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Module A Financial Reporting

HKCA LEARNINGMEDIA

Module Preparation Seminar
(for Dec 2018 Exam Session)

Lecturer: Fanny Lam

AGENDA

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1
- Group Accounting
- – Associate and Subsidiaries

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- How to Pass

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- Consultation

MASTER GUIDE

Module A: FINANCIAL REPORTING

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2018/19

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Chapter 9 Group Accounting, Cash Flows Statement and Foreign Currency Translation (HKFRS 3 (Revised), HKFRS 10, HKFRS 11, HKAS 28, HKFRS 12, HKAS 7, HKAS 21)

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Group Accounting (LP26-29)

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  - **9.1.1.1 Principal vs Agent**
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Disclosure

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.13 Foreign Currency Translation
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9.13.2 Translating Foreign Currency Transactions and Balances of the Reporting Entity
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9.13.6 Disposal or Partial Disposal of a Foreign Operation
9.14 Chapter Summary

In this chapter, we will cover the following Learning Outcomes:

Learning Outcomes	**LP**
Principles of consolidation:	
Identify and describe the concept of a group as a single economic entity	26
Define a subsidiary and when a group should start and stop consolidating a subsidiary	26
Explain what constitutes control and the impact of potential voting rights	26
Describe the reasons why the directors of a company may not want to consolidate a subsidiary and the circumstances in which non-consolidation is permitted	26
Explain the purpose of consolidated financial statements	26
Explain the importance of eliminating intra-group transactions	26
Explain the importance of uniform accounting policies and coterminous year ends in the preparation of consolidated accounts	26
Apply the appropriate accounting treatment of consolidated goodwill	26
Explain how to account for changes in parent's ownership interest in a subsidiary without losing control	26
Acquisition of subsidiaries:	
Prepare a consolidated statement of financial position for a simple/complex group structure including pre and post acquisition profits. Non-controlling interests and goodwill	27
Prepare a consolidated statement of comprehensive income for a simple/complex group structure, dealing with an acquisition and the non-controlling interest	27

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Disposal of subsidiaries:	
Account for the disposal of a subsidiary by a group	27
Account for the change in ownership without loss of control	27
Business combinations:	
Explain the scope of business combinations in accordance with HKFRS 3	26
Identify business combination and the difference between asset and business	26
Determine the acquisition date of an acquisition	26
Identify the identifiable assets (including intangibles) and liabilities acquired in a business combination	26
Explain the recognition principle and measurement basis of identifiable assets and liabilities and the exception	26
Explain what contingent consideration is and how to account for it initially and subsequently	26
Explain how to account for acquisition-related costs, including those related to issue debt or equity securities	26
Determine what is part of the business combination transaction and the consideration	26
Calculate goodwill (including bargain purchase) and account for it	26
Explain the accounting for step acquisition	26
Account for non-controlling interest when the subsidiary have negative equity balance	26
Explain and account for measurement period adjustments	26
Investments in associates:	
Define an associate in accordance with HKAS 28 (2011)	28
Explain what significant influence is and apply the principle	28
Explain the reasons for and impact of equity accounting, including notional purchase price allocation on initial acquisition, fair value adjustments, upstream and downstream transactions, and uniform accounting policies	28
Account for investors' share of losses of an associate in excess of its investments in associates	28
Explain the impairment test and related treatments for investments in associates	28
Account for disposal of an associate	28
Prepare the disclosure in respect of associates	28

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Interests in joint arrangements:	
Define joint arrangements in accordance with HKFRS 11	28
Explain the difference among jointly controlled operations and joint ventures	28
Explain how an entity should account for a joint venture	28
Account for the transactions between a venturer and a joint venture	28
Disclose the relevant information in the venturer's financial statements	28
Consolidated financial statement preparation:	
Prepare a consolidated statement of financial position in accordance with HKFRS 10	27
Prepare a consolidated statement of comprehensive income	27
Prepare a consolidated statement of cash flows	19
Financial statement disclosure requirement:	
Disclose the relevant information for business combinations occurred during and subsequent to the reporting period	26
Merger accounting for common control combinations:	
Describe the principles and practices of merger accounting	29
Apply merger accounting to a common control combination	29
The effects of changes in foreign exchange rates:	
Determine the functional currency of an entity in accordance with HKAS 21	30
Translate foreign operation financial statements to the presentation currency	30
Account for foreign currency transactions within an individual company and in the consolidated financial statements	30
Account for disposal or partial disposal of a foreign operation	30

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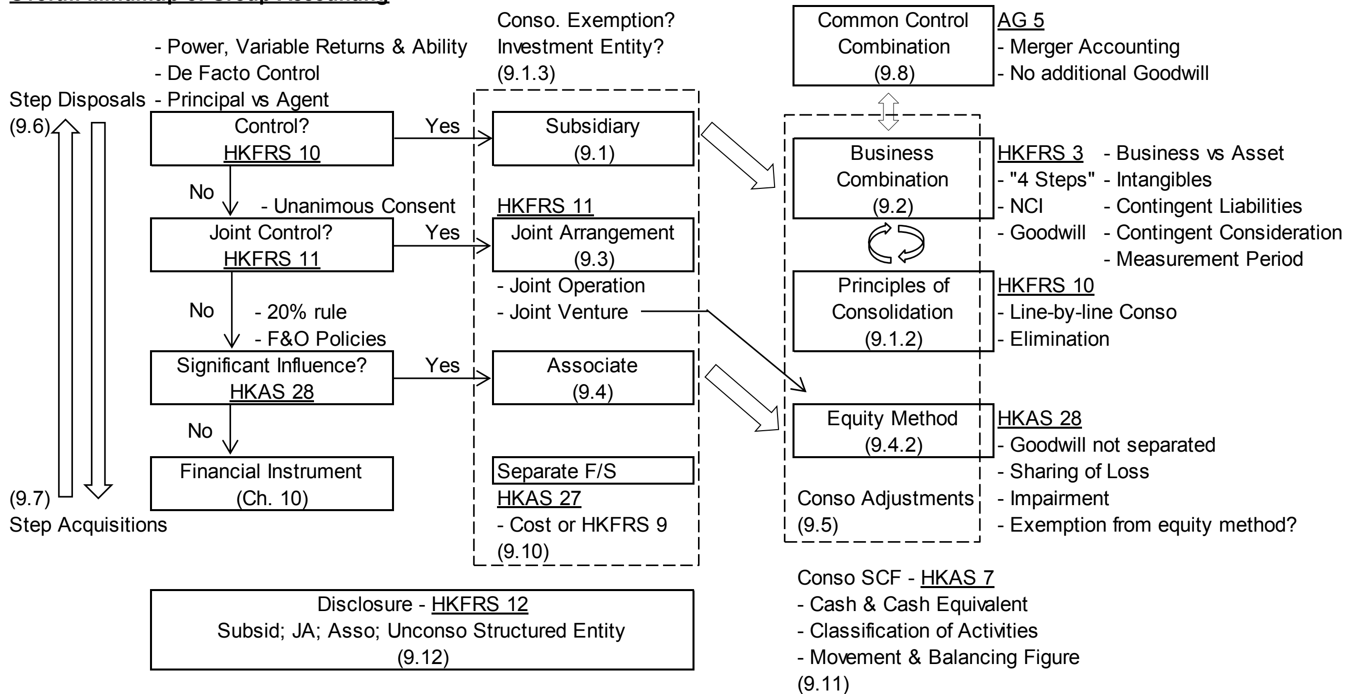
This is a lengthy chapter and covered a number of accounting standards – having said, many areas in this chapter are frequently examined. Readers are encouraged to study this chapter thoroughly.

The flow of this chapter is as follows:

- Determine the classification of an investment (i.e. subsidiary, associate, joint venture) [Financial instruments are discussed in Chapter 10]
- Based on the classification, adopt relevant accounting methods (i.e. acquisition accounting/line-by-line consolidation, equity accounting etc)
- Prepare consolidated balance sheet and income statement using consolidation adjustments
- Discuss the accounting treatment in separate F/S
- Examine more complex group accounting issues (e.g. step acquisitions and disposals, common control combinations, distributions to owners)
- Prepare consolidated statement of cash flows
- Disclosure of group accounting
- Examine the accounting treatments of foreign currency translations and consolidation of foreign subsidiaries

The overall mindmap of this chapter is as follows:



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9.1 Basics of Subsidiaries

Reference: HKFRS 10 *Consolidated Financial Statements* (Revised December 2012)

- applicable for annual periods beginning on or after 1 January 2013
- earlier application is encouraged

HKFRS 10 refines the definition of control (previously addressed by HKAS 27 (Revised) *Consolidated and Separate Financial Statements* and HK(SIC)-Int 12 *Consolidation – Special Purpose Entities*). As a result of the issuance of HKFRS 10, HKAS 27 (Revised) and HK(SIC)-Int 12 are superseded.

[Note on transition: On year of adoption, HKFRS 10 should be applied retrospectively unless impracticable.

