

- (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

17-900 Effective date and transition

HKFRS 9 will become operative for annual periods beginning on or after 1 January 2013 (para 7.1.1). Earlier application is permitted.

HKFRS 9 shall generally be applied retrospectively in accordance with HKAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors" (para 7.2.1). There are, however, several exceptions to this principle and the transitional requirements are lengthy. In particular, if an entity that adopts HKFRS 9 for reporting periods beginning before 1 January 2012, it need not restate prior periods (para 7.2.14).

17-950 Comparison with HKAS 39 "Financial Instruments: Recognition and Measurement"

HKFRS 9 improves and simplifies the existing HKAS 39 approach for classification and measurement of financial assets.

HKAS 39 classifies financial assets into four categories:

- (a) financial assets at fair value through profit or loss, which comprise:
 - (i) "held for trading" securities; and
 - (ii) "designated" securities;
- (b) held-to-maturity investments;
- (c) loans and receivables; and
- (d) available-for-sale financial assets.

HKFRS 9, however, only requires financial assets to be initially measured at fair value, in the case of a financial asset not at fair value through profit or loss, particular transaction costs, and subsequently measured at (a) amortised cost, or (b) fair value. Further, HKFRS 9 establishes the principle-based criteria for determining which of the two measurement methods to apply.

17-980 Comparison with International Accounting Standards

HKFRS 9 is based on IFRS 9 "Financial Instruments". There are no major textual differences between HKFRS 9 and IFRS 9. Compliance with HKFRS 9 will ensure compliance with IFRS 9.

18 HKFRS 10

"Consolidated Financial Statements"

Introduction	18-100
Concept of control	18-200
Elements of control — Power	18-210
Elements of control — Returns	18-220
Elements of control — Linking power and returns	18-230
Accounting requirements	18-300
Disclosures	18-400
Transitional provisions	18-500
Comparison with International Financial Reporting Standards	18-600

18-100 Introduction

In June 2011 the HKICPA issued HKFRS 10 "Consolidated Financial Statements". This is a replacement of HKAS 27 "Consolidated and Separate Financial Statements" and "HK(SIC)-Int 12 Consolidation — Special Purpose Entities". Concurrent with the issuance of HKFRS 10, the HKICPA also issued:

- HKFRS 11 "Joint Arrangements";
- HKFRS 12 "Disclosure of Interests in Other Entities";
- HKAS 27 (2011) "Separate Financial Statements" — the amendment reflects the changes required by the issuance of HKFRS 10 but retains the current guidance for separate financial statements; and
- HKAS 28 (2011) "Investments in Associates and Joint Ventures" — the amendment reflects the changes required by the issuance of HKFRS 10 and HKFRS 11.

Each of the Standards in the "group of five" has an effective date for annual periods beginning on or after 1 January 2013, with earlier application permitted so long as each of the other Standards in the group is also applied early. However, entities are permitted to incorporate any of the disclosure requirements in HKFRS 12 into their financial statements without adopting HKFRS 12 or the other Standards in the "group of five" early.

This diagram displays the five new/amended standards and their respective scopes.

	Accounting	Disclosure	Separate Financial Statements
Subsidiaries	HKFRS 10	HKFRS 12	HKAS 27 (2011)
Associates	HKAS 28 (2011)		
Joint ventures	HKFRS 11		
Joint operations			
Unconsolidated structured entities	HKAS 39		
		HKFRS 12	

18-200 Concept of control

HKFRS 10 includes the concept of control as the basis for consolidation, irrespective of the nature of the investee, eliminating the risks and rewards approach included in HK(SIC)-Int 12 (para 5).

HKFRS 10 identifies the following three elements of control (para 7):

- power over the investee, including de facto control;
- exposure, or rights, to variable returns from involvement with the investee; and
- the ability to use power over the investee to affect the amount of the investor's returns.

An investor must possess all three elements to conclude it controls an investee. The assessment of control is based on all facts and circumstances and the conclusion is reassessed if there is an indication that there are changes to at least one of the three elements of control (para 8).

The development of HKFRS 10 identified the following four areas in determining whether an investee should be consolidated:

- where an investor controls an investee with less than a majority of the voting rights;
- special purpose entities and application of HK(SIC)-Int 12's "economic substance" notion;
- issues around principal vs agent relationships; and
- consideration of protective rights.

