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

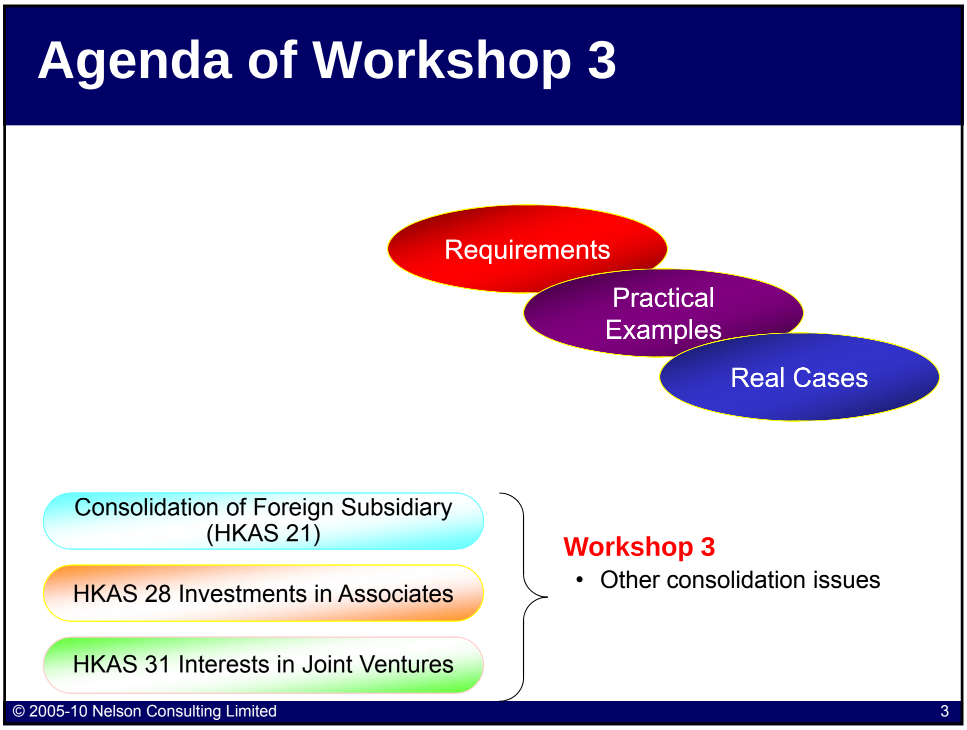
Workshop 2

- Changes in a group

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

Workshop 3

- Other consolidation issues



Agenda of Workshop 3

Requirements

Practical Examples

Real Cases

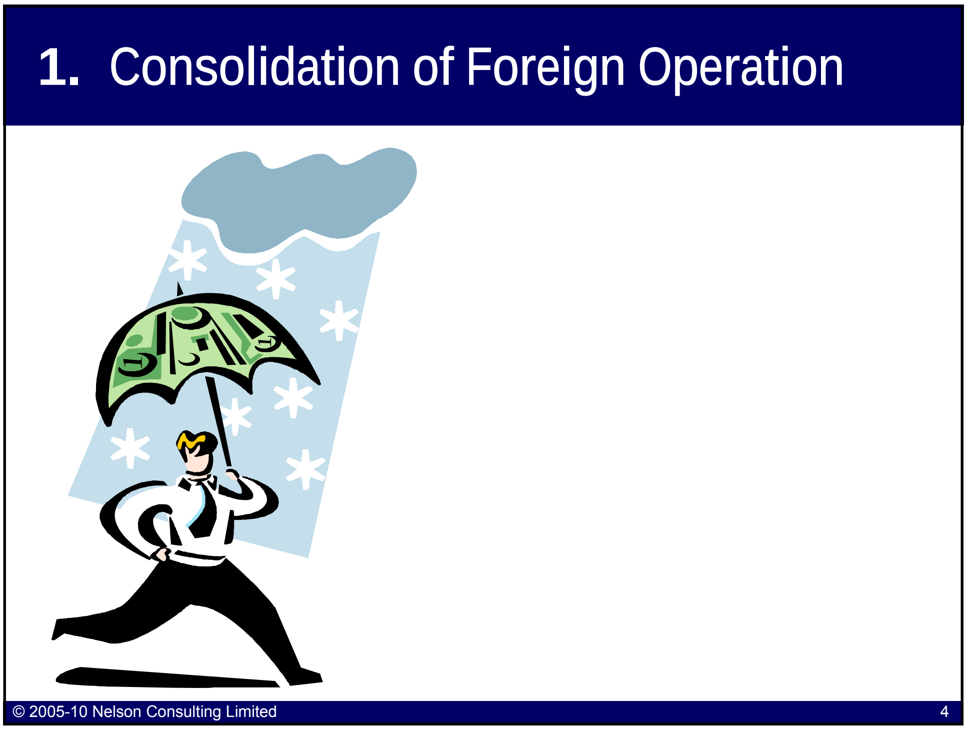
Consolidation of Foreign Subsidiary (HKAS 21)

HKAS 28 Investments in Associates

HKAS 31 Interests in Joint Ventures

Workshop 3

- Other consolidation issues



1. Consolidation of Foreign Operation

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

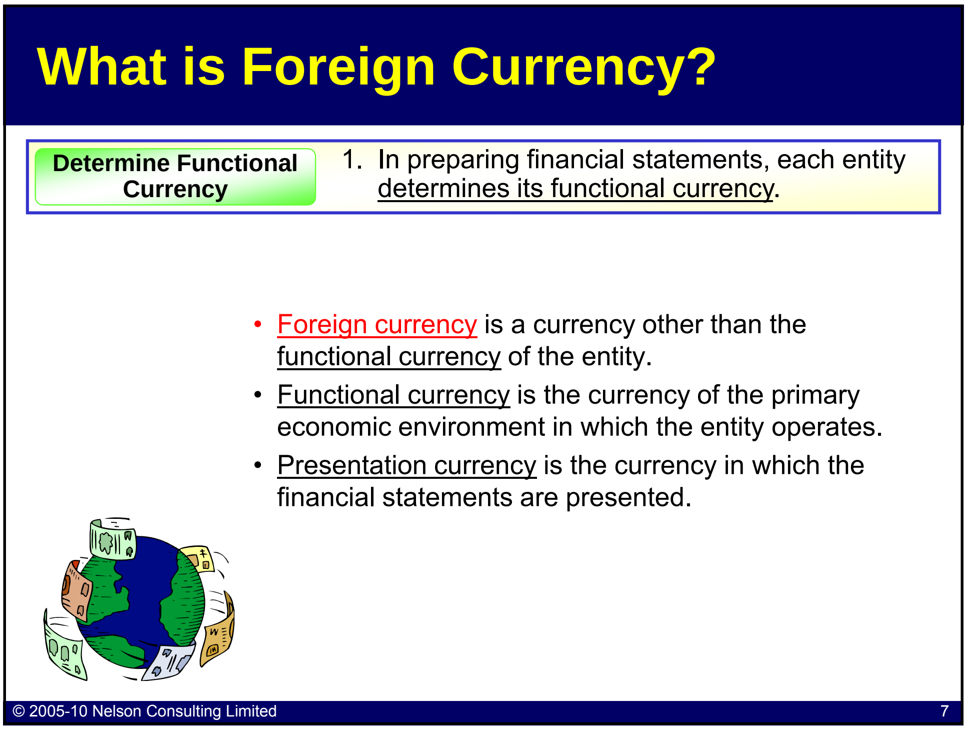
3. The results and financial position of any individual entity (say subsidiary, associate or branches) within the reporting entity (say parent) whose functional currency differs from the presentation currency of the reporting entity are translated.
4. If the entity's presentation currency differs from its functional currency, its results and financial position are also translated into the presentation currency.

Approach in HKAS 21

Determine Functional Currency

Translate Foreign Currency Transactions

Translate Foreign Operation or Whole Set

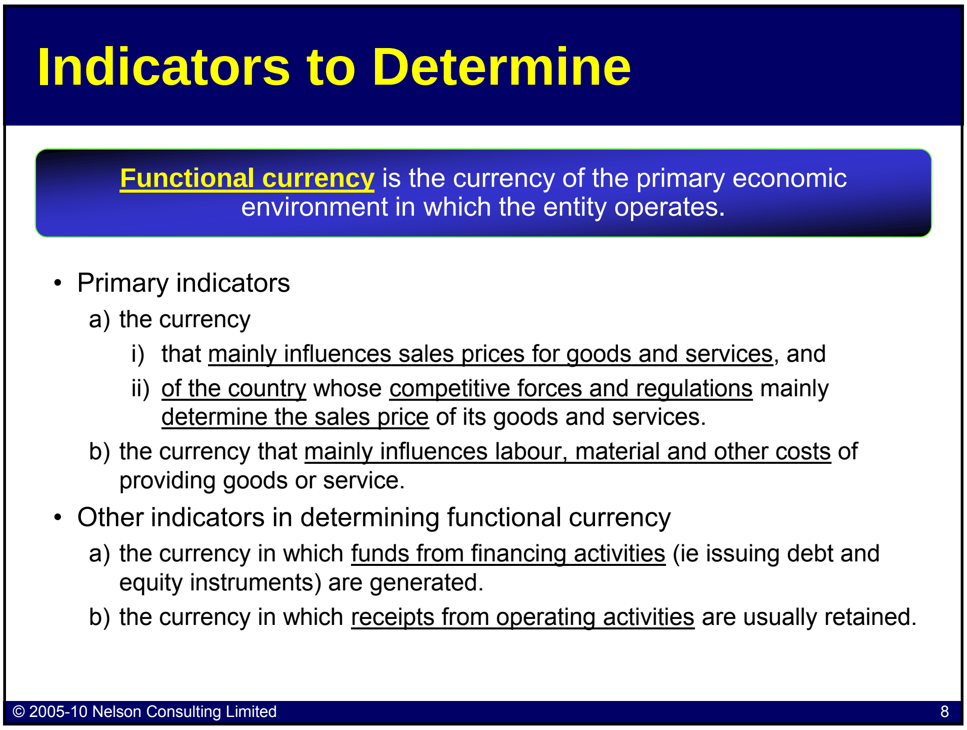


What is Foreign Currency?

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.



Indicators to Determine

Functional currency is the currency of the primary economic environment in which the entity operates.

- Primary indicators
  - a) the currency
    - i) that mainly influences sales prices for goods and services, and
    - ii) of the country whose competitive forces and regulations mainly determine the sales price of its goods and services.
  - b) the currency that mainly influences labour, material and other costs of providing goods or service.
- Other indicators in determining functional currency
  - a) the currency in which funds from financing activities (ie issuing debt and equity instruments) are generated.
  - b) the currency in which receipts from operating activities are usually retained.

Indicators to Determine

Functional currency is the currency of the primary economic environment in which the entity operates.

- When the above indicators are mixed and the functional currency is not obvious
  - management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions.
- An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it
  - once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.
- If the functional currency is the currency of a hyperinflationary economy, the entity's financial statements are restated in accordance with HKAS 29
  - An entity cannot avoid restatement in accordance with HKAS 29 by, for example, adopting as its functional currency a currency other than the functional currency determined in accordance with HKAS 21 (such as the functional currency of its parent).

Indicators to Determine

Example

Functional currency is the currency of the primary economic environment in which the entity operates.

- If Entity A, a HK incorporated company, reports its financial statements in HK$.
- However, its head office is located in HK but only serves for accounting purpose.
- All the other operation, trading and finance souring are located in UK and all the transactions are denominated in UK GBP.
- Which currency is the foreign currency of Entity A under HK SSAP 11 and HKAS 21?

- Under HK SSAP 11
  - The reporting currency is → HK$
  - The foreign currency is → UK GBP
- Under HKAS 21
  - The functional currency is → UK GBP
  - The foreign currency is → HK$

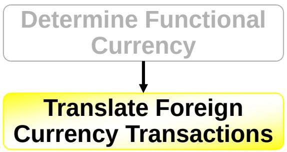
Indicators to Determine

Case

Li & Fung Limited

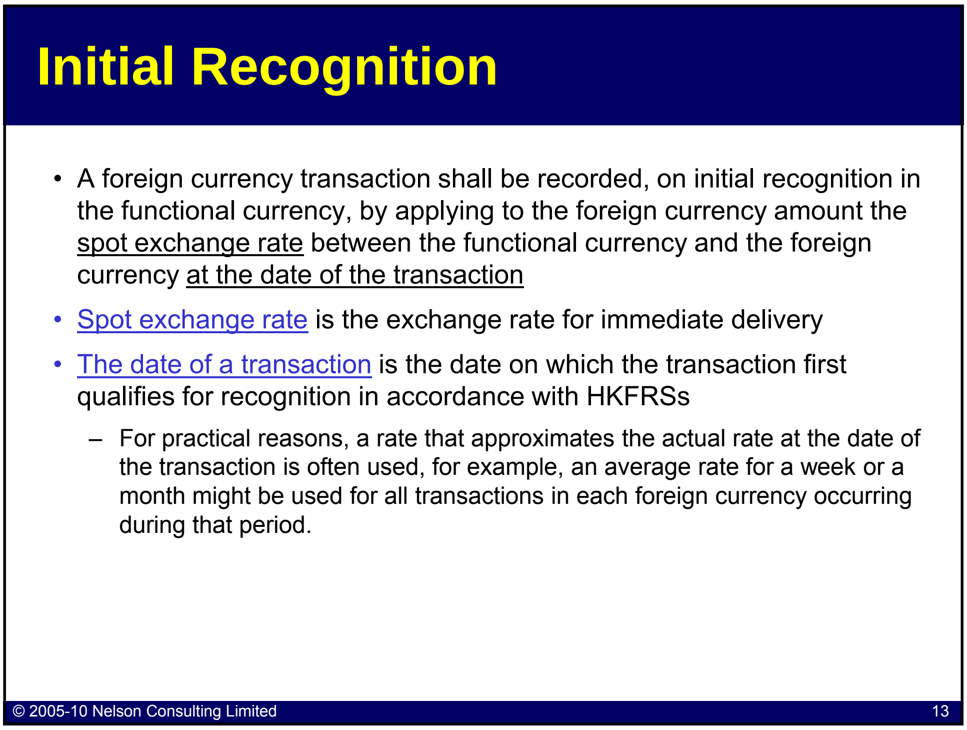
- In annual report of 2008, the ccounting policy on functional and presentation currency of Li & Fung Limited stated that:
  - Items included in the accounts of each of the Group's entities are measured
    - using the currency of the primary economic environment in which the entity operates ("the functional currency").
  - The consolidated accounts are
    - presented in Hong Kong dollars, which is the Company's functional and presentation currency.

Foreign Currency Transactions



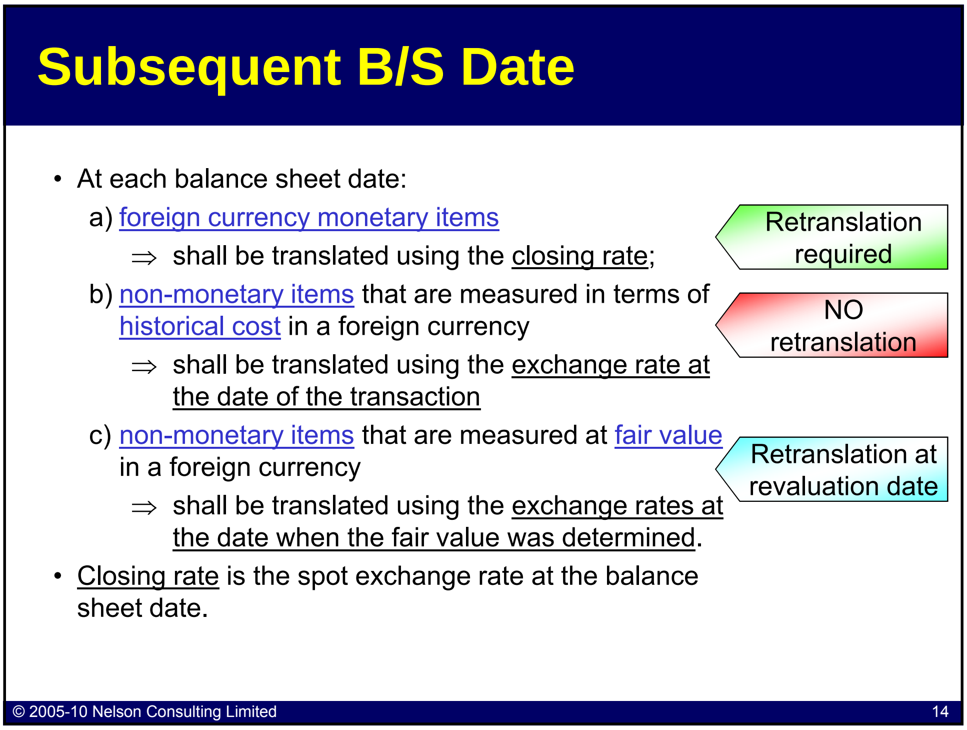
Determine Functional Currency

Translate Foreign Currency Transactions



Initial Recognition

- A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction
- Spot exchange rate is the exchange rate for immediate delivery
- The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with HKFRSs
  - For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period.



Subsequent B/S Date

- At each balance sheet date:

  a) foreign currency monetary items

  ⇒ shall be translated using the closing rate;

  Retranslation required

  b) non-monetary items that are measured in terms of historical cost in a foreign currency

  ⇒ shall be translated using the exchange rate at the date of the transaction

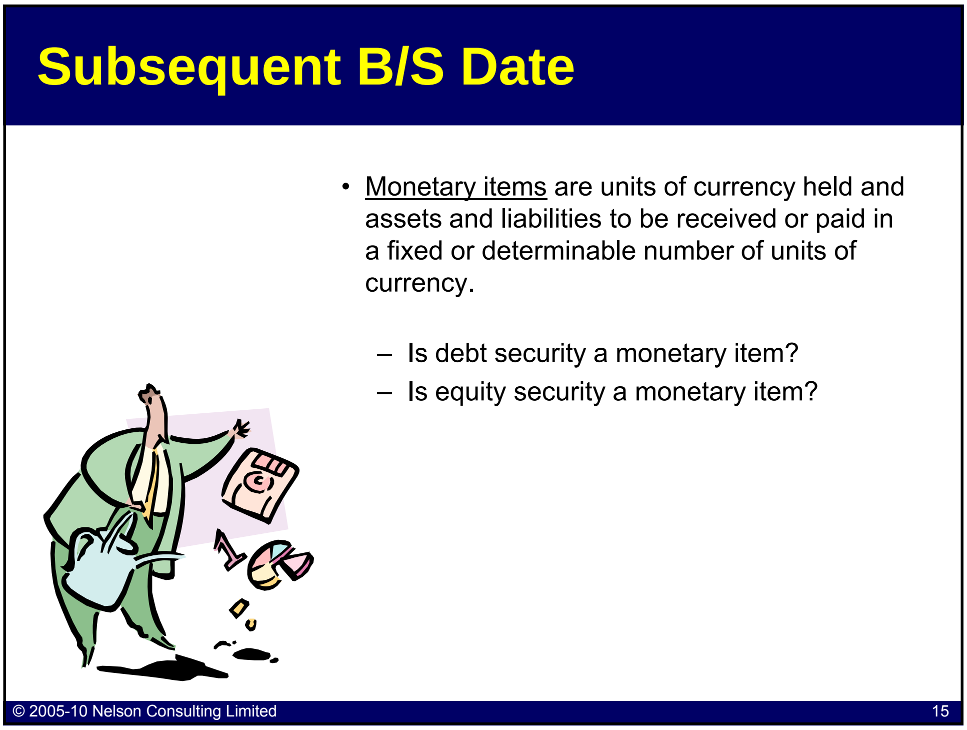
  NO retranslation

  c) non-monetary items that are measured at fair value in a foreign currency

  ⇒ shall be translated using the exchange rates at the date when the fair value was determined.