Typically, retrospective adjustments are not needed when the investee is assessed to be consolidated under both HKFRS 10 and the previous guidance in HKAS 27 (Revised) and HK(SIC)-Int 12. However, if the consolidation conclusion under HKFRS 10 differs from HKAS 27 (Revised) and HK(SIC)-Int 12, the retrospective adjustment should be made to the annual period immediately preceding the date of initial application of HKFRS 10.]

Control is an important concept because it forms the basis for line-by-line consolidation. Also, the assessment of control is always the starting point of classification of investment in an investee.

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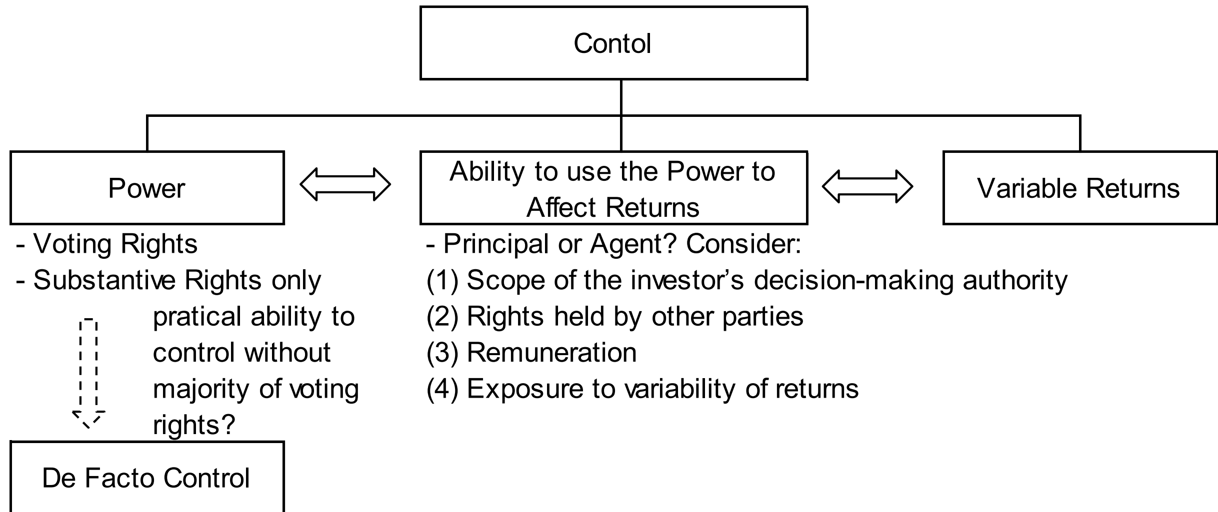
The mindmap of HKFRS 10 on control is as follows:

Mindmap of HKFRS 10 on Control



- Voting Rights
- Substantive Rights only

pratical ability to control without majority of voting rights?

De Facto Control

Step 1 - Consider:
(1) Size relative to other investors
(2) potential voting rights by other investors
(3) any other contractual rights

if not conclusive

Step 2 - Additional Facts and Circumstances:
(1) Voting pattern at previous meetings
(2) Other facts that suggest the contrary

- Principal or Agent? Consider:
(1) Scope of the investor's decision-making authority
(2) Rights held by other parties
(3) Remuneration
(4) Exposure to variability of returns

9.1.1 Control

The key change in control assessment from HKAS 27 (Revised) is that HKFRS 10 does not depend on "50% line" of ownership.

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Control requires that three factors be present. An investor must have **all** of the following [HKFRS 10 para 7]:

Factor	Remarks
Power over the investee [HKFRS 10 para 10, B22, B27]	An investor has power over an investee when the investor has existing rights that give it the current ability to direct the **relevant activities** (i.e. the activities that significantly affect the investee's returns). In most cases, voting rights is the key factor. For the purpose of assessing power, only **substantive rights** should be considered. For a right to be substantive, the holder must have the practical ability to exercise that right. An investor that holds only protective rights cannot have power or prevent another party from having power over an investee.
Exposure or Rights to Variable Returns from its involvement with the investee [HKFRS 10 para 15]	An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance. The investor's returns can be only positive, only negative or both positive and negative. (Note: This explains why a subsidiary should still be consolidated even if it is loss-making.)
Ability to use its Power to affect the amount of returns [HKFRS 10 para 17 & 18]	An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee. Thus, an investor with decision-making rights shall determine whether it is a **principal or an agent** (see next Section).

Note: There can only be 1 controlling party.

The assessment of control is performed on a continuous basis. The investor should reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control above.

[HKFRS 10 para 8]

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9.1.1.1 Principal vs Agent

The assessment of control may be straight-forward in most situations (e.g. holding 100% or majority of interest in the investee), but it is not always the case. For example, imagine a situation where the investor can direct how the investee operates and earn a fee in return but the ownership % in the investee is only minimal (say, 2%). Does control exist? If so, on what basis can we say a 2% investor has control over the remaining 98% investor?

The above example is a typical situation of a fund (asset) manager. In this situation, we should look into the investor's ability to its power to affect its returns in greater details by assessing whether the investor is an agent or principal.

For asset managers in investment funds:

- The manager generally has some degree of power (through the management agreement) and some exposure to variable returns (through fees for services and any ownership interests held)
- But the asset manager's degree of power does not generally change with its exposure to variable returns.
- This is in contrast with an entity's investment in another entity's ordinary shares, where there is generally a direct link between the number of shares held, the power that those shares confer and the share of residual returns that the investor is exposed to.

An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (i.e. the principal(s)) and therefore does not control the investee when it exercises its decision-making authority.
[HKFRS 10 para B58]

In nutshell, if the investor is:

- Agent (i.e. on behalf of others): No control
- Principal (i.e. for itself): Control

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In assessing whether the entity (as decision-maker of the investee) is an agent, it should consider the all of the following:

Factors	Remarks
Scope of the investor's decision-making authority [HKFRS 10 para B62]	The scope of a decision maker's decision-making authority is evaluated by considering: ▪ the activities that are permitted according to the decision-making agreement(s) and specified by law; and ▪ the discretion that the decision maker has when making decisions about those activities.
Rights held by other parties [HKFRS 10 para B64]	This focuses on whether there are any restrictions on decision maker's powers (e.g. rights to remove the decision-maker by other investors). Substantive rights held by other parties may affect the decision maker's ability to direct the relevant activities of an investee. Substantive removal may indicate that the decision maker is an agent.
Remuneration to which it is entitled [HKFRS para B71]	The greater the magnitude of, and variability associated with, the decision maker's remuneration relative to the returns expected from the activities of the investee, the more likely the decision maker is a principal. (In practice, asset managers are entitled to receive a management fee and/or performance fee.)
Exposure to variability of returns [HKFRS 10 para B71 & B72]	A decision maker that holds other interests in an investee (e.g. investments in the investee or provides guarantees with respect to the performance of the investee) may indicate that the decision-maker may be a principal. The greater the magnitude of, and variability associated with, its economic interests, considering its remuneration and other interests in aggregate, the more likely the decision maker is a principal.

It can be seen that HKFRS 10 does not draw a clear line – the assessment of agent/principal involves judgement and should take into account of all the facts and circumstances in the specific case.

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9.1.1.2 De Facto Control

The concept of de facto control is newly introduced by HKFRS 10.

Think about one question: As a major shareholder of a listed company, do you think you really need 50% voting power in order to control the company in substance? Arguably, the answer is probably no but it also depends on some other facts.

Aspects	Remarks
Principle of De Facto Control [HKFRS 10 para B41]	An investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally. (i.e. whether an investor's voting rights are sufficient to give it power)
Factors to Consider [HKFRS 10 para B42]	In assessing de facto control, the investor should consider all facts and circumstance, including: ▪ the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders (see Note 1) ▪ potential voting rights held by the investor, other vote holders or other parties ▪ rights arising from other contractual arrangements ***Note 1: Relative to Other Investors*** ▪ the more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities ▪ the more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities ▪ the more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities (It can be interpreted that the above focuses on what the other investors have rather than what the entity has.)

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<table>
<tr>
<td>Additional Factors to Consider

[HKFRS 10 para B18-20; B45]</td>
<td>In some cases, the factors in the above box may not be conclusive.