Purpose and design of an investee

When assessing control of an investee, an investor needs to consider the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities (para B5 of Application Guidance).

From such a consideration it may be clear that an investee is controlled by means of equity instruments giving the holder proportionate voting rights. In such cases, and in the absence of additional information which might alter the decision, the assessment of control focuses on which party, if any, is able to exercise sufficient voting rights to determine the investee's operating and financing policies. In most simple cases, the investor that holds a majority of those voting rights controls the investee (para B6 of Application Guidance).

18-210 Elements of control — power

Power is deemed to exist when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns (para 10). Control most commonly arises through voting rights granted by equity instruments, but can also arise through other contractual arrangements (para 11). The ability to direct the relevant activities does not need to be exercised for them to provide an investor power (para 12). If two or more investors have rights to direct different relevant activities, the investors must decide which of the relevant activities most significantly affects the returns of the investee (para 13).

The following factors should be considered in determining whether an investor has control over an investee (para B3 and B4 of Application Guidance):

- the purpose and design of the investee;
- what the relevant activities are and how decisions are made to affect those activities;
- whether the investor's rights give it the current ability to direct the relevant activities;
- whether the investor is exposed, or has rights, to variable returns from its involvement with the investee;
- whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns; and
- the nature of the investor's relationship with other parties.

The relevant activities for entities whose operations are directed through voting rights will generally be its operating and financing activities. Examples of activities that may be relevant activities include product development,

purchases and sales of goods or services, managing financial assets, acquiring and disposing of assets or obtaining financing (para B11 of Application Guidance).

Decisions about relevant activities include establishing operating and capital strategies and policies, appointing and remunerating key management personnel or service providers and terminating their employment (para B12 of Application Guidance).

Illustration 18.1 (Relevant activities — adapted from Application examples: Example 1 of HKFRS 10)

Two investors form an investee to develop and market a medical product. One investor is responsible for developing and obtaining regulatory approval of the medical product — that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval. Once the regulator has approved the product, the other investor will manufacture and market it this investor has the unilateral ability to make all decisions about the manufacture and marketing of the product.

In this case, if all the activities — developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product — are relevant activities, each investor needs to determine whether it is able to direct the activities that most significantly affect the investee's returns. Accordingly, each investor needs to consider whether developing and obtaining regulatory approval or the manufacturing and marketing of the medical product is the activity that most significantly affects the investee's returns and whether it is able to direct that activity.

In determining which investor has power, the investors would consider:

- the purpose and design of the investee;
- the factors that determine the profit margin, revenue and value of the investee as well as the value of the medical product;
- the effect on the investee's returns resulting from each investor's decision-making authority with respect to the factors in (b); and
- the investors' exposure to variability of returns.

Illustration 18.2 (Relevant activities — adapted from Application examples: Example 2 of HKFRS 10)

An investment vehicle (the investee) is created and financed with a debt instrument held by an investor (the debt investor) and equity instruments held by a number of other investors. The equity tranche is designed to absorb the first losses and to receive any residual return from the investee. One of the equity investors who holds 30% of the equity is also the asset manager. The investee uses its proceeds to purchase a portfolio of financial assets, exposing the investee to the credit risk associated with the possible default of principal and interest payments of the assets. The transaction is marketed to the debt investor as an

investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investee.

The returns of the investee are significantly affected by the management of the investee's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (that is, when the value of the portfolio is such that the equity tranche of the investee has been consumed).

From that time, a third-party trustee manages the assets according to the instructions of the debt investor. Managing the investee's asset portfolio is the relevant activity of the investee. The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value.

In this case, the asset manager and the debt investor each need to determine whether they are able to direct the activities that most significantly affect the investee's returns, including considering the purpose and design of the investee as well as each party's exposure to variability of returns.

Investee controlled by voting rights

When the investee is controlled through equity instruments, with associated and proportionate voting rights, the assessment of power will focus on which investor, if any, has sufficient voting rights to direct the investee's relevant activities. In most straightforward cases, the investor holding the majority of the voting rights will have power over (and control) the investee (para B6 of Application Guidance).

