beyond those of XZ3. As a result, at the end of 2010, the directors estimated that the patent covering XZ3 had a useful life of 6 rather than 10 years. The directors were further concerned that this development may have harmed the Deep Blue brand, and sought the advice of a brand valuation agency. It indicated that at 31 December 2010 the value in use of the brand name was HK$2.45 million and that it could be sold for HK$2.55 million. The agency also indicated that a year earlier these figures would have been HK$2.6 million and HK$2.68 million respectively, so confirming the directors' concerns. Any sale is subject to 5% broker's fees.

X-lite

On 31 October 2008, after six months of research X-treme's development department created a new extra-lightweight composite material, known as X-lite. At this stage it was thought that the material could be used in the commercial production of ski helmets. Further supplies of X-lite were produced in December 2008 and prototype helmets were manufactured and tested during the first three months of 2009. By 31 March 2009, X-treme had successfully concluded this testing phase and established that there was a market for premium ski helmets made from X-lite. The company then spent the remainder of 2009 and start of 2010 making minor amendments to the X-lite production process and helmet design, testing this improved helmet, installing the required machinery to manufacture X-lite on a large scale, and training staff to use this specialised machinery. By 31 January 2010 X-treme was in a position to commence the manufacture of the helmets, and on 1 February 2010, commercial production and sales commenced. Sales of the ski helmets were expected to be constant at 10,000 units per annum for 4 years and then 5,000 units per annum for another 4 years, before a replacement for X-lite was found.

The costs associated with the development of X-lite (other than the purchase of the machinery) were as follows:

Period	Description	HK$
1 May 2008 – 31 October 2008	Development department costs associated with creation of X-lite	200,000
1 November 2008 – 31 December 2008	Production of further supplies of X-lite	50,000
1 January 2009 – 31 March 2009	Manufacture of prototypes	120,000
	Testing costs	60,000
1 April 2009 – 31 December 2009	Costs of amending production process	90,000
	Costs of amending helmet design and creating new prototypes	10,000
	Testing costs	80,000
	Installation of machinery	16,000
	Staff training	18,000
1 January 2010 – 31 January 2010	Staff training	3,000

The recoverable amount of the development costs was not less than their carrying amount at any relevant year end.

Distributor list

As part of the strategy to expand into Australia and America, X-treme engaged a new 'Market development manager' on a salary of HK$40,000 on 1 February 2010. This manager's job involved identifying wholesale distributors for each of the company's products within the target market areas, prior to visiting them to agree terms and conditions for any future trade. As a result of this manager's work, an extensive list of distributors was in place by 31 December 2010. The manager's office and travel costs amounted to HK$20,000 during 2010. The directors of X-treme felt that the present value of the distributor list in terms of future sales amounted to HK$1 million.

Required

Using the information provided:

(i) **determine which accounting standards are relevant,**

(ii) **discuss the appropriate accounting treatment for each of the three issues,**

(iii) **calculate the correct amounts to be recognised in X-treme's financial statements for the years ended 31 December 2008, 2009 and 2010,**

(iv) **prepare extracts from X-treme's statement of financial position and statement of comprehensive income for each of these years, and**

(v) **List the intangible asset disclosure requirements relevant to X-treme.**

Discussion points

Resolving accounting issues

Case study 2 - X-treme

What are the issues?

X-treme has three accounting issues relating to possible intangible assets:

a) In 2009 it acquired a brand and associated patent. The patent is initially expected to have a useful life of 10 years, and the brand an indefinite life. During 2010, developments made by a competitor mean that the useful life of the patent is reduced to 6 years in total and the value of the brand may be damaged.

b) At the end of 2008 X-treme concluded a 6 month project to develop a new lightweight material. A use for this material in the production of ski helmets was identified and prototypes were made and tested at the start of 2009. By the end of March 2009, X-treme had established a market for the helmets and so spent the remainder of 2009 refining the material and helmet design and preparing itself to go into production. The company was ready to start commercial production by 31 January 2010.

c) In February 2010, X-treme engaged a new employee to develop a list of Australian and American distributors for X-treme's products. A comprehensive list was in place by 31 December 2010.

In each case, it must be considered:

– whether an intangible asset should be recognised

– how the intangible asset should be measured initially

– how the intangible asset should be measured subsequently, including consideration of amortisation and impairment

– what amounts will be recognised in X-treme's financial statements for the years ended 31 December 2008-2010.

Which accounting standard(s) should be used?

HKAS 38 Intangible assets

HKAS 36 Impairment of assets

What are the requirements of the accounting standard(s)?

An intangible asset is an identifiable non-monetary asset without physical substance. An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(HKAS 38.8, LP Chapter 7, Section 1.3)

An intangible asset is recognised when it is probable that the expected future economic benefits attributable to the asset will flow to the entity, and the cost of the asset can be measured reliably.

(HKAS 38.21, LP Chapter 7, Section 1.4)

The probability recognition criterion is always considered to be satisfied for separately acquired intangible assets. In addition, the cost of a separately acquired intangible asset can usually be measured reliably, particularly when the consideration is cash.

(HKAS 38.25, LP Chapter 7, Section 1.4.1)

To assess whether an internally generated asset meets the criteria for recognition, the generation of the asset must be classified as a research phase and a development phase. An intangible asset arising from the research phase is never recognised. An intangible asset arising from the development phase is recognised when:

- Completion of the asset is technically feasible
- The entity intends to complete and use or sell the asset
- The entity can use or sell the asset
- The asset will generate probable future economic benefits
- Resources are available to complete and sell or use the asset, and
- Expenditure on the development phase can be reliably measured

(HKAS 38.52, 54, 57, LP Chapter 7, Sections 1.4.3, 2.2.1, 2.2.2)

The cost of an internally generated asset is the sum of expenditure incurred from the date when the recognition criteria listed above are first met. Costs previously expensed may not be reinstated.

(HKAS 38.65-66, LP Chapter 7, Sections 2.3)

Internally generated brands, mastheads, publishing titles, customer lists and similar items are not recognised as intangible assets.

(HKAS 38.63, LP Chapter 7, Sections 1.4.3)

An intangible asset may have a finite or indefinite useful life. Where its useful life is finite, an intangible asset is amortised over that life. Amortisation begins when the asset is available for use. The amortisation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed. If that pattern cannot be determined reliably, the straight line method is used.

(HKAS 38.97, LP Chapter 7, Sections 2.6)

The term 'indefinite' does not mean 'infinite'. The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level. A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance

(HKAS 38.91)

Where an intangible asset is not amortised as it is not yet available for use, it must be tested for impairment annually.

(HKAS 36.10, LP Chapter 7, Section 4.4)

Where its useful life is indefinite, an intangible asset is not amortised but is tested for impairment annually and whenever there is indication of impairment.

(HKAS 38.108, LP Chapter 7, Section 2.6.6)

The useful life of an intangible asset that is not being amortised should be reviewed each period to determine whether it remains indefinite. If this is not the case, the change in useful life is accounted for as a change in accounting estimate, and applied prospectively.

(HKAS 38.109, LP Chapter 7, Section 2.6.6)

Reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired.

(HKAS 38.110, LP Chapter 7, Section 2.6.6)

An asset is impaired when its carrying amount exceeds its recoverable amount. Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.

(HKAS 36.8, 18, LP Chapter 7, Section 4.5)

An impairment loss, measured as the amount by which carrying amount exceeds recoverable amount is recognised immediately in profit or loss where it relates to assets which have not been revalued.

(HKAS 36.60, LP Chapter 7, Section 4.6.2)

How to apply the standard(s) to the case

Deep Blue

X-treme has separately acquired two intangible assets: the patent and the brand.

Both assets meet the recognition criteria laid down in HKAS 38 and are therefore included in the company's statement of financial position as an asset from 1 October 2009.

Both assets are recognised initially at cost:

Patent	HK$100,000
Brand	HK$2.5 million

As the patent has a finite useful life, it is amortised. The expected useful life of the asset is 10 years and therefore the amortisation charges for the years ended 31 December 2009 and 2010 are:

31.12.09	HK$100,000 /10 x 3/12	HK$2,500
31.12.10	HK$100,000/10	HK$10,000

The amortisation period changes at 31.12.10 and from this date, amortisation is based on the revised remaining useful life of 4 years 9 months.

The brand has an indefinite useful life and it is therefore not amortised. The useful life of the brand should be assessed each period to determine whether it remains indefinite. If this is not the case, it may provide an indicator of impairment. In any case, the brand must be tested for impairment annually and whenever indications of impairment exist:

31 December	Carrying amount	Value in use	Fair value less costs to sell
2009	HK$2.5m	HK$2.6m	HK$2.68m x 95% = HK$2.55m
2010	HK$2.5m	HK$2.45m	HK$2.55m x 95% = HK$2.42m

Recoverable amount is the higher of value in use and fair value less costs to sell. Where recoverable amount is less than carrying amount, the asset is impaired.

At 31 December 2009, the recoverable amount of the brand is HK$2.6m, which exceeds its carrying amount. Therefore there is no impairment.

At 31 December 2010, the recoverable amount is HK$2.45m, which is less than the carrying amount. An impairment loss of HK$50,000 must therefore be recognised.

This amount is recognised in profit or loss for the period.

X-lite

The X-lite material is an internally generated intangible asset and its generation must therefore be classified into a research and development phase.

All costs incurred during the research phase must be recognised as an expense as incurred. Those costs incurred during the development phase, but before the capitalisation criteria for development costs are met, must also be recognised in profit or loss as incurred. Any costs incurred after the capitalisation criteria have been met must be recognised as an intangible asset.

