Student Notes

Module A (June 2012)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		Please refer to Workshop 1 Student Notes
2. Property related standards	• Case study • Group discussion	Ch. 5, 6, 8 and 12	
3. Resolving accounting issues	• Case study • Group discussion	Ch. 9, 11 and 13	
4. Wrap up	• Presentation • Group discussion		
Workshop 2			
5. Reboot	• Presentation • Group discussion		
6. Financial instruments	• Case study • Group discussion	Ch. 18	Pg. 1 – 13
7. Consolidation	• Case study • Group discussion	Ch. 20, 27, 28, 29 and 30	Pg. 14 – 34
8. Leading a team and teamwork	• Group discussion		
9. Conclusion	• Presentation • Group discussion		

Financial instruments

Case study 1

Foxtrot Alpha Limited ('FAL') is a manufacturing company with a year ended 31 March 2012.

On 1 January 2012, FAL purchased a 3% fixed interest investment for its fair value of HK$2 million. 3% was the market rate of interest when the investment was purchased. FAL is risk averse, and decided to take out an interest rate swap also on 1 January 2012. Under the terms of the swap, it exchanges the 3% fixed interest it receives on the investment for floating interest rate payments based on the current market rate of interest.

There are no transaction costs involved in either the purchase of the investment or entering into the interest rate swap.

At 31 March 2012, the market interest rate has increased to 5%. The fair value of the investment has therefore fallen to HK$1.95 million. At the same date the fair value of the derivative is determined to be HK$48,000.

FAL has formally designated the transaction as a hedging transaction and it has been fully documented. The assessment of the effectiveness of the hedge can be conducted on an ongoing basis. The company intends to keep the investment for two years.

Required:

In respect of the transactions described above:

(a) **discuss the appropriate accounting treatment,**

(b) **calculate the amounts to be recognised in the financial statements for the year ended 31 March 2012, and**

(c) **outline the nature of any disclosure requirements.**

Discussion points

Financial instruments – Fair value hedge

Case Study 1 – FAL

What are the issues?

FAL has purchased an investment measured at fair value, and an interest rate swap. Students are required to:

(a) recognise that this is a hedging arrangement

(b) determine the effectiveness of the hedge

(c) discuss the accounting treatment, and

(d) outline the relevant disclosures required.

Which accounting standards should be used?

HKAS 39 *Financial Instruments: Recognition and Measurement*

HKFRS 7 *Financial Instruments: Disclosures*

What are the requirements of the accounting standards?

Definitions

A **derivative** is a financial instrument or other contract with all three of the following characteristics:

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable

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

(c) It is settled at a future date.

Hedging is designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

A **hedged item** is an asset, liability, firm commitment, or forecasted future transaction that:

(a) exposes the entity to risk of changes in fair value or changes in future cash flows, and that

(b) is designated as being hedged.

A **hedging instrument** is a designated derivative or (in limited circumstances) another financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. (A non-derivative financial asset or liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.)

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Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

A fair value hedge is a hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and could affect profit or loss.

(HKAS 39.9, LP Chapter 18, Section 6.2, 6.3)

For a hedging relationship to qualify for hedge accounting, the following conditions must be met:

(a) The hedging relationship must be formally documented (including the identification of the hedged item, the hedging instrument, the nature of the hedged risk and the assessment of 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). The hedging relationship must also be designated at its inception as a hedge based on the entity's risk management objective and strategy.

(b) There is an expectation that the hedge is highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk.

(c) For cash flow hedges, it must be highly probable that there is a forecast transaction since such a transaction is the subject of the hedge. In addition, the transaction must present an exposure to variations in cash flows that could eventually affect profit and loss.

(d) Reliable measurement of the effectiveness of the hedge.

(e) The assessment of the hedge is carried out on an ongoing basis (annually) and it has been effective during the reporting period.

(HKAS 39.88, LP Chapter 18, Section 6.4)

In a fair value hedge, the hedged item is a recognised asset or liability. The hedged item is initially recognised at cost and subsequently remeasured to fair value at the period end with any gain or loss on the remeasurement recognised in profit or loss.

The hedging instrument is a derivative and measured at fair value. Any gain or loss resulting from re-measuring the hedging instrument at fair value is also recognised in profit or loss.

(HKAS 39.89, LP Chapter 18, Section 6.5.1)

According to HKFRS 7, specific disclosures must be made relating to hedge accounting:

(a) Description of hedge.

(b) Description of financial instruments designated as hedging instruments and their fair value at the reporting date.

(c) The nature of the risks being hedged.

(d) For cash flow hedges, periods when the cash flows will occur and when they will affect profit or loss.

(e) For fair value hedges, gains or losses on the hedging instrument and the hedged item.

(f) The ineffectiveness recognised in profit or loss arising from cash flow hedges and net investments in foreign operations.

(HKFRS 7.22-24, LP Chapter 18, Section 7.5.1)

How to apply the standards to the case

(a) **Discussion of accounting treatment**

Hedged item

The 3% fixed interest investment may be classified as a hedged item if it exposes FAL to fair value risk, and if it is designated as a hedged item. The fixed interest element exposes the investment to fluctuations in fair value, because movements in the market rate of interest will cause its fair value to change. FAL has formally designated the transaction as a hedging transaction and this has been fully documented. Therefore the investment is treated as a hedged item according to HKAS 39.

The investment is initially measured at cost of HK$2 million. It is subsequently remeasured at the year end to its fair value of HK$1.95 million. The change in fair value of HK$50,000 is recognised in profit or loss for the year.

Hedging instrument

The interest rate swap is a derivative according to the HKAS 39 definition, as its value changes in response to an underlying characteristic, in this case the variable market interest rate, and it had no initial transaction cost. According to HKAS 39, it also meets the definition of a hedging instrument, as its change in fair value should offset the change in fair value of the investment to which it relates.

The interest rate swap has no initial cost, so there is no accounting entry when it is entered into on 1 January 2012. However by the year end, due to the increase in market interest rates, the swap now has a fair value of HK$48,000. This means that the swap should be recognised as a financial asset, with the change in fair value of HK$48,000 recognised in profit for the year.