If so, the entity should consider additional facts and circumstances, such as:
· whether other shareholders are passive in nature as demonstrated by voting patterns at previous shareholders' meetings
· whether the investor has the practical ability to direct the relevant activities unilaterally
· whether the investor has a special relationship with the investee, which suggests that the investor may have more than a passive interest in the investee
· whether the investor is exposed to, or has rights to, a large exposure to variability of returns which indicates that the investor may have power</td>
</tr>
</table>

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9.1.2 Principles of Consolidation

Once control is established, the subsidiary should be consolidated using the following principles:

Aspects	**Remarks**
Basic [HKFRS 10 para B86]	▪ Combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries ▪ Offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (HKFRS 3 explains how to account for any related goodwill) ▪ Eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full)
Date of Commencement and Cessation of Consolidation [HKFRS 10 para 88]	This is particularly relevant for income and expense of subsidiary. Commencement: The date when control is obtained Cessation: The date when control is lost
Uniform Accounting Policies [HKFRS 10 para B87]	If the subsidiary uses accounting policies that differ from those of the parent, the subsidiary's F/S should be adjusted to reflect the parent's accounting policies for the purpose of consolidation.
Different Year End [HKFRS 10 para B92 & B93]	For consolidation, the parent should use the F/S of the subsidiary as of the same date as the F/S of the parent unless it is impracticable to do so. If it is impracticable, the most recent available F/S of the subsidiary should be used, with adjustments made for the effects of any significant transactions or events occurring between the accounting period ends. However, the difference between the reporting date of the subsidiary and that of the parent cannot be longer than three months.

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Non-Controlling Interests ("NCI") [HKFRS 10 para 22 & B94]	***Financial Position:*** ▪ NCI should be presented within equity (separately from the equity of the owners of the parent). ***Total Comprehensive Income:*** ▪ The entity should attribute the profit or loss and each component of OCI to the owners of the parent and to NCI.

For detailed consolidation journals, please see Section 9.5.

9.1.3 Consolidation Exemptions

There are circumstances where the reporting entity is exempted for preparing consolidated F/S:

Circumstance	**Remarks**
General [HKFRS 10 para 4(a)]	A parent (as reporting entity) need not present consolidated F/S if it meets **all** of the following conditions: ▪ it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated F/S ▪ its debt or equity instruments are not traded in a public market ▪ it did not file, nor is it in the process of filing, its F/S with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market ▪ its ultimate or any intermediate parent produces consolidated F/S that are available for public use and comply with HKFRS or IFRS

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Investment Entities [HKFRS 10 para 27, 30-33]	An investment entity is an entity that: ▪ obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; ▪ commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; **and** ▪ measures and evaluates the performance of substantially all of its investments on a FV basis. [Arguably, the above typically applies to an investment fund.] An entity is required to consider all facts and circumstances when assessing whether it is an investment entity. In nutshell, if the parent (as reporting entity) is an investment entity: ▪ It should not consolidate its subsidiaries. ▪ Instead, the investment in subsidiaries should be measured at FV thought profit or loss in accordance with HKFRS 9. ▪ However, an investment entity is still required to consolidate a subsidiary where that subsidiary provides services that relate to the investment entity's investment activities. A parent that either ceases to be an investment entity or becomes an investment entity shall account for the change in its status prospectively from the date at which the change in status occurred. It should be noted that the above exemption only applies to the investment entity itself. Accordingly, the parent of an investment entity is required to consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

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9.2 Basics of Business Combinations

Reference: HKFRS 3 (Revised) *Business Combinations* (Revised February 2012)

- applicable for annual periods beginning on or after 1 January 2009
- earlier application is encouraged

Once control is established, the subsidiary should be consolidated by the controlling party (i.e. the acquirer). The transaction or other event in which an acquirer obtains control of one or more businesses is known as business combination.

HKFRS 3 establishes principles and requirements for how the acquirer:

- recognises and measures in its F/S the identifiable assets acquired, the liabilities assumed and any NCI in the acquiree
- recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- determines what information to disclose to enable users of F/S to evaluate the nature and financial effects of the business combination

HKFRS 3 must be applied when accounting for business combinations, but does not apply to:

- The formation of a joint venture
- The acquisition of an asset or group of assets that is not a business, although general guidance is provided on how such transactions should be accounted for
- Combinations of entities or businesses under common control (see Section 9.8)
- Acquisitions by an investment entity of a subsidiary that is required to be measured at FV through profit or loss under HKFRS 10

9.2.1 Determining whether a transaction is a business combination

HKFRS 3 provides additional guidance on determining whether a transaction meets the definition of a business combination:

Aspects	Remarks
How Business Combinations may take place	Business combinations can occur in various ways, for example: ▪ by transferring cash ▪ by incurring liabilities ▪ by issuing equity instruments ▪ by not issuing consideration at all (i.e. by contract alone)

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[HKFRS 3 para B5 & B6]	Business combinations can be structured in various ways to satisfy legal, taxation or other objectives, including: · one entity becoming a subsidiary of another · the transfer of net assets from one entity to another or to a new entity
Elements of a Business [HKFRS 3 para B7	As its name suggests, a business combination must involve the acquisition of a business. There is a question as to whether an entity has acquired a business (i.e. business combination) or merely a group of assets (i.e. asset acquisition). Arguably most transactions may be obvious business combinations (e.g. the acquisition of a major multinational business) or asset transactions (e.g. the purchase of an equipment). However, the assessment can be complex and judgmental in some other cases. A business is defined as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return (in the form of dividends, lower costs or other economic benefits) directly to investors or other owners, members or participants." In simple terms, a business consists of inputs and processes applied to those inputs that have the ability to create outputs. As such, there are three elements: · **Inputs**: an economic resource (e.g. non-current assets, intellectual property) that creates outputs when one or more processes are applied to it · **Process**: a system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs (e.g. strategic management, operational processes, resource management) · **Output**: the result of inputs and processes applied to those inputs. Although businesses usually have outputs (e.g. revenue or saleable products or services), outputs are not required for an integrated set to qualify as a business (e.g. a business still in development stage). However, inputs and processes must be present.

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9.2.2 Acquisition Accounting for Business Combinations

HKFRS 3 [para 4] requires that the acquisition method should be used for all business combinations.

Furthermore, HKFRS 3 [para 3.5] specifies the following steps in applying the acquisition method:

1. Identification of the 'acquirer'
2. Determination of the 'acquisition date'
3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any NCI in the acquiree
4. Recognition and measurement of goodwill or a gain from a bargain purchase

Each step above is further discussed in below table:

Step	Remarks
Step 1: Acquirer [HKFRS 3 para 7, B14-17]	The entity should refer to the guidance in HKFRS 10 in identify an acquirer in a business combination, i.e. the entity that obtains 'control' of the acquiree. If the guidance in HKFRS 10 does not clearly indicate which of the combining entities is an acquirer, HKFRS 3 provides additional guidance as follows: ▪ The acquirer is usually the entity that transfers cash or other assets where the business combination is effected in this manner. ▪ The acquirer is usually (but not always) the entity issuing equity interests. The entity also considers other pertinent facts and circumstances including: ➢ relative voting rights in the combined entity after the business combination ➢ the existence of any large minority interest if no other owner or group of owners has a significant voting interest ➢ the composition of the governing body and senior management of the combined entity ➢ the terms on which equity interests are exchanged ▪ The acquirer is usually the entity with the largest relative size (assets, revenues or profit) ▪ For business combinations involving multiple entities, consideration is given to the entity initiating the combination, and the relative sizes of the combining entities.

Step 2: Acquisition Date [HKFRS 3 para 8 & 9]	The acquirer should consider all pertinent facts and circumstances when determining the acquisition date (i.e. the date on which it obtains control of the acquiree). The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree (known as the closing date). The acquisition date may be a date that is earlier or later than the closing date.
Step 3: Identifiable Assets and Liabilities and NCI	***Acquired assets and liabilities:*** HKFRS 3 establishes the following principles in relation to the recognition and measurement of items arising in a business combination: · **Recognition principle**: Identifiable assets acquired, liabilities assumed, and NCI in the acquiree, are recognised separately from goodwill [HKFRS 3 para 10] · **Measurement principle**: All assets acquired and liabilities assumed in a business combination are measured at acquisition-date FV (commonly known as Purchase Price Allocation). [HKFRS 3 para 18] ***Intangibles:*** An intangible asset is identifiable if it meets either: · the separability criterion (capable of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged); or · the contractual-legal criterion (even if the asset is not transferable or separable from the acquiree). Please also refer to Chapter 3.2.2. ***Exceptions to the Recognition and Measurement Principles:*** The following items are exceptions. **Exception to Recognition Principle** · **Contingent liabilities**: the requirements of HKAS 37 do not apply to the recognition of contingent liabilities arising in a business combination

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	<u>**Exception to both Recognition and Measurement Principles**</u> · **Income taxes**: the recognition and measurement of income taxes should be in accordance with HKAS 12 · **Employee benefits**: assets and liabilities arising from an acquiree's employee benefits arrangements are recognised and measured in accordance with HKAS 19 <u>**Exception to Measurement Principle**</u> · **SBPT**: these are measured by reference to the method in HKFRS 2 · **Assets held for sale**: HKFRS 5 should be applied in measuring acquired non-current assets and disposal groups classified as held for sale at the acquisition date. [HKFRS 3 para 21 – 31] ***NCI:*** HKFRS 3 [para 19] allows an <u>accounting policy choice</u> (available on a transaction by transaction basis) to measure NCI either at: · fair value (the "FV method"); or · the NCI's proportionate share of net assets of the acquiree (the "proportional share method") (Effectively, when the FV method is used, NCI is recognised at an amount that includes the NCI's goodwill. If the proportional share method is used, total goodwill does not include any amount related to NCI). The choice in accounting policy <u>applies only to present ownership interests in the acquiree that entitle holders to a proportionate share of the entity's net assets in the event of a liquidation</u>. Other components of NCI at must be measured at acquisition date FV or in accordance with other applicable HKFRSs (e.g. SBPT accounted for under HKFRS 2). (Subsequent to acquisition, profits or loss and OCI are allocated to NCI – this allocation should carry on even the resulting NCI would be a negative (i.e. debit) balance.)