In terms of the X-lite project, the research phase lasts from 1 May 2008 to 31 October 2008.

The development phase lasts from 1 November 2008 to 31 January 2010, however the capitalisation criteria are not met until 31 March 2009. This is the date by which X-treme have concluded successful testing of prototype helmets and have established a market for the helmets.

Therefore those development costs incurred between 1 November 2008 and 31 March 2009 should be recognised in profit or loss. Those incurred between 1 April 2009 and 31 January 2010 should be capitalised as an intangible asset, with the following exceptions:

– Staff training costs do not meet the definition of an asset as the resultant future economic benefits are not within the control of the entity providing the training. In this case, the trained staff may leave X-treme and any benefit is therefore lost.

– Installation of machinery costs should be capitalised as part of the cost of the machinery itself, rather than as an intangible asset.

	Recognise as expense		Capitalise as intangible asset	
2008	Development costs	HK$200,000		
	Production of X-lite	HK$50,000		
2009	Prototypes	HK$120,000	Amendments	HK$90,000
	Testing costs	HK$60,000	New prototypes	HK$10,000
	Staff training	HK$18,000	Testing costs	HK$80,000
2010	Staff training	HK$3,000		

An intangible asset is amortised from the time when it is capable of operating in the manner intended. This is not the case with the X-lite intangible asset until 31 January 2010, and therefore no amortisation is charged in the 2009 financial statements and the asset is carried at original cost of HK$180,000 at 31 December 2009.

As the asset is not yet being amortised, HKAS 36 requires that it is tested for impairment annually. The question indicates that the recoverable amount of X-lite exceeds carrying amount and therefore no impairment loss has occurred.

Amortisation commences from 31 January 2010 and the method should reflect the pattern in which the benefits are expected to be consumed by X-treme. Therefore the expected sales pattern should be taken into account:

Period of sales	Units	Amortisation HK$
1 Feb 2010 – 31 Jan 2011	10,000	30,000
1 Feb 2011 – 31 Jan 2012	10,000	30,000
1 Feb 2012 – 31 Jan 2013	10,000	30,000
1 Feb 2013 – 31 Jan 2014	10,000	30,000
1 Feb 2014 – 31 Jan 2015	5,000	15,000
1 Feb 2015 – 31 Jan 2016	5,000	15,000

1 Feb 2016 – 31 Jan 2017	5,000	15,000
1 Feb 2017 – 31 Jan 2018	5,000	15,000
	60,000	180,000

In the year ended 31 December 2010, the amortisation charge is therefore HK$27,500 (HK$30,000 x 11/12). The carrying value of the asset is therefore HK$152,500 (HK$180,000 – HK$27,500) at 31 December 2010.

Distributor list

The distributor list is an internally generated potential intangible asset. The question here is whether the list meets the definition of an asset and the HKAS 38 recognition criteria.

An asset is defined as a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Although future economic benefits – in particular future sales with a present value of HK$1 million – are expected to result from the distributor list, these benefits are not within the control of X-treme. The distributors on the list are under no obligation to purchase goods from X-treme, and they may instead take their custom elsewhere.

Additionally, HKAS 38 expressly prohibits the recognition of a customer list as an intangible asset, and a distributor is, in effect, a customer (**HKAS 38.64, LP Chapter 7, Section 1.4.3**)

The HK$40,000 salary of the Market Development Manager and HK$20,000 office and travel costs must therefore be expensed to profit or loss as incurred in 2010.

Recommendations

Journal entries

Deep Blue

1 October 2009	DR Patent DR Brand CR Cash	HK$100,000 HK$2,500,000 HK$2,600,000	To record the purchase of a patent and the Deep Blue brand.
31 December 2009	DR Amortisation expense (profit or loss)	HK$2,500	To record amortisation on the patent for 2009.
	CR Accumulated amortisation (patent)	HK$2,500	
31 December 2010	DR Amortisation expense (profit or loss)	HK$10,000	To record amortisation on the patent for 2010.
	CR Accumulated amortisation (patent)	HK$10,000	
	DR Impairment expense (profit or loss)	HK$50,000	To record the impairment loss relating to the Deep Blue brand.
	CR Brand	HK$50,000	

X-lite

y/e 31 December 2008	DR Development expenses (profit or loss)	HK$250,000	To recognise research costs as an expense.
	CR Cash / payable	HK$250,000	
y/e 31 December 2009	DR Development expenses (profit or loss)	HK$180,000	To recognise development costs which do not qualify for capitalisation as an expense.
	DR Staff training (profit or loss)	HK$18,000	
	CR Cash / payable	HK$198,000	
y/e 31 December 2009	DR Development costs intangible asset	HK$180,000	To recognise development costs which do qualify for capitalisation as an asset.
	CR Cash / payable	HK$180,000	
y/e 31 December 2010	DR Staff training (profit or loss)	HK$3,000	To recognise staff training as an expense.
	CR Cash / payable	HK$3,000	
	DR Amortisation expense (profit or loss)	HK$27,500	To recognise amortisation on the capitalised development costs.
	CR Accumulated amortisation	HK$27,500	

Distribution list

y/e 31 December 2010	DR Salaries and wages (profit or loss)	HK$40,000	To recognise Market Development Manager's salary and costs as an expense.
	DR Sundry expenses	HK$20,000	
	CR Cash / payable	HK$60,000	

Financial statements

Statement of financial position at 31 December

	2008 HK$000	2009 HK$000	2010 HK$000
Patent	-	97.5	87.5
Brand	-	2,500	2,450
Development costs: X-lite	-	180	152.5

Statement of comprehensive income for the year ended 31 December

	2008 HK$000	2009 HK$000	2010 HK$000
Amortisation expense	-	2.5	37.5
Impairment expense	-	-	50
Development expenses	250	180	-
Staff training expenses	-	18	3
Salaries and wages	-	-	40
Sundry	-	-	20

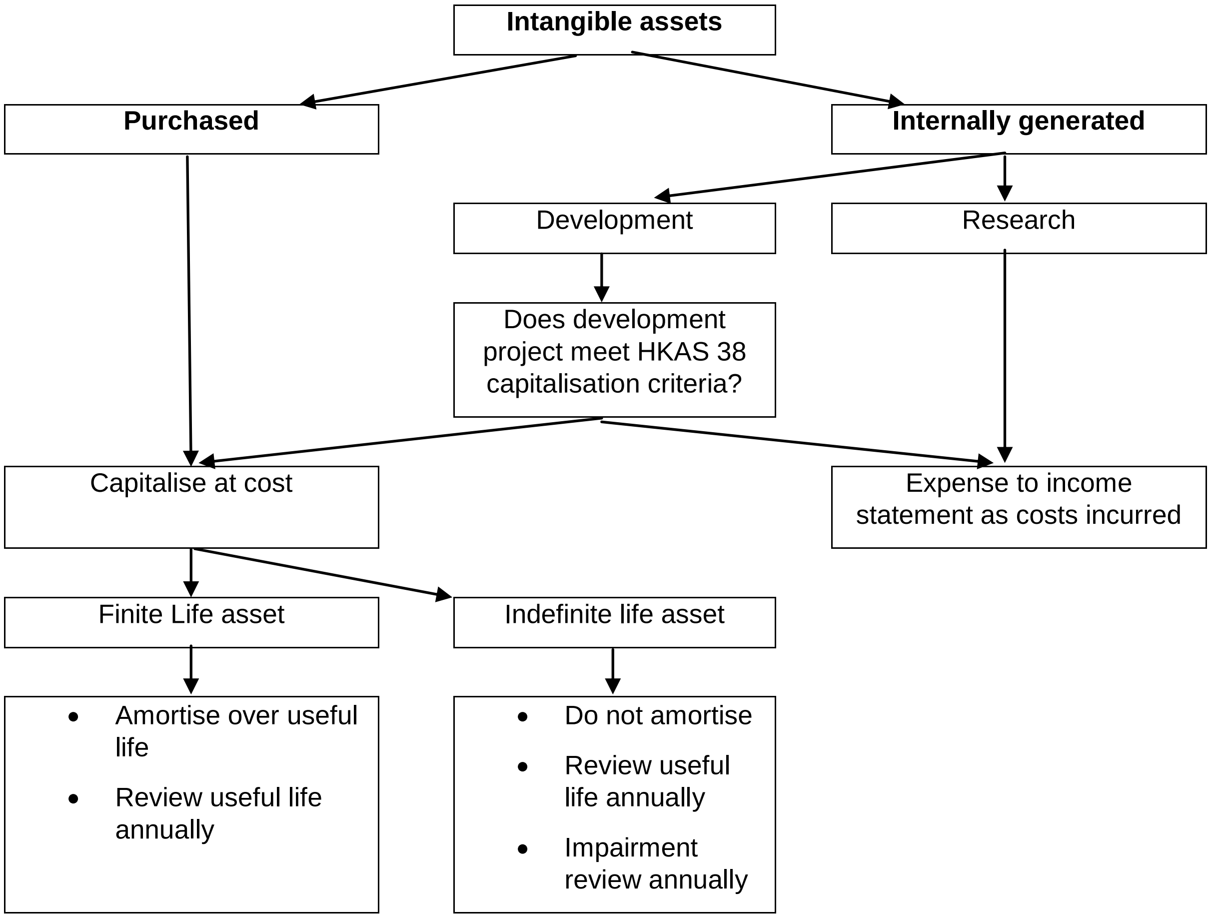
Disclosure requirements

The following HKAS 38 disclosure requirements are relevant to X-treme:

- The accounting policies relevant to intangible assets
- For each class of intangible assets:
  - The method of amortisation used
  - The useful life of the assets or amortisation rate used
  - The gross carrying amount, accumulated amortisation at the beginning and end of the period and a reconciliation between them
  - The carrying amount of internally generated intangible assets
- The carrying amount of intangible assets with an indefinite life and the reasons supporting the assessment of indefinite life
- The carrying amount, nature and remaining amortisation period of any intangible asset that is material to the financial statements as a whole

Further disclosures are required where intangible assets are acquired by way of a government grant, where they have restricted title or have been pledged as security, where they are carried at a revalued amount, or where an entity has committed to the future acquisition of intangible assets.

