

Hong Kong Financial Reporting Standards: HKAS 27

(Relevant to ATE Paper 7 – Advanced Accounting & PBE Paper I – Financial Reporting)

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HKAS 27 “Consolidated and Separate Financial Statements”

This article provides the definition of a subsidiary and some conditions for exemption from consolidation. It also addresses the basic consolidation procedures for the preparation of consolidated financial statements and accounting for investments in subsidiaries in separate financial statements.

Scope and definition

HKAS 27 applies to the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. HKAS 27 contains the following definitions:

1. Parent: an entity that has one or more subsidiaries.
2. Subsidiary: an entity, including an unincorporated entity, that is controlled by another entity (known as the parent). One typical example of an unincorporated entity is partnership.
3. Control: the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. For example, if the parent owns more than 50% voting power of a subsidiary, control is presumed to exist.

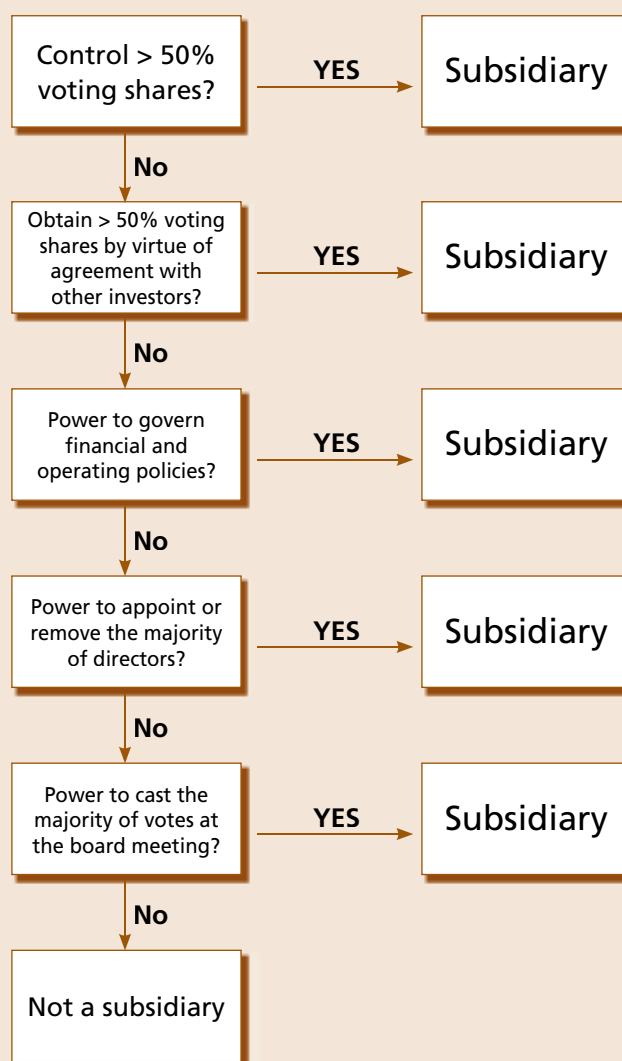
Definition of a subsidiary

HKAS 27 focuses the concept of control on the definition of a subsidiary. In other words, if company A controls more than 50 percent of the voting power in B, B is a subsidiary of A since A can exercise the power to govern B’s financial and operating policies.

In addition, even if less than half of the voting rights are acquired, it is still possible for control to exist where there is:

- (1) power over more than half of the voting rights by virtue of an agreement with other investors;
- (2) power to govern the financial and operating policies of the entity by law or an agreement;
- (3) power to appoint or remove the majority of the members of the board of directors; or
- (4) power to cast the majority of votes at the board meeting or equivalent governing bodies. For example, if A has 30% of the voting shares in B and has a right to nominate three out of five members of the board then B is a subsidiary of

A since A controls the power to cast the majority of votes at the board meeting.



Potential voting rights

HKAS 27 also discusses the effect of potential voting rights on the parent/subsidiary relationship. Potential voting rights are financial instruments like share warrants or options, debt or equity instruments that are convertible into ordinary shares in the future. For example, if A has the power to govern the financial and operating policies of B after exercising or converting these financial instruments, B is a subsidiary of A.

