

HKAS 27 and HKFRS 3

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Nelson Lam 林智遠
MBA MSc BBA ACA ACS CFA CPA(Aust.)
CPA(US) FCCA FCPA(Practising) MSCA

Today's Agenda

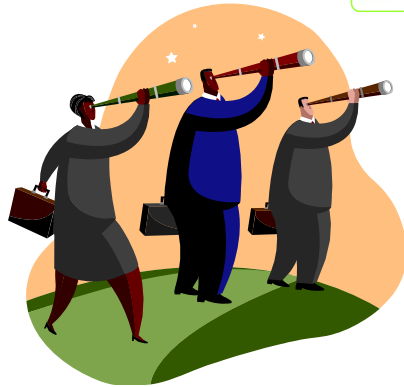
Consolidated and Separate Financial Statements (HKAS 27)

Business Combinations (HKFRS 3)



Consolidated Financial Statements

Consolidated and Separate Financial Statements (HKAS 27)



HKAS 27 (Revised in 2008)

Similar practice as previous HKAS 27, except for



- Scope and definitions
- Presentation of consolidated financial statements
- Scope of consolidated financial statements
- Consolidation procedures
- Loss of control
- Accounting in separate financial statements
- Disclosure
- Effective date and transition

Significant changes

New section

HKAS 27 comparable with IAS 27

- HKAS 27 *Consolidated and Separate Financial Statements* is revised as a result to maintain convergence with IAS 27 (revised in 2008)
- In 2008, IAS 27 was amended as part of the second phase of the business combinations project.
 - That phase of the project was undertaken jointly with the US Financial Accounting Standards Board (FASB).
 - The amendments related, primarily, to accounting for non-controlling interests and the loss of control of a subsidiary.
- The IASB and FASB concluded the second phase of the project by
 - the IASB issuing the amended IAS 27 and the FASB issuing FASB Statement No. 160 *Non-controlling Interests in Consolidated Financial Statements*, along with, respectively,
 - a revised IFRS 3 *Business Combinations* and FASB Statement No. 141 (revised 2007) *Business Combinations*.

Presentation of Consol. Fin. State.

- A parent, other than a parent described below, shall present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with HKAS 27.
- A parent need not present consolidated financial statements if and only if:
 - a) the parent is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
 - b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
 - c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
 - d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with HKFRSs or IFRSs.

Scope of Consol. Fin. State.

- Consolidated financial statements shall include all subsidiaries of the parent.
- Potential voting rights are also counted in assessing whether there is any control on an entity.



Consolidation Procedures

- Consolidation procedures are similar to previous standard, but
- Minority interests renamed as "non-controlling interests", which
 - shall be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. (HKAS 27.27)



Consolidation Procedures



- Profit or loss and each component of other comprehensive income are attributed
 - to the owners of the parent and
 - to the non-controlling interests.
- Total comprehensive income is attributed
 - to the owners of the parent and
 - to the non-controlling interests

even if this results in the non-controlling interests having a deficit balance.

Consolidation Procedures

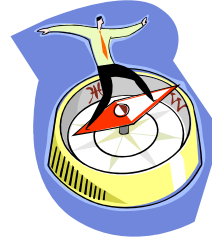
Example

Entity A holds 80% of Entity X since its incorporation and their financial statements are set out below:

	<u>A</u>	<u>X</u>	<u>Consol.</u>	<u>Consol. in old HKAS 27</u>
Property, plant & equipment	3,500	2,000	5,500	5,500
Interest in subsidiary	80	-	-	-
Liabilities	<u>(1,000)</u>	<u>(2,600)</u>	<u>(3,600)</u>	<u>(3,600)</u>
Net assets	<u>2,580</u>	<u>(600)</u>	<u>1,900</u>	<u>1,900</u>
Share capital	200	100	200	200
Reserves	<u>2,380</u>	<u>(700)</u>	<u>1,820</u>	<u>1,700</u>
	<u>2,580</u>	<u>(600)</u>	<u>2,020</u>	<u>1,900</u>
Non-controlling interests (Net liabilities of MI of \$600 x 20%) (Assume fair value = carrying amount)			<u>(120)</u>	<u>0</u>
			<u>1,900</u>	<u>1,900</u>

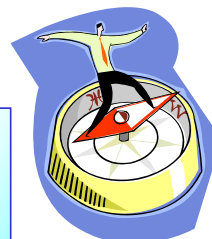
Consolidation Procedures

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



Consolidation Procedures

- In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary.
- Any difference between
 - the amount by which the non-controlling interests are adjusted and
 - the fair value of the consideration paid or received shall be recognised directly in equity and attributed to the owners of the parent.



