Consolidated Financial Statements

(Workshop 3)

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Consolidated Financial Statements

- The Companies Ordinance (Chapter 32)
- HKFRS 3 Business Combinations
- HKAS 27 Consolidated and Separate Financial Statements
- AG 5 Merger Accounting for Common Control Combinations
- Consolidation of Foreign Subsidiary (HKAS 21)
- HKAS 28 Investments in Associates
- HKAS 31 Interests in Joint Ventures

Workshop 1

- Business Combinations and Consolidation in Hong Kong

Workshop 2

- Changes in a group
- *Update of HKFRS 10*

- More calculations in **Workshop 2** and **3**
- You are welcome to bring your own calculator to practise

Workshop 3

- Other consolidation issues
- *Update of HKFRS 11 and 12*

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Agenda of Workshop 3

Requirements

Practical Examples

Real Cases

Consolidation of Foreign Subsidiary (HKAS 21)

HKAS 28 Investments in Associates

HKAS 31 Interests in Joint Ventures

Workshop 3

- Other consolidation issues
- *Update of HKFRS 11 and 12*

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1. Consolidation of Foreign Operation

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Approach in HKAS 21

Determine Functional Currency	1. In preparing financial statements, each entity determines its functional currency.
Translate Foreign Currency Transactions	2. The entity translates foreign currency items or transactions into its functional currency and reports the effects of such translation.
Translate Foreign Operation or Whole Set	3. The results and financial position of any individual entity (say subsidiary, associate or branches) within the reporting entity (say parent) whose functional currency differs from the presentation currency of the reporting entity are translated. 4. If the entity's presentation currency differs from its functional currency, its results and financial position are also translated into the presentation currency.

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What is Foreign Currency?

Determine Functional Currency	1. In preparing financial statements, each entity determines its functional currency.

- **Foreign currency** is a currency other than the functional currency of the entity.
- **Functional currency** is the currency of the primary economic environment in which the entity operates.
- **Presentation currency** is the currency in which the financial statements are presented.

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Foreign Currency Transactions

Determine Functional Currency

↓

Translate Foreign Currency Transactions

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Translate Foreign Operation

Determine Functional Currency

Translate Foreign Currency Transactions

↓

Translate Foreign Operation or Whole Set

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Translate Foreign Operation

- An entity may present its financial statements in any currency (or currencies).
- If the presentation currency differs from the entity's functional currency
  - it translates its results and financial position into the presentation currency.
  - in the translation, firstly to ascertain whether functional currency of an entity is a currency of a hyperinflationary economy

Functional currency is not a currency of a hyperinflationary economy

Functional currency is a currency of a hyperinflationary economy

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Translate Foreign Operation

Functional currency is not a currency of a hyperinflationary economy

The results and financial position of such entity shall be translated into a different presentation currency using the following procedures:

a) assets and liabilities for each balance sheet presented (i.e. including comparatives)

   ⇒ shall be translated at the closing rate at the date of that balance sheet;

b) income and expenses for each income statement (i.e. including comparatives)

   ⇒ shall be translated at exchange rates at the dates of the transactions; and

c) all resulting exchange differences

   ⇒ shall be recognised as a separate component of equity.

For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example, an average rate for the period, is often used to translate income and expense items.

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Translate Foreign Operation

Functional currency is not a currency of a hyperinflationary economy

The exchange differences referred to above result from:

a) translating
   - income and expenses at the exchange rates at the dates of the transactions, and
   - assets and liabilities at the closing rate.

   Such exchange differences arise both on income and expense items recognised in profit or loss and on those recognised directly in equity.

b) translating the opening net assets at a closing rate that differs from the previous closing rate.

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Translate Foreign Operation

Case

中国建设银行
China Construction Bank

Annual Report 2008

- Foreign currency financial statements of overseas branches and subsidiaries are translated into Renminbi for the preparation of consolidated financial statements.
- The assets and liabilities in the financial statements denominated in foreign currencies
  - are translated into Renminbi at the spot exchange rates ruling at the balance sheet date.
- The income and expenses of foreign operations
  - are translated into Renminbi at the spot exchange rates or the rates that approximate the spot exchange rates on the transaction dates.
- Foreign exchange differences arising from transaction
  - are recognised as "exchange reserve" in the shareholder's equity on the balance sheet.

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Translate Foreign Operation

Exchange differences from intragroup elimination

- The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures (see HKAS 27 and HKAS 31).
- However, an intragroup monetary asset (or liability) cannot be eliminated against the corresponding intragroup liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements.
- Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference
  - continues to be recognised in profit or loss, or
  - if it arises from the circumstances that relating to monetary items that forms a part of net investment in a foreign operation, it is classified as equity until the disposal of the foreign operation.

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Translate Foreign Operation

Foreign operation with a different reporting date

- The foreign operation often prepares additional statements as of the same date as the reporting entity's financial statements.
- When this is not done, HKAS 27 allows the use of a different reporting date provided that the difference is no greater than 3 months and adjustments are made for the effects of any significant transactions or other events that occur between the different dates.
- In such a case, the assets and liabilities of the foreign operation are translated at the exchange rate at the balance sheet date of the foreign operation.
- Adjustments are made for significant changes in exchange rates up to the balance sheet date of the reporting entity in accordance with HKAS 27.
- The same approach is used in applying the equity method to associates and joint ventures and in applying proportionate consolidation to joint ventures in accordance with HKAS 28.

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Translate Foreign Operation

Goodwill arising on acquisition

- Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation
  - shall be treated as assets and liabilities of the foreign operation.
- Thus, they
  - shall be expressed in the functional currency of the foreign operation and
  - shall be translated at the closing rate

    (in accordance with the requirements on the functional currency which is or is not a currency hyperinflationary economy).

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Translate Foreign Operation

- On the disposal of a foreign operation, the cumulative amount of the exchange differences deferred in the separate component of equity relating to that foreign operation
  - shall be recognised in profit or loss when the gain or loss on disposal is recognised.

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Translate Foreign Operation

Example

On 1.1.2005	Parent P	Sub S
Property	$ 0	¥ 6,000
Investment	0	0
Cash at bank	30,000	2,000
	30,000	8,000
Issued equity	$ (30,000)	¥ (5,000)
Retained earnings	0	(3,000)
	(30,000)	(8,000)

Same example as before except …

HK$1 = RMB 1 on 1.1.2007
HK$1 = RMB 1 on 1.1.2008
HK$1 = RMB 0.5 on 31.12.2008
(No profit for 2008 for P and S)

On 1.1.2007

- Parent P acquired 20% interest in Subsidiary S at $3,500 by cash.
- Fair value of the property of S was $8,000.

During 2007

- Parent P reported nil profit and profit of S was HK$6,000 (became cash).
- Fair value of S is HK$30,000 at year-end.
- P accounted for S as held for trading.

On 1.1.2008

- P acquired additional 60% interest in S at $22,000 by cash.
- Fair value of the property of S was $11,000.

