Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Guidance Notes
Workshop 1			**Released on 1 Dec 10**
1. Introduction	• Presentation • Group discussion		
2. Property related standards	• Case study • Group discussion	Ch. 3, 4, 5, 7 & 16	Pg. 1 – 19
3. Resolving accounting issues	• Case study • Group discussion	Ch. 7, 9, 10 & 12	Pg. 20 – 30
4. Wrap up	• Presentation • Group discussion		
Workshop 2			**Released on 10 Dec 10**
5. Reboot	• Presentation • Group discussion		
6. Financial Instrument	• Case study • Group discussion	Ch. 17	Pg. 1 – 10
7. Consolidation	• Case study • Group discussion	Ch. 14, 20, 27, 28 & 29	Pg. 11 – 28
8. Leading a team and teamwork	• Group discussion		
9. Conclusion	• Presentation • Group discussion		

Financial instruments

Case study 6 – Big Top Limited

On 1 July 2009, Big Top Limited (BTL) issues a financial instrument. The proceeds will be used to finance further expansion of the company. The details are shown below:

3,000,000 convertible bonds issued at par value of HK$ 10 each. The bonds have a three-year term, and interest is payable annually in arrears at 6%. Each bond is potentially convertible into 15 equity shares of BTL. Conversion may occur at any time until maturity. The market rate of interest for similar debt without a conversion option is 9% at the date the bonds were issued. On issuing the bonds, BTL incurred issue costs of HK$ 300,000. The effective rate of interest on the bonds is 9.3877%.

BTL's accounting policy is to measure financial instruments at amortised cost whenever possible.

Required

Determine how BTL should account for these financial instruments in its financial statements. Provide calculations to show the amount that should be recognised in the financial statements for the year ended 30 June 2010. Journal entries should be prepared.

Discussion points

What are the issues?

BTL issued convertible bonds on 1 July 2009. How to separate the convertible bonds into liability and equity components? How should BTL account for the convertible bonds in the statement of financial position and comprehensive income in the year ending 30 June 2010?

Which accounting standard(s) should be used?

HKAS 32: Financial Instruments: Presentation

HKAS 39: Financial Instruments: Recognition and measurement

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

A compound financial instrument is a non-derivative instrument that from the issuer's perspective contains a liability and an equity component.

An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

[HKAS 32.29 LP Ch 17 para2.3]

Once a compound instrument has been separated into liability and equity components, the classification of the components is not revised as a result of any change in the likelihood of the conversion option being exercised, even if it seems very likely that conversion will take place. This is because the obligation to deliver cash is not extinguished until maturity is reached, and the liability may not be derecognised.

The liability and equity components are initially separated and measured as follows:

(a) The fair value (i.e. present value) of the liability component is measured using an interest rate attached to a similar instrument but without a conversion option. All future cash flows, both interest and principal are included in the discounted cash flow calculation.

(b) The equity component is the residual amount after deduction from the fair value of the instrument as a whole the amount determined for the liability component.

[HKAS 32.32 LP Ch 17 section 2.4.4]

HKAS 32 requires the issuer of a financial instrument to present the liability component and the equity component separately in the statement of financial position as follows:

(a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. On initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any.

[HKAS 32.AG31]

How to apply the standard(s) to the case?

The convertible bonds are an example of a compound or hybrid financial instrument according to HKAS 32. A compound financial instrument is a non-derivative instrument that from the issuer's perspective contains a liability and an equity component. Therefore BTL must recognise separately in the statement of financial position a liability and an equity component of the bonds.

The financial liability arises as BTL has a contractual obligation to deliver cash on the payment of annual interest, and a further cash payment will be made on maturity if the principal is not converted to equity.

An equity element arises as the bonds contain a call option granting the holder the right to convert the bonds into a fixed number of BTL's equity shares for a determined period of time.

Any issue costs must be allocated between the liability and equity components in proportion, as calculated in [W2].

[W1] **Calculation of fair value of liability and equity components at initial recognition**

Fair value of the liability component

	Cash flow	*Discount factor Using 9% interest rate*	*Present Value Cash flow* HK$
Year 1 – interest	30m × 6% = 1,800,000	0.9174	1,651,320
Year 2 – interest	1,800,000	0.8417	1,515,060
Year 3 – interest	1,800,000	0.7722	1,389,960
Year 3 – principal	30m	0.7722	23,166,000
PV / FV of liability			27,722,340

The fair value of the proceeds received = HK$ 30,000,000

From the calculation above, the fair value of the liability is HK$ 27,722,340

Hence, the equity is valued as the residual amount of HK$ 2,277,660

[W2] **Allocation of issue costs**

	Liability Component HK$	Equity Component HK$	Total HK$
Proceeds allocated [W1]	27,722,340	2,277,660	30,000,000
Issue costs	(277,223)	(22,777)	(300,000)
Net proceeds	27,445,117	2,254,883	29,700,000

[W3] **Amortised cost measurement of financial liability**

Year	Opening Liability HK$	Finance charge at 9.3877% HK$	Interest paid HK$	Closing liability HK$
1	27,445,117 [W2]	2,576,465	(1,800,000)	28,221,582
2	28,221,582	2,649,357	(1,800,000)	29,070,939
3	29,070,939	2,729,093	(1,800,000)	30,000,000 *

*(Closing liability at end of 3rd year per calculation = HK$30,000,032 approx HK$30,000,000)

Recommendation/ justification

For BTL the following amounts would be disclosed in the statement of financial position as at 30 June 2010:

Financial liability HK$28,221,582 [W3]
Equity HK$ 2,254,883 [W2]

The statement of comprehensive income for the year ended 30 June 2010 will include a finance charge of HK$2,576,465 [W3].