Consolidation Procedures

Example

Entity A holds 80% of Entity X since its incorporation and their financial statements are set out below:

Disposed of 20% interest at \$50

	<u>A</u>	<u>X</u>	<u>Consol pre-change</u>
Property, plant & equipment	3,500	2,000	5,500
Interest in subsidiary	80	-	-
Net current liabilities	<u>(1,000)</u>	<u>(2,600)</u>	<u>(3,600)</u>
Net assets	<u>2,580</u>	<u>(600)</u>	<u>1,900</u>
Share capital	200	100	200
Reserves	<u>2,380</u>	<u>(700)</u>	<u>1,820</u>
	<u>2,580</u>	<u>(600)</u>	<u>2,020</u>
Non-controlling interests			<u>(120)</u>
(Assume fair value = carrying amount)			<u>1,900</u>

Consolidation Procedures

Example

Entity A holds 80% of Entity X since its incorporation and their financial statements are set out below:

Disposed of 20% interest at \$50

	<u>A</u>	<u>X</u>	<u>Consol pre-change</u>
<ul style="list-style-type: none"> In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between <ul style="list-style-type: none"> – the amount by which the non-controlling interests are adjusted and – the fair value of the consideration paid or received shall be <u>recognised directly in equity</u> and <u>attributed to the owners of the parent</u>. 			
Non-controlling interests			<u>(120)</u>
(Assume fair value = carrying amount)			<u>1,900</u>

NCI to be adjusted	(120)
Consideration	50
Difference to equity	170

Consolidation Procedures

Example

Entity A holds 80% of Entity X since its incorporation and their financial statements are set out below:

Disposed of 20% interest at \$50

	A	X	Consol pre-change	Dr/(Cr)	Consol. after change
Property, plant & equipment	3,500	2,000	5,500		5,500
Interest in subsidiary	80	-	-		-
Net current liabilities	<u>(1,000)</u>	<u>(2,600)</u>	<u>(3,600)</u>	50	<u>(3,550)</u>
Net assets	<u>2,580</u>	<u>(600)</u>	<u>1,900</u>		<u>1,950</u>
Share capital	200	100	200		200
Reserves	<u>2,380</u>	<u>(700)</u>	<u>1,820</u>	170	<u>1,990</u>
	<u>2,580</u>	<u>(600)</u>	<u>2,020</u>		<u>2,190</u>
Non-controlling interests			<u>(120)</u>	(120)	<u>(240)</u>
<i>(Assume fair value = carrying amount)</i>			<u>1,900</u>		<u>1,950</u>

Loss of Control

- Specific requirements introduced when a parent loses control of a subsidiary:
 - If a parent loses control of a subsidiary, it:
 - a) derecognises the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;
 - b) derecognises the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them);
 - c) recognises:
 - i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control; and
 - ii) if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution;

Loss of Control

- Specific requirements introduced when a parent loses control of a subsidiary:
 - If a parent loses control of a subsidiary, it:
 - d) recognises any investment retained in the former subsidiary at its fair value at the date when control is lost;
 - e) reclassifies to profit or loss, or transfers directly to retained earnings if required in accordance with other HKFRSs, the amounts identified in HKAS 27.35 (discussed in next slide); and
 - f) recognises any resulting difference as a gain or loss in profit or loss attributable to the parent.



Loss of Control

- If a parent loses control of a subsidiary,
 - the parent shall account for all amounts recognised in other comprehensive income in relation to that subsidiary
 - on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.
- Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities,
 - the parent reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary.



Loss of Control

Example

Think about 2 different cases with similar figures:

HK\$	Sub. A	Sub. B
Sale proceeds	100	100
Carrying amount of the subsidiary's net assets in consolidated financial statements	100	100



Anything recognised in profit or loss?

What is the further information you have to ask?

Loss of Control

Example

What if

similar figures:

HK\$	Sub. A	Sub. B
Sale proceeds	100	100
Carrying amount of the subsidiary's net assets in consolidated financial statements	100	100
Representing:		
- Revalued amount of available-for-sale	100	
- Revalued amount of PPE		100
Revaluation reserves	20	20



Anything recognised in profit or loss?

Loss of Control

Example

A parent loses control of a subsidiary and the subsidiary has the following assets:

- The subsidiary has available-for-sale financial assets
- The subsidiary has property, plant and equipment with revaluation surplus previously recognised in other comprehensive income

The parent shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets.