Overall learning summary



Impairment reviews - intangible assets

- When indication of impairment
- Annually if not yet available for use
- Annually if asset has indefinite life

Asset is impaired where:

Carrying value

exceeds

Recoverable amount

= higher of

Fair value less costs to sell

Value in use

Future estimated cash flows discounted to present value

Impairment loss reduces carrying value to recoverable amount and is recognised in profit or loss.

Financial instruments

Case study 1

Fun4All is a Hong Kong based distributor of toys and games with a year end of 31 December. Fun4All's customer base is global, with approximately 20% of total sales made to Europe, 40% to the Americas and 30% to Australia. As part of the company's strategy to further penetrate the European market, Fun4All sold its eastern European distribution centre on 1 September 2009, having invested in a new central European distribution centre in January of the same year.

The proceeds raised from the sale of the old distribution centre amounted to 50 million Florings (Fl), which Fun4All transferred to Hong Kong and placed on deposit with a domestic bank on 1 September 2009 when the exchange rate was Fl 3.5:HK$ 1. The bank has agreed to pay interest on the last day of each month directly to the credit of the foreign currency saving account. Interest is calculated at a rate of 5.05%, provided the exchange rate on the payment date does not fall below Fl 3.4:HK$ 1. Where the Floring strengthens against the HK$, the interest rate drops as follows:

Exchange rate on interest payment date	Interest rate applicable
HK$1 buys:	
Fl 3.30 – 3.39	**4.90%**
Fl 3.20 – 3.29	**4.75%**
Fl 3.10 – 3.19	**4.60%**
Fl 3.00 – 3.09	**4.45%**
Fl 2.90 – 2.99	**4.30%**
Fl 2.80 – 2.89	**4.15%**

Exchange rates were as follows:

30 Sept 2009	Fl 3.50: HK$ 1	31 May 2010	Fl 3.30: HK$ 1
31 Oct 2009	Fl 3.45: HK$ 1	30 June 2010	Fl 3.32: HK$ 1
30 Nov 2009	Fl 3.40: HK$ 1	31 July 2010	Fl 3.17: HK$ 1
31 Dec 2009	Fl 3.40: HK$ 1	31 Aug 2010	Fl 3.02: HK$ 1
31 Jan 2010	Fl 3.39: HK$ 1	30 Sept 2010	Fl 2.96: HK$ 1
28 Feb 2010	Fl 3.40: HK$ 1	31 Oct 2010	Fl 3.18: HK$ 1
31 Mar 2010	Fl 3.40: HK$ 1	30 Nov 2010	Fl 3.30: HK$ 1
30 Apr 2010	Fl 3.32: HK$ 1	31 Dec 2010	Fl 3.34: HK$ 1

Required

Using the information provided:

(i) **determine the relevant accounting standards,**

(ii) **determine the appropriate accounting treatment of the deposit in Fun4All's financial statements,**

(iii) **calculate the amounts which should be recognised in Fun4All's statement of financial position at 31 December 2009 and 31 December 2010, and prepare extracts from Fun4All's statement of comprehensive income at the same dates, and**

(iv) **List the HKFRS 7 requirements applicable to Fun4All.**

Discussion points

Financial instruments

Case study 1 - Fun4All

What are the issues?

Fun4All places 50 million Florings on deposit in a foreign currency account at a domestic Hong Kong bank. The issues to be considered are:

(a) How the deposit should be accounted for in accordance with HKFRS 9

(b) How the deposit should be accounted for in accordance with HKAS 21

(c) How the embedded derivative, being the variable interest rate, should be accounted for in accordance with HKFRS 9.

Which accounting standards should be used?

HKFRS 9 Financial Instruments

HKAS 21 The Effects of Changes in Foreign Exchange Rates

What are the requirements of the accounting standards?

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 assets, and
(b) the contractual cash flow characteristics of the financial asset.

(HKFRS 9, 4.1, LP Chapter 17, Section 3.2.2)

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 17, Section 3.2.2)

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host. The effect of an embedded derivative is that some of the cash flows related to the hybrid contract are modified according to a special interest rate, foreign exchange rate or other variable.

(HKFRS 9, 4.6, LP Chapter 17, Section 5)

Where the host contract within a hybrid contract is within the scope of HKFRS 9, the entire hybrid contract is treated as a single financial asset.

(HKFRS 9, 4.7, LP Chapter 17, Section 5.2)

Measurement

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

(HKFRS 9.5.1, LP Chapter 17, Section 4.1)

HKAS 21 states that a foreign currency transaction should initially be converted to the functional currency, by applying the spot exchange rate between the reporting currency and the foreign currency at the date of the transaction.

(HKAS 21.20, LP Chapter 17, Section 2.1)

Where a foreign currency balance is not settled before the end of the reporting period, it may require re-translating for inclusion in the period end accounts. HKAS 21 requires that foreign currency balances are classified as either monetary or non-monetary for this purpose. Monetary items are cash or amounts that will be settled in cash, for example receivables, payables and loans.

(HKAS 21.23, LP Chapter 17, Section 2.3)

How to apply the standards to the case?

Classification

The Fl 50 million deposit is a financial asset within the scope of HKFRS 9; therefore the embedded derivative is not separated out for accounting purposes and HKFRS 9 is applied to the whole hybrid contract.

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, money placed on deposit at a bank meets the HKFRS 9 criteria that the asset is held to collect contractual cash flows. Additionally, contractual cash flows arise on specified dates, being interest payable on the principal outstanding.

Conclusion: the deposit is classified as measured at amortised cost.

Measurement

The deposit is initially recorded at its fair value, being Fl 50 million. This amount is translated at the exchange rate on 1 September 2009, and recorded as a bank deposit on this date:

Fl 50,000,000 / 3.50 = HK$14,285,714

Interest is calculated and recognised as income on the last day of each calendar month, using an interest rate dependent on the exchange rate on that day:

2009		Balance on deposit Florings			Balance per accounts HK$
Deposit at 1 Sept		50,000,000			14,285,714
Sept 2009	$\frac{\text{Fl 50m} \times 5.05\%}{12}$	210,417	÷ 3.50	60,119	
Oct 2009	$\frac{\text{Fl 50m} \times 5.05\%}{12}$	210,417	÷ 3.45	60,990	
Nov 2009	$\frac{\text{Fl 50m} \times 5.05\%}{12}$	210,417	÷ 3.40	61,887	
Dec 2009	$\frac{\text{Fl 50m} \times 5.05\%}{12}$	210,417	÷ 3.40	61,887	244,883
Deposit at 31 Dec		50,841,668			14,530,597

At 31 December 2009, the deposit balance must be re-translated using the closing exchange rate, in accordance with HKAS 21:

Fl 50,841,668 / 3.40 = HK$14,953,432

An exchange gain of HK$422,835 (HK$14,953,432 – 14,530,597) arises and is recorded in profit or loss for the year.

Interest is calculated monthly in 2010, again applying an interest rate determined by the exchange rate on the last day of each calendar month:

2010		Balance on deposit Florings			Balance per accounts HK$
Deposit at 1 Jan		50,841,668			14,953,432
Jan 2010	$\frac{\text{Fl 50m} \times 4.90\%}{12}$	204,167	÷ 3.39	60,226	
Feb 2010	$\frac{\text{Fl 50m} \times 5.05\%}{12}$	210,417	÷ 3.40	61,887	
March 2010	$\frac{\text{Fl 50m} \times 5.05\%}{12}$	210,417	÷ 3.40	61,887	
April 2010	$\frac{\text{Fl 50m} \times 4.90\%}{12}$	204,167	÷ 3.32	61,496	
May 2010	$\frac{\text{Fl 50m} \times 4.90\%}{12}$	204,167	÷ 3.30	61,869	
June 2010	$\frac{\text{Fl 50m} \times 4.90\%}{12}$	204,167	÷ 3.32	61,496	
July 2010	$\frac{\text{Fl 50m} \times 4.60\%}{12}$	191,667	÷ 3.17	60,463	
August 2010	$\frac{\text{Fl 50m} \times 4.45\%}{12}$	185,417	÷ 3.02	61,396	
September	$\underline{\text{Fl 50m} \times 4.30\%}$	179,167	÷ 2.96	60,529	

2010	12				
October 2010	Fl 50m × 4.60% / 12	191,667	÷ 3.18	60,273	
November 2010	Fl 50m × 4.90% / 12	204,167	÷ 3.30	61,869	
December 2010	Fl 50m × 4.90% / 12	204,167	÷ 3.34	61,128	734,519
Deposit at 31 Dec		53,235,422			15,687,951

At 31 December 2010, the deposit balance must be again re-translated using the closing exchange rate, in accordance with HKAS 21:

Fl 53,235,422 / 3.34 = HK$15,938,749

An exchange gain of HK$250,798 (HK$15,938,749 – 15,687,951) arises and is recorded in profit or loss for the year.