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Translate Foreign Operation

Example

The calculation approach would be revised as ……

			NCI at old approach
			New 1
a(i)	**Consideration transferred**		22,000
a(ii)	**Non-controlling interest (NCI)**	($19K x 20%)	3,800
a(iii)	**Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree**		7,333
			33,133
b.	**Acquisition-date amount of net identifiable assets**		
	Property, at fair value		11,000
	Cash		2,000
	Cash (profit for the year)		6,000
			19,000
Goodwill			14,133

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Translate Foreign Operation

Example

Consolidation journals (for NCI at old approach):

		Dr($)	Cr($)
Dr	Investment ($7,333 – $6,000)	1,333	
Cr	Profit or loss		1,333

To remeasure the previously held 20% in S at acquisition-date fair value

Dr	Property – fair value adjustment ($11,000 - $6,000)	5,000	
	Issued equity – subsidiary (given)	5,000	
	Retained earnings – subsidiary (given)	9,000	
	Goodwill (as calculated in last slide)	14,133	
Cr	Investment ($7,333 + $22,000)		29,333
	Non-controlling interest ($19,000 x 20%)		3,800

To recognise the goodwill and eliminate the investments with the equity shares

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Translate Foreign Operation

Example

On 1.1.2008	Parent P	Sub S	J#1	J#2	Consolidated
Property	$ 0	¥ 6,000		5,000	$ 11,000
Goodwill	0	0		14,133	14,133
Investment	28,000	0	1,333	(29,333)	0
Cash at bank	4,500	8,000			12,500
	32,500	14,000			37,633
Issued equity	$ (30,000)	¥ (5,000)		5,000	$ (30,000)
Retained earnings	(2,500)	(9,000)	(1,333)	9,000	(3,833)
Non-controlling int.	0	0		(3,800)	(3,800)
	(32,500)	(14,000)			(37,633)

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Translate Foreign Operation

Try this ……

Example

On 31.12.2008	Parent P	Sub S	Sub S
Property	$ 0	¥ 6,000	$ 12,000
Goodwill	0	0	0
Investment	28,000	0	0
Cash at bank	4,500	8,000	16,000
	32,500	14,000	28,000
Issued equity	$ (30,000)	¥ (5,000)	$(10,000)
Retained earnings	(2,500)	(9,000)	(18,000)
Translation reserves	0	0	0
Non-controlling int.	0	0	0
	(32,500)	(14,000)	(28,000)

Please prepare the consolidated balance sheet of Parent P as at 31.12.2008

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Translate Foreign Operation

Example

Consolidation journals:

		Dr($)	Cr($)
Dr	Investment ($7,333 – $6,000)	1,333	
Cr	Profit or loss		1,333

To remeasure the previously held 20% in S at acquisition-date fair value

Dr	Property – fair value adjustment (¥5,000 ÷ 0.5)	10,000	
	Issued equity – subsidiary (¥5,000 ÷ 0.5)	10,000	
	Retained earnings – subsidiary (¥9,000 ÷ 0.5)	18,000	
	Goodwill (¥14,133 ÷ 0.5)	28,266	
Cr	Investment		29,333
	Non-controlling interest (¥3,800 ÷ 0.5)		7,600
	Translation reserves (balancing figure)		**29,333**

To recognise the goodwill and eliminate the investments with the equity shares

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Translate Foreign Operation

Example

Calculation of translation reserves

- Net investment in Subsidiary S at RMB as at 1.1.2008:

Property	¥ 11,000
Cash	8,000
Goodwill	14,133
	¥ 33,133
Less: Non-controlling interest	(3,800)
	¥ *29,333*
Re-translated at 31.12.2008 (at HK$1 =RMB 0.5)	$ 58,666
Balance recognised at 1.1.2008 (at HK$ 1 = RMB 1)	(29,333)
Exchange gain recognised in translation reserve	$ 29,333

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Translate Foreign Operation

Example

On 31.12.2008	Parent P	Sub S	Sub S	J#1	J#2	Consolidated
Property	$ 0	¥ 6,000	$ 12,000		10,000	$ 22,000
Goodwill	0	0	0		28,266	28,266
Investment	28,000	0	0	1,333	(29,333)	0
Cash at bank	4,500	8,000	16,000			20,500
	32,500	14,000	28,000			70,766
Issued equity	$ (30,000)	¥ (5,000)	$(10,000)		10,000	$ (30,000)
Retained earnings	(2,500)	(9,000)	(18,000)	(1,333)	18,000	(3,833)
Translation reserve	0	0	0		(29,333)	(29,333)
Non-controlling int.	0	0	0		(7,600)	(7,600)
	(32,500)	(14,000)	(28,000)			(70,766)

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Translate Foreign Operation

Case

ESPRIT

Esprit Holdings Limited

- 2009 Annual Report stated accounting policy on foreign currency transactions and balances
  - On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments,
    - are taken to shareholders' equity.
  - When a foreign operation is sold,
    - such exchange differences are recognised in the income statement as part of the gain or loss on sale.
  - Goodwill and fair value adjustments arising on the acquisition of a foreign entity
    - are treated as assets and liabilities of the foreign entity and translated at the closing rate.

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2. Equity Accounting

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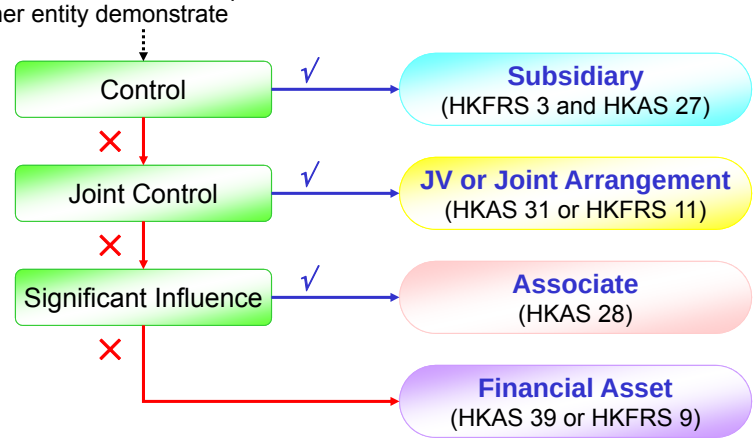
3. Equity Accounting

An entity shall consider whether all of its financial assets in respect of another entity demonstrate



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What is Associate?

- An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.
- Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.
  - A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).
  - Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
  - Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

What is Significant Influence?

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What is Associate?

- A significant influence is presumed for holding 20% or more of the voting power of the investee, unless it can be clearly demonstrated that this is not the case.
- No significant influence is presumed for holding less than 20% of the voting power of the investee, unless such influence can be clearly demonstrated.
- A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.
- The existence of significant influence by an investor is usually evidenced in one or more of the following ways:
  a) representation on the board of directors or equivalent governing body of the investee;
  b) participation in policy-making processes, including participation in decisions about dividends or other distributions;
  c) material transactions between the investor and the investee;
  d) interchange of managerial personnel; or
  e) provision of essential technical information.

What is Significant Influence?

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Apply Equity Method to an Associate

- An investment in an associate shall be accounted for using the equity method
  – whether or not the investor also has investments in subsidiaries and/or prepares consolidated financial statements
- Except when:
  a) the investment is classified as held for sale in accordance with HKFRS 5;
  b) the exception in HKAS 27, allowing a parent that also has an investment in an associate not to present consolidated financial statements, applies; or
  c) all of the following apply:
    i) the investor is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners do not object to such non-application;
    ii) the investor's debt or equity instruments are not traded in a public market;
    iii) the investor did not file, nor is it in the process of filing, its financial statements for *issuing any class of securities in a public market*; and
    iv) the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with HKFRSs/IFRSs.

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Apply Equity Method to an Associate

Implication

New rules as resulted

- Unless the above exemption rule can be relied upon
- Otherwise, an entity
  - which does not prepare consolidated financial statements and does not have subsidiaries
  - is still required to use Equity Method to account for associate in its financial statements
  - such financial statements are not separate financial statements as discussed in HKAS 27 and HKAS 28

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Apply Equity Method to an Associate

Example

Can the following entities have an exemption to account for associate by using equity method?