The parent transfers the revaluation surplus directly to retained earnings when it loses control of the subsidiary

- since the revaluation surplus would be transferred directly to retained earnings on the disposal of the asset

Loss of Control

Example

What if

similar figures:

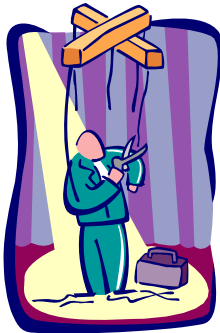
HK\$	Sub. A	Sub. B
Sale proceeds	100	100
Carrying amount of the subsidiary's net assets in consolidated financial statements	100	100
Representing:		
- Revalued amount of available-for-sale	100	
- Revalued amount of PPE		100
Revaluation reserves	20	20



Revaluation reserves relating to available-for-sale reclassified to profit or loss

Revaluation reserves relating to PPE transferred directly to retained earnings

Loss of Control



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- On the loss of control of a subsidiary, any investment retained in the former subsidiary and any amounts owed by or to the former subsidiary shall be accounted for in accordance with other HKFRSs from the date when control is lost.
- The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with
 - HKAS 39 *Financial Instruments: Recognition and Measurement* or,
 - when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

Disclosure

- In addition to those required in previous HKAS 27, it requires now:
 - a schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary that do not result in a loss of control on the equity attributable to owners of the parent (HKAS 27.41e)
 - if control of a subsidiary is lost, the parent shall disclose the gain or loss, if any, recognised in accordance with HKAS 27.34 (as discussed in loss of control), and:
 - i) the portion of that gain or loss attributable to recognising any investment retained in the former subsidiary at its fair value at the date when control is lost; and
 - ii) the line item(s) in the statement of comprehensive income in which the gain or loss is recognised (if not presented separately in the statement of comprehensive income) (HKAS 27.41f)

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Effective and Transition

- An entity shall apply the amendments to HKAS 27 made in 2008 for annual periods beginning on or after 1 July 2009.
- Earlier application is permitted.
- However, an entity shall not apply these amendments for annual periods beginning before 1 July 2009 unless it also applies HKFRS 3 (as revised in 2008).
- If an entity applies the amendments before 1 July 2009,
 - it shall disclose that fact.



Effective and Transition

- An entity shall apply the amendments retrospectively, with the following exceptions:
 - a) the amendment to HKAS 27.28 for attributing total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.
 - Therefore, an entity shall not restate any profit or loss attribution for reporting periods before the amendment is applied.
 - b) the requirements in HKAS 27.30 and 31 for accounting for changes in ownership interests in a subsidiary after control is obtained.
 - Therefore, the requirements in HKAS 27.30 and 31 do not apply to changes that occurred before an entity applies the amendments.
 - c) the requirements in HKAS 27.34–37 for the loss of control of a subsidiary.
 - An entity shall not restate the carrying amount of an investment in a former subsidiary if control was lost before it applies those amendments.
 - In addition, an entity shall not recalculate any gain or loss on the loss of control of a subsidiary that occurred before the amendments are applied.

Business Combinations



Business Combinations (HKFRS 3)

HKFRS 3 comparable with IFRS 3

- HKFRS 3 *Business Combinations* is revised as a result to maintain convergence with IFRS 27 (revised in 2008)
- The revised IFRS 3 is part of a joint effort by the IASB and the US Financial Accounting Standards Board (FASB) to improve financial reporting while promoting the international convergence of accounting standards.
- The IASB and FASB decided to address the accounting for business combinations in two phases.
- The IASB and FASB decided that a significant improvement could be made to financial reporting if they had similar standards for accounting for business combinations.
- Thus, they decided to conduct the second phase of the project as a joint effort with the objective of reaching the same conclusions.

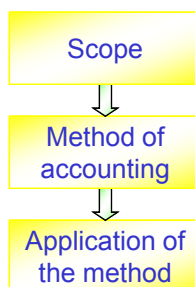


HKFRS 3 comparable with IFRS 3

- The IASB and FASB concluded the second phase of the project by issuing
 - IFRS 3 and FASB Statement No. 141 (revised 2007) *Business Combinations* and
 - the related amendments to
 - IAS 27 *Consolidated and Separate Financial Statements* and
 - FASB Statement No. 160 *Non-controlling Interests in Consolidated Financial Statements*.



Introduction



- The objective of HKFRS 3 (revised 2008) is
 - to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects.
- To accomplish that, HKFRS 3 establishes principles and requirements for how the acquirer:
 - a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;
 - b) recognises and measures
 - the goodwill acquired in the business combination or
 - a gain from a bargain purchase; and What is it?
 - c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.



Scope

Scope

- HKFRS 3 applies to a transaction or other event that meets the definition of a business combination.
- HKFRS 3 does not apply to:
 - a) the formation of a joint venture.
 - b) the acquisition of an asset or a group of assets that does not constitute a business.
 - Brief requirements set out for such acquisition and it does not give rise to goodwill
 - c) a combination of entities or businesses under common control.

