

» Double entry

The consolidation adjustments that will be made during the preparation of group accounts can be thought of and will be explained in terms of double entry.

If you are rusty regarding double entry then you may wish to refer to the recap on double entry bookkeeping found at the back of this book that sets out the basic double entry principles. Or you may wish to avoid double entry terms and that is OK as all the primary explanations and all the workings will be done in proformas with numbers being added and subtracted. This book is not about T accounts!

However, the only consolidation adjustment in the above example relates to the parent's investment in the subsidiary (\$300m) and the share capital and retained earnings of the subsidiary (\$300m). All the other numbers have been cross cast.

The investment is an asset and thus a DR balance, and the share capital and retained earnings of the subsidiary are equity and thus are CR balances. Accordingly, when in w3 they are offset against each other the result is a perfect cancellation.

⚙️ Technical corner

Substance over form

There is a concept in accounting known as "substance over form". Accounting concepts are ideas and assumptions that are generally accepted.

Substance over form means that when preparing accounts it is assumed that we are striving to reflect the true economic reality of events and transactions i.e. to account for the truth rather than reflect the strict legal situation.

The preparation of group accounts is often quoted as an example of substance over form. You see, strictly the parent company and the subsidiary company are two separate legal entities but we prepare the group accounts as if they were a single entity to reflect the fact that the parent company is in sole control. Because the parent controls the subsidiary's assets and liabilities it is appropriate to fully cross cast them to ensure that the shareholders of the parent company can appreciate the total resources that are controlled, even if the parent does not hold 100% of the shares in the subsidiary.

I suppose preparing a statement of financial position for the group is a bit like preparing one for a marriage! It may be useful to aggregate the assets and liabilities of a husband and wife in a single statement but legally the husband and wife have separate legal personalities.

The parent company is not responsible for the liabilities of its subsidiary company, after all the parent is simply a shareholder in the subsidiary, which is a limited liability company. To that extent the preparation of the group accounts could appear misleading to a casual user as the group accounts aggregate all the assets and liabilities of the parent and its subsidiary companies together. For example a lender to a highly geared and potentially insolvent subsidiary company needs to be reviewing the individual company's financial statements to assess the likelihood of recovering its money, rather than the overall group accounts.

⚙️ Technical corner

Negative goodwill

In exam questions – and in real life – goodwill almost inevitably arises on the acquisition of a subsidiary. This is because it is normal for the value of the subsidiary's business as a whole (as represented by the parent's consideration and the NCI) to exceed the identifiable assets acquired and liabilities assumed by the parent. As we have seen this excess, this premium, that arises in the group accounts is treated as an intangible asset. As we shall see in Chapter 7 *Impairment review of goodwill*, it will then be subject to an annual impairment review.

Thus for example, if the parent pays \$200m for 100% of a subsidiary with net assets of \$150m then the goodwill arising is \$50m.

	\$m
Cost of parent's investment	200
NCI at acquisition	Nil
Less the subsidiary's net assets at acquisition	<u>(150)</u>
Goodwill "positive = an asset"	<u>50</u>

This positive goodwill is an asset and arguably is attributable to the general reputation of the business, its prospects of making future profits, and reflects a strong loyal customer base and a skilled workforce.

But there is a very unusual situation where on the consolidation of a subsidiary the goodwill that arises is not an asset. Let us consider the situation where instead of the parent paying a premium for the investment in the subsidiary it is able to acquire the subsidiary at a discount. Thus for example, if the parent pays \$140m for 100% of the \$150m net assets of the subsidiary the goodwill arising is a negative \$10m.

	\$m
Cost of parent's investment	140
NCI at acquisition	Nil
Less the subsidiary's net assets at acquisition	<u>(150)</u>
Goodwill "negative = a profit"	<u>(10)</u>

This is negative goodwill. It arguably arises because the future prospects of the business are poor. This negative goodwill is really a discount arising on consolidation. It comes about where there has been a bargain purchase if you like. Negative goodwill is therefore treated as a profit. This means it is included in group retained earnings (w5) as a positive number!

Question Trinidad

The statements of financial position of two companies are as follows.

Use this investment in the goodwill calculation w3.

	Trinidad \$m	Tobago \$m
Investment in Tobago	<u>800</u>	
Assets	<u>1,000</u>	<u>900</u>
	<u>1,800</u>	<u>900</u>
Ordinary shares (\$1)	400	300
Retained earnings	<u>500</u>	<u>400</u>
Equity	900	700
Liabilities	<u>900</u>	<u>200</u>
	<u>1,800</u>	<u>900</u>

Additional information

Trinidad has today acquired 225m shares of Tobago's 300m shares.

The value of the non-controlling interest in Tobago at acquisition is \$175m.

Use the number of shares bought in the w1 group structure working to show the parent's interest and NCI.

Required

Prepare the consolidated statement of financial position for Trinidad.

Let's look at a comprehensive example.

Example

Poland has made an acquisition of 100% of the shares in Warsaw. The consideration that Poland gave for the investment in the subsidiary Warsaw comprised:

- 1 Cash – Poland paid \$25,471 to the shareholders of Warsaw.
- 2 Shares – Poland issued 10,000 shares to the shareholders of Warsaw, each with a nominal value of \$1 and a market value of \$4.
- 3 Interest bearing loan notes – Poland issued \$5,000 10% loan notes to the shareholders of Warsaw.
- 4 Deferred consideration – \$20,000 is to be paid two years after the date of acquisition. The relevant discount rate is 10%.
- 5 Contingent consideration – Further monies may be payable at a later date subject to performance targets being met. The fair value of this consideration is \$38,000.

At the date of acquisition Warsaw's net assets were \$80,000.

