The problem of differential reporting

There are problems associated with having a set of reporting standards for small and medium entities:

- It can be difficult to define a small or medium entity.
- If a company ceases to qualify as a small or medium entity then there will be a cost and time burden in order to comply with full IFRS and IAS Standards.
- There may be comparability problems if one company applies full IFRS and IAS Standards whilst another applies the SMEs Standard.

What is the effect of introducing the SMEs Standard?

The SMEs Standard will be updated approximately every three years. In contrast, companies that use full IFRS and IAS Standards have to incur the time cost of ensuring compliance with regular updates.

Accounting under full IFRS and IAS Standards necessitates compliance with approximately 3,000 disclosure points. In contrast, the SMEs Standard comprises approximately 300 disclosure points all contained within the one document. This significantly reduces the time spent and costs incurred in producing financial statements.

Key omissions from the SMEs Standard

The subject matter of several reporting standards has been omitted from the SMEs Standard, as follows:

- Earnings per share (IAS 33)
- Interim reporting (IAS 34)
- Segmental reporting (IFRS 8)
- Assets held for sale (IFRS 5).

Omission of subject matter from the SMEs Standard is usually because the cost of preparing and reporting information exceeds the expected benefits which users would expect to derive from that information.

Accounting choices disallowed under the SMEs Standard

There are a number of accounting policy choices allowed under full IFRS and IAS Standards that are not available to companies that apply the SMEs Standard. Under the SMEs Standard:

- Goodwill is always recognised as the difference between the cost of the business combination and the fair value of the net assets acquired. In other words, the fair value method for measuring the non-controlling interest is not available.

- Intangible assets must be accounted for at cost less accumulated amortisation and impairment. The revaluation model is not permitted for intangible assets.
- After initial recognition, investment property is remeasured to fair value at the year end with gains or losses recorded in profit or loss. The cost model can only be used if fair value cannot be measured reliably or without undue cost or effort.

Key simplifications in the SMEs Standard

The subject matter of other reporting standards has been simplified for inclusion within the SMEs Standard. Key simplifications to be aware of are as follows:

- Borrowing costs are always expensed to profit or loss.
- Whilst associates and jointly controlled entities can be accounted for using the equity method in the consolidated financial statements, they can also be held at cost (if there is no published price quotation) or fair value. Therefore, simpler alternatives to the equity method are available.
- Depreciation and amortisation estimates are not reviewed annually. Changes to these estimates are only required if there is an indication that the pattern of an asset's use has changed.
- Expenditure on research and development is always expensed to profit or loss.
- If an entity is unable to make a reliable estimate of the useful life of an intangible asset, then the useful life is assumed to be ten years.
- Goodwill is amortised over its useful life. If the useful life cannot be reliably established then management should use a best estimate that does not exceed ten years.
- On the disposal of an overseas subsidiary, cumulative exchange differences that have been recognised in other comprehensive income are not recycled to profit or loss.
- There are numerous simplifications with regards to financial instruments. These include:
  - Measuring most debt instruments at amortised cost.
  - Recognising most investments in shares at fair value with changes in fair value recognised in profit or loss. If fair value cannot be measured reliably then the shares are held at cost less impairment.

Advantages and disadvantages of the SMEs Standard

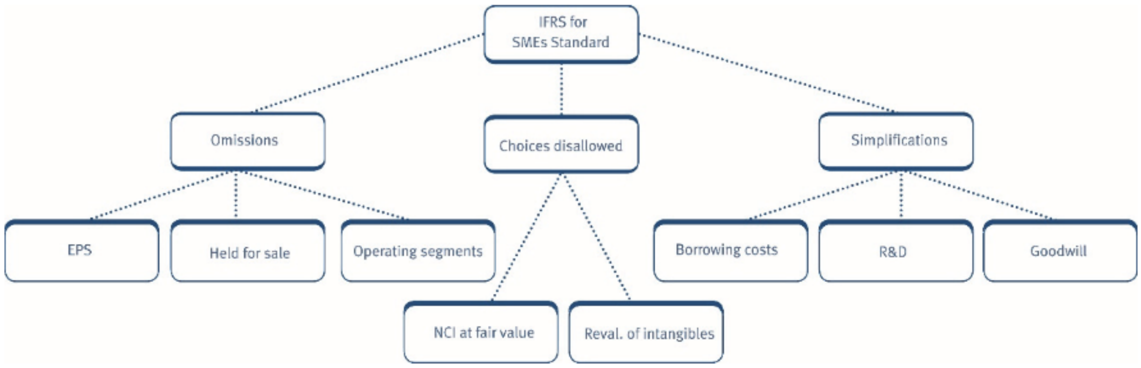
Advantages

- There will be time and cost savings due to simplifications and omissions, particularly with regards to disclosure.
- The SMEs Standard is worded in an accessible way.
- All standards are located within one document so it is therefore easier and quicker to find the information required.

Disadvantages

- There are issues of comparability when comparing one company that uses full IFRS and IAS Standards and another which uses the SMEs Standard.
- The SMEs Standard is arguably still too complex for many small companies. In particular, the requirements with regards to leases and deferred tax could be simplified.

2 Chapter summary



Chapter

18

Group accounting – basic groups

Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss and apply the control principle and principles to determine whether a business combination has occurred
- Discuss and apply the acquisition method of accounting for a business combination
- Apply the recognition and measurement criteria for identifiable acquired assets and liabilities
- Discuss and apply the accounting for goodwill and non-controlling interest
- Determine and apply procedures used in preparing consolidated financial statements
- Identify and outline the circumstances in which a group is required to prepare consolidated financial statements; the circumstances when a group may claim and exemption from the preparation of consolidated financial statements; and why directors may not wish to consolidate a subsidiary and where this is permitted
- Discuss and apply accounting for group companies in the parent's separate financial statements
- Identify and account for associate entities
- Discuss and apply the application of the joint control principle and the classification of joint arrangements
- Prepare the financial statements of parties to the joint arrangement.

PER

One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.

Revision of group SFP

Revision of group P/L and OCI

Revision of associates

Control

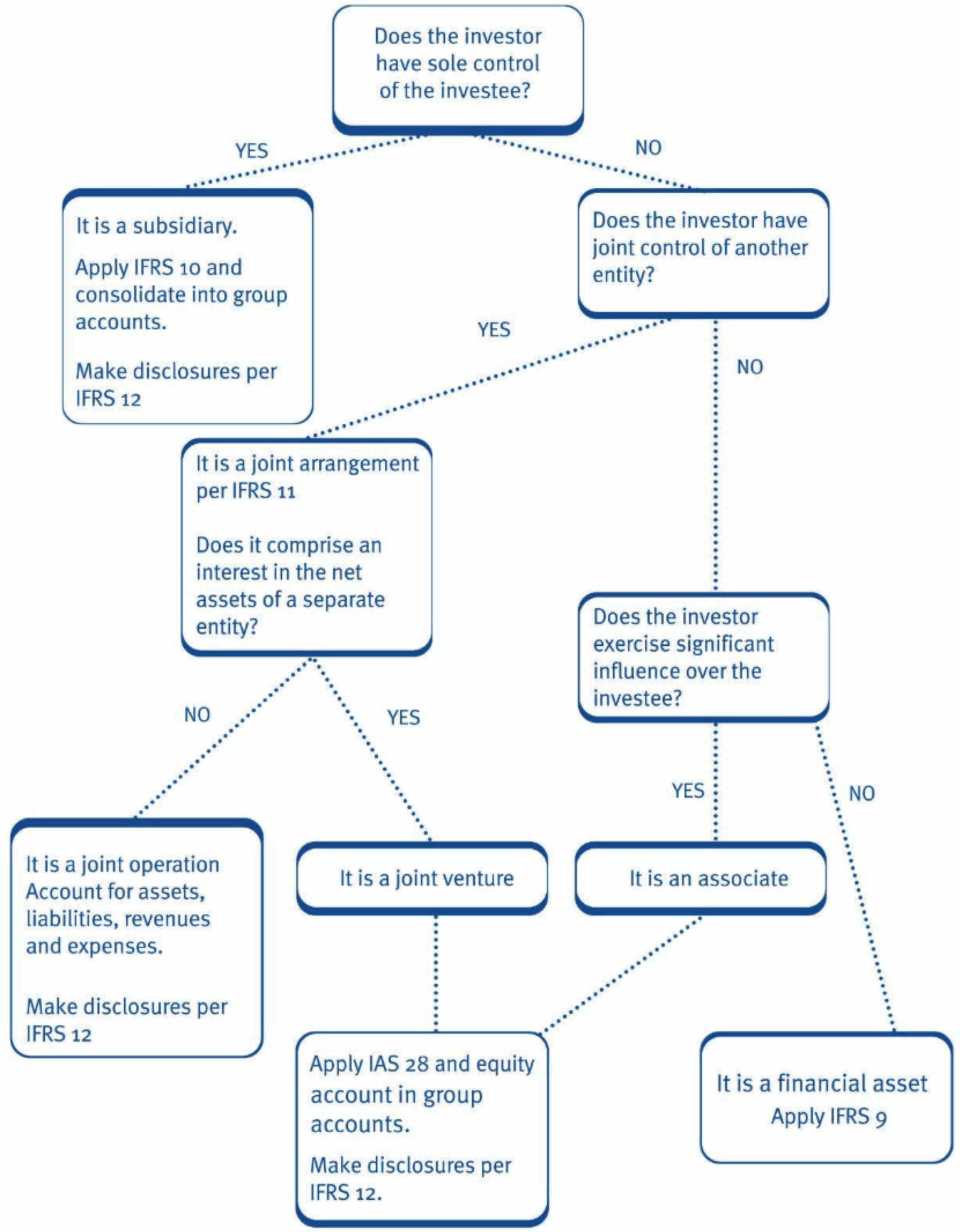
The acquisition method

Impairment of goodwill

Joint arrangements

1 Overview of interests in other entities

The following diagram presents an overview of the varying types of interests in other entities, together with identification of applicable reporting standards.



The standards referred to in the diagram above cover a range of group accounting issues:

- IFRS 10 *Consolidated Financial Statements*
- IFRS 11 *Joint Arrangements*
- IFRS 12 *Disclosure of Interests in Other Entities*
- IAS 28 *Investments in Associates and Joint Ventures*

These standards, as well as IFRS 3 *Business Combinations*, are covered in this chapter. IFRS 9 *Financial Instruments* was dealt with earlier in the publication.

Progression

You have covered group accounting extensively in your prior studies. A more detailed knowledge is required for SBR. More emphasis will be placed on discussion of group accounting issues than on number-crunching.

2 Definitions

IFRS 10 *Consolidated Financial Statements* says that an entity that is a parent is required to prepare consolidated financial statements. The standard provides the following definitions:

A **parent** is an entity that controls another entity.

A subsidiary is an entity that is controlled.

An investor controls an investee when:

- the investor has power over the investee, and
- the investor is exposed, or has rights, to variable returns from its involvement with the investee, and
- the investor has the ability to affect those returns through its power over the investee.

Consolidated financial statements present the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries as if they were a single economic entity.

The *Conceptual Framework*

In the *Conceptual Framework* the Board notes that consolidated financial statements are important for investors in the parent company. This is because their economic returns are dependent on profits made by the subsidiaries that are then distributed to the parent.

The separate (non-consolidated) financial statements of the parent company provide useful information to its investors (such as the level of distributable reserves) but are not a substitute for information provided in consolidated financial statements.

Exam focus

Question 1 in the SBR exam will always test consolidated financial statements. However, the exam will not ask for the production of full consolidated financial statements. Instead, candidates will be required to produce extracts from these statements and to explain the accounting numbers that they have produced.