AG 5 is still applicable

Identifying a Business Combination

Scope

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

Business Combination

VS

Asset Acquisition

Identifying a Business Combination

Scope

- An entity shall determine whether a transaction or other event is a business combination by applying the definition in HKFRS 3,
 - which requires that the assets acquired and liabilities assumed constitute a business. (HKFRS 3.3)

- Business is defined as:

- an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

- Business combination is defined as

- a transaction or other event in which an acquirer obtains control of one or more businesses.
- Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations as that term is used in HKFRS 3.

Business Combination

Identifying a Business Combination

Example

- A business consists of inputs and processes applied to those inputs that have the ability to create outputs.
 - In other words, the three elements of a business are inputs, processes and outputs.
 - Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business.
- To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements – inputs and processes applied to those inputs, which together are or will be used to create outputs.
- However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs & processes.

Business Combination

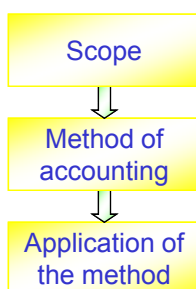
Identifying a Business Combination

Example

- An integrated set of activities and assets in the development stage might not have outputs.
- If not, the acquirer should consider other factors to determine whether the set is a business.
- Those factors include, but are not limited to, whether the set:
 - a) has begun planned principal activities;
 - b) has employees, intellectual property and other inputs and processes that could be applied to those inputs;
 - c) is pursuing a plan to produce outputs; and
 - d) will be able to obtain access to customers that will purchase the outputs.
- Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.

Business Combination

The Acquisition Method



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

The Acquisition Method

Indication as an Acquirer

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

The Acquisition Method

Indication as an Acquirer

- However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree.
- HKFRS 3 provide guidance on accounting for reverse acquisitions.
- Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:
 - the relative voting rights in the combined entity after the business combination
 - the existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest
 - the composition of the governing body of the combined entity
 - the composition of the senior management of the combined entity
 - the terms of the exchange of equity interests

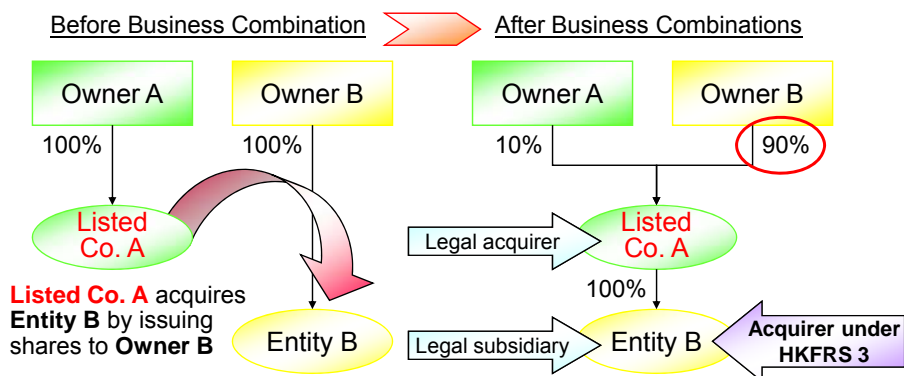
The Acquisition Method

Indication as an Acquirer

- A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance in HKFRS 3.
- The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.
 - For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares.

The Acquisition Method

Example



Which entity is the legal acquirer?
 Which entity is the acquirer under HKFRS 3?

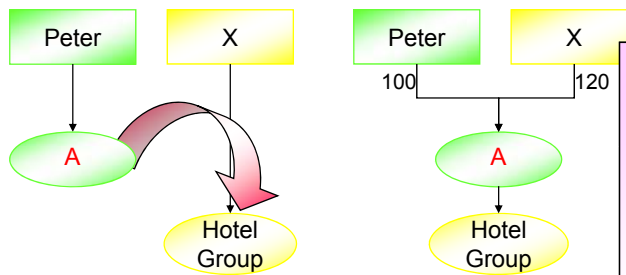
The Acquisition Method

Example

Is the following case a **Reverse Acquisition**?