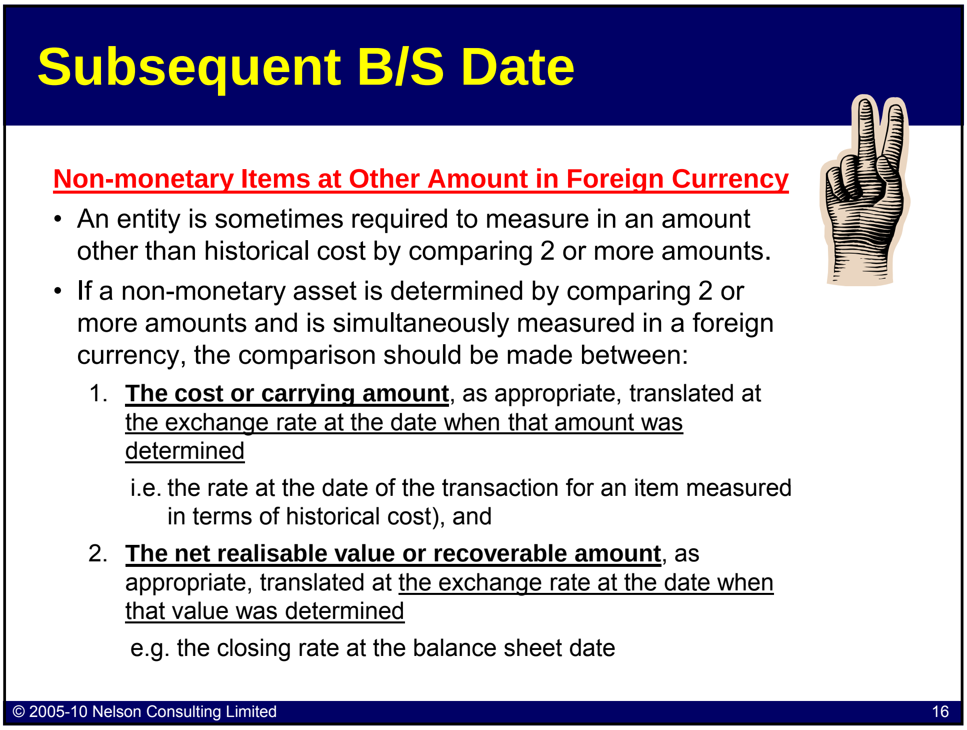
  Retranslation at revaluation date

- Closing rate is the spot exchange rate at the balance sheet date.



Subsequent B/S Date

- Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.
  - Is debt security a monetary item?
  - Is equity security a monetary item?



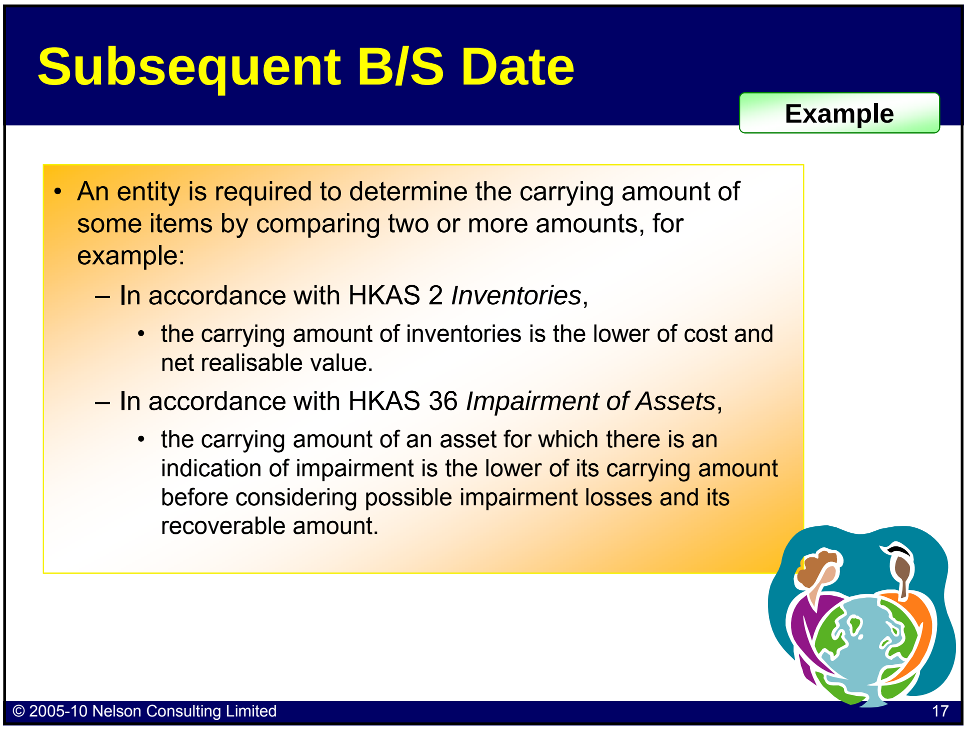
Subsequent B/S Date

Non-monetary Items at Other Amount in Foreign Currency

- An entity is sometimes required to measure in an amount other than historical cost by comparing 2 or more amounts.
- If a non-monetary asset is determined by comparing 2 or more amounts and is simultaneously measured in a foreign currency, the comparison should be made between:
  1. **The cost or carrying amount**, as appropriate, translated at the exchange rate at the date when that amount was determined

     i.e. the rate at the date of the transaction for an item measured in terms of historical cost), and
  2. **The net realisable value or recoverable amount**, as appropriate, translated at the exchange rate at the date when that value was determined

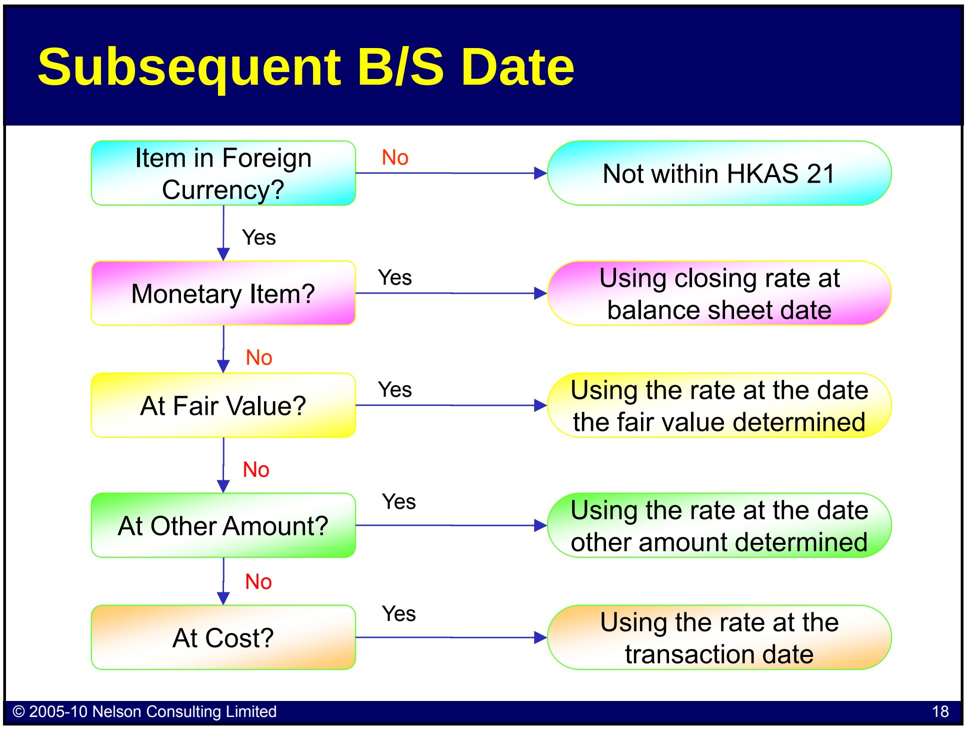
     e.g. the closing rate at the balance sheet date



Subsequent B/S Date

Example

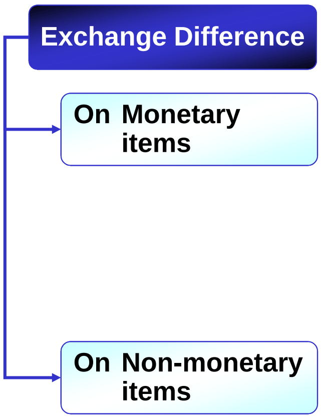
- An entity is required to determine the carrying amount of some items by comparing two or more amounts, for example:
  - In accordance with HKAS 2 *Inventories*,
    - the carrying amount of inventories is the lower of cost and net realisable value.
  - In accordance with HKAS 36 *Impairment of Assets*,
    - the carrying amount of an asset for which there is an indication of impairment is the lower of its carrying amount before considering possible impairment losses and its recoverable amount.



Subsequent B/S Date

Item in Foreign Currency?
No
Not within HKAS 21
Yes
Monetary Item?
Yes
Using closing rate at balance sheet date
No
At Fair Value?
Yes
Using the rate at the date the fair value determined
No
At Other Amount?
Yes
Using the rate at the date other amount determined
No
At Cost?
Yes
Using the rate at the transaction date

Exchange Difference



- Exchange difference is the difference resulting from translating a given no. of units of one currency into another currency at different exchange rates.

- Exchange differences arising
  - on the settlement of monetary items or
  - on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements

  shall be recognised in profit or loss in the period in which they arise, *except for those form part of net investment in a foreign operation*

- When a gain or loss on a non-monetary item is recognised directly in equity
  ⇒ any exchange component of that gain or loss shall be recognised directly in equity
- Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss
  ⇒ any exchange component of that gain or loss shall be recognised in profit or loss

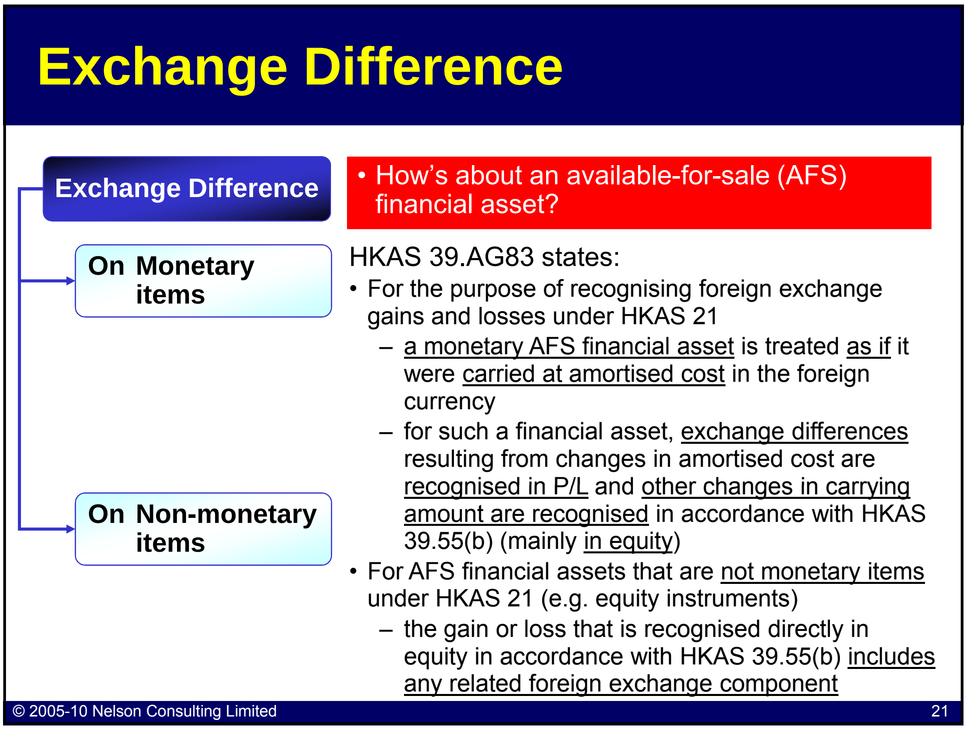
Exchange Difference

Case

中国建设银行
China Construction Bank

Annual Report 2008

- Non-monetary items denominated in foreign currencies
  - that are measured at fair value are translated using the spot exchange rates at the dates the fair value are determined;
  - the exchange differences are recognised in the income statement,
    - except for the differences arising from the translation of available-for-sale equity instruments, which are recognised in equity.



Exchange Difference

Exchange Difference

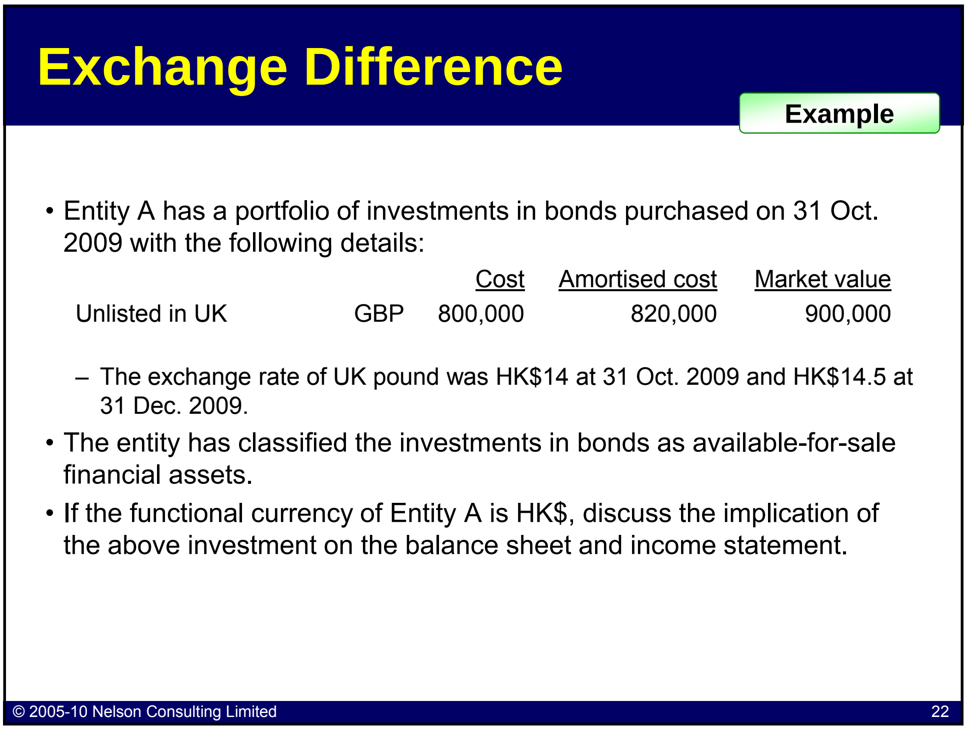
On Monetary items

On Non-monetary items

- How's about an available-for-sale (AFS) financial asset?

HKAS 39.AG83 states:

- For the purpose of recognising foreign exchange gains and losses under HKAS 21
  - a monetary AFS financial asset is treated as if it were carried at amortised cost in the foreign currency
  - for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in P/L and other changes in carrying amount are recognised in accordance with HKAS 39.55(b) (mainly in equity)
- For AFS financial assets that are not monetary items under HKAS 21 (e.g. equity instruments)
  - the gain or loss that is recognised directly in equity in accordance with HKAS 39.55(b) includes any related foreign exchange component



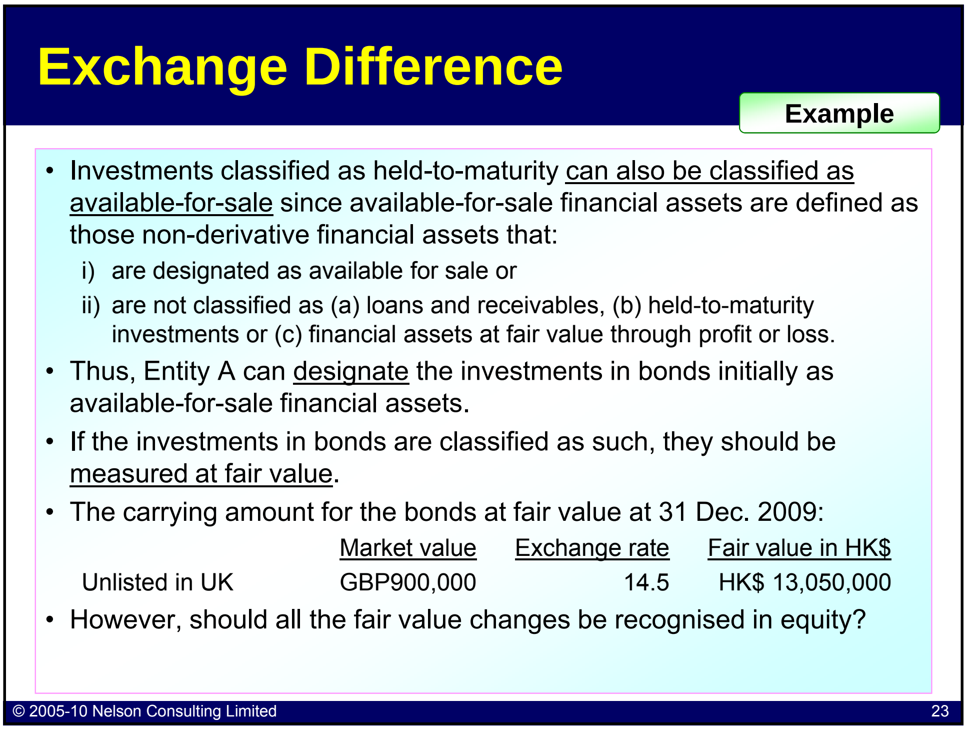
Exchange Difference

Example

- Entity A has a portfolio of investments in bonds purchased on 31 Oct. 2009 with the following details:

		Cost	Amortised cost	Market value
Unlisted in UK	GBP	800,000	820,000	900,000

  - The exchange rate of UK pound was HK$14 at 31 Oct. 2009 and HK$14.5 at 31 Dec. 2009.
- The entity has classified the investments in bonds as available-for-sale financial assets.
- If the functional currency of Entity A is HK$, discuss the implication of the above investment on the balance sheet and income statement.