Complex cases

For complex control cases it will generally be necessary to consider a number of factors when assessing what is relevant in evaluating control and identifying the controlling party (para B7 of Application Guidance). This will involve the identification and analysis of (para B3 of Application Guidance):

- the purpose and design of the investee;
- what its relevant activities are and how decisions regarding relevant activities are made;
- whether the investor is exposed to or has rights to variable returns; and
- whether the investor has the ability to affect the amount of its own returns from the investee.

Voting rights not considered relevant

Certain investees are designed such that voting rights are not the primary determination of power. Instead, other rights are considered relevant. These entities generally correspond to structured entities as defined in HKFRS 12.

In such cases, the consideration of the purpose and design of the investee would include:

Measurement at recognition and determination of cost

48-400 Measurement at recognition and determination of cost

HKAS 16 provides that upon recognition as an asset, an item of property, plant and equipment shall be measured at its cost (para 15).

The cost of property, plant and equipment normally comprises two components: the initial cost of acquisition and subsequent cost incurred.

48-410 Initial cost

HKAS 16 provides that the initial cost of a purchased property, plant and equipment comprises (para 16):

- its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
- any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and
- the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

It should be noted that HKAS 16 requires the costs of dismantlement and restoration (generally referred to as decommissioning costs) to be included in the initial cost of property, plant and equipment. HK(IFRIC)-Int 1 "Changes in Existing Decommissioning, Restoration and Similar Liabilities" deals with accounting for changes in these decommissioning costs arising from change in estimation of the costs, change in discount rate and unwinding of the discount. Specifically, HK(IFRIC)-Int 1 provides that changes in decommissioning costs arising from change in estimate and discount rate should be adjusted to the cost of the asset in the current period prospectively, and changes in decommissioning costs arising from unwinding of the discount should be accounted for as a finance cost as it occurs.

Illustration 48.1

On 1 January 20x1, ABC Ltd purchases a plant for cash consideration of \$30,000,000. However, ABC Ltd is required to dismantle the plant after a 20-year period. It is estimated that the dismantlement will cost \$10,000,000. The relevant discount rate is 6%, and the present value of the dismantlement cost is therefore

\$3,120,000 ($\$10,000,000 / (1 + 6\%)^{20}$). In this case, ABC Ltd will record the plant at a cost of \$33,120,000 on 1 January 20x1 as follows:

Dr	Plant	33,120,000	
Cr	Cash		30,000,000
Cr	Provision for decommissioning		3,120,000

On 31 December 20x1, ABC Ltd has to provide depreciation on the plant, by allocating the costs of \$33,120,000 over 20 years. Besides, ABC Ltd will also have to account for the change in the decommissioning cost due to unwinding of discount (from 20 periods to 19 periods). In this case, the present value of the decommissioning cost has increased from \$3,120,000 to \$3,307,000 ($\$3,120,000 \times 1.06$) because of the unwinding of discount. The journal entry to record this change is as follows:

Dr	Finance costs	187,000	
Cr	Provision for decommissioning		\$187,000

Assume that on 31 December 20x9, it is estimated that, due to technological advancement, the dismantlement cost will be just \$8,000,000. In this case, the present value of the decommissioning cost will change from \$5,200,000 ($\$10,000,000$ discounted at 6% for 11 periods) to \$4,210,000 ($\$8,000,000$ discounted at 6% for 11 periods). The journal entry to record this change is as follows:

Dr	Provision for decommissioning	990,000	
Cr	Plant		990,000

The annual depreciation charge for the years 20x1 to 20x9 will be based on the cost of \$33,120,000, whereas the depreciation for years thereafter will be based on the cost of \$32,130,000 ($\$33,120,000 - \$990,000$).

Further discussion on the initial cost of property, plant and equipment is related to specific issues regarding assets acquired through a purchase transaction, through an exchange transaction, and those that are constructed internally.

Purchased property, plant and equipment

In most cases, the "purchase price" is easily determinable, given that there is a purchase transaction. However, where the purchase price is not quoted or payable in cash, there may be some difficulty in determining the amount to be treated as the cost of the property, plant and equipment purchased. In such cases, the "cash price equivalent" of the purchase price would be relevant.