- Group A has 100 outstanding shares wholly owned by Peter
- It acquires Group X's interest in **Hotel Group** by issuing additional 120 outstanding to Group X

Before Business Combination \rightarrow After Business Combinations



Yes, a reverse acquisition

- After the share issues, Group X will hold 54.5% of Group
- In substance, **Hotel Group** (or Group X) has power to govern the financial and operating policies of Group A

The Acquisition Method

Example

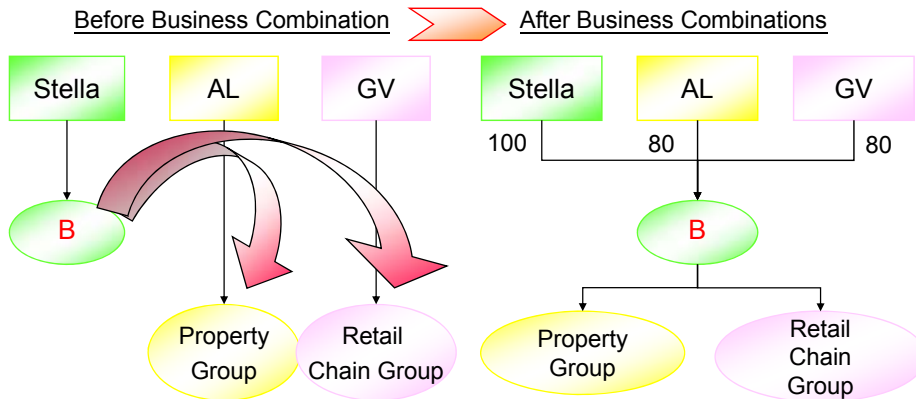
Is the following case a **Reverse Acquisition**?

- Group B has 100 outstanding shares in issue wholly owned by Stella
- It acquires
 - Group AL's interest in **Property Group** by issuing 80 shares to Group AL
 - GV's interest in **Retail Chain Group** by issuing 80 shares to Group GV
- Let's see the changes in group structure

The Acquisition Method

Example

Is the following case a **Reverse Acquisition**?



Not a reverse acquisition

- Neither **Property Group** nor **Retail Chain Group** has the power to govern the financial and operating policies of Group B

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The Acquisition Method

- Determining the acquisition date

Application of the method

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

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The Acquisition Method

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

Application of the method

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

The Acquisition Method

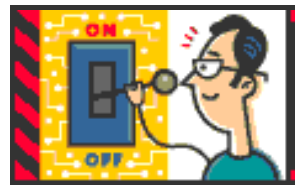
- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

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



The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- The acquirer's application of the recognition principle and conditions may result in
 - recognising some assets and liabilities that the acquiree had not previously recognised as assets and liabilities in its financial statements.



The Acquisition Method

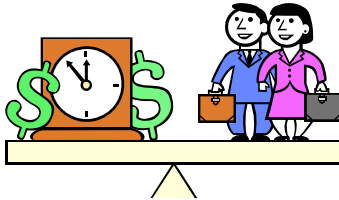
Example

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- For example, the acquirer recognises the acquired identifiable intangible assets, such as
 - a brand name,
 - a patent, or
 - a customer relationship,that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense.

The Acquisition Method

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

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



The Acquisition Method

Example

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

- Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:
 - a) classification of particular financial assets and liabilities as
 - as a financial asset or liability at fair value through profit or loss, or
 - as a financial asset available for sale or held to maturity, in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*,
 - b) designation of a derivative instrument as a hedging instrument in accordance with HKAS 39; and
 - c) assessment of whether an embedded derivative should be separated from the host contract in accordance with HKAS 39 (which is a matter of 'classification' as this HKFRS uses that term).

The Acquisition Method

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

- HKFRS 3 provides two exceptions to the above classification or designation principle:
 - a) classification of a lease contract as either an operating lease or a finance lease in accordance with HKAS 17 *Leases*; and
 - b) classification of a contract as an insurance contract in accordance with HKFRS 4 *Insurance Contracts*.
- The acquirer shall classify those contracts on the basis of the contractual terms and other factors
 - at the inception of the contract, or
 - if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date.

The Acquisition Method

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

- The acquirer shall **measure** the identifiable assets acquired and the liabilities assumed

- at their **acquisition-date fair values**.
(HKFRS 3.18)

Affect acquisition in stages

- For each business combination, the acquirer shall **measure** any non-controlling interest in the acquiree either

- at **fair value** or

New alternative ("full goodwill method")

- at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

Existing practice

The Acquisition Method

Example

Existing practice

New alternative
("Full goodwill method")

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

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The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- Exception to the recognition principle of HKFRS 3:
 - **Contingent liabilities:**
 - Recognised as of the acquisition date if it is a present obligation that arises from past events and its fair value can be measured reliably
 - Even if it is not probable that an outflow of resources will be required.

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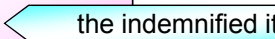
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The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- Exception to the recognition and measurement principles of HKFRS 3
 1. **Income taxes:**
 - in accordance with HKAS 12 *Income Taxes*
 2. **Employee benefits:**
 - in accordance with HKAS 19 *Employee Benefits*
 3. **Indemnification assets** (say indemnified by the seller):
 - recognise an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item,
 - subject to the need for a valuation allowance for uncollectible amounts.
 - » if the indemnification relates to an asset or a liability that is recognised at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognise the indemnification asset at the acquisition date measured at its acquisition-date fair value.