Some questions in this text require the production of full consolidated financial statements. This is to enable SBR candidates to revise, practice and develop a deeper understanding of consolidation techniques. Without this, you will find it difficult to tackle discursive exam-style questions.

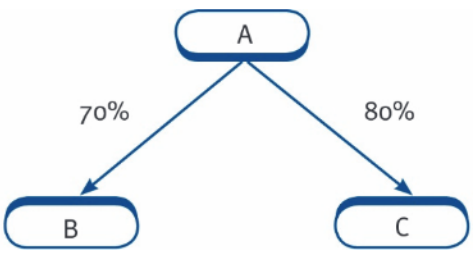
3 Revision from prior studies

Consolidated statement of financial position

When required to produce a consolidated statement of financial position from the individual financial statements of group companies then the easiest method is to use five standard workings. These will assist you in understanding the structure of the group and in calculating goodwill, the non-controlling interest and group reserves.

Note that the SBR exam will **not** require you to prepare full consolidated financial statements. However, the following workings are still important when preparing calculations and extracts.

(W1) **Group structure**



This working is useful to decide the status of any investments. If one entity is controlled by another entity then it is a subsidiary and must be consolidated.

Control is normally presumed to exist if one company owns more than half of the voting capital of another entity.

Once the group structure has been determined, set up a proforma statement of financial position.

Group statement of financial position as at the reporting date

	$000
Goodwill (W3)	X
Assets (P + S)	X
Total assets	X
Equity capital (Parent's only)	X
Retained earnings (W5)	X
Other components of equity (W5)	X
Non-controlling interest (W4)	X
Total equity	X
Liabilities (P + S)	X
Total equity and liabilities	X

You will need to do the following:

– Eliminate the carrying amount of the parent's investments in its subsidiaries (these will be replaced by goodwill)

– Add together the assets and liabilities of the parent and its subsidiaries in full

– Include only the parent's balances within share capital and share premium

– Set up and complete standard workings 2 – 5 to calculate goodwill, the non-controlling interest and group reserves.

(W2) **Net assets of each subsidiary**

This working sets out the fair value of the subsidiary's identifiable net assets at acquisition date and at the reporting date.

	At acquisition	**At reporting date**
	$000	$000
Equity capital	X	X
Share premium	X	X
Other components of equity	X	X
Retained earnings	X	X
Goodwill in the accounts of the sub.	(X)	(X)
Fair value adjustments (FVA)	X	X
Post acq'n dep'n/amort. on FVA		(X)
PURP if the sub is the seller		(X)
	X	X
	(to W3)	

Remember to update the face of the statement of financial position for adjustments made to the net assets at the reporting date (such as fair value uplifts and provisions for unrealised profits (PURPS)).

The fair value of the subsidiary's net assets at the acquisition date are used in the calculation of goodwill.

The movement in the subsidiary's net assets since acquisition is used to calculate the non-controlling interest and group reserves.

(W3) **Goodwill**

	$000
Fair value of purchase consideration	X
NCI at acquisition**	X
	X
Less: fair value of identifiable net assets at acquisition (W2)	(X)
Goodwill at acquisition	X
Less: impairment to date	(X)
Goodwill to consolidated SFP	X

**if full goodwill method adopted, NCI value = FV of NCI at date of acquisition. This will normally be given in a question.

**if proportionate goodwill method adopted, NCI value = NCI % of the fair value of the subsidiary's net assets at acquisition (per W2).

(W4) **Non-controlling interest**

	$000
NCI value at acquisition (W3)	X
NCI % of post-acquisition movement in net assets (W2)	X
Less: NCI % of goodwill impairment (fair value method only)	(X)
	–––
NCI to consolidated SFP	X
	–––

(W5) **Group reserves**

Retained earnings

	$000
Parent's retained earnings (100%)	X
For each subsidiary: group share of post-acquisition retained earnings (W2)	X
Add: gain on bargain purchase (W3)	X
Less: goodwill impairment** (W3)	(X)
Less: PURP if the parent was the seller	(X)
	–––
Retained earnings to consolidated SFP	X
	–––

** If the NCI was valued at fair value at the acquisition date, then only the parent's share of the goodwill impairment is deducted from retained earnings.

Other components of equity

	$000
Parent's other components of equity (100%)	X
For each subsidiary: group share of post-acquisition other components of equity (W2)	X
	–––
Other components of equity to consolidated SFP	X
	–––

Consolidated statement of profit or loss and other comprehensive income

If required to produce a consolidated statement of profit or loss and other comprehensive income from the individual financial statements of group companies, the following four step approach will help.

Step 1: Group structure

This working is useful to decide the status of any investments. If one entity is controlled by another entity then it is a subsidiary and must be consolidated.

In numerical exam questions, control is normally presumed to exist if one company owns more than half of the voting capital of another entity.

Step 2: Pro-forma

Once the group structure has been determined, set up a proforma statement of profit or loss and other comprehensive income.

Remember to leave space at the bottom to show the profit and total comprehensive income (TCI) attributable to the owners of the parent company and the profit and TCI attributable to the non-controlling interest.

Group statement of profit or loss and other comprehensive income for the year ended 30 June 20X8

	$000
Revenue (P + S)	X
Cost of sales (P + S)	(X)
	–––––
Gross profit	X
Operating costs (P + S)	(X)
	–––––
Profit from operations	X
Investment income (P + S)	X
Finance costs (P + S)	(X)
	–––––
Profit before tax	X
Income tax (P + S)	(X)
	–––––
Profit for the period	X
Other comprehensive income (P + S)	X
	–––––
Total comprehensive income	X
	–––––
Profit attributable to:	
Equity holders of the parent (bal. fig)	X
Non-controlling interest (Step 4)	X
	–––––
Profit for the period	X
	–––––
Total comprehensive income attributable to:	
Equity holders of the parent (bal. fig)	X
Non-controlling interest (Step 4)	X
	–––––
Total comprehensive income for the period	X
	–––––

Step 3: Complete the pro-forma

Add together the parent and subsidiary's income and expenses and items of other comprehensive income on a line-by-line basis.

- If the subsidiary has been acquired mid-year, make sure that you prorate the results of the subsidiary so that only post-acquisition income, expenses and other comprehensive income are consolidated.
- Ensure that you eliminate intra-group income and expenses, unrealised profits on intra-group transactions, as well as any dividends received from the subsidiary.

Step 4: Calculate the profit/TCI attributable to the non-controlling interest

Remember, profit for the year and TCI for the year must be split between the group and the non-controlling interest. The following proforma will help you to calculate the profit and TCI attributable to the non-controlling interest.

	Profit	**TCI**
	$000	$000
Profit/TCI of the subsidiary for the year (pro-rated for mid-year acquisition)	X	X
PURP (if S is the seller)	(X)	(X)
Excess depreciation/amortisation	(X)	(X)
Goodwill impairment (under FV model only)	(X)	(X)
	–––	–––
× NCI %	X	X
	–––	–––
Profit/TCI attributable to the NCI	X	X
	–––	–––

4 Associates

Definitions

An **associate** is defined as **'an entity over which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor'** (IAS 28, para 3).

Significant influence is the power to participate in, but not control, the financial and operating policy decisions of an entity. IAS 28 *Investments in Associates and Joint Ventures* states that:

- Significant influence is usually evidenced by representation on the board of directors, which allows the investing entity to participate in policy decisions.
- Holding between 20% and 50% of the voting power is presumed to give significant influence.

The existence of significant influence normally entails at least one of the following:

- representation on the board of directors
- ability to influence policy making
- significant levels of transactions between the entity and the investee
- management personnel being shared between the entity and the investee
- provision of important technical information.

Test your understanding 1 – Sparrow

Sparrow owns 18% of the ordinary shares of Blackbird. The remaining 82% of the ordinary shares are held by hundreds of investors, and no single investor has a holding of more than 5%.

Blackbird has six directors and Sparrow is able to appoint two of these.

Blackbird is one of Sparrow's key suppliers. Sparrow's operations and human resource managers spend several days a year at Blackbird in order to ensure that trading between the two entities is as smooth as possible.

In the consolidated financial statements, the directors of Sparrow wish to account for the investment in Blackbird as a financial asset.

Required:

Discuss whether the proposed accounting treatment is correct.

Accounting for associates

Associates are not consolidated because the investor does not have control. Instead they are accounted for using the **equity method**.

Statement of financial position

IAS 28 requires that the carrying amount of the associate is determined as follows:

	$000
Cost	X
P% of post-acquisition reserves	X/(X)
Impairment losses	(X)
P% of unrealised profits if P is the seller	(X)
P% of excess depreciation on fair value adjustments	(X)
Investment in associate	X

The investment in the associate is shown in the non-current assets section of the consolidated statement of financial position.

Statement of profit or loss and other comprehensive income

For an associate, a single line item is presented in the statement of profit or loss below operating profit. This is made up as follows:

	$000
P% of associate's profit after tax	X
Less: Current year impairment loss	(X)
Less: P% of unrealised profits if associate is the seller	(X)
Less: P% of excess depreciation on fair value adjustments	(X)
	–––
Share of profit of associate	X
	–––

Within consolidated other comprehensive income, the group should present its share of the associate's other comprehensive income (if applicable).

Adjustments

Dividends received from the associate must be removed from the consolidated statement of profit or loss.

Transactions and balances between the associate and the parent company are not eliminated from the consolidated financial statements because the associate is not a part of the group.

The group share of any unrealised profit arising on transactions between the group and the associate must be eliminated.

- If the associate is the seller:

  Dr Share of the associate's profit (P/L)/Retained earnings (SFP)

  Cr Inventories (SFP)

- If the associate is the purchaser:

  Dr Cost of sales (P/L)/Retained earnings (SFP)

  Cr Investment in the associate (SFP)

When an investor contributes assets in exchange for an equity interest in the associate, the investor recognises the portion of the gain or loss on disposal attributable to the **other investors** in the associate (i.e. if the investor owns 40% of the associate, it recognises 60% of the gain or loss).

General points and disclosures

IAS 28 notes the following:

- The financial statements used to equity account for the associate should be drawn up to the investor's reporting date. If this is not possible, then the difference in reporting dates should be less than three months.
- The associate's accounting policies should be harmonised with those of its investor.
- The investor should disclose its share of the associate's contingencies.

Illustration 1 – Consolidated statement of financial position

Financial statements for three entities for the year ended 30 June 20X8 are as follows:

Statements of financial position

	Borough	**High**	**Street**
Assets	$	$	$
Property, plant and equipment	100,000	80,000	60,000
Investments	121,000	–	–
Inventories	22,000	30,000	15,000
Receivables	70,000	10,000	2,000
Cash and cash equivalents	47,000	25,000	3,000
	360,000	145,000	80,000
Equity and liabilities			
Equity capital ($1 shares)	100,000	75,000	35,000
Retained earnings	200,000	50,000	40,000
Other components of equity	10,000	5,000	–
Liabilities	50,000	15,000	5,000
	360,000	145,000	80,000

On 1 July 20X7, Borough purchased 45,000 shares in High for $100,000. At that date, High had retained earnings of $30,000 and no other components of equity. High's net assets had a fair value of $120,000 and the fair value of the non-controlling interest was $55,000. It is group policy to value the non-controlling interest at acquisition at fair value.

The excess of the fair value of High's net assets over their carrying amounts at the acquisition date relates to property, plant and equipment. This had a remaining estimated useful life of five years at the acquisition date. Goodwill has been subject to an impairment review and it was determined to be impaired by $7,000.

On 1 July 20X7, Borough purchased 10,500 equity shares in Street for $21,000. At that date, Street had retained earnings of $25,000 and no other components of equity.

During the year Borough sold goods too High for $10,000 at a margin of 50%. By the reporting date, High had only sold 80% of these goods. Included in the receivables of Borough and the liabilities of High are intragroup balances of $5,000.