Where the terms of purchase allow for a cash discount, a common practice is to deduct the cash discount, whether or not taken, from the purchase price, so

that only the "cash price equivalent" is recorded as part of the cost of the property, plant and equipment.

Illustration 48.2

Assume that a piece of equipment is purchased at a quoted price of \$100,000 on a term of 2/20, n/60 (meaning a discount of 2% will be given if the payment is made within 20 days, or the full \$100,000 will have to be paid within 60 days).

In this case, the purchase price should be recorded at its "cash price equivalent" of \$98,000 (\$100,000 less cash discount of \$2,000) irrespective of whether the cash discount is taken advantage of.

If the price is paid within 20 days, the journal entry will be as follows:

Dr	Equipment	98,000	
Cr	Cash		98,000

If the price is paid after the 20th day, the journal entry will be as follows:

Dr	Equipment	98,000	
Dr	Cash discount forgone	2,000	
Cr	Cash		100,000

Where property, plant and equipment are purchased and to be paid for only after a long-term credit period, the concept of "cash price equivalent" should again be used. The cash price equivalent will be equal to the present value of the cash payments.

Illustration 48.3

Assume that a piece of specialised equipment is purchased under an agreement which provides for payment of five equal yearly instalments of \$100,000 each at the end of each of the five years after the date of purchase.

In this case, to record the purchase price of the equipment at \$500,000 is to ignore the fact that there are interest charges in the contract.

Assuming an interest rate of 10%, the equipment should be recorded at \$379,080, ie the present value of the cash payments ($\$100,000 \times 3.7908 = \$379,080$). The journal entry to record the transaction will be as follows:

Dr	Equipment	379,080	
Dr	Deferred interest (500,000 - 379,080)	120,920	
Cr	Notes payable		500,000

HKAS 16 provides that the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is recognised in the carrying amount of the item in accordance with HKAS 23 "Borrowing Costs" (para 23).

Sometimes, property, plant and equipment may be acquired and paid for by the issuance of the entity's shares or debentures. In such cases, the property, plant and equipment should be recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident, as required by HKFRS 2 "Share-based Payment".

The fair value of a property, plant and equipment is clearly evident if the asset is commonly traded; whereas the fair value of a specialised asset will generally be more difficult to determine. On the other hand, the fair value of securities will be easily determined if the securities have been actively traded on the stock exchange. HKFRS 2 provides that, if the property, plant and equipment is acquired from a party other than the employee, there is a presumption that the fair value of the property, plant and equipment acquired is more clearly evident.

Illustration 48.4

Assume that ABC Ltd purchases a piece of specialised machinery through an issue of 1,000,000 of its ordinary shares at \$1.00 each. Assume also that 100 million of ABC Ltd's ordinary shares have been actively traded on the Hong Kong Stock Exchange at \$2.50 per share, and that there has been no transaction involving similar machinery in recent years.

In this case, it is obvious that the fair value of the ordinary shares is "more clearly evident" than the fair value of the machinery. Accordingly, the machinery should be recorded at the fair value of the shares issued of \$2,500,000. Share premium of \$1,500,000 should also be recorded, in compliance with sec 48 of the *Companies Ordinance*. The journal entry to record the transaction will be as follows:

Dr	Machinery	2,500,000	
Cr	Share capital (1,000,000 × \$1)		1,000,000
Cr	Share premium (1,000,000 × (\$2.50 - \$1))		1,500,000

As mentioned above, the initial cost of purchased property, plant and equipment not only includes the purchase price, but also "any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management".

Some examples of directly attributable costs are costs of employee benefits arising from the construction or acquisition of the item of property, plant and

equipment, costs of site preparation, initial delivery and handling costs, installation and assembly costs, costs of testing whether the asset is functioning properly and professional fees.

HKAS 16 specifically provides that the following are not costs of an item of property, plant and equipment (para 19):

- costs of opening a new facility;
- costs of introducing a new product or service;
- costs of conducting business in a new location or with a new class of customer; and
- administration and other general overhead costs.

When two or more property, plant and equipment are acquired simultaneously, the question arises as to which cost element should be recognised as the cost of which property, plant and equipment. In this respect, the words "operating in the manner intended by management" would serve as a good guide.

