Business Combinations & Consolidation

(Under HKFRS and IFRS)

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Regulatory Framework in HK

In HK, the regulatory framework for consolidation is established by:

The Companies Ordinance (Chapter 32)	• Set out the legal boundary on a group and group accounts
HKFRS 3 Business Combinations (Revised in 2008)	• Specify the purchase method on accounting business combinations
HKAS 27 Consolidated and Separate Fin. Statements (Revised in 2008)	• Specify the consolidation requirements and procedures
AG 5 Merger Accounting for Common Control Combinations	• Describe the accounting of common control combinations

In addition, a group may have associate or joint venture that should be accounted for under:

- HKAS 28 Investments in Associates
- HKAS 31 Interests in Joint Ventures

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- HKFRS 3 Business Combinations (Revised in 2008)
- HKAS 27 Consolidated and Separate Fin. Statements (Revised in 2008)
- AG 5 Merger Accounting for Common Control Combinations

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- HKAS 28 Investments in Associates
- HKAS 31 Interests in Joint Ventures

From annual periods beginning on or after 1 January 2013

- Will become HKAS 27 *Separate Financial Statements*
- New HKFRS 10 *Consolidated Financial Statements*
- New HKFRS 12 *Disclosure of Interests in Other Entities*
- Will become HKAS 28 *Investments in Associates and Joint Ventures*
- Will be replaced by HKFRS 11 *Joint Arrangements*

Today's Agenda

- The Companies Ordinance (Chapter 32)
- HKFRS 3 Business Combinations (Revised in 2008)
- HKAS 27 Consolidated and Separate Fin. Statements (Revised in 2008)

From annual periods beginning on or after 1 January 2013

- Will become HKAS 27 *Separate Financial Statements*
- New HKFRS 10 *Consolidated Financial Statements*
- New HKFRS 12 *Disclosure of Interests in Other Entities*

蘋果日報（2011.5.28）

Case

Today's Agenda

The Companies Ordinance
(Chapter 32)

The Companies Ordinance

- Section 124 of the HK Companies Ordinance requires
  - a company to prepare **group accounts** if it has subsidiaries at the end of its financial year.
- Section 2(4) defines subsidiary as follows:

A company shall, subject to the provisions of subsection (6), be deemed to be a subsidiary of another company, if -

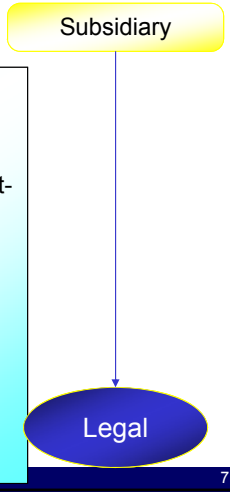
a) that other company -

i) controls the composition of the board of directors of the first-mentioned company; or

ii) controls more than half of the voting power of the first-mentioned company; or

iii) holds more than half of the issued share capital of the first-mentioned company (excluding any part of it which carries no right to participate beyond a specified amount in a distribution of either profits or capital); or

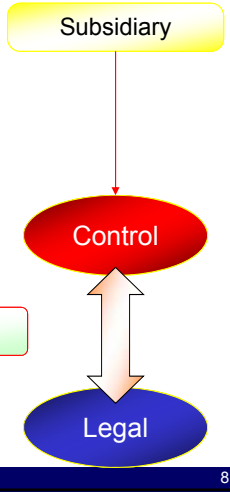
b) the first-mentioned company is a subsidiary of any company which is that other company's subsidiary.



HKAS 27 and HKFRS 3

- HKAS 27 requires that (except for one exempted)
  - a **parent**, shall present
    - **consolidated financial statements** in which it consolidates its investments in **subsidiaries** in accordance with HKAS 27.
      (consolidation is one kinds of group accounts)
- Under HKFRS 3 and HKAS 27
  - 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).

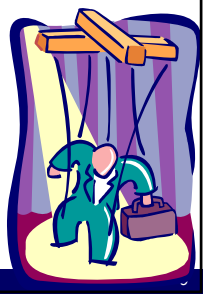
What is Control?



What is Control?

Control

- is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities
- is presumed to exist when the parent owns, directly or indirectly, 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.
- but 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.



What is Control?

Special Purpose Entities

- An entity
  - may be created to accomplish a narrow and well-defined objective
  - may take the form of a corporation, trust, partnership or unincorporated entity.
- The sponsor or creator frequently transfers assets to the SPE, obtains the right to use assets held by the SPE or performs services for the SPE.
- An entity that engages in transactions with an SPE
  - may in substance control the SPE
  - may have a beneficial interest in an SPE by, for example, taking the form of a debt or equity instrument, a participation right, a residual interest or a lease.
  - may have some beneficial interests by simply providing 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

What is Control?