Journal entries -

On issuance of the CB:

	Dr	Cr
Dr Cash	29,700,000 (net proceeds of bond deducting issue costs)	
Cr Financial Liability		27,445,117 [W2]
Cr Equity		2,254,883 [W2]

Finance charges to be accrued on the financial liability in 2010:

	Dr	Cr
Dr Finance cost	2,576,465	
Cr Financial liability		2,576,465

30 June 2010 pay interest:

	Dr	Cr
Dr Financial liability	1,800,000	
Cr Cash		1,800,000

Subsequent to initial recognition, the liability is measured according to the normal measurement rules in HKAS 39 – the liability is measured at amortised cost, or the entity can choose to measure the liability at fair value. BTL's accounting policy is to measure at amortised cost. This will result in a finance charge based on the effective rate of interest of the CB being recognised in the income statement each year.

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

Financial instruments

Case study 7 – Massive Movers Limited

Massive Movers Limited (MML) operates in the extraction industry. On 1 April 2010, MML agreed to purchase a large piece of equipment from Big Brands Company (BBC), a company incorporated in a foreign country for 10 million zlotti. BBC would invoice 10 million zlotti to MML and deliver the equipment on 3 August 2010.

MML is risk averse, and wished to hedge the transaction by entering into a forward exchange contract to buy 10 million zlotti on 3 August 2010 at a rate of HK$ 1 = 15.5 zlotti. The contract was entered into on 1 April 2010.

Information on spot and forward rates is shown below:

	Spot rate	*Forward rate*
1 April 2010	HK$ 1 = 15 zlotti	HK$ 1 = 15.5 zlotti
30 June 2010	HK$ 1 = 13.8 zlotti	HK$ 1 = 14 zlotti
3 August 2010	HK$ 1 = 12 zlotti	HK$ 1 = 12 zlotti

MML has a financial year ending on 30 June and wishes to use hedge accounting techniques where possible.

Required

You should:

- **determine the accounting treatment for the transaction**
- **explain whether MML can use hedge accounting for this transaction. You are expected to prepare journal entries, if any.**
- **explain the documentation that is needed to demonstrate that hedge accounting may be applied to a transaction.**

Discussion points

What are the issues?

The forward exchange contract is a financial instrument.

(a) How should it be measured at the end of reporting date?

(b) Should gains or losses arising on the contract be recognised in profit or in equity at the end of reporting date?

(c) What should be the accounting treatment when the contract is closed out?

(d) What documentation should exist in order for hedge accounting to be applied to the transaction?

Which accounting standard(s) should be used?

HKAS 39: Recognition and Measurement

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

A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met.

(a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

(b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

(c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

[HKAS 39.88 LP Ch 17 section 6.4]

If a cash flow hedge meets the conditions above, during the period, it shall be accounted for as follows:

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

(b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.

[HKAS 39.95 LP Ch 17 section 6.5.2]

How to apply the standard(s) to the case?

The transaction involves a forward exchange contract which is an example of a derivative financial instrument. A derivative is an item whose value depends on the value of an underlying item. In this case the value of the forward exchange contract depends on the movement in the HK$/zlotti exchange rate.

Initially, on 1 April 2010, there are no accounting entries to record. The equipment is not recognised as an asset as MML does not have exposure to the risks and rewards of the asset until it is purchased in August 2010. The purchase has been agreed to however, and would be disclosed in a narrative note to the financial statements as required by HKAS 16 *Property, Plant and Equipment*.

At this date the forward exchange contract is also not recognised as it has no cost. But at 30 June 2010, the derivative must be measured at fair value. HKAS 39 require that derivatives are recognised as a financial asset or liability depending on whether the terms of the derivative are favourable or unfavourable to the company at the year end.

The fair value of the forward contract at 30 June 2010 is HK$ 69,125 [W1]. The contract is favourable to MML so the amount is recognised as a financial asset.

Under the normal accounting rules of HKAS 39, the change in fair value of HK$ 69,125 should be recognised in profit. However, the hedge accounting rules can be invoked if various criteria are met. If hedge accounting is applied, the effective portion of the change in fair value is recognised in other comprehensive income and disclosed as part of equity, while the ineffective portion is recognised in profit.