On 5 July 20X8, Borough received notification that an employee was claiming damages against them as a result of a work-place accident that took place on 30 April 20X8. Lawyers have advised that there is a 60% chance that Borough will lose the case and will be required to pay damages of $30,000.

Required:

Prepare the consolidated statement of financial position as at 30 June 20X8.

Solution

Borough Group statement of financial position as at 30 June 20X8

Non-Current Assets	$
Goodwill (W3)	28,000
Property, plant and equipment	192,000
($100,000 + $80,000 + $15,000 (W2) – $3,000 (W2))	
Investment in Associate (W7)	25,500
Current Assets	
Inventories ($22,000 + $30,000 – $1,000 (W6))	51,000
Receivables ($70,000 + $10,000 – $5,000 inter.co)	75,000
Cash and cash equivalents ($47,000 + $25,000)	72,000
	443,500
Equity capital	100,000
Retained earnings (W5)	179,500
Other components of equity (W5)	13,000
Non-controlling interest (W4)	61,000
Total equity	353,500
Liabilities	90,000
($50,000 + $15,000 – $5,000 inter.co + $30,000 (W8))	
	443,500

(W1) **Group structure**

Borough is the parent

High is a 60% subsidiary (45/75)

Street is a 30% associate (10.5/35)

Both acquisitions took place a year ago

(W2) **Net assets of High**

	Acq	Rep date
	$	$
Equity capital	75,000	75,000
Other components of equity	–	5,000
Retained earnings	30,000	50,000
Fair value adjustment (FVA)	15,000*	15,000
Depreciation on FVA ($15,000/5)	–	(3,000)
*bal fig	120,000	142,000

(W3) **Goodwill**

	$
Consideration	100,000
FV of NCI at acquisition	55,000
	155,000
FV of net assets at acquisition (W2)	(120,000)
Goodwill at acquisition	35,000
Impairment	(7,000)
Goodwill at the reporting date	28,000

(W4) **Non-controlling interest**

	$
Fair value of NCI at acquisition	55,000
NCI % of post-acquisition net assets (40% × ($142,000 – $120,000) (W2))	8,800
NCI share of goodwill impairment (40% × $7,000)	(2,800)
	61,000

(W5) **Group reserves**

Group retained earnings

	$
Parent	200,000
Provision (W8)	(30,000)
Share of post-acquisition retained earnings:	
High: 60% × (($50,000 – $3,000) – $30,000) (W2)	10,200
Street: 30% × ($40,000 – $25,000)	4,500
Group share of goodwill impairment (60% × $7,000)	(4,200)
PURP (W6)	(1,000)
	179,500

Other components of equity

	$
Parent	10,000
Share of post-acquisition other components of equity:	
High: 60% × ($5,000 – $nil) (W2)	3,000
	13,000

(W6) **Provision for unrealised profit**

The profit on the intra-group sale was $5,000 (50% × $10,000).

The unrealised profit still in inventory is $1,000 (20% × $5,000).

The parent was the seller, so retained earnings is adjusted in (W5)

Dr Retained earnings	$1,000
Cr Inventories	$1,000

(W7) **Investment in the associate**

	$
Cost	21,000
Share of increase in retained earnings (30% × ($40,000 – $25,000))	4,500
	25,500

(W8) **Provision**

The obligating event, the accident, happened during the reporting period. This means that there is an obligation from a past event, and a probable outflow of resources that can be measured reliably. A provision is therefore required for the best estimate of the amount payable, which is $30,000. This is charged to the statement of profit or loss so will reduce retained earnings in (W5).

Dr Retained earnings	$30,000
Cr Provisions	$30,000

e.g

Illustration 2 – Consolidated statement of profit or loss

H has owned 80% of the ordinary shares of S and 30% of the ordinary shares of A for many years. The information below is required to prepare the consolidated statement of profit or loss for the year ended 30 June 20X8.

Statements of profit or loss for the year ended 30 June 20X8

	H	**S**	**A**
	$	$	$
Revenue	500,000	200,000	100,000
Cost of sales	(100,000)	(80,000)	(40,000)
Gross profit	400,000	120,000	60,000
Distribution costs	(160,000)	(20,000)	(10,000)
Administrative expenses	(140,000)	(40,000)	(10,000)
Profit from operations	100,000	60,000	40,000
Tax	(23,000)	(21,000)	(14,000)
Profit after tax	77,000	39,000	26,000

Note: There were no items of other comprehensive income in the year.

At the date of acquisition, the fair value of S's plant and machinery, which at that time had a remaining useful life of ten years, exceeded the book value by $10,000.

During the year S sold goods to H for $10,000 at a margin of 25%. By the year-end H had sold 60% of these goods.

The group accounting policy is to measure non-controlling interests using the proportion of net assets method. The current year goodwill impairment loss was $1,200, and this should be charged to administrative expenses.

By 30 June 20X8 the investment in A had been impaired by $450, of which the current year loss was $150.

On 1 January 20X8, H signed a contract to provide a customer with support services for the following twelve months. H received the full fee of $30,000 in advance and recognised this as revenue.

Required:

Prepare the consolidated statement of profit or loss for the year ended 30 June 20X8.

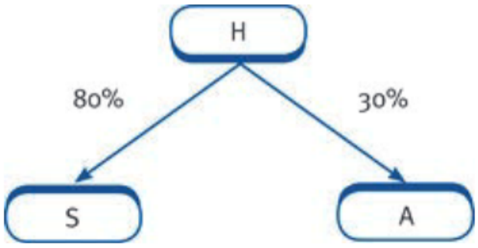
Solution

Group statement of profit or loss for the year ended 30 June 20X8

	$
Revenue	675,000
($500,000 + $200,000 – $10,000 (W3) – $15,000 (W4))	
Cost of sales	(172,000)
($100,000 + $80,000 + $1,000 (W2) – $10,000 (W3) + $1,000 (W3))	–––––––
Gross profit	503,000
Distribution costs ($160,000 + $20,000)	(180,000)
Administrative expenses	(181,200)
($140,000 + $40,000 + $1,200 GW imp)	–––––––
Profit from operations	141,800
Share of profit of associate	7,650
((30% × $26,000) – $150 impairment)	–––––––
Profit before tax	149,450
Tax ($23,000 + $21,000)	(44,000)
	–––––––
Profit for the period	105,450
	–––––––
Attributable to:	
Equity holders of the parent (bal. fig)	98,050
Non-controlling interest (W5)	7,400
	–––––––
Profit for the period	105,450
	–––––––

Workings

(W1) **Group structure**



(W2) **Excess depreciation**

$10,000/10 years = $1,000.

The adjusting entry is:

Dr Cost of sales	$1,000
Cr PPE	$1,000

(W3) **Intra-group trading**

The $10,000 trading between S and H must be eliminated:

Dr Revenue	$10,000
Cr Cost of sales	$10,000

The profit on the sale was $2,500 (25% × $10,000). Of this, $1,000 ($2,500 × 40%) remains within the inventories of the group. The PURP adjustment is therefore:

Dr Cost of sales	$1,000
Cr Inventories	$1,000

(W4) **Revenue**

The performance obligation is satisfied over time. Based on the passage of time, the contract is 50% (6/12) complete so only 50% of the revenue should be recognised by the reporting date. Therefore $15,000 ($30,000 × 50%) should be removed from revenue and held as a liability on the SFP.

Dr Revenue	$15,000
Cr Contract liability	$15,000

(W5) **Profit attributable to NCI**

	$	$
S's profit for the year	39,000	
PURP (W3)	(1,000)	
Excess depreciation (W2)	(1,000)	
	———	
	37,000	
× 20%		———
Profit attributable to NCI		7,400
		———

Note: If the parent had sold goods to the subsidiary then the PURP adjustment would not be included when calculating the profit attributable to the NCI.

Goodwill has been calculated using the share of net assets method. Therefore, none of the impairment loss is attributable to the NCI.

e.g

Illustration 3 – Associates

Paint has several investments in subsidiary companies. On 1 July 20X1, it acquires 30% of the ordinary shares of Animate for $2m. This holding gives Paint significant influence over Animate.

At the acquisition date, the fair value of Animate's net assets approximate to their carrying values with the exception of a building. This building, with a remaining useful life of 10 years, had a carrying value of $1 m but a fair value of $1.8m.

Between 1 July 20X1 and 31 December 20X1, Animate sold goods to Paint for $1 million making a profit of $100,000. All of these goods remain in the inventory of Paint. This sale was made on credit and the invoice has not yet been settled.

Animate made a profit after tax of $800,000 for the year ended 31 December 20X1. At 31 December 20X1, the directors of Paint believe that the investment in the associate needs impairing by $50,000.

Required:

Prepare extracts from the consolidated statement of financial position and the consolidated statement of profit or loss showing the treatment of the associate for the year ended 31 December 20X1.

Solution

Consolidated statement of financial position

Non-current assets	$
Investment in associate (W1)	2,058,000

Consolidated statement of profit or loss

Share of profit of associate (W2)	28,000

Note: No adjustment is required for receivables and payables held between Paint and Animate.

(W1) **Investment in associate**

	$
Cost	2,000,000
Share of post-acquisition profit (30% × $800,000 × 6/12)	120,000
Share of excess depreciation (30% × (($1.8m – $1m)/10 years) × 6/12)	(12,000)
Impairment	(50,000)
Investment in associate	2,058,000

The inventory is held within the group so the parent's share of the PURP is credited against inventory rather than the investment in the associate.

(W2) **Share of profit of associate**

	$
P's share of A's profit after tax (30% × $800,000 × 6/12)	120,000
Impairment	(50,000)
P's share of excess depreciation (30% × (($1.8m – $1m)/10 years) × 6/12)	(12,000)
P's share of PURP (30% × $100,000)	(30,000)
Share of profit of associate	28,000

5 Control

Consolidated statements are produced if one entity controls another entity that constitutes a business. It is often presumed that control exists if a company owns more than 50% of the ordinary shares of another company. However, the Strategic Business Reporting exam might test the definition of control in more detail.

The *Conceptual Framework*
The *Conceptual Framework* says that an entity controls a resource if it can direct its use and obtain economic benefits that may flow from it. Control includes the ability to prevent others from directing the use of the resource and from obtaining economic benefits that may flow from it. IFRS 10 *Consolidated Financial Statements* sets out how to apply the principle of control to identify whether an investor controls an investee.

According to IFRS 10, an investor **controls an investee** when:

- the investor has power over the investee, and
- the investor is exposed, or has rights, to variable returns from its involvement with the investee, and
- the investor has the ability to affect those returns through its power over the investee.

IFRS 10 identifies a range of circumstances that may need to be considered when determining whether or not an investor has power over an investee, such as:

- exercise of the majority of voting rights in an investee
- contractual arrangements between the investor and other parties
- holding less than 50% of the voting shares, with all other equity interests held by a numerically large, dispersed and unconnected group
- holding potential voting rights (such as convertible loans) that are currently capable of being exercised
- the nature of the investor's relationship with other parties that may enable that investor to exercise control over an investee.

It is therefore possible to own less than 50% of the ordinary shares of another entity and to still exercise control over it.

Test your understanding 2 – Control

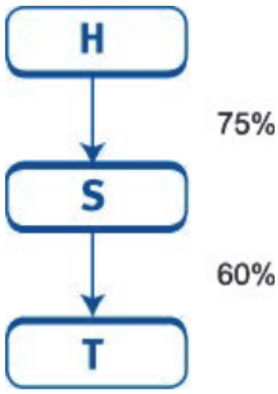
Parsley has a 40% holding in the ordinary shares of Oregano. Another investor has a 10% shareholding in Oregano whilst the remaining voting rights are held by thousands of shareholders, none of whom individually hold more than 1 per cent of the voting rights. Parsley also holds debt instruments that, as at 30 April 20X4, are convertible into ordinary shares of Oregano at a price of $4 per share. At 30 April 20X4, the shares of Oregano trade at $3.80 per share. If the debt was converted into ordinary shares, Parsley would hold 60% of the voting rights in Oregano. Parsley and Oregano undertake similar activities and would benefit from synergies.

