HKAS 27 Consolidated and Separate Financial Statements[1]

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1. Scope of HKAS 27

Hong Kong Accounting Standard (HKAS) 27* Consolidated and Separate Financial Statements *shall be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. *(HKAS 27 para. 1)*[2]

> ***Consolidated financial statements* are the financial statements of a group presented as those of a single economic entity. A *group* is a parent and all its subsidiaries.** *(HKAS 27 para. 4)*

HKAS 27 does not deal with methods of accounting for business combinations and their effects on consolidation, including goodwill arising on a business combination; instead they are covered in Hong Kong Financial Reporting Standard (HKFRS) 3 *Business Combinations*.

HKAS 27 shall also be applied in accounting for investments in subsidiaries, jointly controlled entities and associates when an entity elects, or is required by local regulations, to present separate financial statements. *(HKAS 27 para. 3)*

2. Presentation of Consolidated Financial Statements

A parent, other than a parent described in section 2.1 below (i.e. paragraph 10 of HKAS 27), shall present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with HKAS 27. *(HKAS 27 para. 9)*

> ***A parent is an entity that has one or more subsidiaries. A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).*** *(HKAS 27 para. 4)*

A parent or its subsidiary may be an investor in an associate or a venturer in a jointly controlled entity. In such cases, consolidated financial statements prepared and presented in accordance with HKAS 27 are also prepared so as to comply with HKAS 28 *Investments in Associates* and HKAS 31 *Interests in Joint Ventures*.

For an entity described in the above paragraph, separate financial statements are those prepared and presented in addition to the financial statements referred to in the above paragraph. Separate financial statements need not be appended to, or accompany, those statements. (See section 5 below)

2.1 Exemption in HKAS 27

A parent need not present consolidated financial statements if and only if:

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

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[1] *This note is sourced from HKAS 27 Consolidated and Separate Financial Statements. While the note is aimed at covering all critical points of HKAS 27, a complete and comprehensive coverage should still be the original standard, HKAS 27.*

[2] *All the paragraphs in the HKAS have equal authority now. While certain paragraphs in HKAS are highlighted in bold and italic, the same format is adopted in this note for those paragraphs.*

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

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

(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with HKFRSs or International Financial Reporting Standards (IFRSs). *(HKAS 27 para. 10)*

A parent that elects in accordance with the above paragraph not to present consolidated financial statements, and presents only separate financial statements, complies with the requirements set out in section 5 below (paragraphs 37-42 of HKAS 27).

A parent that is exempted in accordance with this section from presenting consolidated financial statements may present separate financial statements as its only financial statements. (See section 5 below)

2.2 Exemption in the Hong Kong Companies Ordinance

Section 124(2) of the Hong Kong Companies Ordinance permits a holding company not to prepare group accounts if the company is a wholly-owned subsidiary of another company at the end of its financial year.

Accordingly, a Hong Kong incorporated parent company can only take advantage of the exemption under section 2.1 above (i.e. paragraph 10 of HKAS) if it also satisfies the exemption allowed under the above section (section 124(2) of the Hong Kong Companies Ordinance).

3. Scope of Consolidated Financial Statements

Consolidated financial statements shall include all subsidiaries of the parent. *(HKAS 27 para. 12)*

As defined above, ***a <u>subsidiary</u> is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).***

<u>Control</u> is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. *(HKAS 27 para. 4)*

If on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it shall be accounted for in accordance with that Standard.

3.1 Control

Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.

Control also exists when the parent owns half or less of the voting power of an entity when there is:

(a) power over more than half of the voting rights by virtue of an agreement with other investors;

(b) power to govern the financial and operating policies of the entity under a statute or an agreement;

(c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or

(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

3.2 Potential voting rights

An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (**potential voting rights**).

The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, are considered when assessing whether an entity has the power to govern the financial and operating policies of another entity. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

In assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert.

3.3 Loss of control

A parent loses control when it loses the power to govern the financial and operating policies of an investee so as to obtain benefit from its activities.

The loss of control can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when a subsidiary becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual agreement.

3.4 Special purpose entities[3]

An entity may be created to accomplish a narrow and well-defined objective (e.g., to effect a lease, research and development activities or a securitisation of financial assets). Such a special purpose entity (SPE) may take the form of a corporation, trust, partnership or unincorporated entity.

3.4.1 Features of special purpose entities

SPEs are often created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the operations of the SPE. Frequently, these provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its creator or sponsor (i.e., they operate on so-called "autopilot").