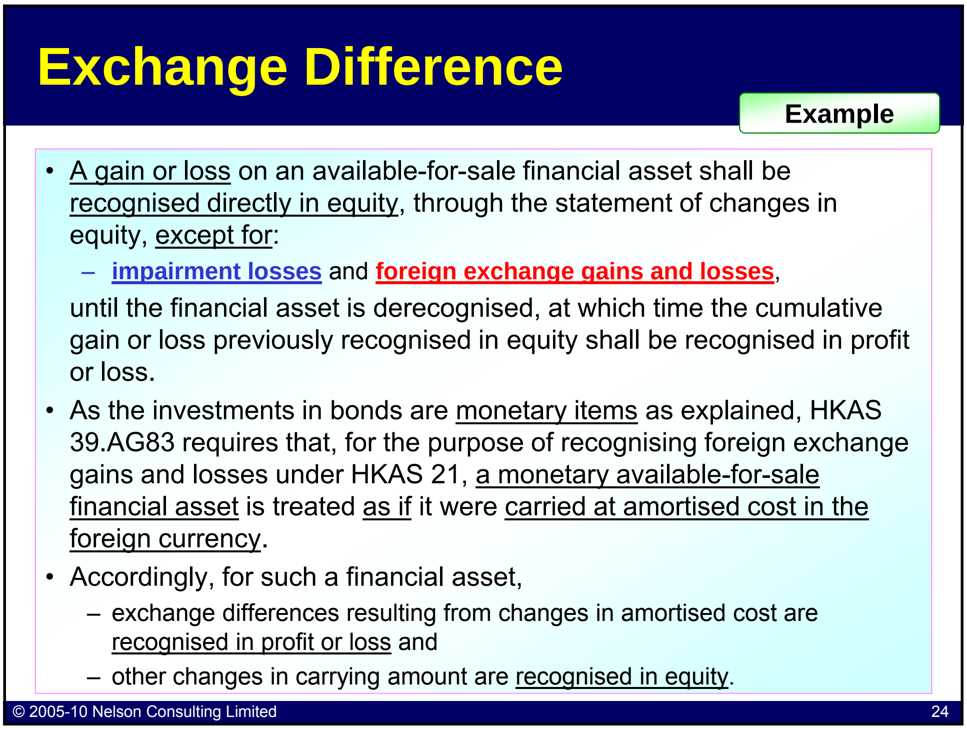
Exchange Difference

Example

- Investments classified as held-to-maturity can also be classified as available-for-sale since available-for-sale financial assets are defined as those non-derivative financial assets that:
  - i) are designated as available for sale or
  - ii) are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.
- Thus, Entity A can designate the investments in bonds initially as available-for-sale financial assets.
- If the investments in bonds are classified as such, they should be measured at fair value.
- The carrying amount for the bonds at fair value at 31 Dec. 2009:

	Market value	Exchange rate	Fair value in HK$
Unlisted in UK	GBP900,000	14.5	HK$ 13,050,000

- However, should all the fair value changes be recognised in equity?



Exchange Difference

Example

- A gain or loss on an available-for-sale financial asset shall be recognised directly in equity, through the statement of changes in equity, except for:
  - **impairment losses** and **foreign exchange gains and losses**,

  until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss.
- As the investments in bonds are monetary items as explained, HKAS 39.AG83 requires that, for the purpose of recognising foreign exchange gains and losses under HKAS 21, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency.
- Accordingly, for such a financial asset,
  - exchange differences resulting from changes in amortised cost are recognised in profit or loss and
  - other changes in carrying amount are recognised in equity.

Exchange Difference

Example

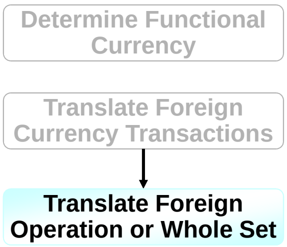
- As explained by HKAS 39.IG.E.3.2, the cumulative gain or loss that is recognised in equity is the difference between
  - the amortised cost (adjusted for impairment, if any) and
  - fair value of the available-for-sale monetary financial asset

  in the functional currency of the reporting entity.
- In summary, investment in bonds in functional currency, HK$, at:

- Cost (GBP 800,000 x 14)	HK$ 11,200,000
- Amortised cost (GBP 820,000 x 14.5)	HK$ 11,890,000
- Fair value (GBP 900,000 x 14.5)	HK$ 13,050,000

- In consequence,
  - the difference between the amortised cost and fair value of HK$1,160,000 is recognised in equity.
  - the remaining gain of HK$690,000 is recognised in the income statement (what kinds of components are included?)

Translate Foreign Operation



Determine Functional Currency

Translate Foreign Currency Transactions

Translate Foreign Operation or Whole Set

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

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.

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.

Translate Foreign Operation

Case

中国建设银行
China Construction Bank

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- 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.

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.

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.

Translate Foreign Operation

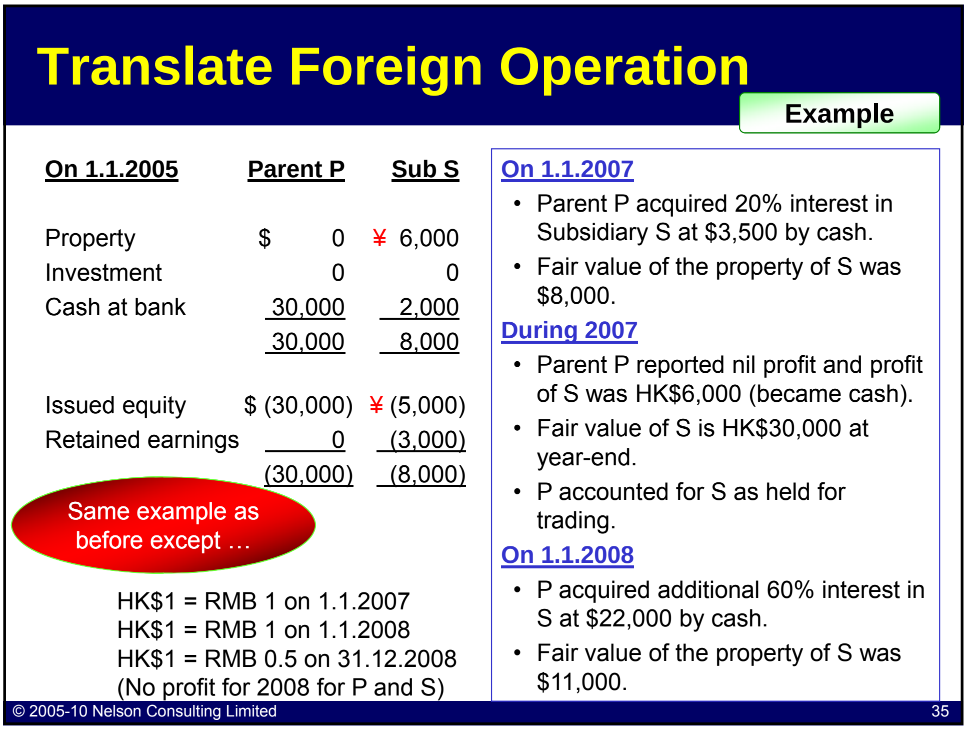
Goodwill arising on acquisition

- 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).

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.



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

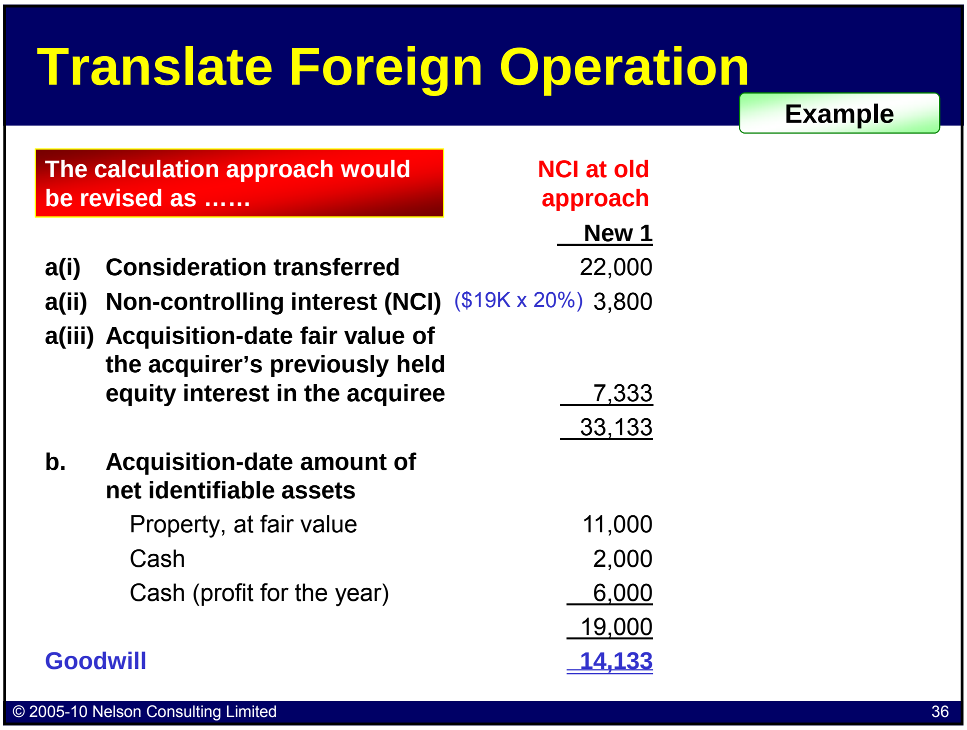
- Parent P acquired 20% interest in Subsidiary S at $3,500 by cash.
- Fair value of the property of S was $8,000.

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.

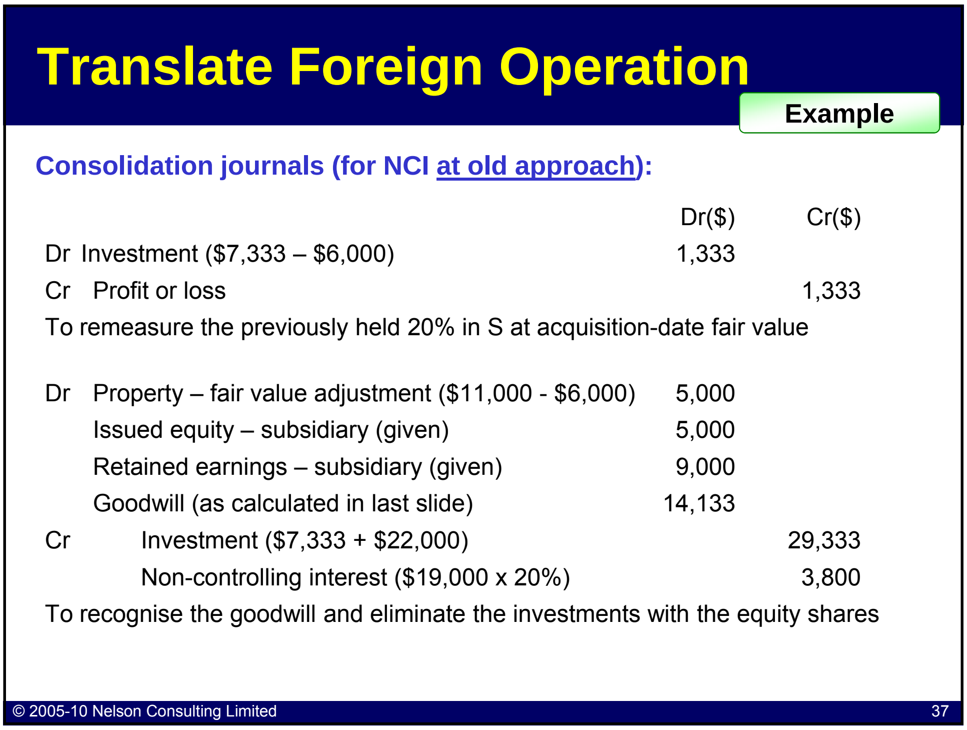


Translate Foreign Operation

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



Translate Foreign Operation

Example

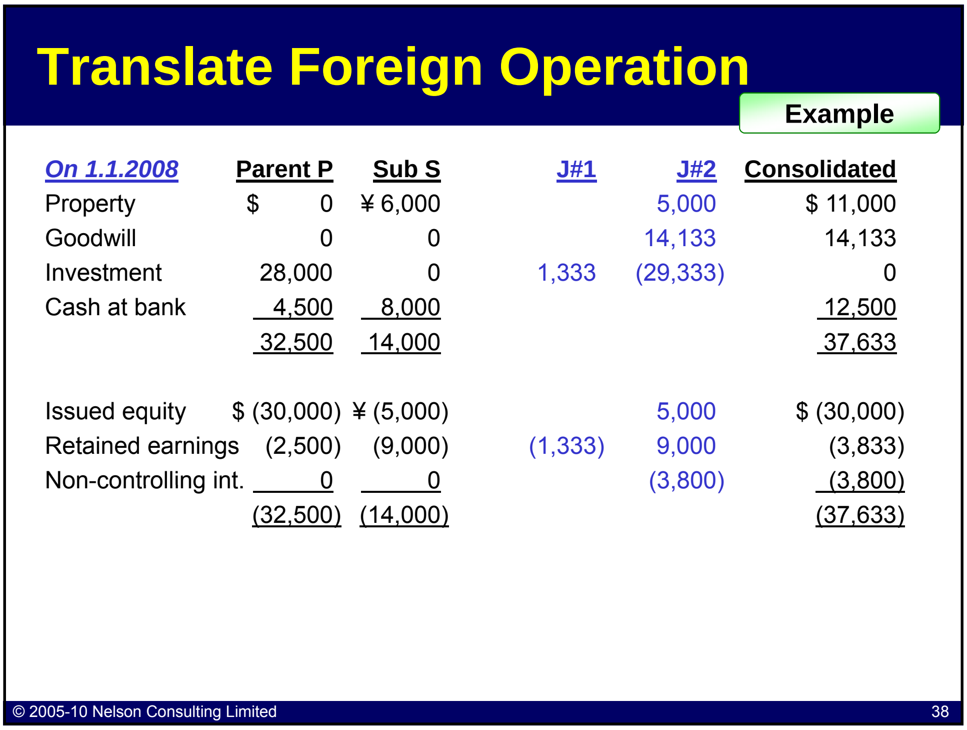
Consolidation journals (for NCI at old approach):

		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($)	Cr($)
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

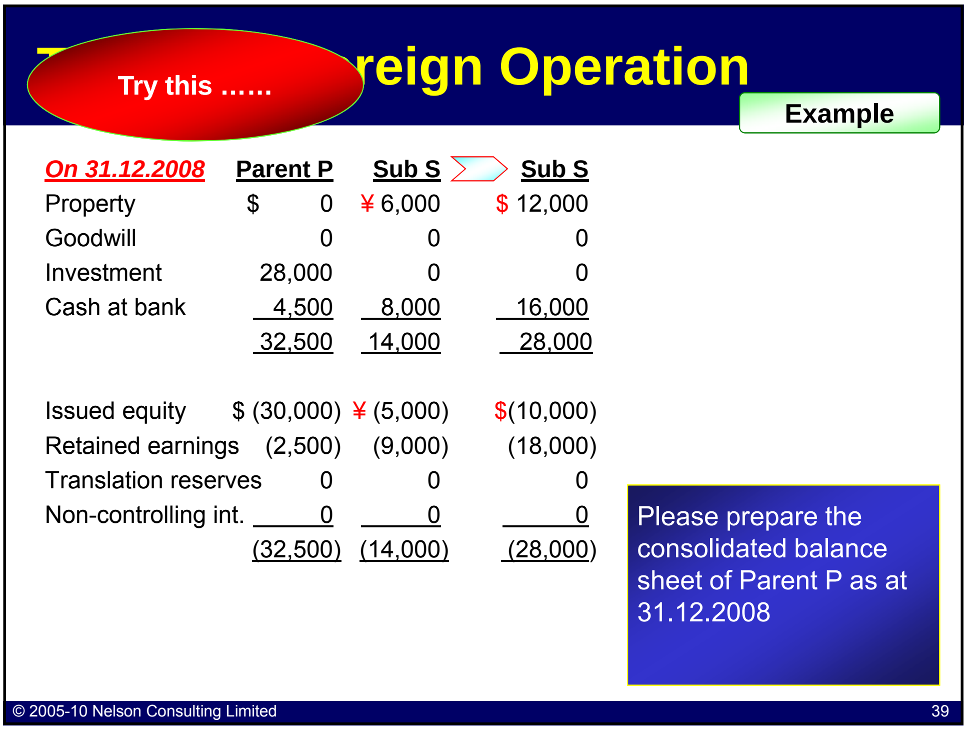
To recognise the goodwill and eliminate the investments with the equity shares



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)