Required:

Discuss how Parsley's investment in the ordinary shares of Oregano should be treated in the consolidated financial statements for the year ended 30 April 20X4.

Test your understanding 3 – Vertical group

Look at the group structure below:



Required:

Does Company H control Company T?

6 Business combinations

The definition of a business

The acquisition method (i.e. consolidation) is applied when one entity obtains control over another entity that constitutes a business. If the assets acquired are not a business, the transaction should be accounted for as the purchase of an asset

A business is not simply a collection of resources. For example, a restaurant is more than just a building with ovens, tables and chairs. It also has trained chefs who use this equipment in combination with ingredients and their knowledge of the restaurant's recipes to produce sellable finished goods.

Per IFRS 3 *Business Combinations*, a business must have processes that are able to convert acquired inputs into outputs.

Inputs are economic resources that can create outputs once processes are applied to them. Examples include property, plant and equipment, intangible assets, raw materials, and employees.

Processes are '**any system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs or has the ability to contribute to the creation of outputs**' (IFRS 3, B7b). Processes are normally documented. However, employee knowledge and experience in following rules and conventions can also constitute a process

Outputs result from inputs and the processes applied to inputs. Outputs include goods, services and income.

Concentration test

The Board are aware that the definition of a business can be difficult and judgemental to apply. As such, there is an optional concentration test that preparers of financial statements can use to assess whether an acquired set of assets is **not** a business.

The concentration test is met (i.e. the acquired assets are not a business) if substantially all of the fair value of the total assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

Test your understanding 4 – Taco
Taco purchases 100% of the shares in Fajita, a non-listed company. Fajita owns 20 houses, which are leased to tenants. The houses are located in the same area. The fair value of the consideration paid for the shares in Fajita is equal to the total fair value of the 20 houses. **Required:** **Apply the optional concentration test in IFRS 3 *Business Combinations* to determine whether Fajita is not a business.**

Elements of a business

If the concentration test is not met, or if the test is not applied, a more detailed assessment of the facts and circumstances is required to ascertain if a business has been acquired.

To meet the definition of a business, there must be inputs and processes that, when applied to acquired inputs, are capable of producing outputs. The processes acquired must be important and considerable (or, as IFRS 3 says, 'substantive').

Outputs are not required for an acquisition of assets to constitute a business. This is because some early stage entities may have engaged in significant research and development activities but not, as yet, finished any projects or generated any revenue.

If there are no outputs at the acquisition date then an acquired process is only substantive if:

- it is critical to convert an input to an output, **and**
- inputs acquired include a knowledgeable, skilled, organised workforce able to perform that process on other acquired inputs to produce outputs.

If there are outputs at the acquisition date then an acquired process is substantive if it:

- is critical to continuing to produce outputs, and the inputs acquired include an organised workforce with the skills and knowledge to perform that process, **or**
- significantly contributes to the ability to continue producing outputs and is either rare or not capable of easy replacement.

Test your understanding 5 – Shepherd and Pie

Shepherd purchases 100% of the shares in Pie, a non-listed company. Pie owns 10 houses, which are leased to residential tenants, and two multi-story office blocks, which are leased to commercial tenants. Pie has no employees, with all property management tasks to be performed by other employees from within the Shepherd group. There are contracts in place for third parties to provide cleaning and security services to the commercial tenants. The total fair value of the houses is similar to the total fair value of the office blocks.

The directors of Shepherd wish to apply the optional concentration test to determine whether Pie is not a business.

Required:

Discuss whether Pie constitutes a business.

Test your understanding 6 – Tahini and Kofta

Tahini purchases 100% of the ordinary share capital of Kofta, an entity that does not yet generate revenue. Kofta operates in the biotech industry. It has engaged in research and development activities into a number of drug compounds, and also owns a headquarters, research laboratories and technical equipment. Kofta employs senior management and highly-skilled research scientists. Each of Kofta's assets has a similar fair value.

Required:

Discuss whether Kofta constitutes a business.

7 Acquisition accounting

The acquisition method

The acquisition method has the following requirements:

- Identifying the acquirer
- Determining the acquisition date
- Recognising and measuring the subsidiary's identifiable assets and liabilities
- Recognising goodwill (or a gain from a bargain purchase) and any non-controlling interest.

Although you will be aware of many of these requirements from your previous studies, as well as from the illustrations earlier in this chapter, you are expected to have a more detailed knowledge of each of these elements for the SBR exam.

Identifying the acquirer

The acquirer is the entity that has assumed control over another entity.

In a business combination, it is normally clear which entity has assumed control.

e.g

The acquirer
Lyra pays $1 million to obtain 60% of the ordinary shares of Pan.
Lyra is the acquiring company.

However, sometimes it is not clear as to which entity is the acquirer. For these cases, IFRS 3 provides guidance:

- The acquirer is normally the entity that has transferred cash or other assets within the business combination
- If the business combination has not involved the transfer of cash or other assets, the acquirer is usually the entity that issues its equity interests.

Other factors to consider are as follows:

- The acquirer is usually the entity whose (former) management dominates the combined entity
- The acquirer is usually the entity whose owners have the largest portion of voting rights in the combined entity
- The acquirer is normally the bigger entity.

Test your understanding 7 – Identifying the acquirer

Abacus and Calculator are two public limited companies. The fair values of the net assets of these two companies are $100 million and $60 million respectively.

On 31 October 20X1, Abacus incorporates a new company, Phone, in order to effect the combination of Abacus and Calculator. Phone issues its shares to the shareholders of Abacus and Calculator in return for their equity interests.

After this, Phone is 60% owned by the former shareholders of Abacus and 40% owned by the former shareholders of Calculator. On the board of Phone are 4 of the former directors of Abacus and 2 of the former directors of Calculator.

Required:

With regards to the above business combination, discuss which company is the acquirer.

The acquisition date

The acquisition date is the date on which the acquirer obtains control over the acquiree. This will be the date at which goodwill must be calculated and from which the income and expenses of the acquiree will be consolidated.

Identifiable assets and liabilities

The acquirer must measure the identifiable assets acquired and the liabilities assumed at their fair values at the acquisition date.

IFRS 3 says that an asset is identifiable if:

- It is capable of disposal separately from the business owning it, or
- It arises from contractual or other legal rights, regardless of whether those rights can be sold separately.

The identifiable assets and liabilities of the subsidiary should be recognised at fair value if they:

- meet the definitions of assets and liabilities in the *Conceptual Framework*, and
- are exchanged as part of the business combination rather than a separate transaction.

Items that are not identifiable or do not meet the definitions of assets or liabilities are subsumed into the calculation of purchased goodwill.

Watch out for the following items:

- **Contingent liabilities** are recognised at fair value at the acquisition date. This is true even where an economic outflow is not probable. The fair value will incorporate the probability of an economic outflow.
- **Provisions** for future operating losses cannot be created as this is a post-acquisition item. Similarly, restructuring costs are only recognised to the extent that a liability actually exists at the date of acquisition.
- **Intangible assets** are recognised at fair value if they are separable or arise from legal or contractual rights. This might mean that the parent recognises an intangible asset in the consolidated financial statements that the subsidiary did not recognise in its individual financial statements, e.g. an internally generated brand name.
- **Goodwill** in the subsidiary's individual financial statements is not consolidated. This is because it is not separable and it does not arise from legal or contractual rights.

There are some exceptions to the requirement to measure the subsidiary's net assets at fair value when accounting for business combinations. Assets and liabilities falling within the scope of the following standards should be valued according to those standards:

- IAS 12 *Income Taxes*
- IAS 19 *Employee Benefits*
- IFRS 2 *Share-based Payment*
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations.*

Test your understanding 8 – Fair value of identifiable net assets

P purchased 60% of the shares of S on 1 January 20X1. At the acquisition date, S had share capital of $10,000 and retained earnings of $190,000.

The property, plant and equipment of S includes land with a carrying value of $10,000 but a fair value of $50,000.

Included within the intangible assets of S is goodwill of $20,000 which arose on the purchase of the trade and assets of a sole-trader business. S has an internally generated brand that is not recognised (in accordance with IAS 38 *Intangible Assets*). The directors of P believe that this brand has a fair value of $150,000.

In accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the financial statements of S disclose the fact that a customer has initiated legal proceedings against them. If the customer wins, which lawyers have advised is unlikely, estimated damages would be $1 million. The fair value of this contingent liability has been assessed as $100,000 at the acquisition date.

The directors of P wish to close one of the divisions of S. They estimate that this will cost $200,000 in redundancy payments.

Required:

Discuss, with calculations, the fair value of S's identifiable net assets at the acquisition date.

Goodwill

Goodwill should be recognised on a business combination. This is calculated as the difference between:

1 The aggregate of the fair value of the consideration transferred and the non-controlling interest in the acquiree at the acquisition date, and

2 The fair value of the acquiree's identifiable net assets and liabilities.

Purchase consideration

When calculating goodwill, purchase consideration transferred to acquire control of the subsidiary must be measured at fair value.

When determining the fair value of the consideration transferred:

- Contingent consideration is included even if payment is not deemed probable. Its fair value will incorporate the probability of payment occurring.
- Acquisition costs are excluded from the calculation of purchase consideration.
  - Legal and professional fees are expensed to profit or loss as incurred
  - Debt or equity issue costs are accounted for in accordance with IFRS 9 *Financial Instruments*.

Replacement share-based payment schemes

Consideration transferred in exchange for control of a subsidiary could include replacement share-based payment schemes exchanged for share-based payments schemes held by the subsidiary's employees.

If the acquirer is obliged to issue replacement share-based payments to employees of the subsidiary in exchange for their existing schemes, then the fair value of the replacement scheme must be allocated between:

- purchase consideration, and
- post-acquisition remuneration expense.

The amount allocated as purchase consideration cannot exceed the value of the original share scheme at the date of acquisition. The amount attributable to post-acquisition service is recognised in accordance with IFRS 2 *Share-based Payments*.

Test your understanding 9 – Purchase consideration

Following on from Test your understanding 8, the purchase consideration transferred by P in exchange for the shares in S was as follows:

- Cash paid of $300,000
- Cash to be paid in one year's time of $200,000
- 10,000 shares in P. These had a nominal value of $1 and a fair value at 1 January 20X1 of $3 each
- $250,000 to be paid in one year's time if S makes a profit before tax of more than $2m. There is a 50% chance of this happening. The fair value of this contingent consideration can be measured as the present value of the expected value.
- P is required to replace a share-based payment scheme previously granted by S to its employees. By the acquisition date, S's employees had rendered the required service for the award but had not exercised their options. The fair value of S's award at the acquisition date was $400,000. The fair value of P's replacement award, which has no post-acquisition vesting conditions attached, was $500,000.

Legal fees associated with the acquisition were $10,000.

Where required, a discount rate of 10% should be used.

Required:

Discuss, with calculations, the fair value of the consideration transferred to acquire control of S.

Goodwill and the non-controlling interest

The calculation of goodwill will depend on the method chosen to value the non-controlling interest at the acquisition date.

IFRS 3 provides a choice in valuing the non-controlling interest at acquisition:

EITHER:	OR:
Method 1 – The proportionate share of net assets method	**Method 2 – The fair value method**
NCI % × fair value of the net assets of the subsidiary at the acquisition date.	Fair value of NCI at date of acquisition. This is usually given in the question.