In order for hedge accounting to apply, firstly, there must be a hedged item and a hedging instrument. In this case, the probable future purchase of equipment is the hedged item. This hedged item exposes MML to a risk of changes in future cash flows depending on movements in the exchange rate. HKAS 39 state that a future transaction must be highly probable in order to qualify as a hedged item.

The forward exchange contract is the hedging instrument which is used to mitigate the currency risk.

Secondly, the hedge must be expected to be highly effective in mitigating risk, with the results of the hedge being in the range 80 – 125%. At 30 June 2010 [W2] shows the effectiveness to be 119%, so highly effective.

Thirdly, documentation must be maintained in relation to the hedge transaction to demonstrate the effectiveness of the hedge and to measure the fair values of the hedging instrument at the reporting date.

HKAS 39 requires formal hedge documentation to be prepared at the inception of the hedge. In MML's case, the documentation would indicate the date on which the hedged transaction is expected to occur.

Because the criteria for hedge accounting have been met, MML can take the effective portion (HK$57,971) [W1] of the movement on the forward contract to other comprehensive income. This means that the ineffective portion of HK$11,154 (69,125-57,971) is credited to profit in the year ending 30 June 2010.

The following amounts would be disclosed in the financial statements at 30 June 2010:

Financial Asset (current asset) HK$ 69,125

Gain on hedging instrument-OCI HK$ 57,971

This gain will be disclosed as a credit to other comprehensive income in the statement of comprehensive income and as a separate component of equity in the statement of financial position.

Gain on hedging instrument-P&L HK$11,154

This gain will be credited to profit or loss in the statement of comprehensive income.

In August 2010, the asset is purchased and the forward contract closed out. The equipment must be recognised as soon as risks and rewards have passed to MML, and it should be capitalised at fair value, ie measured using the spot (market) exchange rate on the date of purchase, resulting in a value of HK$ 833,333 [W3].

The forward contract is re-measured at the purchase date, and as long as the hedge has continued to be highly effective, the effective portion of the movement in fair value is taken to other comprehensive income. [W3] shows that the hedge has continued to be highly effective, at 109%. The increase in the value of the contract from 30 June 2010 to 3 August 2010 is HK$ 119,047 [W3], of which HK$108,695 is the effective portion credited to OCI and HK$10,352 is the ineffective portion credited to profit or loss.

Immediately after this re-measurement, the forward contract is derecognised. The cumulative amount which has been taken to other comprehensive income of HK$ 166,666 (57,971 + 108,695) is released to the income statement over the estimated economic life of the asset. This release to the income statement can be achieved either by crediting an annual proportion to profit or loss (effectively reducing the annual depreciation charge) or by crediting the whole amount against the cost of the asset and then depreciating this net amount.

[W1] **Measurement of the forward contract at 30 June 2010**

		HK$
Contract valued at forward rate at 30 June 2010	10m/14	714,286
Contract valued at fixed contract rate	10m/15.5	(645,161)
Increase in fair value		69,125

Measurement of the hedged item at 30 June 2010 (this is calculated only for the purpose of determining the effectiveness of the hedge)

		HK$
Asset valued at spot rate at 30 June 2010	10m/13.8	724,638
Asset valued at spot rate 1 April 2010	10m/15	(666,667)
Increase in fair value		57,971

[W2] **Hedge effectiveness at 30 June 2010**

$$\frac{\text{Change in value of hedging instrument}}{\text{Change in value of hedged item}} = \frac{69{,}125}{57{,}971} = 1.19$$

[W3] **Measurement of forward contract at purchase date**

		HK$
Contract valued at spot rate at 3 August 2010	10m/12	833,333
Contract valued last year end	10m/14	(714,286)
Increase in fair value		119,047

Measurement of the hedged item at purchase date (this is calculated only for the purpose of determining the effectiveness of the hedge)

		HK$
Asset valued at spot rate at 3 August 2010	10m/12	833,333
Asset valued last year end	10m/13.8	(724,638)
Increase in fair value		108,695

Hedge effectiveness at 3 August 2010

$$\frac{\text{Change in value of hedging instrument}}{\text{Change in value of hedged item}} = \frac{119{,}047}{108{,}695} = 1.09$$

Recommendation/ justification

Journal entries

1 April 2010

No entries are required

30 June 2010

Dr	forward contract (financial asset)	HK$69,125	
Cr	other comprehensive income		HK$57,971
Cr	profit or loss		HK$11,154

3 August 2010

Dr	forward contract (financial asset)	HK$119,047	
Cr	other comprehensive income		HK$108,695
Cr	profit or loss		HK$10,352

Being the re-measurement of the derivative prior to close-out

Dr	property, plant and equipment	HK$833,333	
Cr	cash (10m/15.5)		HK$645,161
Cr	forward contract (financial asset) (69,125 + 119,047)		HK$188,172

Being the recognition of property, plant and equipment at market price, the close out of the derivative and the cash paid on its settlement.

Documentation

Documentation must be prepared in accordance with the requirements of HKAS 39, to demonstrate the effectiveness of the hedge, and to measure the fair values of the hedging instrument at the reporting date. Because the documentation must exist at the inception of the hedging arrangement, a hedge relationship cannot be designated as a hedge transaction for accounting purposes retrospectively.