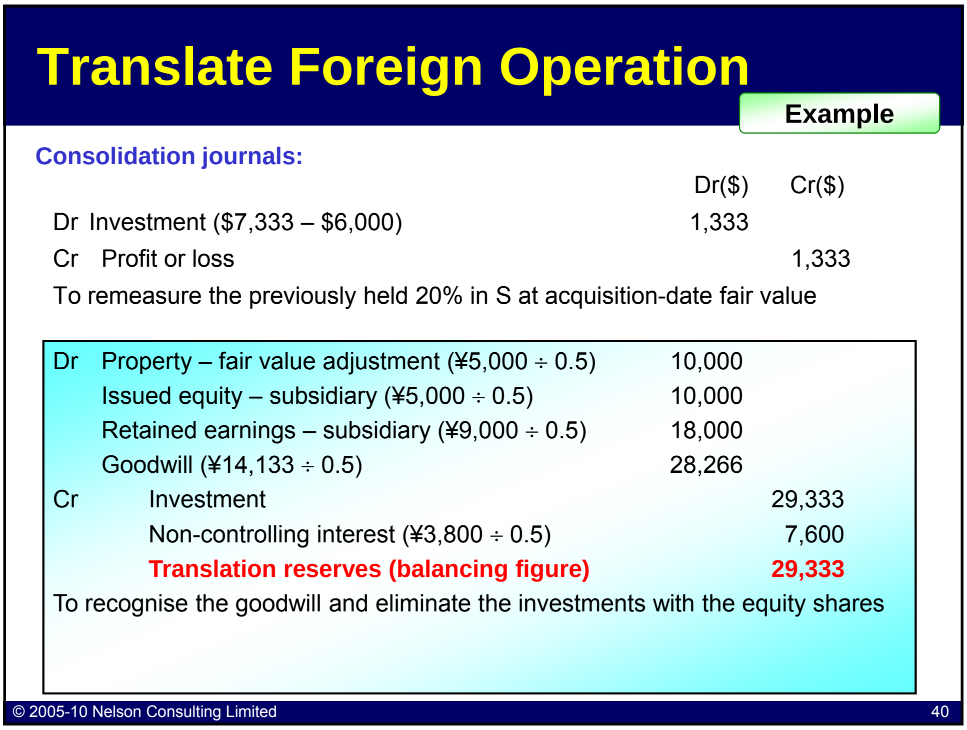
reign Operation

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



Translate Foreign Operation

Example

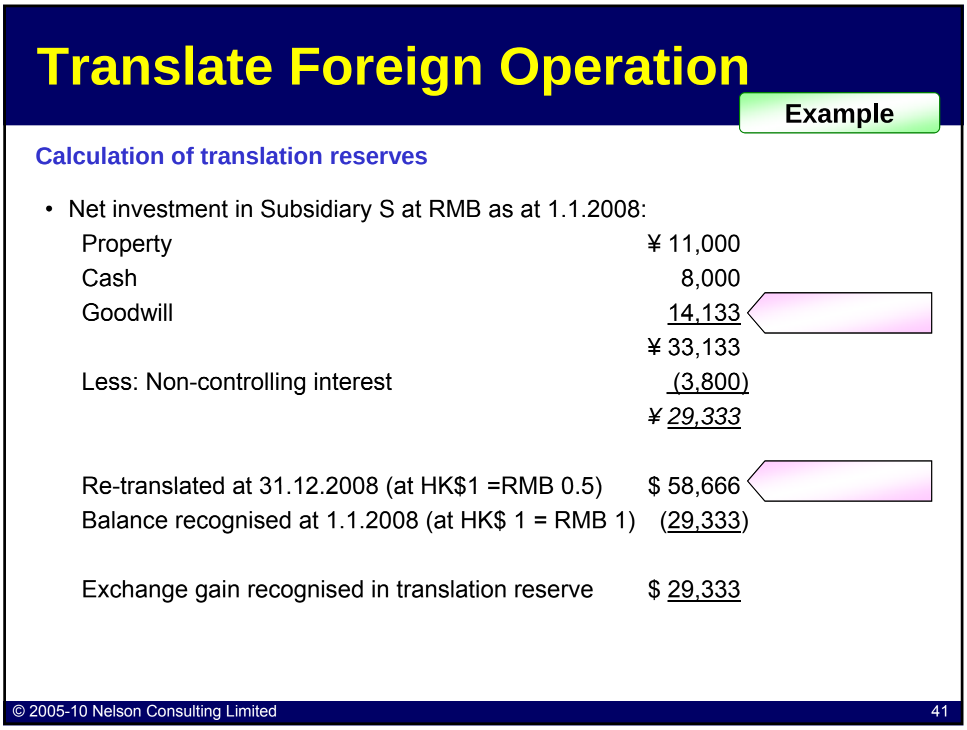
Consolidation journals:

		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($)	Cr($)
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



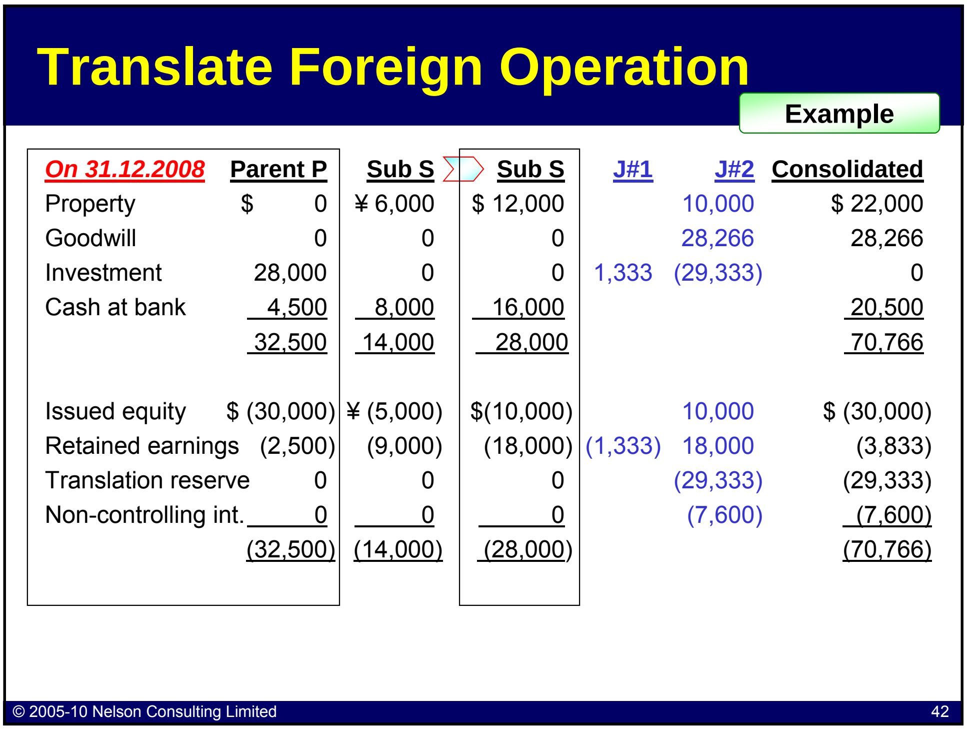
Translate Foreign Operation

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



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)

Translate Foreign Operation

Case

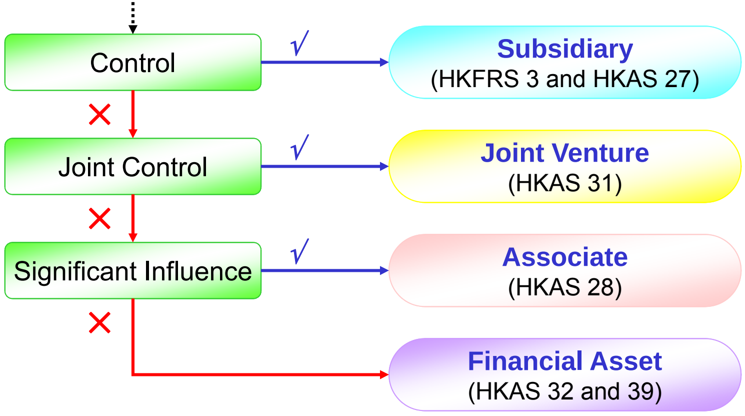
Esprit Holdings Limited

- 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.

2. Equity Accounting

3. Equity Accounting

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



Control √ → **Subsidiary** (HKFRS 3 and HKAS 27)

✕

Joint Control √ → **Joint Venture** (HKAS 31)

✕

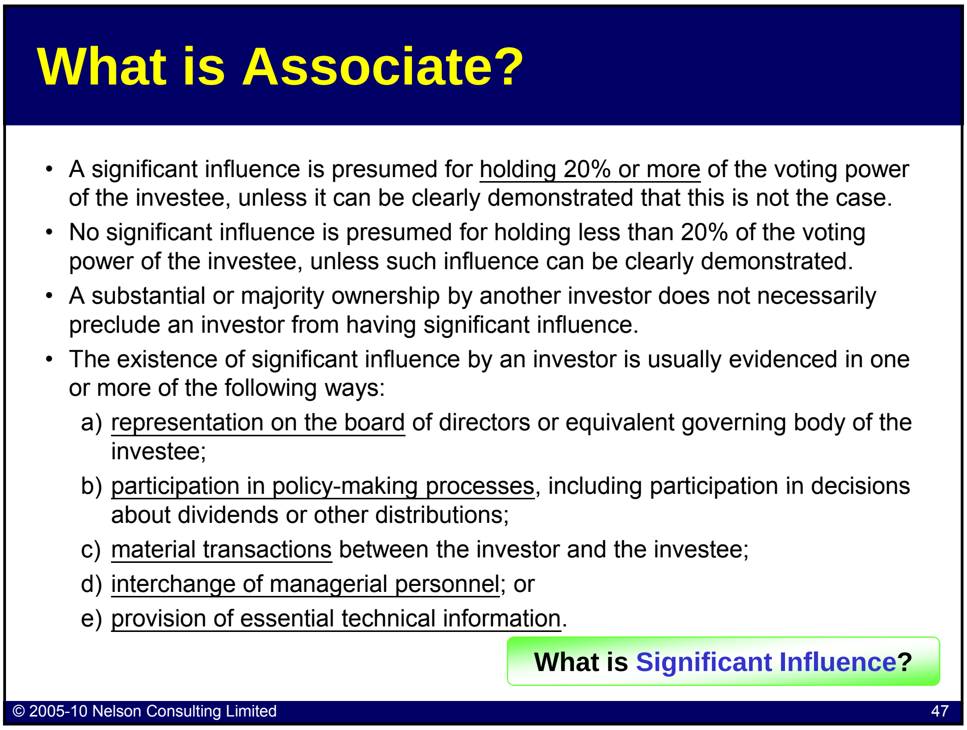
Significant Influence √ → **Associate** (HKAS 28)

✕ → **Financial Asset** (HKAS 32 and 39)

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).

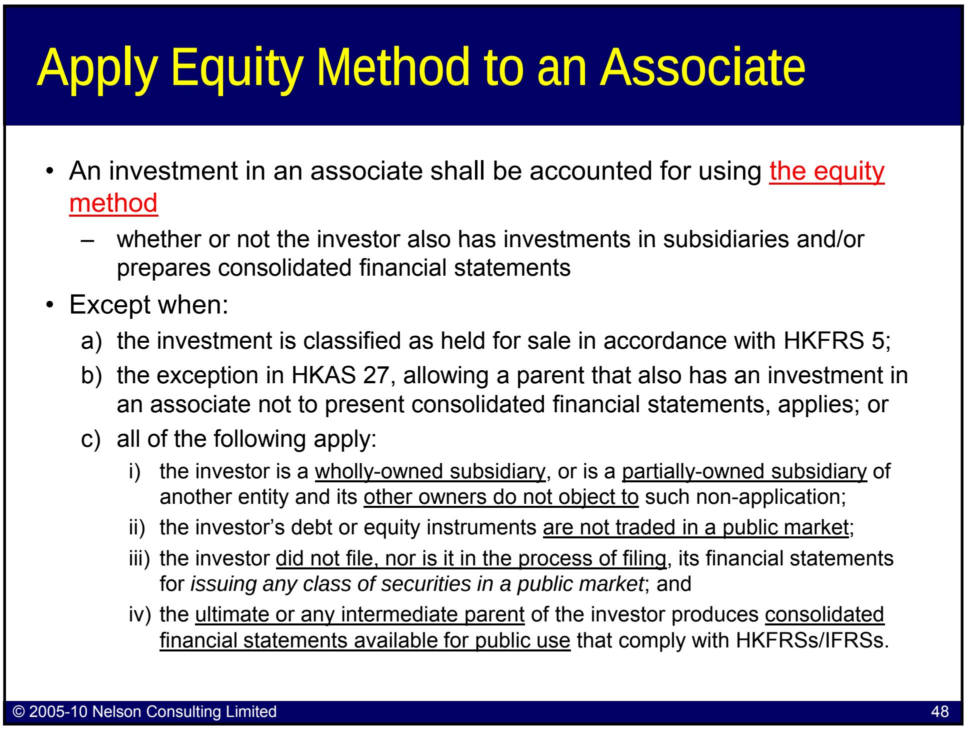
What is Significant Influence?



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?



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.

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

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

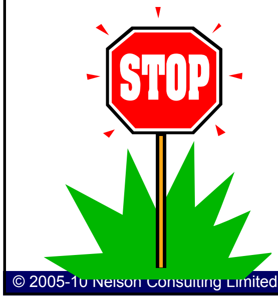
Apply Equity Method to an Associate

- **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

Apply Equity Method to an Associate

- **Discontinue the Use of the Equity Method**
  - discontinue the use of the equity method from the date that 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)



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.

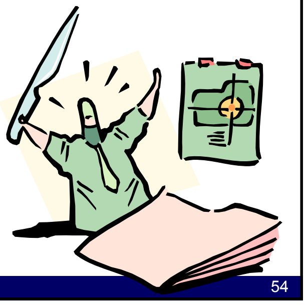
Initial Cost

Share of post-acquisition change in net assets

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.



Application of Equity Method

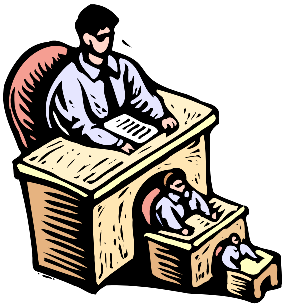
A. Initial recognition & subsequent changes under the equity method

- Adjustments to the carrying amount may include
  - changes in the investor's proportionate interest in the investee arising from **changes in the investee's equity** that have not been recognised in the investee's profit or loss
  - 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 equity of the investor.
- 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.

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

Application of Equity Method

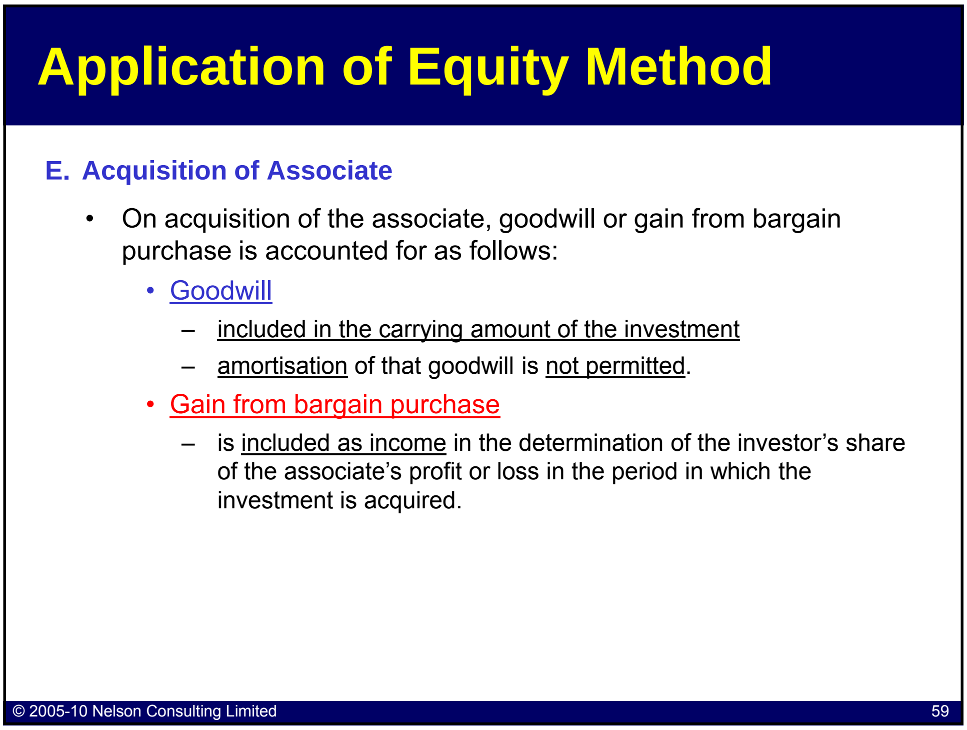
C. Complex Holding Structure

- 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.

Application of Equity Method

D. Transactions with Associate

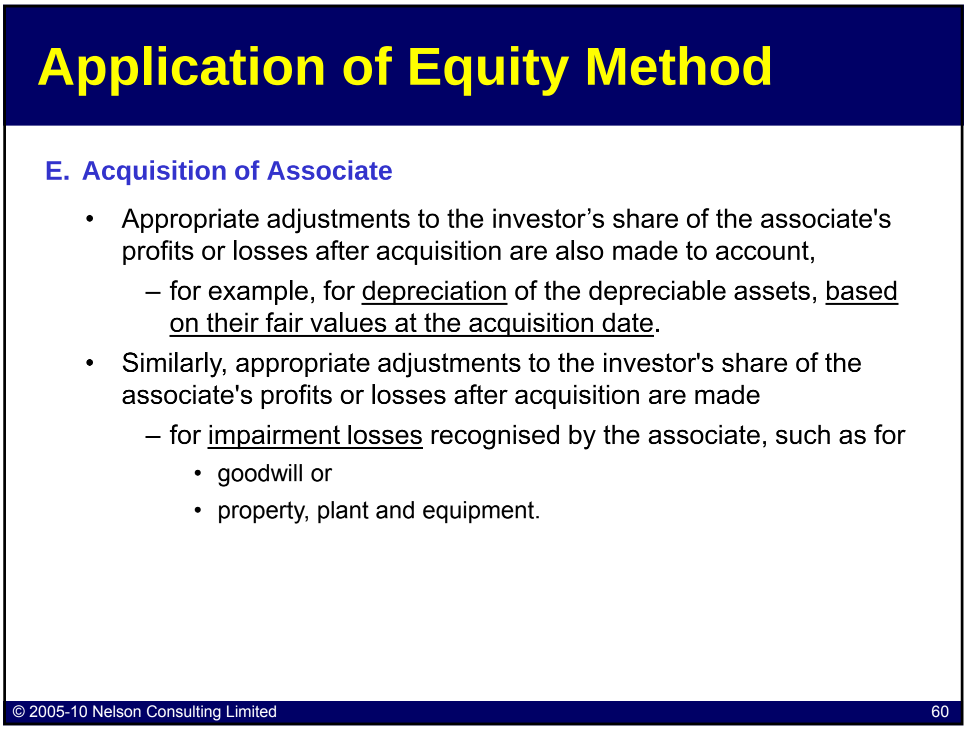
- Profits and losses resulting from ‘upstream’ and ‘downstream’ transactions between an investor (including its consolidated subsidiaries) and an associate are recognised in the investor’s financial statements only to the extent of unrelated investors’ interests in the associate.
  - ‘Upstream’ transactions 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.