If the NCI is valued at acquisition as their proportionate share of the acquisition net assets, then only the acquirer's goodwill will be calculated.

If the NCI is valued at acquisition at fair value, then goodwill attributable to both the acquirer and the NCI will be calculated. This is known as the 'full goodwill method'.

The method used to measure the NCI should be decided on a transaction by transaction basis. This means that, within the same group, the NCI in some subsidiaries may have been measured at fair value at acquisition, whilst the NCI in other subsidiaries may have been measured at acquisition using the proportionate basis.

Test your understanding 10 – Goodwill

Following on from Test your understanding 8 and 9, the fair value of the non-controlling interest at the acquisition date is $160,000.

Required:

Calculate the goodwill arising on the acquisition of S if the non-controlling interest at the acquisition date is valued at:

(a) **fair value**

(b) **its proportion of the fair value of the subsidiary's identifiable net assets.**

Bargain purchase

If the share of net assets acquired exceeds the consideration transferred, then a gain on bargain purchase ('negative goodwill') arises on acquisition. The accounting treatment for this is as follows:

- IFRS 3 says that negative goodwill is rare and may suggest that errors were made when determining the fair value of the consideration transferred and the net assets acquired. The figures should be reviewed for accuracy.
- If no errors have been made, the negative goodwill is credited immediately to profit or loss.

Measurement period

During the measurement period, IFRS 3 requires the acquirer in a business combination to retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date.

This would result in goodwill arising on acquisition being recalculated.

The measurement period ends no later than twelve months after the acquisition date.

e.g

Measurement period illustration

P bought 100% of the shares of S on 31 December 20X1 for $60,000. On the acquisition date, it was estimated that the fair value of S's net assets were $40,000.

For the year ended 31 December 20X1, P would consolidate S's net assets of $40,000 and would also show goodwill of $20,000 ($60,000 – $40,000).

However, P receives further information on 30 June 20X2 which indicates that the fair value of S's net assets at the acquisition date was actually $50,000. This information was determined within the measurement period and so is retrospectively adjusted for.

Therefore, the financial statements for the year ended 31 December 20X1 will be adjusted. P will now consolidate S's net assets of $50,000 and will show goodwill of $10,000 ($60,000 – $50,000).

8 Impairment of goodwill

IAS 36 *Impairment of Assets* requires that goodwill is tested for impairment annually.

Goodwill does not generate independent cash inflows. Therefore, it is tested for impairment as part of a cash generating unit.

A cash-generating unit is the **'smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets'** (IAS 36, para 6).

For exam purposes, a subsidiary is normally designated as a cash-generating unit.

Accounting for an impairment

An **impairment loss** is the amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount.

Recoverable amount is the higher of fair value less costs to sell and value in use.

Impairment losses on a subsidiary will firstly be allocated against goodwill and then against other assets on a pro-rata basis.

Accounting for an impairment with a non-controlling interest

NCI – fair value method

If the NCI is measured at fair value at the acquisition date then the goodwill calculated and recognised represents full goodwill. It can therefore be added together with the other net assets of the subsidiary and compared to the recoverable amount of the subsidiary's net assets on a like for like basis.

Any impairment of goodwill is allocated between the group and the NCI based upon their respective shareholdings.

NCI – proportionate method

If the NCI is measured at acquisition at its share of the fair value of the subsidiary's identifiable net assets then only the goodwill attributable to the group is calculated. This means that the NCI share of goodwill is not reflected in the group accounts. As such, any comparison between the carrying amount of the subsidiary (including goodwill) and the recoverable amount of its net assets will not be on a like-for-like basis.

- In order to address this problem, goodwill must be grossed up to include goodwill attributable to the NCI prior to conducting the impairment review. This grossed up goodwill is known as **total notional goodwill**.
- As only the parent's share of the goodwill is recognised in the group accounts, only the parent's share of the goodwill impairment loss should be recognised.

e.g

Illustration 4 – Impairment of goodwill

A owns 80% of B. At 31 October 20X6 the carrying amount of B's net assets is $60 million, excluding goodwill of $8 million that arose on the original acquisition.

The recoverable amount of the net assets of B is $64 million.

Required:

Discuss the implications of the recoverable amount of the net assets of B if:

(a) **the NCI at acquisition was measured at fair value**

(b) **the NCI at acquisition was measured at its proportion of the fair value of the subsidiary's identifiable net assets.**

Solution

Impairment

According to IAS 36 *Impairment of Assets*, goodwill must be reviewed annually for impairment. Impairment arises when an asset's carrying amount exceeds its recoverable amount.

Goodwill does not generate independent cash flows and so must be tested for impairment as part of a cash generating unit. The calculation of the impairment loss is dependent on the method used to value the non-controlling interest at acquisition.

(a) **NCI at fair value**

If the NCI at acquisition was measured at fair value then full goodwill has been calculated. This means that the carrying amount of the subsidiary's net assets and goodwill can be compared to the subsidiary's recoverable amount on a like-for-like basis.

	$m
Goodwill	8
Net assets	60
Carrying amount	68
Recoverable amount	64
Impairment	4

The impairment loss will be allocated against goodwill, reducing it from $8m to $4m.

The $4m impairment expense will be charged to profit or loss. Of this, $3.2m ($4m × 80%) is attributable to the group and $0.8m ($4m × 20%) is attributable to the NCI.

(b) **NCI using proportionate method**

If the NCI at acquisition was measured using the proportionate method then only the group's share of the goodwill has been calculated – i.e. 80% of the goodwill This means that the carrying amount of the subsidiary's net assets and goodwill cannot be compared to the subsidiary's recoverable amount on a like-for-like basis. As such, goodwill must be grossed up to include the NCI's unrecognised 20% share.

	$m	$m
Goodwill	8	
Unrecognised NCI (20/80 × $8m)	2	
	–––	
Total notional goodwill		10
Net assets		60
		–––
Carrying amount		70
Recoverable amount		64
		–––
Impairment		6
		–––

The impairment loss is allocated against the total notional goodwill of $10 million.

However, only the group's share of goodwill has been recognised in the financial statements and so only the group's share (80%) of the impairment is recognised. The impairment charged to profit or loss is therefore $4.8m and goodwill will be reduced to $3.2m ($8m – $4.8m).

Test your understanding 11 – Happy

On 1 January 20X5, Lucky group purchased 80% of Happy for $500,000. The fair value of the identifiable net assets of Happy at the date of acquisition amounted to $590,000.

The carrying amount of Happy's net assets at 31 December is $520,000 (excluding goodwill). Happy is a cash-generating unit.

At 31 December 20X5 the recoverable amount of Happy's net assets is $530,000.

Required:

Calculate the impact of the impairment review if:

(a) **the NCI at acquisition was measured at its fair value of $130,000.**

(b) **the NCI at acquisition was measured at its share of the fair value of Happy's identifiable net assets.**

Test your understanding 12 – Pauline

Extracts from the statements of financial position at 31 March 20X8 for three companies are below:

	Pauline	Sonia	Arthur
	$000	$000	$000
Non-current assets			
Property, plant and equipment	36,800	20,800	36,000
Investments in Sonia and Arthur	26,500	–	–
Equity and liabilities			
Equity shares of $1 each	20,000	8,000	8,000
Retained earnings			
– at 31 March 20X7	32,000	12,000	22,000
– for year ended 31 March 20X8	18,500	5,800	10,000

The following information is relevant to the preparation of the consolidated statement of financial position.

Sonia

On 1 April 20X7 Pauline acquired 6 million of Sonia's equity shares by an exchange of one share in Pauline for every two shares in Sonia plus $1.25 per acquired Sonia share in cash. The market price of each Pauline share at the date of acquisition was $6 and the market price of each Sonia share at the date of acquisition was $3.25.

The cash consideration transferred for the acquisition of Sonia has been recorded by Pauline in its separate financial statements but the share consideration has not been recorded. In addition $1 million of professional costs relating to the acquisition of Sonia are included in the cost of the investment.

At the date of acquisition Sonia had an internally generated brand name that was unrecognised in its separate financial statements. The directors of Pauline estimate that this brand name has a fair value of $2 million and an indefinite life.

Pauline has a policy of valuing non-controlling interests at fair value at the date of acquisition. For this purpose the share price of Sonia should be used.

Impairment tests on 31 March 20X8 concluded that the recoverable amount of the net assets of Sonia was $34 million.

Arthur

On 1 April 20X7 Pauline acquired 30% of Arthur's equity shares at a cost of $7.50 per share in cash and recorded this in its separate financial statements.

Required:

(a) **Discuss how to determine the carrying amount of the goodwill arising on the acquisition of Sonia that will be reported in the consolidated statement of financial position as at 31 March 20X8.**

(b) **Discuss how to account for the investment in Arthur in the consolidated statement of financial position as at 31 March 20X8.**

(c) **Prepare the non-current assets section of the consolidated statement of financial position as at 31 March 20X8.**

e.g

Investor perspective

The method used to measure the non-controlling interest (NCI) at acquisition will have an impact on the consolidated financial statements.

Normally, the NCI figure will be higher if measured using the fair value method rather than the proportion of net assets method. This is because goodwill and equity are increased by the goodwill attributable to the NCI. As a result, the group may look more asset-rich to potential investors.

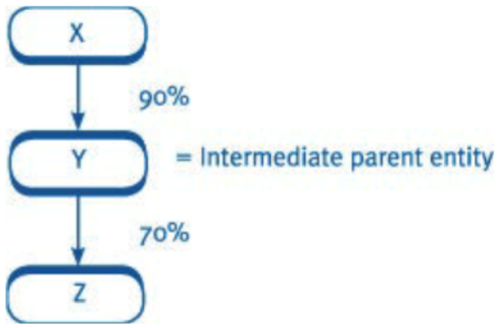
Using the fair value method will increase goodwill on the statement of financial position, and so goodwill impairments charged to profit or loss will be greater. In the long-term, this may lead to lower reported profits.

9 Exemptions from consolidation

Valid consolidation exemptions

Intermediate parent companies

An intermediate parent entity is an entity which has a subsidiary but is also itself a subsidiary of another entity. For example:



IFRS 10 permits a parent entity not to present group financial statements provided all of the following conditions apply:

- it is a wholly-owned, or partially-owned subsidiary where owners of the non-controlling interest do not object to the non-preparation
- its debt or equity instruments are not currently traded in a domestic or foreign market
- it is not in the process of having any of its debt or equity instruments traded on a domestic or foreign market
- the ultimate parent entity produces consolidated financial statements that comply with IFRS Standards and which are available to the public.

If this is the case, IAS 27 *Separate Financial Statements* requires that the following disclosures are made:

- the fact that consolidated financial statements have not been presented
- a list of significant investments (subsidiaries, joint ventures and associates) including percentage shareholdings, principal place of business and country of incorporation
- the bases on which those investments listed above have been accounted for in its separate financial statements.

Investment entities

An investment entity is defined by IFRS 10 as an entity that:

(a) obtains funds from investors and provides them with investment management services, and

(b) invests those funds to earn returns from capital appreciation, investment income, or both, and

(c) measures the performance of its investments on a fair value basis.

Investment entities do not consolidate an investment over which they have control. Instead, the investment is measured at fair value at each reporting date with gains and losses recorded in profit or loss.

Invalid reasons for excluding a subsidiary

In addition to the valid reasons to exclude a subsidiary from consolidation, directors of the parent entity may seek to exclude a subsidiary from group accounts for several invalid reasons, including:

- **Long-term restrictions on the ability to transfer funds to the parent**. This exclusion from consolidation is not permitted as it may still be possible to control a subsidiary in such circumstances.
- The **subsidiary undertakes different activities** and/or operates in different locations, thus being distinctive from other members of the group. This is not a valid reason for exclusion from consolidation. Indeed it could be argued that inclusion within the group accounts of such a subsidiary will enhance the relevance and reliability of the information contained within the group accounts.