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Example 1

ABC Ltd owns 30 percent of the voting shares in XYZ Ltd and 10 percent of the convertible debentures issued from XYZ Ltd at the beginning of year one. If the convertible debentures were exercised, ABC Ltd would have an additional of 25 percent voting shares in XYZ Ltd. Is XYZ Ltd a subsidiary of ABC Ltd in year two if:

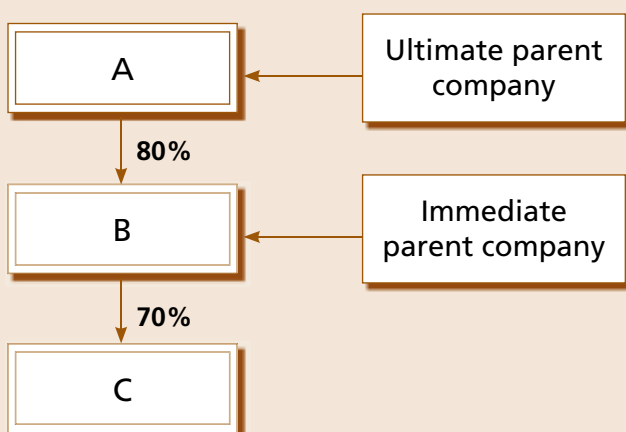
- (a) the convertible debentures are exercised in year one?
- (b) the convertible debentures are exercised in year three?

(a) In this case, XYZ Ltd is a subsidiary of ABC Ltd in year two since the exercise of the convertible debentures in year one would give ABC Ltd 55 percent voting shares in year one .

(b) In this case, XYZ Ltd is not a subsidiary of ABC Ltd in year two since the exercise of the convertible debentures in year three would give ABC Ltd 55 percent voting shares only in year three.

Exemption from consolidation

HKAS 27 and section 124(1) of the Companies Ordinance require every parent company to present consolidated financial statements. In other words, all immediate parent companies in the group should prepare their own consolidated financial statements. An immediate parent company is a company which has a subsidiary but is also itself a subsidiary of another company. For example:



In the above example, company A and company B are both required to prepare consolidated financial statements since both companies are parent companies.

However, an immediate parent company is exempt from the requirement to prepare group accounts if it satisfies the

conditions specified under section 124(2) of Companies Ordinance and HKAS 27. The following table compares the conditions for exemption from consolidation:

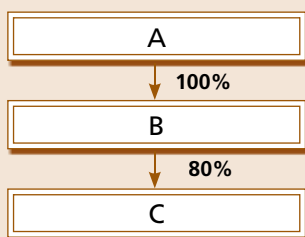
No	Conditions	Section 124(2) of the Companies Ordinance	HKAS 27
1.	(a) The parent (i.e. B) is itself a wholly-owned subsidiary (i.e. of A) OR	✓	✓
	(b) The parent (i.e. B) is a partially-owned subsidiary of another entity (i.e. of A) and its other owners do not object the exemption.	N/A	✓
2.	The parent's (i.e. B's) debt or equity instruments are not traded in a public market.	N/A	✓
3.	The parent (i.e. B) did not file and is not in the process of filing its financial statements with regulatory organization.	N/A	✓
4.	The ultimate (i.e. A) or intermediate parent of the parent produces consolidated financial statements available for public use that comply with Hong Kong Financial Reporting Standards (HKFRSs) or International Financial Reporting Standards (IFRSs).	N/A	✓

So section 124(2) permits a parent not to prepare group accounts only if the parent company is a wholly-owned subsidiary of another company at the end of its financial year. In other words, if a Hong Kong incorporated parent company is a wholly-owned subsidiary of another company, this parent company does not need to comply with the exemption criteria under HKAS 27.

Example 2

Case 1

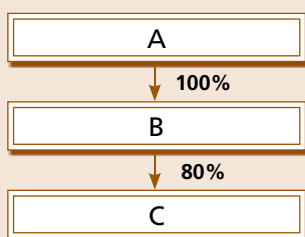
A owns 100 percent of the ordinary shares of B and B owns 80 percent of the ordinary shares of C. All companies are incorporated in Hong Kong and listed in Hong Kong. A has prepared consolidated financial statements in accordance with HKFRSs.