Hedge effectiveness

HKAS 39 states that hedge accounting can be applied only when certain criteria have been met. One of the criteria relates to the effectiveness of the hedge. The effectiveness must be in the range of 80-125%, and is calculated for this transaction as follows:

$$\frac{\text{change in hedging instrument}}{\text{hange in hedged item}} = \frac{48{,}000}{50{,}000} = 96\%$$

The hedge effectiveness is 96% for FAL's transaction, which falls within the HKAS 39 parameters of 80-125%, so hedge accounting is applied.

Hedge accounting

This simply means that the gain on fair value remeasurement of the interest rate swap is directly offset against the loss on fair value remeasurement of the investment. Therefore a net figure is presented in the statement of comprehensive income.

(b) **Accounting entries**

		HK$	
1 January 2012			
DEBIT	Financial assets	2,000,000	
CREDIT	Cash		2,000,000

Being the purchase of the fixed interest investment and recognition at cost / fair value.

Note: there is no accounting entry for the interest rate swap on 1 January 2012 as it has no initial transaction cost.

31 March 2012		HK$	
DEBIT	Profit or loss	50,000	
CREDIT	Financial assets		50,000

Being the loss on fair value remeasurement of the fixed interest investment.

DEBIT	Financial assets	48,000	
CREDIT	Profit or loss		48,000

Being the increase in fair value remeasurement of the interest rate swap.

Recommendation / Justification

FAL's statement of financial position includes:

Non-current assets	*HK$*
Financial assets:	
Fixed interest investment	1,950,000
Derivative	48,000

FAL's statement of comprehensive income includes:	*HK$*
Net loss on remeasurement of hedged transaction	2,000

(c) The notes to the financial statements should include the following disclosure notes:

Description of hedge and the nature of the risks being hedged.

FAL purchased a fixed interest investment and due to the fair value risk exposure created by the investment, on the same date entered into a variable interest rate swap. This has been designated as a hedging transaction and fully documented as such.

Description of financial instruments designated as hedging instruments and their fair value at the reporting date.

The interest rate swap is a derivative financial instrument whose fair value is determined by the market rate of interest. The fair value of the swap at 31 March 2012 is HK$48,000.

Gains or losses on the hedging instrument and the hedged item.

Movement in the market rate of interest caused the investment to fall in value by HK$50,000. At the same time the fair value of the derivative increased by HK$48,000. These gains and losses have been recognised as part of profit for the year.

Student Notes

Key Learning Points

1. Investments in financial assets often expose a company to the risk that the fair value of the investment may change.
2. A company may enter into a derivative to counter against the fair value risk of the investment.
3. When these two things happen the company may choose to designate the transaction as a hedge transaction.
4. The derivative is recognised as a financial asset or liability at fair value at the year end, and the investment is also remeasured to fair value at the year end.
5. Assuming other criteria have been met, the gains and losses on the remeasurement of the investment (hedged item) and the derivative (hedging instrument) are both taken to profit or loss and netted against each other.
6. To ensure transparency HKFRS 7 requires disclosures to be made which help users of the financial statements understand the nature of hedging arrangements and the impact they have had on profit or loss for the year.

Financial instruments

Case study 2

Dearden Robson Limited ('DRL') is a Hong Kong based transportation company. On 1 April 2006, the company took out a HK$24 million bank loan with HCS Bank at a fixed interest rate of 10% in order to finance the acquisition of new technology which it expected to generate revenues until 2018. The loan agreement required repayment of the full amount outstanding on 31 March 2014, with interest payments made annually in arrears over the term of the loan.

During the course of the year ended 31 March 2011, DRL suffered from poor trading conditions as a result of the weak world economy. The company has therefore renegotiated the terms of the outstanding bank loan such that the term of the loan is extended by two years and a new interest rate of 5% is applied to the loan with effect from 1 April 2011. DRL determines that the market interest rate at which it could obtain a new loan with similar terms on this date is 11%.

As a direct result of the re-negotiation of the loan, legal and other costs of HK$120,000 are incurred.

Required:

(a) **Discuss the accounting treatment of the modification of terms of the bank loan.**

(b) **Calculate amounts to be recognised in the financial statements of DRL in respect of the loan in the year ended 31 March 2012 and subsequent years.**

(c) **List the disclosures required by HKFRS 7 in respect of the loan.**

Discussion points

Financial instruments – Modification of bank loan

Case Study 2 – DRL

What are the issues?

DRL has renegotiated the terms of an existing long term bank loan such that the fixed annual interest rate is reduced and the loan term extended.

Students must:

(a) consider the accounting treatment required to reflect the modification of the loan.

(b) calculate amounts for inclusion in the financial statements of DRL for the year ended 31 March 2012 and subsequent years until the loan is extinguished.

(c) draft the disclosures required by HKFRS 7 in respect of the loan.

Which accounting standards should be used?

HKFRS 7 *Financial Instruments: Disclosures*

HKFRS 9 *Financial Instruments*

What are the requirements of the accounting standards?

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

(HKFRS 9.3.1.1, LP Chapter 18, Section 3.2)

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

(HKFRS 9.5.1.1, LP Chapter 18, Section 4.1)

The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity should establish fair value by using a valuation technique in order to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same and discounted cash flow analysis.

(HKFRS 9.5.4.2, LP Chapter 18, Section 4.1)

An entity shall remove a financial liability from its statement of financial position when it is extinguished i.e. when the obligation specified in the contract is discharged, cancelled or expires.

(HKFRS 9.3.3.1, LP Chapter 18, Section 3.4.2)

A substantial modification of the terms of an existing financial liability, or part of it, is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

(HKFRS 9.3.3.2, LP Chapter 18, Section 3.4.2)

The terms of a modified financial liability are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

(HKFRS 9.B3.3.6, LP Chapter 18, Section 3.4.2)

The difference between the carrying amount of a financial liability extinguished, and the consideration paid, including non-cash assets transferred or liabilities assumed should be recognised in profit or loss.