- The **subsidiary has made losses or has significant liabilities** which the directors would prefer to exclude from the group accounts to improve the overall reported financial performance and position of the group. This could be motivated, for example, by determination of directors' remuneration based upon group financial performance. This is not a valid reason for exclusion from consolidation.
- The directors may seek to **disguise the true ownership of the subsidiary**, perhaps to avoid disclosure of particular activities or events, or to avoid disclosure of ownership of assets. This could be motivated, for example, by seeking to avoid disclosure of potential conflicts of interest which may be perceived adversely by users of financial statements.
- The directors may seek to exclude a subsidiary from consolidation in order for the group to **disguise its true size and extent**. This could be motivated, for example, by trying to avoid legal and regulatory compliance requirements applicable to the group or individual subsidiaries. This is not a valid reason for exclusion from consolidation.

Special purpose entities

A **special purpose entity** (SPE) is a subsidiary created by a parent company for a specific purpose. Since SPEs are separate legal entities, liable for their own debts, they might be used when the parent decides to embark on a new but risky venture. Alternatively, a parent company might set up a SPE to hold some of its debt, hence improving the parent’s separate statement of financial position.

There have been instances of groups not reporting SPEs in the group financial statements. This is frequently a breach of IFRS Standards. If a parent controls the SPE then its assets, liabilities, income and expenses must be consolidated.

10 IFRS 11 *Joint Arrangements*

Joint arrangements are defined '**as arrangements where two or more parties have joint control'** (IFRS 11, Appendix A). This will only apply if the relevant activities require unanimous consent of those who collectively control the arrangement.

Joint arrangements may take the form of either:

- joint operations
- joint ventures.

The key distinction between the two forms is based upon the parties’ rights and obligations under the joint arrangement.

Joint operations

Joint operations are defined as joint arrangements whereby **'the parties that have joint control have rights to the assets and obligations for the liabilities'** (IFRS 11, Appendix A). Normally, there will not be a separate entity established to conduct joint operations.

Example of a joint operation

A and B decide to enter into a joint operation to produce a new product. A undertakes one manufacturing process and B undertakes the other. A and B have agreed that decisions regarding the joint operation will be made unanimously and that each will bear their own expenses and take an agreed share of the sales revenue from the product.

Accounting treatment

If the joint operation meets the definition of a 'business' then the principles in IFRS 3 *Business Combinations* apply when an interest in a joint operation is acquired:

- Acquisition costs are expensed to profit or loss as incurred
- The identifiable assets and liabilities of the joint operation are measured at fair value
- The excess of the consideration transferred over the fair value of the net assets acquired is recognised as goodwill.

At the reporting date, the individual financial statements of each joint operator will recognise:

- its share of assets held jointly
- its share of liabilities incurred jointly
- its share of revenue from the joint operation
- its share of expenses from the joint operation.

The joint operator's share of the income, expenses, assets and liabilities of the joint operation are included in its individual financial statements and so they will automatically flow through to the consolidated financial statements.

Joint ventures

Joint ventures are defined as joint arrangements whereby **'the parties have joint control of the arrangement and have rights to the net assets of the arrangement'** (IFRS 11, Appendix A). This will normally be established in the form of a separate entity to conduct the joint venture activities.

Example of a joint venture

A and B decide to set up a separate entity, C, to enter into a joint venture. A will own 55% of the equity capital of C, with B owning the remaining 45%. A and B have agreed that decision-making regarding the joint venture will be unanimous. Neither party will have direct right to the assets, or direct obligation for the liabilities of the joint venture; instead, they will have an interest in the net assets of entity C set up for the joint venture.

Accounting treatment

In the individual financial statements, an investment in a joint venture can be accounted for:

- at cost
- in accordance with IFRS 9 *Financial Instruments*, or
- by using the equity method.

In the consolidated financial statements, the interest in the joint venture entity will be accounted for using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*. The treatment of a joint venture in the consolidated financial statements is therefore identical to the treatment of an associate.

Test your understanding 13 – A, B, C and D

A, B and C establish a new entity, which is called D. A has 50 per cent of the voting rights in the new entity, B has 30 per cent and C has 20 per cent. The contractual arrangement between A, B and C specifies that at least 75 per cent of the voting rights are required to make decisions about the activities of entity D.

Required:

Discuss how A should account for its investment in D in its consolidated financial statements?

Illustration 5 – Joint operation - Blast

Blast has a 30% share in a joint operation. The assets, liabilities, revenues and costs of the joint operation are apportioned on the basis of shareholdings. The following information relates to the joint arrangement activity for the year ended 30 November 20X2:

- The manufacturing facility cost $30m to construct and was completed on 1 December 20X1 and is to be dismantled at the end of its estimated useful life of 10 years. The present value of this dismantling cost to the joint arrangement at 1 December 20X1, using a discount rate of 8%, was $3m.
- During the year ended 30 November 20X2, the joint operation entered into the following transactions:
  - goods with a production cost of $36m were sold for $50m
  - other operating costs incurred amounted to $1m
  - administration expenses incurred amounted to $2m.

Blast has only accounted for its share of the cost of the manufacturing facility, amounting to $9m. The revenue and costs are receivable and payable by the two other joint operation partners who will settle amounts outstanding with Blast after each reporting date.

Required:

Show how Blast will account for the joint operation within its financial statements for the year ended 30 November 20X2.

Solution – Blast

Profit or loss impact:	$m
Revenue ($50m × 30%)	15.000
Cost of sales ($36m × 30%)	(10.800)
Operating costs ($1m × 30%)	(0.300)
Depreciation (($30m + 3m) × 1/10 × 30%)	(0.990)
Administration expenses ($2m × 30%)	(0.600)
Finance cost ($3m × 8% × 30%)	(0.072)
Share of net profit re joint operation (include in retained earnings within SOFP)	2.238

Statement of financial position impact:	$m
Property, plant and equipment (amount paid = share of cost)	9.000
Dismantling cost ($3m × 30%)	0.900
Depreciation ($33m × 1/10 × 30%)	(0.990)
	8.910
Trade receivables (i.e. share of revenue due)	15.000
Non-current liabilities:	
Dismantling provision (($3m × 30%) + $0.072)	0.972
Current liabilities:	
Trade payables ($10.8m + $0.3m + $0.6m) (i.e. share of expenses to pay)	11.700

The amounts calculated above should be classified under the appropriate headings within the statement of profit or loss for the year or statement of financial position as appropriate.

Note also that where there are amounts owed to and from a joint operating partner, it may be acceptable to show just a net amount due to or from each partner.

11 Other issues in group accounting

IFRS 12 *Disclosure of Interests in Other Entities*

IFRS 12 is the single source of disclosure requirements for business combinations. Disclosure requirements include:

- disclosure of significant assumptions and judgements made in determining whether an investor has control, joint control or significant influence over an investee
- disclosure of the nature, extent and financial effects of its interests in joint arrangements and associates
- additional disclosures relating to subsidiaries with non-controlling interests, joint arrangements and associates that are individually material
- significant restrictions on the ability of the parent to access and use the assets or to settle the liabilities of its subsidiaries.

IAS 27 *Separate Financial Statements*

IAS 27 applies when an entity has interests in subsidiaries, joint ventures or associates and either elects to, or is required to, prepare separate non-consolidated financial statements.

In separate financial statements, investments in subsidiaries, joint ventures or associates can be accounted for:

- at cost
- in accordance with IFRS 9 *Financial Instruments*, or
- by using the equity method.

In separate financial statements, dividends received from an investment are recognised in profit or loss unless the equity method is used. If the equity method has been used, then dividends received reduce the carrying amount of the investment.

Criticisms of IFRS 3 *Business Combinations*

The Board has conducted a post-implementation review of IFRS 3. Users of the standard raised the following issues.

Fair values

The requirement to fair value the assets and liabilities of the acquired subsidiary at the acquisition date makes it difficult to compare entities that grow via acquisitions with those that grow organically.

Recognising the inventory of a subsidiary at its acquisition date fair value will reduce profit margins in the next period, thus reducing comparability year-on-year.

Intangible assets

IFRS 3 requires entities to recognise separable intangibles at fair value at the acquisition date, but this is difficult and judgemental if no active market exists.

Contingent consideration

The calculation of the fair value of contingent consideration is subjective, increasing the risk of bias and reducing comparability.

Contingent consideration may be linked to the success of a long-term development project. It has been argued that changes in the fair value of the consideration in such scenarios should be recorded against the development asset, rather than in profit or loss.

Goodwill

Some have argued that a gain on a bargain purchase should not be recognised in profit or loss, but rather in other comprehensive income, because it distorts the performance profile of an entity.

Goodwill impairment reviews are complex, subjective and time-consuming.

Performing annual impairment reviews in respect of goodwill, rather than amortising it, increases volatility in profit or loss.

Over time, purchased goodwill will be replaced by internally generated goodwill. Per IAS 38 Intangible Assets, internally generated goodwill should not be recognised as an asset. As such, some argue that purchased goodwill should be amortised, rather than be subject to annual impairment review.

NCI

Allowing a measurement choice for the NCI at acquisition reduces comparability between entities.

Measuring the fair value of the NCI can be problematic, and highly judgemental, if the entity is not listed.

12 Exam focus

Question 1 in the SBR exam will always test group accounting. However, it will not ask for the production of full consolidated financial statements. Instead, candidates will be required to produce extracts from these statements and to explain the accounting numbers that they have produced. You should attempt the SBR specimen papers and past exam papers (included in the Exam Kit) to ensure you are comfortable with this style of requirement. The following question also provides relevant practice.

Test your understanding 14 – Fish

On 1 January 20X1, Fish acquired 80% of the ordinary shares of Lobster. The group accountant has calculated that the goodwill arising on acquisition was $40 million. However, the financial controller has uncovered a number of errors and requires advice about how to resolve them:

- No entries have been posted in respect of contingent cash consideration that will be paid in 20X5 if Lobster meets profit targets. The contingent consideration had a fair value of $4 million at acquisition and was calculated using a discount rate of 10%.
- No fair value adjustment has been recorded in respect of Lobster's non-depreciable land. This land had a carrying amount of $2 million at acquisition and a fair value of $3 million.
- Lobster's brand is internally generated and has not been recognised in the consolidated financial statements. At acquisition it had a fair value of $5 million and a remaining estimated useful life of 5 years.

Fish's policy is to value the non-controlling interest (NCI) at acquisition at fair value. The fair value of the NCI at acquisition was correctly calculated and included in the goodwill calculation.

Required:

Discuss how the above three issues should have been accounted for in the consolidated financial statements for the year ended 31 December 20X1. Provide the adjustments required to correct any errors. Ignore deferred tax.

13 Chapter summary

Revision of group SFP:
- Group structure (W1)
- Proforma and adding
- Workings 2 – 5

Revision of group P/L and OCI:
- Group structure
- Proforma and adding
- Profit and TCI split

Revision of associates:
- Use the equity method

Control:
- Power
- Rights to variable returns
- The ability to use power to affect returns

The acquisition method:
- Identify the acquirer
- Identify the acquisition date
- Recognise net assets at fair value
- Recognise goodwill and the NCI

Impairment of goodwill:
- Goodwill calculated under the proportionate method must be grossed up.

Joint arrangements:
- Joint operations
- Joint ventures

Test your understanding answers

Test your understanding 1 – Sparrow

Sparrow owns less than 20% of the ordinary shares of Blackbird. As such, per IAS 28 *Investments in Associates and Joint Ventures*, it would normally be presumed that significant influence does not exist.