In this case, B can apply for exemption from consolidation under the Companies Ordinance since B is a Hong Kong incorporated company and is a wholly-owned subsidiary of A and so satisfies the exemption requirement under section 124(2) of the Companies Ordinance. The exemption criteria under HKAS 27 do not apply in this case.

Case 2

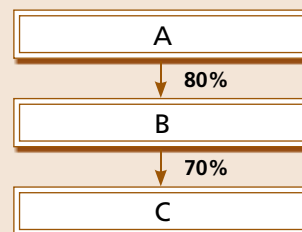
Same information as in Case 1 except that B is incorporated in the US.



In this case, B cannot apply for an exemption from consolidation under the Companies Ordinance since B is not a Hong Kong incorporated company. Instead, B can apply for an exemption from consolidation under HKAS 27. As B satisfies all the exemption conditions under HKAS 27, B needs not prepare consolidated financial statements.

Case 3

A owns 80 percent of the ordinary shares of B and B owns 70 percent of the ordinary shares of C. A and C are incorporated in Hong Kong but B is not. A has prepared consolidated financial statements in accordance with HKFRSs. B is not a listed company and the other owners in B do not object to the exemption from consolidation.



In this case, B can only apply for exemption from consolidation under HKAS 27. Since B is not incorporated in Hong Kong it does not meet the section 124(2) requirements; however it does meet all four conditions for exemption under HKAS 27.

HKAS 27 also requires that if the immediate parent company (i.e. B) satisfies the exemption criteria and elects not to present consolidated financial statements, the company (i.e. B) should present its own separate financial statements.

Exclusion of subsidiaries from consolidation

HKAS 27 states that all subsidiaries should be consolidated except where on acquisition a subsidiary meets the criteria to be classified as held for sale. The criteria include:

- (1) The subsidiary must be available for immediate sale in its present condition. In other words, the sale should be completed within a year.
 - (2) Its sale must be highly probable. For the sale to be highly probable, management must be committed to sell the subsidiaries and must be actively looking for a buyer.
- If the above conditions are met, the subsidiary does not have to be consolidated and it should be accounted for in accordance with HKFRS 5 "Non-current Assets held for Sale and Discontinued Operations".

However, a subsidiary cannot be excluded from consolidation because of the following reasons:

- (1) the investor is a venture capital organization, mutual fund, unit trust or similar entity; or
- (2) its business activities are dissimilar from those of other entities within a group.

Reporting dates and accounting policies

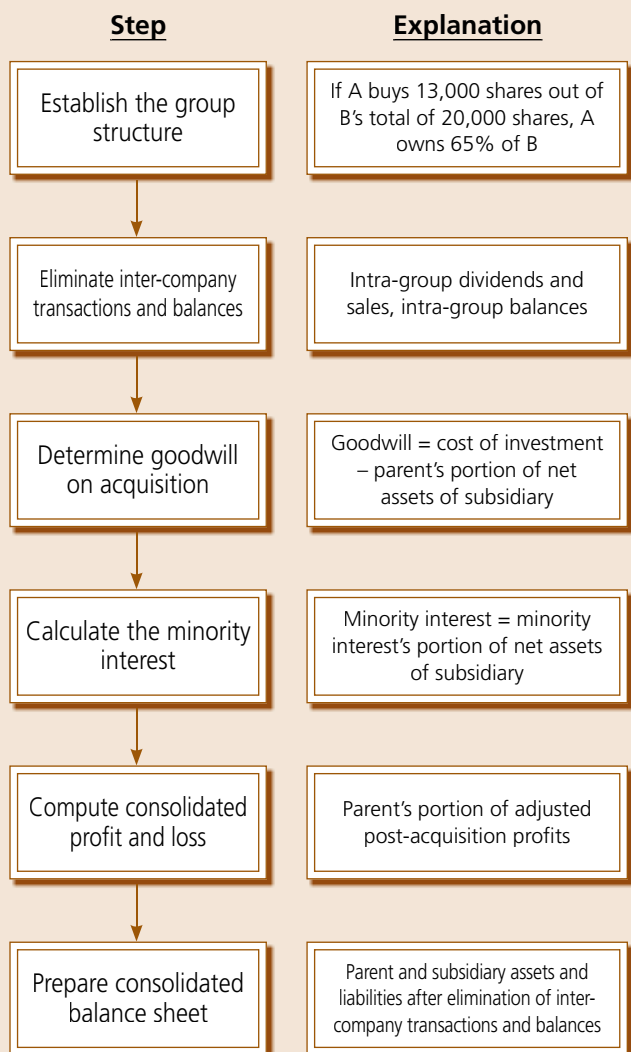
According to HKAS 27, all companies in the group should have same financial year-end as the parent. If the reporting date is different, adjustments should be made for the effects of significant transactions or events that occur between that date and the date of the parent's financial statements. For example, A, the parent whose financial year-end is 31 March,