The sponsor (or entity on whose behalf the SPE was created) frequently transfers assets to the SPE, obtains the right to use assets held by the SPE or performs services for the SPE, while other parties ("capital providers") may provide the funding to the SPE. An entity that engages in transactions with an SPE (frequently the creator or sponsor) may in substance control the SPE.

A beneficial interest in an SPE may, for example, take the form of a debt instrument, an equity instrument, a participation right, a residual interest or a lease. Some beneficial interests may simply provide the holder with a fixed or stated rate of return, while others give the holder rights or access to other future economic benefits of the SPE's activities. In most cases, the creator or sponsor (or the entity on whose behalf the SPE was created) retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity.

3.4.2 Consolidation of special purpose entities

HKAS 27 requires the consolidation of entities that are controlled by the reporting entity. Thus, an SPE should be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity.

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[3] *Source from HKAS Interpretation 12 Consolidation – Special Purpose Entities.*

In the context of an SPE, control may arise through the predetermination of the activities of the SPE (operating on "autopilot") or otherwise. Section 3.1 above indicates several circumstances which result in control even in cases where an entity owns one half or less of the voting power of another entity. Similarly, control may exist even in cases where an entity owns little or none of the SPE's equity. The application of the control concept requires, in each case, judgement in the context of all relevant factors.

In addition to the situations described in section 3.1 above, the following circumstances, for example, may indicate a relationship in which an entity controls an SPE and consequently should consolidate the SPE:

(a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation;

(b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "autopilot" mechanism, the entity has delegated these decision making powers;

(c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or

(d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

Examples: Indicators of Control Over an SPE

(a) Activities

The activities of the SPE, in substance, are being conducted on behalf of the reporting entity, which directly or indirectly created the SPE according to its specific business needs.

Examples are:

- the SPE is principally engaged in providing a source of long-term capital to an entity or funding to support an entity's ongoing major or central operations; or
- the SPE provides a supply of goods or services that is consistent with an entity's ongoing major or central operations which, without the existence of the SPE, would have to be provided by the entity itself. Economic dependence of an entity on the reporting entity (such as relations of suppliers to a significant customer) does not, by itself, lead to control.

(b) Decision-making

The reporting entity, in substance, has the decision-making powers to control or to obtain control of the SPE or its assets, including certain decision-making powers coming into existence after the formation of the SPE. Such decision making powers may have been delegated by establishing an "autopilot" mechanism.

Examples are:

- power to unilaterally dissolve an SPE;
- power to change the SPE's charter or bylaws; or
- power to veto proposed changes of the SPE's charter or bylaws.

(c) Benefits

The reporting entity, in substance, has rights to obtain a majority of the benefits of the SPE's activities through a statute, contract, agreement, or trust deed, or any other scheme, arrangement or device. Such rights to benefits in the SPE may be indicators of control when they are specified in favour of an entity that is engaged in transactions with an SPE and that entity stands to gain those benefits from the financial performance of the SPE.

Examples are:

- rights to a majority of any economic benefits distributed by an entity in the form of future net cash flows, earnings, net assets, or other economic benefits; or
- rights to majority residual interests in scheduled residual distributions or in a liquidation of the SPE.

(d) Risks

An indication of control may be obtained by evaluating the risks of each party engaging in transactions with an SPE. Frequently, the reporting entity guarantees a return or credit protection directly or indirectly through the SPE to outside investors who provide substantially all of the capital to the SPE. As a result of the guarantee, the entity retains residual or ownership risks and the investors are, in substance, only lenders because their exposure to gains and losses is limited.

Examples are:

- the capital providers do not have a significant interest in the underlying net assets of the SPE;
- the capital providers do not have rights to the future economic benefits of the SPE;
- the capital providers are not substantively exposed to the inherent risks of the underlying net assets or operations of the SPE; or
- in substance, the capital providers receive mainly consideration equivalent toa lender's return through a debt or equity interest.

3.5 Subsidiary excluded from consolidation

A subsidiary is not excluded from consolidation simply because the investor is a venture capital organisation, mutual fund, unit trust or similar entity.

A subsidiary is not excluded from consolidation because its business activities are dissimilar from those of the other entities within the group. Relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by HKAS 14 *Segment Reporting* help to explain the significance of different business activities within the group.