Despite the above, there are several indications that significant influence does exist.

Firstly, Sparrow is able to appoint two directors to Blackbird's board of directors. Moreover, Blackbird is one of Sparrow's key suppliers, which means that there are high levels of transactions between the two entities. Finally, there is interchange of management personnel between the two entities.

As such, it can be concluded that Sparrow has significant influence over Blackbird. The directors are incorrect to account for Blackbird as a financial asset in the consolidated financial statements and should instead account for the investment as an associate.

Test your understanding 2 – Control

An investor controls an investee if the investor has:

- **'power over the investee**
- **exposure, or rights, to variable returns from its involvement with the investee**
- **the ability to use its power over the investee to affect the amount of the investor's returns'** (IFRS 10, para 7).

When assessing control, an investor considers its potential voting rights. Potential voting rights are rights to obtain voting rights of an investee, such as those arising from convertible instruments or options.

Potential voting rights are considered if the rights are substantive. This would mean that the rights need to be currently exercisable. Other factors that should be considered in determining whether potential voting rights are substantive, according to IFRS 10, include:

- whether the exercise price creates a financial barrier that would prevent (or deter) the holder from exercising its rights
- whether the party or parties that hold the rights would benefit from the exercise of those rights.

Parsley has voting rights that are currently exercisable and these should be factored into an assessment of whether control exists. The fact that the exercise price on the convertible instrument is out of the money (i.e. the exercise price is higher than the current market price) could potentially deter Parsley from taking up these voting rights.

However, these options are not deeply out of the money. This may also be compensated by the fact that synergies would arise on the acquisition. This would suggest that it is likely that Parsley will exercise the options. The potential voting rights should therefore be considered substantive.

Based on the above, Parsley has control over Oregano. Oregano should be treated as a subsidiary and consolidated.

Test your understanding 3 – Vertical group

H controls S because the size of its shareholding gives it the ability to affect variable returns through the power it exercises.

S controls T for the same reasons as above.

H is therefore also able to exert control over T by virtue of its ability to control S.

All three companies form a group. H is a parent company and S and T are its subsidiaries.

Test your understanding 4 – Taco

The houses are a group of similar assets and so the fair value of the total assets acquired is concentrated in a group of similar assets. This means that the purchase of Fajita's ordinary shares does not constitute a business combination. In substance, Taco is simply purchasing twenty houses.

Test your understanding 5 – Shepherd and Pie

Pie's assets are all buildings (and, potentially, associated land). However, the risks associated with operating residential properties are very different from those associated with operating office blocks and so these assets are dissimilar. This means that the fair value of the assets acquired is not concentrated in a single group of assets.

As such, Shepherd must engage in a more detailed assessment of whether Pie constitutes a business.

Pie's assets produce outputs because there are leases in place that generate rental income. However, the purchase of Pie does not constitute a business because a substantive process has not been acquired. This is because:

- there is no organised workforce in place that can produce outputs
- the security and cleaning services are relatively minor and could be easily replaced.

As such, the acquisition of Pie is, in substance, an asset acquisition and not a business combination.

Test your understanding 6 – Tahini and Kofta

The optional concentration test is not met because the fair value of the total assets acquired is not concentrated in a single asset or group of similar assets.

Tahini has purchased inputs (research and development, tangible assets, employees). It also appears to have purchased a substantive process because experienced employees will have knowledge of the rules and conventions that are capable of turning the other acquired inputs (in-progress research and development activities, and tangible equipment) into finished, marketable products.

As such, the acquisition of Kofta is a business combination.

Test your understanding 7 – Identifying the acquirer

If the business combination has not involved the transfer of cash or other assets, the acquirer is usually the entity that issues its equity interests. This might point towards Phone being the acquirer, since Phone has issued shares in exchange for the shares of Abacus and Calculator.

However, other circumstances must be considered:

- The acquirer is usually the entity whose (former) management dominates the management of the combined entity.
- The acquirer is usually the entity whose owners retain or receive the largest portion of the voting rights in the combined entity.
- The acquirer is normally the entity whose size is greater than the other entities.

All three of these circumstances would point towards Abacus being the acquirer. This would appear to reflect the substance of the transaction since Phone has been incorporated by Abacus as a way of enabling a business combination with Calculator.

Test your understanding 8 – Fair value of identifiable net assets

In the separate financial statements, the net assets are carried at $200,000 ($10,000 share capital + $190,000 retained earnings). In the consolidated financial statements, the identifiable net assets of a subsidiary must be recognised at fair value as at the acquisition date. An asset is identifiable if it is capable of separate disposal, or arises from legal or contractual rights.

Land is carried in the individual financial statements at $10,000. It should be recognised in the consolidated financial statements at $50,000. Therefore, its carrying amount must be increased by $40,000 ($50,000 – $10,000).

Goodwill in the subsidiary's own financial statements is not an identifiable asset because it cannot be disposed of separately from the rest of the business. As such, it is not recognised in the consolidated financial statements.

The brand is unrecognised in the individual financial statements but must be recognised in the consolidated financial statements at its fair value of $150,000.

The contingent liability is disclosed in the individual financial statements. However, it must be recognised in the consolidated financial statements at its fair value of $100,000. This is a liability and so reduces the total fair value of the identifiable net assets.

No adjustment is made to the fair value of the net assets for the estimated redundancy provision. This is because no obligation exists as at the acquisition date.

	$
Share capital	10,000
Retained earnings	190,000
Land fair value uplift	40,000
Goodwill	(20,000)
Brand	150,000
Contingent liability	(100,000)
Fair value of identifiable net assets at acquisition	270,000

Test your understanding 9 – Purchase consideration

Purchase consideration should be measured at its fair value as at the acquisition date.

With regards to deferred cash, this should be discounted to its present value and included in the goodwill calculation at a value of $181,818 (($200,000 × (1/1.1)). A liability should be recorded for the same amount.

Share consideration should be measured at its fair value of $30,000 (10,000 × $3) at the acquisition date. Credit entries should be posted to share capital ($10,000) and share premium ($20,000).

Contingent consideration should also be measured at its fair value of $113,636 (($250,000 × 50% × (1/1.1)). This fair value will incorporate the probability of payment and the time value of money. A corresponding entry should be made to provisions.

The fair value of the replacement share-based payment scheme should be allocated between purchase consideration and a post-acquisition expense. Only $400,000 should be allocated as purchase consideration because this is the fair value of the original scheme at the acquisition date. The remaining $100,000 is recognised immediately in the consolidated statement of profit or loss as a post-acquisition expense because there are no vesting conditions to satisfy.

Legal fees are expensed to the statement of profit or loss.

The total fair value of the consideration transferred is calculated below:

	$
Cash paid	300,000
Deferred cash	181,818
Shares	30,000
Contingent consideration	113,636
Replacement share-based payment	400,000
Fair value of consideration	1,025,454

Test your understanding 10 – Goodwill

	Fair value method	Net assets method
	$	$
Consideration (TYU 9)	1,025,454	1,025,454
Add: NCI at acquisition (part b = 40% × $270,000)	160,000	108,000
FV of identifiable net assets at acquisition (TYU 8)	(270,000)	(270,000)
	915,454	863,454

The fair value method calculates both the group's goodwill and the goodwill attributable to the non-controlling interest. Therefore, goodwill is higher under this method.

The proportion of net assets method only calculates the goodwill attributable to the group. Goodwill is lower under this method.

Test your understanding 11 – Happy

(a) **Full goodwill method**

Goodwill arising on acquisition:

	$000
Fair value of consideration paid	500
NCI at acquisition	130
	630
Less fair value of net assets at acquisition	(590)
Goodwill	40

Impairment review:

	$000
Goodwill	40
Net assets	520
Carrying amount	560
Recoverable amount	(530)
Impairment	30

The impairment loss is allocated against goodwill, reducing it from $40,000 to $10,000.

The $30,000 impairment expense will be charged to the statement of profit or loss. Of this, $24,000 (80% × $30,000) is attributable to the group and $6,000 (20% × $30,000) is attributable to the NCI.

(b) **Proportionate method**

Goodwill arising on acquisition:

	$000
Fair value of consideration paid	500
NCI at acquisition (20% × $590,000)	118
	618
Less: fair value of net assets at acquisition	(590)
Goodwill	28

Impairment review:

	$000	$000
Goodwill	28	
Unrecognised NCI (20/80 × $28,000)	7	
Total notional goodwill		35
Net assets		520
Carrying amount		555
Recoverable amount		(530)
Impairment		25

The impairment loss is firstly allocated to the notional goodwill. However, only the group's share of the goodwill was recognised in the financial statements and so only the group's share of the impairment is recognised.

The total impairment recognised is therefore $20,000 (80% × $25,000). This will be charged to the statement of profit or loss and is all attributable to the group.

Test your understanding 12 – Pauline

(a) **Consideration**

When calculating goodwill, IFRS 3 *Business Combinations* states that purchase consideration must be measured at fair value.

Pauline has issued 3 million shares (1/2 × 6m) and these must be valued at their fair value of $6 each. Share consideration will be included in the goodwill calculation at $18 million and a corresponding credit made to equity ($3 million share capital and $15 million share premium).

Cash consideration should be included in the goodwill calculation at its fair value of $7.5 million (6m × $1.25).

The current treatment of the $1 million professional fees is incorrect. These must be written off to the statement of profit or loss.

Fair value of net assets

At the acquisition date, Sonia's identifiable net assets must be measured at fair value.

The carrying amount of Sonia's net assets in its individual financial statements at acquisition is $20 million ($8m share capital + $12m retained earnings).

However, Sonia's brand name is an identifiable asset because it can be sold separately. Therefore, it must be included in the consolidated financial statements at its fair value of $2 million. This means that the fair value of Sonia's identifiable net assets at acquisition is $22 million ($20m + $2m).

The brand has an indefinite useful life so will not be amortised. It should be reviewed annually for impairment.

Non-controlling interest

IFRS 3 allows non-controlling interests (NCI) at acquisition to be valued at fair value or at the NCI's share of the subsidiary's identifiable net assets.

Pauline wishes to use the fair value method and so should value the NCI at $6.5 million (2m × $3.25). This will be included in the goodwill calculation and in the NCI balance within equity.

Goodwill at acquisition

Goodwill arising at acquisition is calculated as follows:

	$000
Fair value of consideration:	
Share exchange	18,000
Cash paid	7,500
FV of NCI at acquisition	6,500
Less FV of net assets at acquisition	(22,000)
Goodwill at acquisition	10,000

Impairment

Goodwill must be reviewed annually for impairment. An impairment review involves comparing an asset's carrying amount to its recoverable amount. Goodwill does not generate independent cash flows and so must be tested for impairment as part of a cash generating unit.

Pauline valued the NCI at acquisition at fair value. Therefore, full goodwill was calculated. This can be added to the carrying amount of Sonia's other net assets in the consolidated statements and compared with the recoverable amount on a like-for-like basis (i.e. no grossing up of goodwill is required).

	$000	$000
Goodwill (see calc. above)		10,000
Net assets:		
Share capital	8,000	
Retained earnings bfd	12,000	
Profit for the period	5,800	
Brand	2,000	
		27,800
Total carrying amount		37,800
Recoverable amount		(34,000)
Impairment		3,800

The impairment loss will reduce goodwill from $10 million to $6.2 million. The loss of $3.8 million will be charged to the statement of profit or loss.

Full goodwill has been calculated so the impairment expense must be allocated between the owners of the parent company ($3.8m × 75% = $2.85 million) and the NCI ($3.8m × 25% = $0.95m) in proportion to their shareholdings.

(b) **Arthur**

Pauline has acquired 30% of the ordinary shares of Arthur. According to IAS 28 *Investments in Associates and Joint Ventures* this should be presumed to give Pauline significant influence over Arthur. This means that Arthur is an associate and should be accounted for using the equity method in the consolidated financial statements.

