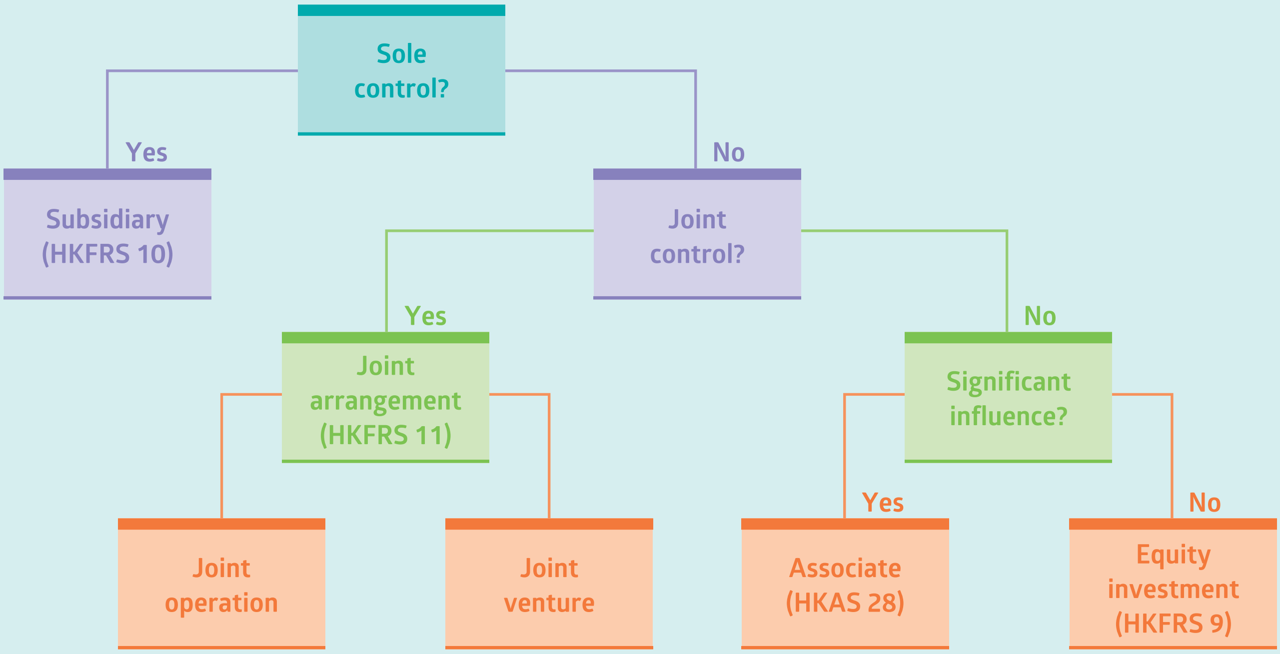
Classification of Equity Investments

Nowadays, it is common for a commercial entity to set up a holding company structure with its wholly or partially-owned entities engaging in different lines of business and/or operating in different geographical regions. This arrangement has the benefit of limiting the financial and legal liability of the holding company and its related entities. Under the accounting regime, these entities can be classified as subsidiaries, joint arrangements, associates or equity investments. They have different accounting treatments in the financial statements, and therefore, a proper classification of these entities is important for the presentation of the financial statements.

Overview of Classification of Equity Investments



This year's accounting mini-series will tell you how to classify, measure and recognise the above group entities in the financial statements.

Subsidiary

HKFRS 10 Consolidated Financial Statements provides a single consolidation model that identifies control as the basis for consolidation for all types of entities. The control model of HKFRS 10 encompasses three distinct principles which, if present, identify the existence of control by an investor, hence forming a parent-subsidiary relationship. They are:

- power over an investee;
- exposure or rights to variable returns from the investee;
- ability to use its power to affect the amount of these returns.

All these three elements must be present for an investor to conclude that it has control over an investee.

Consolidated financial statements are prepared for the parent and subsidiaries to show the effect as if the parent and all the subsidiaries were one entity. Transactions within the Group are eliminated.

Several considerations of the control model

Potential voting rights

Potential voting rights are voting power over an investee through the exercise or conversion of certain convertible debt or equity instruments and/or contractual arrangements. These rights should be considered when assessing investor's power over an investee.

Substantive rights vs protective rights

Substantive rights are rights that confer an investor the current ability to direct an investee's relevant activities. Protective rights are defined as rights to protect the interest of an investor under exceptional circumstances or relate to fundamental changes in an investee without giving power to the holder. When assessing whether an investor has power over an investee, protective rights are not relevant.

Variable returns

Variable returns include not only the conventional returns such as dividends and changes in investment value, but also synergistic returns such as economies of scale and cost savings. Returns shall have the potential to vary as a result of the performance of an investee, of which an investor is able to affect it by exercising its power over an investee.

CLP Case Study

CLP holds 49% interest in SE Solar Limited (SE Solar) through CLP India, with an option to acquire the remaining 51% interest one year after project commissioning.