The Acquisition Method

Example

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability.
- For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency;  the indemnified item
 - in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount.
- As a result, the acquirer obtains an indemnification asset.

The Acquisition Method

- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- Exception to the measurement principle of HKFRS 3
 1. **Reacquired rights** (i.e. grant other a right to use some assets):
 - measure the value of a reacquired right recognised as an intangible asset on the basis of the remaining contractual term of the related contract
 - regardless of whether market participants would consider potential contractual renewals in determining its fair value.
 2. **Share-based payment awards**
 - in accordance with HKFRS 2 *Share-based Payment*
 3. **Assets held for sale:**
 - in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

The Acquisition Method

Critical Amendment

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

- The acquirer shall **recognise goodwill** as of the acquisition date measured as the excess of (a) over (b) below:
 - a) the aggregate of:
 - i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;
 - ii) the amount of any non-controlling interest in the acquiree measured in accordance with HKFRS 3; and
 - iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
 - b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with HKFRS 3. (HKFRS 3. 32)

Application of the method

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

Practices changed

The Acquisition Method

Example

Existing practice

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

$$\begin{aligned}
 & \$ (120 + 25) - \$100 \\
 & = \$45
 \end{aligned}$$

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The Acquisition Method

Example

Existing practice

New alternative
("Full goodwill method")

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

$$\begin{aligned}
 & \$ (120 + 25) - \$100 \\
 & = \$45
 \end{aligned}$$

$$\begin{aligned}
 & \$ (120 + 40) - \$100 \\
 & = \$60
 \end{aligned}$$

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The Acquisition Method

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

- When the goodwill becomes a negative figure, it is a bargain purchase.
- A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion.
- However, the recognition or measurement exceptions for particular items may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.



The Acquisition Method

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

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

The Acquisition Method

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

Consideration transferred

- The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of
 - the acquisition-date fair values of the assets transferred by the acquirer,
 - the liabilities incurred by the acquirer to former owners of the acquiree and
 - the equity interests issued by the acquirer.
- Examples of potential forms of consideration include
 - cash, other assets, a business or a subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options, warrants and member interests of mutual entities.

The Acquisition Method

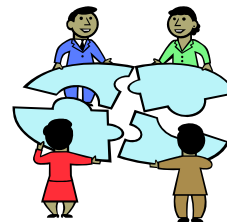
- Recognising and measuring goodwill or a gain from a bargain purchase

Consideration transferred – **Contingent Consideration**

- If there is any contingent consideration arrangement, the acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.
 - The acquirer shall classify an obligation to pay contingent consideration **as a liability or as equity** on the basis of the definitions of an equity instrument and a financial liability in accordance with HKAS 32 or other applicable HKFRSs.
 - The acquirer shall classify **as an asset** a right to the return of previously transferred consideration if specified conditions are met.

The Acquisition Method

- Additional guidance
 - Amended practices on business combination achieved in stages
- In a business combination achieved in stages, the acquirer shall
 - remeasure its previously held equity interest in the acquiree **at its acquisition-date fair value** and
 - recognise the resulting gain or loss, if any, in profit or loss. (HKFRS 3.42)



The Acquisition Method

- Additional guidance
 - Amended practices on business combination achieved in stages
- In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income (for example, because the investment was classified as available for sale).
 - If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest. (HKFRS 3.42)
 - In other words, “the amount recognised directly in other comprehensive income is reclassified and included in the calculation of the gain or loss recognised in profit or loss”. (KPMG-UK, 2008.01)

The Acquisition Method

Example

<u>On 1.1.2010</u>	<u>Parent P</u>	<u>Sub S</u>
Property	\$ 0	\$ 6,000
Investment	0	0
Cash at bank	<u>30,000</u>	<u>2,000</u>
	<u>30,000</u>	<u>8,000</u>
Issued equity	\$ (30,000)	\$ (5,000)
Retained earnings	<u>0</u>	<u>(3,000)</u>
	<u>(30,000)</u>	<u>(8,000)</u>

On 1.1.2010

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

During 2010

- 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 1.1.2011

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

The Acquisition Method

You would miss this

Example

	<u>1st Transaction</u>	<u>2nd Transaction</u>	<u>Total</u>
Cost of combinations (or investments)	<u>3,500</u>	<u>22,000</u>	25,500
Fair value information			
Property, at fair value	8,000	11,000	
Cash	2,000	2,000	
Cash (profit for the year)	<u>0</u>	<u>6,000</u>	
	10,000	<u>19,000</u>	
Ownership interest	<u>20%</u>	<u>60%</u>	80%
Share of fair value	<u>2,000</u>	<u>11,400</u>	
Goodwill	<u>1,500</u>	<u>10,600</u>	12,100