Required

- (i) Determine the fair value of the consideration that Poland has given in buying its investment in Warsaw.
- (ii) Determine the goodwill arising on the consolidation of Warsaw in the Poland group accounts.
- (iii) Show the subsequent accounting for the deferred consideration.
- (iv) Show the subsequent accounting for the contingent consideration on the basis that the performance targets were not met.

- (i) The cost of the investment that Poland made in Warsaw can be ascertained by aggregating the fair value of the consideration given.

Investment in Warsaw

		\$
Cash	There is no problem ascertaining the fair value of cash!	25,471
Shares	The fair value of the 10,000 shares that the parent issued is the market value of \$4 each	40,000
Interest bearing loan notes	The fair value of the \$5,000 10% loan notes is simply \$5,000	5,000
Deferred consideration	The fair value of the \$20,000 liability payable in two years is the present value of the future cash flow. Thus with a 10% discount rate, the present value is the \$20,000 multiplied by $\frac{1}{1.1^2}$	16,529
Contingent consideration	The contingent consideration must also be at fair value	38,000
		<u>125,000</u>

- (ii) Having ascertained the correct fair value of the consideration given by the parent, and since the value of the subsidiary's net assets at acquisition is given we can move straight on to working 3 to ascertain the goodwill arising.

	\$
Fair value of the parent's investment	125,000
NCI at acquisition	Nil
Less the subsidiary's net assets at acquisition	(80,000)
Goodwill at acquisition	<u>45,000</u>

- (iii) Subsequent accounting for the deferred consideration.

The recognition of the liability of deferred consideration will result in further accounting entries.

At the date of acquisition Poland recorded a liability to pay the shareholders of Warsaw \$20,000 in two year's time, which because of the time value of money was discounted and measured at the present value of \$16,529. Now whenever a liability has been discounted that discounting will be need to be subsequently unwound to reflect the increase in the present value as each year passes. This unwinding of the discount creates a finance charge (interest cost). As an extra expense this will reduce the group retained earnings (w5) and as we shall see later, appear as an additional expense in the group statement of profit or loss.

(ii) When applying the proportionate method NCI is measured as the % of the net assets at the date of acquisition.

30%	x	\$600m	=	\$180m
NCI %		The net assets of the subsidiary at acquisition		NCI at acquisition on a proportionate basis

Goodwill is then calculated as follows

W3 Goodwill

	\$m
Fair value of the parent's investment	800
NCI at acquisition - proportionate basis (30% x 600)	180
Less the subsidiary's net assets at acquisition	(600)
Goodwill at acquisition - attributable to the parent	380

(iii) You will I hope observe that as a result of the NCI at acquisition being measured differently this results in the goodwill at acquisition also being measured differently.

When NCI is measured at fair value then the goodwill arising is said to be the full goodwill. It represents all the goodwill of the subsidiary, and is attributable to the parent and the NCI. As a result when full goodwill is impaired the loss will be shared between the parent's profits (w5) and the NCI (w4) in proportion that the group share profits and losses.

When NCI is measured on a proportionate basis then the goodwill arising is only attributable to the parent. As a result when the goodwill attributable to the parent is impaired the loss will only be charged against the parent's profits (w5).

In our Libya example when NCI is measured at fair value the full goodwill is \$470m, but when NCI is measured on a proportionate basis then the goodwill attributable to the parent is \$380m. The difference between the two of \$90m is the goodwill that is attributable to the NCI.

Because these are such important principles let's have a look at another example - this time with an impairment loss and NCI being reported at the year-end.

Example

Last year Mount acquired 60% of Everest's share capital for \$900m when the net assets of Everest were \$800m and the market value of Everest's shares \$5. Everest has share capital of 200m equity shares. At the reporting date, the net assets of Everest are \$950m; Mount has retained earnings of \$500m and the goodwill has been impaired by \$100m.

Required

- On the basis of measuring NCI at acquisition at fair value (and therefore goodwill in full), calculate at the reporting date the goodwill, NCI and the group retained earnings.
- On the basis of measuring NCI at acquisition on a proportionate basis (and therefore goodwill is attributable to the parent only), calculate at the reporting date the goodwill, NCI and the group retained earnings.

- NCI at fair value / goodwill in full

First let us calculate the fair value of the NCI of the date of acquisition, being the market price of the shares not acquired by the parent.

40%	x	200m	x	\$5	=	\$400m
NCI %		The number of shares in Everest - the subsidiary		The market value of the shares at acquisition		The fair value of the NCI at acquisition

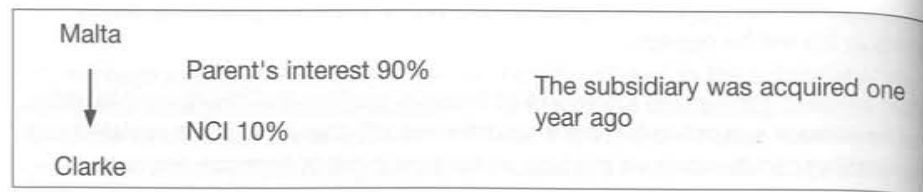
Now we can calculate the goodwill arising at acquisition before then deducting the impairment loss.

W3 Goodwill

	\$m
Fair value of the parent's investment	900
Fair value of NCI at acquisition	400
Less the subsidiary's net assets at acquisition	(800)
Goodwill at acquisition - in full	500
Less impairment loss	(100)
Goodwill at reporting date	400

As NCI is at fair value, so the goodwill is in full i.e. attributable to both the parent and the NCI. Accordingly the impairment loss of \$100m is then split between the parent's profits (w5) and the NCI (w4) in the usual proportions that they share profits and losses i.e. 60/40.