CLP India
49%
SE Solar
51%
Third Party

- Potential voting right–call option to acquire the 51% interest
- Other facts and circumstances–shares pledged to CLP and CLP has decision-making power over SE Solar

CLP has control on SE Solar → Subsidiary

Joint Arrangement

HKFRS 11 Joint Arrangements specifies two types of joint arrangement, namely joint venture and joint operation. Classification of them is driven by the rights and obligations of the parties arising from the arrangement, rather than the legal form of the arrangement.

Determining the classification of joint arrangements can be set out as a four-step process.

1. Is the joint arrangement structured through a separate vehicle? — No → Joint Operation; Yes ↓
2. Does the legal form of the separate vehicle confer direct rights to assets and obligations for liabilities to the parties of the arrangement? — Yes → Joint Operation; No ↓
3. Do the contractual terms between the parties confer upon them rights to assets and obligations for liabilities relating to the arrangement? — Yes → Joint Operation; No ↓
4. Do other facts and circumstances lead to rights to assets and obligations for liabilities being conferred to the parties of the arrangement? — Yes → Joint Operation; No ↓

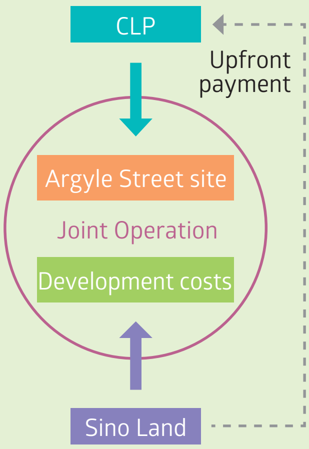
Joint Venture

The parties to a joint operation have rights to the assets and obligations for the liabilities. A joint operator accounts for assets, liabilities and corresponding revenues and expenses arising from the arrangement.

The parties to a joint venture have rights to the net assets. A joint venture partner accounts for an investment in the arrangement using the equity method. Equity method records the initial investment at cost which is adjusted periodically to reflect the changes in value due to the share of the joint venture's performance.

CLP Case Study

CLP and Sino Land Company Limited (Sino Land) executed a development agreement on redeveloping the Group's former headquarters at Argyle Street for residential purposes and to preserve the Clock Tower building for community use.

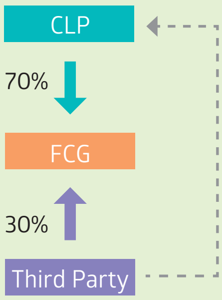


- No separate legal entity is formed
- CLP provides the site
- Sino Land is fully responsible for all development costs
- CLP will share a percentage of sales proceeds

CLP and Sino Land jointly operate the project ➡ Joint Operation

CLP Case Study

CLP holds 70% interest in CLP Guangxi Fangchenggang Power Company Limited (FCG). Under the joint venture agreement, none of the joint venture partners has unilateral control over the economic activities of FCG.



Joint venture agreement
Unanimous consent on economic activities is required

CLP does not have sole control on FCG ➡ Joint Venture

Associate

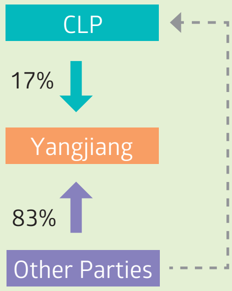
HKAS 28 Investment in Associates defines an associate as an entity over which the investor has significant influence but not control or joint control. Significant influence is the power to participate in the operating and financial policy decisions of an entity, but it has no control over those policies.

Usually, a holding of 20% or more of the voting power (directly or through subsidiaries) will indicate significant influence and vice versa. Other factors like representation on the board of directors or participation in the policy-making process may also evident the existence of significant influence by an investor.

Similar to the accounting for a joint venture, an investor accounts for the investment in an associate by using the equity method.

CLP Case Study

CLP holds 17% interest in Yangjiang Nuclear Power Co. Ltd. (Yangjiang). CLP has a representative in both the Board of Directors and the Supervisory Committee.



Shareholders' agreement
- One seat in the Board of Directors
- One seat in the Supervisory Committee
- Right to assign management representative

CLP is able to participate in the policy making process ➡ Associate

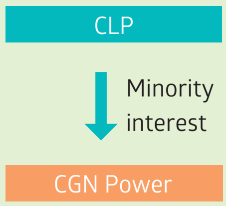
Equity Investment

Equity investments are financial assets under HKFRS 9 Financial Instruments. Investors of these investments have neither control, joint control nor significant influence over investees.

They are measured at fair value through profit or loss (FVTPL) but an irrevocable election at initial recognition may be made to present the fair value change to other comprehensive income (FVOCI) which are not held for trading.

CLP Case Study

CLP has invested in CGN Power Company Limited (CGN Power) as a minority shareholder for strategic purpose. CGN Power is principally engaged in the production and sale of electricity.



Quoted equity investment
- A minority shareholder
- Have neither control, joint control nor significant influence over CGN Power

CLP has no participation rights in CGN Power ➡ Equity Investment (FVOCI)