Illustration 48.5

Assume that ABC Ltd acquires a piece of land for the purpose of building a factory on it. Assume also the following expenditures are incurred:

- purchase price of land: \$1,000,000;
- legal fees for land purchase: \$50,000;
- cost of demolishing an old building on the land: \$30,000;
- cost of clearing and levelling the land: \$80,000;
- architect's fee for the factory: \$20,000;
- cost of construction of factory: \$1,500,000; and
- cost of constructing and demolishing living quarters for the workers building the factory: \$60,000.

Since the land is acquired for the purposes of constructing a factory on it, the cost of demolishing the old building and the cost of clearing and levelling, which are necessary to bring the land to the location and condition necessary for it to be capable of operating in the manner intended by management, ie for the construction of the factory, should be recognised as part of the cost of land. The architect's fee and the cost of constructing and demolishing the workers' quarters are necessary for the construction of the factory, and should therefore be recognised in the cost of the factory.

Thus, using the concept of "operating in the manner intended by management", items (a) to (d) should be recognised as part of cost of land, and items (e) to (g) should be recognised as part of the cost of building.

Exchanged property, plant and equipment

When an item of property, plant and equipment is acquired in exchange for a non-monetary asset, the question arises as to whether the asset acquired should be measured based on the "book value" or the "fair value" of the asset.

Valuing the asset acquired based on the fair value of the asset given up/acquired will be more consistent with the historical cost convention. However, taking account of the fair value of the asset given up/acquired will give rise to a gain or loss, which many accountants argue, should not be recognised. They contend that where the exchange is not essentially the culmination of an earning process, for example, where the exchange involves a similar productive asset, no gain or loss should be recognised.

HKAS 16 specifically provides that the cost of the asset acquired should be measured at fair value unless (para 24):

- the exchange transaction lacks commercial substance; or
- the fair value of neither the asset received nor the asset given up is reliably measurable.

HKAS 16 further provides that the fair value of the asset given up should be used unless the fair value of the asset received is more clearly evident (para 26). If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up (para 24).

Illustration 48.6

ABC Ltd trades in a used Mercedes car for a photocopying machine. The Mercedes was bought for \$160,000, is carried in the books at \$90,000, and has a market value of \$100,000 at the time of the trade-in. The photocopying machine has a market value of \$120,000.

This will be a case of exchange. Therefore, in accordance with the provisions of HKAS 16, the photocopying machine should be measured based on the fair value of the used Mercedes car or on that of the photocopying machine, as follows:

Dr	Office equipment	120,000	
Dr	Motor vehicle (old) —	70,000	
	Accumulated depreciation		160,000
Cr	Motor vehicle (old)		10,000
Cr	Gain on sale of vehicle		20,000
Cr	Cash (120,000 – 100,000)		

- (3) CJE (b) and (c) are to eliminate the intragroup items in the statement of comprehensive income. The elimination of intragroup items does not affect the group profit. The total group profit for the year of \$220,000 is equal to the profit of P Ltd of \$140,000 plus the profit of S Ltd of \$80,000, unaffected by CJE (b) and (c) (only adjustments for "unrealised intragroup profits and losses" affect group profit).
- (4) CJE (d) is to adjust for the cash in transit of \$10,000 as if P Ltd has received the money, so that:
- the cash in transit of \$10,000 (which is not reflected in the statements of financial position of P Ltd and S Ltd) will be properly accounted for in the consolidated statement of financial position; and
 - the intragroup trade balances will be equal in amount and can then be eliminated in CJE (e) (it may be noted that before CJE (d), the intragroup trade payable in S Ltd's statement of financial position was carried at \$70,000, whereas the intragroup trade receivable in P Ltd's statement of financial position was carried at \$80,000).
- (5) CJE (f) is to eliminate the intragroup bills. The end result of this elimination is that the group would have, and the consolidated statement of financial position would show, bills payable for \$4,000. This is the amount of intragroup bills that P Ltd discounted with an outside party. Once the bill is discounted with the outside party, the group would have a liability (in this case, either S Ltd pays to the discount houses the \$4,000, or P Ltd would have to pay; in other words, the group would have to pay \$4,000 to the discount houses). Therefore, it is often said that the contingent liability (that is disclosed in the notes of P Ltd for the discounted bills) has become an actual liability (bills payable in the consolidated statement of financial position).
- However, if P Ltd were to hold all the intragroup bills at the end of the reporting period, that is, assuming that P Ltd did not discount any of the bills, CJE (e) would have eliminated \$10,000 of bills payable against \$10,000 of bills receivable, and there will be no "bills" in the consolidated statement of financial position.
- (6) CJE (g) records non-controlling interest in the subsidiary's profit for the year. The debit entry is for the purpose of inclusion of non-controlling interest in the consolidated statement of comprehensive income (non-controlling interest in the subsidiary's profit for the year must be calculated and deducted from the total profit for the year so as to arrive at the profit attributable to owners of the parent).
- (7) Having recorded the credit entry of CJE (g), what is required in CJE (h) is to take up non-controlling interest in the remaining balance of the subsidiary's shareholders' equity, namely, the subsidiary's share capital and opening retained profit. (Note that if only the consolidated statement of financial position is required, then as far as non-controlling interest is concerned, CJE (g) is not necessary, and CJE (h) would simply account for non-controlling interest in subsidiary's share capital and the closing retained profit.)