4. Consolidation Procedures

4.1 General procedures

In preparing consolidated financial statements, an entity combines the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single economic entity, the following steps are then taken:

(a) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated (see HKFRS 3, which describes the treatment of any resultant goodwill);

(b) minority interests in the profit or loss of consolidated subsidiaries for the reporting period are identified; and

(c) minority interests in the net assets of consolidated subsidiaries are identified separately from the parent shareholders' equity in them. Minority interests in the net assets consist of:

(i) the amount of those minority interests at the date of the original combination calculated in accordance with HKFRS 3; and

(ii) the minority's share of changes in equity since the date of the combination.

When potential voting rights exist, the proportions of profit or loss and changes in equity allocated to the parent and minority interests are determined on the basis of present ownership interests and do not reflect the possible exercise or conversion of potential voting rights.

4.2 Intragroup balances, transactions, income and expenses

Intragroup balances, transactions, income and expenses shall be eliminated in full. *(HKAS 27 para. 24)*

Intragroup balances and transactions, including income, expenses and dividends, are eliminated in full. Profits and losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full. Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. HKAS 12 *Income Taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.

4.3 Same reporting date of parent and subsidiaries

The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as of the same reporting date. When the reporting dates of the parent and a subsidiary are different, the subsidiary prepares, for consolidation purposes, additional financial statements as of the same date as the financial statements of the parent unless it is impracticable to do so. *(HKAS 27 para. 26)*

When, in accordance with the above paragraph (paragraph 26 of HKAS 27), the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a reporting date different from that of the parent, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the parent's financial statements.

In any case, the difference between the reporting date of the subsidiary and that of the parent shall be no more than three months. The length of the reporting periods and any difference in the reporting dates shall be the same from period to period. *(HKAS 27 para. 27)*

4.4 Uniform accounting policies

Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances. *(HKAS 27 para. 28)*

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements.

4.5 Income and expenses of a subsidiary

The income and expenses of a subsidiary are included in the consolidated financial statements from the acquisition date, as defined in HKFRS 3. The income and expenses of a subsidiary are included in the consolidated financial statements until the date on which the parent ceases to control the subsidiary.

The difference between the proceeds from the disposal of the subsidiary and its carrying amount as of the date of disposal, including the cumulative amount of any exchange differences that relate to the subsidiary recognised in equity in accordance with HKAS *21 The Effects of Changes in Foreign Exchange Rates*, is recognised in the consolidated income statement as the gain or loss on the disposal of the subsidiary.

4.6 Minority interest

<u>Minority interest</u> is that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent. *(HKAS 27 para. 4)*

Minority interests shall be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity. Minority interests in the profit or loss of the group shall also be separately disclosed. *(HKAS 27 para. 33)*

The profit or loss is attributed to the parent shareholders and minority interests. Because both are equity, the amount attributed to minority interests is not income or expense.

Losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the subsidiary's equity. The excess, and any further losses applicable to the minority, are allocated against the majority interest except to the extent that the minority has a binding obligation and is able to make

an additional investment to cover the losses. If the subsidiary subsequently reports profits, such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

If a subsidiary has outstanding cumulative preference shares that are held by minority interests and classified as equity, the parent computes its share of profits or losses after adjusting for the dividends on such shares, whether or not dividends have been declared.

4.7 Cease to be a subsidiary

An investment in an entity shall be accounted for in accordance with HKAS 39 from the date that it ceases to be a subsidiary, provided that it does not become an associate as defined in HKAS 28 or a jointly controlled entity as described in HKAS 31. *(HKAS 27 para. 31)*

The carrying amount of the investment at the date that the entity ceases to be a subsidiary shall be regarded as the cost on initial measurement of a financial asset in accordance with HKAS 39. *(HKAS 27 para. 32)*

Examination question

Question *Modified from ACCA Paper 3.6H 2003 June Question 4*

The managing partner has asked you, on behalf of a shareholder, to prepare a report on the financial and business position of Issue, a public limited company. There has been adverse press comment on the 'aggressive management of earnings' by the company and criticism of the management.

Issue provides internet-based electronic hosting, delivery and marketing services. The company was formed in 1999 with the Board promising to take the company into the top 10% of listed companies within five years. Management are highly motivated and are compensated in part via share/stock options. Management work in a pressurised environment.