<table>
<tr>
<td>Step 4:
Goodwill or Gain from a Bargain Purchase</td>
<td>
Effectively, this represents the difference between what the acquirer has paid and obtained. If the acquirer paid more than what is obtained, this would be a goodwill, and vice versa as gain from a bargain purchase.
Goodwill:
Goodwill is measured as the difference between:
· the aggregate of:
(i) the value of the consideration transferred (generally at FV),
(ii) the amount of any NCI, and
(iii) in a business combination achieved in stages (see Sections 9.6 & 9.7), the acquisition-date FV of the acquirer's previously-held equity interest in the acquiree, and
· the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed (measured in accordance with HKFRS 3).
[HKFRS 3 para 32]
Typically, goodwill can be computed by:
<u>Goodwill Calculation</u>
<table>
<tr><td></td><td></td><td>HK$</td></tr>
<tr><td>Consideration Paid</td><td></td><td>x</td></tr>
<tr><td>Add:</td><td></td><td></td></tr>
<tr><td>Contingent Consideration at FV (see next Section)</td><td></td><td>x</td></tr>
<tr><td>FV of NCI at acquisition date</td><td></td><td>x</td></tr>
<tr><td>Less:</td><td></td><td></td></tr>
<tr><td>FV of Identifiable Net Assets Acquired:</td><td></td><td></td></tr>
<tr><td>Book Value</td><td>(x)</td><td></td></tr>
<tr><td>FV Difference from PPA exercise</td><td>(x)</td><td>(x)</td></tr>
<tr><td>Deferred Tax on FV difference</td><td></td><td>(x)</td></tr>
<tr><td>Contingent Liabilities (see next Section)</td><td></td><td>(x)</td></tr>
<tr><td>Goodwill Balance</td><td></td><td>x</td></tr>
</table>
There are 2 specific issues relating to goodwill which are contingent considerations and contingent liabilities. Please see below table.
Gain from a Bargain Purchase:
If the difference above is negative, the resulting gain is a bargain purchase in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion.

However, <u>before</u> any bargain purchase gain is <u>recognised in profit or loss</u>, the acquirer is required to undertake a <u>review to ensure the identification of assets and liabilities is complete</u>, and that measurements appropriately reflect consideration of all available information.
[HKFRS 3 para 34 – 36]
</td>
</tr>
</table>

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9.2.3 Other Issues in Business Combinations

Having establishing the basic principles of business combination in the previous section, this section deals with some specific considerations under HKFRS 3.

Aspects	Remarks
Acquisition-related Costs [HKFRS 3 para 53] Expenses	Acquisition-related costs are costs the acquirer incurs to effect a business combination. They may include: ▪ finder's fees ▪ advisory, legal, accounting, valuation and other professional or consulting fees ▪ general administrative costs (e.g. costs of maintaining an internal acquisitions department) ▪ costs of registering and issuing debt and equity securities Costs of issuing debt or equity instruments are accounted for under HKAS 32 and HKFRS 9. All other costs associated with an acquisition must be expensed in the periods in which the costs are incurred and the services are received.
Contingent Liabilities [HKFRS 3 para 56]	Contingent liabilities are recognised (and included in goodwill) for those that are a presentation obligation and can be measured reliably. (Note: this is in contrast to recognition by HKAS 37) Until a contingent liability is settled, cancelled or expired, contingent liability is measured at the higher of: ▪ the amount the liability would be recognised under HKAS 37; and ▪ the amount initially recognised less (if appropriate) cumulative amortisation recognised in accordance with HKAS 18.

<table>
<tr><td>Contingent Consideration

[HKFRS 3 para 40 & 58]</td><td>In some cases, the acquirer may have the obligation to transfer additional assets or equity interests to the former owners of an acquiree if specified future events occur or conditions are met (e.g. meeting an earnings target). Contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

Because of the nature of contingent consideration, it creates a potential problem that the goodwill figure may be “floating” depending on future events. To tackle this problem, HKFRS 3 sets out specific requirements below.

▪ Contingent consideration must be measured at FV at the time of the business combination and is taken into account in the determination of goodwill.
▪ The additional consideration may be classified as an equity instrument or an asset or liability – this classification drives the accounting for the change in consideration:
➢ If classified as an equity instrument: the original amount is not remeasured.
➢ If classified as an asset or liability that is a financial instrument: the contingent consideration is measured at FV and gains and losses are recognised in either profit or loss or OCI in accordance with HKFRS 9 or HKAS 39
➢ If not within the scope of HKFRS 9 or HKAS 39: it is accounted for in accordance with HKAS 37 or other HKFRSs as appropriate.

Change in the FV of contingent consideration as a result of additional information about facts and circumstances that existed at the acquisition date:
▪ Account for the changes as measurement period adjustments if they arise during the measurement period (see below).</td></tr>
<tr><td>Measurement Period

[HKFRS 3 para 45 & 50]</td><td>The concept of measurement period applies when the initial accounting for a business combination (e.g. FV of net assets or contingent consideration) can be determined only provisionally by the end of the first reporting period.</td></tr>
</table>

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	The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognised for a business combination. The measurement period cannot exceed one year from the acquisition date and no adjustments are permitted after one year except to correct an error in accordance with HKAS 8. Adjustments to provisional amounts, and the recognition of newly identified asset and liabilities, must be made within the 'measurement period' where they reflect new information obtained about facts and circumstances that were in existence at the acquisition date. During the measurement period, the acquirer should retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.
Reverse Acquisitions [HKFRS 3 para B19]	A reverse acquisition occurs when the entity that issues securities (the 'legal acquirer') is identified as the acquiree. The entity whose equity interests are acquired (the 'legal acquiree') must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity. In this example, the public entity is the legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquire. But for accounting purpose: · the public entity as the **acquiree** for accounting purposes (the 'accounting acquiree') · the private entity as the **acquirer** for accounting purposes (the 'accounting acquirer') The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition, and all of the recognition and measurement principles of HKFRS 3 (including the requirement to recognise goodwill) apply.

9.4 Basics of Associates

Reference: HKAS 28 (2011) *Investments in Associates and Joint Ventures*

- applicable for annual periods beginning on or after 1 January 2013
- earlier application is encouraged

HKAS 28 was reissued following the issuance of HKFRS 11. HKAS 28 prescribes:

- the accounting for investments in associates; and
- the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

HKAS 28 should be applied by all entities that are investors with joint control of, or significant influence over, an investee.

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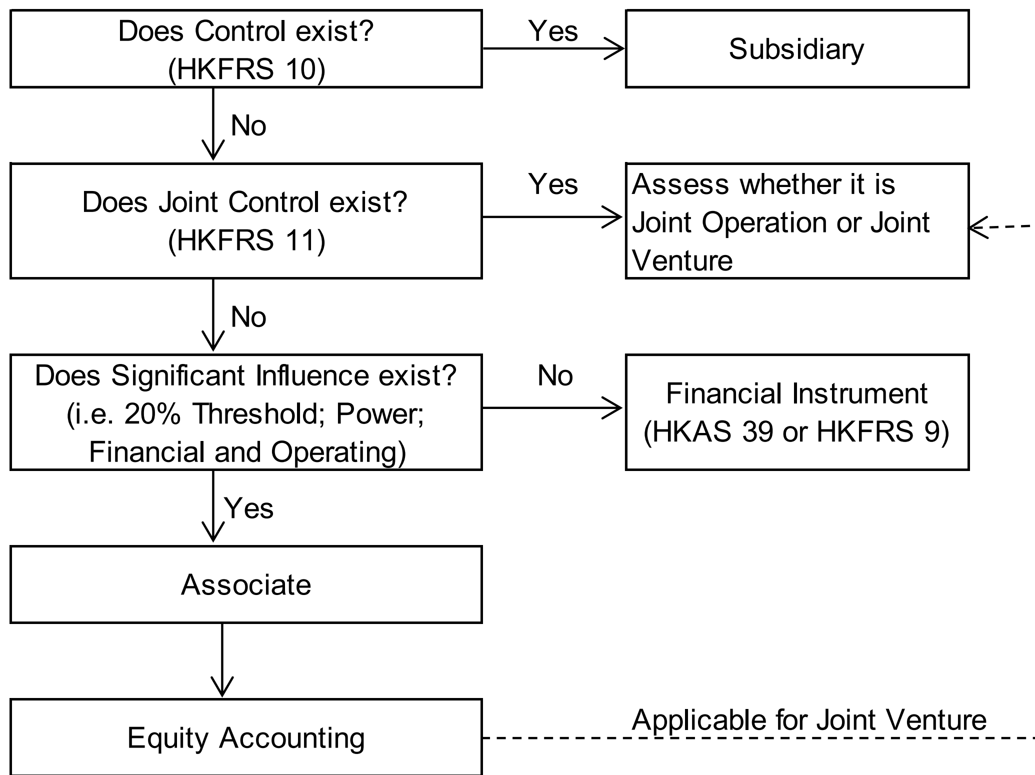
Definition:

An **associate** is an entity over which the investor has significant influence.