(HKFRS 9.3.3.3, LP Chapter 18, Section 3.4.2)

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

- the carrying amount of financial liabilities measured at amortised cost

  (HKFRS 7.8)

- net gains or net losses on financial liabilities measured at amortised cost

  (HKFRS 7.20)

- total interest expense calculated using the effective interest method

  (HKFRS 7.20)

- the fair value of each class of financial assets and liabilities

  (HKFRS 7.25)

- qualitative and quantitative data which enables users to assess the nature and extent of risks arising from financial instruments.

  (HKFRS 7.31–32A)

(HKFRS 7, LP Chapter 18, Section 7)

How to apply the standard to the case

On 1 April 2006, when DRL took out the bank loan, this would have been recorded at fair value as (HK$000):

DEBIT	Cash	24,000	
CREDIT	Bank loan		24,000

At the end of each accounting period to the date of modification ie on 31 March 2007, 2008, 2009, 2010 and 2011, interest arising on the loan would have been recorded by (HK$000):

DEBIT	Finance costs (24m × 10%)	2,400	
CREDIT	Cash		2,400

At the date of the modification, 1 April 2011, the loan is therefore still reflected in the accounts of DRL at its original value of HK$24 million.

On 1 April 2011, the modification must be assessed in order to determine whether it is 'substantial'. The modification is substantial if the present value of the future cash flows under the new terms, including net fees paid, differs by 10% or more from the present value of the remaining cash flows of the existing liability. The calculation should be carried out using the original effective interest rate, in this case 10%:

Original liability – cash flows

Date of cash flow	*Cash flow HK$*	*Discount factor*	*PV of cash flow HK$*
31 March 2012	(2,400,000)	1/1.1	2,181,818
31 March 2013	(2,400,000)	$1/1.1^2$	1,983,471
31 March 2014	(26,400,000)	$1/1.1^3$	19,834,711
			24,000,000

Therefore the modification is substantial if the present value of the modified cash flows including fees incurred is less than HK$21.6 million (90% of HK$24m) or greater than HK$26.4m (110% of HK$24m).

Modified liability – cash flows

The interest rate is modified to be 5% therefore interest of HK$1,200,000 (HK$24m x 5%) arises each year. The term is also extended by two years:

Date of cash flow	*Cash flow HK$*	*Discount factor*	*PV of cash flow HK$*
31 March 2012	(1,200,000)	1/1.1	1,090,909
31 March 2013	(1,200,000)	$1/1.1^2$	991,736
31 March 2014	(1,200,000)	$1/1.1^3$	901,578
31 March 2015	(1,200,000)	$1/1.1^4$	819,616
31 March 2016	(25,200,000)	$1/1.1^5$	15,647,217
			19,451,056
Renegotiation fees			120,000
			19,571,056

The present value of the modified cash flows is lower than HK$21.6 million and therefore this is a substantial modification.

HKFRS 9 therefore requires that the original liability is derecognised and a new liability recognised in its place.

In order to recognise a new liability, its fair value must be estimated. This is determined as the present value of the future cash flows associated with the loan, discounted at the market rate at which DRL could currently obtain a loan with similar terms. The estimated fair value is therefore:

Date of cash flow	*Cash flow HK$*	*Discount factor*	*PV of cash flow HK$*
31 March 2012	(1,200,000)	1/1.11	1,081,081
31 March 2013	(1,200,000)	$1/1.11^2$	973,947
31 March 2014	(1,200,000)	$1/1.11^3$	877,430
31 March 2015	(1,200,000)	$1/1.11^4$	790,477
31 March 2016	(25,200,000)	$1/1.11^5$	14,954,973
			18,677,908

The entry on 1 April 2011 required to derecognise the old liability, recognise the new liability and associated costs and recognise the gain on extinguishment is (HK$):

DEBIT	Existing bank loan	24,000,000	
CREDIT	New bank loan		18,677,908
CREDIT	Cash (renegotiation fees)		120,000
CREDIT	Gain on extinguishment (24m – 18,677,908 – 120,000)		5,202,092

The new liability is now accounted for using the new effective interest rate of 11% and amortised as follows:

Y/e 31 March	*Loan b/f HK$*	*Finance cost (11%) HK$*	*Cash HK$*	*Loan c/f HK$*
2012	18,677,908	2,054,570	(1,200,000)	19,532,478
2013	19,532,478	2,148,573	(1,200,000)	20,481,051
2014	20,481,051	2,252,916	(1,200,000)	21,533,967
2015	21,533,967	2,368,736	(1,200,000)	22,702,703
2016	22,702,703	2,497,297	(25,200,000)	-

Therefore in the year ended 31 March 2012, and subsequent years, the following entries are required to recognise the finance cost and payment of interest (HK$):

2012	DEBIT	Finance cost	2,054,570	
	CREDIT	Cash		1,200,000
	CREDIT	New bank loan (balance)		854,570
2013	DEBIT	Finance cost	2,148,573	
	CREDIT	Cash		1,200,000
	CREDIT	New bank loan (balance)		948,573
2014	DEBIT	Finance cost	2,252,916	
	CREDIT	Cash		1,200,000
	CREDIT	New bank loan (balance)		1,052,916
2015	DEBIT	Finance cost	2,368,736	
	CREDIT	Cash		1,200,000
	CREDIT	New bank loan (balance)		1,168,736
2016	DEBIT	Finance cost	2,497,297	
	CREDIT	Cash		1,200,000
	CREDIT	New bank loan (balance)		1,297,297
	DEBIT	New bank loan	24,000,000	
	CREDIT	Cash		24,000,000

Recommendation / Justification

Statement of financial position for DRL as at 31 March

	2012	*2013*	*2014*	*2015*	*2016*
	HK$	*HK$*	*HK$*	*HK$*	*HK$*
Non-current liabilities					
Bank loan	19,532,478	20,481,051	21,533,967	-	-
Current liabilities					
Bank loan	-	-	-	22,702,703	-

Statements of comprehensive income for DRL for the years ended 31 March

	2012	*2013*	*2014*	*2015*	*2016*
	HK$	*HK$*	*HK$*	*HK$*	*HK$*
Exceptional gain on extinguishment of bank loan	(5,202,092)				
Finance costs	2,054,570	2,148,573	2,252,916	2,368,736	2,497,297

In addition to the amounts presented in the financial statements and shown above, DRL should disclose the following in the notes to its financial statements:

- The fair value of the liability
- Qualitative data including:
  - exposures to different types of risk and how they arise
  - objectives, policies and processes for managing the risk
  - methods for monitoring the risk
  - any changes in these since the previous period.
- Quantitative data including:
  - summary quantitative data about the exposure to risk at the period end
  - a maturity analysis of non-derivative financial liabilities
  - a description of how liquidity risk in relation to non-derivative financial liabilities is managed
  - a sensitivity analysis for market risk
  - concentrations of risk if not apparent from other disclosures.