1. Entity A – non-HK incorporated and non-listed but 90% owned by Entity X which has prepared consolidated financial statements available for public use	Yes
2. Entity B – HK incorporated and non-listed but 90% owned by Entity X which has prepared consolidated financial statements available for public use	Yes
3. Entity C – HK incorporated and wholly owned by Entity Y, a BVI entity, which is not required to prepare consolidated financial statements	No Entity C follows the exemption rule in HKAS 28
4. Entity D – it is a single entity has no parent and no subsidiary (not required to prepare consolidation) but it has an associate	No The exemption rule cannot be fulfilled

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Apply Equity Method to an Associate

- **Rationale in Applying the Equity Method**
  - The recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate
    - because the distributions received may bear little relation to the performance of the associate.
  - The investor has significant influence over the associate, the investor has an interest in the associate's performance and, as a result, the return on its investment.
  - The investor accounts for this interest by extending the scope of its financial statements to include its share of profits or losses of such an associate. As a result, application of the equity method provides more informative reporting of the net assets and profit or loss of the investor

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Application of Equity Method

- **The equity method** is a method of accounting whereby
  - the investment is initially recognised at cost and
  - adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee.
- The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

Initial Cost

Share of post-acquisition change in net assets

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Application of Equity Method

A. Initial recognition & subsequent changes under the equity method

- The investment in an associate
  - is initially recognised at cost and
  - the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.
- The investor's share of the profit or loss of the investee
  - is recognised in the investor's profit or loss
  - distributions received from an investee reduce the carrying amount of the investment.

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Application of Equity Method

A. Initial recognition & subsequent changes under the equity method

- Adjustments to the carrying amount may include
  - changes in the investor's proportionate interest in the investee arising from **changes in the investee's other comprehensive income**
  - Such changes include those arising:
    a) from the revaluation of property, plant and equipment, and
    b) from foreign exchange translation differences.
  - The investor's share of those changes is recognised directly in other comprehensive income of the investor. (HKAS 28.11)
- When potential voting rights exist, the investor's share of profit or loss of the investee and of changes in the investee's equity is determined on
  - the basis of present ownership interests and
  - does not reflect the possible exercise or conversion of potential voting rights.

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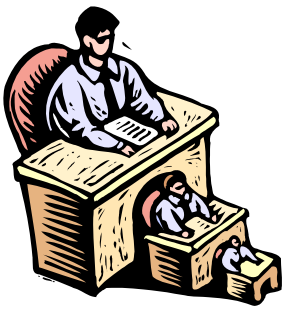
Application of Equity Method

B. Procedures on Application of the Equity Method



- Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures described in HKAS 27.
- Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.

Similar to HKAS 27

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Application of Equity Method

C. Complex Holding Structure

- A group's share in an associate
  - is the aggregate of the holdings in that associate by the parent and its subsidiaries.
- The holdings of the group's other associates or joint ventures
  - are ignored for this purpose.
- When an associate has subsidiaries, associates, or joint ventures,
  - the profits or losses and net assets taken into account in applying the equity method are
    - those recognised in the associate's financial statements,
    - after any adjustments necessary to give effect to uniform accounting policies.

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Application of Equity Method

D. Transactions with Associate

- Profits and losses resulting from 'upstream' and 'downstream' 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.
  - 'Upstream' transactions are, for example, sales of assets from an associate to the investor.
  - 'Downstream' transactions are, for example, sales of assets from the investor to an associate. The investor's share in the associate's profits and losses resulting from these transactions is eliminated.

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Application of Equity Method

E. Acquisition of Associate

- On acquisition of the associate, goodwill or gain from bargain purchase is accounted for as follows:
  - Goodwill
    - included in the carrying amount of the investment
    - amortisation of that goodwill is not permitted.
  - Gain from bargain purchase
    - is included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.

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Application of Equity Method

E. Acquisition of Associate

- Appropriate adjustments to the investor's share of the associate's profits or losses after acquisition are also made to account,
  - for example, for depreciation of the depreciable assets, based on their fair values at the acquisition date.
- Similarly, appropriate adjustments to the investor's share of the associate's profits or losses after acquisition are made
  - for impairment losses recognised by the associate, such as for
    - goodwill or
    - property, plant and equipment.

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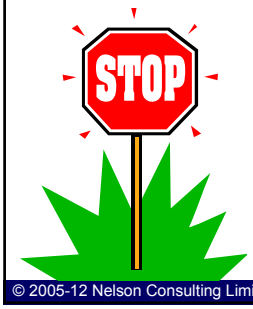
Application of Equity Method

F. Cease to Have Significant Influence

- An investor shall discontinue the use of the equity method from the date when it ceases to have significant influence over an associate and
- shall account for the investment in accordance with HKAS 39 from that date
  - (provided the associate does not become a subsidiary or a joint venture as defined in HKAS 31)



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Application of Equity Method

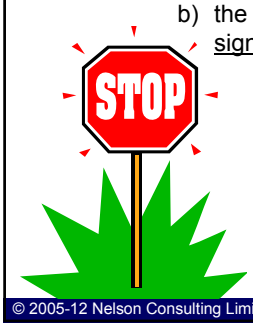
F. Cease to Have Significant Influence

– On the loss of significant influence, the investor shall measure at **fair value** any investment the investor retains in the former associate.

- The investor shall recognise in profit or loss any difference between:

  a) the **fair value** of any retained investment and any **proceeds from disposing of** the part interest in the associate; and

  b) the **carrying amount of the investment** at the date when significant influence is lost. (HKAS 28.18)



– When an investment ceases to be an associate and is accounted for in accordance with HKAS 39,

- the fair value of the investment at the date that when it ceases to be an associate shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKAS 39. (HKAS 28.19)

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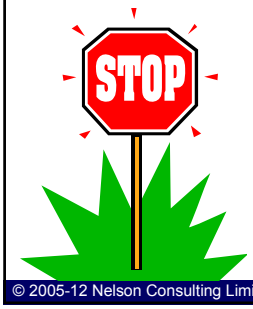
Application of Equity Method

F. Cease to Have Significant Influence

– If an investor loses significant influence over an associate,

- the investor shall account for all amounts recognised in other comprehensive income in relation to that associate on the same basis as would be required if the associate had directly disposed of the related assets or liabilities. (HKAS 28.19A)



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Application of Equity Method

Example

ABC's associate has available-for-sale financial assets and it loses significant influence over the associate.

- If a gain or loss previously recognised in other comprehensive income by an associate would be reclassified to profit or loss on the disposal of the related assets or liabilities,
  - the investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses significant influence over the associate. (HKAS 28.19A)
- In consequence, when ABC's associate has available-for-sale financial assets and it loses significant influence over the associate,
  - ABC shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets.

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Application of Equity Method

- **Ownership Interest Reduced but Continue to be an Associate**
  - If an investor's ownership interest in an associate is reduced, but the investment continues to be an associate,
    - the investor shall reclassify to profit or loss only a proportionate amount of the gain or loss previously recognised in other comprehensive income. (HKAS 28.19A)

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Share of Associate's Losses

In **HKAS 28**, if an investor's share of losses of an associate equals or exceeds its interest in the associate (so-called the base against losses)

- the investor discontinues recognising its share of further losses.

In **HKAS 28**

- A broader base, the interest in an associate, is used
- It includes
  - the carrying amount of the investment in the associate under the equity method together with
  - any long-term interests that, in substance, form part of the investor's net investment in the associate.