W1 Group structure



In the group structure it is now highly relevant to note that the subsidiary was acquired one year ago as this will mean that there will be one year of extra depreciation required on the plant.

The fair value adjustment of \$50m on the plant increases the net assets both at acquisition as well as at the year-end. Because the plant is being increased in value there will be an increase in depreciation in the post-acquisition period. The plant has a remaining five year life and has been held by the group for one year.

The additional depreciation is $\$50m \times \frac{1}{5} \times 1 \text{ year} = \$10m$.

This additional depreciation decreases the net assets at the year-end.

W2 Net assets of the subsidiary

	At acquisition	At year-end
	\$m	\$m
Share capital	200	200
Retained earnings	200	350
Fair value adjustment	50	50
Additional depreciation	Nil	(10)
	<u>450</u>	<u>590</u>

\$140m

The increase in the net assets since acquisition is \$140m (\$590m - \$450m) and this represents the profits the subsidiary has made since acquisition. The parent's share of this will be taken to the group retained earnings in w5 and the NCI's share to the NCI in w4. The post-acquisition profits of \$140m include the additional depreciation that has been charged.

As a proof the \$140m can be thought of as the rise in the unadjusted profits of the subsidiary since acquisition ($\$350m - \$200m$) = \$150m less the additional depreciation of \$10m arising from the fair value adjustment.

The goodwill, NCI and group retained earnings can now be processed in the normal way.

W3 Goodwill

	\$m
FV of the parent's investment	900
FV of the NCI at acquisition	50
Less the FV of the subsidiary's net assets at acquisition	<u>(450)</u>
Goodwill at acquisition	500
Less impairment loss	<u>(Nil)</u>
Goodwill at reporting date	<u>500</u>

W4 NCI

		\$m
Fair value of the NCI at acquisition		50
Plus the NCI% of the post-acquisition profits w2	(10% x 140)	<u>14</u>
		<u>64</u>

W5 Group retained earnings

		\$m
Parent's retained earnings		400
Plus the parent's % of the post-acquisition profits w2	(90% x 140)	<u>126</u>
		<u>526</u>

Malta group statement of financial position

		\$m
Goodwill	w3	500
Assets	(600 + 650 plus the fair value adjustment 50 less the additional depreciation 10)	<u>1,290</u>
		<u>1,790</u>
Ordinary shares (\$1)		800
Retained earnings	w5	526
NCI	w4	<u>64</u>
Equity		1,390
Liabilities	(300 + 100)	<u>400</u>
		<u>1,790</u>

⚙️ Technical corner

Determining the recoverable amount

There are two ways of recovering cash from an asset or collection of net assets (cash-generating unit).

One way of recovering cash from an asset is to sell it. The measurement of the recoverable amount can therefore be the fair value less costs to sell i.e. sale proceeds less any costs necessary to achieve the sale.

The other way of recovering cash from an asset is to keep and use the asset so that it generates a cash flow in the future. This second way is termed the "value in use". When measuring the future cash flows it will be necessary to discount the figures to a present value.

The recoverable amount is the higher of the net sale proceeds and the value in use. It is the higher because that is what the standard¹ says – but actually also to reflect the common sense that losses will always try to be minimised.

For example if an asset could be sold for \$230m net of selling costs, but has a value in use of \$150m, the recoverable amount will be \$230m (the higher) as the sensible decision will be to sell the asset. But if the asset could be sold for \$125m net of selling costs and has a value in use of \$200m, then the asset will be kept, making the recoverable amount \$200m. The recoverable amount will always be the higher of the two figures on offer.

The measurement of the recoverable amount is of course subjective since the sale proceeds are an estimate as indeed are the future cash flows in the value in use calculation.

¹ IAS36 Impairment of Assets

Question Singapore

The following information relates to Singapore a 60% subsidiary.

Net assets at acquisition	Net assets at year-end	Fair value of the NCI at acquisition	Parent's investment	Recoverable amount at year-end
\$m	\$m	\$m	\$m	\$m
500	600	250	800	1,000

Required

- (i) Assuming that NCI at acquisition is measured at fair value and so that goodwill is full, determine the goodwill that will be recognised in the group statement of financial position at the reporting date i.e. after the impairment review.
- (ii) Assuming that the NCI at acquisition is measured as a proportion of net assets so that goodwill is attributable to the parent only, determine the goodwill that will be recognised in the group statement of financial position at the reporting date i.e. after the impairment review.

where the goodwill is attributable to the parent only, when doing the impairment review the goodwill will have to be notionally grossed up

What's new?

I don't think you can make a profit from selling to yourself!

So on that basis, as the group is in substance a single entity there can be no profits from the sale and purchase of goods between the parent and the subsidiary!

Where there is trading between the parent and the subsidiary, the sale of goods may be sold at a transfer price rather than at cost. For example the parent may have sold goods that it purchased for \$80 to the subsidiary for \$100 and the goods remain in inventory at the year-end. The parent company therefore has recognised a profit of \$20 on the sale and the subsidiary has inventory in its accounts at a cost of \$100.