Key Learning Points

1. Where the terms of an existing financial liability (or part of it) are substantially modified, the financial liability is extinguished and a new financial liability is recognised.
2. A financial liability is substantially modified if the discounted present value of the cash flows under the new terms (discounted using the original effective interest rate) is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability.
3. The difference between the carrying amount of a financial liability extinguished, and the consideration paid, including non-cash assets transferred or liabilities assumed is recognised in profit or loss.
4. The amount recognised in profit or loss includes and costs or fees incurred.
5. If terms of a modified financial liability are not substantially modified, the modification is not accounted for as an extinguishment and any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

What are the issues?

Newcastle has owned 50% of Corbridge for a number of years. The other 50% is owned by an otherwise unrelated company, Morpeth. On the first day of the current accounting period, Newcastle acquired 80% of Hexham.

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

(a) How to account for the investment in Corbridge.

(b) The non-controlling interest is to be measured at fair value.

(c) A fair value adjustment must be made to Hexham's receivables balance for consolidation purposes.

(d) Since acquisition, Hexham has sold goods to Newcastle, resulting in a year end intercompany balance and stock balance.

(e) Since acquisition, Newcastle has transferred a depreciable asset to Hexham, which is still owned by that company at the year end.

Which accounting standards should be used?

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

HKFRS 3 (Revised) *Business Combinations*

HKFRS 10 *Consolidated Financial Statements*

HKFRS 11 *Joint Arrangements*

What are the requirements of the accounting standards?

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

(HKFRS 10.2, LP Chapter 27, Section 1.4)

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

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

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

(HKFRS 3.32, LP Chapter 27, Section 4.3.4)

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

(HKFRS 3.19, LP Chapter 27, Section 5.2)

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

(HKFRS 11.16, LP Chapter 29, Section 2.1)

A joint venturer recognises its interest in a joint venture as an investment and should account for that investment using the equity method in accordance with HKAS 28 (2011) *Investments in Associates and Joint Ventures*.

(HKFRS 11.24, LP Chapter 29, Section 2.3.2)

An investment in a joint venture is initially recognised at cost. The carrying amount is increased or decreased by the investor's share of the joint venture's profit or loss and other comprehensive income after the acquisition date. Dividends received from the joint venture reduce the carrying amount of the investment in the investor's accounts.

The investor's share of a joint venture's profit or loss and other comprehensive income is recognised in the investor's statement of comprehensive income.

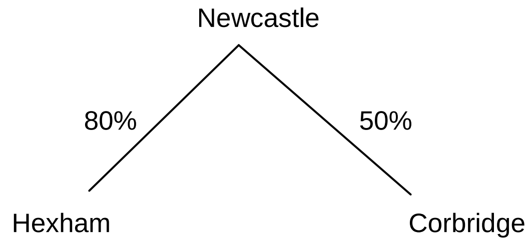
(HKAS 28.10-11, LP Chapter 29, Section 2.3.3)

How to apply the standards to the case

Consolidation

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

(W1) Group structure



(W2) Net asset working - Hexham

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

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

Hexham	*Net assets at acquisition*	*Net assets at reporting date*
	HK$000	*HK$000*
Share capital	12,000	12,000
Retained earnings	49,000	66,000
Fair value adjustment for receivable	500	-
	61,500	78,000

(W3) Goodwill on acquisition - Hexham

	HK$000
Cost of investment	57,000
Non-controlling interest 20% x 12m × 5.20	12,480
	69,480
Net assets at acquisition (W2)	(61,500)
Goodwill	7,980

Journal for initial recognition of goodwill (HK$000)

DEBIT	Share capital	12,000	
DEBIT	Retained earnings	49,000	
DEBIT	Receivables	500	
DEBIT	Goodwill	7,980	
CREDIT	Cost of investment in Hexham		57,000
CREDIT	Non-controlling interest		12,480

An adjustment needs to be made to reflect the fact that the receivables with the fair value uplift have been settled. The adjustment is (HK$000):

DEBIT	Statement of comprehensive income	500	
CREDIT	Receivables		500

As it relates to Hexham, the debit entry is split between the parent and the non-controlling interest in proportion to their holding (20%:80%). Therefore in the statement of financial position, HK$100,000 is debited to the non-controlling interest and HK$400,000 to group retained earnings.

The question stated that the receivables have been settled or written off during the year. This will have been reflected in the books of the subsidiary in current year. However, fair value adjustment is included on acquisition, so both the parent's and the non-controlling interest's shares of the HK $500,000 at the date of acqusition need to be reversed out to avoid double counting. The reversal is recognised in this year's statement of comprehensive income to ensure that this year's profits are not overstated.

You may understand the mechanism using a hypothetical example.

Say that Hexham wrote off a $500,000 debt in the year prior to acquisition:

DEBIT	Bad debt expense	500	
CREDIT	Receivables		500

This debt is not considered to be bad by Newcastle, and hence on acquisition it is allocated a fair value of HK$500,000 (so resulting in the FV uplift).