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Share of Associate's Losses

HKAS 28 further clarifies that:

- Losses recognised under the equity method in excess of the investor's investment in ordinary shares
  - are applied to the other components of the investor's interest in an associate in the reverse order of their seniority (i.e. priority in liquidation).
- After the investor's interest is reduced to zero
  - additional losses are provided for, and a liability is recognised, only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate.
- If the associate subsequently reports profits
  - the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

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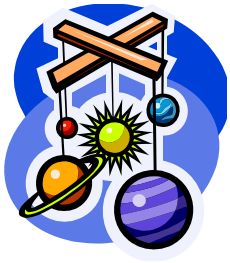
Share of Associate's Losses

Example

Examples of long-term interests form part of the investor's net investment:

- An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate.
- Such items may include:
  - Preferred shares
  - Long-term receivables or loans
- But do not include
  - Trade receivables
  - Trade payables or
  - Any long-term receivables for which adequate collateral exists, such as secured loans.



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Share of Associate's Losses

Case

ESPRIT

Esprit Holdings Limited

- 2009 Annual Report stated
  - The Group's share of its associates' post-acquisition profits or losses is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves.
  - The cumulative post-acquisition movements are adjusted against the carrying amount of the investment.
  - When the Group's share of losses in an associate equals or exceeds its interest in the associate, including any long-term interests that form part of the investor's net investment in the associates, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

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Associate Held for Sale

- As discussed, an investment in an associate shall not be accounted for using the equity method when
  - the investment is classified as held for sale in accordance with HKFRS 5
- Such investments described above shall be accounted for in accordance with HKFRS 5.

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Associate Held for Sale

Ceased to be held for sale

- When an investment in an associate previously classified as held for sale no longer meets the criteria to be so classified
  - it shall be accounted for using the equity method as from the date of its classification as held for sale.
  - Financial statements for the periods since classification as held for sale shall be amended accordingly

    (i.e. all financial statements for the prior periods shall be amended)

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Associate Held for Sale

Example

- Entity Jedi acquired 30% interest in Neo in Year 0 at $20,000 without any goodwill in the acquisition and accounted it as an associate.
- In July of Year 0, Jedi decided to sell Neo and classified it as held for sale. Then, for Year 0, Neo reported a loss of $10,000.
- Fair value less cost to sale of Neo was $20,000 in Year 0 and Year 1.
- At the end of Year 1, Neo reported a further loss of $10,000.
- By reviewing the criteria in HKFRS 5, Neo can no longer be classified as held for sale at the end of Year 1.
- Jedi's balance sheet in Year 0 while Neo was classified as held for sale:

	Year 0
Investment in associate held for sale	$20,000

- Jedi's balance sheet in Year 1:

	Year 1	Year 0 (Restated)
Interests in associate	$14,000 ($17,000 - $10,000 x 30%)	$17,000 ($20,000 - $10,000 x 30%)

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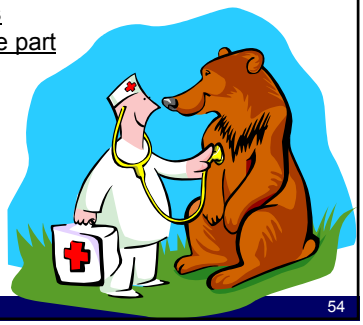
Impairment Losses

- After application of the equity method including recognising the associate's losses,
  - the investor applies the requirements of HKAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.
  - The investor also applies the requirements of HKAS 39 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.



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Impairment Losses

- Because goodwill that forms part of the carrying amount of an investment in an associate is not separately recognised,
  - it is not tested for impairment separately by applying the requirements for impairment testing goodwill in HKAS 36 *Impairment of Assets*.
- Instead, the entire carrying amount of the investment is tested for impairment in accordance with HKAS 36 as a single asset, by comparing
  - its recoverable amount (higher of value in use and fair value less costs to sell) with
  - its carrying amount,

  whenever application of the requirements in HKAS 39 indicates that the investment may be impaired.

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Impairment Losses

- An impairment loss recognised in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate.
- Accordingly, any reversal of that impairment loss is recognised in accordance with HKAS 36 to the extent that the recoverable amount of the investment subsequently increases. (HKAS 28.33)

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Impairment Losses

- In determining the value in use of the investment, an entity estimates:
  a) its share of the present value of the estimated future cash flows expected to be generated by the associate,
     - including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or
  b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal. (HKAS 28.33)
- Under appropriate assumptions, both methods give the same result. (HKAS 28.33)
- The recoverable amount of an investment in an associate is assessed for each associate,
  – unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity. (HKAS 28.34)

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Disclosure

- **The following disclosures shall be made:**
  a) fair value of investments in associates for which there are published price quotations;
  b) summarised financial information of associates, including the aggregated amounts of assets, liabilities, revenues and profit or loss;
  c) the reasons why the presumption that an investor does not have significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting or potential voting power of the investee but concludes that it has significant influence;
  d) the reasons why the presumption that an investor has significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, 20% or more of the voting or potential voting power of the investee but concludes that it does not have significant influence;
  e) the reporting date of the financial statements of an associate, when such financial statements are used in applying the equity method and are as of a reporting date or for a period that is different from that of the investor, and the reason for using a different reporting date or different period;

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Disclosure

- **The following disclosures shall be made:**
  - f) the nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements or regulatory requirements) on the ability of associates to transfer funds to the investor in the form of cash dividends, or repayment of loans or advances;
  - g) the unrecognised share of losses of an associate, both for the period and cumulatively, if an investor has discontinued recognition of its share of losses of an associate;
  - (h) the fact that an associate is not accounted for using the equity method in accordance with HKAS 28; and
  - (i) summarised financial information of associates, either individually or in groups, that are not accounted for using the equity method, including the amounts of total assets, total liabilities, revenues and profit or loss.

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Disclosure

- Investments in associates accounted for using the equity method shall be **classified as non-current assets**.
- The investor's share of the profit or loss of such associates, and the carrying amount of those investments, shall be **separately disclosed**.
- The investor's share of any discontinued operations of such associates shall also be **separately disclosed**. (HKAS 28.38)
- The investor's share of changes recognised in other comprehensive income by the associate shall be recognised by the investor **in other comprehensive income**. (HKAS 28.39)
- In accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the investor shall disclose:
  - a) its share of the contingent liabilities of an associate incurred jointly with other investors; and
  - b) those contingent liabilities that arise because the investor is severally liable for all or part of the liabilities of the associate. (HKAS 28.40)

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Disclosure

Example

	2009	2008
Income statement (extract)		
• Share of profits of associates (net of tax expenses)	X	X
Notes to financial statements		
Summary financial information on associates:		
• Assets	X	X
• Liabilities	X	X
• Revenues	X	X
• Profit/(Loss)	X	X

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3. Proportionate Consolidation

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Scope

- A venturer with an interest in a jointly controlled entity is also exempted from complying HKAS 31 when it meets the following conditions:
  a) the investment is classified as held for sale in accordance with HKFRS 5;
  b) the exception in HKAS 27, allowing a parent that has an interest in a jointly controlled entity not to present consolidated financial statements, applies; or
  c) all of the following apply:
     i) the investor is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners do not object to such non-application;
     ii) the investor's debt or equity instruments are not traded in a public market;
     iii) the investor did not file, nor is it in the process of filing, its financial statements for *issuing any class of securities in a public market*; and
     iv) the ultimate or any intermediate parent of the investor produces consolidated financial statements available for public use that comply with HKFRSs/IFRSs.