57-238 Unrealised intragroup profits and losses

When entities in a group trade with each other, they will record in their own books the intragroup profits and losses arising therefrom, just like the way they record profits and losses arising from trade with entities outside the group. However, in consolidation, when the entities in the group are deemed to be a single (economic) entity, these intragroup profits and losses may give rise to problems, depending on whether they are realised or unrealised, from the group's viewpoint during the reporting period. (Intragroup profits and losses would, of course, not arise if the intragroup transactions were transacted at cost.)

Intragroup profits and losses are said to be realised from the group's viewpoint when the goods or assets involved are sold to outside parties.

Thus, if the goods or assets involved in intragroup transactions are sold to external parties during the same accounting period, no adjustment will be necessary for the intragroup profits and losses because they are realised, both from the selling entity's viewpoint and from the group's viewpoint, in the same accounting period.

For example, assume that a parent sold goods costing \$100,000 to its subsidiary for \$120,000 in March 20x8, and that the subsidiary sold the goods to outside parties for \$150,000 in May 20x8 (assume also 31 December as the accounting year-end). The intragroup profit of \$20,000 made by the parent is said to be realised from the group's viewpoint, and no adjustment is required for the intragroup profit in the preparation of consolidated financial statements for 20x8. It is also easy to see that no consolidation adjustment will be necessary because the group profit of \$50,000 (sales proceeds of \$150,000 less original cost of \$100,000) may be obtained by simply adding across the profit of \$20,000 reported by the parent and the profit of \$30,000 reported by its subsidiary.

However, if the goods sold by one entity to another entity in the group remains with the buying entity at the end of the accounting period, then the profit or loss made by the selling entity is said to be unrealised during the accounting period from the group's viewpoint. This is because from the group's viewpoint (when the entities in a group are deemed to be a single (economic) entity), the goods have just moved from one storeroom to another storeroom within the entity. There is no external transaction that results in an increase or decrease in the net assets of the group, and the realisation test is therefore not met. The unrealised intragroup profit or loss must therefore be eliminated and not reported in the consolidated statement of comprehensive income. For example, assume that the parent sold goods costing \$100,000 to its subsidiary for \$110,000 in March 20x8 and that the goods are still held by the subsidiary at 31 December 20x8 (assume also 31 December as the accounting year-end). The \$10,000 intragroup profit reported by the parent is said to be

unrealised from the group's viewpoint and must therefore be eliminated and not reported in the consolidated financial statements for 20x8.

As an extension, assume that the parent sold goods costing \$100,000 to a subsidiary for \$130,000 in October 20x8, which was in turn sold by the subsidiary to an external party in March 20x9 (assume also 31 December as the accounting year-end). In this case, the parent would report a profit of \$30,000 in 20x8. However, from the group's viewpoint, the intragroup profit of \$30,000 was realised only in 20x9 (together with the profit reported by the subsidiary on the sale to the external party). In other words, the parent's profit for 20x8 is overstated and its profit for 20x9 is understated from the group's viewpoint. Thus, in the 20x8 consolidation, the intragroup profit of \$30,000 reported by the parent must be eliminated. In the 20x9 consolidation, \$30,000 must be deducted from the parent's opening retained profit and added to its current year's profit. Note, however, that the effect of the adjustment in 20x9 consolidation is merely a transfer of the intragroup profit from the 20x8 statement of comprehensive income to the 20x9 statement of comprehensive income, which would not be necessary if only the consolidated statement of financial position is prepared. This is also because, from the group's viewpoint, while the retained profit in the parent's statement of financial position as at 31 December 20x8 is overstated, the retained profit in the parent's statement of financial position as at 31 December 20x9 would have been properly stated.