Recommendation / justification

Journal entries

1 September 2009	DR Bank deposit CR Disposal proceeds	HK$14,285,714 HK$14,285,714	To record the initial deposit of Fl 50 million translated at the spot rate on 1 September 2009
September – December 2009	DR Bank deposit CR Interest income	HK$244,883 HK$244,883	To record interest received on the last day of September, October, November and December 2009 (60,119 + 60,990+61,887+61,887)
31 December 2009	DR Bank deposit CR Exchange gain	HK$422,835 HK$422,835	To re-translate the foreign currency deposit at the closing rate
January – December 2010	DR Bank deposit CR Interest income	HK$734,519 HK$734,519	To record interest received on the last day of the month throughout the year
31 December 2010	DR Bank deposit CR Exchange gain	HK$250,798 HK$250,798	To re-translate the foreign currency deposit at the closing rate

Extracts from financial statements

Statement of financial position at 31 December	**2009**	**2010**
	HK$	**HK$**
Bank deposit	14,953,432	15,938,749

Income statement for the year ended 31 December

	2009	**2010**
	HK$	**HK$**
Investment income	244,883	734,519
Exchange gain	422,835	250,798

Disclosure requirements

HKFRS 7 requires the following disclosures in respect of all financial instruments:

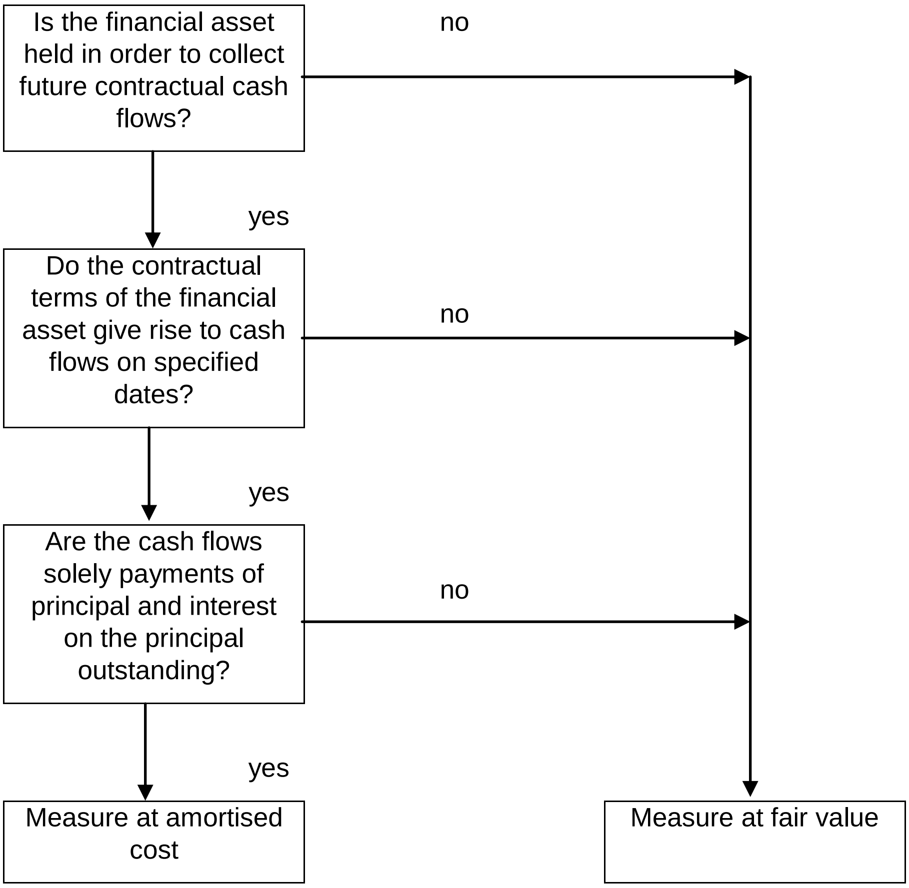
- Significant accounting policies
- The nature and extent of risks arising from financial instruments, including credit, currency, interest rate, liquidity, market and other price risk. Disclosure must be:
    - Qualitative, including exposures to risk and how these are managed, and
    - Quantitative, including maturity analyses of outstanding amounts and amounts of collateral pledged.

It also requires the following disclosures for financial assets measured at amortised cost:

- The carrying amount of financial assets in the statement of financial position by HKFRS 9 category
- The existence of embedded derivatives within hybrid instruments
- Interest income in the statement of comprehensive income

Additional disclosure is required where financial assets are measured at fair value, have been reclassified, pledged as collateral, impaired or defaults or breaches have occurred.

Key learning summary – classification of financial assets



Financial instruments

Case study 2

On 1 January 2010 XYZ purchases a debt instrument (a bond) which is denominated in Gilders for its fair value of 1,000 Gilder, when the exchange rate was 1 Gilder:HK$1.50. The bond matures on 31 December 2014 at its nominal value of 1,250 Gilders, it carries fixed interest of 4.7% payable on 31 December annually, and the effective interest rate is 10%.

At 31 December 2010, the fair value of the bond is 1,060 Gilder and the exchange rate is 1 Gilder:HK$2. The average exchange rate for 2010 was 1 Gilder:HK$1.75.

XYZ intends to hold the bond for at least 2 years, after which time it is likely to trade the bond on the open market.

Required

Using the information provided:

(i) determine the relevant accounting standards,

(ii) determine the appropriate accounting treatment of the bond in XYZ's financial statements,

(iii) calculate the amount at which the bond should be recognised in XYZ's statement of financial position at 31 December 2010, and prepare extracts from XYZ's statement of comprehensive income at the same date, and

(iv) List the disclosure requirements of HKFRS 7 in relation to the bond.

Discussion points

Financial instruments

Case study 2 - XYZ

What are the issues?

XYZ has purchased a financial asset denominated in a foreign currency.

(a) At what value should be bond be initially recognised?
(b) At what value should it be recognised at the year end?
(c) What is recognised in profit in relation to the bond for 2010?

Which accounting standards should be used?

HKAS 39 Financial Instruments: Recognition and Measurement

HKFRS 9 Financial Instruments

HKAS 21 The Effects of Changes in Foreign Exchange Rates

HKFRS 7 Financial Instruments: Disclosures

What are the requirements of the accounting standards?

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 assets, and
(b) the contractual cash flow characteristics of the 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.

The HKFRS 9 requirement to classify financial assets on recognition as one of two types is a significant simplification of the previous HKAS 39 rules. These required financial assets to be classified as one of four types, being:

- at fair value through profit or loss
- held to maturity
- available for sale, and
- loans and receivables

(HKAS 39.45, HKFRS 9.4.1, LP Chapter 17, Section 3.2.2)

Measurement

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

(HKFRS 9.5.1, LP Chapter 17, Section 4.1)

Where a financial asset is classified as measured at fair value, fair value is established at each period end by reference to either the market price, where the instrument is quoted, or valuation techniques otherwise. HKFRS 9 also states that in some cases, cost may be the best estimate of fair value. Any changes in fair value are normally recognised in profit or loss.

(HKFRS 9.5.2, LP Chapter 17, Section 4.2.1)

HKAS 21 states that a foreign currency transaction should initially be converted to the functional currency, by applying the spot exchange rate between the reporting currency and the foreign currency at the date of the transaction.

(HKAS 21.20, LP Chapter 18, Section 2.1)

Where a foreign currency balance is not settled before the end of the reporting period, it may require re-translating for inclusion in the period end accounts. HKAS 21 requires that foreign currency balances are classified as either monetary or non-monetary for this purpose. Monetary items are cash or amounts that will be settled in cash, for example receivables, payables and loans.

(HKAS 21.23, LP Chapter 18, Section 2.3)

How to apply the standards to the case?

Classification

The bond is a financial asset, and the first issue to deal with is the initial classification of the asset in XYZ's accounts. HKFRS 9 requires that 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.

As XYZ intends to trade the bond before its maturity date, it does not intend to collect all of the contractual cash flows which arise over the 5 year term of the bond. Therefore the bond is not classified as measured at amortised cost.

Conclusion: the bond is classified as measured at fair value

Measurement

HKFRS 9 requires financial assets to be initially recorded at the fair value of consideration given. The bond costs 1,000 Gilder, which should be translated to HK$ using the exchange rate on the date of the transaction, which was 1 Gilder:HK$1.50.

Therefore the bond is recorded at HK$1,500 on 1 January 2010. (1,000 × 1.5).

Subsequent measurement of the bond should be at fair value, as discussed above. At 31 December 2010, the fair value of the bond is 1,060 Gilder, and the exchange rate is 1 Gilder:HK$2. Therefore the fair value to be recognised in XYZ's statement of financial position is HK$2,120.

The bond has increased in value by HK$620 (2,120 - 1,500) in 2010. Not all of this increase in value is a fair value gain to XYZ. Some of the increase in value is due to exchange rate movement, and some is due to interest receivable on the bond. Calculations need to be performed to determine the components of the HK$620 increase in value, and so to account for them accurately in XYZ's financial statements.

Working – Amortised cost calculation – calculate in foreign currency

Year	Amortised cost at beginning of year	Interest income @10%	Interest received 4.7% × 1,250 (nominal value of bond)	Amortised cost at end of year
2010	1,000	100	(59)	1,041

The amortised cost at the year end is 1,041 Gilder, which translated at the year end exchange rate is HK$2,082. (1,041 × 2).

The difference between the amortised cost of HK$2,082, and the fair value of the bond recognised in the statement of financial position of HK$2,120 is HK$38. This is the increase in the value of the bond caused by fair value alone. According to HKFRS 9, the change in fair value should be recognised in profit or loss for the year.