Investment in associate or joint venture should be classified as non-current asset unless the investment is classified as held for sale in accordance with HKFRS 5. [HKAS 28 para 15]

The mindmap of HKAS 28 is as follows:

Mindmap of HKAS 28



- Goodwill not separately recognised
- Share of loss limited to interest ; Subsequent profit shared to the extent loss not recognised
- Impairment as single asset (no internal allocation)
- Exemption (mandatory or optional)

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9.4.1 Significant Influence

Significant influence is an important concept because it drives the classification of an associate and thus the accounting. The below table summarises the key points for assessing significant influence:

Aspects	Remarks
Definition	Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies. The existence of significant influence is usually evidenced in one or more of the following ways: ▪ representation on the board of directors or equivalent governing body of the investee ▪ participation in policy-making processes, including participation in decisions about dividends or other distributions ▪ material transactions between the entity and its investee ▪ interchange of managerial personnel ▪ provision of essential technical information
Assessing whether Significant Influence exists ("20% threshold") [HKAS 28 para 5]	HKAS 28 draws a **20% threshold** to assess whether "power to participate" (i.e. significant influence) exists. If an entity holds, directly or indirectly (e.g. through subsidiaries), 20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly (e.g. through subsidiaries), less than 20% of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.
Potential Voting Rights [HKAS 28 para 7 & 8]	The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence.

	All facts and circumstances should be examined. However, the intentions of management and the financial ability to exercise or convert those potential rights are not considered. ***What does it mean by "currently exercisable or convertible"?*** Potential voting rights are <u>not</u> currently exercisable or convertible when they cannot be exercised or converted until a future date or until the occurrence of a future event.

9.4.2 Equity Method (applicable to both Associate and Joint Venture)

An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. Below are the key points to note for equity accounting:

Aspects	**Remarks**
Principle of Equity Method [HKAS 28 para 10]	1. On initial recognition the investment in an associate or a joint venture is recognised at cost 2. The carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. 3. The investor's share of the investee's profit or loss is recognised in the investor's profit or loss. 4. Distributions received from an investee reduce the carrying amount of the investment. 5. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's OCI (e.g. revaluation of PPE). (Note: The figures for calculating investor's share are from the F/S of the associate or joint venture – this applies even if those F/S are themselves consolidated F/S.) See below example for illustration.
% to apply [HKAS 28 para 12 & 13]	When potential voting rights exist, the entity's interest in an associate or a joint venture is determined <u>solely on the basis of existing ownership interests</u>.

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	In other words, the entity's interest does not reflect the possible exercise or conversion of potential voting rights, unless the entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the returns.
Uniform Accounting Policies [HKAS 28 para 35 & 36]	If the associate or joint venture uses accounting policies that differ from those of the investor, the associate or joint venture's F/S should be adjusted to reflect the investor's accounting policies for the purpose of applying the equity method.
Different Year End [HKAS 28 para 33 & 34]	In applying the equity method, the investor should use the F/S of the associate or joint venture as of the same date as the F/S of the investor unless it is impracticable to do so. If it is impracticable, the most recent available F/S of the associate or joint venture should be used, with adjustments made for the effects of any significant transactions or events occurring between the accounting period ends. However, the difference between the reporting date of the associate and that of the investor cannot be longer than three months.
Goodwill [HKAS 28 para 32]	On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net FV of the investee's identifiable assets and liabilities is accounted for as follows: ▪ (Cost > Net FV): **Goodwill** relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted. ▪ (Net FV > Cost): Any excess of the entity's share of the net FV of the investee's identifiable assets and liabilities over the cost of the investment is included as **income** in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.

	However, it is necessary to make appropriate adjustments to the entity's share of profit or loss after acquisition in order to account for any subsequent items due to FV exercise at acquisition date. For example, depreciation of the depreciable assets based on their FV at the acquisition date; goodwill impairment)
Sharing of Loss [HKAS 28 para 38 & 39]	Recall that equity accounting involves sharing of the investee's profit or loss. If the entity's <u>share of losses</u> of an associate or a joint venture <u>equals or exceeds its interest</u> in the associate or joint venture, the entity should <u>discontinue</u> recognising its share of further losses. After the entity's interest is reduced to zero, <u>additional losses</u> are provided for (as a liability) <u>only to the extent</u> that the entity has incurred <u>legal or constructive obligations</u> or made payments on behalf of the associate or joint venture. If the associate or joint venture <u>subsequently reports profits</u>, the entity <u>resumes</u> recognising its share of those profits <u>only after</u> its share of the profits equals the share of losses not recognised.
Impairment [HKAS 28 para 40 – 43]	***Impairment Assessment when Share of Loss:*** ▪ Apply HKAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to its net investment in the associate or joint venture. ***If Impairment is Indicated:*** ▪ The amount is calculated by reference to HKAS 36 (i.e. comparing carrying amount with recoverable amount) ▪ The entire carrying amount of the investment is tested for impairment as a single asset. (i.e. goodwill is not tested separately) ▪ The recoverable amount of the investment is assessed for each individual associate or joint venture (unless the associate or joint venture does not generate cash flows independently) ▪ Any impairment loss is <u>not allocated</u> to any assets (including goodwill) that form part of the investment

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Transactions between Investor and Associate or Joint Venture [HKAS 28 para 28 – 30]	Profits and losses resulting from upstream and downstream transactions are eliminated to the extent of the investor's interest in the associate or joint venture. The investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated. See also Section 9.5 for journal entries.
Exemption from using Equity Method [HKAS 28 para 17 & 18]	***Mandatory Exemption:*** ▪ if the entity is a parent that is exempt from preparing consolidated F/S under HKFRS 10 (i.e. consolidation exemption in Section 9.1.3 applies). ***Optional Exemption:*** ▪ When the investment in an associate or a joint venture is held by (or is held indirectly through) an entity that is: ➢ a venture capital organisation; or ➢ a mutual fund, unit trust and similar entities including investment-linked insurance funds In such case, the entity may elect to measure investments in those associates and joint ventures at FV through profit or loss in accordance with HKFRS 9
Cessation of Use of Equity Method [HKAS 28 para 22]	The entity should discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture (i.e. the date significant influence or joint control is lost). Also see Section 9.6 for step disposal.

<u>Example – Principle of Equity Method</u>

Entity A acquired a 20% interest in entity B for HK$300,000. Entity B is the associate of Entity A.

At the acquisition date, Entity B has net assets of HK$500,000. The FV of those net assets is HK$600,000 as the FV of PPE is HK$100,000 higher than its book value. The remaining useful life of that PPE is 10 years.

Financial data of Entity B:

- Profit after tax of HK$120,000
- Paid a dividend out of these profits of HK$8,000
- Exchange losses of HK$50,000 directly in OCI

In other words, the closing net asset of Entity B is:

Net Assets	
	HK$
Opening	500,000
Profits	120,000
Dividends	(8,000)
Fx Loss	(50,000)
Closing	562,000

Applying Equity Method		
	HK$	
Cost of Investment	300,000	Including goodwill of HK$180,000
Share of Profit	24,000	= (20% x HK$120,000)
Share of OCI	(10,000)	= (20% x HK$50,000)
Share of Additional Depreciation due to FV uplift	(2,000)	= (20% x HK$10,000)
Elimination of Dividend	(1,600)	= (20% x HK$8,000)
Carryng Amount of Investment in Entity B	**310,400**	
Reconciliation by "Balance Sheet" Approach		
	HK$	
Share of Net Assets	112,400	= (20% x HK$562,000)
Goodwill	180,000	= (HK$300,000 - 20% x HK$600,000)
Share of FV adjustments	18,000	= (20% x HK$90,000) ; Note 1
Carryng Amount of Investment in Entity B	**310,400**	
Note 1: The initial FV difference of HK$100,000 has been reduced by HK$10,000 due to depreciation in the year. (i.e. share of "additional" asset)		

9.5 Preparation of Consolidated Balance Sheet and Income Statement

Needless to say, this is the most common examinable area you would expect to see in any financial reporting exams. While the setting or style may vary among different questions, below are some useful reminders:

- Pay attention to acquisition dates and dates of data given.
- Include subsidiaries in consolidation worksheet only
- The question may or may not be required to consider deferred tax implications.
- You may need to incorporate journal entries in other parts of the question.
- FV of net assets acquired may be given in the question in the following ways:
  - Share Capital + Retained Earnings with no FV adjustment
  - In purchase price allocation lead schedule
- Dividends from subsidiaries is usually hidden in income statement given (rather than in narratives)

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- For intra-group transactions (e.g. inventory or PPE), note carefully:
  - whether prior years or current year
  - whether upstream or downstream
- Always use further schedule to calculate NCI's share of profit or loss
- Both profit or loss and OCI should be allocated to NCI

It is virtually not possible to list all the consolidation adjustments. In fact, the adjustments should be tailored to specific circumstances. Nevertheless, some commonly applicable entries are listed below which would prove to be useful by adopting the following steps:

General:

1. Draw the Group Chart.
2. Highlight the Acquisition Date(s).
3. Copy and paste the individual balance sheets or income statements of the parent and subsidiaries (no need for associates) to the consolidation worksheet.