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Scope

Implication

Same as HKAS 28

- Unless the above exemption rule can be relied upon
- Otherwise, an entity
  – which does not prepare consolidated financial statements and does not have subsidiaries
  – is still required to use Proportionate Consolidation (to be discussed) or Equity Method in its financial statements to account for jointly controlled entities
  – such financial statements are not separate financial statements as discussed in HKAS 27 and HKAS 28

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Scope

- A venturer is a party to a joint venture and has joint control over that joint venture.
- An investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

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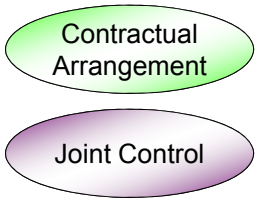
Definition

- A joint venture is a contractual arrangement whereby 2 or more parties undertake an economic activity that is subject to joint control.
- The following characteristics are common to all joint ventures:
  a) 2 or more venturers are bound by a contractual arrangement; and
  b) the contractual arrangement establishes joint control.



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Definition

- The existence of a contractual arrangement distinguishes interests that involve joint control from investments in associates in which the investor has significant influence.
  - Activities that have no contractual arrangement to establish joint control are not joint ventures for the purposes of HKAS 31.
  - The contractual arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers.
  - In some cases, the arrangement is incorporated in the articles or other by-laws of the joint venture.

Contractual Arrangement

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Definition

In **HKAS 31**

- Joint control is the contractually agreed sharing of control over an economic activity

  and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

What are the changes in HKFRS 11?

Joint Control

- Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.
- What is joint control?

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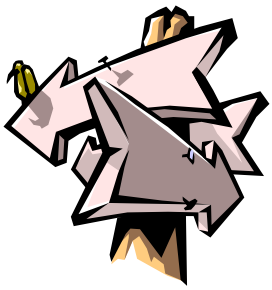
Forms of Joint Venture

- HKAS 31 identifies 3 broad types of joint ventures :

Jointly controlled operations

Jointly controlled assets

Jointly controlled entities



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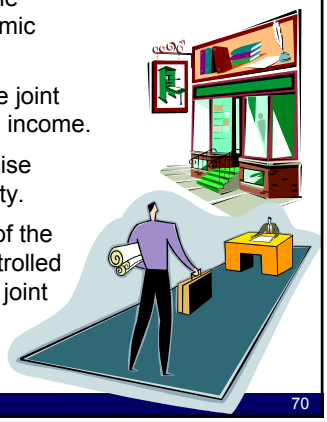
Jointly Controlled Entities

- A jointly controlled entity is a joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest.
  - The entity operates in the same way as other entities, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.
  - A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns income.
  - It may enter into contracts in its own name and raise finance for the purposes of the joint venture activity.
  - Each venturer is entitled to a share of the profits of the jointly controlled entity, although some jointly controlled entities also involve a sharing of the output of the joint venture.



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Jointly Controlled Entities

Recognition of jointly controlled entities:

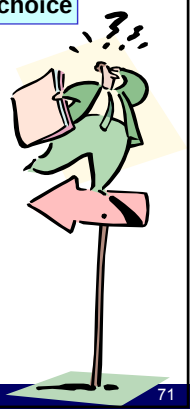
- A venturer shall recognise its interest in jointly controlled entity using either

  Proportionate Consolidation

  or

  Equity Method

  An entity has a choice



- When proportionate consolidation is used, one of the two reporting formats identified in HKAS 31 shall be used.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

- a method of accounting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity
  - <u>is combined line by line with similar items</u> in the venturer's financial statements, or
  - <u>reported as separate line items</u> in the venturer's financial statements
- A venturer recognises its interest in a jointly controlled entity using one of the two reporting formats for proportionate consolidation irrespective of whether it also has investments in subsidiaries or whether it describes its financial statements as consolidated financial statements.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

- When recognising an interest in a jointly controlled entity, it is essential that a venturer reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form.
- In a jointly controlled entity, a venturer has control over its share of future economic benefits through its share of the assets and liabilities of the venture.
- The application of proportionate consolidation means that the statement of financial position of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible.
- The statement of comprehensive income of the venturer includes its share of the income and expenses of the jointly controlled entity.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

- When **Proportionate Consolidation** is used, One of the Two Reporting Formats shall be used, the venturer may:

1. **Combine** its share of each of the assets, liabilities, income and expenses of the jointly controlled entity **with the similar items, line by line**, in its financial statements, or alternatively

2. **Include separate line items** for its share of the assets, liabilities, income and expenses of the jointly controlled entity in its financial statements

Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in subsidiaries, which are set out in HKAS 27.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

Two Reporting Format

Proportionate Consolidation Reporting Format 1 (PCRF 1)

1. **Combine with the similar items line by line**

2. **Include separate line items**

Proportionate Consolidation Reporting Format 2 (PCRF 2)

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Jointly Controlled Entities

Example

The financial statements of VT and its 50% jointly controlled entity, JCE, are set out below:

	VT	JCE	Equity Method	PCRF 1	PCRF 2
Non-current assets					
Property, plant & equipment	1,000	2,000	1,000	**2,000**	
Interest in JCE	500	0	**1,000**	0	
	1,500	2,000	2,000	2,000	
Current assets					
Account receivables	100	500	100	**350**	
Cash at bank	100	100	100	**150**	
	200	600	200	500	
Current liabilities					
Account payables	(100)	(600)	(100)	**(400)**	
Net current assets	100	0	100	100	
Net assets	*1,600*	*2,000*	*2,100*	*2,100*	2,100

1,000 PPE-VT
1,000 PPE-JCE

100 A/R-VT
250 A/R-JCE

100 Cash-VT
50 Cash-JEC

(100) A/P-VT
(300) A/P-JCE

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Jointly Controlled Entities

Example

The financial statements of VT and its 50% jointly controlled entity, JCE, are set out below:

	VT	JCE	Equity Method	PCRF 1	PCRF 2
Non-current assets					
PPE	1,000	2,000	1,000	2,000	1,000
PPE - JCE					1,000
Interest in JCE	500	0	1,000	0	0
	1,500	2,000	2,000	2,000	2,000
Current assets					
Inventories	100	500	100	350	100
Inventories – JCE					250
Cash at bank	100	100	100	150	100
Cash at bank - JCE	0	0	0	0	50
	200	600	200	500	500

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Jointly Controlled Entities

Example

	Equity Method	PCRF 1
Non-current assets		
Property, plant & equipment	1,000	**2,000**
Interest in JCE	**1,000**	0
	2,000	2,000
Current assets		
Account receivables	100	**350**
Cash at bank	100	**150**
	200	500
Total assets	2,200	2,500
Current liabilities		
Account payables	(100)	**(400)**
Net assets	*2,100*	*2,100*

PCRF

- Has a higher total assets
  ⇒ Return on total assets ↓
- Has a higher debt level
  ⇒ Gearing ↑
- Offsetting effect eliminated
- What's the difference between 49%, 50% and 51%?