XYZ should also recognise in profit or loss for the year the interest income arising on the bond. The amortised cost working above shows that interest income of 100 Gilder accrues during 2010, which should be retranslated using the average exchange rate for the year. This gives interest income of HK$175 (100 x 1.75) to recognise in profit or loss.

Finally, XYZ's profit should also include an exchange gain or loss which arises on the retranslation of the bond. The exchange gain or loss has two components. First, the bond itself had a value initially recognised at HK$1,500 (1,000 Gilder x 1.5), this is then retranslated at the year end to HK$2,000 (1,000 Gilder x 2). The difference of HK$500 represents an exchange gain arising from the retranslation of the original amount recognised as an asset (and excludes any fair value gain). Secondly, the interest income of 100 Gilder gives rise to an exchange difference, as it has been recognised as part of the bond asset at the year end exchange rate of 1 Gilder:HK$2, but included in profit at the average exchange rate of 1 Gilder:HK$1.75. Therefore an exchange gain of HK$25 (100 x (2 - 1.75)) arises on the interest income.

In summary, XYZ's statement of financial position will include the bond at fair value of HK$2,120 at the year end, the profit will include a fair value gain of HK$38, interest income of HK$175, and an exchange gain of HK$525 (500+25).

Recommendation / justification

At 1 January 2010, the bond is initially recorded at fair value:

	HK$	HK$
DR Bond	1,500	
CR Cash		1,500

The movements in the year are recorded as follows:

	HK$	
DR Bond	620	Being the increase in value of the bond
DR Cash	118	Being interest received in cash (59 Gilder x HK$2)
CR Profit	38	Being the fair value increase
CR Profit	175	Being interest income based on amortised cost
CR Profit	525	Being the total exchange gain for the year

Statement of financial position at 31 December 2010	**HK$**
Financial assets measured at fair value	2,120
Statement of comprehensive income for the year ended 31 December 2010	**HK$**
Investment income	175
Net gains on financial assets measured at fair value	38
Exchange gain	525

Disclosure requirements

HKFRS 7 requires the following disclosures in respect of all financial instruments:

– Significant accounting policies

– The nature and extent of risks arising from financial instruments, including credit, currency, interest rate, liquidity, market and other price risk. Disclosure must be:

  o Qualitative, including exposures to risk and how these are managed, and

  o Quantitative, including maturity analyses of outstanding amounts and amounts of collateral pledged.

It also requires the following disclosures for financial assets measured at fair value through profit or loss:

– The carrying amount of financial assets in the statement of financial position by HKFRS 9 category

– Net gains or losses in the statement of comprehensive income by HKFRS 9 category and broken down as appropriate (for example interest, changes in fair value and dividend income)

– Interest income in the statement of comprehensive income

Additional disclosure is required where financial assets have been reclassified, pledged as collateral, impaired or defaults or breaches have occurred.

Discussion points

What are the issues?

Panther has an 80% interest in a subsidiary, Tiger, which in turn has a 60% interest in Cougar.

The consolidated statement of financial position must be prepared for this 'vertical group', and the following issues considered:

(a) The non-controlling interest is to be measured as a proportion of net assets in respect of Tiger and at fair value in respect of Cougar. This is in accordance with the choice allowed by HKFRS 3 (Revised).

(b) Cougar is a mid-year acquisition and therefore profits need pro-rating to find retained earnings at the date of acquisition.

(c) The calculations of goodwill in Cougar and Cougar's contribution to group retained earnings must take into account the effective group share in Cougar.

The deferred tax impact of a consolidation must also be considered as an additional requirement.

Which accounting standards should be used?

HKFRS 3 Business Combinations

HKAS 27 Consolidated and Separate Financial Statements

HKAS 12 Income Taxes

What are the requirements of the accounting standards?

Subsidiary companies should be consolidated. **(HKAS 27.9, LP Chapter 26, 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. **(HKAS 27.18, LP Chapter 26 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 26, Section 3.3.4)**

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 26, Section 4.2)**

The choice of measurement method for the non-controlling interests is made for each business combination (rather than being an accounting policy choice), and will require management to carefully consider their **future intentions** regarding the acquisition of the non-controlling interests, as the two methods will potentially result in significantly different amounts of goodwill. **(LP Chapter 26, Section 4.2.2)**

An entity should recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries except where the parent is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the future. **(HKAS 12.39, LP Chapter 14, Section 8.1)**

The identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Fair value adjustments may result in temporary differences and have deferred tax implications. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill **(HKAS 12.19, LP Chapter 14, Section 8.1.1, 8.1.2)**

HKFRS 3 *Business Combinations* requires an entity to recognise any deferred tax assets (to the extent that they meet the relevant recognition criteria) or deferred tax liabilities resulting from temporary differences on a business combination as identifiable assets and liabilities at the date of acquisition. These deferred tax assets and deferred tax liabilities, consequently, will affect the amount of goodwill or the bargain purchase gain the entity recognises. (**HKAS 12.66, LP Chapter 14, Section 8.4)**

An entity will not, however, recognise deferred tax liabilities arising from the initial recognition of goodwill. (**HKAS 12.66, LP Chapter 14, Section 8.4)**

How to apply the standard(s) to the case

The following workings to the consolidated statement of financial position show how the relevant accounting standards are applied to the case.

These workings assume that no sub-consolidation is performed for Tiger and Cougar prior to the preparation of the top-level consolidation. An alternative answer is given afterwards which assumes that a sub-consolidation **is** performed.

(W1) **Group structure**

In a scenario where there is a vertical group, it is important to establish the group percentage holding in both the subsidiary and sub-subsidiary:

Panther
80%
Tiger — Therefore effective group holding in Cougar is 48%
60%
Cougar

(W2) **Net asset working**

The fair value of the net assets of the subsidiary and sub-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 (group share) for inclusion in group retained earnings

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

Tiger	Net assets at acquisition	Net assets at reporting date
	HK$000	HK$000
Share capital	45,000	45,000
Retained earnings	25,000	129,000
	70,000	174,000

Cougar	Net assets at acquisition	Net assets at reporting date
	HK$000	HK$000
Share capital	30,000	30,000
Revaluation reserve	5,000	5,000
Retained earnings 38,000 – (4/12 × 9,600)	34,800	38,000
	69,800	73,000

(W3) **Goodwill on acquisition**

	Tiger
	HK$000
Cost of investment	76,000
Non-controlling interest measured as % of net assets (20% × 70,000 (W2))	14,000
	90,000
Net assets at acquisition (W2)	(70,000)
Goodwill	20,000

(i) Journal for goodwill (HK$000)

DR	Share capital	45,000	
DR	Retained earnings	25,000	
DR	Goodwill	20,000	
CR	Cost of investment in Tiger		76,000
CR	Non-controlling interest		14,000

		Cougar	
	Group		**NCI**
	HK$000		**HK$000**
Cost of investment (group share)(80% x 63,000)	50,400		
FV of NCI (52% x 30,000 x HK$3.50 x 100/125)			43,680
Net assets at acquisition (W2) x 48%/52%*	(33,504)		(36,296)
Goodwill	16,896		7,384
Total Goodwill		24,280	

*the effective group holding in Cougar ie 48% is relevant when calculating the percentage of the net assets of Cougar acquired by Panther. The NCI's holding is therefore the remaining 52%.

(ii) Journal for goodwill (HK$000)

DR	Share capital	30,000	
DR	Retained earnings	34,800	
DR	Revaluation reserve	5,000	
DR	Goodwill	24,280	
CR	Cost of investment in Cougar		50,400
CR	Non-controlling interest		43,680

(W4) **Non-controlling interest at 31 December 2010**

(i) In Tiger

	HK$000
Net assets at reporting date (W2)	174,000
Less investment in Cougar	(63,000)
	111,000
NCI share (20%)	22,200

At acquisition the non-controlling interest in Tiger was HK$14,000,000. This was recognised within consolidation adjustment (i) in (W3) above. Therefore an increase of HK$8,200,000 must now be recognised as a further consolidation adjustment.

In a basic parent – subsidiary consolidation this amount corresponds exactly to the NCI's share of post acquisition reserves in the acquiree. However, here we also have a sub-subsidiary.

The NCI share of the increase in the retained earnings of Tiger since Acquisition is HK$20,800,000 (20% x (174,000-70,000) (W2)). This increase is in part due to the NCI's share of profits earned (HK$8,200,000), and in part due to the NCI's share of the investment in Cougar of HK$12,600,000 (20% x 63,000).

As we are preparing group accounts, NCI's share of the investment in Cougar must be eliminated:

Journal for change in non-controlling interest since acquisition – Tiger (HK$000)

DR	Retained earnings	20,800
CR	Investment in Cougar	12,600
CR	Non-controlling interest	8,200

(ii) In Cougar

	HK$000
Net assets at reporting date (W2)	73,000
NCI share (52% x 73,000)	37,960
NCI goodwill (W3)	7,384
NCI	45,344

At acquisition the non-controlling interest in Cougar was HK$43,680,000. This was recognised within consolidation adjustment (i) in (W3) above. Therefore an increase of HK$1,664,000 (HK$45,344,000-HK$43,680,000) must now be recognised as a further consolidation adjustment.

Here, as there is no sub-subsidiary, the corresponding debit is to retained earnings.