Subsidiaries:

4. Calculate Goodwill.
5. Determine any Deferred Tax implication on FV Differences (if required).
6. Calculate any Impairment Loss and additional Depreciation or Amortisation due to Goodwill allocation.
7. Allocate Post-Acquisition Profit or Loss and OCI to NCI.
8. Eliminate Intra-Group Transactions (e.g. Dividend, Upward or Downward Transactions).
9. Determine any Deferred Tax implication on Intra-Group Transactions.
10. Allocate Current Year's Profit and OCI to NCI.

Associates:

11. Create a new FSLI in Conso P/L "Share of Associate's Profit".
12. Calculate the share of profit using holding %.
13. Eliminate Intra-Group Transactions (e.g. Dividend, Upward or Downward Transactions).

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Consolidation Adjustments for Subsidiaries

Accounting for Acquisiton Date and related matters

#CJ1 - Elimination of Share Capital

If Direct Holding:

		HK$	HK$	Remarks
Dr	Share Capital (B/S)	x		Always 100% of subsidiaries' Share Capital
Dr	Pre-Acq Retained Earnings (B/S)	x		Always 100% of subsidiaries' Pre-Acquisition Profit (Dr) or Loss (Cr).
Dr	(Any FV difference)	x		If given in the Q
Dr	(Assets - excess specifically allocated) (B/S)	x		If given in the Q
Dr	Goodwill (B/S)	x		Balancing figure after allocated to specific assets
Cr	Contingent Liabilities of Subsidiary (B/S)		x	If given in the Q
Cr	Deferred Tax Liability on FV Difference (B/S)		x	If required in the Q (= FV difference x tax rate)
Cr	Investment in Subsidiary (B/S)		x	In parent's book, typically consideration paid
Cr	NCI (B/S)		x	FV or Share of Net Assets of NCI as at Acquisition Date

If Indirect Holding:

		HK$	HK$	Remarks
Dr	Share Capital (B/S)	x		Same as the case for direct holding
Dr	Pre-Acq Retained Earnings (B/S)	x		Same as the case for direct holding
Dr	(Any FV difference)	x		Same as the case for direct holding
Dr	(Assets - excess specifically allocated) (B/S)	x		Same as the case for direct holding
Dr	NCI (B/S) - consideration belonging to NCI	x		= Consideration x NCI % of Intermediate Parent
Dr	Goodwill (B/S)	x		Balancing figure after allocated to specific assets
Cr	Contingent Liabilities of Subsidiary (B/S)		x	Same as the case for direct holding
Cr	Deferred Tax Liability on FV Difference (B/S)		x	Same as the case for direct holding
Cr	Investment in Subsidiary (B/S)		x	Same as the case for direct holding
Cr	NCI (B/S)		x	@ Effective NCI% to Ultimate Parent

CJ#2 - Additional Depreciation due to Goodwill Allocation (also apply to Intangible Assets with Amortisation)

		HK$	HK$	Remarks
Dr	Opening Retained Earnings - my % (B/S)	A		Reflect PY additional depn since acquisition (= additional consideration for PPE/Useful Life x % x no. of yrs)
Dr	NCI - their % (B/S)	B		Reflect PY additional depn since acquisition (= additional consideration for PPE/Useful Life x % x no. of yrs)
Dr	Depreciation (P/L)	C		Reflect current year only (= additional consideration for PPE/Useful Life)
Cr	Accumulated Depreciation (B/S)		D	Balancing figure

Remarks: To provide additional depn due to additional cost for parent and NCI

IF DEFERRED TAX IS REQUIRED:

		HK$	HK$	Remarks
Dr	Deferred Tax Liability (B/S)	x		To provide DTL for accumulated depn (= D x tax rate)
Cr	Opening Retained Earnings (B/S)		x	To provide DTL for opening RE (= A x tax rate)
Cr	NCI (B/S)		x	To provide DTL for NCI (= B x tax rate)
Cr	Tax Expense (P/L)		x	To provide DTL for current year's depn (= C x tax rate)

CJ#3 - Additional Depreciation due to FV Difference

		HK$	HK$	
Dr	Depreciation (P/L)	x		= FV difference of PPE/useful live
Cr	Accumulated Depreciation (B/S)		x	

Remarks: To recognise additional depreciation due to valued-up cost at group level

CJ#4 - Tax Effects on FV Difference (for FV uplift)

		HK$	HK$	
Dr	Deferred Tax Liability (B/S)	x		= FV Difference x Tax Rate
Cr	Tax Expense (P/L)		x	corresponding entry

Remarks: Reverse if FV down

CJ#5 - Impairment of Goodwill

	HK$	HK$
Dr Goodwill Impairment Loss (P/L)	x	
Cr Goodwill (B/S)		x

Remarks: No deferred tax impact on goodwill impairment

Allocation of Post-Acquisition Income to NCI (if not the first year of acquisition)

CJ#6 - Allocation of Post-Acquisition Profit to NCI (Note: Pre-Acq profit has been allocated in goodwill calculation)

	HK$	HK$	Remarks
Dr Opening Retained Earnings (B/S)	x		NCI's share of post-acquisition profit (= post-acq profit x NCI %)
Cr NCI (B/S)		x	NCI's share of post-acquisition profit (= post-acq profit x NCI %)

Remarks: Applicable when it is not first year of acquisition

CJ#7 - Allocation of Post-Acquisition OCI to NCI (Note: Pre-Acq OCI has been allocated in goodwill calculation)

	HK$	HK$	Remarks
Dr Opening Revaluation Surplus (B/S)	x		NCI's share of post-acquisition OCI (= post-acq OCI x NCI %)
Cr NCI (B/S)		x	NCI's share of post-acquisition OCI (= post-acq OCI x NCI %)

Remarks: Applicable when it is not first year of acquisition

Elimination of Intra-group Transactions

CJ#8 - Elimination of DVD from subsidiary

	HK$	HK$	Remarks
Dr Dividend Income (P/L)	x		Typically included in Other Income in parent's book (= DVD recognised in subsidiary's book x %)
Dr NCI (B/S)	x		Allocate NCI portion (= DVD recognised in subsidiary's book x %)
Cr Dividend Declared		x	100% of DVD recognised in subsidiary book

Remarks: to take out DVD income in parent's book and to allocate NCI portion

CJ#9 - Elimination of Intra-group sale of inventory (from Subsid to Parent) - Prior Year

	HK$	HK$	Remarks
Dr Opening Retained Earnings (B/S)	A		= Unrealised profit by Subsid x %
Dr NCI (B/S)	B		= Unrealised profit by Subsid x %
Cr Cost of Goods Sold (P/L)		C	Unrealised profit by Subsid (= Proceed - Cost of Inventory)
IF DEFERRED TAX IS REQUIRED:			
Dr Tax Expense (P/L)	x		= To provide DTL for unrealised profit (= C x tax rate)
Cr Opening Retained Earnings (B/S)		x	= To provide DTL for opening RE (= A x tax rate)
Cr NCI (B/S)		x	= To provide DTL for NCI (= B x tax rate)

CJ#10 - Elimination of Intra-group sale of inventory (from Subsid to Parent) - Current Year

	HK$	HK$	Remarks
Dr Sales (P/L)	A		To take out Sales by subsidiary to parent
Cr Cost of Goods Sold (P/L)		B	To account for COS to outside (= balancing figure)
Cr Inventory Unsold (B/S)		C	To take out inventory unsold (i.e. inflated cost) to outside (= unsold % x unrealised profit by subsidiary)
IF DEFERRED TAX IS REQUIRED:			
Dr Deferred Tax Asset (B/S)	x		= To provide DTA for unrealised profit (= C x tax rate)
Cr Tax Expense (P/L)		x	Corresponding entry

Remarks: Reverse as DTL if unrealised loss

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CJ#11 - Elimination of Intra-group sale of PPE (from Parent to Subsid) - Prior Year

		HK$	HK$	Remarkss
Dr	Opening Retained Earnings (B/S)	x		To take out the disposal gain at parent book
Cr	PPE (B/S)		x	To take out the inflated PPE cost in subsid book

Remarks: No NCI adjustment since it is the parent making the unrealised profit.

