

Technical Note 01/2007 – Separate Financial Statements of Wholly Owned Subsidiaries

What are separate financial statements?

Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees. In general, in the separate financial statements, investments in subsidiaries, jointly controlled entities and associates shall be accounted for at cost. Separate financial statements shall disclose:

- (a) the fact that the financial statements are separate financial statements;
- (b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and
- (c) a description of the method(s) used to account for these investments in the separate financial statements;
- (d) when the separate financial statements are prepared because the entity is a parent company and elects not to prepare consolidated financial statements in accordance with paragraph 10 of HKAS 27 “Consolidated Financial and Separate Financial Statements”:
 - (i) the fact that the exemption from consolidation has been used;
 - (ii) the name and country of incorporation or residence of the entity whose consolidated financial statements that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards have been produced for public use; and the address where those consolidated financial statements are obtainable; and
- (e) in all cases other (d), the separate financial statements should:
 - (i) disclose the reasons why separate financial statements are prepared if they are not required by law; and
 - (ii) identify the consolidated financial statements of the entity prepared in accordance with HKAS 27 (or the financial statements of an investor in jointly controlled entity or associates but does not have subsidiaries prepared in accordance with HKAS 28 “Investments in Associates” and HKAS 31 “Interests in Joint Ventures”)

Circumstances that separate financial statements are required?

HKAS 27 does not mandate the preparation and presentation of separate financial statements for public use. Strictly speaking, even if an eligible parent company elects not to prepare consolidated financial statements, HKAS 27 does not mandate that parent company to prepare and present separate financial statements for public use.

However, if an entity prepares and presents separate financial statements that comply with Hong Kong Financial Reporting Standards (“HKFRSs”), the separate financial statements must comply with all HKFRSs, in particular requirements of paragraphs 37, 39 to 42 of HKAS 27 summarised above.

For a company incorporated in Hong Kong, separate financial statements prepared in accordance with HKFRSs should satisfy the requirements of sections 122 and 123 of the Companies Ordinance, which require the directors of a company to prepare a profit and loss account and a balance sheet of the company that give a true and fair view.

Should separate financial statements of wholly owned subsidiaries be qualified?

The Companies Ordinance requires a parent company to prepare group accounts. [Group accounts are more general than consolidated financial statements. Strictly speaking, separate financial statements of a parent physically put together with financial statements of its subsidiaries would satisfy the definition of “group accounts” under the Companies Ordinance. However, HKAS 27 requires parent companies to prepare “consolidated” financial statements, not just “group” accounts.]

Under section 124(2)(a) of the Companies Ordinance, group accounts are not required where the holding company is at the end of its financial year the wholly-owned subsidiary of another body corporate. Therefore, for a wholly owned parent company incorporated under the Companies Ordinance, preparation of separate financial statements alone would satisfy the requirements of the Companies Ordinance.

However, for the purpose of HKAS 27, a parent (“reporting parent”) is exempted from preparing consolidated financial statements if and only if:

- (a) the reporting 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 reporting parent not presenting consolidated financial statements;

- (b) the reporting 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 reporting 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 reporting parent produces consolidated financial statements available for public use that comply with HKFRSs or International Financial Reporting Standards.

Condition (d) above effectively bars all private groups of companies from the eligibility of the exemption, causing the unreasonable situation that all intermediate holding companies must prepare and present consolidated financial statements. Condition (d) also bars a reporting parent from the eligibility of the exemption even if its ultimate or intermediate parent produces consolidated financial statements available for public use in accordance with a reporting framework other than HKFRSs or International Financial Reporting Standards, e.g. UK GAAP or US GAAP.

A number of attempts have been proposed to "deal with" these unreasonable situations, such as publishing the consolidated financial statements of the ultimate or immediate holding company in the internet, disclosing the address of the ultimate or immediate holding company and stating that consolidated financial statements would be available there for public inspection, or arguing that UK GAAP or US GAAP is the same as HKFRSs / International Financial Reporting Standards! All these proposals are equally unreasonable, if not more unreasonable, than requiring each and every wholly owned subsidiary of a private group to prepare consolidated financial statements.

In the end, auditors qualify the opinion on the financial statements, or even give an adverse opinion, disagreeing the accounting treatments because financial information of subsidiaries has not been consolidated into the financial statements.

If the financial statements are separate financial statements prepared in accordance with HKFRSs, such qualification or adverse opinion is not necessary. While consolidated financial statements should be prepared, they are not required to be presented together with the separate financial statements. Paragraph 6 of HKAS 27 states that "Separate financial statements need not be appended to, or accompany, those [consolidated financial] statements." Non-preparation or non-presentation of consolidated financial statements would not affect the true and fair view of the separate financial statements, provided that the separate financial statements comply with all the requirements of all applicable HKFRSs.

According to HKSA 701 Modifications to the Independent Auditor's Report, auditors may modify the auditor's report by using an emphasis of matter paragraph after the opinion paragraph to report on matters other than those affecting the financial statements.

Therefore, if the auditor considers it necessary, the auditor may add an emphasis of matter in the auditor's report on the separate financial statements, stating that the entity has not prepared and presented consolidated financial statements in accordance with the requirements of HKAS 27.

Sample disclosures (other than the list of subsidiaries, joint ventures and associates) in the separate financial statements of a wholly owned parent who has not prepared consolidated financial statements in accordance with HKAS 27 are as follows:

2. BASIS OF PREPARATION

(a) Compliance with Hong Kong Financial Reporting Standards

The financial statements have been prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRS"), Hong Kong Accounting Standards ("HKAS") and Interpretations issued by the Hong Kong Institute of Certified Public Accountants (hereinafter collectively referred to as "Hong Kong Financial Reporting Standards").

These financial statements are separate financial statements. The Company has not prepared and presented separately the consolidated financial statements required by HKAS 27 "Consolidated and Separate Financial Statements".

3. PRINCIPAL ACCOUNTING POLICIES

(i) Investment in subsidiaries

A subsidiary is an entity that is controlled by the Company. Investments in subsidiaries are stated in the Company's balance sheet at cost less any identified impairment loss. Income from subsidiaries is recognised in the Company's financial statements on the basis of dividends declared by the subsidiaries.

(j) Jointly controlled entities

A joint venture is a contractual arrangement whereby the Company and other parties undertake an economic activity which is subject to joint control and over which none of the participating parties having unilateral control. Jointly controlled entities are joint venture arrangements which involve the establishment of a separate entity in which each venturer has an interest.

Interests in jointly controlled entities are stated in the Company's balance sheet at cost less any identified impairment loss. Income from jointly controlled entities is recognised in the Company's financial statements on the basis of dividends declared by the jointly controlled entities.

(k) Investments in associates

An associate is an entity, not being a subsidiary or a joint venture, in which the Company is in a position to exercise significant influence, including participation in financial and operating policy decisions.

Interests in associates are stated in the Company's balance sheet at cost less any identified impairment loss. Income from associates is recognised in the Company's financial statements on the basis of dividends declared by the associates.

Sample "emphasis of matter" paragraph in auditor's report on the separate financial statements of a wholly owned parent who has not prepared consolidated financial statements in accordance with HKAS 27 are as follows:

Without qualifying our opinion we draw attention to Note 2(a) to the financial statements. These financial statements are separate financial statements. The Company has not prepared and presented separately the consolidated financial statements required by HKAS 27 "Consolidated and Separate Financial Statements".