Journal for change in non-controlling interest since acquisition - Cougar (HK$000)

DR	Retained earnings (52% x 73,000) – (52% x 69,800)	1,664
CR	Non-controlling interest	1,664

(W5) **Group retained earnings**	**HK$000**
Panther retained earnings	128,000
Tiger – group share of post acquisition earnings	
80% (129,000-25,000)	83,200
Cougar – group share of post acquisition earnings	
48%(38,000 – 34,800)	1,536
Group retained earnings	212,736

Tax implications of the business combination

Deferred tax arises on consolidation in a number of circumstances, including:

– where the carrying value of the investment in a subsidiary (ie net assets plus goodwill) differs from its tax base (normally cost) due to the undistributed profits of the subsidiary

– where fair value adjustments are made on acquisition of a subsidiary

– where adjustment is made to group accounts for unrealised profits but the individual selling company recognises and taxes the profit

Fair value and unrealised profits

No fair value adjustments are made to either Tiger or Cougar's accounts; equally there are no unrealised profits, and therefore no deferred tax adjustments are required on consolidation.

The group deferred tax balance is therefore the aggregate of the individual companies' deferred tax balances.

Recommendation / Justification

	Panther	Tiger	Cougar	Subtotal	W3(i) Adj	W3(ii) Adj	W4 (i) Adj	W4 (ii) Adj	Consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
PPE	184,000	108,000	67,000	359,000					359,000
Intangibles	12,000	4,000	-	16,000					16,000
Goodwill	-	-	-	-	20,000	24,280			44,280
Investment (Tiger)	76,000	-	-	76,000	(76,000)				-
Investment (Cougar)	-	63,000	-	63,000		(50,400)	(12,600)		-
	272,000	175,000	67,000	514,000					419,280
Inventories	10,000	11,000	13,000	34,000					34,000
Receivables	13,000	9,000	14,000	36,000					36,000
Cash	3,000	-	8,000	11,000					11,000
	298,000	195,000	102,000	595,000					500,280
Share capital	70,000	45,000	30,000	145,000	(45,000)	(30,000)			70,000
Retained earnings	128,000	129,000	38,000	295,000	(25,000)	(34,800)	(20,800)	(1,664)	212,736
Revaluation reserve	40,000	-	5,000	45,000		(5,000)			40,000
NCI	-	-	-	-	14,000	43,680	8,200	1,664	67,544
	238,000	174,000	73,000	485,000					390,280
Deferred tax	12,000	3,000	6,000	21,000					21,000
Loan	25,000	-	10,000	35,000					35,000
Overdraft	-	5,000	-	5,000					5,000
Payables	21,000	10,000	12,000	43,000					43,000
Accrual	2,000	3,000	1,000	6,000					6,000
	298,000	195,000	102,000	595,000					500,280

Alternative Method
Some students may approach this case study by first performing a sub-consolidation for the Tiger Group and then consolidating Panther and the Tiger Group.

The following is an alternative answer which takes this approach, and is for use only if students within your group use the sub-consolidation approach.

Alternative calculations assuming that a sub-consolidation is performed for Tiger and Cougar prior to the top-level consolidation.

Step 1: Tiger-Cougar consolidation

(W1) Group Structure

T
|
| 60%
|
C

(W2) Net assets in Cougar

	Net assets at acquisition	Net assets at reporting date
	HK$000	HK$000
Share capital	30,000	30,000
Revaluation reserve	5,000	5,000
Retained earnings 38,000 – (4/12 x 9,600)	34,800	38,000
	69,800	73,000

(W3) Goodwill in Cougar

	Cougar
	HK$000
Cost of investment	63,000
Non-controlling interest (40% x 30,000 x 3.5 x 100/125)	33,600
	96,600
Net assets at acquisition (W2)	(69,800)
Goodwill	26,800

Recorded by (HK$000):

DR	Goodwill	26,800
DR	Share capital	30,000
DR	Retained earnings	34,800
DR	Revaluation reserve	5,000
CR	Investment	63,000
CR	Non-controlling interest	33,600

(W4) Non-controlling interest

	HK$000
At the reporting date the NCI is calculated as:	
Fair value at acquisition	33,600
Share of post acquisition profits 40% (73 – 69.8)	1,280
	34,880

The increase of HK$1,920,000 since acquisition is recorded by (HK$000):

DR	Retained earnings	1,280
CR	Non-controlling interest	1,280

(W5) Retained earnings

At the reporting date retained earnings for the Tiger sub-group are:

	HK$000
Tiger	129,000
Cougar 60% (38 – 34.8)	1,920
	130,920

Step 2: Panther – Tiger Group consolidation

(W6) Group Structure

P

80%

TG

(W7) Goodwill in Tiger

		Tiger HK$000
Cost of investment		76,000
Non-controlling interest measured as % of net assets (20% x 70,000 (W2))		14,000
		90,000
Net assets at acquisition		
Share capital	45,000	
Retained earnings	25,000	
		(70,000)
		20,000

Goodwill

Recorded by (HK$000):

DR	Share capital	45,000	
DR	Retained earnings	25,000	
DR	Goodwill	20,000	
CR	Cost of investment in Tiger		76,000
CR	Non-controlling interest		14,000

(W8) Post acquisition profits of Tiger Group

The post acquisition profits of the Tiger group are HK$105,920,000 (130,920 – 25,000). At the Panther Group level, the NCI share (20%) of the Tiger Group post acquisition profits should be removed from group retained earnings and credited to the NCI (HK$000):

Dr	Retained earnings (20% x 105,920)	21,184	
Cr	Non-controlling interest		21,184

(W9) At the Tiger Group level, goodwill in Cougar is based on the cost of a 60% shareholding and the fair value of a 40% NCI. At the Panther Group level the effective shareholding in Cougar is 48% (80% x 60%) and the NCI has a 52% holding. Therefore adjustment must be made to both goodwill and the NCI:

Cost of group share

	HK$000	HK$000
Cost of investment (60% shareholding)	63,000	
Cost of investment (48% holding: 80% x 63,000)	50,400	
		12,600

NCI Fair value

Based on 40% (40% x 30,000 x 3.5 x 100/125)	33,600	
Based on 52% (52% x 30,000 x 3.5 x 100/125)	43,680	
Amount by which goodwill and the NCI are increased		10,080

The HK$12,600,000 adjustment in respect of cost of the group share:
- Reduces goodwill (as the 63,000 cost in (W3) is effectively being replaced by 50,400 at Panther Group level), and
- Reduces the NCI (to eliminate the group NCI share of the investment in Cougar. This is included in the NCI at a Tiger Group level, however not at the Panther Group level)

The HK$10,080,000 adjustment in respect of the fair value of the NCI share:
- Increases goodwill (as the 33,600 fair value of the NCI in (W3) is being replaced by 43,680 at Panther Group level)
- Increases the NCI (to reflect the increase in the NCI goodwill)

The net adjustment is therefore a HK$2,520,000 reduction to both goodwill and the NCI:

DR	Non-controlling interest	2,520
CR	Goodwill	2,520

(W10) Group retained earnings(check)

	HK$000
Panther	128,000
Tiger Group 80% (130,920-25,000)	84,736
	212,736

Recommendation / Justification

	Tiger	Cougar	Total	(W2) Adj	(W3) Adj	Sub-consol	Panther	(W7) Adj	(W8) Adj	(W9) Adj	Consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000		HK$000	HK$000
PPE	108,000	67,000	175,000			175,000	184,000				359,000
Intangibles	4,000	-	4,000			4,000	12,000				16,000
Goodwill	-	-	-	26,800		26,800	-	20,000		(2,520)	44,280
Investment (Tiger)	-	-	-				76,000	(76,000)			-
Investment (Cougar)	63,000	-	63,000	(63,000)		-	-				-
	175,000	67,000	242,000			205,800	272,000				419,280
Inventories	11,000	13,000	24,000			24,000	10,000				34,000
Receivables	9,000	14,000	23,000			23,000	13,000				36,000
Cash	-	8,000	8,000			8,000	3,000				11,000
	195,000	102,000	297,000			260,800	298,000				500,280
Share capital	45,000	30,000	75,000	(30,000)		45,000	70,000	(45,000)			70,000
Retained earnings	129,000	38,000	167,000	(34,800)	(1,280)	130,920	128,000	(25,000)	(21,184)		212,736
Revaluation reserve	-	5,000	5,000	(5,000)		-	40,000				40,000
NCI	-	-	-	33,600	1,280	34,880	-	14,000	21,184	(2,520)	67,544
	174,000	73,000	247,000			210,800	238,000				390,280
Deferred tax	3,000	6,000	9,000			9,000	12,000				21,000
Loan	-	10,000	10,000			10,000	25,000				35,000
Overdraft	5,000	-	5,000			5,000	-				5,000
Payables	10,000	12,000	22,000			22,000	21,000				43,000
Accruals	3,000	1,000	4,000			4,000	2,000				6,000
	195,000	102,000	297,000			260,800	298,000				500,280

Consolidation

Additional information 1

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

1. At acquisition, a property owned and occupied by Tiger had a fair value HK$15 million in excess of its carrying value. This property had a remaining useful life at that time of 20 years.
2. When Cougar was acquired by Tiger, the due diligence process revealed a contingent liability in respect of an ongoing legal case. The Directors of Cougar believed that it was possible that an amount of HK$4 million would be paid to settle the case. In accordance with HKAS 37, they have not recognised a provision, but have provided a disclosure in relation to the contingency. The case has subsequently been settled in December 2010, with no payment. The amount is tax deductible when paid.
3. During the year Tiger has sold goods to Panther at a total transfer price of HK$125 million, representing a mark up of 25%. At the reporting date:
   - Tiger's current account with Panther shows a balance of HK$6 million.
   - Panther's current account balance with Tiger shows a balance of HK$4.5 million, the difference being due to cash in transit.
   - Inventory from Tiger which cost Panther HK$12.5 million remained in Panther's warehouse.
4. Since acquisition, Cougar has purchased goods from Tiger for HK$15 million. The transfer price is established based on a margin of 20%. At the reporting date the current account balances between the two companies are settled, however Cougar still has half of the goods in stock.
5. It is more likely than not that sufficient taxable profits will be available against which deductible temporary differences can be utilised.
6. The measurement period after acquisition of Cougar ended on 30 November 2010.
7. Goodwill in Tiger has been impaired by HK$5 million during the year ended 31 December 2010. As at 1 January 2010, the goodwill was not impaired.