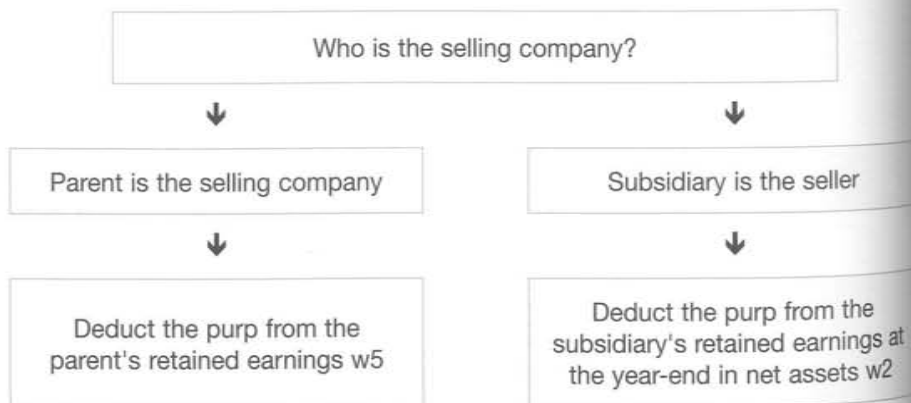
However if we consider the group context, the parent and subsidiary as if they were a single economic entity, then there has been no profit to the group from the inter-company sale and the cost to the group of the inventory remains at \$80. We cannot make a profit by simply selling goods to ourselves.

Therefore a consolidation adjustment is required to both eliminate the unrealised profit of \$20 and to reduce the asset of inventory by \$20 to bring it back to the original cost when it was first purchased by a group company.

This consolidation adjustment is known as making a "provision for unrealised profit" (purp).

Where the parent company is the seller then the parent's profits need to be reduced. This is achieved by charging the purp against the parent's profits in group retained earnings w5.

Where the subsidiary is the seller then it is appropriate to reduce the subsidiary's post-acquisition profits with the knock on effect of splitting the charge between the parent and the NCI. This is achieved by charging the purp against the subsidiary's year-end retained earnings in net assets w2.



The information provided to calculate the purp may be expressed in terms of being a gross profit margin or a gross profit mark-up.

Calculation of the purp with a margin

If the question gives a gross profit margin, this is a % based on the sales price. As the unsold inventory is at the internal selling price this % can be multiplied by the unsold inventory to determine the purp.

To illustrate, the example could be expressed in a question as "The parent has sold inventory for \$100 to the subsidiary at a margin of 20% and at the year-end all remain in inventory at the year-end."

The unsold inventory at the year-end		The gross profit margin		The purp
\$100	x	20%	=	\$20

The purp will be applied to reducing the inventory in current assets and because the parent is the seller the purp is also applied to reducing the parent's retained earnings in w5.

Calculation of the purp with a mark-up

If the question gives a gross profit mark-up, this is a % based on the cost of sales. As the unsold inventory is at the internal selling price the mark-up % needs to be converted to a new fraction before it can be multiplied by the unsold inventory to determine the purp. The mark-up % is used to create a fraction where the mark-up % is the numerator (top half of the fraction) and the denominator (bottom half of the fraction) is 100 plus the mark-up %. In other words a mark-up of 25% becomes 25/125.

To illustrate, the example could be expressed in a question as "During the year the subsidiary has sold inventory for \$100 to the parent at a mark-up of 25%. At the year-end it all remains in inventory."

The unsold inventory at the year-end		The gross profit mark-up		The purp
\$100	x	25/125	=	\$20

The purp will be applied to reducing the inventory in current assets and because the subsidiary is the seller the purp is also applied to reducing the subsidiary's retained earnings at the year-end in net assets w2.

Statement of financial position

Non-current assets			
Intangibles	Parent plus subsidiary.	Plus the goodwill arising on the consolidation of the subsidiary less any impairment losses. (w3)	Plus intangible assets of the subsidiary recognised as a fair value adjustment less any amortisation.
Tangibles	Parent plus subsidiary.	Plus the fair value adjustments at acquisition on subsidiary assets that remain held less any cumulative extra depreciation.	Less the provision for unrealised profit net on inter-company transfers of non-current assets between group companies.
Investments	Parent plus subsidiary.	Less inter-company long term loans.	Less the investment that the parent has made on acquiring the subsidiary.
Current assets			
Inventory	Parent plus subsidiary.	Plus goods in transit.	Less provision for unrealised profit.
Receivables	Parent plus subsidiary.	Less inter-company current accounts.	
Cash at bank	Parent plus subsidiary.	Plus cash in transit.	

Equity			
Ordinary share capital	Parent only.	Plus any previously unrecorded shares issued on the acquisition.	
Share premium	Parent only.	Plus any previously unrecorded premium on shares issued on the acquisition less issue costs.	
Other reserves	Parent plus the parent's share of the subsidiary's post-acquisition increases.	Plus any previously unrecorded deferred or contingent equity consideration on the acquisition.	
Retained earnings	w5		
Non-controlling interest	w4		
Liabilities			
Non-current liabilities	Parent plus subsidiary.	Less inter-company long term loans.	Plus any previously unrecorded deferred or contingent consideration on the acquisition, including the finance costs to date.
Current liabilities	Parent plus subsidiary.	Less inter-company current accounts.	

Example

Cairo is an 80% subsidiary of Egypt that was acquired one year ago.

The following information relates to Cairo at the date of acquisition.

Ordinary share capital	Reserves	Fair value of the net assets	Fair value of the NCI	Cost of the investment
m	\$m	\$m	\$m	\$m
300	500	1,000	250	2,000

Statements of profit or loss

	Egypt \$m	Cairo \$m
Revenue	9,000	4,000
Cost of sales	(5,000)	(2,000)
Gross profit	4,000	2,000
Operating costs	(2,000)	(1,698)
Finance costs	(500)	(2)
Profit before tax	1,500	300
Tax	(700)	(100)
Profit for the year	800	200

Additional Information

- During the year Egypt has sold goods to Cairo for \$100 million. These goods were sold at a margin of 40% and one half remains in inventory at the year-end.
- At the date of acquisition the fair values of Cairo's net assets were equal to their book value with the exception of an item of plant that had a remaining useful life of five years.
- Goodwill is to be calculated using the fair value of the non-controlling interest at the date of acquisition. An impairment review at the year-end reveals that one tenth of the goodwill that arose on acquisition was impaired during the year.