Application of Equity Method

E. Acquisition of Associate

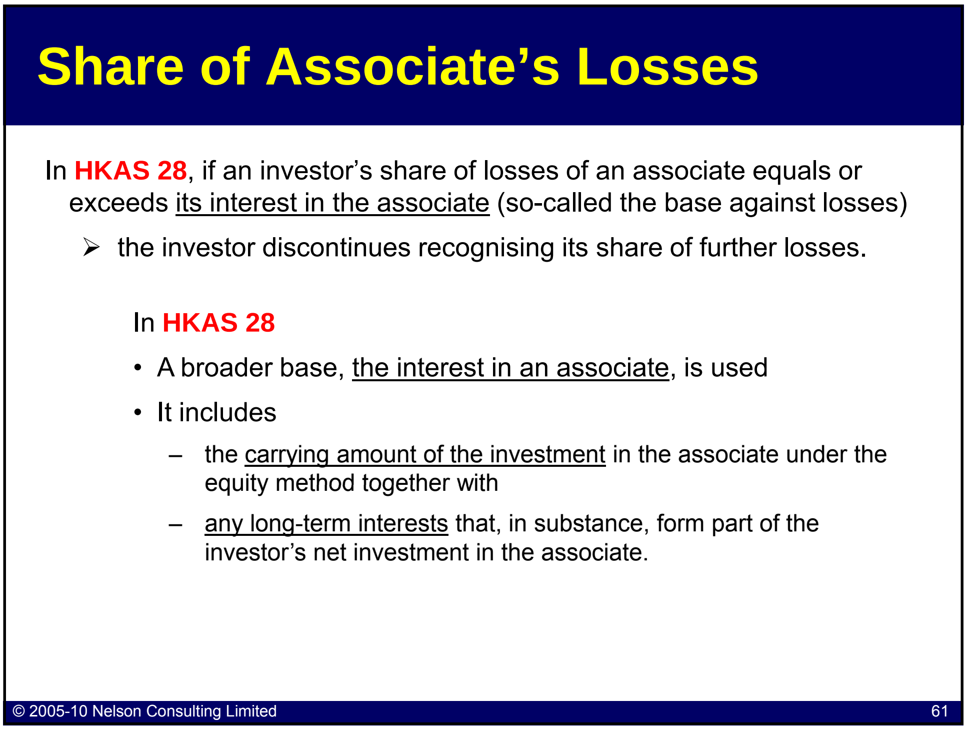
- On acquisition of the associate, goodwill or gain from bargain purchase is accounted for as follows:
  - Goodwill
    - included in the carrying amount of the investment
    - amortisation of that goodwill is not permitted.
  - Gain from bargain purchase
    - is included as income in the determination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



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.



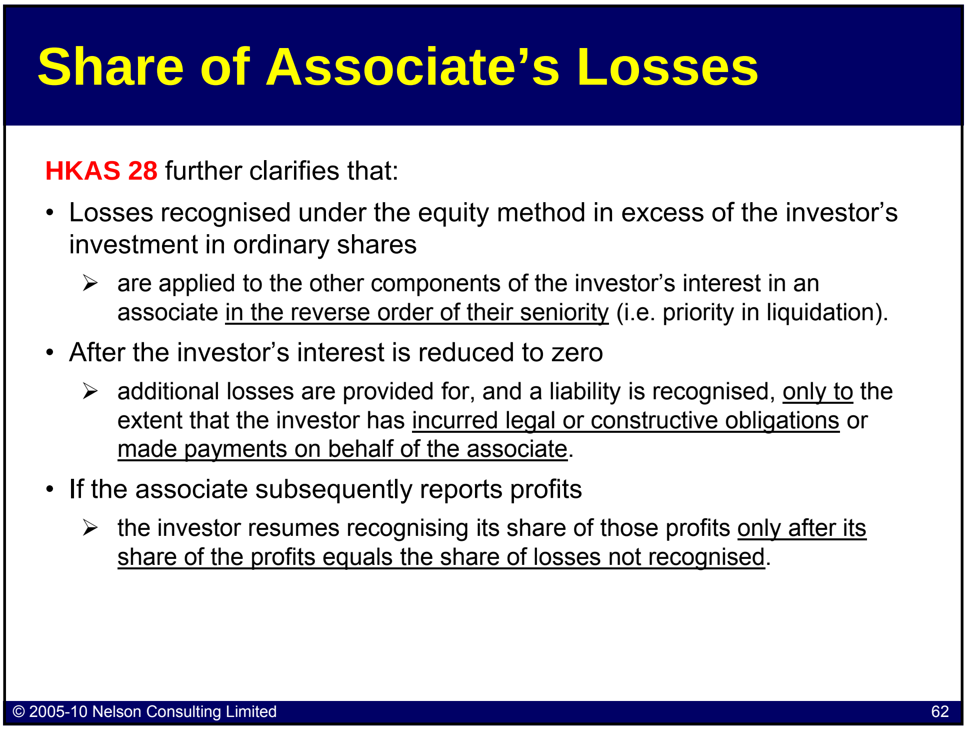
Share of Associate's Losses

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.



Share of Associate's Losses

HKAS 28 further clarifies that:

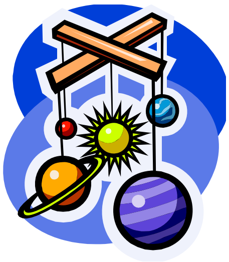
- Losses recognised under the equity method in excess of the investor's investment in ordinary shares
  - ➢ are applied to the other components of the investor's interest in an associate in the reverse order of their seniority (i.e. priority in liquidation).
- After the investor's interest is reduced 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.

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.



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.

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.

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)

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
	($17,000 - $10,000 x 30%)	($20,000 - $10,000 x 30%)

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.

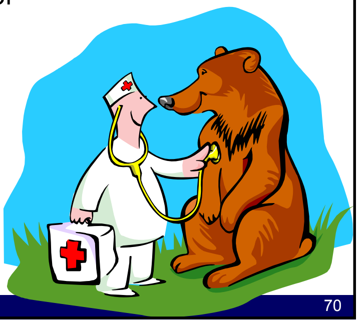
Impairment Losses

- 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.

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.



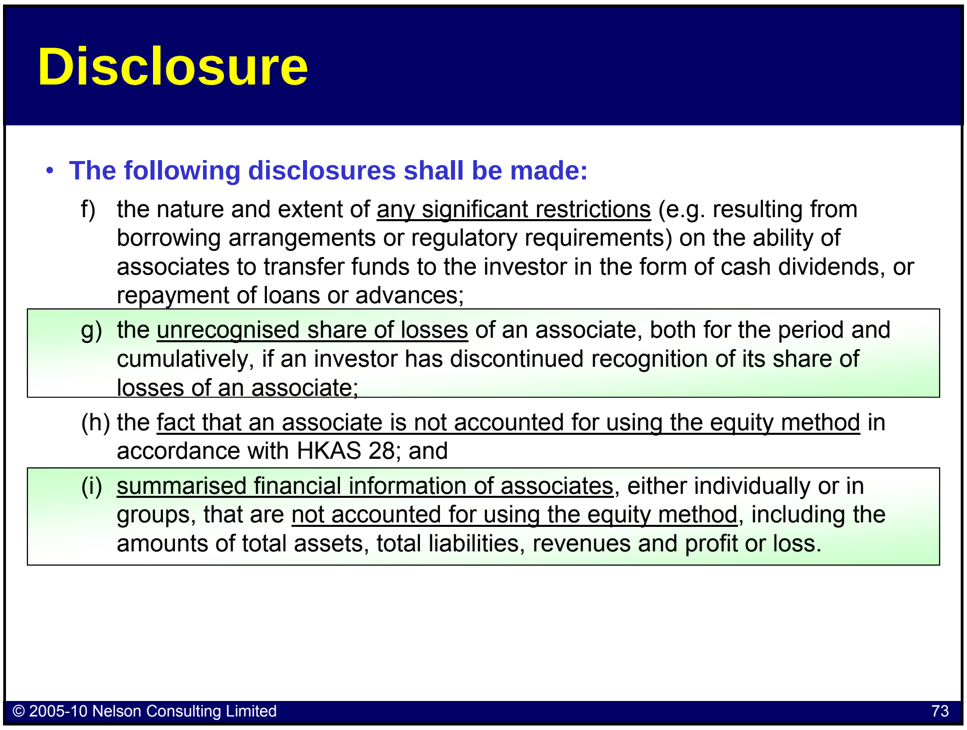
Impairment Losses

- 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.
- Under appropriate assumptions, both methods give the same result.
- 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.

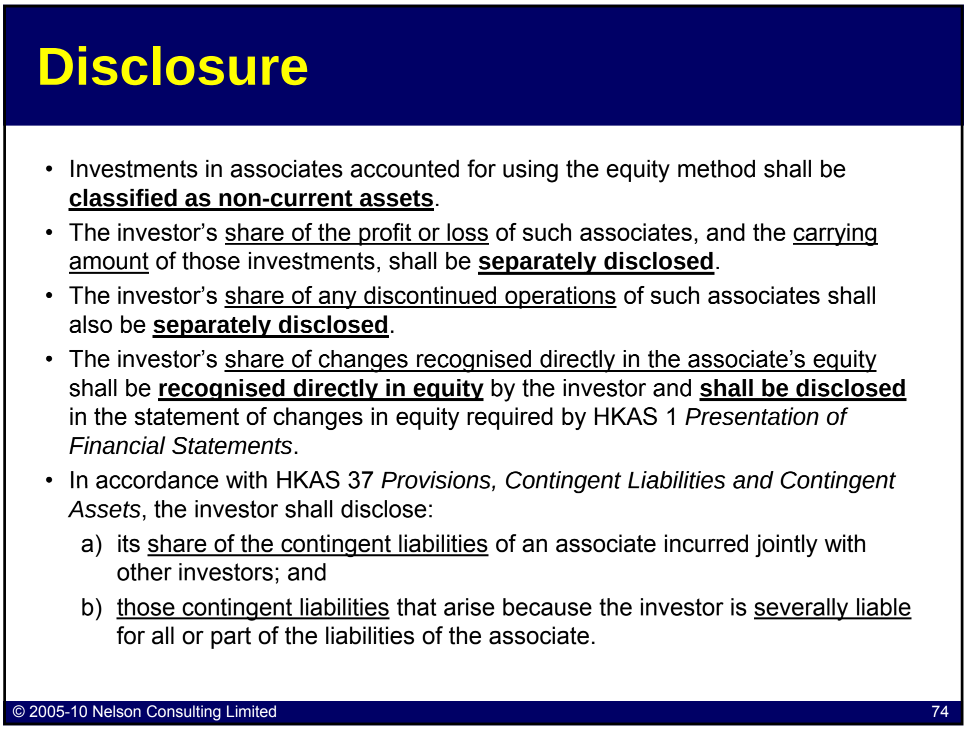
Disclosure

- **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;



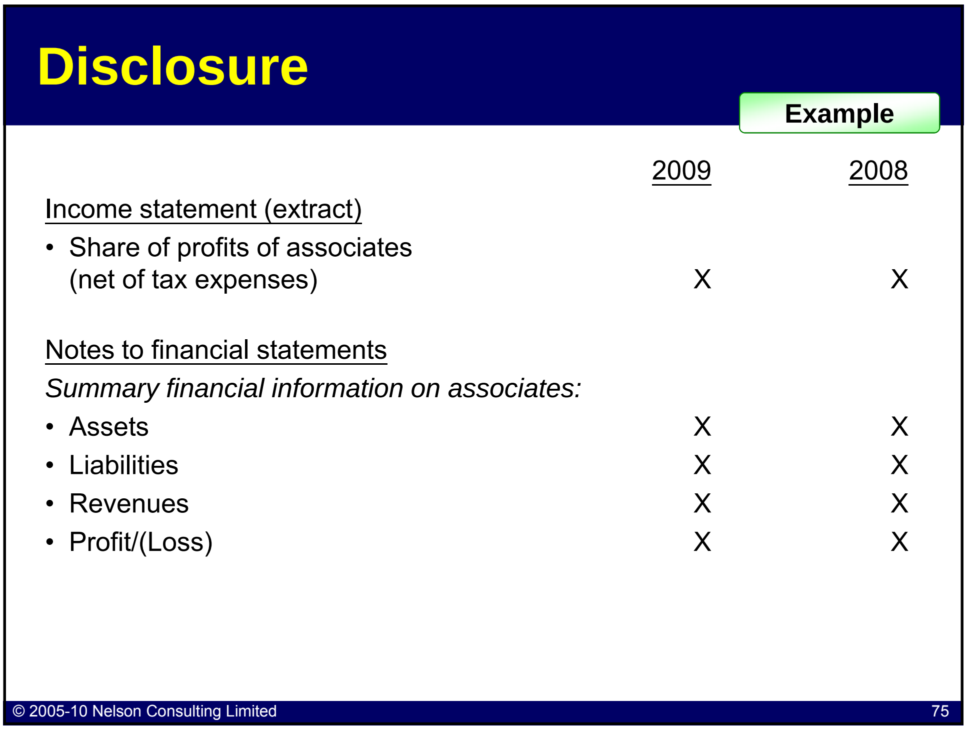
Disclosure

- **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.



Disclosure

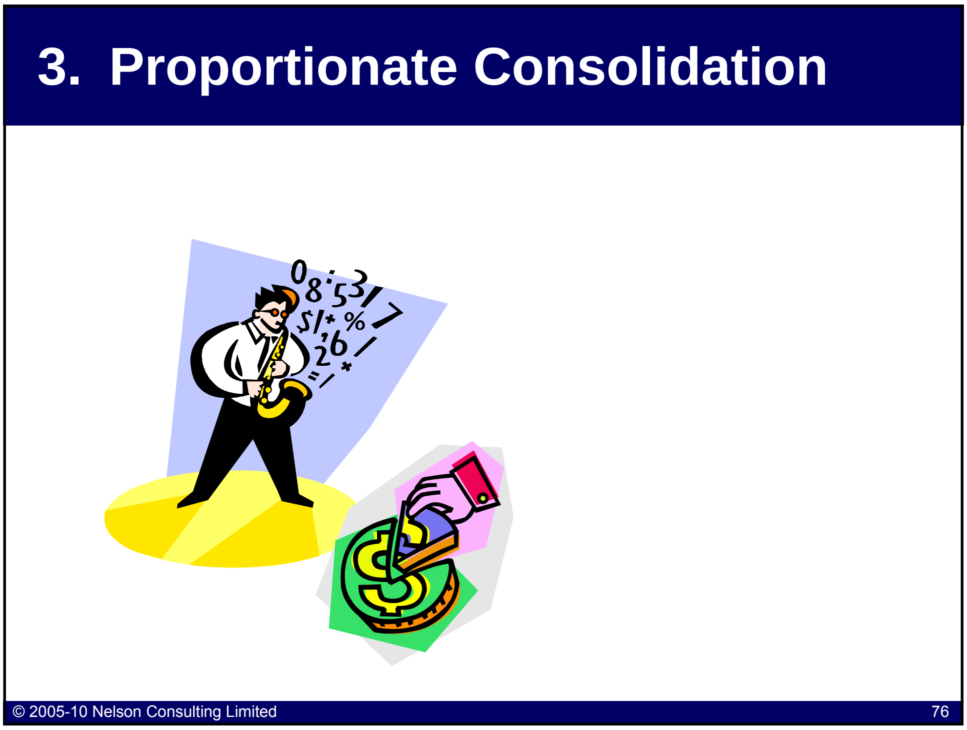
- Investments in associates accounted for using the equity method shall be **classified as non-current assets**.
- The investor's share of the profit or loss of such associates, and the carrying amount of those investments, shall be **separately disclosed**.
- The investor's share of any discontinued operations of such associates shall also be **separately disclosed**.
- The investor's share of changes recognised directly in the associate's equity shall be **recognised directly in equity** by the investor and **shall be disclosed** in the statement of changes in equity required by HKAS 1 *Presentation of Financial Statements*.
- 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.



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



3. Proportionate Consolidation

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.

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

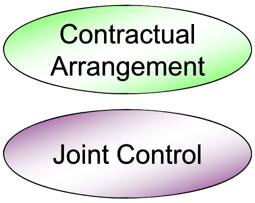
Scope

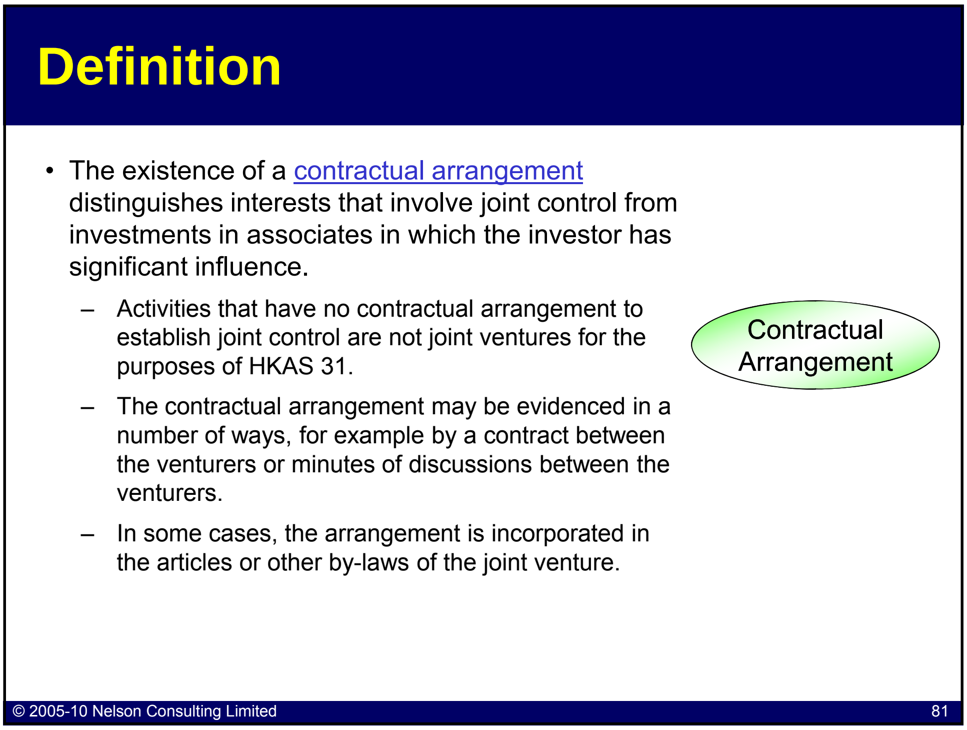
- A venturer is a party to a joint venture and has joint control over that joint venture.
- An investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

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.