Required

(i) Prepare a revised consolidated statement of financial position, based on the additional information, ignoring tax.

(ii) Assuming a tax rate of 16%, prepare the necessary journal entries to adjust the consolidation.

Discussion points

Consolidation

Additional information 1(i) –ignoring tax

What are the issues?

The Panther Group consolidated statement of financial position must be adjusted to take into account:

(a) a fair value uplift on acquisition
(b) a contingent liability that existed at acquisition
(c) intercompany balances
(d) unrealised profits in inventory
(e) the impairment of goodwill

Which accounting standards should be used?

HKFRS 3 Business Combinations

HKAS 27 Consolidated and Separate Financial Statements

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. **(HKAS 27.18, LP Chapter 26 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. **(HKFRS 3.32, LP Chapter 26, Section 3.3.4)**

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. **(HKAS 27.21, LP Chapter 27, Section 2.5)**

An acquirer should recognise a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. **(HKFRS 3.23, LP Chapter 26, Section 4.3.3)**

A contingent liability is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one of more uncertain future events; or

(b) a present obligation that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) the amount of the obligation cannot be measured with sufficient reliability.

(HKAS 37.10, LP Chapter 10, Section 1.2)

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) **Fair value adjustment – property**

The owner-occupied property is uplifted to its fair value for the purposes of consolidation. Tiger's adjusted net assets are:

	Net assets at acquisition	Net assets at reporting date	Post acquisition
	HK$000	HK$000	HK$000
As per pre-workshop question	70,000	174,000	104,000
Fair value adjustment	15,000	15,000	
Depreciation on FV adjustment		(7,500)	
As adjusted	85,000	181,500	96,500

Goodwill is recalculated , taking into account the fair value adjustment as:

	Tiger
	HK$000
Cost of investment	76,000
Non-controlling interest (20% x 85,000 (W1))	17,000
	93,000
Net assets at acquisition (W1)	(85,000)
Goodwill	8,000

Goodwill was originally HK$20 million.. The fair value adjustment to the property reduces goodwill (before consideration of the impairment) by HK$12 million (being 80% of the HK$15 million FV adjustment).

The non-controlling interest at acquisition was initially recorded at HK$14 million. As a result of the fair value uplift this must be adjusted up by HK$3 million to HK$17 million (20% × HK$85 million).

The journal to record the adjustments to property, goodwill and the NCI at the date of acquisition is (HK$000):

Dr	Property	15,000	
Cr	Goodwill		12,000
Cr	NCI		3,000

The fair value uplift is subsequently depreciated such that by the reporting date its carrying value is HK$7.5 million (10/20 yrs × HK$15 million). The journal to record the consolidation adjustment for extra depreciation is (HK$000):

Dr	Group retained earnings (80% × 7,500)	6,000	
Dr	NCI (20% × 7,500)	1,500	
Cr	Property – accumulated depreciation		7,500

(W2) **Contingent liability**

In the individual financial statements of Cougar, provision has not been made for the HK$4million contingency, as it does not meet all of the HKAS 37 recognition criteria, which require that there must be:

1 a present obligation as a result of a past event, and
2 a probable outflow of economic benefits, and
3 reliable estimate of the amount of the obligation

Here, the outflow of economic benefits is assessed as 'possible' rather than 'probable'.

HKFRS 3 (Revised), however, applies different recognition criteria. It requires that a contingent liability assumed in a business combination is recognised as a provision if it is a present obligation that arises from past events and its fair value can be measured reliably. There is no requirement for a probable outflow of economic benefits (HKFRS3.22).

The absence of the 'probable' criterion in HKFRS 3 (Revised) means that Cougar's contingent liability should be recognised as a provision for the purposes of the calculation of goodwill and consolidation.

Therefore the contingent liability is measured at its fair value of HK$4 million and included as a provision within the net assets of Cougar at acquisition.

As the HK$4 million contingent liability no longer exists at the reporting date, post acquisition profits are HK$4 million greater than those in the original case study:

	Net assets at acquisition HK$000	Net assets at reporting date HK$000	Post acquisition HK$000
As per pre-workshop question	69,800	73,000	3,200
Contingent liability	(4,000)	-	(4,000)
As adjusted	65,800	73,000	7,200

Therefore goodwill is recalculated as:

	Cougar	
	Group HK$000	**NCI HK$000**
Cost of investment (group share)(80% x 63,000)	50,400	
FV of NCI (52% x 30,000 x HK$3.50 x 100/125)		43,680
Net assets at acquisition (W2) x 48%/52%	(31,584)	(34,216)
Goodwill	18,816	9,464
Total Goodwill	28,280	

This is HK$4 million greater than the goodwill calculated originally.

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

1 When the Fair value of the liability is recognised on acquisition (HK$000):

DR	Goodwill	4,000	
CR	Provision		4,000

2 When the case is settled without payment the provision is released back to profits (HK$000):

DR	Provision	4,000	
CR	Retained earnings (48% x 4,000)		1,920
CR	Non-controlling interest (52% x 4,000)		2,080

In this case goodwill is adjusted by the whole HK$4 million FV adjustment, whereas in the case of Tiger, goodwill was only adjusted by the group share of the HK$15 million FV adjustment. This is because the NCI is measured at fair value in the case of Cougar and as a proportion of net assets in the case of Tiger.

(W3) **Intercompany balances**

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

DR	Cash	1,500	
CR	Receivables		1,500

The intercompany balance now matches in both Tiger and Panther's accounts, and may be cancelled (HK$000):

DR	Payables	4,500	
CR	Receivables		4,500

(W4) **Unrealised profits**

The total unrealised profit in inventory is calculated as:

			HK$000
Unrealised profit on sale to Panther:	HK$12.5m × 25/125	=	2,500
Unrealised profit on sale to Cougar:	HK$15m × ½ × 20/100	=	1,500
			4,000

This amount is removed from the group inventory balance and the retained earnings of the selling company are adjusted. As the selling company is Tiger, the adjustment is allocated between group retained earnings and the non-controlling interest (HK$000):

DR	Group retained earnings (80% × 4,000)	3,200	
DR	Non-controlling interest (20% × 4,000)	800	
CR	Inventory		4,000

(W5) **Impairment of goodwill**

Goodwill in Tiger has been impaired during the accounting period by HK$5 million.

Original goodwill as recalculated in (W1) is HK$8 million, meaning that after the impairment it is reduced to HK$3million. As the non-controlling interest is measured as a proportion of the net assets of Tiger, none of the impairment is attributable to the NCI.

Journal for impairment of goodwill (HK$000)

DR	Retained earnings	5,000	
CR	Goodwill		5,000

Recommendation / Justification

	Consolidated (per original case study)	(W1) i	(W1)ii	(W2)	(W3) i	(W3) ii	(W4)	(W5)	Adjusted consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000		HK$000
PPE	359,000	15,000	(7,500)						366,500
Intangibles	16,000								16,000
Goodwill	44,280	(12,000)		4,000				(5,000)	31,280
	419,280								413,780
Inventories	34,000						(4,000)		30,000
Receivables	36,000				(1,500)	(4,500)			30,000
Cash	11,000				1,500				12,500
	500,280								486,280
Share capital	70,000								70,000
Retained earnings	212,736		(6,000)	1,920			(3,200)	(5,000)	200,456
Revaluation reserve	40,000								40,000
NCI	67,544	3,000	(1,500)	2,080			(800)		70,324
	390,280								380,780
Deferred tax	21,000								21,000
Loan	35,000								35,000
Overdraft	5,000								5,000
Payables	43,000					(4,500)			38,500
Accruals	6,000								6,000
	500,280								486,280

Discussion points

Consolidation

Additional information 1(ii) – assuming a tax rate of 16%

What are the issues?

The Panther Group consolidated statement of financial position has been adjusted to take into account:

(a) a fair value uplift on acquisition
(b) a contingent liability that existed at acquisition
(c) intercompany balances
(d) unrealised profits in inventory.

The deferred tax implications of each of these adjustments must be considered and the statement of financial position further adjusted.

Which accounting standards should be used?

HKAS 12 Income Taxes

What are the requirements of the accounting standard?

The identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Fair value adjustments may result in temporary differences and have deferred tax implications. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill. **(HKAS 12.19, LP Chapter 14, Section 8.1.1, 8.1.2)**

HKFRS 3 *Business Combinations* requires an entity to recognise any deferred tax assets (to the extent that they meet the relevant recognition criteria) or deferred tax liabilities resulting from temporary differences on a business combination as identifiable assets and liabilities at the date of acquisition. These deferred tax assets and deferred tax liabilities, consequently, will affect the amount of goodwill or the bargain purchase gain the entity recognises. (**HKAS 12.66, LP Chapter 14, Section 8.4)**

How to apply the standard(s) to the case

There is a deferred tax implication of the fair value adjustments and the unrealised profits, but not the intercompany balances:

Fair value adjustment – property

At acquisition, property held within Tiger's accounts is uplifted by HK$15 million as a consolidation adjustment.