has a subsidiary B whose financial year-end is 31 December. A should adjust B's financial statements by including transactions occurred between January to March.

In addition, HKAS 27 also requires uniform accounting policies for like transactions and other events in similar circumstances in all the companies within the group. If the accounting policies are not the same, appropriate adjustments should be made in the consolidated financial statements.

Consolidation procedures

The basic principle for preparation of consolidated financial statements is to combine the like items of assets, liabilities, equity, income and expenses of the parent and its subsidiaries after certain consolidation adjustments like intra-group balances and dividends and unrealized profit on inventory. The consolidation adjustments required will vary with different circumstances but basically follow these steps:



Example 3

The balance sheets of parent P and subsidiary S at 31 December 2008 are as follows:

	P	S
	\$000	\$000
Fixed assets	180	130
Investment in S	70	-
Current account with S	80	-
Trade receivables	20	15
Cash and bank	10	25
	<u>360</u>	<u>170</u>
Ordinary shares (\$1 shares)	220	50
Retained earnings	70	20
Current account with P	-	60
Trade payables	15	10
Accrued expenses	5	-
Proposed dividend	50	30
	<u>360</u>	<u>170</u>

Additional information:

- (a) P acquired 30,000 shares in S on 1 May 2008, when S's retained earnings were \$10,000.
- (b) On 29 December 2008, S sent a cheque to P for \$20,000 but this was not received by P until 2 January 2009.
- (c) The proposed dividends are declared and approved by P and S on 12 March 2009 and 14 March 2009 respectively. P has not included any entries in its accounts relating to the dividend receivable from S.

Required:

Prepare the consolidated balance sheet at 31 December 2008.

Step 1 Establish group structure

P acquires 30,000 shares of S's total of 50,000 shares. Therefore P owns 60% (30,000/50,000) of S.

Step 2 Eliminate inter-company transaction and balances

	\$000
Per current account with S	80
Less: cash in transit	<u>20</u>
Current account with S after adjustment	<u>60</u>
Agreed with current account with P	<u>60</u>

Accounting for investments in separate financial statements HKAS 27 allows two treatments for investment in subsidiaries in the books of parent company. The following summarizes these two treatments:

Situation	Accounting treatment
(1) If the investment in subsidiaries is classified as held for sale	The investment in subsidiaries should be reclassified as non-current assets held for sale and measured at the lower of the carrying amount and fair value less cost to sell in accordance with HKFRS 5.
(2) If the investment in subsidiaries is not classified as held for sale	The investment in subsidiaries should be accounted for either at cost or in accordance with HKAS 39.

Example 4

Suppose A acquires 80 percent of the shares in B for \$100,000 on 1 January 2008 when the fair value of B's net assets is \$110,000. The fair value less cost to sell for this investment at 31 December 2008 is \$90,000.

- (a) What is the value of the investment in B if this investment is classified as held for sale on 31 December 2008?
- (b) What is the value of investment in B if this investment is not classified as held for sale on 31 December 2008? (Assume A uses the cost method to account for its investment in subsidiaries.)
- (a) If the investment in B is classified as held for sale, this investment should be valued at the lower of the carrying amount and fair value less cost to sell. Therefore the investment in B at 31 December 2008 is \$90,000 in A's books.
- (b) If the investment in B is not classified as held for sale, this investment should be accounted for either at cost or in accordance with HKAS 39. Therefore, the investment in B at 31 December 2008 is still \$100,000 in A's books.