In relation to a cash flow hedge, as in MML's case, the documentation must also identify the date on which the hedged transaction is expected to occur.

Disclosure requirement

HKFRS 7 requires entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance. MML should disclose:

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

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

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

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

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

[HKAS 7.23 LP Ch17 Section 7.5.1]

Discussion points

What are the issues?

HCL has interests in a subsidiary (SCL) and an associate (ACL).

It is required to prepare the consolidated statement of financial position, taking into account the non-controlling interest in SCL and goodwill arising in SCL.

How should the following issues be reflected in the consolidation process:

(a) Fair values of intangibles, non-current assets and inventory differ from their carrying values;

(b) Part of the consideration in the acquisition of SCL was a loan made from HCL to SCL;

(c) The non-controlling interest is to be measured at fair value;

(d) An impairment loss has arisen in ACL.

Which accounting standard(s) should be used?

HKAS 27: Consolidated and Separate Financial Statements

HKAS 28: Investments in Associates

HKFRS 3: Business Combinations

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

Subsidiary companies should be consolidated and associates accounted for using the equity method.

[HKAS 27.9, HKAS 28.11 LP Ch 26 section 1.4]

The assets and liabilities of parent and subsidiary are added together on a line by line basis, eliminating any intercompany items. Fair values at the acquisition date and any subsequent changes to them are reflected.

[HKAS 27.18 LP Ch 26 section 2.3.1, 2.3.2, 3.3.3]

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 Ch 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 within the equity and liabilities section of the consolidated statement of financial position.

[HKFRS 3.19 LP Ch 26 section 4.2]

Associates are carried as a non-current asset measured at cost plus the group share of post-acquisition movement in reserves less impairment losses.

[HKAS 28.11 LP Ch 28 section 1.3]

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:

[W1] **Net asset working – SCL**

The fair value of the net assets of the subsidiary is calculated at the acquisition date for inclusion in the goodwill calculation, and at the consolidation date in order to calculate post acquisition movements in reserves arising in SCL for inclusion in group retained earnings.

	Net assets at acquisition	*Net assets at consolidation*
	HK$'000	HK$'000
Share capital	100,000	100,000
Retained earnings	12,000	51,000
Fair value adjustments		
Brand name	25,000	15,000 (a)
Inventories (20 - 15)	5,000	0 (b)
PPE (100 – 90)	10,000	5,000 (c)
	152,000	171,000

(a) The internally generated brand name would not be recognised in the individual financial statements of SCL. However, HKFRS 3 requires that internally generated brand names are recognised on the consolidation of a subsidiary, and should be measured in the consolidated financial statements at fair value. In this case the brand has fallen in value between the date of acquisition and the reporting date to HK$ 15 million.

The consolidation journal at 30 June 2010 is:

Dr	retained earnings (SCL)	HK$10 million	
Cr	intangible assets		HK$10 million

(HK$25m-HK$15m)

(b) HKFRS 3 requires inventories to be measured at fair value at acquisition. Respective inventories were all sold as at 30 June 2010.

The consolidation journal at 30 June 2010 is:

Dr	retained earnings (SCL)	HK$5 million	
Cr	inventories (HK$20m-HK$15m)		HK$5 million

(c) HKFRS 3 requires PPE to be measured at fair value at acquisition. The asset should be depreciated over the remaining life of 4 years. Hence, on consolidation the asset is increased in value to reflect the fair value adjustment, but then reduced in value over a 4 year period to reflect annual depreciation. At 30 June 2010, 2 years after acquisition, the asset is increased by HK$ 10 million, but then reduced by accumulated depreciation on the fair value uplift of HK$ 5 million. So the net uplift required at 30 June 2010 is HK$ 5 million.

The consolidation journal at 30 June 2010 is:

Dr	retained earnings (SCL)	HK$5 million	
Cr	property, plant and equipment (HK$10m-HK$5m)		HK$5 million

[W2] **Goodwill on acquisition of SCL**

		HK$'000	
Cost of investment	170,000 – 20,000 (a)	150,000	
Fair value of NCI	30,000 × 2 (b)	60,000	
		210,000	
Less: net assets at acquisition at fair value		(152,000)	[W1]
		58,000	

(a) The loan of HK$ 20 million made by HCL to SCL is an inter-company item to be eliminated on consolidation. It is not part of cost of investment for the purpose of calculating goodwill.

(b) HCL selected to measure the non-controlling interest in SCL by using the fair value method. The equity shares of SCL at acquisition date have a market value of HK$ 2 each. HCL purchases 70,000 of SCL's shares, leaving the NCI holding 30,000 shares, valued at HK$ 2 each.