Required

Prepare the consolidated statement of profit or loss for Egypt.

Well the first thing to do is to make sure that we are happy with the group structure.

W1 Group structure



Now whilst when doing the consolidation of group statement of financial positions there is a consistent structure to w2 to w5 the same is not true when preparing the group statement of profit or loss.

W2 Inter-company trading (including purp)

Now there are some consolidation adjustments in respect of the inter-company sale and purp that it is worthwhile clearing up at this stage. The question informs us that there has been an inter-company sale (and therefore automatically an inter-company purchase) and that a purp will arise in respect of the unsold inventory.

To eliminate the effects of the inter-company sale both revenue and cost of sales will be reduced. The elimination of the inter-company transaction has no impact on the NCI.

Reduce revenue	\$100m	
Reduce cost of sales		\$100m

There is a provision for unrealised profit in this question that arises from the unsold goods following the inter-company sale at a transfer price.

Unsold inventory at the year-end ($\frac{1}{2} \times \$100m$)	x	Gross profit margin 40%	=	\$20m
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This \$20m is an extra expense.

Increase cost of sales	\$20m	
Reduce inventory (in current assets)		\$20m

As the parent is the seller in the inter-company transaction there will be no impact on the NCI as the adjustment to profit relates to the parent.

For the record all the components of other comprehensive income³ are

- gains or losses on the revaluation of non-current assets recognised in accordance with IAS16 *Property, Plant and Equipment* (as illustrated above)
- the group exchange gains and losses arising from translating the financial statements of a foreign operation in accordance with IAS21 *The Effects of Changes in Foreign Exchange Rates* (see Chapter 19 *Overseas subsidiaries*)
- the re-measurement gains and losses on defined benefit pension plans recognised in accordance with IAS19 *Employee Benefits*
- gains and losses on remeasuring financial assets classified as Fair Value Through Other Comprehensive Income in accordance with IFRS9 *Financial Instruments* and,
- the effective portion of gains and losses on hedging instruments in a cash flow hedge in accordance with IAS39 *Financial Instruments: Recognition and Measurement*.

The objective of this book is to concentrate on the preparation of group accounts and not to explain the finer points of accounting for financial instruments or defined benefit pensions plans!

For further details on why these gains and losses are treated in this way and information on all other international financial reporting standards please see *A student's guide to International Financial Reporting Standards* by Clare Finch (Published by Kaplan Publishing.)

³ Strictly the tax on these items should also be recognised in other comprehensive income.

Example

Tokyo is an 80% subsidiary of Japan that was acquired two years ago.

Statements of profit or loss and other comprehensive income

	Japan	Tokyo
	\$m	\$m
Statement of profit or loss		
Revenue	5,000	1,000
Cost of sales	(2,000)	(200)
Gross profit	3,000	800
Operating costs	(1,500)	(450)
Operating profits	1,500	350
Investment income	1,500	350
Finance costs	(300)	(50)
Profit before tax	2,700	650
Tax	(400)	(100)
Profit for the year	2,300	550
Other comprehensive income		
Revaluation gains	100	10
Total comprehensive income for the year	2,400	560

- 1 During the year Tokyo has sold goods to Japan for \$750m. These goods were sold at a mark-up of 50%. At the year-end one fifth of these goods remain unsold by Japan.
- 2 An impairment review was conducted at the year-end. This reveals that no goodwill was impaired during the year.
- 3 On the acquisition of Tokyo a fair value adjustment of \$50m was made to the plant of Tokyo. The plant had a remaining useful life of five years and is depreciated on a straight-line basis down to a nil residual value. The fair value adjustment had not been incorporated into the accounting records of the subsidiary.
- 4 At acquisition Japan advanced Tokyo a loan of \$500m and charged its subsidiary an effective rate of interest of 10%. Both companies have correctly accounted for the transaction.

Required

Prepare the consolidated statement of profit or loss and other comprehensive income for Japan.

⚙️ Technical corner

Consolidating all subsidiaries

IAS27 *Separate Financial Statements* (as amended) is quite explicit in requiring that the consolidated accounts should include all of the parent's subsidiaries.

For the avoidance of doubt there is specifically no exemption from consolidating a subsidiary on the grounds that

- it's an overseas subsidiary
- the subsidiary conducts a business of a different nature from the parent's
- or even that the subsidiary operates under severe long-term restrictions impairing the subsidiary's ability to transfer funds to the parent. Control must be lost for exclusion to occur.

Held for sale exemption

There is however one situation where a subsidiary is not consolidated in the normal way. That is where control over the subsidiary is intended to be temporary because the subsidiary was acquired and is held exclusively with a view to its subsequent disposal in the near future. For such a subsidiary, if it is highly probable that the sale will be completed within 12 months then the parent should account for its investment in the subsidiary as an asset that is held for sale in accordance with IFRS5 *Non-current Assets Held for Sale and Discontinued Operations*. In other words the subsidiary is treated as a current asset investment and held at the lower of cost and the fair value less costs to sell.

Creative accounting and off balance sheet finance

All this regulation is designed to prevent creative accounting i.e. the manipulation of the group accounts by the deliberate non-consolidation of an entity that is nevertheless controlled by the group. The hope of the creative accountant is that, by the non-consolidation of a particular subsidiary, in some way the users of the group accounts will have a more favourable impression of the group's performance and position.