In the year ended 31 March 2012, the debt is settled in full. On receipt of the HK$500,000, Hexham will make the following entry in its individual books:

DEBIT	Cash	500	
CREDIT	Bad debt expense		500

At group level, however, the correct entry is:

DEBIT	Cash	500	
CREDIT	Receivables		500

Therefore a consolidation adjustment is required to reverse the bad debt recover recognised by Hexham and recognise the settlement of the receivable recognised by the Group:

DEBIT	Bad debt expense	500	
CREDIT	Receivables		500

(W4) Non-controlling interest in Hexham

In the statement of comprehensive income, HK$3.4 million, being 20% of Hexham's profit for the year of HK$17 million, is allocated to the non-controlling interest. The subsidiary was acquired on the first day of the year, so this HK$3.4 million is also part of the NCI share of the post-acquisition retained earnings of Hexham:

DEBIT	Retained earnings	3,400	
CREDIT	Non-controlling interest		3,400

(W5) Intercompany trading

(i) Intercompany sales are cancelled from the consolidated statement of comprehensive income by (HK$000):

DEBIT	Revenue	750	
CREDIT	Cost of sales		750

(ii) The intercompany receivable and payable accounts must be cancelled. In this case they are not equal due to cash in transit. Therefore in the first instance, the cash must be accounted for as received in Hexham's accounts (HK$000):

DEBIT	Overdraft	10	
CREDIT	Receivable		10

(iii) The intercompany amounts are now equal and may be cancelled (HK$000):

DEBIT	Payables	240	
CREDIT	Receivables		240

(iv) There is an unrealised profit in inventory of HK$75,000 (1/2 × HK$750,000 × 25/125). This is removed from inventory and profit in Hexham, the selling company (HK$000):

DEBIT	Cost of sales	75	
CREDIT	Inventory		75

As Hexham is the selling company, the profit adjustment impacts the non-controlling interest. HK$15,000 is allocated to the NCI and the remaining HK$60,000 to the parent.

In the consolidated statement of financial position, the journal is (HK$000):

DEBIT	Non-controlling interest	15	
DEBIT	Retained earnings	60	
CREDIT	Inventory		75

(W6) Intercompany transfer of non-current asset

(i) During the year, Newcastle transferred a machine to Hexham. Any profit or loss recognised on this transfer in Newcastle's accounts must be eliminated on consolidation:

	HK$	*HK$*
Proceeds on disposal		190,000
Carrying value at disposal:		
Cost	400,000	
Depreciation (6/10 yrs)	(240,000)	
		(160,000)
Profit on disposal		30,000

The necessary elimination journal is (HK$000):

DEBIT	Other gain or loss	30	
CREDIT	PPE		30

As the parent company is the seller, the adjustment does not affect the non-controlling interest in profit.

The debit entry is made to retained earnings in the statement of financial position.

(ii) In addition, any increase or decrease in the depreciation charge as a result of the transfer must be eliminated from the consolidated accounts.

		HK$
Annual depreciation charge prior to transfer	HK$400,000/10 years	40,000
Annual depreciation charge post transfer	HK$190,000/ 4 years	47,500
Increase		7,500

As the transfer took place half way through the financial year, the required adjustment, is (HK$000):

DEBIT	PPE (7,500 × 6/12m)	4	
CREDIT	Cost of sales		4

Again, the adjustment does not affect the non-controlling interest since the selling company is the parent. The credit entry is therefore to retained earnings in the statement of financial position.

(W7) Investment in Corbridge

Newcastle, along with Morpeth, has rights to the net assets of Corbridge. Therefore the investment qualifies as a joint venture in accordance with HKFRS 11 and is equity accounted for in accordance with HKAS 28 (Revised). Therefore, the investment is held at cost plus the venturer's share of profits made since acquisition.

Between the acquisition date and end of the current accounting period, Corbridge made a profit of HK$29m (HK$74m – 45m).

Newcastle's share is therefore brought into the consolidated statement of financial position by (HK$'000):

DEBIT	Investment in Corbridge (1/2 × 29m)	14,500	
CREDIT	Retained earnings b/f (14,500 – 6,150)		8,350
CREDIT	Retained earnings for the current year		6,150

Of the amount credited to retained earnings, HK$6.15m (1/2 × 12,300) are current year earnings. These are reported in the consolidated statement of comprehensive income as the share of profit of joint venture.

Consolidated statement of financial position at 31 March 2012

	Newcastle	Hexham	Subtotal	(W3)		(W4)	(W5) (ii)	(W5) (iii)	(W5) (iv)	(W6) (i)	(W6) (ii)	(W7)	Consolidated
	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000	HK$000
Property, plant and equipment	168,400	65,670	234,070							(30)	4		234,044
Intangible assets	12,430	8,500	20,930										20,930
Goodwill	-	-	-	7,980									7,980
Investment in Hexham	57,000	-	57,000	(57,000)									-
Investment in Corbridge	34,500	-	34,500									14,500	49,000
	272,330	74,170	346,500										311,954
Inventories	28,900	12,340	41,240						(75)				41,165
Trade receivables	42,450	12,675	55,125	500	(500)		(10)	(240)					54,875
US receivable	-	5,625	5,625										5,625
Cash	1,630	-	1,630										1,630
	72,980	30,640	103,620										103,295
	345,310	104,810	450,120										415,249
Ordinary share cap	60,000	12,000	72,000	(12,000)									60,000
Retained earnings	210,330	66,000	276,330	(49,000)	(400)	(3,400)			(60)	(30)	4	14,500	237,944
	270,330	78,000	348,330										297,944
Non controlling interest	-	-	-	12,480	(100)	3,400			(15)				15,765
													313,709
Deferred tax	19,340	8,500	27,840										27,840
Provisions	100	-	100										100
	19,440	8,500	27,940										27,940
Overdraft	-	2,450	2,450				(10)						2,440
Trade payables	33,250	12,110	45,360					(240)					45,120
Finance lease obligation	4,700	-	4,700										4,700
Income tax payable	4,150	2,450	6,600										6,600
Accrual	13,440	1,300	14,740										14,740
	55,540	18,310	73,850										73,600
	345,310	104,810	450,120										415,249