Journal for goodwill

	Dr	Cr
Dr Property, plant and equipment	HK$10 million	
Dr Intangible assets	HK$25 million	
Dr Goodwill	HK$58 million	
Dr Inventories	HK$ 5 million	
Dr Loans	HK$20 million	
Dr Share capital	HK$100 million	
Dr Retained earnings(SCL)	HK$12 million	
Cr Cost of investment in SCL		HK$170 million
Cr Non-controlling interest		HK$60 million

[W3] **Non-controlling interest in SCL at 30 June 2010**

		HK$'000
NCI initially recognised [W2]		60,000
Add: NCI share of post acquisition profits of SCL	30% × (171,000 – 152,000)[W1]	5,700
		65,700

[W4] **Investment in associate**

ACL – associate net asset working

	Net assets at acquisition	*Net assets at consolidation*
	HK$'000	HK$'000
Share capital	50,000	50,000
Retained earnings	25,000	80,000
	75,000	130,000

	HK$'000
Cost of investment	40,000
Add: Post acquisition profit 40% × (130,000 – 75,000)	22,000
Less: impairment	(2,500)
	59,500

The consolidation journal at 30 June 2010 is:

(a) Share of post acquisition profit

Dr Investment in ACL	HK$22million	
Cr Retained earnings (HCL)		HK$22million

(b) Impairment loss

Dr Retained earnings (HCL)	HK$2.5million	
Cr Investment in ACL		HK$2.5million

[W5] **Consolidated retained earnings**

	HK$'000	HK$'000
HCL retained earnings:		
Per SOFP	139,000	
Less: Goodwill impairment [W4]	(2,500)	
		136,500
Add: Post acquisition profit of SCL 70% × (171,000 – 152,000) [W1]		13,300
Add: Post acquisition profit of ACL 40% × (130,000 – 75,000) [W4]		22,000
		171,800

Recommendation/ justification

HCL Group
Consolidated statement of financial position at 30 June 2010

	HCL	SCL	Adj	Adj	Adj	Adj	Adj	Adj	Adj	Consolidated	
	HK$'000	HK$'000	W2	W1(a)	W1(b)	W1(c)	W3	W4(a)	W4(b)	HK$'000	
Non-current assets											
Property, plant and equipment	202,000	185,000	10,000			(5,000)				392,000	
Intangible assets	80,000	-	25,000	(10,000)						95,000	
Goodwill	-	-	58,000							58,000	[W2]
Investment in SCL	170,000	-	(170,000)							-	
Investment in ACL	40,000	-						22,000	(2,500)	59,500	[W4]
	492,000	185,000								604,500	
Current assets											
Inventories	25,000	14,000	5,000		(5,000)					39,000	
Trade receivables	18,000	12,000								30,000	
Cash	14,000	5,000								19,000	
	57,000	31,000								88,000	
Total assets	549,000	216,000	(72,000)	(10,000)	(5,000)	(5,000)	-	22,000	(2,500)	692,500	
Equity											
Share capital	300,000	100,000	(100,000)							300,000	
Retained earnings	139,000	51,000	(12,000)	(10,000)	(5,000)	(5,000)	(5,700)	22,000	(2,500)	171,800	[W5]
Non-controlling interest	-	-	60,000				5,700			65,700	[W3]
	439,000	151,000								537,500	
Non-current liabilities											
Deferred tax	-	-								-	
Provisions	25,000	10,000								35,000	
Loans	50,000	25,000	(20,000)							55,000	
	75,000	35,000								90,000	
Current liabilities											
Trade payables	30,000	28,000								58,000	
Accrual	5,000	2,000								7,000	
	35,000	30,000								65,000	
Total equity and liabilities	549,000	216,000	(72,000)	(10,000)	(5,000)	(5,000)	-	22,000	(2,500)	692,500	

Additional information 1 – Intra group transactions

On 1 July 2009, HCL sold a factory to SCL for proceeds of HK$ 65 million. Accumulated depreciation of HK$ 10 million had been charged up to the date of the disposal, and the factory had originally cost HCL HK$ 50 million. All group companies depreciate factories using the straight-line method at 5% per annum.

On 1 April 2010, SCL sold inventory to HCL for HK$ 5 million, including a margin of 40%. Half of these goods remain unsold by HCL at the year end. On the same date, HCL sold inventory to ACL for HK$ 40 million, including a margin of 25%. ACL had sold 80% of these goods by the year end.

Required

You should:

- **Consider the proper accounting treatment by reference to the relevant accounting standards**
- **Prepare the consolidation journal entries required in respect of the additional information**

You may ignore tax at this stage.

Discussion points

What are the issues?

HCL entered into intra group transactions with SCL and ACL respectively.

(a) Any unrealised profit should be eliminated?

(b) What is the consolidation journal entries?

Which accounting standard(s) should be used?

HKAS 27 Consolidated and Separate Financial Statements

HKAS 28 Investments in Associates

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

The unrealised profit in non-current assets and inventory is eliminated on consolidation. In the case of transactions involving associates, the adjustment relates only to the group share.

[HKAS 27.21 LP Ch 26 section 2.3.2]

Non-controlling interest should be measured at fair value or as a proportion of the net assets in the non-wholly owned subsidiary.