Special Purpose Entities

- The followings, 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.

What is Control?

Example

- CFO of Anron established an entity, Jedy.
- Jedy's sole business is to obtain a loan of $8,000 from Bank BB to finance its purchase of property of $10,000.
- Anron tendered a corporate guarantee to Bank X for Jedy's loan and lent another $2,000 to Jedy.
- To compensate the loan and guarantee, Jedy promised to lease the property to Anron for 10 years and not to dispose of the property without Anron's prior agreement.
- Anron in turn derived an annual rental income of $1,000 from the property.
- Assess the impact and how the transaction should be accounted for.

Jedy's sole business is property holding

The residual risk is vested to Anron

Significant decision has to be approved by Anron

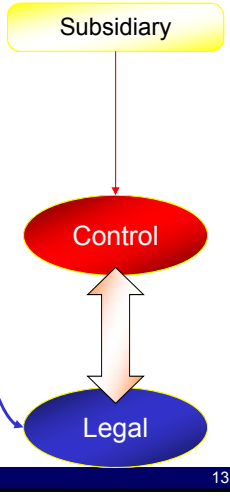
Anron obtained the right of majority of benefits

- In substance, Anron has control over Jedy and it should consolidate Jedy because of the above observation.

HKFRS vs. Companies Ordinance

- HK incorporated company may not consolidate a company that does not meet the definition of a subsidiary in the HK Companies Ordinance
- In preparing consolidated financial statements of a HK incorporated company
  - Only companies that fall within the definition of a subsidiary as set out in section 2(4) of the HK Companies Ordinance may be consolidated.
- When a HK incorporated company holds an entity which would be a subsidiary as defined in HKAS 27 but is not accounted for as a subsidiary as a result of the HK Companies Ordinance
  - it should disclose in the notes details of the effect on the consolidated financial statements had the requirements of HK Companies Ordinance not applied.

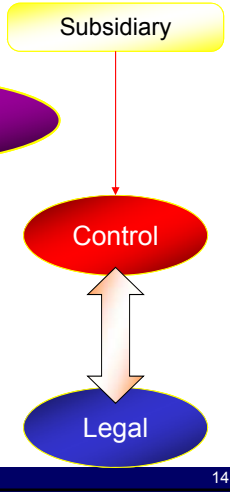
Changed since 2006!



Companies (Amendment) Ordinance 2005

Changes since 2006!

For annual periods beginning on or after 1 Jan. 2006:
- the Companies (Amendments) Ordinance 2005 becomes effective
- Consequential amendments in HKFRS 3 and HKAS 27 introduced by HKICPA in Dec. 2005



Companies (Amendment) Ordinance 2005

- The commencement date of the HK Companies (Amendment) Ordinance 2005 was gazetted on 7 Oct. 2005 as 1 Dec. 2005.

  ⇨ Implies that the Ordinance will be effective for the financial reporting periods beginning on or after 1 Jan. 2006.

- The Ordinance introduces a definition of "subsidiary undertaking"
  - an undertaking is defined as a body corporate, a partnership or an unincorporated association carrying on a trade or business, whether for profit or not
  - an entity is a subsidiary of a parent if that parent has "**the right to exercise a dominant influence**" over the subsidiary undertaking by virtue of
    - i) the provisions contained in the subsidiary undertaking's memorandum or articles or equivalent constitutional documents; or
    - ii) a control contract.

Aligned with HKAS ?

Companies (Amendment) Ordinance 2005

Under 23rd Schedule (a new sch.) of the Ordinance

- An undertaking shall not be regarded as having the right to exercise a dominant influence over another undertaking
  - unless it has the right to **gives directions** with respect to **the operating and financial policies of that other undertaking**
  - which the directors are, or a majority of the directors is, obliged to comply with whether or not they are for the benefit of the other undertaking

As a result, a parent is required to consolidate the entities (not only body corporate) if it has control over those entities.

Today's Agenda

HKAS 27 Consolidated and Separate Fin. Statements (Revised in 2008)

1. Scope

- 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.
- Consolidated financial statements are the financial statements of a group presented as those of a single economic entity.