Issue makes use of different corporate entities in order to finance its business. The company has borrowed $40 million from twenty different entities which are owned by a bank, which itself owns twenty per cent of the shares of Issue. Issue has deposited $35 million with the entities with the balance being shown as a current liability. The management of Issue say that the entities are not under their control and that because each amount borrowed is individually immaterial there is no need to disclose the relationship in the financial statements.

Prepare a report setting out the implications of the financial and other information outlined above.

Answers

Issue makes use of special purpose vehicles (SPV)/special purpose entities (SPE). Transactions with SPV/SPEs are often intended to shift assets/liabilities off the balance sheet and require special attention because of the often complex accounting and disclosure rules which apply.

The company has borrowed $40 million from twenty different entities and has deposited the majority of the borrowings with the SPV/SPEs in order that only the net amount of $5 million is shown in the financial satements. The use of such transactions poses a potential risk to an investor in the company as there are issues concerning the reasons why management uses such vehicles and the nature of the accounting treatment of these transactions. In this case it could be argued that the SPV/SPEs are subsidiaries of Issue rather than subsidiaries of the bank in which case the offset of the gross asset and liability could be achieved through a consolidation adjustment. The arrangements need to be carefully examined as it is important to determine whether the entities are subsidiaries of Issue or the bank.

Reference will be required to be made to HKFRS 3 *Business Combinations*, HKAS 27 *Consolidated and Separate Financial Statements* and the *Framework for the Preparation and Presentation of Financial Statements*. There will be a need to determine whether the bank is exposed to the potential loss of $5 million ($40 million – $35 million) indicating that it is the economic as well as the legal owner of the entities. There is a potential, therefore, for an additional $35 million of loans to be shown on the balance sheet of Issue, if the bank is in fact the owner of the entities and if the transaction does not meet the criteria for offset.

Also, the bank owns 20% of the shares of Issue and may be deemed a related party under HKAS 24 *Related Party Disclosures*. This heightens the risk of improper accounting and the possibility that the economic substance of the transaction may be other than its legal form, or that the transactions lack substance. Further, management's assertion that each individual transaction with the SPVs/SPEs is immaterial is not a valid one. Transactions of this nature should be looked at collectively and not individually.

5. Accounting for Investments in Subsidiaries, Jointly Controlled Entities and Associates in Separate Financial Statements

Separate financial statements ***are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees.*** *(HKAS 27 para. 4)*

The financial statements of an entity that does not have a subsidiary, associate or venturer's interest in a jointly controlled entity are not separate financial statements.

When separate financial statements are prepared, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 shall be accounted for either:

(a) at cost, or

(b) in accordance with HKAS 39.

The same accounting shall be applied for each category of investments. Investments in subsidiaries, jointly controlled entities and associates that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 shall be accounted for in accordance with that HKFRS. *(HKAS 27 para. 37)*

The cost method is a method of accounting for an investment whereby the investment is recognised at cost. The investor recognises income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment. *(HKAS 27 para. 4)*

HKAS 27 does not mandate which entities produce separate financial statements available for public use. The requirements set out in the section apply when an entity prepares separate financial statements that comply with HKFRSs. The entity also produces consolidated financial statements available for public use as required by paragraph 9 of HKAS 27 (see section 2 above), unless the exemption provided in paragraph 10 of HKAS 27 (see section 2.1 above) is applicable.

Investments in jointly controlled entities and associates that are accounted for in accordance with HKAS 39 in the consolidated financial statements shall be accounted for in the same way in the investor's separate financial statements. *(HKAS 27 para. 39)*

6. Disclosure

6.1 Disclosures in consolidated financial statements

The following disclosures shall be made in consolidated financial statements:

(a) the nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;

(b) the reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control;

(c) the reporting date of the financial statements of a subsidiary when such financial statements are used to prepare consolidated financial statements and are as of a reporting date or for a period that is different from that of the parent, and the reason for using a different reporting date or period; and

(d) the nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances. *(HKAS 27 para. 40)*

6.2 Disclosures in separate financial statements

When separate financial statements are prepared for a parent that, in accordance with section 2.1 above (paragraph 10 of HKAS 27), elects not to prepare consolidated financial statements, those separate financial statements shall disclose:

(a) the fact that the financial statements are separate financial statements;

that the exemption from consolidation has been used;

the name and country of incorporation or residence of the entity whose consolidated financial statements that comply with HKFRSs or IFRSs have been produced for public use; and

the address where those consolidated financial statements are obtainable;