Dr	Accumulated Depreciation (B/S)	x		To take out additional depreciation due to inflated PPE cost
Cr	Depreciation (P/L)		x	To take out additional depreciation due to inflated PPE cost

Allocation of Current Year's Income to NCI

CJ#12 - Allocation of Current Year Profit to NCI

		HK$	HK$	Remarks
Dr	NCI (P/L)	x		= Adjusted profits (i.e. before OCI) after P/L adj x NCI %
Cr	NCI (B/S)		x	= Adjusted profits (i.e. before OCI) after P/L adj x NCI %

Calculation of NCI's shares of profit for the year

Profit (i.e. total comprehensive income) for the year	x	
add: previous year's unrealised profit now realised	x	
less: deferred tax on previous year's unrealised profit	(x)	
less: any additional depn/amortisation for the year	(x)	
add: deferred tax on additional depn/amortisation	x	
less: current year's unrealised profit	(x)	
add: deferred tax on unrealised profit	x	
less: Goodwill impairment	(x)	
Adjusted profit	**x**	
NCI's share	**x**	= Adjusted profit x NCI %

CJ#13 - Allocation of Current Year OCI to NCI (e.g. PPE revaluation reserve)

		HK$	HK$	Remarks
Dr	NCI (P/L)	x		= OCI x NCI %
Cr	NCI (B/S)		x	= OCI x NCI %

Adjustments for Associates (also applicable to Joint Ventures)

Share of Associate's Profit for the year

		HK$	HK$	Remarks
Dr	Investment in Associate (B/S)	x		This creates a new FSLI in conso P/L (= Associate's reported profit x %)
Cr	Share of Associate's profit for the year (P/L)		x	This creates a new FSLI in conso P/L (= Associate's reported profit x %)

Elimination of Dividend from Associate

		HK$	HK$	Remarks
Dr	Investment in Associate (B/S)	x		= Dividend declared by asso x %
Cr	Share of Associate's profit for the year (P/L)		x	corresponding entry

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Elimination of intra-group sale of PPE (from Investor to Asso)

		HK$	HK$	Remarks
Dr	Gain on Disposal (P/L)	x		Typically included in Other Income in investor's book (= (Proceed - Carrying Amount at disposal date) x %)
Cr	Investment in Associate (B/S)		x	Balancing figure
Cr	Share of Associate's profit for the year (P/L)		x	= (Proceed - Carrying Amount at disposal date)/Useful life x %

Elimination of intra-group sale of PPE (from Asso to Investor)

		HK$	HK$	Remarks
Dr	Share of Associate's profit for the year (P/L)	x		= Disposal gain by asso x %
Cr	Investment in Associate (B/S)		x	Corresponding entry

Elimination of intra-group sale of Inventory (from Investor to Asso)

		HK$	HK$	Remarks
Dr	Sales (P/L)	x		To take out sales NOT made to outside party (= Unrealised sales x %)
Cr	Cost of goods sold (P/L)		x	To take out COS NOT made to outside party (= Unrealised profit x %)
Cr	Investment in Associate (B/S)		x	Balancing figure

Elimination of intra-group sale of Inventory (from Asso to Investor)

		HK$	HK$	Remarks
Dr	Share of Associate's profit for the year (P/L)	x		To take out unrealised profit (= (Proceed - Carrying Amount at disposal date) x %)
Cr	Investment in Associate (B/S)		x	Corresponding entry

Reconciliation of Investment in Associate

	HK$	Remarks
Investment Cost	x	Implicitly this includes goodwill but not separately recognised
Add: Share of post-acquisition profit	x	
Add: Share of current year's profit	x	
Add: Share of current year's OCI	x	
Less: Share of dividend for the year	(x)	
Less/Add: Unrealised (profit)/loss	(x)	
Carrying amount of associate	x	

9.10 Separate Financial Statements

Reference: HKAS 27 (2011) *Separate Financial Statements* (Revised December 2012)

- applicable for annual periods beginning on or after 1 January 2013
- earlier application is encouraged

HKAS 27 was reissued following the issuance of HKFRS 10. The nature of change is apparent from the change in title from "Consolidated Financial Statements" to "Separate Financial Statements". Requirements on consolidation exemption are also moved to HKFRS 10.

With the requirements on control now addressed by HKFRS 10, HKAS 27 prescribes the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when the entity prepares separate F/S.

A Hong Kong company is required by HKCO to present separate balance sheet (see Chapter 1.1).

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Clarification of the concept about "separate F/S":

- Separate F/S are those presented by:
  - a parent (i.e. an investor with control of a subsidiary); or
  - an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with HKFRS 9.
- Accordingly, F/S in which the equity method is applied are not separate F/S.
- Similarly, F/S of an entity that does not have a subsidiary, associate or joint venturer's interest in a joint venture are not separate F/S.

HKAS 27 sets out the below requirements:

Aspects	**Remarks**
Choice of Accounting Method [HKAS 27 para 10]	In the separate F/S, investments in subsidiaries, joint ventures and associates should be accounted for either: (a) at cost, or (b) in accordance with HKFRS 9. [Note: Effective from annual periods beginning on or after 1 January 2016 (early adoption is permitted), equity method is also allowed.]
Dividend from Subsidiary, Joint Venture or Associate [HKAS 27 para 12]	Dividend should be recognised in profit or loss in separate F/S when the right to receive the dividend is established. [Note: If Equity Method is used then the dividend should be recognised as a reduction from the carrying amount of the investment.]
Investment Entities	(Note: The investment entity consolidation exemption below is covered in HKFRS 10 which is effective for annual periods beginning on or after 1 January 2014.) Under HKFRS 10, an investment entity is required to apply the exception to consolidation. If a parent (as investment entity) is required to measure its investment in a subsidiary at FV through profit or loss under HKFRS 10, it is required to also account for its investment in a subsidiary in the same way in its separate F/S. [HKAS 27 para 11A]

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	When a parent ceases to be an investment entity: · account for an investment in a subsidiary: ➢ at cost (based on FV at the date of change or status); or ➢ in accordance with HKFRS 9. ***When an entity becomes an investment entity:*** · account for an investment in a subsidiary at FV through profit or loss in accordance with HKFRS 9. [HKAS 27 para 11B] Note: Effective from annual periods beginning on or after 1 January 2016 (early adoption is permitted):- · When an entity ceases to be an investment entity, the entity shall account for an investment in a subsidiary in accordance with para 10 above. · The date of the change of status shall be the deemed acquisition date. The FV of the subsidiary at the deemed acquisition date shall represent the transferred deemed consideration when accounting for the investment in accordance with para 10 above.

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Group Accounting and Business Combinations

Extract from QP MA Sept 08 Q2b

Question 2 (10 marks – approximately 18 minutes)

Discuss the following statements:

(b) "It is an option for an entity with an investment in a subsidiary not to prepare consolidated financial statements."

(5 marks)

Answer to QP MA Sept 08 Q2b

Answer 2(b)

The statement is incorrect.

Under HKAS 27, parents should prepare consolidated financial statements in which they consolidate their investments in subsidiaries subject to one exception when ALL of the following conditions set out in HKAS 27.10 are met:

(a) the parent is itself a wholly-owned subsidiary, or the parent is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not preparing consolidated financial statements;

(b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards.

If on acquisition of a subsidiary meets the criteria to be classified as held for sale in accordance with HKFRS 5, it shall be accounted for in accordance with that standard.

Extract from QP MA Sept 08 Q5b

Question 5 (12 marks – approximately 22 minutes)

(b) "In a business combination, if the fair value of the identifiable assets and liabilities and contingent liabilities at the acquisition date can only be determined provisionally, the acquirer shall adjust such provisional value upon the finalisation of the fair value determination." Discuss.

(4 marks)

Answer to QP MA Sept 08 Q5b

Answer 5(b)

Under HKFRS 3.45 (Revised), adjustments to provisional values may be made within a period not exceed one year from the acquisition date and accounted for as if they were made at the acquisition date.

Therefore, the acquiree's net assets are calculated as if the adjusted fair value was recognised at the acquisition date.

Goodwill or any discount on acquisition recognised shall be adjusted from the acquisition date by an amount equal to the adjustments to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.

Comparative figures are restated accordingly.

Revisions of estimates identified after the twelve-month period are not adjusted retrospectively, but accounted for in the period in which they are identified.

After the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Extract from QP MA Feb 10 Q2b

Question 2 **(10 marks – approximately 18 minutes)**

(b) **"No goodwill is recognised in the financial statements prepared under merger accounting for business combination under common control. However, goodwill can still appear in the consolidated financial statements after applying merger accounting for business combination under common control." Discuss.**

(5 marks)

Answer to QP MA Feb 10 Q2b

Answer 2(b)

Goodwill can still be recognised in the financial statements prepared under merger accounting for a business combination under common control.

The concept underlying the use of merger accounting to account for a common control combination is that no acquisition has occurred and there has been a continuation of the risks and benefits to the controlling party (or parties) that existed prior to the combination.