HKAS 28 requires that profits and losses resulting from “upstream” (sales of assets from an associate to the investor) and “downstream” (sales of assets from the investor to an associate) transactions between an investor (including its consolidated subsidiaries) and an associate are recognised in the investor’s financial statements only to the extent of unrelated investors’ interests in the associate.

[HKAS 28.22 LP Ch 26 section 2.3.2]

How to apply the standard(s) to the case?

Transaction with SCL

Any intra group transactions with SCL should be eliminated in the consolidation. Non-controlling interest for SCL should be calculated based on the adjusted profit of SCL.

Purchase of inventories from SCL

A provision for unrealised profit is necessary to eliminate profit added onto intra-group sales, which do not represent profit generated by the group.

Intra-group sales value = HK$5 million

Margin of 40% = HK$2 million (HK$5million x 40%)

Unrealised profit for 50% inventories remain in the group = HK$1 million (HK$2 million x 50%)

The inventories have been sold by the subsidiary to the parent company, so the provision for unrealised profit is charged against the subsidiary's retained earnings.

Sales of factory to SCL

When a non-current asset is transferred between group companies, two adjustments are necessary. One to eliminate any profit or loss made on the transfer (which is adjusted in the vendor's retained earnings, i.e. HCL), and one to eliminate any excess depreciation charged by the purchaser (adjusted in the purchaser's retained earnings, i.e. SCL).

	HK$'000
Original asset cost in HCL	50,000
Accumulated depreciation as at 1 April 2010	(10,000)
Carrying value at 1 April 2010	40,000
Selling price received from SCL	65,000
Gain on disposal recorded in HCL	25,000

The adjustment on depreciation is:

In group level, the depreciation should be charged: HK$50,000,000 × 5% = HK$2,500,000

In SCL company level, depreciation has been charged: HK$65,000,000 × 5% = HK$3,250,000

The difference of HK$750,000 is adjusted.

Adjustments for non-controlling interest:

SCL share of adjustment for unrealised profit:

HK$1,000,000 x 30% = HK$300,000 Dr

SCL share of adjustment for additional depreciation:

HK$750,000 x 30% = HK$225,000 Cr

Non-controlling interest adjustment = HK$300,000 Dr - HK$225,000 Cr = HK$75,000 Dr

Transaction with ACL

HCL has sold inventories to ACL. The investor's share in the associate's profits and losses resulting from these transactions should be eliminated. When HCL sells goods to ACL (an associate), HCL should not recognise its share of the associate's profit or loss from the transaction in its consolidated financial statements until the goods or assets have been resold to an independent party. The provision for unrealised profit must be accounted for by recognising an expense in the retained earnings of the vendor i.e. HCL, and by reducing the value of the investment in associate (because the inventory which contains unrealised profit is part of the net assets of the associate).

HCL's share of any unrealised profit or loss in the inventories that were retained by ACL at the end of the reporting period should be eliminated.

Intra-group sales value = HK$40 million

Margin of 25% = HK$10 million (HK$40million x 25%)

Unrealised profit for 20% inventories remain unsold = HK$2 million (HK$10 million x 20%)

HCL's share at 40% = HK$0.8 million (HK$2 million x 40%)

Recommendation/ justification

Journal entries for Consolidation adjustments:

1. The adjustment on elimination of unrealised profit for purchase from SCL is:

Dr retained earnings (SCL)	HK$1 million	
Cr inventories		HK$1 million

2. The adjustment on elimination of intra group profit on asset transfer recorded in HCL is:

Dr retained earnings (HCL)	HK$25 million	
Cr property, plant and equipment - Factory		HK$25 million

3. The adjustment on elimination of depreciation recorded in SCL is:

Dr Non-current asset	HK$750,000	
Cr retained earnings (SCL)		HK$750,000

4. The adjustment on non-controlling interest is:

Dr non-controlling interest	HK$75,000	
Cr retained earnings		HK$75,000

5. The adjustment on elimination of unrealised profit for sales to ACL is:

Dr retained earnings (HCL)	HK$0.8 million	
Cr investment in associate		HK$0.8 million

Additional information 2 – Tax implications of business combinations

In the pre-workshop exercise and additional information 1, you are requested to ignore the tax. Assume now a tax rate of 16% should be used.

Required

You should:

- **Consider the proper accounting treatment by reference to the relevant accounting standards**
- **Prepare the consolidation journal entries required in respect of the additional information**
- **Revise the consolidated statement of financial positions based on the additional information 1 and 2.**

Discussion points

What are the issues?

Any consolidation adjustment is required if assume the tax rate is 16% at acquisition and at consolidation?

Which accounting standard(s) should be used?

HKAS 12: Income Taxes

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

Where the tax base of an asset of liability differs from its carrying amount, there is a temporary difference and deferred tax arises.

[HKAS 12.11 LP Ch 14 section 2.1.2]

Where the carrying amount exceeds the tax base there is a taxable temporary difference and a deferred tax liability arises.

[HKAS 12.15 LP Ch14 section 3]

Where the tax base exceeds the carrying amount there is a deductible temporary difference and a deferred tax asset arises provided that profits against which it can be used will probably be available.