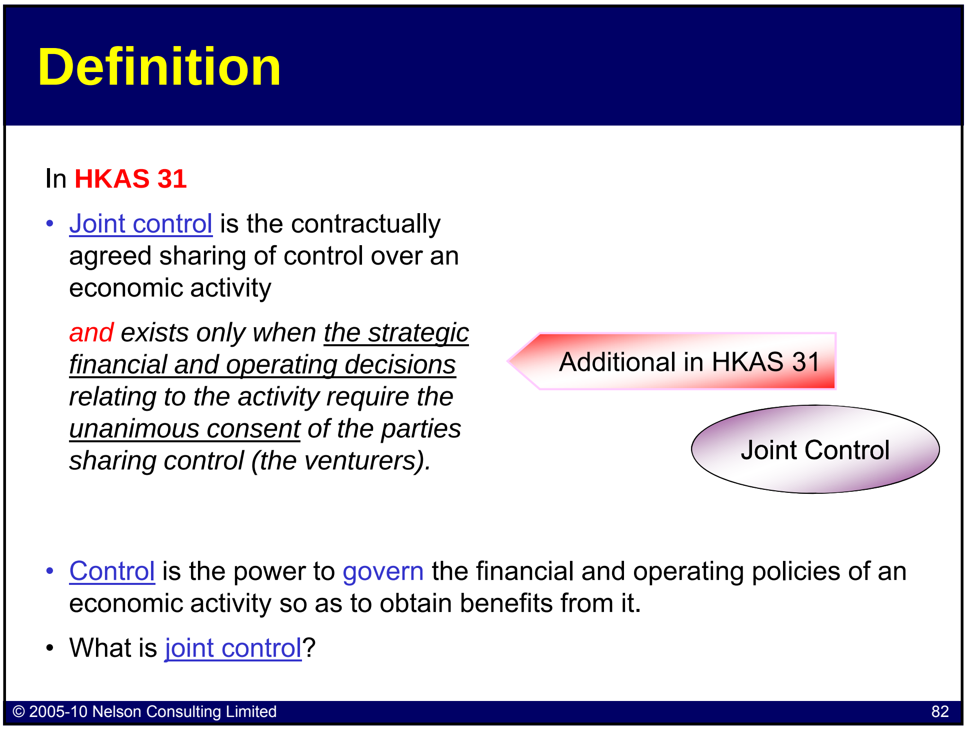




Definition

- 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



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).

Additional in HKAS 31

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?

Definition

Example

The following entities are owned by A (35%), B (35%), C (15%) and D (15%) with different strategic decision arrangement as follows:

1. Entity OB's strategic decision requires 100% approval from A, B, C and D

A, B, C and D share joint control and OB would be classified as a jointly controlled entity for all of them

2. Entity Vader's strategic decision requires a simple majority vote

Vader is not controlled or jointly controlled by A, B, C and D. Depending on the extent of influence, it may be an associate to A and B

3. Entity Yoda's strategic decision requires 70% approval

A and B share joint control and would classify it as joint venture. C and D may only be an investor in this case

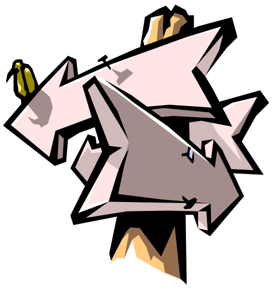
Forms of Joint Venture

- HKAS 31 identifies 3 broad types of joint ventures :

Jointly controlled operations

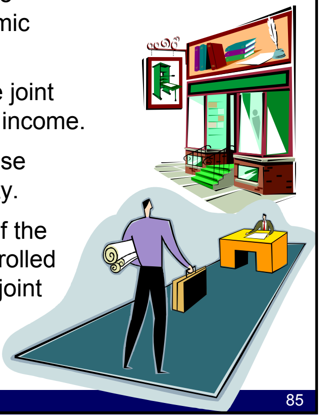
Jointly controlled assets

Jointly controlled entities



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.



Jointly Controlled Entities

Recognition of jointly controlled entities:

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

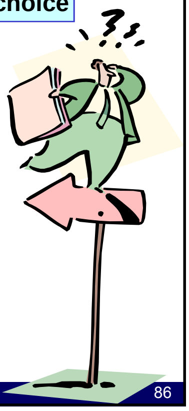
Proportionate Consolidation

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.



Jointly Controlled Entities

Recognition of jointly controlled entities:

Proportionate Consolidation

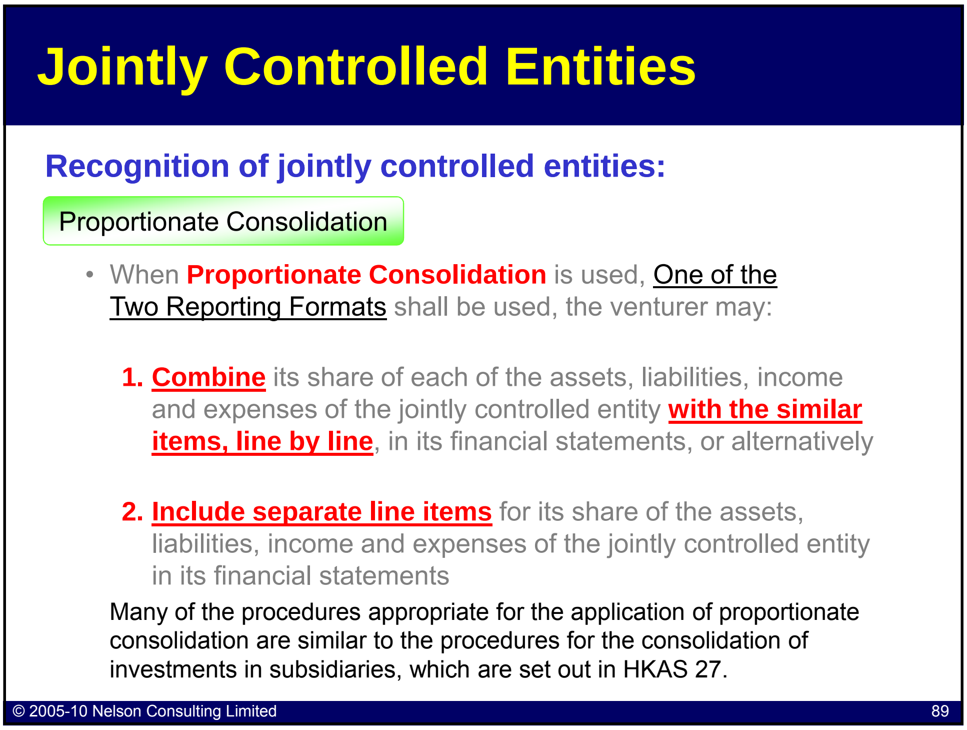
- a method of accounting whereby a venturer’s share of each of the assets, liabilities, income and expenses of a jointly controlled entity
  - is combined line by line with similar items in the venturer’s financial statements, or
  - reported as separate line items in the venturer’s financial statements
- 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.

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 balance sheet 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 income statement of the venturer includes its share of the income and expenses of the jointly controlled entity.



Jointly Controlled Entities

Recognition of jointly controlled entities:

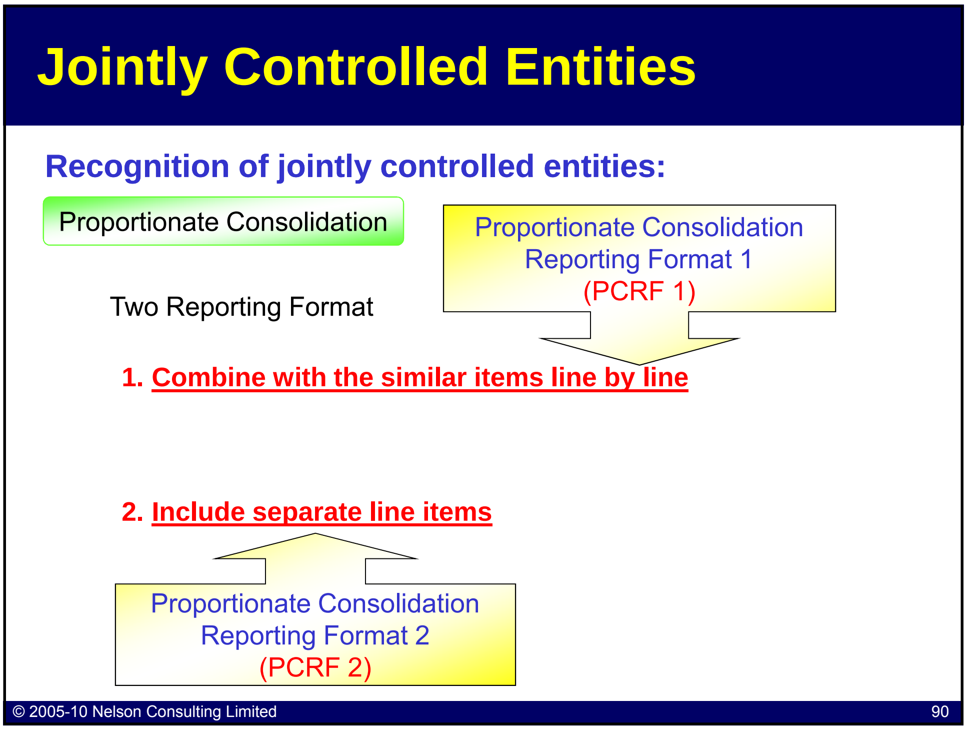
Proportionate Consolidation

- 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.



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)

Jointly Controlled Entities

Example

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

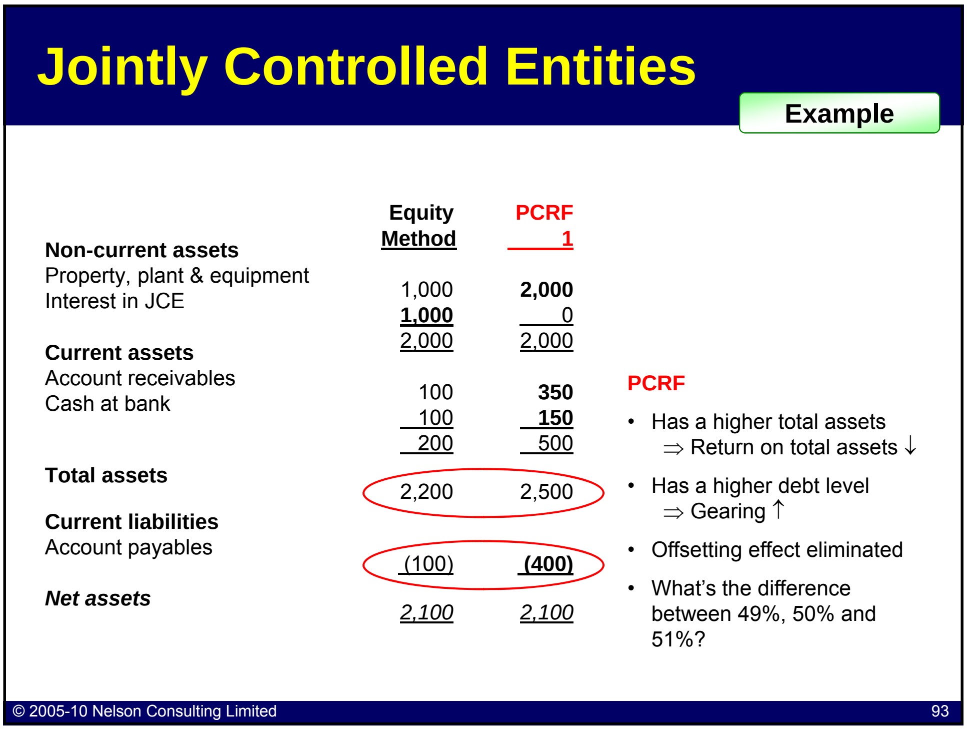
	VT	JCE	Equity Method	PCRF 1	PCRF 2
Non-current assets					
Property, plant & equipment	1,000	2,000	1,000	**2,000**	**1,000** PPE-VT **1,000** PPE-JCE
Interest in JCE	500	0	**1,000**	0	
	1,500	2,000	2,000	2,000	
Current assets					
Account receivables	100	500	100	**350**	**100** A/R-VT **250** A/R-JCE
Cash at bank	100	100	100	**150**	**100** Cash-VT **50** Cash-JEC
	200	600	200	500	
Current liabilities					
Account payables	(100)	(600)	(100)	**(400)**	**(100)** A/P-VT **(300)** A/P-JCE
Net current assets	100	0	100	100	
Net assets	*1,600*	*2,000*	*2,100*	*2,100*	2,100

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



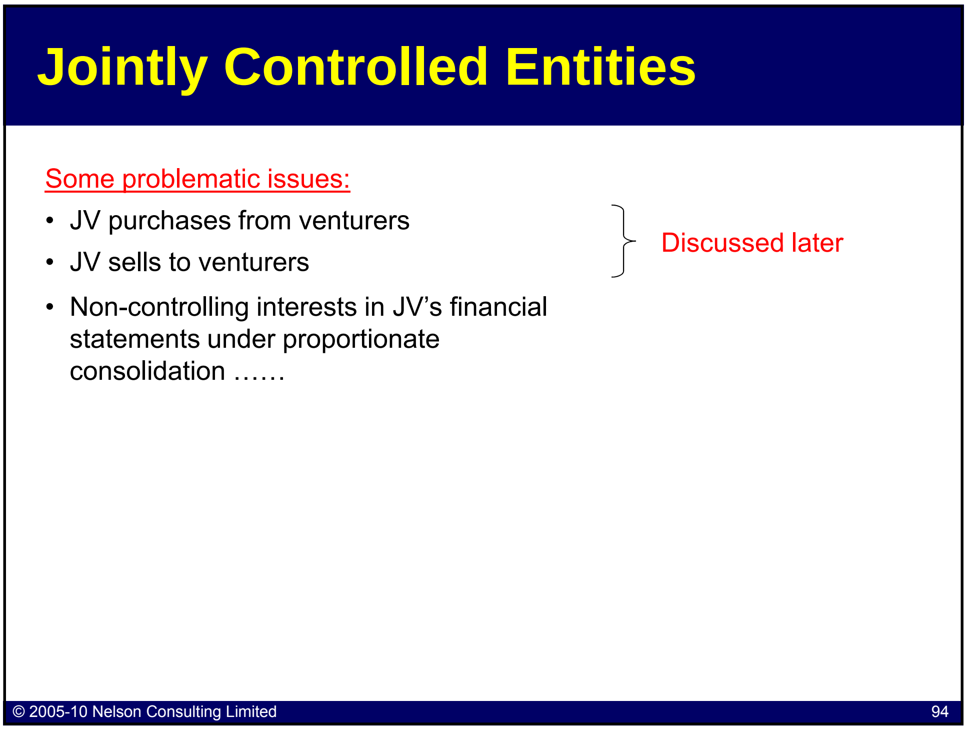
Jointly Controlled Entities

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%?



Jointly Controlled Entities

Some problematic issues:

- JV purchases from venturers
- JV sells to venturers
- Non-controlling interests in JV's financial statements under proportionate consolidation ……

} Discussed later

Jointly Controlled Entities

Example

Think about this case

- Assume Venturer has a joint control 50% on a JCE
- JCE's assets represent JCE's 80% interest in a subsidiary, which has assets of $125

	Venturer	JCE
Assets		125
Investment in JCE	50	
	50	125
Equity	50	100
Non-controlling interests		25
	50	125

Jointly Controlled Entities

Case

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

2009 Annual Report states:

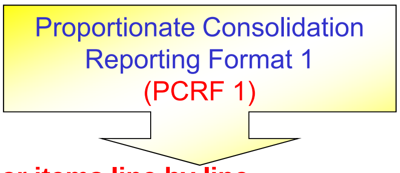
- The Group reports its interests in jointly controlled entities
  - using the proportionate consolidation method based on the profit-sharing ratios or net cash flow sharing ratio (as the case may be) specified in the relevant joint venture agreements.
- The Group's share of the income, expenses, assets 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.

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**

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.

Jointly Controlled Entities

Recognition of jointly controlled entities:

Equity Method

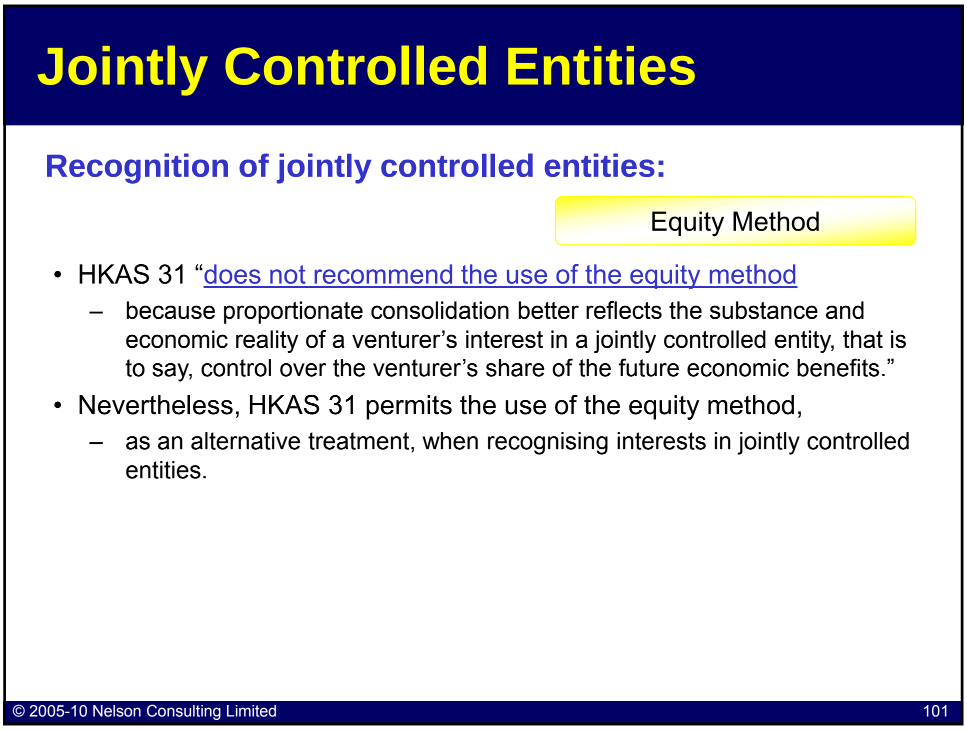
- As an alternative to proportionate consolidation described above, a venturer shall recognise its interest in a jointly controlled entity using the equity method
  - that is a method of accounting (same as described in HKAS 28) whereby
    - an interest in a jointly controlled entity is initially recorded 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.

Jointly Controlled Entities

Recognition of jointly controlled entities:

Equity Method

- The use of the equity method is supported
  - by those who argue that it is inappropriate to combine controlled items with jointly controlled items and
  - by those who believe that venturers have significant influence, rather than joint control, in a jointly controlled entity.
- A venturer shall discontinue the use of the equity method from the date on which it ceases to have joint control over, or have significant influence in, a jointly controlled entity.