(b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including

(i) the name,

(ii) country of incorporation or residence,

(iii) proportion of ownership interest and,

(iv) if different, proportion of voting power held; and

(c) a description of the method used to account for the investments listed under (b). *(HKAS 27 para. 41)*

When a parent (other than a parent covered by the above paragraph), venturer with an interest in a jointly controlled entity or an investor in an associate prepares separate financial statements, those separate financial statements shall disclose:

(a) the fact that the statements are separate financial statements and the reasons why those statements are prepared if not required by law;

(b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including

(i) the name,

(ii) country of incorporation or residence,

(iii) proportion of ownership interest and,

(iv) if different, proportion of voting power held; and

(c) a description of the method used to account for the investments listed under (b);

and shall identify the financial statements prepared in accordance with paragraph 9 of HKAS 27 (see section 2 above)***, HKAS 28 and HKAS 31 to which they relate.*** *(HKAS 27 para. 42)*

7. Specific Provisions for Hong Kong Incorporated Companies

HKAS 27 defines a subsidiary as "an entity that is controlled by another entity". For this purpose, control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. This definition of subsidiary could result in an investee entity being classified as a subsidiary when it does not meet the definition of a subsidiary as set out in section 2(4) of the Hong Kong Companies Ordinance.

7.1 Legal opinion on the definition of subsidiary

In issuing HKAS 27, the Hong Kong Institute of Certified Public Accountants has obtained legal advice on the legality of introducing a requirement in HKAS 27 to consolidate certain entities which are not subsidiaries as defined by section 2(4) of the Hong Kong Companies Ordinance in group accounts of a Hong Kong incorporated company.

The legal opinion states that the definitions of "subsidiary" and "holding company" in sections 2(4) and 2(7) of the Hong Kong Companies Ordinance are exhaustive for the purposes of group accounts as defined by section 124(1) of the Hong Kong Companies Ordinance.

Accordingly, a Hong Kong incorporated company may not consolidate a company that does not meet the definition of a subsidiary in the Hong Kong Companies Ordinance.

The principles laid down in HKAS 27 are applicable to Hong Kong incorporated companies except to the extent that the legal constraints do not permit them to include in their consolidated financial statements an entity which does not meet the definition of a subsidiary in the Hong Kong Companies Ordinance.

7.2 Definition of subsidiary inapplicable to HK incorporated companies

In preparing consolidated financial statements of a Hong Kong incorporated company, only companies that fall within the definition of a subsidiary as set out in section 2(4) of the Hong Kong Companies Ordinance may be consolidated. Therefore, for the purposes of applying HKAS 27, Hong Kong incorporated companies should use the definition of a subsidiary as set out in section 2(4) of the Hong Kong Companies Ordinance where it conflicts with the definition of subsidiary in HKAS 27 (see section 3 above)**.** *(HKAS 27 para. 21A)*

In the circumstances where a company is a subsidiary as defined by section 2(4) of the Hong Kong Companies Ordinance but the parent does not have unilateral control over it, it should not be dealt with in the consolidated financial statements as a subsidiary.

Where a subsidiary is excluded on the grounds of lack of effective control, it should be accounted for as a jointly controlled entity in accordance with HKAS 31 **Interests in Joint Ventures** ***or an associate in accordance with HKAS 28,*** **Investments in Associates***, as appropriate.* *(HKAS 27 para. 21B)*

7.3 Specific disclosures for HK incorporated companies

However, HKAS 27 requires Hong Kong incorporated companies to disclose certain additional information to enable users of the consolidated financial statements to assess the effects as if HKAS 27 had been fully complied with.

When a Hong Kong incorporated company holds an entity which would be a subsidiary as defined in HKAS 27 (see section 3) ***but is not accounted for as a subsidiary as a result of paragraph 21A*** (of HKAS 27, see section 7.2 above)***, it should disclose in the notes details of the effect on the consolidated financial statements had the exemption given in paragraph 21A*** (of HKAS 27) ***not applied.*** *(HKAS 27 para. 42A)*

8. Effective Date

An entity shall apply HKAS 27 for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies HKAS 27 for a period beginning before 1 January 2005, it shall disclose that fact and apply HKAS Interpretation (HKAS-Int 12) **Consolidation – Special Purpose Entities** ***at the same time.*** *(HKAS 27 para. 43)*

If an entity decides to apply HKAS 27 for an earlier period, it is not required to apply all the HKASs with the same effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period(s).