Consolidated Financial Statements

2. Presentation of Consol. F.S.

- A parent, other than a parent descried below, shall present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with HKAS 27.
  - 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).
- A parent need not present consolidated financial statements if and only if:
  a) the parent is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners do not object such non-presenting
  b) the parent's debt or equity instruments are not traded in a public market;
  c) the parent did not file, nor is it in the process of filing, its financial statements with a regulatory organization for issuing 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 IFRSs.
  (disclosure is required on the address where those consolidated financial statements are obtainable)

3. Scope of Consol. Fin. Statement

- Consolidated financial statements shall include all subsidiaries of the parent.
- If on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with HKFRS 5, it shall be accounted for in accordance with HKFRS 5 (not HKAS 27).
  - It implies that exclusions are eliminated and
    - Control intended to be temporary should still meet HKFRS 5
    - Control of an entity, which is operating under severe long-term restrictions that significantly impair its ability to transfer funds to the parent, is no longer a reason to exclude a subsidiary

3. Scope of Consol. Fin. Statement

Subsidiary excluded from consolidation

- HKAS 27 specifically states that a subsidiary is NOT excluded from consolidation because
  - the investor is a venture capital organisation, mutual fund, unit trust or similar entity.
  - 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.

3. Scope of Consol. Fin. Statement

Section 124(2) of the HK Companies Ordinance has exemptions that:

- Group accounts need not deal with a subsidiary of the company if the company's directors are of opinion that
  - i) it is impracticable, *or* would be of no real value to members of the company, in view of the insignificant amount involved, *or* would involve expense or delay out of proportion to the value to members of the company; or
  - ii) the result would be misleading, or harmful to the business of the company or any of its subsidiaries; or
  - iii) the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking; and, if the directors are of such an opinion about each of the company's subsidiaries, group accounts shall not be required:

But 2 points should be taken care:

- Even the Companies Ordinance excluded that subsidiary,
  - **HKAS 27 has no such exclusion**
- the approval of the Financial Secretary shall be required
  - on the grounds that the result would be harmful or
  - on the ground of the difference between the business of the holding company and that of the subsidiary.

4. Consolidation Procedures

- Consolidation procedures are similar to previous standard, but ……
- Minority interests renamed as "non-controlling interests", which
  - is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

4. Consolidation Procedures

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 consolidation, the following steps are 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) non-controlling interests in the profit or loss of consolidated subsidiaries for the reporting period are identified; and
  c) non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the parent shareholders' equity in them. Non-controlling interests in the net assets consist of:
     i) the amount of those non-controlling interests at the date of the original combination calculated in accordance with HKFRS 3; and
     ii) the non-controlling interests' share of changes in equity since the date of the combination.

4. Consolidation Procedures

Example

Entity A acquired 80% of Entity X at year end by issuing 1,600 shares of HK$1 each and their financial statements are set out below:

	A	X
Non-current assets		
Property, plant & equipment	1,500	2,000
Current assets		
Inventories	100	500
Cash at bank	100	100
	200	600
Current liabilities		
Account payables	(100)	(600)
Net current assets	100	0
Net assets	*1,600*	*2,000*
Share capital	100	200
Reserves	1,500	1,800
	1,600	2,000

Please prepare

- The journals and/or consolidation journals
- The consolidation spreadsheet
- The consolidated balance sheet right after the acquisition

4. Consolidation Procedures

Example

Journal and consolidation journal:

		Dr($)	Cr($)
On the company level of Entity A			
Dr	Investment in subsidiary	1,600	
Cr	Share capital		1,600
Being the shares issued to acquire Entity X			
On the consolidated level (consolidation journal)			
Dr	Share capital - Entity X	200	
	Reserves - Entity X	1,800	
Cr	Investment in subsidiary		1,600
	Non-controlling interests ($2,000 x 20%)		400
Being elimination of investment in Entity X (assume fair value = book value)			

4. Consolidation Procedures

Example

Consolidation spreadsheet and consolidated balance sheet:

	A	X	Dr/(Cr)	Line by Line Consol
Non-current assets				
Investment in subsidiary	1,600	0	(1,600)	0
Property, plant & equipment	1,500	2,000		3,500
	3,100	2,000		3,500
Current assets				
Inventories	100	500		600
Cash at bank	100	100		200
	200	600		800
Current liabilities				
Account payables	(100)	(600)		(700)
Net current assets	100	0		100
Net assets	*3,200*	*2,000*		*3,600*
Share capital	(1,700)	(200)	200	(1,700)
Reserves	(1,500)	(1,800)	1,800	(1,500)
	(3,200)	(2,000)		(3,200)
Non-controlling interest			(400)	(400)
			0	(3,600)

4. Consolidation Procedures

Intragroup balances, transactions, income and expenses

- Intragroup balances, transactions, income and expenses shall be eliminated in full.