[HKAS 12.24 LP Ch 14 section 4]

Assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. These fair values may differ from the tax base of the asset. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill.

[HKAS 12.19 LP Ch 14 section 8.1.1]

The deferred tax asset or liability is calculated by applying the tax rate expected to apply when the asset is realised or liability settled to the temporary difference.

[HKAS 12.47 LP Ch 14 section 8.4]

How to apply the standard(s) to the case?

Taxes are being charged on the individual entities, the consolidation adjustments will not affect the current tax liability, i.e. the amount that is expected to be paid in tax.

However, tax-effect adjustments are necessary when, during the consolidation, adjustments are made to the carrying amounts of assets.

The consolidation adjustments relating to the carrying amount of assets will affect the differences between the tax base and the carrying amount of an asset. This then affects future tax (deferred tax amounts) rather than current tax payable.

It should calculate the deferred tax effect for each individual consolidation adjustments:

[W1] The internally generated brand name:

	At acquisition	At consolidation	Change
	HK$'000	HK$'000	HK$'000
Carrying value	25,000	15,000	10,000
Tax Base	-	-	-
Temporary Difference	25,000	15,000	10,000
Deferred Tax @16%	*4,000*	*2,400*	*1,600*

[W2] Fair value adjustment on plant:

	At acquisition	At consolidation	Change
	HK$'000	HK$'000	HK$'000
Carrying value	100,000	50,000	50,000
Tax Base	90,000	45,000	45,000
Temporary Difference	10,000	5,000	5,000
Deferred Tax @16%	*1,600*	*800*	*800*

[W3] Fair value adjustment on inventories:

	At acquisition	At consolidation	Change
	HK$'000	HK$'000	HK$'000
Carrying value	20,000	-	20,000
Tax Base	15,000	-	15,000
Temporary Difference	5,000	-	5,000
Deferred Tax @16%	*800*	*-*	*800*

[W4] Intra-group transfer of inventories:

	At consolidation
	HK$'000
Carrying value	1,500
Tax Base	2,500
Temporary Difference	(1,000)
Deferred Tax @16%	*(160)*

[W5] Intra-group sales of factory:

	At Transfer	Depreciation	At consolidation
	HK$'000	HK$'000	HK$'000
Carrying value	40,000	(2,500)	37,500
Tax Base	65,000	(3,250)	61,750
Temporary Difference	(25,000)	750	(24,250)
Deferred Tax @16%	*(4,000)*	*120*	*(3,880)*

[W6] Deferred Taxation:

	At acquisition	At consolidation	Change
	HK$'000	HK$'000	
Deferred tax relating to SCL:			
[W1] Internally generated brand name	4,000	2,400	
[W2] Fair value adjustment on plant	*1,600*	800	
[W3] Fair value adjustment on inventories	*800*	-	
[W4] Intra-group transfer of inventories	-	*(160)*	
[W5] Excess Depreciation in SCL level	-	*120*	
	6,400	*3,160*	*3,240*
Deferred tax relating to HCL:			
[W5] Gain on disposal of factory	-	*(4,000)*	*4,000*
Deferred Tax liability (asset) in consolidation level	*6,400*	*(840)*	*7,240*

a) Adjusting entries for deferred tax at acquisition:

Dr goodwill	HK$6.4 million	
Cr Deferred taxation		HK$6.4 million

b) Adjusting entries for the deferred tax at 30 June 2010 is:

Dr Deferred taxation	HK$4 million	
Cr Retained earnings		HK$4 million

Deferred tax effect for elimination of gain on disposal of factory

Dr Deferred taxation	HK$3.24 million	
Cr Retained earnings		HK$2.268 million
Cr non-controlling interests (3.24millionx30%)		HK$0.972 million

Deferred tax effect for other transactions related to SCL

Revised Net assets of SCL:

	Net assets at acquisition	*Net assets at consolidation*	
	HK$'000	HK$'000	
Original net assets of SCL	152,000	171,000	
Provision for unrealised profit	-	(1,000)	[W4]
Excess depreciation	-	750	[W5]
Deferred Tax liability	(6,400)	(3,160)	[W6]
	145,600	167,590	

Adjustment on Goodwill for the deferred tax liabilities created at date of acquisition:

	HK$'000
Original goodwill	58,000
Deferred tax liability at acquisition	6,400
Adjusted goodwill	64,400

Revised Non-controlling interest in SCL at 30 June 2010:

		HK$'000
NCI initially recognised		60,000
Add: NCI share of post acquisition profits of SCL	30% × (167,590 – 145,600)	6,597
		66,597

[W7] Tax effect on unrealised profit for transactions with associate:

Unrealised profit for sales to ACL: HK$800,000

Tax effect: HK$800,000 x 16% = HK$128,000

Adjusting entries for the deferred tax at 30 June 2010 is:

Dr Investment in ACL	HK$128,000	
Cr Retained earnings		HK$128,000

	HK$'000
Original investment in ACL	59,500
Less: Unrealised profit	(800)
Add: Share of tax effect	128
	58,828