For example if a subsidiary has been making losses then creative accountants may try to find excuses for the non-aggregation of the subsidiary's losses.

Another situation where groups try to avoid consolidating subsidiaries is where the subsidiary is highly geared i.e. has a relatively large amount of liabilities compared to its equity. If a group has a high debt to equity ratio it is perceived to be highly geared and then investors and other users may

regard the group as being a high risk. In these circumstances the group can find it harder to refinance debt and borrow new funds or be charged a higher rate of interest to compensate for the lender's increase in risk.

Being perceived as highly geared can also potentially have a negative impact on the share price as one method of a highly geared group raising funds is from the shareholders in the form of a rights issue of shares. The shares issued in a rights issue are issued at a discount on the current market price with the result that normally after the rights issue the share price of the company will fall due to the increased shares in circulation. Now it can be argued that if there is a perception that the company is highly geared and so may make a rights issue the share price may fall as shareholders sell in anticipation of the fall in the share price. Fear of a fall in the share price can therefore become a self-fulfilling prophecy.

Income from associate / joint venture	
Parent's % of the associate's / joint venture profit for the year	X
Less any impairment loss on the parent's investment in the current year	(X)
Less the parent's % of the purp (where the associate / joint venture is the seller)	(X)
	X

this is the figure that goes into the group statement of profit or loss just before profit before tax

The income and expenses of the associate or joint venture are not cross cast in the group accounts, as the group's interest in their profits are represented in the one line, regardless of whether any dividend has been paid.

If the associate or joint venture has been acquired during the accounting period then its profit for the year will be time apportioned to reflect only the post-acquisition element.

If the associate or joint venture has any other comprehensive income recognised in the post- acquisition period then the appropriate % will be aggregated in the group other comprehensive income.

Other issues when applying equity accounting

- Transactions between group companies and associates or joint ventures

As we have seen the financial statements of the subsidiary are consolidated in the group accounts using acquisition accounting. Accordingly, if during the accounting period the parent has sold goods to its subsidiary for \$100 there will be a consolidation adjustment in the group statement of profit or loss to eliminate both sides of the inter-company transaction as it is between two group companies. In other words it is necessary to cancel the sales (of the parent) against the cost of sales (of the subsidiary) by \$100 in the group statement of profit or loss.

Now, as associates and joint ventures are not full members of the group, they are only equity accounted (single line approach) and so their revenue and cost of sales are not aggregated in the group statement of profit or loss.

Accordingly if a transaction involves an associate or joint venture, e.g. the parent has sold goods to its associate or joint venture for \$100, the transaction cannot be eliminated on consolidation. The purchase by the associate or joint venture is not a transaction between two group companies.

To recap any sales and purchases between group companies and associates or joint ventures remain.

- Balances between group companies and associates or joint ventures

The same principle applies to balances (receivables and payables) between group companies and associates or joint ventures in the group statement of financial position as it does to transactions, in that as only one balance is aggregated as part of the group statement of financial position the balances cannot be eliminated against each other.

Accordingly if at the reporting date the parent has a receivable due from its associate or joint venture, this balance cannot be eliminated on consolidation. The payable of the associate or joint ventures is not a balance between two group companies.

To recap any current account balances between group companies and associates or joint ventures remain.

- Dividend income received by the parent from the associate or joint venture

This will not be reported in the group statement of profit or loss because equity accounting ensures that the appropriate % of profit for the year is reported instead.

- Purps on transactions between group companies and associates and joint ventures

There will be consolidation adjustments for the appropriate % of any purps arising from these transactions - but let us consider the question first before considering this thorny issue.

Well let's have a look at a question.

Question Sierra

The following are the financial statements of Sierra, Leone and Freetown.

Statements of financial position

	Sierra \$	Leone \$	Freetown \$
Non-current assets			
Tangible	100,000	80,000	60,000
Investments	130,000		
Current assets			
Inventory	22,000	30,000	15,000
Receivables	58,000	10,000	2,000
Cash at bank	40,000	20,000	3,000
	<u>350,000</u>	<u>140,000</u>	<u>80,000</u>
Share capital (\$1)	100,000	75,000	35,000
Retained earnings	190,000	50,000	40,000
Revaluation reserve	10,000	Nil	Nil
Equity	300,000	125,000	75,000
Liabilities	50,000	15,000	5,000
	<u>350,000</u>	<u>140,000</u>	<u>80,000</u>

Statements of profit or loss and other comprehensive income

	Sierra \$	Leone \$	Freetown \$
Statement of profit or loss			
Revenue	500,000	200,000	150,000
Cost of sales	(300,000)	(140,000)	(110,000)
Gross profit	200,000	60,000	40,000
Operating costs	(65,000)	(10,000)	(10,000)
Operating profit	135,000	50,000	30,000
Interest receivable	25,000	Nil	4,000
Finance cost	(Nil)	(10,000)	(Nil)
Profit before tax	160,000	40,000	34,000
Tax	(60,000)	(20,000)	(19,000)
Profit for the financial year	100,000	20,000	15,000
Other comprehensive income			
Revaluation gains	6,000	Nil	Nil
Total comprehensive income for the year	<u>106,000</u>	<u>20,000</u>	<u>15,000</u>

Additional information

- One year ago Sierra acquired 60% of the equity interests of Leone. The purchase consideration was \$100,000. The fair value of the identifiable net assets at that date was \$150,000 and the retained earnings were \$30,000. There has been no new issue of capital by Leone since the date of acquisition and the excess of the fair value of the net assets is due to an increase in the value of plant with a five year life. It is group policy to value the NCI at acquisition at fair value and the fair value of the NCI of Leone at acquisition was \$63,000. Goodwill has been subject to an impairment review and no impairment loss arises.