Example

- Examples include:
  - Income, expenses and dividends
  - Profits and losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets

Example

  - 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. Consolidation Procedures

Example

Same example as before, but some balances due to Entity A by Entity X

	A	X
Non-current assets		
Property, plant & equipment	1,500	2,000
Current assets		
Inventories	100	500
Amount due from X	50	0
Cash at bank	50	100
	200	600
Current liabilities		
Account payables	(100)	(550)
Amount due to A	0	(50)
Net current assets	100	0
Net assets	*1,600*	*2,000*
Share capital	100	200
Reserves	1,500	1,800
	1,600	2,000

Intragroup Balances

- Should we prepare the journals and/or consolidation journals?

4. Consolidation Procedures

Example

Same example as before, but some balances due to Entity A by Entity X

	A	X	Line by Line Consol
Non-current assets			
Investment in subsidiary	1,600	0	0
Property, plant & equipment	1,500	2,000	3,500
	3,100	2,000	3,500
Current assets			
Inventories	100	500	600
Cash at bank	50	100	150
	150	600	750
Current liabilities			
Account payables	(100)	(550)	(650)
Net current assets	50	50	100
Amount due from/(to) group co.	**50**	**(50)**	*0*
Net assets	*3,200*	*2,000*	*3,600*
Share capital	1,700	200	1,700
Reserves	1,500	1,800	1,500
Non-controlling interests			400
	3,200	2,000	3,600

4. Consolidation Procedures

Example

Same example as before: Entity A sold inventories at a price of HK$100 to Entity X with a margin of 20% and X immediately disposed of goods of HK$60 .

	A	X
Non-current assets		
Property, plant & equipment	1,500	2,000
Current assets		
Inventories	100	500
Cash at bank	100	100
	200	600
Current liabilities		
Account payables	(100)	(600)
Net current assets	100	0
Net assets	*1,600*	*2,000*
Share capital	100	200
Reserves	1,500	1,800
	1,600	2,000

Intragroup Sales

Please prepare

- The journals and/or consolidation journals
- The consolidation spreadsheet
- The consolidated balance sheet right after the acquisition

4. Consolidation Procedures

Example

Journal and consolidation journal:

		Dr($)	Cr($)
On the company level of Entity A			
Dr	Investment in subsidiary	1,600	
Cr	Share capital		1,600
Being the shares issued to acquire Entity X			
On the consolidated level (consolidation journal)			
Dr	Share capital - Entity X	200	
	Reserves - Entity X	1,800	
Cr	Investment in subsidiary		1,600
	Non-controlling interests ($2,000 x 20%)		400
Being elimination of investment in Entity X (assume fair value = book value)			
Additional consolidation journal			
Dr	Reserves	8	
Cr	Inventories [($100 - $60) x 20%]		8
Being elimination of unrealised gain on inventory resulted from intragroup sales			

4. Consolidation Procedures

Example

Consolidation spreadsheet and consolidated balance sheet:

	A	X	J#1	J#2	Dr/(Cr)	Line by Line Consol
Non-current assets						
Investment in subsidiary	1,600	0	(1,600)		(1,600)	0
Property, plant & equipment	1,500	2,000				3,500
	3,100	2,000				3,500
Current assets						
Inventories	100	500		(8)	(8)	592
Cash at bank	100	100				200
	200	600				792
Current liabilities						
Account payables	(100)	(600)				(700)
Net current assets	100	0				92
Net assets	*3,200*	*2,000*				*3,592*
Share capital	(1,700)	(200)	200		200	(1,700)
Reserves	(1,500)	(1,800)	1,800	8	1,808	(1,492)
	(3,200)	(2,000)				(3,192)
Non-controlling interest			(400)		(400)	(400)
			0	0	0	(3,592)

4. Consolidation Procedures

Uniform accounting policies

- Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.
- If different accounting policies are adopted for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements

4. Consolidation Procedures

Income and expenses of a subsidiary

- Included in the consolidated financial statements
  - from the acquisition date, as defined in HKFRS 3.
  - 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 (per HKAS 21)
  - is recognised in the consolidated income statement as the gain or loss on the disposal of the subsidiary.

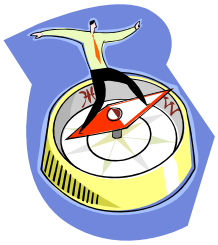
4. Consolidation Procedures

Non-controlling Interests

- is the equity in a subsidiary <u>not attributable, directly or indirectly, to a parent</u>.
- shall be presented in the consolidated statement of financial position <u>within equity</u>, separately from the equity of the owners of the parent.

4. Consolidation Procedures

- Most critical ……
  - Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control
    - are accounted for **as equity transactions** (i.e. transactions with owners in their capacity as owners)
    - i.e. no gain or loss on disposal of interests in subsidiary can be recognised in profit or loss if the subsidiary is still a subsidiary.