[W8] Consolidated retained earnings

	HK$'000	HK$'000
HCL retained earnings:		
Per SOFP	139,000	
Less:		
Goodwill impairment in ACL	(2,500)	
Elimination on gain on disposal of factory to SCL, net (HK$25,000-$4,000)	(21,000)	
Elimination on unrealised profit for sales to ACL, net (HK$800-HK$128)	(672)	
		114,828
Add: Post acquisition profit of SCL 70% × (167,590 – 145,600) [W6]		15,393
Add: Post acquisition profit of ACL 40% × (130,000 – 75,000)		22,000
		152,221

HCL Group
Consolidated statement of financial position at 30 June 2010

		<----------------Additional Information 1---------------->					<---------Additional Information 2--------->				
	pre-workshop HK$'000	Adj #1	Adj #2	Adj #3	Adj #4	Adj #5	Adj W6(a)	Adj W6(bi)	Adj W6(bii)	Adj W7	Adjusted HK$'000
Non-current assets											
Property, plant and equipment	392,000		(25,000)	750							367,750
Intangible assets	95,000										95,000
Goodwill	58,000						6,400				64,400
Investment in SCL	-										-
Investment in ACL	59,500					(800)				128	58,828
	604,500										585,978
Current assets											
Inventories	39,000	(1,000)									38,000
Trade receivables	30,000										30,000
Cash	19,000										19,000
	88,000										87,000
Total assets	692,500	(1,000)	(25,000)	750	-	(800)	6,400	-	-	128	672,978
Equity											
Share capital	300,000										300,000
Retained earnings	171,800	(1,000)	(25,000)	750	75	(800)		4,000	2,268	128	152,221
Non-controlling interest	65,700				(75)				972		66,597
	537,500										518,818
Non-current liabilities											
Deferred tax	-						6,400	(4,000)	(3,240)		(840)
Provisions	35,000										35,000
Loans	55,000										55,000
	90,000										89,160
Current liabilities											
Trade payables	58,000										58,000
Accrual	7,000										7,000
	65,000										65,000
Total equity and liabilities	692,500	(1,000)	(25,000)	750	-	(800)	6,400	-	-	128	672,978

Additional information 3 – Increase in shareholding in SCL

HCL wishes to increase its holding in SCL. Two different transactions are available, which would happen on 1 July 2010.

(i) HCL would acquire a further 30% of SCL's shares for cash consideration of HK$ 60 million.

(ii) HCL would acquire a further 20% of SCL's shares for cash consideration of HK$ 50 million. The residual 10% shares in SCL would not be acquired, and have a fair value of HK$ 1.795 each.

Required

Discuss the accounting treatment for the two transactions, and advise the relevant consolidation journal entries in the consolidated financial statements as at 1 July 2010.

Discussion points

What are the issues?

HCL has owned 70% SCL for a number of years. It now wishes to increase its shareholding by buying either an extra 30% or 20% shareholding.

What treatment should be applied in each case and what will be the effect on the consolidated financial statements?

Which accounting standard(s) should be used?

HKAS 27 Consolidated and Separate Financial Statements

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

Changes in ownership interest that do not result in a change of control are accounted for as equity transactions (that is, transactions with owners in their capacity as owners).

[HKAS 27.30 LP Ch. 29 Section 2.4]

On the acquisition of further shares in a subsidiary, the carrying amounts of the controlling and non-controlling interest are adjusted. Any difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent.

[HKAS 27.31 LP Ch. 29 Section 2.4]

How to apply the standard(s) to the case?

HCL already owns 70% of the equity shares of SCL, so any increase in the shareholding of SCL does not cause a change in the status of the company in that it is already controlled by HCL.

No goodwill is calculated on the acquisition of the further shares. This is because goodwill should only arise on the initial acquisition giving rise to control.

The income statement is not affected by the transaction, as the accounting entries only affect equity and non-controlling interest.

Increase in extra 30% interest

SCL becomes a wholly owned subsidiary, and the non-controlling interest of HK$ 66,597,000 should be de-recognised. The difference between the NCI de-recognised, and the fair value of the cash paid to acquire the further shares of HK$ 6,597,000 (66,597,000 – 60,000,000) should be credited to equity.

Increase in extra 20% interest

After acquire extra 20% interest in SCL, a 10% NCI will remain. HKAS 27 (Revised) requires that NCI be adjusted in value, in this case to 10 million shares × HK$ 1.795 = HK$ 17,950,000. The difference between the NCI de-recognised, and the fair value of the cash paid to acquire the further shares should be debited to equity.

Recommendation/ justification

The journal entries are as follows:

Increase in extra 30% interest

	Dr	Cr
Dr Non controlling interests	HK$66,597,000	
Cr Equity		HK$6,597,000
Cr Cash		HK$60,000,000

Increase in extra 20% interest

	Dr	Cr
Dr Non controlling interests	HK$48,647,000	
(66,597,000 – 17,950,000)		
Dr Equity	HK$1,353,000	
Cr Cash		HK$50,000,000