Having been given the fair value of the net assets at acquisition, the fair value adjustment will be the balancing figure in net assets at w2

- One year ago Sierra acquired 30% of the equity interests of Freetown and achieved significant influence when the retained earnings were \$25,000. The purchase consideration was \$30,000.

Freetown is the associate, so equity account, single line in the group income and in the group statement of financial position.

⚙️ Technical corner

Step acquisition, when the prior holding is an associate and becomes a subsidiary.

Where the step acquisition results in an associate being reclassified as a subsidiary then when preparing the group statement of profit or loss and other comprehensive income for the accounting period the investment will be accounted for part of the time as an associate and part of the time as a subsidiary. However at the reporting date when preparing the group statement of financial position the investment is a subsidiary.

Accordingly in the group accounts;

- the results of the associate will consolidated in the group statement of profit or loss and other comprehensive income on a time apportionment basis using equity accounting (single line approach) from the start of the accounting period to the date of acquisition, and
- the exceptional gain arising to the group on the revaluation of the first investment will be the difference between the fair value of the investment and the carrying value of the associate, and
- the results of the subsidiary will consolidated in the group statement of profit or loss and other comprehensive income on a time apportionment basis, line by line, from the date of acquisition to the reporting date, and
- at the reporting date the investment is a subsidiary and so the assets and liabilities are cross cast with goodwill, NCI and post-acquisition profits being accounted for as a normal subsidiary.

Consider

On 1 January, the first day of the accounting period, the parent makes a 30% investment for \$30,000. This level of investment gives significant influence over the financial and operating policies of the investment. Accordingly in the group accounts the investment is accounted for as an associate using equity accounting. On 1 July the parent acquires control of the investment by acquiring a further 45% of the shares for \$86,000 at a time when the fair value of the original 30% investment is \$40,000 and the NCI is \$25,000. The group policy is to value the NCI at fair value at acquisition. At the date of acquisition the fair value of the net assets is \$50,000. During the year the investment reports profits of \$12,000.

Required

Calculate the goodwill arising on acquisition, the NCI at the reporting date, and so far as possible the extracts from the group retained earnings.

When calculating the goodwill at the date of acquisition on 1 July the initial investment made on 1 January must be restated to the fair value at acquisition i.e. to \$40,000. The gain to the group on restating the initial investment compares this fair value with the carrying value of the associate in the group accounts which is the initial investment of \$30,000 plus the share of the post-acquisition profits. ($30\% \times 6/12 \times \$12,000 = \$1,800$). The gain of \$8,200 is the difference between the fair value of \$40,000 and the carrying value of \$31,800 and is reported in retained earnings.

Goodwill

	\$
Parent's first investment (30%)	40,000
Parent's second investment (45%)	<u>86,000</u>
Fair value of parent's investment	126,000
FV of the NCI	25,000
Less FV of the net assets	<u>(50,000)</u>
Goodwill at acquisition	<u>101,000</u>

In the retained earnings we see the % of the associate's profits for the first six months, the gain on the restatement of the initial investment to fair value and the % of the subsidiary's post-acquisition profits.

Extract from group retained earnings

		\$
Parent's % of the associate's post-acquisition profits	(30% x 6/12 x 12,000)	1,800
Gain on the restatement of the first investment to fair value	(40,000 - 31,800)	8,200
Parent's share of the subsidiary's post-acquisition profits	(75% x 6/12 x 12,000)	4,500

An alternative approach would be to pretend in w5 that the associate status never existed and to calculate the gain on the restatement of the first investment at the individual company stage. In which case the \$1,800 the associate's post-acquisition profits would be omitted and instead the gain on the restatement of the first investment be determined as \$10,000 rather than \$8,200. The gain of \$10,000 being the difference between the fair value of \$40,000 and the carrying value to the parent of \$30,000.

The distinction is very important to make, as the accounting for the sale of shares will vary depending on whether control has been lost so that there has been a disposal of a subsidiary or whether it is simply a transfer of some of the net assets and goodwill to the NCI.

Discontinued operations

In the group statement of profit or loss, where the sale of the subsidiary has occurred during the year, basic consolidation principles will only allow the income and expenses of the subsidiary to be consolidated up to the date of disposal.

But it will also be necessary to consider how the results of the subsidiary, up to the date of the disposal are presented in the group statement of profit or loss, and that will depend on whether the subsidiary's activities are regarded as discontinued from a group perspective or not.

Discontinued operations

Single line presentation

If subsidiary that has been disposed of qualifies as a discontinued operation in accordance with "IFRS5 *Non-current Assets Held for Sale and Discontinued Operations*", then the pre-disposal results of the subsidiary are aggregated and presented in a single line on the face of the statement of profit or loss immediately after profit for the year from continuing operations.

Continuing operations

Line by line consolidation

If the subsidiary that has been disposed of represents continuing operations of the group then the pre-disposal results of the subsidiary are consolidated line by line up to the date of disposal, and the gain on disposal is reported as exceptional.

To be classified as a discontinued operation basically means that the group must have stopped, or be about to stop, trading in a particular business activity (the sale of the subsidiary represents the groups withdrawal from say the hotel industry) or from a particular region (the sale of the subsidiary represents the group ceasing to have any operations in say Europe). Of course IFRS5 *Accounting for Non-current Assets Held for Sale and Discontinued Operations* has a precise definition and set of conditions as follows.

A discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale, and:

- represents a separate major line of business or geographical area of operations
- is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
- is a subsidiary acquired exclusively with a view to resale and the disposal involves loss of control.