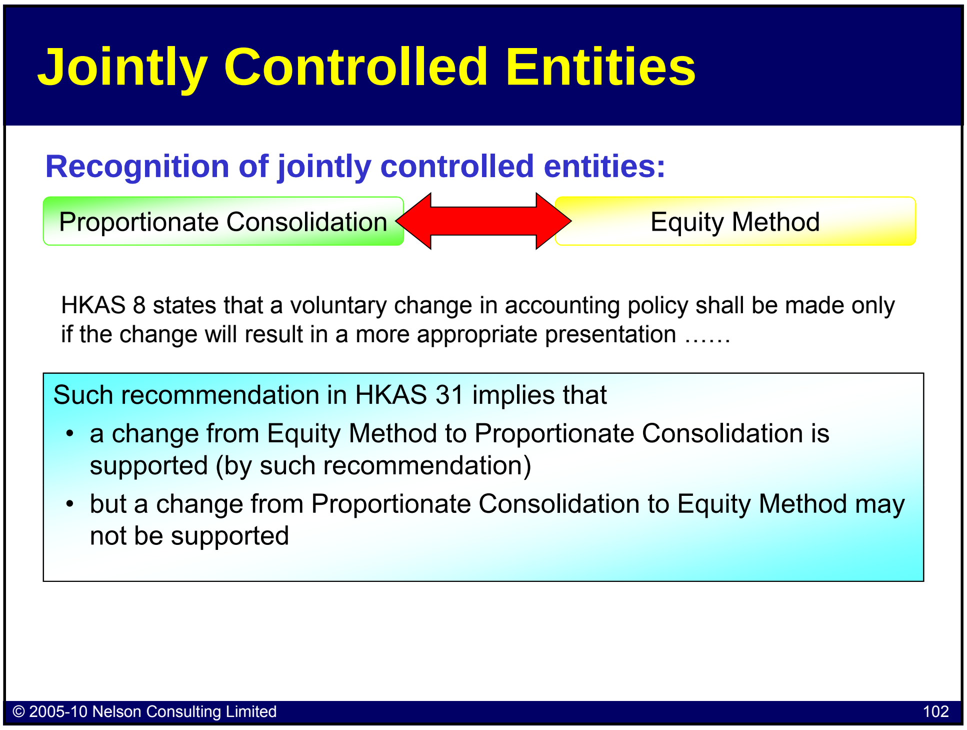


Jointly Controlled Entities

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.



Jointly Controlled Entities

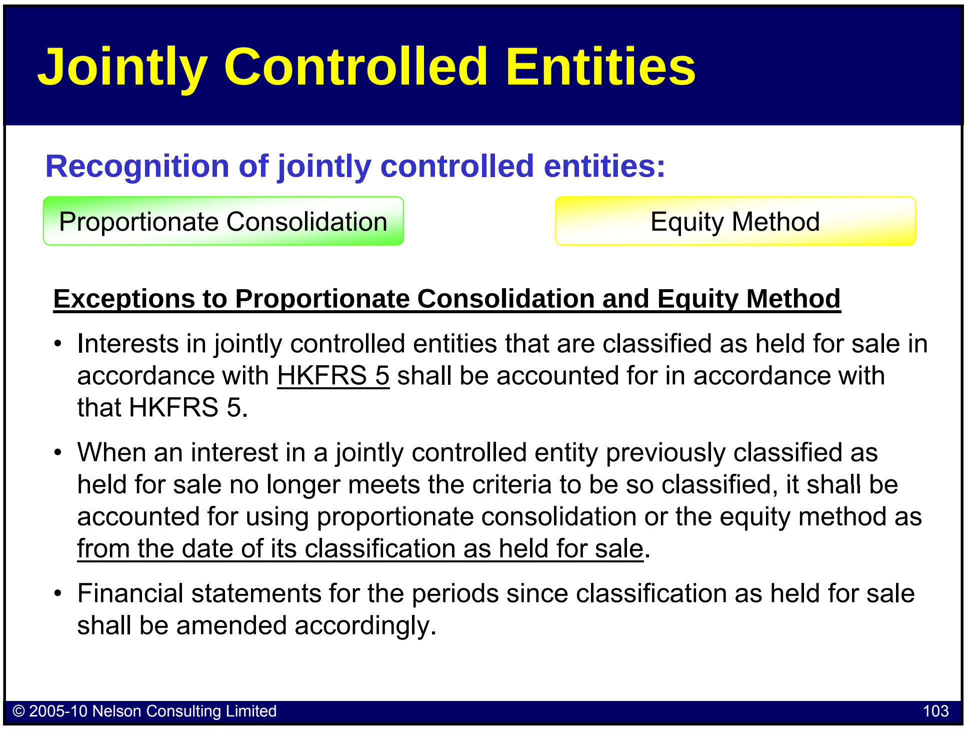
Recognition of jointly controlled entities:

Proportionate Consolidation ⟷ Equity Method

HKAS 8 states that a voluntary change in accounting policy shall be made only if the change will result in a more appropriate presentation ……

Such recommendation in HKAS 31 implies that

- a change from Equity Method to Proportionate Consolidation is supported (by such recommendation)
- but a change from Proportionate Consolidation to Equity Method may not be supported



Jointly Controlled Entities

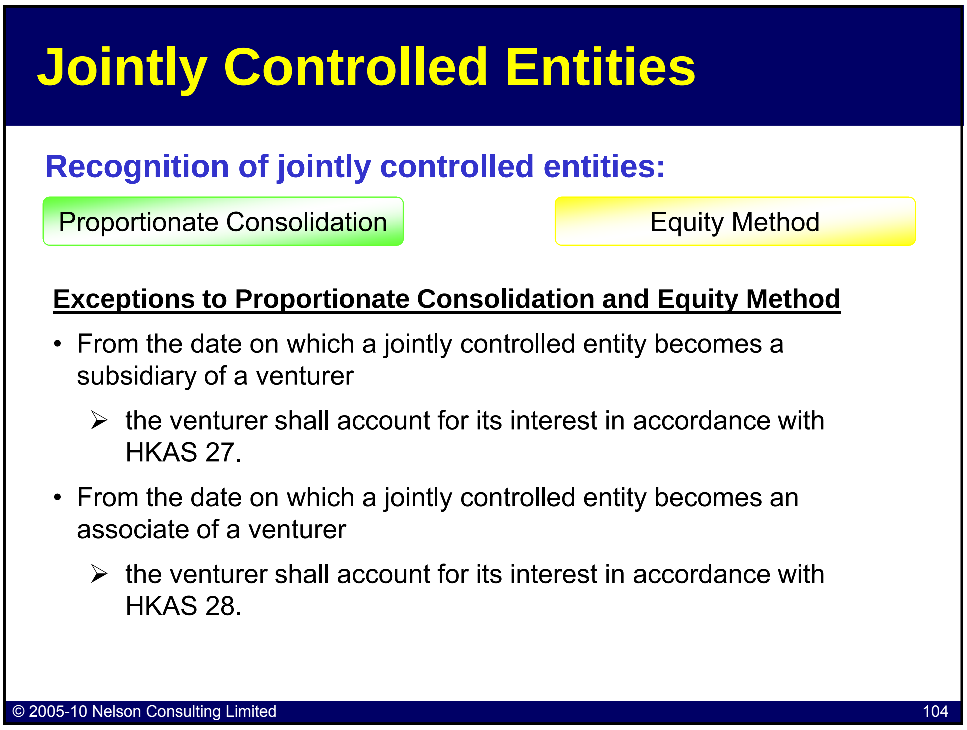
Recognition of jointly controlled entities:

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.



Jointly Controlled Entities

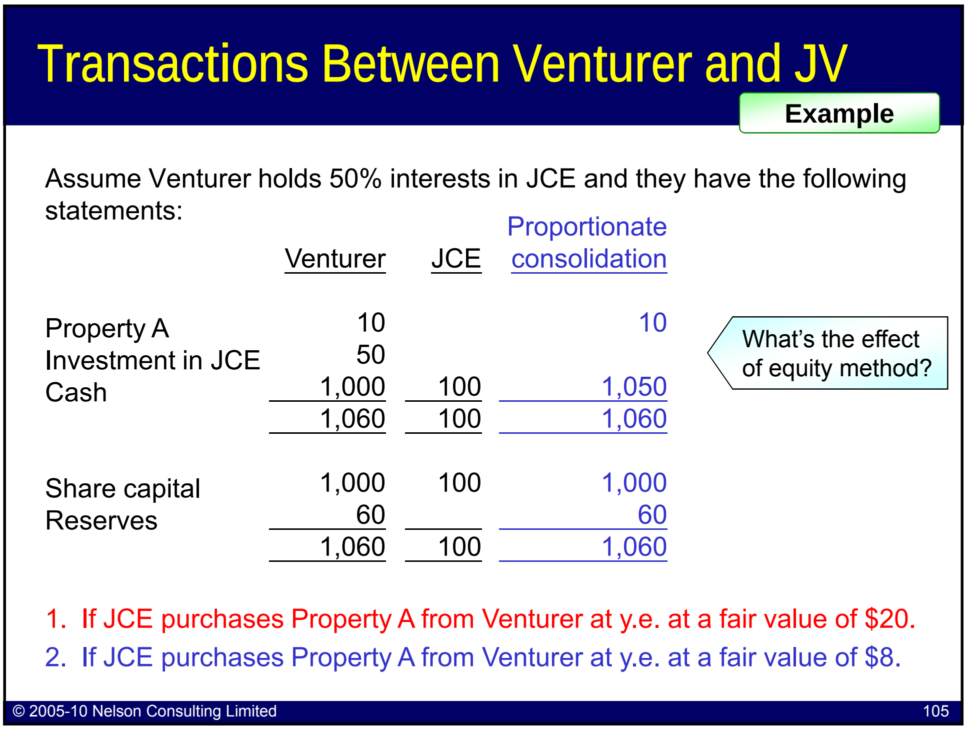
Recognition of jointly controlled entities:

Proportionate Consolidation

Equity Method

Exceptions to Proportionate Consolidation and Equity Method

- From the date on which a jointly controlled entity becomes a subsidiary of a venturer
  - ➢ the venturer shall account for its interest in accordance with HKAS 27.
- From the date on which a jointly controlled entity becomes an associate of a venturer
  - ➢ the venturer shall account for its interest in accordance with HKAS 28.



Transactions Between Venturer and JV

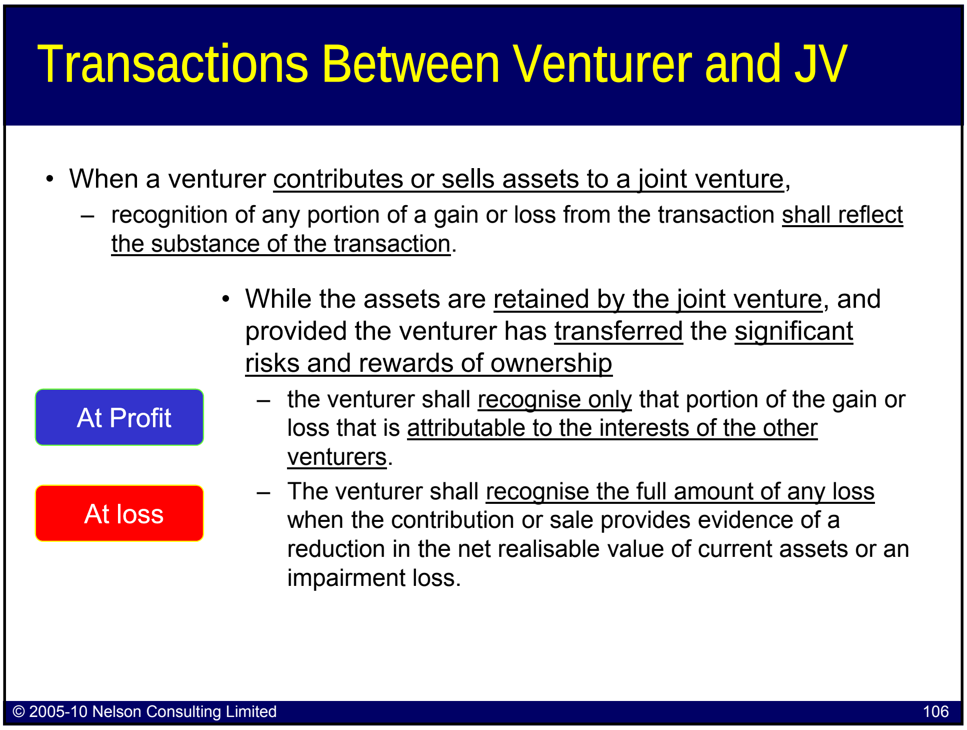
Example

Assume Venturer holds 50% interests in JCE and they have the following statements:

	Venturer	JCE	Proportionate consolidation
Property A	10		10
Investment in JCE	50		
Cash	1,000	100	1,050
	1,060	100	1,060
Share capital	1,000	100	1,000
Reserves	60		60
	1,060	100	1,060

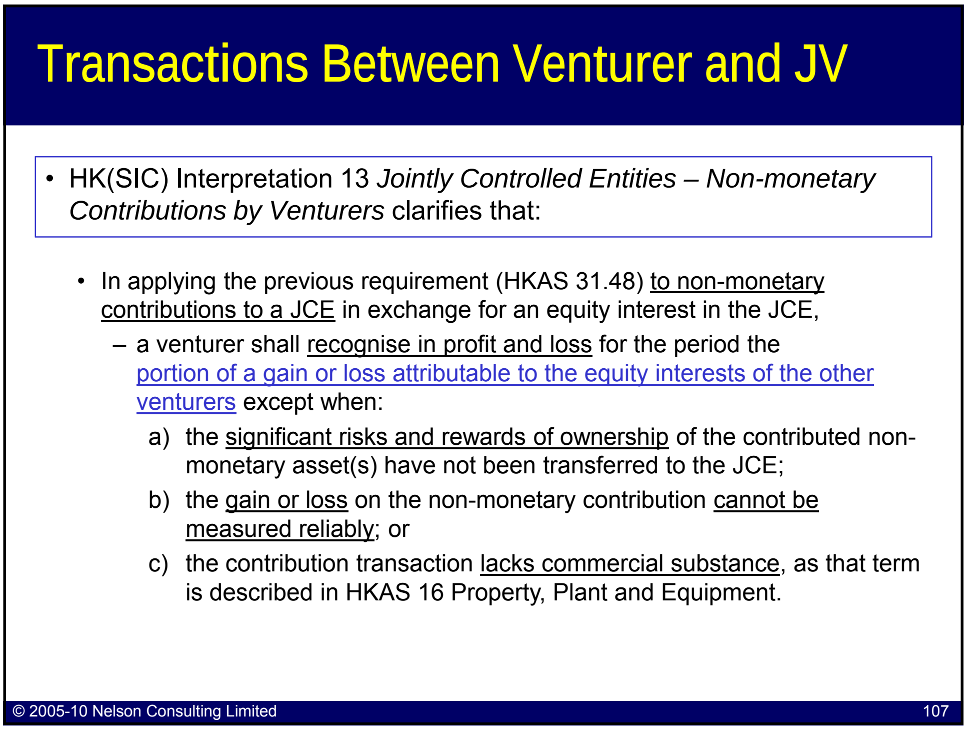
What's the effect of equity method?

1. If JCE purchases Property A from Venturer at y.e. at a fair value of $20.
2. If JCE purchases Property A from Venturer at y.e. at a fair value of $8.



Transactions Between Venturer and JV

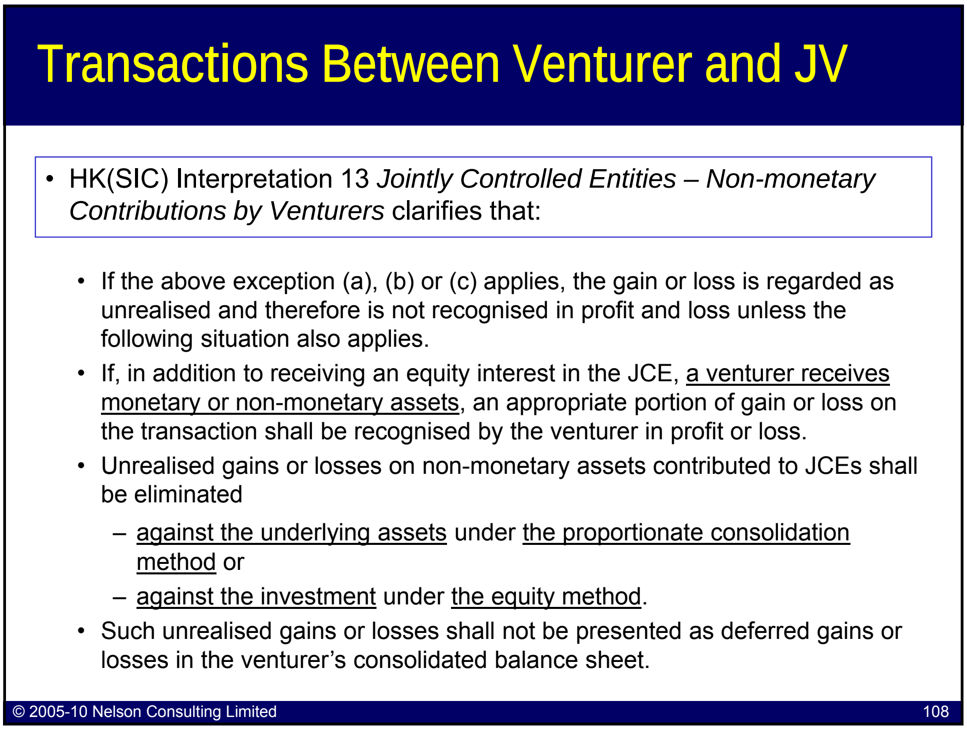
- When a venturer contributes or sells assets to a joint venture,
  - recognition of any portion of a gain or loss from the transaction shall reflect the substance of the transaction.
    - While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership
      - At Profit: the venturer shall recognise only that portion of the gain or loss that is attributable to the interests of the other venturers.
      - At loss: The venturer shall recognise the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.