Today's Agenda

HKFRS 3 Business Combinations
(Revised in 2008)

Introduction

Scope

⇩

Method of accounting

⇩

Application of the method

- The objective of HKFRS 3 (revised in 2008) is
  - to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects.
- To accomplish that, HKFRS 3 establishes principles and requirements for how the acquirer:

a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;

b) recognises and measures
   - the goodwill acquired in the business combination or
   - a gain from a bargain purchase; and

What is it?

c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

Identifying a Business Combination

Scope

- An entity shall determine whether a transaction or other event is a business combination by applying the definition in HKFRS 3,
  - which requires that the assets acquired and liabilities assumed constitute a business.
- If the assets acquired are not a business,
  - the reporting entity shall account for the transaction or other event as an asset acquisition. (HKFRS 3.3)
- HKFRS 3.B5–B12 provide guidance on identifying a business combination and the definition of a business.

Business Combination

vs

Asset Acquisition

The Acquisition Method

Scope

⇩

Method of accounting

⇩

Application of the method

- An entity shall account for each business combination by applying the acquisition method. (HKFRS 3.4)
- Applying the acquisition method requires:
  a) identifying the acquirer; Guidance in HKAS 27
  b) determining the acquisition date; Date of control obtained
  c) recognising and measuring
     - the identifiable assets acquired,
     - the liabilities assumed and
     - any non-controlling interest in the acquiree; and
  d) recognising and measuring
     - goodwill or
     - a gain from a bargain purchase. (HKFRS 3.5)

The Acquisition Method

Indication as an Acquirer

- The guidance in HKAS 27 shall be used to identify the acquirer – the entity that obtains control of the acquiree.
- If a business combination has occurred but applying the guidance in HKAS 27 does not clearly indicate which of the combining entities is the acquirer, the factors in HKFRS shall be considered in making that determination.
  - In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually
    - *the entity that transfers the cash or other assets or incurs the liabilities.*
  - In a business combination effected primarily by exchanging equity interests, the acquirer is usually
    - *the entity that issues its equity interests.*

The Acquisition Method

- Determining the acquisition date

Application of the method

- The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree. (HKFRS 3.8)
  - The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree — the closing date.
  - However, the acquirer might obtain control on a date that is either earlier or later than the closing date.
    - For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date.
    - An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

The Acquisition Method

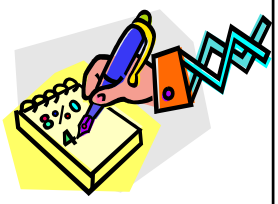
- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Application of the method

- As of the acquisition date, the acquirer shall recognise, separately from goodwill,
  - the identifiable assets acquired,
  - the liabilities assumed and
  - any non-controlling interest in the acquiree.
- Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in HKFRS 3.11 and 3.12. (HKFRS 3.10)

The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree



- To qualify for recognition as part of applying the acquisition method,
  - the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the *Framework for the Preparation and Presentation of Financial Statements* at the acquisition date.
- In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be
  - part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction
  - rather than the result of separate transactions.

The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

- The acquirer's application of the recognition principle and conditions may result in
  - recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements.

The Acquisition Method

Example

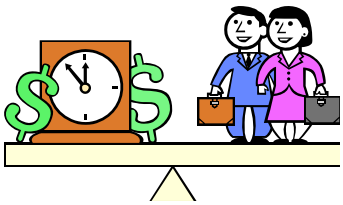
- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

- An operating lease in which the acquiree is the lessee is normally not recognised as assets or liabilities except for:
  - if the terms of an operating lease are favourable relative to market terms
    - the acquirer shall recognise an intangible asset
  - if the terms are unfavourable relative to market terms
    - the acquirer shall recognise a liability (HKFRS 3.B29)
- If the terms of an operating lease in which the acquiree is the lessor are either favourable or unfavourable when compared with market terms
  - The acquirer does not recognise a separate asset or liability(HKFRS 3.B42)

The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

- At the acquisition date, the acquirer shall
  - classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other HKFRSs subsequently.
- The acquirer shall make those classifications or designations on the basis of
  - the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date. (HKFRS 3.15)



The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

- The acquirer shall measure the identifiable assets acquired and the liabilities assumed
  - at their acquisition-date fair values. (HKFRS 3.18)

Affect acquisition in stages

- For each business combination, the acquirer shall measure any non-controlling interest in the acquiree either
  - at fair value or
  - at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. (HKFRS 3.19)

New alternative ("full goodwill method")