The Acquisition Method

Example

<u>On 1.1.2010</u>	<u>Parent P</u>	<u>Sub S</u>
Property	\$ 0	\$ 6,000
Investment	0	0
Cash at bank	<u>30,000</u>	<u>2,000</u>
	<u>30,000</u>	<u>8,000</u>
Issued equity	\$ (30,000)	\$ (5,000)
Retained earnings	<u>0</u>	<u>(3,000)</u>
	<u>(30,000)</u>	<u>(8,000)</u>

On 1.1.2010

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

During 2010

- 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 1.1.2011

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

The Acquisition Method

Example

- Firstly, the acquirer (i.e. P) shall
 - remeasure its previously held equity interest in the acquiree (i.e. S) at its acquisition-date fair value and
 - recognise the resulting gain or loss, if any, in profit or loss.
- On 1.1.2011, P acquired additional 60% interest in S at \$22,000 by cash
 - It implies that previously held equity interest of 20% (acquired on 1.1.2010) should have a fair value of \$7,333 ($\$22,000 \div 60\% \times 20\%$)
 - The resulting gain should be recognised in profit or loss as follows:

	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		

The Acquisition Method

Example

The calculation approach would be revised as

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

The Acquisition Method

Example

Consolidation journals (for NCI at old approach):

	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		

The Acquisition Method

Example

The calculation approach would be revised as

	NCI at old approach	NCI at fair value
	<u>New 1</u>	<u>New 2</u>
1. Consideration transferred	22,000	22,000
2. Non-controlling interest (NCI)	(\$19K x 20%) 3,800	(\$22K ÷ 60% x 20%) 7,333
3. Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree	<u>7,333</u>	<u>7,333</u>
	<u>33,133</u>	<u>36,666</u>
Less: Acquisition-date amount of net identifiable assets		
Property, at fair value	11,000	11,000
Cash	2,000	2,000
Cash (profit for the year)	<u>6,000</u>	<u>6,000</u>
	<u>19,000</u>	<u>19,000</u>
Goodwill	<u>14,133</u>	<u>17,666</u>

The Acquisition Method

Example

Consolidation journals (for NCI at 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)	17,666	
Cr Investment (\$7,333 + \$22,000)		29,333
Non-controlling interest (\$22,000 ÷ 60% x 20%)		7,333
To recognise the goodwill and eliminate the investments with the equity shares		

The Acquisition Method

Example

<u>On 1.1.2011</u>	<u>Parent P</u>	<u>Sub S</u>	<u>Old</u>	<u>New 1</u>	<u>New 2</u>
Property	\$ 0	\$ 6,000	\$ 11,000	\$ 11,000	\$ 11,000
Goodwill	0	0	12,100	14,133	17,666
Investment	28,000	0	0	0	0
Cash at bank	<u>4,500</u>	<u>8,000</u>	<u>12,500</u>	<u>12,500</u>	<u>12,500</u>
	<u>32,500</u>	<u>14,000</u>	<u>35,600</u>	<u>37,633</u>	<u>41,166</u>
Issued equity	\$ (30,000)	\$ (5,000)	\$(30,000)	\$(30,000)	\$(30,000)
Retained earnings	(2,500)	(9,000)	(1,200)	(3,833)	(3,833)
Revaluation reserves	0	0	(600)	0	0
Minority interest	<u>0</u>	<u>0</u>	<u>(3,800)</u>	<u>(3,800)</u>	<u>(7,333)</u>
	<u>(32,500)</u>	<u>(14,000)</u>	<u>(35,600)</u>	<u>(37,633)</u>	<u>(41,166)</u>
Non-controlling interests					

The Acquisition Method

• Measurement Period

Application of the method

- If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs,
 - the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete.
- During the measurement period,
 - the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

The Acquisition Method

• Measurement Period

- During the measurement period, the acquirer shall also recognise additional assets or liabilities
 - if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date.
- The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.
- However, the measurement period shall not exceed one year from the acquisition date. (HKFRS 3.45)

The Acquisition Method

• Determining what is part of the business combination transaction

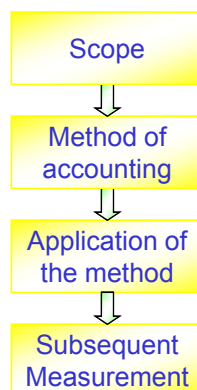
- The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination.
- In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, ie amounts that are not part of the exchange for the acquiree.
- The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree.
- Separate transactions shall be accounted for in accordance with the relevant HKFRSs. (HKFRS 3.51)

The Acquisition Method

• Acquisition-related costs

- Acquisition-related costs are costs the acquirer incurs to effect a business combination.
 - Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities.
- The acquirer shall account for acquisition-related costs **as expenses in the periods** in which the costs are incurred and the services are received, with one exception.
- The costs to issue debt or equity securities shall be recognised in accordance with HKAS 32 and HKAS 39.