Consolidated statement of comprehensive income for the year ended 31 March 2012

	Newcastle	*Hexham*	*Subtotal*	*(W3)*	*(W4)*	*(W5)(i)*	*(W5)(iv)*	*(W6) (i)*	*(W6) (ii)*	*(W7)*	*Consolidated*
	HK$000	*HK$000*	*HK$000*	*HK$000*	*HK$000*	*HK$000*	*HK$000*	*HK$000*	*HK$000*	*HK$000*	*HK$000*
Revenue	240,120	85,770	325,890			(750)					325,140
Cost of sales	(167,500)	(52,300)	(219,800)			750	(75)		4		(219,121)
Gross profit											106,019
Distribution costs	(23,100)	(6,520)	(29,620)								(29,620)
Administrative expenses	(26,900)	(6,450)	(33,350)	(500)							(33,850)
Exchange loss	-	(225)	(225)								(225)
Share of profits of joint venture										6,150	6,150
Other gains and losses	200	(15)	185					(30)			155
Profit before interest and tax											48,629
Finance charge	(450)	(60)	(510)								(510)
Profit before tax											48,119
Income tax charge	(3,810)	(3,200)	(7,010)								(7,010)
Profit for the year	18,560	17,000	35,560				(75)	(30)	4	6,150	41,109
Total comprehensive income	18,560	17,000	35,560				(75)	(30)	4	6,150	41,109
Profit attributable to owners of parent (balancing figure)				(400)			(60)	(30)	4	6,150	37,824
Profit attributable to NCI		-		(100)	3,400		(15)				3,285
TCI attributable to owners of parent (balancing figure)				(400)			(60)	(30)	4	6,150	37,824
TCI attributable to NCI				(100)	3,400		(15)				3,285

Consolidation

Additional information 1

The following information relates to the Newcastle Group:

1. Newcastle's individual company statement of financial position as at 31 March 2011 was as follows:

	HK$000
Non-current assets	
Property, plant and equipment	174,600
Intangible assets	9,300
Investment in Corbridge	34,500
	218,400
Current assets	
Inventories	29,350
Trade receivables	46,800
Cash	58,780
	134,930
	353,330
Equity	
HK$1 ordinary share capital	50,000
Retained earnings	196,370
	246,370
Non-current liabilities	
Deferred tax liability	19,610
Provision	600
Finance lease obligation	4,700
	24,910
Current liabilities	
Overdraft	22,000
Trade payables	40,630
Finance lease obligation	4,600
Income tax payable	3,940
Accrual	10,880
	82,050
	353,330

In Newcastle's individual accounts, the investment in Corbridge is held at cost in accordance with HKAS 28 and HKAS 27.10.

2. At the date of acquisition, the statement of financial position of Hexham was as follows:

	HK$000
Non-current assets	
Property, plant and equipment	70,195
Intangible assets	9,400
	79,595
Current assets	
Inventories	8,320
Trade receivables	11,450
Cash	230
	20,000
	99,595
Equity	
HK$1 ordinary share capital	12,000
Retained earnings	49,000
	61,000
Non-current liabilities	
Deferred tax liability	7,710
Current liabilities	
Trade payables	22,035
Income tax payable	3,100
Accrual	5,750
	30,885
	99,595

3. Included in determining the profits of the respective companies for the year ended 31 March 2012 are the following amounts:

	Newcastle HK$000	*Hexham* HK$000	*Corbridge* HK$000
Depreciation	20,200	7,880	10,200
Amortisation	600	900	460
Loss / (profit) on disposal of property, plant and equipment	(8,390)	360	700

4. During the year, Newcastle and Hexham disposed of property, plant and equipment with carrying amounts of HK$9.68 million and HK$845,000 respectively.

5. Newcastle's finance lease is in respect of an item of machinery. The lease agreement requires payments of HK$5 million per annum in arrears, and is due to expire in the year ended 31 March 2013.

6. Overdrafts in all group companies are repayable on demand.

Required:

Prepare the consolidated statement of cash flows for the Newcastle Group for the year ended 31 March 2012 using the indirect method.

Discussion points

What are the issues?

The consolidated statement of financial position of Newcastle at the start of the year and that of Hexham on its acquisition date are provided, along with other information regarding transactions in the year ended 31 March 2012.

Using this information together with the consolidated financial statements for Newcastle prepared in the pre-workshop case study, students are required to prepare a consolidated statement of cash flows for the Newcastle Group for the year ended 31 March 2012.

Which accounting standards should be used?

HKAS 7 *Statement of Cash Flows*

What are the requirements of the accounting standards?

The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities.

(HKAS 7.10, LP Chapter 20, Section 1.2.1)

Cash flows are inflows and outflows of cash and cash equivalents.

Cash includes cash on hand and demand deposits; cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities; investing activities are the acquisition and disposal of long term assets and other investments not included in cash equivalents; financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

(HKAS 7.6, LP Chapter 20, Section 1.2.3)

Bank borrowings are generally considered to be financing activities. However, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents.

(HKAS 7.8, LP Chapter 20, Section 1.2.3)

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. An entity shall report cash flows from operating activities using either:

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed, or

(b) the indirect method, whereby any profit or loss is adjusted for certain items.

(HKAS 7.14, 18, LP Chapter 20, Section 2.2)

Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables

(b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses and undistributed profits of associates, and

(c) all other items for which the cash effects are investing or financing cash flows.

(HKAS 7.20, LP Chapter 20, Section 2.2)

Cash flows arising from taxes on income are separately disclosed and classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

(HKAS 7.35, LP Chapter 20, Section 2.3.2)

Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets

(c) cash payments to acquire equity or debt instruments of other entities (other than payments for those instruments considered to be cash equivalents).

(HKAS 7.16, LP Chapter 20, Section 2.1.2)

The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.

(HKAS 7.39, 42, LP Chapter 20, Section 3.1)

Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing shares

(b) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

(HKAS 7.17, LP Chapter 20, Section 2.1.3)

Cash flows from interest and dividends received and paid are disclosed separately and classified consistently from period to period as either operating, investing or financing activities.

(HKAS 7.31, LP Chapter 20, Section 2.3.1)

Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

(HKAS 7.28, LP Chapter 20, Section 3.4)

An entity which reports an interest in a joint venture using the equity method should include in its statement of cash flows the cash flows in respect of its investments in the joint venture, and distributions and other payments or receipts between it and the joint venture.

(HKAS 7.38, LP Chapter 20, Section 3.3)

How to apply the standard to the case

Operating activities

The first stage in preparing the consolidated statement of cash flows is to reconcile the profit for the year to the cash generated by operations, adjusting for non-cash items in the consolidated statement of comprehensive income and also for movements in working capital.