The net assets of the combining entities or businesses are consolidated using the existing book value from the controlling parties' perspective.

The assets and liabilities of the acquired entity or business should be recorded at the book values as stated in the financial statements of the controlling party.

That is, it will require recording of:

- The fair value of the identifiable assets and liabilities of the acquired entity or business at the date of original acquisition from third parties by the controlling party.

- Any remaining goodwill arising on the previous acquisition and non-controlling interest recorded in the consolidated financial statements of the controlling party.

There is no recognition of any additional goodwill or excess of acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of common control combination to the extent of the continuation of the controlling party or parties' interest.

Extract from QP MA Dec 10 Q3

Question 3 **(16 marks – approximately 29 minutes)**

On 1 October 2009, Smart Computer Limited (SCL) acquired an 80% interest in Breakthrough Disc Company (BDC) at a consideration of HK$72 million. Fair value of BDC shares at that date was HK$45 each.

The carrying amount of identifiable net assets of BDC reported on its statement of financial position at the date of acquisition was HK$42 million. Other than the property, plant and equipment with carrying amount of HK$60 million and fair value of HK$76 million, there were no differences between the carrying amount and the fair value for all other reported assets and liabilities. An internally generated intangible asset with fair value of HK$8 million was identified. Both the property, plant and equipment and the intangible asset have an estimated useful life of 10 years from the date of acquisition.

On 1 April 2010, SCL distributed 300,000 shares of BDC, represented 15% interest in BDC, to its shareholders ("the Distribution"). Fair value of the BDC share at that date was HK$63 each. Post acquisition profit reported by BDC before adjustment of depreciation and amortisation attributable to fair value up to 1 April 2010 was HK$8 million.

SCL has four shareholders with equal ownership and adopts the accounting policy to measure any non-controlling interests in the acquiree at fair value.

Required:

Assuming that BDC is not subject to income tax in any jurisdiction,

(a) **calculate the amount of goodwill recognised for the acquisition.**

(7 marks)

(b) **calculate the amount of non-controlling interests in BDC as at 1 April 2010 before the Distribution to be reflected in the consolidated statement of financial position of SCL.**

(5 marks)

(c) **explain the accounting treatment and prepare the necessary consolidation adjustment journal(s) for the Distribution for the preparation of the consolidated financial statements of SCL.**

(4 marks)

Answer to QP MA Dec 10 Q3

Answer 3(a)

The amount of goodwill is calculated as follows:

Consideration transferred: HK$72 million

Amount of non-controlling interests: HK$45 x 2,000,000 x 20% = HK$18 million

Identifiable net assets of BDC acquired:

Net carrying amount in the books of BDC = HK$42 million

Fair value adjustments:

Property, plant and equipment = HK$76 - HK$60 million = HK$16 million
Intangible asset = HK$8 million

Net of the acquisition-date amounts of the identified assets acquired and the liabilities assumed = HK$[42 + 16 + 8] million = HK$66 million

Goodwill acquired = HK$[72 + 18 – 66] million = HK$24 million

Answer 3(b)

Non-controlling interests in BDC as at 1 April 2010 before the Distribution to be reflected in the consolidated statement of financial position of SCL:

Net of the acquisition-date amounts of the identified assets acquired and the liabilities assumed (as above) = HK$66 million

Post acquisition profit reported by BDC before adjustment of depreciation and amortisation attributable to fair value up to 1 April 2010 = HK$8 million

Additional depreciation for the period from 1 October 2009 to 31 March 2010:
= HK$16 million / 10 x 0.5
= HK$0.8 million

Additional amortisation for the period from 1 October 2009 to 31 March 2010:
= HK$8 million / 10 x 0.5
= HK$0.4 million

Adjusted post acquisition profit of BDC incorporated into the consolidated financial statements of SCL up to 1 April 2010 = HK$[8 – 0.8 – 0.4] million = HK$6.8 million

Non-controlling interest of 20% = HK$18 million + [HK$6.8 million x 20%]
= HK$19.36 million

Answer 3(c)

According to paragraphs 30 and 31 of HKAS 27, changes in a parent's ownership interest in a subsidiary that do not result in a loss of control (i.e. still accounted for as a subsidiary) are accounted for as equity transactions (i.e. transactions with owners in their capacity as owners). In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received shall be recognised directly in equity and attributed to the owners of the parent.

The journal entries to be recorded by SCL for the Distribution were:

		Dr	Cr
Dr	Dividend	HK$14,520,000	
	Cr Non-controlling interest		HK$14,520,000

(15/80 of the goodwill attributable to SCL and 15% of adjusted net assets of BDC incorporated into the consolidated financial statements of SCL as at 1 April 2010 = HK$[72 + (6.8 x 80%)] million x 15/80

[OR**
15% of total goodwill and adjusted net assets of BDC incorporated into the consolidated financial statements of SCL as at 1 April 2010 = HK$(66 + 6.8 + 24) million x 15%])

HK(IFRIC) – Int 17 para. 7 states that in accordance with paragraph 5, this Interpretation does not apply when an entity distributes some of its ownership interests in a subsidiary but retains control of the subsidiary. The entity making a distribution that results in the entity recognising a non-controlling interest in its subsidiary accounts for the distribution in accordance with HKAS 27 (as amended in 2008).

Extract from QP MA Jun 15 Q4a-b

Question 4 **(16 marks – approximately 29 minutes)**

On 15 May 2014, Apple Company Limited ("ACL"), a company listed on the Hong Kong Stock Exchange, has entered into an agreement to acquire 60,000 shares of Juice Manufacturing Limited ("JML"), representing a 60% interest in JML, at a consideration of HK$30 million, which would be settled by cash of HK$10 million and 20 million shares of ACL. As a contingent consideration, a further consideration to be settled by 4 million shares of ACL would be made if the profit of JML for the year ending 31 December 2015 exceeds HK$15 million. Upon acquisition of the 60% interest in JML, JML has become a subsidiary of ACL. The principal activity of JML is the manufacture and sale of apple juice in Hong Kong.

The acquisition is subject to the shareholders' approval of ACL and the fulfilment of certain other substantive pre-conditions by ACL to obtain the control over JML. The shareholders' approval of ACL was obtained on 30 June 2014 while all the required conditions were satisfied on 15 August 2014.

The fair values of each of the shares of ACL on 15 May 2014, 30 June 2014 and 15 August 2014 are HK$1.50, HK$1.20 and HK$1.40 respectively. The fair values of each of the share of JML on 15 May 2014, 30 June 2014 and 15 August 2014 are HK$500, HK$510 and HK$515 respectively. The fair values of the contingent consideration on 15 May 2014, 30 June 2014 and 15 August 2014 are HK$2 million, HK$2.5 million and HK$1.8 million respectively. The control premium is not considered for the purposes of fair value measurement.

There were no differences between the carrying amount and the fair value of all assets and liabilities of JML except for certain property, plant and equipment with carrying amount of HK$36 million and fair value of HK$40 million.

In addition, certain intangible assets were identified upon the acquisition of JML as follows:

- technologies with carrying amount of HK$2 million and fair value of HK$10 million;
- potential contracts from prospective new customers for a total contract sum of HK$8 million; and
- existing customer's relationship with fair value of HK$4 million.

Deferred tax impact of HK$2 million was not recognised by JML due to initial recognition exemption. Direct transaction cost for advisory service of HK$200,000 was incurred.

Required:

(a) Advise as to the accounting implications of the contingent consideration in relation to the profit of JML at the date of acquisition and as at 31 December 2015.
(4 marks)

(b) Advise as to the accounting implications of the consideration transferred and calculate the relevant amount recognised for the acquisition.
(4 marks)

Answer to QP MA Jun 15 Q4a-b

Answer 4(a)

Contingent consideration is recognised as part of the consideration transferred for a business combination, measured at fair value at the date of acquisition.

As the number of shares that will ultimately be delivered by ACL does not vary (i.e. the only outcomes are nil or 4 million shares to be issued depending on the profit of JML), the contingent consideration meets the definition of equity instrument under HKAS 32 and would be classified as equity upon initial recognition.

As at 31 December 2015, if JML fails the profit target, no remeasurement is required and there will not be any impact on profit or loss. If JML fulfills the profit target, 4 million shares will be issued to the vendor which will be dealt within the equity.

Answer 4(b)

The consideration transferred in a business combination is measured at fair value, which is calculated as the sum of the acquisition-date fair values of the asset transferred, liabilities incurred and the equity interest issued by ACL according to paragraph 37 of HKFRS 3.

The acquisition date is defined as the date on which ACL obtains control over JML, i.e. 15 August 2014 on which all the conditions to obtain control were satisfied.

Thus, the consideration transferred by ACL is the aggregate value of cash of HK$10 million, the fair value of its shares and the fair value of the contingent consideration at the date of acquisition, i.e. 15 August 2014.

Consideration transferred
= HK$10 million + [20 million x HK$1.40] + HK$1.8 million
= HK$39.8 million