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Jointly Controlled Entities

Case

Hopewell Highway Infrastructure Limited
合和公路基建有限公司

2009 Annual Report states:

- The Group reports its interests in jointly controlled entities
  - using the proportionate consolidation method based on the profit-sharing ratios or net cash flow sharing ratio (as the case may be) specified in the relevant joint venture agreements.
- The Group's share of the income, expenses, assets and liabilities of jointly controlled entities, other than the transactions and balances between the Group and jointly controlled entities,
  - are consolidated with the equivalent items in the consolidated financial information on a line-by-line basis.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

Two Reporting Formats

Proportionate Consolidation Reporting Format 1 (PCRF 1)

1. Combine with the similar items line by line

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

- A venturer shall discontinue the use of proportionate consolidation from the date on which it ceases to have joint control over a jointly controlled entity.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Equity Method

- As an alternative to proportionate consolidation described above, a venturer shall recognise its interest in a jointly controlled entity using the equity method
  - that is a method of accounting (same as described in HKAS 28) whereby
    - an interest in a jointly controlled entity is initially recorded at cost and
    - adjusted thereafter for the post-acquisition change in the venturer's share of net assets of the jointly controlled entity.
  - The profit or loss of the venturer includes the venturer's share of the profit or loss of the jointly controlled entity.
- A venturer recognises its interest in a jointly controlled entity using the equity method
  - irrespective of whether it also has investments in subsidiaries or whether it describes its financial statements as consolidated financial statements.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Equity Method

- HKAS 31 "does not recommend the use of the equity method
  - because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity, that is to say, control over the venturer's share of the future economic benefits."
- Nevertheless, HKAS 31 permits the use of the equity method,
  - as an alternative treatment, when recognising interests in jointly controlled entities.

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Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

Equity Method

Exceptions to Proportionate Consolidation and Equity Method

- Interests in jointly controlled entities that are classified as held for sale in accordance with HKFRS 5 shall be accounted for in accordance with that HKFRS 5.
- When an interest in a jointly controlled entity previously classified as held for sale no longer meets the criteria to be so classified, it shall be accounted for using proportionate consolidation or the equity method as from the date of its classification as held for sale.
- Financial statements for the periods since classification as held for sale shall be amended accordingly.

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Jointly Controlled Entities

Loss of Joint Control

- When an investor ceases to have joint control over an entity,
  - it shall account for any remaining investment in accordance with HKAS 39 from that date, provided that the former jointly controlled entity does not become a subsidiary or associate.
- From the date when a jointly controlled entity becomes a subsidiary of an investor
  - ➢ the investor shall account for its interest in accordance with HKAS 27 and HKFRS 3.
- From the date on which a jointly controlled entity becomes an associate of an investor
  - ➢ the investor shall account for its interest in accordance with HKAS 28. (HKAS 31.45)

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Jointly Controlled Entities

Similar to HKAS 28

Loss of Joint Control

- On the loss of joint control, the investor shall measure at **fair value** any investment the investor retains in the former jointly controlled entity.
  - The investor shall recognise in profit or loss any difference between:
    - a) the fair value of any retained investment and any proceeds from disposing of the part interest in the jointly controlled entity; and
    - b) the carrying amount of the investment at the date when joint control is lost. (HKAS 31.45)
- When an investment ceases to be a jointly controlled entity and is accounted for in accordance with HKAS 39,
  - the fair value of the investment when it ceases to be a jointly controlled entity shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKAS 39. (HKAS 31.45A)

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Jointly Controlled Entities

Similar to HKAS 28

Loss of Joint Control

- If an investor loses joint control of an entity,
  - the investor shall account for all amounts recognised in other comprehensive income in relation to that entity on the same basis as would be required if the jointly controlled entity had directly disposed of the related assets or liabilities. (HKAS 31.45B)

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Jointly Controlled Entities

Interest Reduced but Still Have Joint Control

- If an investor's ownership interest in a jointly controlled entity is reduced, but the investment continues to be a jointly controlled entity,
  - the investor shall reclassify to profit or loss only a proportionate amount of the gain or loss previously recognised in other comprehensive income. (HKAS 31.45B)

Similar to HKAS 28

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Disclosure

Contingent liabilities

- A venturer shall disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:
  a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities that have been incurred jointly with other venturers;
  b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and
  d) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

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Disclosure

Commitments

- A venturer shall disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:
  a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and
  b) its share of the capital commitments of the joint ventures themselves.

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Disclosure

Other disclosure

- A venturer shall disclose a listing and description of interests in significant joint ventures and the proportion of ownership interest held in jointly controlled entities.
- A venturer that recognises its interests in jointly controlled entities using the line-by-line reporting format for proportionate consolidation or the equity method shall disclose the aggregate amounts of each of current assets, long-term assets, current liabilities, long-term liabilities, income and expenses related to its interests in joint ventures.
- A venturer shall disclose the method it uses to recognise its interests in jointly controlled entities.

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Disclosure

Example

	2009	2008
Income statement (extract)		
Share of profits less losses of jointly controlled entities (net of tax expenses)	X	X
Notes to financial statements		
Summary financial information on jointly controlled entities related to the company's interests:		
– Non-current assets	X	X
– Current assets	X	X
– Non-current liabilities	X	X
– Current liabilities	X	X
– Net assets	X	X
– Income	X	X
– Expenses	X	X
– Profit/(Loss)	X	X

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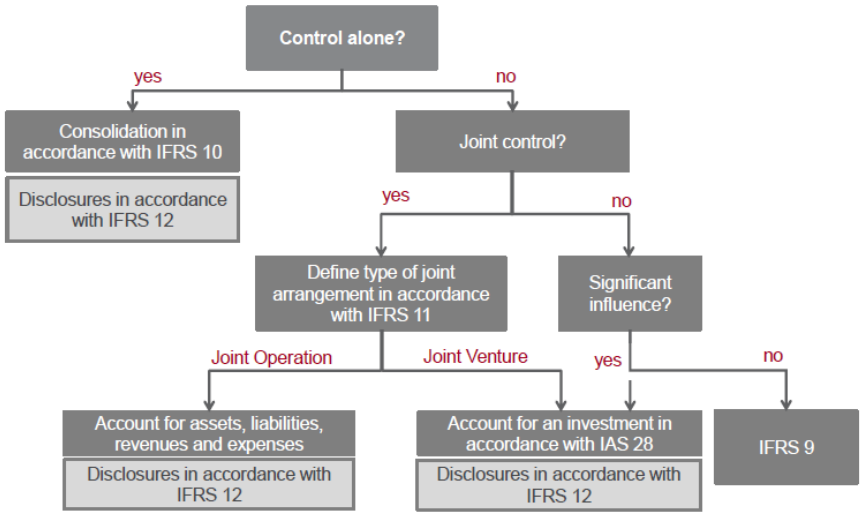
Briefing on HKFRS 10, 11 and 12

Interaction between IFRS/HKFRS 10, 11 and 12 and IAS/HKAS 28



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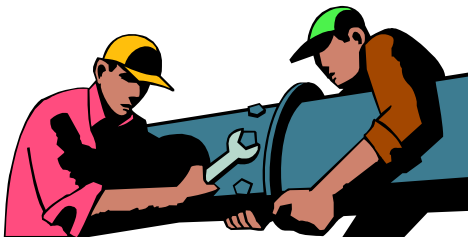
The graph is sourced from the IASB

Joint Arrangement

(HKFRS 11)



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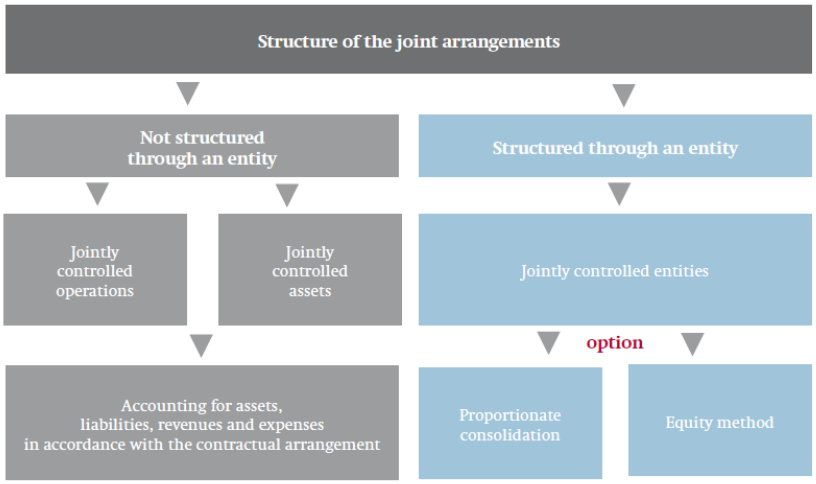
HKFRS 11 Joint Arrangements