Transactions Between Venturer and JV

- HK(SIC) Interpretation 13 *Jointly Controlled Entities – Non-monetary Contributions by Venturers* clarifies that:

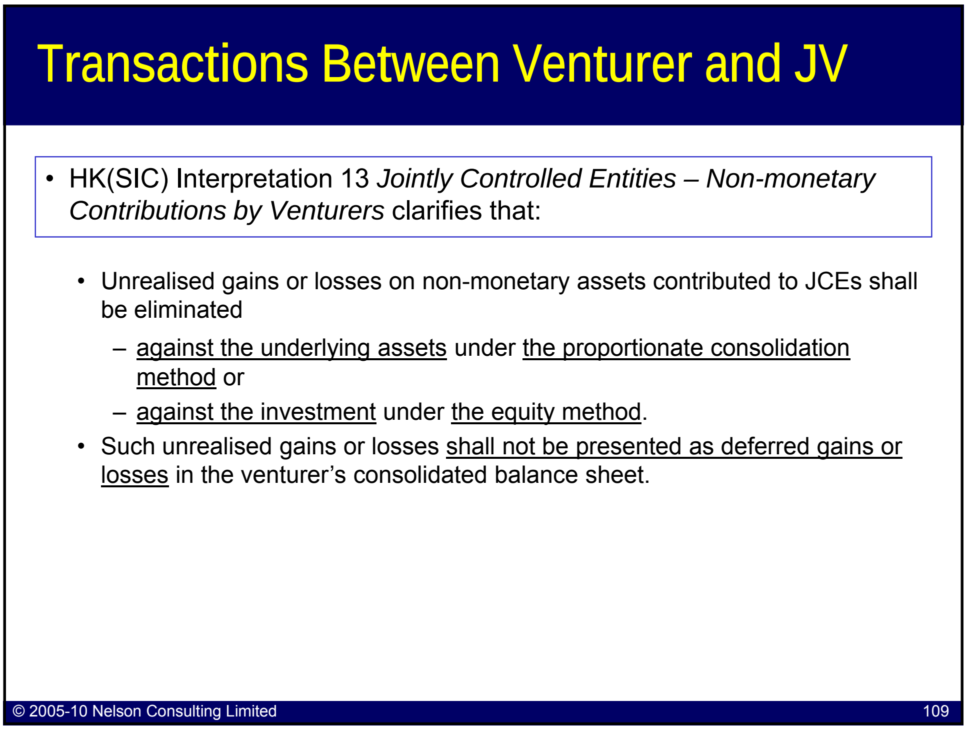
  - In applying the previous requirement (HKAS 31.48) to non-monetary contributions to a JCE in exchange for an equity interest in the JCE,
    - a venturer shall recognise in profit and loss for the period the portion of a gain or loss attributable to the equity interests of the other venturers except when:
      - a) the significant risks and rewards of ownership of the contributed non-monetary asset(s) have not been transferred to the JCE;
      - b) the gain or loss on the non-monetary contribution cannot be measured reliably; or
      - c) the contribution transaction lacks commercial substance, as that term is described in HKAS 16 Property, Plant and Equipment.



Transactions Between Venturer and JV

- HK(SIC) Interpretation 13 *Jointly Controlled Entities – Non-monetary Contributions by Venturers* clarifies that:

  - If the above exception (a), (b) or (c) applies, the gain or loss is regarded as unrealised and therefore is not recognised in profit and loss unless the following situation also applies.
  - If, in addition to receiving an equity interest in the JCE, a venturer receives monetary or non-monetary assets, an appropriate portion of gain or loss on the transaction shall be recognised by the venturer in profit or loss.
  - Unrealised gains or losses on non-monetary assets contributed to JCEs shall be eliminated
    - against the underlying assets under the proportionate consolidation method or
    - against the investment under the equity method.
  - Such unrealised gains or losses shall not be presented as deferred gains or losses in the venturer's consolidated balance sheet.



Transactions Between Venturer and JV

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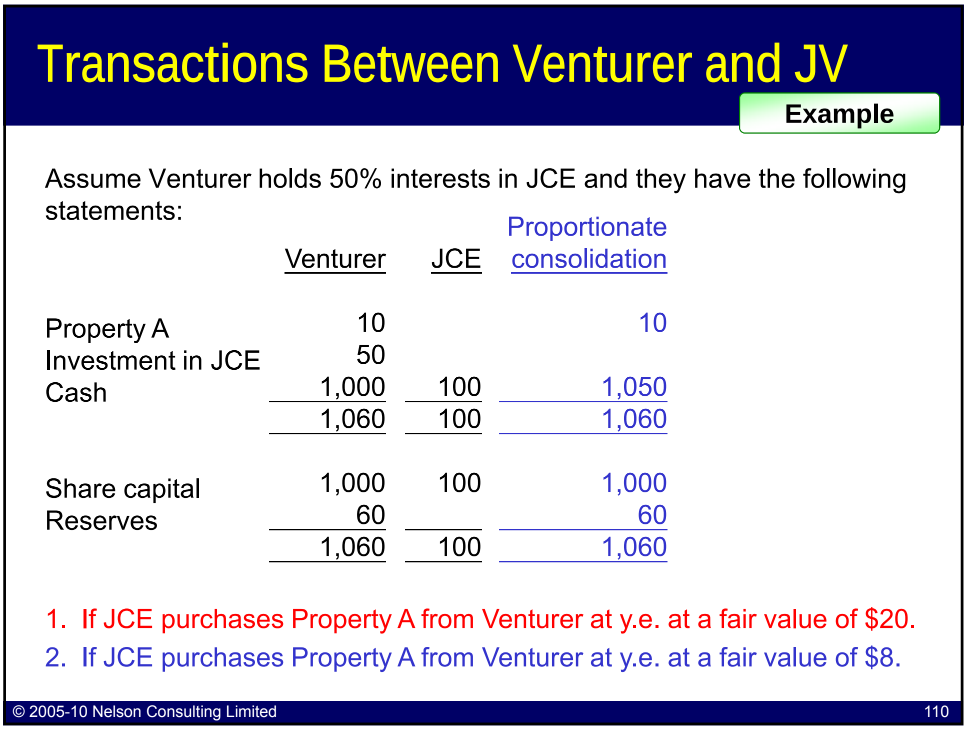
  - Unrealised gains or losses on non-monetary assets contributed to JCEs shall be eliminated
    - against the underlying assets under the proportionate consolidation method or
    - against the investment under the equity method.
  - Such unrealised gains or losses shall not be presented as deferred gains or losses in the venturer's consolidated balance sheet.



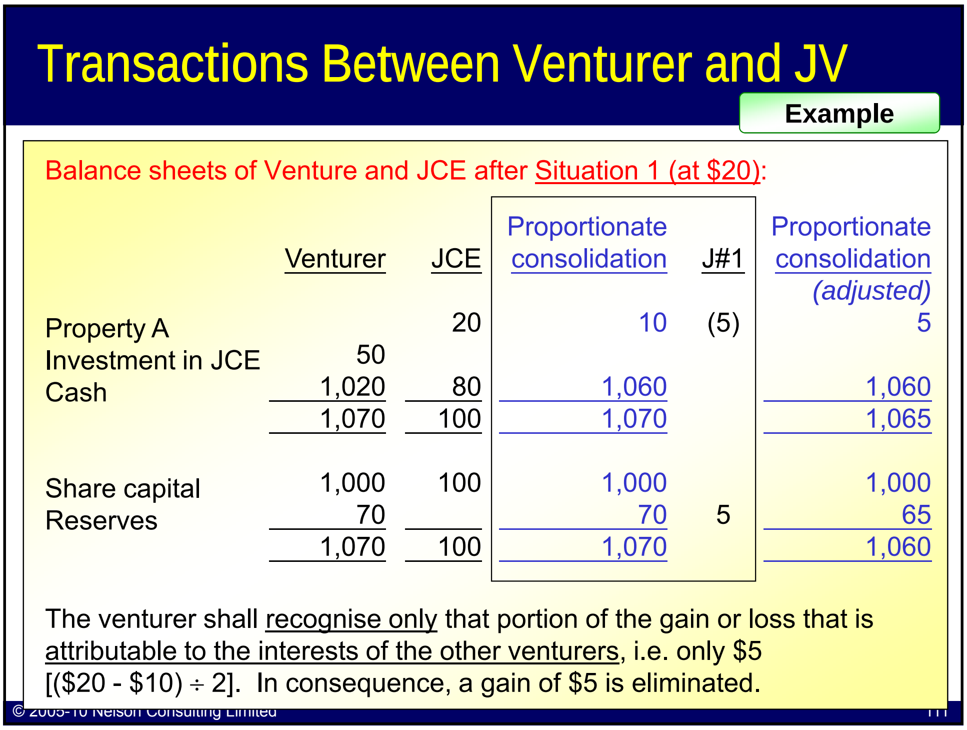
Transactions Between Venturer and JV

Example

Assume Venturer holds 50% interests in JCE and they have the following statements:

	Venturer	JCE	Proportionate consolidation
Property A	10		10
Investment in JCE	50		
Cash	1,000	100	1,050
	1,060	100	1,060
Share capital	1,000	100	1,000
Reserves	60		60
	1,060	100	1,060

1. If JCE purchases Property A from Venturer at y.e. at a fair value of $20.
2. If JCE purchases Property A from Venturer at y.e. at a fair value of $8.



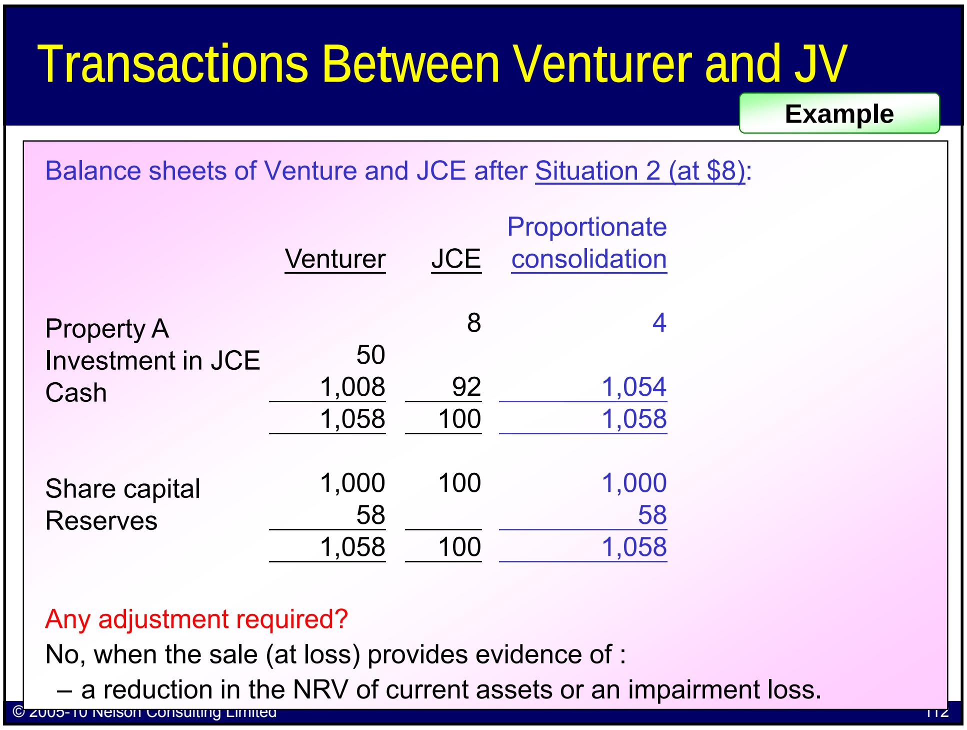
Transactions Between Venturer and JV

Example

Balance sheets of Venture and JCE after Situation 1 (at $20):

	Venturer	JCE	Proportionate consolidation	J#1	Proportionate consolidation *(adjusted)*
Property A		20	10	(5)	5
Investment in JCE	50				
Cash	1,020	80	1,060		1,060
	1,070	100	1,070		1,065
Share capital	1,000	100	1,000		1,000
Reserves	70		70	5	65
	1,070	100	1,070		1,060

The venturer shall recognise only that portion of the gain or loss that is attributable to the interests of the other venturers, i.e. only $5 [($20 - $10) ÷ 2]. In consequence, a gain of $5 is eliminated.



Transactions Between Venturer and JV

Example

Balance sheets of Venture and JCE after Situation 2 (at $8):

	Venturer	JCE	Proportionate consolidation
Property A		8	4
Investment in JCE	50		
Cash	1,008	92	1,054
	1,058	100	1,058
Share capital	1,000	100	1,000
Reserves	58		58
	1,058	100	1,058

Any adjustment required?

No, when the sale (at loss) provides evidence of :

– a reduction in the NRV of current assets or an impairment loss.

Transactions Between Venturer and JV

- When a venturer purchases assets from a joint venture
  - the venturer shall not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party.
  - A venturer shall recognise its share of the losses resulting from these transactions in the same way as profits except that losses shall be recognised immediately when they represent a reduction in the net realisable value of current assets or an impairment loss.

At Profit

At loss

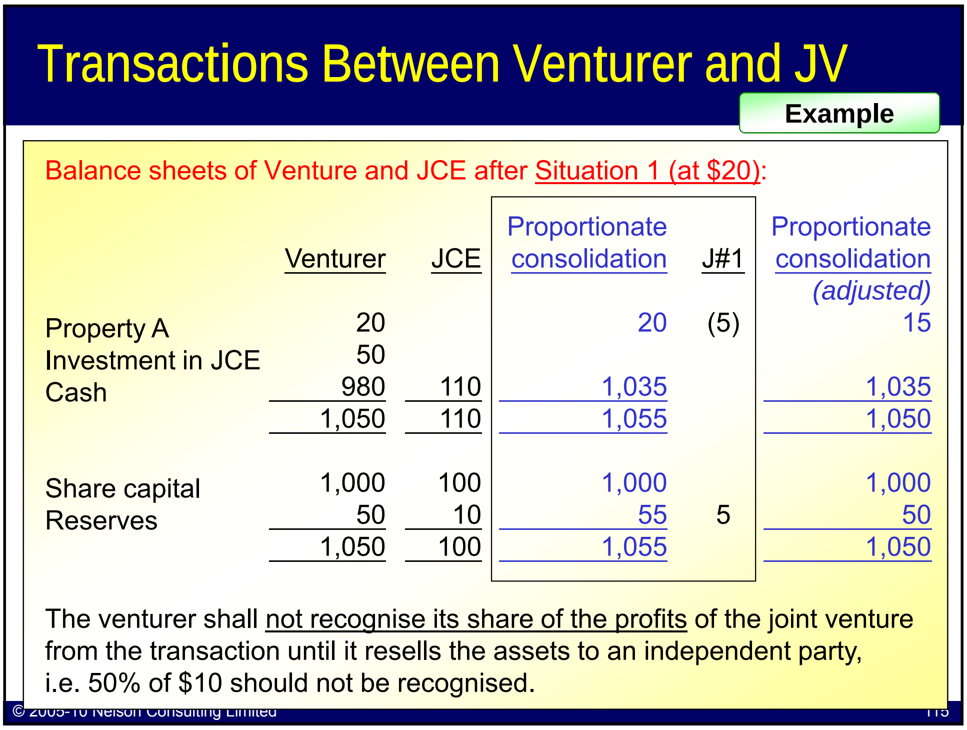
Transactions Between Venturer and JV

Example

Assume Venturer holds 50% interests in JCE and they have the following statements:

	Venturer	JCE	Proportionate consolidation
Property A		10	5
Investment in JCE	50		
Cash	1,000	90	1,045
	1,050	100	1,050
Share capital	1,000	100	1,000
Reserves	50		50
	1,050	100	1,050

1. If JCE sells Property A to Venturer at y.e. at a fair value of $20.
2. If JCE sells Property A to Venturer at y.e. at a fair value of $8.



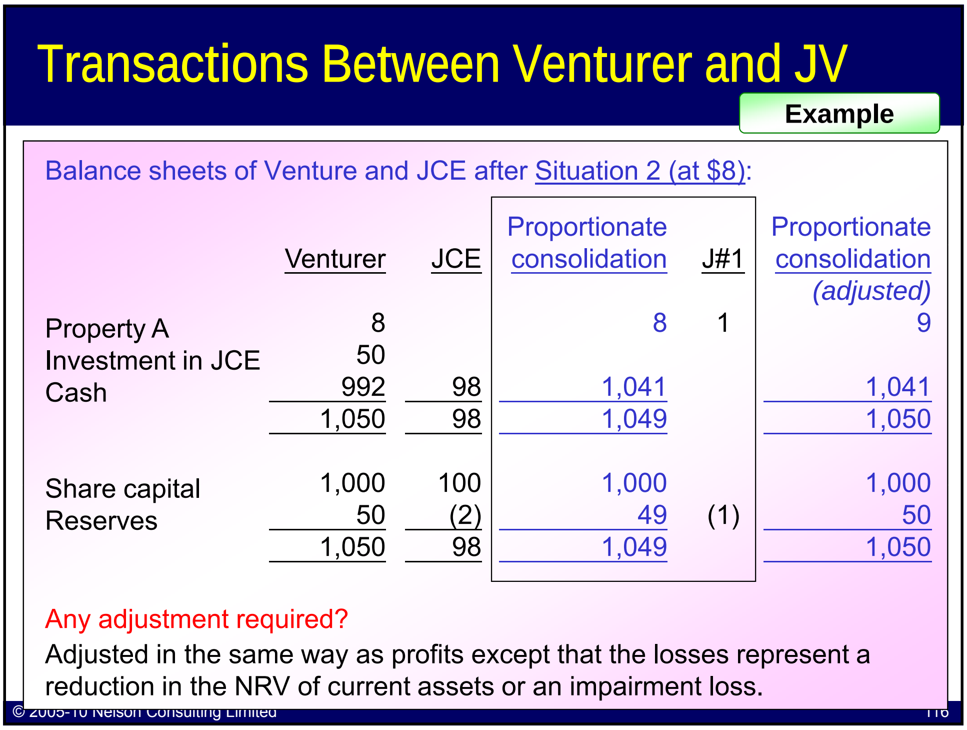
Transactions Between Venturer and JV

Example

Balance sheets of Venture and JCE after Situation 1 (at $20):

	Venturer	JCE	Proportionate consolidation	J#1	Proportionate consolidation *(adjusted)*
Property A	20		20	(5)	15
Investment in JCE	50				
Cash	980	110	1,035		1,035
	1,050	110	1,055		1,050
Share capital	1,000	100	1,000		1,000
Reserves	50	10	55	5	50
	1,050	100	1,055		1,050

The venturer shall not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party, i.e. 50% of $10 should not be recognised.



Transactions Between Venturer and JV

Example

Balance sheets of Venture and JCE after Situation 2 (at $8):

	Venturer	JCE	Proportionate consolidation	J#1	Proportionate consolidation *(adjusted)*
Property A	8		8	1	9
Investment in JCE	50				
Cash	992	98	1,041		1,041
	1,050	98	1,049		1,050
Share capital	1,000	100	1,000		1,000
Reserves	50	(2)	49	(1)	50
	1,050	98	1,049		1,050

Any adjustment required?

Adjusted in the same way as profits except that the losses represent a reduction in the NRV of current assets or an impairment loss.

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.

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.

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.

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

Consolidated Financial Statements

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