Existing practice

The Acquisition Method

Example

Existing Methodology

	HK$
Fair value of identifiable net assets of Entity A	100
Purchase 75% interest in Entity A (consideration is $120)	120
Parent's interest – 75% of fair value of identifiable net assets ($100 × 75%)	75
Non-controlling interest ($100 × 25%) (at its proportionate share of Entity A's identifiable net assets)	25
Goodwill ($120 - $75)	45

The Acquisition Method

Example

Existing Methodology		New Methodology	
	HK$		HK$
Fair value of identifiable net assets of Entity A	100		
Purchase 75% interest in Entity A (consideration is $120)	120	Fair value of Entity A as a whole ($120 ÷ 75%)	160
Parent's interest – 75% of fair value of identifiable net assets ($100 × 75%)	75		
Non-controlling interest ($100 × 25%) (at its proportionate share of Entity A's identifiable net assets)	25	NCI ($160 × 25%) (at fair value)	40
Goodwill ($120 - $75)	45	Goodwill ($160 – $100)	60

The Acquisition Meth

Critical Amendment

- Recognising and measuring goodwill or a gain from a bargain purchase

Application of the method

If fair value is adopted, it will affect the amount of goodwill

Practices changed

- The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:
  - a) the aggregate of:
    - i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;
    - ii) the amount of any non-controlling interest in the acquiree measured in accordance with HKFRS 3; and
    - iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
  - b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with HKFRS 3. (HKFRS 3.32)

The Acquisition Method

Example

Existing Methodology

	HK$
Fair value of identifiable net assets of Entity A	100
Purchase 75% interest in Entity A (consideration is $120)	120
Parent's interest – 75% of fair value of identifiable net assets ($100 × 75%)	75
Non-controlling interest ($100 × 25%) (at its proportionate share of Entity A's identifiable net assets)	
Goodwill ($120 - $75)	45

The Acquisition Method

Example

Existing Methodology		New Methodology	
	HK$	HK$	
Fair value of identifiable net assets of Entity A	100	100	b
Purchase 75% interest in Entity A (consideration is $120)	120	120	a(i)
Parent's interest – 75% of fair value of identifiable net assets ($100 × 75%)	75		
Non-controlling interest ($100 × 25%) (at its proportionate share of Entity A's identifiable net assets)		25 145	a(ii)
Goodwill ($120 - $75)	45	45	

$(120 + 25) – $100
= $45

The Acquisition Method

Example

	Existing Methodology	New Methodology			
	HK$	HK$		HK$	
Fair value of identifiable net assets of Entity A	100	100		100	b
Purchase 75% interest in Entity A (consideration is $120)	120	120		120	a(i)
Parent's interest – 75% of fair value of identifiable net assets ($100 × 75%)	75		$120 ÷ 75% = $160		
Non-controlling interest ($100 × 25%) (at its proportionate share of Entity A's identifiable net assets)		25 145	$160×25%=	40 160	a(ii)
Goodwill ($120 - $75)	45	45		60	

$(120 + 40) – $100 = $60

The Acquisition Method

- Recognising and measuring goodwill or a gain from a bargain purchase

- When the goodwill becomes a negative figure
  - It is a bargain purchase.
- The acquirer shall recognise the resulting gain in profit or loss on the acquisition date
  - The gain shall be attributed to the acquirer.
- A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.
- However, the recognition or measurement exceptions for particular items may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

The Acquisition Method

- Recognising and measuring goodwill or a gain from a bargain purchase

- Before recognising a gain on a bargain purchase
  - the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review.
  - the acquirer shall then review the procedures used to measure the amounts HKFRS 3 requires to be recognised at the acquisition date for all of the following:
    a) the identifiable assets acquired and liabilities assumed;
    b) the non-controlling interest in the acquiree, if any;
    c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and
    d) the consideration transferred.
  - The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

Today's Agenda

From annual periods beginning on or after 1 January 2013

- Will become HKAS 27 *Separate Financial Statements*
- New HKFRS 10 *Consolidated Financial Statements*
- New HKFRS 12 *Disclosure of Interests in Other Entities*

IFRS/HKFRS Issued in 2011

On 12 May 2011

- The IASB issued 4 new IFRS ……
  - IFRS 10 *Consolidated Financial Statements*
  - IFRS 11 *Joint Arrangements*
  - IFRS 12 *Disclosure of Interests in Other Entities*
  - IFRS 13 *Fair Value Measurement*