Previously in HKAS 31



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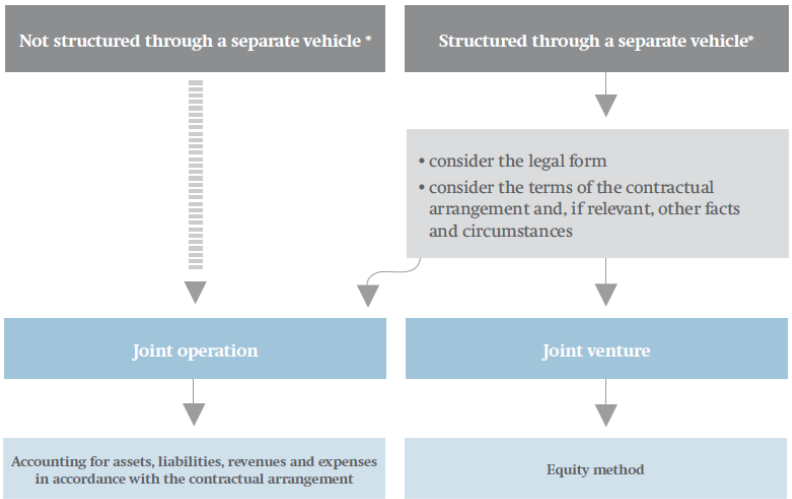
HKFRS 11 Joint Arrangements

Introduced and amended in HKFRS 11



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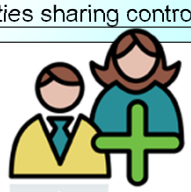
The graph is adapted from the IASB

HKFRS 11 Joint Arrangements

- **Joint Arrangement**,
  - a new name to subrogate joint venture, simultaneously, joint venture has another meaning now
  - is defined to be an arrangement of which two or more parties have **joint control**.
  - has the following characteristics:
    a. The parties are bound by a contractual arrangement .
    b. The contractual arrangement gives two or more of those parties joint control of the arrangement.
    (HKFRS 11.4-5)

Joint control is defined as

- the contractually agreed sharing of control of an arrangement,
- which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.



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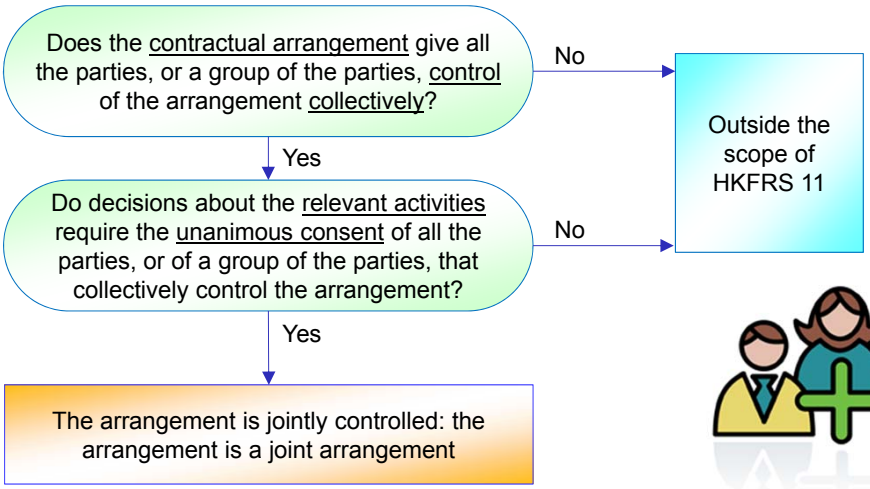
HKFRS 11 Joint Arrangements

Assessing Joint Control



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The graph is adapted from HKFRS 11.B10

HKFRS 11 Joint Arrangements

- In consequence, joint arrangement is a new name to subrogate joint venture,
  - simultaneously, joint venture has another meaning now
- A new structure in classification, a joint arrangement is either (HKFRS 11.6)

Joint Operation

Joint Venture

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HKFRS 11 Joint Arrangements

- An entity shall determine the type of joint arrangement in which it is involved.
- The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement. (HKFRS 11.14)

Joint Operation

Joint Venture

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HKFRS 11 Joint Arrangements

Joint Operation

Joint Venture

- When making assessment the rights and obligations arising from the arrangement, an entity shall consider the following:
  a. the structure of the joint arrangement
  b. when the joint arrangement is structured through a separate vehicle:
     i. the legal form of the separate vehicle;
     ii. the terms of the contractual arrangement; and
     iii. when relevant, other facts and circumstances. (HKFRS 11.B15)

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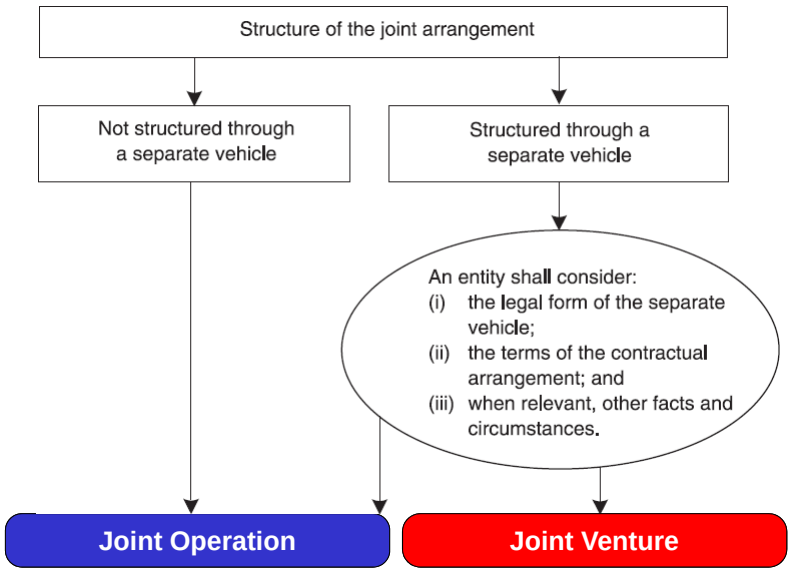
HKFRS 11 Joint Arrangements



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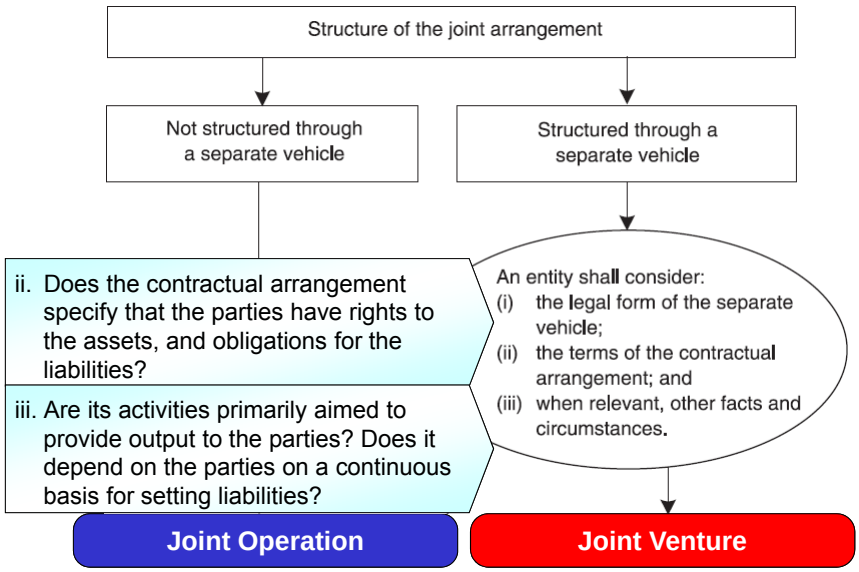
The graph is adapted from HKFRS 11.B21