This results in a taxable temporary difference of HK$15 million, and so a deferred tax liability of HK$2.4 million (16% × 15 million) at acquisition.

This is recognised by:

		HK$000	HK$000
DR	Goodwill	1,920	
DR	Non-controlling interest (20% × 2,400)	480	
CR	Deferred tax liability		2,400

By the reporting date, HK$7.5 million of this temporary difference has reversed and therefore a further journal is required to reduce the deferred tax liability by HK$1.2 million (16% × 7.5 million) (HK$000):

DR	Deferred tax liability	1,200	
CR	Retained earnings (80% × 1,200)		960
CR	NCI (20% × 1,200)		240

Fair value adjustment – contingent liability

At acquisition, a provision of HK$4 million is recognised as a consolidation adjustment within Cougar's books.

The carrying value of the provision is HK$(4 million); its tax base is nil, since legal expenses such as these are not allowable for tax purposes until paid.

The carrying value is therefore less than the tax base and a deductible temporary difference of HK$4 million arises.

This results in a deferred tax asset of HK$640,000 (16% × 4 million), which is recognised in Cougar's acquisition statement of financial position with a resulting impact on goodwill (HK$000):

DR	Deferred tax asset	640	
CR	Goodwill		640

By 31 December 2010 the amount has been settled without payment and the provision is accordingly reversed. The deferred tax asset is therefore written back to profit (HK$000):

DR	NCI (52% x 640)	333	
DR	Retained Profit (48% x 640)	307	
CR	Deferred tax asset		640

Unrealised profits

On the sale of goods to Panther and Cougar, as an individual company, Tiger has made and reported a profit, and it will be taxed on this profit.

From a group perspective, the profit is not made until the goods are sold outside the group, and equally tax is not relevant until this time.

Therefore, on consolidation, a provision is made against inventory for unrealised profit and a deferred tax asset is recognised. The provision for unrealised profit creates a deductible temporary difference as the provision for unrealised profit changes the carrying value of the asset, reducing it in value, however the tax base remains unchanged.

The inventory sold by Tiger to Panther has a carrying amount in the consolidated statement of financial position at 31 December 2010 of HK$12.5 million x 100/125 = HK$10 million, but a tax base of HK$12.5 million.

The inventory sold by Tiger to Cougar has a carrying amount in the consolidated statement of financial position at 31 December 2010 of HK$15 million x ½ x 80% = HK$6 million, but a tax base of HK$7.5 million.

The deductible temporary difference arising is therefore HK$4 million (2.5m + 1.5m).

Deferred tax of HK$640,000 (16% × 4m) arises and should be recognised as a non-current asset of the group (HK$000):

DR	Deferred tax asset	640	
CR	Retained earnings (80% x 640)		512
CR	NCI (20% x 640)		128

Recommendation / Justification

	As adjusted	Fair value adjustment – acquisition	Fair value adjustment – post acquisition	Contingent liability – acquisition	Contingent liability – post acquisition	Unrealised profits	Adjusted for tax
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
PPE	366,500						366,500
Intangibles	16,000						16,000
Goodwill	31,280	1,920		(640)			32,560
	413,780						415,060
Inventories	30,000						30,000
Receivables	30,000						30,000
Cash	12,500						12,500
Deferred tax asset				640	(640)	640	640
	486,280						488,200
Share capital	70,000						70,000
Retained earnings	200,456		960		(307)	512	201,621
Revaluation reserve	40,000						40,000
NCI	70,324	(480)	240		(333)	128	69,879
	380,780						381,500
Deferred tax liability	21,000	2,400	(1,200)				22,200
Loan	35,000						35,000
Overdraft	5,000						5,000
Payables	38,500						38,500
Accruals	6,000						6,000
	486,280						488,200

* HKAS 12 allows that deferred tax assets and liabilities are offset where there is a legally enforceable right to do so and the entity intends to settle on a net basis. This should not be assumed to be the case. A deferred tax asset and liability should be recognised separately.

Consolidation

Additional information 2

The following additional information is provided in respect of transactions between Panther Group companies and other parties:

1. A director of Tiger has borrowed HK$30,000 from Panther.
2. Two of the directors of Panther are paid by Cougar to act as 'independent consultants'. This was the case prior to the acquisition of Cougar by the group and has continued since. Each director is paid an annual sum of HK$40,000.
3. Leopard Co, a company controlled by the son of a director of Panther is a customer of Tiger. During the year ended 31 December 2010, Leopard purchased HK$100,000 goods from Tiger; at the year end, HK$6,000 is outstanding. HK$1,000 of this amount is 6 months overdue and the directors of Tiger have decided to provide for this amount in full.
4. Tiger has provided a bank guarantee to its main supplier in order to ensure continuing supply.
5. Directors of group companies are remunerated as follows:

	Salary HK$	Bonus HK$	Pension HK$
Panther			
Mr A	165,000	30,000	5,000
Mrs B	123,000	26,000	5,000
Mrs C	104,000	24,000	4,000
Mr D	102,000	24,000	4,000
Tiger			
Mrs L	129,000	40,000	4,000
Mr M	138,000	38,000	3,000
Mr N	136,000	36,000	5,000
Cougar			
Mr S	122,000	37,000	2,000
Mrs T	117,000	37,000	4,000
Mrs U	231,000	37,000	4,000

Required

(i) Identify which parties are related to each company in respect of the specific transactions listed above in accordance with HKAS 24

(ii) Prepare the group related parties disclosure using only the information provided above.

Discussion points

Consolidation

Additional information 2 - related parties disclosure

What are the issues?

(a) Details of transactions between the Panther Group companies and other parties are provided.

(b) Which of the parties are related parties in accordance with HKAS 24?

(c) What disclosures are required by HKAS 24 in respect of transactions with these parties?

(d) What further disclosures are required by HKAS 24?

Which accounting standards should be used?

HKAS 24 Related Party Disclosures

What are the requirements of the accounting standards?

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

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

- (i) has control or joint control over the reporting entity;
- (ii) has significant influence over the reporting entity; or
- (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

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

- (i) the entity and the reporting entity are members of the same group
- (ii) one entity is an associate or joint venture of the other entity (or an associate or joint venture of a group of which the other entity is a member)
- (iii) both entities are joint ventures of the same third party
- (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity
- (v) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity
- (vi) the entity is controlled or jointly controlled by a person identified in (a)
- (vii) the person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or a parent of the entity)

(HKAS 24.9, LP Chapter 20, Section 1.3)

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

(HKAS 24.9, LP Chapter 20, Section 1.3)

Any single customer, supplier, franchisor, distributor, or general agent with whom the entity transacts a significant amount of business, is not a related party simply by virtue of the resulting economic dependence.

(HKAS 24.11, LP Chapter 20, Section 1.3.2)

Relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been transactions between them.

(HKAS 24.13, LP Chapter 20, Section 1.4)

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

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

(HKAS 24.17, LP Chapter 20, Section 1.4)

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

(a) The amount of the transactions

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

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

  (ii) details of any guarantees given or received

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

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

(HKAS 24.18, LP Chapter 20, Section 1.4)

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

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

(HKAS 24.19, LP Chapter 20, Section 1.4)

How to apply the standards to the case

In respect of the transactions in the case:

1 The loan from Panther to a director of Tiger is not a related party transaction as the director of Tiger cannot influence Panther. A company can only be influenced by a director where that director is on the board of the company itself or a parent company. Therefore, the directors of Panther are related to Panther, Tiger and Cougar; the directors of Tiger are related to Tiger and Cougar only; the directors of Cougar are related to Cougar only. (HKAS 24.9 (a))

2 Panther's directors' work as 'independent consultants' for Cougar is a related party transaction since the date on which Cougar was acquired. (HKAS 24.9 (b) (vi))

3 The transactions between Tiger and Leopard Co are related party transactions. This is because the director and his son are assumed to be close family. The son controls Leopard and the director is key management personnel of Panther. Therefore the son could influence the director of Panther who in turn could influence Panther, Tiger or Cougar to enter into transactions with Leopard Co. (HKAS 24.9 (b) (vii))

4 The bank guarantee is not a related party transaction. Tiger's main supplier is not related to Tiger simply by virtue of Tiger's economic dependence on that supplier. (HKAS 24.11 (d))

HKAS 24 requires disclosure of the remuneration of the key management personnel of the entity. The key management personnel are 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity'. At a group level, the key management personnel are therefore, in most cases, the directors of the parent company only. Therefore only the remuneration of the directors of Panther need be disclosed.

Recommendation / justification

Group Related Parties Disclosure Note

The Panther Group includes the following companies:

Panther

Tiger	80% owned by Panther
Cougar	60% owned by Tiger

Balances and transactions between Panther and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note.

Trading transactions

During the year, group companies entered into the following transactions with related parties who are not members of the group:

	HK$
Sale of goods to other related parties	100,000
Receipt of services from key management personnel other than in their capacity as key management personnel (4/12 x 2 x 40,000)	26,667

The following amounts were outstanding at the reporting date:

	Amounts owed by related parties HK$
Other related parties	6,000
Less provision for doubtful debt	(1,000)
	5,000

Compensation of key management personnel

The compensation of the directors, who are the key management personnel of the group is set out below in aggregate for each of the categories specified in HKAS 24 *Related Party Disclosures.*

	HK$ 000
Short term employee benefits	598
Post employment benefits	18
	616