Subsequent Measurement and Acc.



- In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable HKFRSs for those items, depending on their nature.
- However, HKFRS 3 provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:
 - a) reacquired rights;
 - b) contingent liabilities recognised as of the acquisition date;
 - c) indemnification assets; and
 - d) contingent consideration. (HKFRS 3.54)

Subsequent Measurement and Acc.

a) Reacquired rights

- A reacquired right recognised as an intangible asset shall be amortised over the remaining contractual period of the contract in which the right was granted.
- An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

Subsequent
Measurement

Subsequent Measurement and Acc.

b) Contingent liabilities recognised as of the acquisition date

- After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:
 - a) the amount that would be recognised in accordance with HKAS 37; and
 - b) the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with HKAS 18 Revenue.
- This requirement does not apply to contracts accounted for in accordance with HKAS 39.

Subsequent
Measurement

Subsequent Measurement and Acc.

c) Indemnification assets

- At the end of each subsequent reporting period, the acquirer shall measure an indemnification asset that was recognised at the acquisition date on the same basis as the indemnified liability or asset,
 - subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.
- The acquirer shall derecognise the indemnification asset only when it collects the asset, sells it or otherwise loses the right to it.

Subsequent
Measurement

Subsequent Measurement and Acc.

d) Contingent consideration

- Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date.
 - Such changes are measurement period adjustments in accordance with HKFRS 3.45 – 49.
- However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments.

Subsequent
Measurement

Subsequent Measurement and Acc.

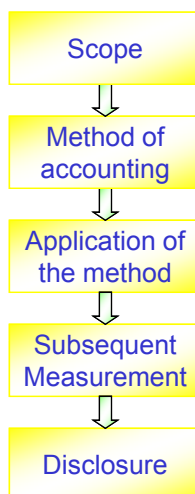
d) Contingent consideration

– The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

- a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.
- b) Contingent consideration classified as an asset or a liability that:
 - i) is a financial instrument and is within the scope of HKAS 39 shall be measured at fair value, with any resulting gain or loss recognised either in profit or loss or in other comprehensive income in accordance with that HKFRS.
 - ii) is not within the scope of HKAS 39 shall be accounted for in accordance with HKAS 37 or other HKFRSs as appropriate.

Subsequent
Measurement

Disclosure



- The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:
 - a) during the current reporting period; or
 - b) after the end of the reporting period but before the financial statements are authorised for issue.
 - HKFRS 3.B64 to B66 have further disclosure requirements
- The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods.
 - HKFRS 3.B67 has further disclosure requirements

Effective Date

- HKFRS 3 (revised 2008) shall be applied prospectively to
 - business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009.
- Earlier application is permitted.
 - However, HKFRS 3 shall be applied only at the beginning of an annual reporting period that begins on or after 30 June 2007.
 - If an entity applies HKFRS 3 before 1 July 2009, it shall
 - disclose that fact and
 - apply HKAS 27 (as amended in 2008) at the same time.



Transition

- Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of HKFRS 3
 - shall not be adjusted upon application of HKFRS 3.
- An entity, such as a mutual entity, that has not yet applied HKFRS 3 and had one or more business combinations that were accounted for using the purchase method shall apply the transition provisions in HKFRS 3.B68 and B69.



Transition

- For business combinations in which the acquisition date was before HKFRS 3 is applied, the acquirer shall apply the requirements of IAS 12.68 of HKAS 12, as amended by HKFRS 3, prospectively.
- That is to say, the acquirer shall not adjust the accounting for prior business combinations for previously recognised changes in recognised deferred tax assets.
- However, from the date when this HKFRS is applied, the acquirer shall recognise, as an adjustment to profit or loss (or, if HKAS 12 requires, outside profit or loss), changes in recognised deferred tax assets.



HKAS 27 and HKFRS 3

9 January 2009



Nelson Lam 林智遠
nelson@nelsoncpa.com.hk
www.nelsoncpa.com.hk

HKAS 27 and HKFRS 3

9 January 2009



Nelson Lam 林智遠
nelson@nelsoncpa.com.hk
www.nelsoncpa.com.hk

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