On 16 June 2011

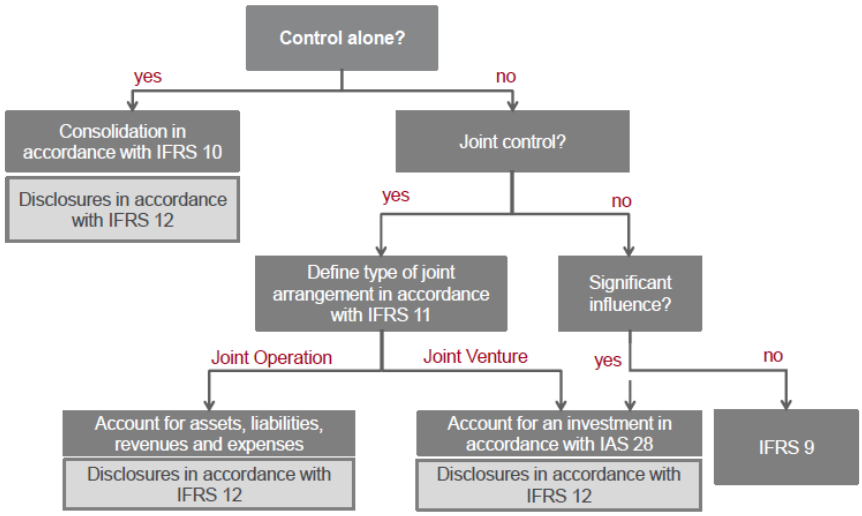
- The IASB amended 2 other IFRS
  - IAS 1 Presentation of Financial Statements
  - IAS 19 Employee Benefits

On 24 June and 14 July 2011

- The HKICPA issued the same in HKFRS and HKAS

Briefing on HKFRS 10, 11 and 12

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

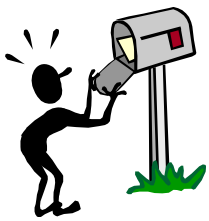


The graph is adapted from the IASB

Consolidated Financial Statements
(HKFRS 10)

HKFRS 10 Consol. Financial Statements

- The contents of HKFRS 10:
  a. requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements;
  b. defines the principle of control, and establishes control as the basis for consolidation;
  c. sets out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee; and
  d. sets out the accounting requirements for the preparation of consolidated financial statements (HKFRS 10.2).



HKFRS 10 Consol. Financial Statements

- The IASB explains that
  - The application of IAS 27 and SIC-12 revealed inconsistent application in a number of areas:
    - Applying the definition of control: the perceived conflict of emphasis between
      - IAS 27 (power to govern financial and operating policies) and
      - SIC-12 (risks and rewards)

      led to inconsistent application of the definition of control for different types of entities.
    - Control without a majority of voting rights: because IAS 27 does not provide explicit guidance in this area, similar relationships between entities were being accounted for differently.
    - Agency relationships: the lack of guidance for these relationships meant that similar transactions (e.g. those involving funds or investment conduits) were being accounted for differently.
  - Instead, IFRS 10 contains a single consolidation model that identifies control as the basis for consolidation for all types of entities
    - Also providing additional application guidance, will increase consistent application in these areas.

HKFRS 10 Consol. Financial Statements

- While HKFRS 10 become effective,
  - HKAS 27 becomes "separate financial statements"
- Indicator still refers to "**control**" but ……
- An investor, regardless of the nature of its involvement with an entity (the investee),
  - shall determine whether it is a parent by assessing whether it controls the investee. (HKFRS 10.5)
- An investor controls an investee when
  - it is exposed, or has rights, to variable returns from its involvement with the investee and
  - has the ability to affect those returns through its power over the investee. (HKFRS 10.6)

HKFRS 10 Consol. Financial Statements

- Thus, an investor controls an investee if and only if the investor has all the following:
  a. **power** over the investee;
  b. **exposure**, or **rights**, to **variable returns** from its involvement with the investee; and
  c. the **ability to use its power** over the investee to **affect** the amount of the investor's **returns** (HKFRS 10.7)

Power is defined as "existing rights that give the current ability to direct the *relevant activities*"

relevant activities are "activities of the investee that significantly affect the investee's returns"

Rights include
- voting rights, potential voting rights, proportionate voting rights, substantive rights, removal rights, decision-making rights, protective rights, contractual rights ……

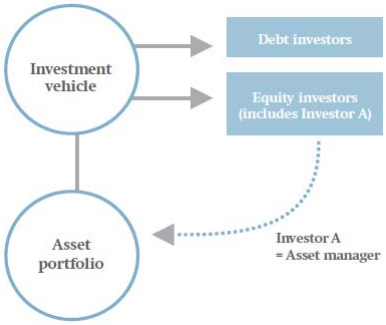
HKFRS 10 Consol. Financial Statements

- Consideration of the following factors may assist in making the determination whether an investor controls an investee:
  a. the purpose and design of the investee;
  b. what the relevant activities are and how decisions about those activities are made;
  c. whether the rights of the investor give it the current ability to direct the relevant activities;
  d. whether the investor is exposed, or has rights, to variable returns from its involvement with the investee; and
  e. whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns. (HKFRS 10.B3)