Non-cash items

The profit before tax for the year of HK$48,119,000 is the starting point for this reconciliation, and this is initially adjusted for the following non-cash items:

- Finance charge of HK$510,000
- Share of profit of the joint venture of HK$6.15 million
- The exchange loss of HK$225,000
- Depreciation of HK$28,076,000 (see W1) and amortisation of HK$1.5 million
- The loss on disposal of property, plant and equipment of HK$360,000 and profit on disposal of HK$8.36 million (see W2)
- The decrease in provisions by HK$500,000
- Reversal of receivables fair value uplift HK$500,000

(W1) The depreciation adjustment is calculated as:

	HK$000
Depreciation charge – Newcastle	20,200
Depreciation charge – Hexham	7,880
Adjustment to depreciation charge on consolidation (pre-workshop case study W6(ii))	(4)
	28,076

(W2) The adjustment for profit on disposal of property, plant and equipment is calculated as:

	HK$000
Profit on disposal – Newcastle	8,390
Intercompany profit eliminated on consolidation (pre-workshop case study W6(i))	(30)
	8,360

(W3) Movements in working capital

The movements in working capital over the course of the year are adjusted for, taking into account the acquisition of the subsidiary:

		HK$000
Inventory	At 31 March 2011	29,350
	At 31 March 2012	41,165
	Increase	11,815
	Less amount attributable to acquisition of sub	(8,320)
	Net increase	3,495

Receivables (excluding US)	At 31 March 2011	46,800
	At 31 March 2012	54,875
	Increase	8,075
	Less amount attributable to acquisition of sub	(11,950)
	Reversal of FV adjustment made on acquisition of sub	500
	Net decrease	(3,375)
Trade payables	At 31 March 2011	40,630
	At 31 March 2012	45,120
	Increase	4,490
	Less amount attributable to acquisition of sub	(22,035)
	Net decrease	(17,545)
Accrual	At 31 March 2011	10,880
	At 31 March 2012	14,740
	Increase	3,860
	Less amount attributable to acquisition of sub	(5,750)
	Net decrease	(1,890)

In the case of the US trade receivable, the exchange loss is taken into account when considering the movement:

		HK$000
US receivable	At 31 March 2011	-
	At 31 March 2012	5,625
	Increase	5,625
	Add back exchange loss	225
	Increase	5,850

The next stage in preparing the statement of cash flows is the calculation of cash flows in relation to operating activities. In this case, interest paid is simply the amount in the consolidated statement of comprehensive income. Tax paid, however requires calculating, as follows:

(W4) Income taxes paid

		HK$000
Newcastle	Income tax b/f	3,940
	Deferred tax b/f	19,610
Hexham acquisition	Income tax	3,100
	Deferred tax	7,710
Consolidated tax charge		7,010
		41,370
Consolidated	Income tax c/f	(6,600)
	Deferred tax c/f	(27,840)
Tax paid		6,930

Investing activities

Non-current assets and the acquisition of the subsidiary are dealt with in the investing activities section of the statement of cash flows.

(W5) Proceeds on disposal of property, plant and equipment

Proceeds is calculated by adjusting the carrying amount of the assets disposed of (given in the additional information) by the profit or loss on disposal. This calculation should also take into account the intercompany transfer.

	HK$000	*HK$000*
Newcastle		
Carrying amount of disposal		9,680
Profit on disposal		8,390
		18,070
Less intercompany proceeds (pre-workshop case study working 6(i))		(190)
		17,880
	HK$000	*HK$000*
Hexham		
Carrying amount of disposal	845	
Loss on disposal	(360)	
		485
Total proceeds		18,365

(W6) Purchases of property, plant and equipment

		HK$000
Consolidated property, plant and equipment at 31 March 2012		234,044
Depreciation charge	(W1)	28,076
Carrying amount of disposals (9,680 – 190 + 30 + 845)		10,365
		272,485
Newcastle property, plant and equipment at 31 March 2011		(174,600)
Hexham property, plant and equipment on acquisition		(70,195)
Purchases of property, plant and equipment		27,690

(W7) Purchases of intangible assets

	HK$000
Consolidated intangible assets c/f	20,930
Amortisation charge (600 + 900)	1,500
	22,430
Newcastle intangible assets b/f	(9,300)
Hexham intangible assets on acquisition	(9,400)
Purchases of intangible assets	3,730

(W8) Acquisition of subsidiary

The acquisition of the subsidiary is included in the statement of cash flows at the cash paid for the investment net of any cash held by the subsidiary on the date of acquisition:

	HK$000
Cash paid to acquire Hexham (pre-workshop case study background information)	57,000
Cash held by subsidiary on acquisition date	(230)
	56,770

Financing activities

Dividends paid, the issue of shares and the payment in respect of finance leases are dealt with in this section of the statement of cash flows.

(W9) Dividends paid

We are told in the pre-workshop case study that the only group company which has paid a dividend is Newcastle, the parent company. The amount of the dividend is calculated by considering the movement in Newcastle's retained earnings balance:

	HK$000
Retained earnings b/f	196,370
Newcastle's profit for the year	18,560
Retained earnings c/f	(210,330)
Dividends paid	4,600

(W10) Repayment of obligations under finance leases

Again, the amount paid in respect of finance leases is established by considering the movement in the finance lease obligation in the statement of financial position:

	HK$000
Finance lease obligation b/f (4,700 + 4,600)	9,300
Finance lease obligation c/f	(4,700)
Cash paid	4,600

(W11) Proceeds on issue of shares

Newcastle has issued shares during the period, with its share capital increasing by HK$10 million. As there is no share premium account in Newcastle, this HK$10 million is the cash inflow.