HKFRS 11 Joint Arrangements



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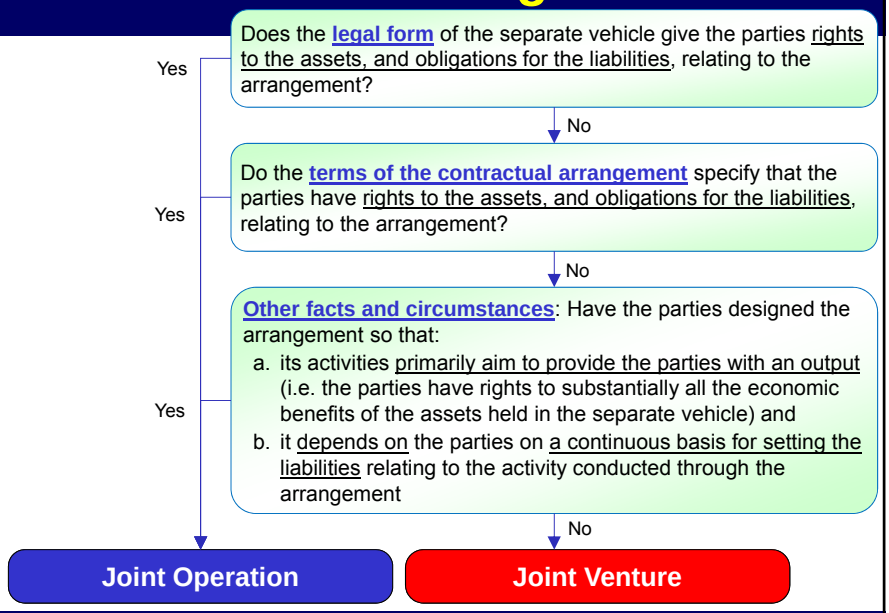
The graph is adapted from HKFRS 11.B21

HKFRS 11 Joint Arrangements



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The graph is adapted from HKFRS 11.B33

HKFRS 11 Joint Arrangements

Joint Operation

A joint operation is

- a joint arrangement whereby the parties that have joint control of the arrangement have rights to ***the assets, and obligations for the liabilities***, relating to the arrangement.

Those parties are called joint operators (HKFRS 11.15).

Joint Venture

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.

Those parties are called joint venturers (HKFRS 11.16).

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HKFRS 11 Joint Arrangements

Joint Operation

- A joint operator shall recognise in relation to its interest in a joint operation:
  a. its assets, including its share of any assets held jointly;
  b. its liabilities, including its share of any liabilities incurred jointly;
  c. its revenue from the sale of its share of the output arising from the joint operation;
  d. its share of the revenue from the sale of the output by the joint operation; and
  e. its expenses, including its share of any expenses incurred jointly. (HKFRS 11.20)

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HKFRS 11 Joint Arrangements

Joint Venture

- A joint venturer
  - shall recognise its interest in a joint venture ***as an investment*** and
  - shall account for that investment using ***the equity method*** in accordance with HKAS 28 *Investments in Associates and Joint Ventures*
    - unless the entity is exempted from applying the equity method as specified in HKAS 28 (HKFRS 11.24).
- HKAS 28 is renamed as "*Investments in Associates and Joint Ventures*"

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HKFRS 11: Effective Date

- An entity shall apply HKFRS 11 for annual periods beginning on or after 1 January 2013.
- Earlier application is permitted.
- If an entity applies HKFRS 11 earlier, it shall disclose that fact and apply HKFRS 10, HKFRS 12, HKAS 27 (as amended in 2011) and HKAS 28 (as amended in 2011) at the same time. (HKFRS 11.C1)

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Discl. Interests in Other Entities

(HKFRS 12)

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HKFRS 12 Discl. of Interest in Other Entities

- The objective of HKFRS 12 is to require an entity to disclose information that enables users of its financial statements to evaluate:
  a. the nature of, and risks associated with, its interests in other entities; and
  b. the effects of those interests on its financial position, financial performance and cash flows

  (HKFRS 12.1).

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HKFRS 12 Discl. of Interest in Other Entities

- To meet the objective of HKFRS 12, an entity shall disclose:
  a. the significant judgements and assumptions it has made
     - in determining the nature of its interest in another entity or arrangement, and
     - in determining the type of joint arrangement in which it has an interest; and
  b. information about its interests in:
     i. subsidiaries;
     ii. joint arrangements and associates; and
     iii. ***structured entities*** that are not controlled by the entity (unconsolidated structured entities) (HKFRS 12.2).

What is Structured Entity?

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HKFRS 12 Discl. of Interest in Other Entities

- Structured entity is defined as:
  - An entity that has been designed so that
    - voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and
    - the *relevant activities* are directed by means of contractual arrangements.
- HKFRS 12.B22–B24 provide further information about structured entities.

What is Structured Entity?

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HKFRS 12 Discl. of Interest in Other Entities

- Structured entity often has some or all of the following features or attributes:
  a. restricted activities.
  b. a narrow and well-defined objective, such as
     - to effect a tax-efficient lease,
     - to carry out research and development activities,
     - to provide a source of capital or funding to an entity or
     - to provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors.
  c. insufficient equity to permit the structured entity to finance its activities without subordinated financial support.
  d. financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches). (HKFRS 12.B22).

Examples include:

a. securitisation vehicles,
b. asset-backed financings.
c. some investment funds.

What is Structured Entity?

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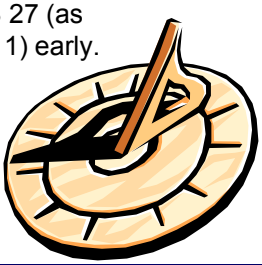
HKFRS 12: Effective Date

- An entity shall apply HKFRS 12 for annual periods beginning on or after 1 January 2013.
- Earlier application is permitted.
- An entity is encouraged to provide information required by HKFRS 12 earlier than annual periods beginning on or after 1 January 2013.
- Providing some of the disclosures required by HKFRS 12 does not compel the entity to comply with all the requirements of HKFRS 12 or to apply HKFRS 10, HKFRS 11, HKAS 27 (as amended in 2011) and HKAS 28 (as amended in 2011) early. (HKFRS 12.C1)



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Consolidated Financial Statements

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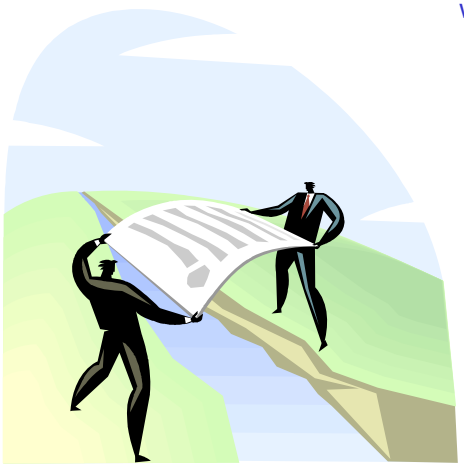

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