In cases where unrealised intragroup profits or losses arise from transactions between the parent and its partly-owned subsidiary, two issues will have to be resolved.

The first issue is how much of the intragroup profits and losses are deemed to be unrealised ("partial" versus "full" elimination).

For example, assume that the parent sold goods costing \$100,000 to its 80% owned subsidiary for \$150,000, and that the goods are still held by the subsidiary at year-end. The question arises as to how much of the intragroup profit is unrealised. It may be argued that all the goods are deemed to have simply moved within the entity and therefore the whole \$50,000 profit is unrealised from the group's viewpoint. On the other hand, it may be argued that since the goods are sold to an 80% owned subsidiary, only 80% of the goods are deemed to have remained within the entity; the other 20% of the goods have been sold to outsiders. Thus, only 80% of the intragroup profit is unrealised. Similar arguments can be put forward in a case where a partly-owned subsidiary sold goods costing \$100,000 to its parent for \$150,000.

HKAS 27 requires, however, the unrealised intragroup profits and losses to be "eliminated in full" (para 20). Thus, "full elimination" rather than "partial elimination" will be adopted in this chapter.

The other issue is who should bear the adjustment for the unrealised intragroup profits and losses.

The controversy is whether non-controlling interest should be adjusted for the unrealised intragroup profits and losses. One view is that all the unrealised intragroup profits and losses should be adjusted to the group profit, and therefore non-controlling interest is not affected by the elimination of the unrealised profits and losses in consolidation. The other view is that the non-controlling interest would be affected if the unrealised profits and losses arise from an "upstream transaction" (subsidiary selling to parent), but not be affected if the unrealised profits and losses arise from a "downstream transaction" (parent selling to subsidiary). The argument is that in upstream sales, the profits and losses are reported in the books of the subsidiary. When the profits and losses are deemed to be unrealised and eliminated in consolidation, the subsidiary's profit will be affected, and therefore non-controlling interest (the amount of which is calculated based on the subsidiary's profit) will also be affected. In downstream sales, the intragroup profits and losses are recorded in the books of the parent. When the intragroup profits and losses are deemed to be unrealised and eliminated in consolidation, the parent's profit is affected. That would of course have no effect in the calculation of non-controlling interest.

The adoption of the first view may result in some awkward situations in practice. To illustrate, assume an extreme case where the parent reports no profit or loss. The 80% owned subsidiary reports a profit of \$100,000, which is deemed to be unrealised and therefore eliminated in the consolidation process. The resultant consolidated statement of comprehensive income, if the first view is adopted, will show a total profit of \$0, less non-controlling interest of \$20,000. This is awkward because, if there is no group profit (given that the parent's statement of comprehensive income shows no profit, it will be assumed that the subsidiary would also have no profit), how can non-controlling shareholders have a \$20,000 interest in the profits?

The adoption of the second view would result in the consolidated statement of comprehensive income showing no profit and no non-controlling interest, which appears to be more logical. The second view is also conceptually superior because it results in reporting both the group's profit and the non-controlling interest's profit on the basis of income that is realised from the viewpoint of the economic entity. Thus, the second view that non-controlling interest is to be adjusted for unrealised intragroup profits and losses arising from upstream transactions will be adopted in this chapter.

Eliminating the unrealised intragroup profits and losses in "full" and adjusting non-controlling interest for unrealised intragroup profits and losses arising from upstream transactions is sometimes referred to as the "full proportionate method".

The application of the full proportionate method can easily be put into effect by:

- (a) eliminating 100% of the unrealised intragroup profits and losses, regardless of whether the subsidiary is wholly owned or partly owned; and
- (b) adjusting the unrealised intragroup profits and losses against the profit of the *selling entity* in the intragroup transaction, for the purpose of calculating non-controlling interest, regardless of whether the transaction is upstream or downstream.