For the subsidiary to qualify as being held for sale at the year-end all the following conditions must be met at the year-end:

- management is committed to a plan to sell
- the subsidiary is being actively marketed
- the subsidiary is available for immediate sale
- the subsidiary is being offered for sale at a reasonable price
- the sale is highly probable, within 12 months of classification as held for sale
- actions required to complete the plan indicate that it is unlikely that the plan will be significantly changed or withdrawn.

The rationale behind stripping out the results of a discontinued operation and reporting them in a separate line in the statement of profit or loss stems from wanting to present information in such a way that will be useful to the users of the financial statements. It is a well worn criticism that the financial accounts lack a certain relevance because they are backward looking i.e. are reporting on what has happened, whereas users are living in the present and have information needs about what is going to happen in the future. By separating out the results of a discontinued operation the users are presented with the results from continuing operations that increases the predictive quality of the statement of profit or loss and thus aids the users in their interpretation of the performance of the group.

Sale of shares to the NCI i.e. increase in NCI

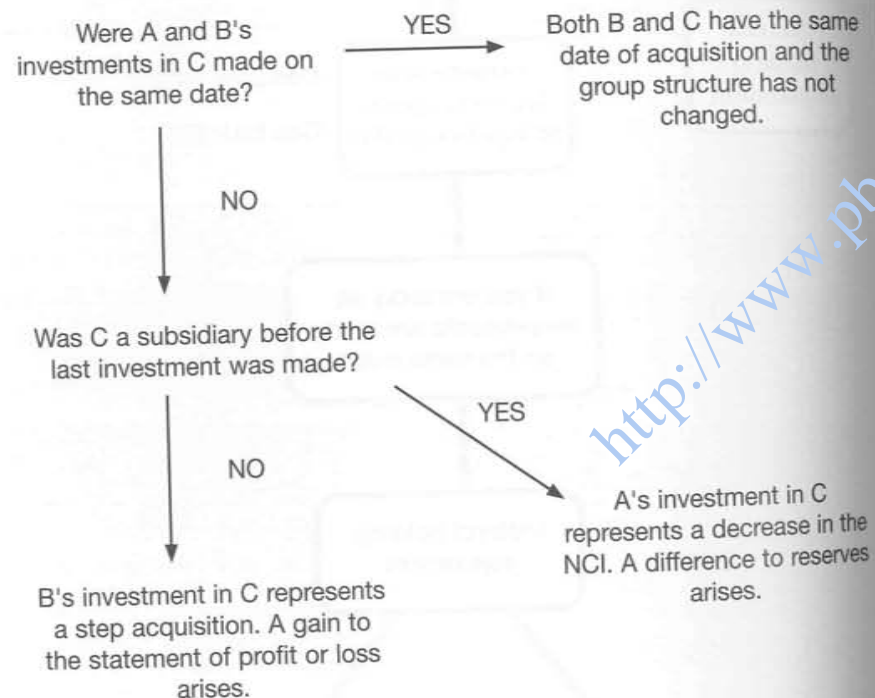
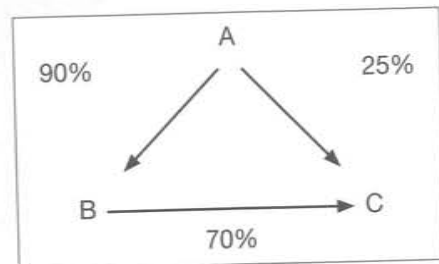
This is similar in principle to the decrease in the NCI in Chapter 14 *Changes in the group structure due to buying more shares*.

From the perspective of the group accounts where there is a sale of shares but control is maintained, (as the parent's holding does not fall below 50%), this is not a disposal of a subsidiary rather it is an increase in the NCI. The group has not sold a subsidiary rather the parent has transferred a stake in the net assets and goodwill of the subsidiary to the NCI.

As such it is a transaction between the parent and the NCI i.e. within equity. Accordingly no gain or loss arises in the group accounts. However a difference does arise where the proceeds from the sale of the investment to the NCI - a cash inflow - is different from the increase in the NCI's interest in the net assets and goodwill. This difference will be taken to an equity reserve (e.g. other components of equity).

» Double entry

There are no new double entries introduced in complex group structures, instead here is a decision tree to recap on the consequences of the order in which the group is put together.



⚙️ Technical Corner

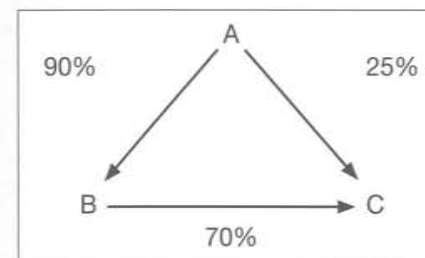
Mixed groups - Step acquisition and reduction in the NCI

When we considered a vertical group, it was relevant to be aware of the order the investments were made so that the date that the ultimate parent acquired control of the sub-subsidiary was correctly determined.

It is also the case that with D shaped or mixed group structures we need to be aware of the sequence that the investments were made. In our first example all investments were made at the same time, which neatly side-stepped potential complications.

We are now going to review three group structures and in each group structure evaluate the consequences of the group being put together in a different sequence.

Group structure ABC



Now what is common to all of the following analysis of this ABC group is that

- A is the parent company
- B is a simple subsidiary with an NCI of 10%
- C is also a subsidiary of the A, with an effective interest of 88% and an NCI of 12%.

A's direct interest in C		25%
A's indirect interest (via B)	(90% x 70%)	63%
A's interest in C's profits		88%
NCI in C	(Balancing figure)	12%
		<u>100%</u>

By definition group accounts are only prepared when there is a parent and a subsidiary, so in considering group accounts the starting point for the A group will always be A having acquired B.