(W12) Cash and cash equivalents

	Cash	*Overdraft*	*Total*
	HK$000	*HK$000*	*HK$000*
B/f	58,780	(22,000)	36,780
C/f	1,630	(2,440)	(810)

Recommendation / Justification

Consolidated Statement of Cash Flows for the Newcastle Group for the year ended 31 March 2012

	Ref	*HK$000*
Profit before tax for the year		48,119
Adjustment for:		
Finance charge		510
Share of profit of joint venture		(6,150)
Exchange loss		225
Depreciation (20,200 + 7,880 – 4)	(W1)	28,076
Amortisation (600 + 900)		1,500
Loss on disposal		360
Profit on disposal (8,390 – 30)	(W2)	(8,360)
Decrease in provisions		(500)
Reversal of receivables fair value uplift		500
Operating cash flows before movements in working capital		64,280
Increase in inventories	(W3)	(3,495)
Decrease in receivables	(W3)	3,375
Increase in US receivable	(W3)	(5,850)
Decrease in trade payables	(W3)	(17,545)
Decrease in accrual	(W3)	(1,890)
Cash generated from operations		38,875
Income taxes paid	(W4)	(6,930)
Interest paid		(510)
Net cash from operating activities		31,435
Investing activities		
Proceeds from disposal of property, plant and equipment	(W5)	18,365
Purchases of property, plant and equipment	(W6)	(27,690)
Payment for intangible assets	(W7)	(3,730)
Net cash outflow on acquisition of subsidiary	(W8)	(56,770)
Net cash used in investing activities		(69,825)
Financing activities		
Dividends paid	(W9)	(4,600)
Repayment of obligations under finance leases	(W10)	(4,600)
Proceeds from issue of share capital	(W11)	10,000
Net cash from financing activities		800
Net decrease in cash and cash equivalents		(37,590)
Cash and cash equivalents at beginning of year	(W12)	36,780
Cash and cash equivalents at end of year	(W12)	(810)

Key Learning Points

1. A statement of cash flows is prepared for the same period as a statement of comprehensive income and classifies cash flows into those arising as a result of operating, investing and financing activities.
2. The net cash flow from operating activities can be calculated using either the direct or indirect method; the indirect method involves adjusting profit before tax for non-cash items, non-operating items and the effect of the accrual basis of accounting.
3. Tax paid is normally included as a cash flow from operating activities; interest and dividends paid and received may be classified as cash flows from operating, investing or financing activities, but the classification must be consistent from year to year.
4. Cash flows associated with the acquisition and sale of property, plant and equipment, intangible assets and the acquisition and disposal of investments including group entities are classified as cash flows from investing activities.
5. Cash flows associated with the issue of shares and debt (including finance lease obligations) are classified as cash flows from financing activities.
6. Where a subsidiary has been acquired in the year, the asset and liability balances acquired must be taken into account when calculating movements in working capital and cash flows.
7. Cash paid to acquire a subsidiary is included in the statement of cash flows net of any cash held by the subsidiary at the date of acquisition.
8. Cash equivalents are short-term highly liquid investments that are readily convertible to known amounts of cash.

Consolidation

Additional information 2

With reference to the research that you prepared prior to attending the workshop, prepare the required notes to the consolidated statement of cash flows for the Newcastle Group for the year ended 31 March 2012.

Discussion points

What are the issues?

Disclosure notes to the statement of cash flows are required for the Newcastle Group in respect of:

(a) cash and cash equivalents

(b) the acquisition of the subsidiary.

Which accounting standards should be used?

HKAS 7 *Statement of Cash Flows*

What are the requirements of the accounting standards?

Disclosure is required of the components of cash and cash equivalents together with a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.

(HKAS 7.45, LP Chapter 20, Section 2.4.2)

All entities should disclose, together with a commentary by management, any other information likely to be of importance, for example:

(a) Restrictions on the use of or access to any part of cash equivalents.

(b) The amount of undrawn borrowing facilities which are available.

(c) Cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity.

(HKAS 7.48-50, LP Chapter 20, Section 2.4.3)

Disclosure is required, in aggregate, in respect of obtaining control of subsidiaries, of each of the following:

(a) The total consideration paid or received

(b) The portion of the consideration consisting of cash and cash equivalents

(c) The amount of cash and cash equivalents in the subsidiary over which control is obtained

(d) The amount of the assets and liabilities other than cash and cash equivalents in the subsidiary over which control is obtained, summarised by each major category.

(HKAS 7.40, LP Chapter 20, Section 3.1.1)

How to apply the standard to the case / Recommendation / Justification

Cash and cash equivalents

	31 March 2012	*31 March 2011*
	HK$000	*HK$000*
Cash and bank balances	1,630	58,780
Bank overdrafts	(2,440)	(22,000)
	(810)	36,780

Cash and cash equivalents comprise cash and short-term bank deposits with an original maturity term of three months or less, net of outstanding bank overdrafts. The carrying amount of these assets is approximately equal to their fair value.

Acquisition of a subsidiary

On 1 April 2011, Newcastle acquired 80% of the issued share capital of Hexham for cash consideration of HK$57 million. This transaction has been accounted for by the purchase method of accounting.

	Book value	*Fair value*
	HK$000	*HK$000*
Net assets acquired:		
Property, plant and equipment	70,195	70,195
Intangible assets	9,400	9,400
Inventories	8,320	8,320
Trade receivables	11,450	11,950
Cash	230	230
Deferred tax liability	(7,710)	(7,710)
Trade payables	(22,035)	(22,035)
Income tax payable	(3,100)	(3,100)
Accrual	(5,750)	(5,750)
	61,000	61,500
Goodwill		7,980
Non-controlling interest		(12,480)
Total consideration		57,000
Satisfied by:		
Cash		57,000
Net cash outflow arising on acquisition:		
Cash consideration		57,000
Cash and cash equivalents acquired		(230)
		56,770

The goodwill arising on the acquisition of Hexham is attributable to the anticipated profitability of this company and future operating synergies from the combination.

Hexham has contributed HK$85,770,000 to revenues and HK$17 million to profits since acquisition.

Key Learning Points

1. Entities must disclose components of cash and cash equivalents together with a reconciliation of the amounts in the statement of cash flows to the equivalent amounts in the statement of financial position.

2. Where a subsidiary has been acquired, disclosure is required of the consideration paid, the amount of consideration consisting of cash and cash equivalents, cash and cash equivalents of the subsidiary obtained through the acquisition, and other assets and liabilities of the subsidiary by category.