Note that it is the profit of the group, not that of the individual entity, that is adjusted in consolidation. The identification of the selling entity is merely for the purpose of giving due consideration to non-controlling interest in the intragroup profits and losses. As mentioned earlier, under the full proportionate method, non-controlling interest will be affected only if the subsidiary is the selling entity in the intragroup transaction. The identification of the selling entity will greatly aid the calculation of non-controlling interest, especially in cases where the group structure is complex.

So far, the discussion on unrealised intragroup profits and losses has been focused on the income effect. The other effect of unrealised intragroup profits and losses is on asset valuation.

For example, in a case where the parent sold goods costing \$100,000 to its subsidiary for \$110,000 in March 20x8 and the goods are still held by the subsidiary at 31 December 20x8, two problems exist in consolidation. Besides the problem of the existence of an unrealised profit of \$10,000, there is another problem relating to asset valuation. The unrealised profit of \$10,000, as discussed above, is to be eliminated. As for asset valuation, it may be noted that, in the above case, the inventory will be carried at \$110,000 in the subsidiary's statement of financial position. However, from the group's viewpoint, the cost of the inventory to the group is only \$100,000. Thus, in consolidation, besides the elimination of the unrealised profit of \$10,000 from the consolidated statement of comprehensive income, the inventory value should also be reduced by \$10,000 so as to report the inventory in the consolidated statement of financial position at \$100,000, its original cost to the group.

Consistent with the adoption of "full elimination" for the income effect of the unrealised intragroup profits and losses, "full elimination" will also be adopted for the adjustment of the asset valuation.

In summary, where one entity in a group sells goods or assets at a price above or below cost to another entity in the group and the goods or assets are still held by the buying entity at the end of the accounting period, two adjustments must be made in consolidation. The first adjustment is to eliminate 100% of the unrealised intragroup profits and losses from group profit (identify the selling entity, for the purpose of calculating non-controlling interest). The

second adjustment is to revert the value of the asset back to its original cost to the group. The purposes of these adjustments are to revert the relevant account balances back to the original position as if no transactions have taken place.

It should, however, be noted that the above adjustments will not be necessary in the case where the intragroup transaction is transacted below cost and there is an indication for impairment that requires recognition (para 21). For example, if the parent sells a piece of damaged goods which costs \$100,000 for \$80,000 to its subsidiary and assuming that the goods will ultimately be sold to "outsiders" at or below \$80,000, the "unrealised loss" of \$20,000 will not be eliminated in consolidation. The loss of \$20,000 will be recorded in the consolidated statement of comprehensive income, and the inventory will be reported at \$80,000 in the consolidated statement of financial position (it may be noted, even if the intragroup transaction is ignored in this case, there will still be a loss of \$20,000 and the inventory will be carried at \$80,000 in the parent's financial statements). If, however, the goods will ultimately be sold to "outsiders" at a price at or above \$100,000, the unrealised loss of \$20,000 will be eliminated as discussed in the previous paragraphs, so that no loss is reported in the consolidated statement of financial position and the inventory will be carried at \$100,000 (original cost) in the consolidated statement of financial position. Again, the guiding principle here is to make consolidation adjustments that are necessary to revert the relevant account balances back to the original position ignoring the intragroup transactions.

In the following sections, intragroup transactions involving different assets (non-depreciable assets, inventory, and depreciable assets) are discussed in greater detail.

Intragroup sales of non-depreciable assets (land)

Intragroup transaction in a non-depreciable asset, like land, will be the easiest to deal with in consolidation.

Illustration 57.12

P Ltd acquired 60% of S Ltd on 1 July 20x2 and obtained control of S Ltd. On 30 December 20x3, P Ltd sold a piece of land to S Ltd for \$700,000. The cost of the land to P Ltd was \$500,000. S Ltd held the land until 30 December 20x8 when it was sold to an outside party for \$800,000.

Required:

Prepare the necessary consolidation journal entry (CJE) for each of the years 20x3 to 20x9 in respect of the intragroup sale of land.

Solution:

(I) CJE for 20x3		
Dr	Profit on sale of land (P)	200,000
Cr	Land	200,000
	(to eliminate unrealised intragroup profit in land)	