HKFRS 10 Consol. Financial Statements

Example

- An investment vehicle
  - It is created to purchase a portfolio of financial assets, funded by debt and equity instruments issued to a number of investors.
  - The equity tranche is designed to absorb the first losses and to receive residual returns of the investee.
- Investor A holds 30% of the equity
  - is also the asset manager who manages the vehicle's asset portfolio within portfolio guidelines.
  - The management includes decisions about
    - the selection, acquisition and disposal of the assets within those portfolio guidelines and
    - the management upon default of any asset in the portfolio.



The graph is adapted from the IASB

HKFRS 10 Consol. Financial Statements

Example

- In applying HK(SIC)-Int 12, some would conclude that Investor A does not consolidate the investment vehicle.
  - Investor A holds 30% of the equity and therefore does not bear the majority of the risks and rewards.
  - The investment vehicle was arguably created for the benefit of all investors, and not only for the benefit of Investor A.
- According to IFRS 10, Investor A controls the investment vehicle.
  - Investor A
    - has the ability to direct the relevant activities,
    - has rights to variable returns from the performance of the vehicle and
    - has the ability to use its power to affect its own returns.

HKFRS 10: 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 11, HKFRS 12 , HKAS 27 (as amended in 2011) and HKAS 28 (as amended in 2011) at the same time. (HKFRS 10.C1)

Discl. Interests in Other Entities

(HKFRS 12)

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).

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?

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?

HKFRS 12 Discl. of Interest in Other Entities

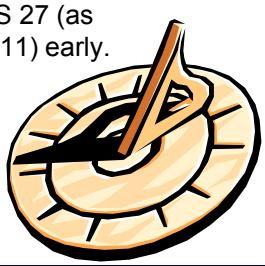
- Structured entity often has some or all of the following features or attributes:
  a. restricted activities.
  b. a narrow and well-defined objective, such as
     - to effect a tax-efficient lease,
     - to carry out research and development activities,
     - to provide a source of capital or funding 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?

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)



Subsequent Measurement and Acc.

Case

UBS Securities Asia Ltd. states that

- The accounting rule states all payments to purchase a business are to be recorded at fair value at the acquisition date, with *contingent payments* classified as debt (under balance of purchase consideration payable), *subsequently remeasured through the consolidated profit and loss account*. (25.5.2011)

Li & Fung issued a clarification announcement on 27.5.2011 and stated:

- It is stated on page 11 of the Report that …… "L&F has recently adopted a new accounting rule, HKFRS 3 (revised). This potentially allows companies to convert earn-out payments to earnings".
- These statements *are misleading* …… It is not optional ……

Subsequent Measurement and Acc.

Case

UBS Securities Asia Ltd. states:

- Under the new accounting rule, *goodwill* associated with the acquired operation *will not be impaired* …… (See appendix section for more detail)
- …… *goodwill* is *not tested annually for impairment* or *when there are indications of impairment*. (25.5.2011)

Li & Fung clarified on 27.5.2011 that:

- It is also stated on page 23 of the Report that "goodwill is not tested annually for impairment or when there are indications of impairment".
- These statements *are all fundamentally incorrect*.

HKFRS 3 (revised 2007) states:

- The acquirer measures goodwill at the amount recognised at the acquisition date ***less any accumulated impairment losses***.
- **HKAS 36 *Impairment of Assets*** prescribes the accounting for impairment losses. (HKFRS 3.63a)

蘋果日

Case

「瑞銀的分析員可能沒有看過筆者的分析，同時亦可能忽略了，過去放在財務滙報準則第3條的商譽減值測試，現在只放在會計準則第36條，故此在其報告中弄錯了新會計準則的要求，利豐澄清其報告的錯誤是合理的。」

「大型證券行也弄錯不斷改變的會計準則，一般投資者可能更無法理解，故此更要小心。」

《香港經濟日報》楊青峰 (2011.6.2)

「上周利豐（494）突然上演利豐大戰瑞銀 …… 嘩，一牽涉會計制度，當然觸動投資者的神經，因投資者除了可以風聲鶴唳，根本沒有空間加入討論 ……

「老實說，上述艱澀的會計用詞對於公眾來說實在不易理解 ……」

《信報》陳焱 (2011.5.30)

Business Combinations & Consolidation
(Under HKFRS and IFRS) 2 March 2012

Updated slides in PDF can be found in
www.NelsonCPA.com.hk

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