The investment in Arthur should be initially recognised at its cost of $18 million (8m × 30% × $7.50).

Pauline will account for its share of Arthur's post-acquisition profits. This amounts to $3 million ($10m × 30%). This will be credited to the statement of profit or loss and debited to the investment in the associate.

The investment in the associate will therefore be carried in the consolidated financial statements at $21 million ($18m + $3m).

(c) **Extract from consolidated statement of financial position as at 31 March 20X8**

Non-current assets	$000
Property, plant and equipment ($36,800 + $20,800)	57,600
Goodwill ($10m – $3.8m impairment)	6,200
Intangible assets	2,000
Investment in associate	21,000
	86,800

Test your understanding 13 – A, B, C and D

A does not control the arrangement because it needs the agreement of B when making decisions. This would imply that A and B have joint control of the arrangement because decisions about the activities of the entity cannot be made without both A and B agreeing.

In the consolidated financial statements of the A Group, D should be treated as a joint venture. This is because it is a separate entity over which A has joint control. The joint venture will be accounted for using the equity method.

Test your understanding 14 – Fish

Contingent consideration

Contingent consideration should be included in the goodwill calculation at its fair value at the acquisition date. This will increase the value of goodwill by $4 million. A non-current liability should also be recognised. The entry to correct this is:

Dr Goodwill	$4m
Cr Liabilities	$4m

The discount on the contingent consideration should be unwound over the year. This gives rise to a finance cost of $0.4 million ($4m × 10%) in the statement of profit or loss and increases the carrying amount of the liability to $4.4 million. The entry to correct this is:

Dr Finance costs	$0.4m
Cr Liabilities	$0.4m

Land

IFRS 3 says that the identifiable net assets of the subsidiary should be consolidated at fair value. The property, plant and equipment balance therefore needs uplifting by $1 million. This will reduce the goodwill arising on acquisition by $1 million. The entry to correct this is:

Dr Property, plant and equipment	$1m
Cr Goodwill	$1m

Brand

The brand is an identifiable asset and so should have been consolidated at its fair value of $5 million as at the acquisition date. This reduces the goodwill balance by $5 million:

Dr Intangible assets	$5m
Cr Goodwill	$5m

The fair value adjustment should be amortised over its remaining useful life. This will give rise to an amortisation charge of $1 million ($5m/5 years) in the statement of profit or loss, reducing the carrying amount of the brand to $4 million.

Dr Profit or loss	$1m
Cr Intangible assets	$1m

Of the total $1 million expense, $0.8 million is attributable to the owners of the parent company and $0.2 million is attributable to the non-controlling interest.

Goodwill

The total goodwill arising on the acquisition of Fish is $38 million ($40m + $4m – $1m – $5m). This should be subject to annual impairment review.

Chapter

19

Change in a group structure

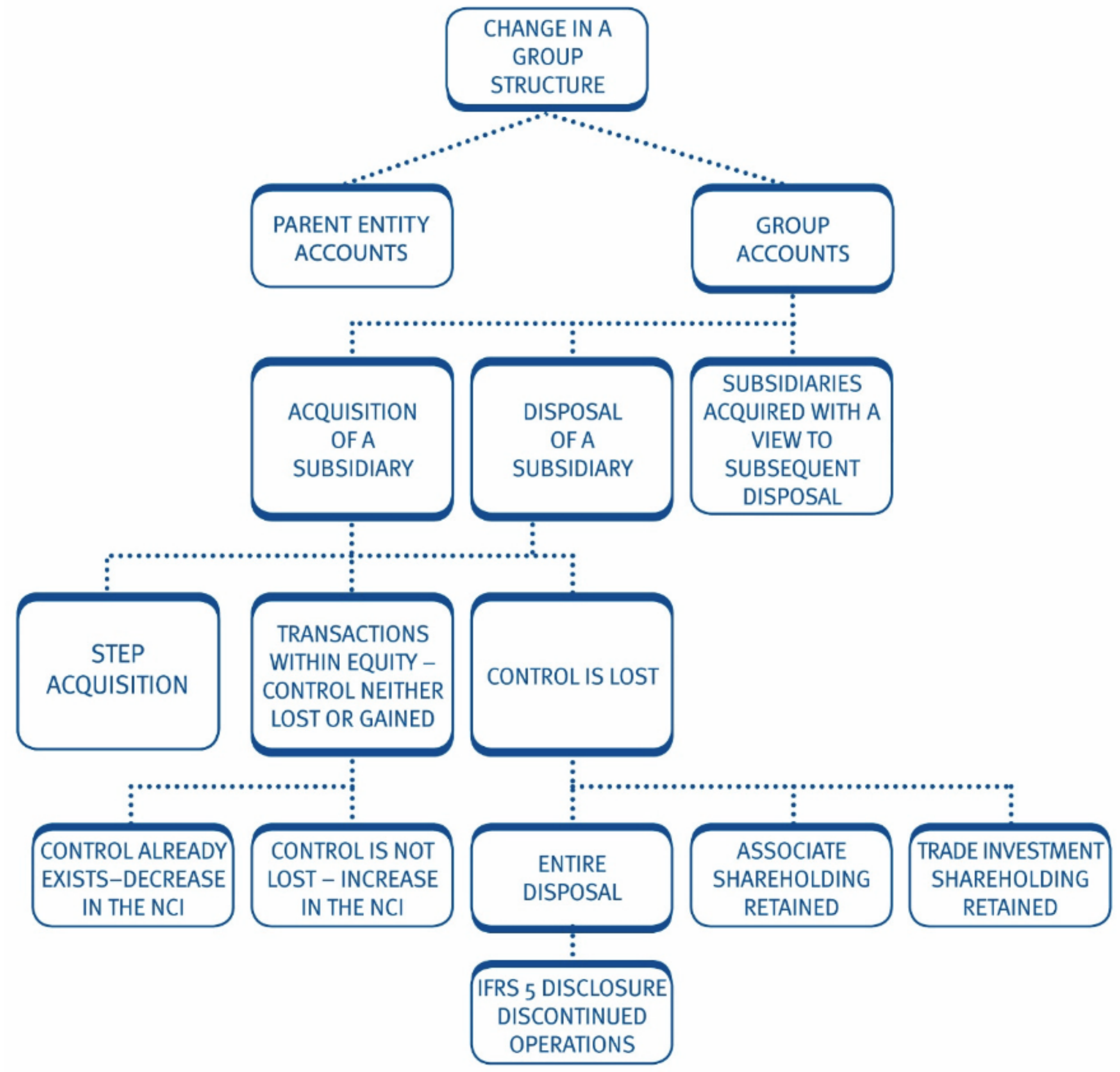
Chapter learning objectives

Upon completion of this chapter you will be able to:

- Apply the accounting principles relating to a business combination achieved in stages
- Discuss and apply the implications of changes in ownership interest and loss of control or significant influence
- Prepare group financial statements where activities have been discontinued, or have been acquired or disposed of in the period
- Discuss and apply the treatment of a subsidiary which has been acquired exclusively with a view to subsequent disposal.

PER

One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



1 Acquisition of a subsidiary

There are two acquisition scenarios that need to be considered in more detail:

- mid-year acquisitions
- step acquisitions.

Mid-year acquisitions

A parent entity consolidates a subsidiary from the date that it achieves control. If this happens partway through the reporting period then it will be necessary to pro-rate the results of the subsidiary so that only the post-acquisition income and expenses are consolidated into the group statement of profit or loss.

Illustration 1 – Tudor – mid-year acquisition of a subsidiary

On 1 July 20X4 Tudor purchased 1,600,000 of the 2,000,000 $1 equity shares of Windsor for $10,280,000. At the date of acquisition the retained earnings of Windsor were $6,150,000.

The statements of profit or loss for each entity for the year ended 31 March 20X5 were as follows.

	Tudor	**Windsor**
	$000	$000
Revenue	60,000	24,000
Cost of sales	(42,000)	(20,000)
	–––––––	–––––––
Gross profit	18,000	4,000
Distribution costs	(2,500)	(50)
Administrative expenses	(3,500)	(150)
	–––––––	–––––––
Profit from operations	12,000	3,800
Investment income	75	–
Finance costs	–	(200)
	–––––––	–––––––
Profit before tax	12,075	3,600
Tax	(3,000)	(600)
	–––––––	–––––––
Profit for the year	9,075	3,000
	–––––––	–––––––
Retained earnings bfd	16,525	5,400

There were no items of other comprehensive income in the year.

The following information is relevant:

1. The fair values of Windsor's net assets at the date of acquisition were equal to their carrying values with the exception of plant and equipment, which had a carrying value of $2,000,000 but a fair value of $5,200,000. The remaining useful life of this plant and equipment was four years at the date of acquisition. Depreciation is charged to cost of sales and is time apportioned on a monthly basis.
2. During the post-acquisition period Tudor sold goods to Windsor for $12 million. The goods had originally cost $9 million. During the remaining months of the year Windsor sold $10 million (at cost to Windsor) of these goods to third parties for $13 million.
3. Income and expenses accrued evenly throughout the year.

4 Tudor has a policy of valuing non-controlling interests using the full goodwill method. The fair value of non-controlling interest at the date of acquisition was $2,520,000.

5 The recoverable amount of the net assets of Windsor at the reporting date was $14,150,000. Any goodwill impairment should be charged to administrative expenses.

Required:

Prepare a consolidated statement of profit or loss for Tudor group for the year ended 31 March 20X5.

Solution

Tudor group statement of profit or loss for the year ended 31 March 20X5

	$000
Revenue ($60,000 + (9/12 × $24,000) – $12,000)	66,000
Cost of sales	
($42,000 + (9/12 × $20,000) – $12,000 + $600 (W6) + $500 (W5))	(46,100)
Gross profit	19,900
Distribution costs ($2,500 + (9/12 × $50))	(2,538)
Administrative expenses	
($3,500 + (9/12 × $150) + $300 (W2))	(3,912)
Profit from operations	13,450
Investment income ($75 + nil)	75
Finance costs (nil + (9/12 × $200))	(150)
Profit before tax	13,375
Tax ($3,000 + (9/12 × $600))	(3,450)
Profit after tax for the year	9,925
Profit attributable to:	
Owners of the parent (bal. fig)	9,655
Non-controlling interest (W7)	270
	9,925

There were no items of other comprehensive income in the year.

(W1) **Group structure – Tudor owns 80% of Windsor**

- the acquisition took place three months into the year
- nine months is post-acquisition.

(W2) **Goodwill impairment**

	$000
Net assets of the subsidiary (W3)	13,000
Goodwill (W4)	1,450
	14,450
Recoverable amount	(14,150)
Impairment	300

The impairment will be allocated against goodwill and charged to the statement of profit or loss.

Goodwill has been calculated using the fair value method so the impairment needs to be factored in when calculating the profit attributable to the NCI (W7).

(W3) **Net assets**

	Acq'n date	**Rep. date**
	$000	$000
Equity capital	2,000	2,000
Retained earnings	6,150	8,400
(Rep date = $5,400 bfd + $3,000)		
Fair value adjustment – PPE ($5.2m – $2.0m)	3,200	3,200
Depreciation on FVA (W6)	–	(600)
	11,350	13,000

(W4) **Goodwill**

	$000
Consideration	10,280
FV of NCI at acquisition	2,520
	12,800
FV of net assets at acquisition (W3)	(11,350)
Goodwill pre-impairment review (W2)	1,450

(W5) **PURP**

$2 million ($12m – $10m) of the $12 million intra-group sale remains in inventory.

The profit that remains in inventory is $500,000 (($12m – $9m) × 2/12).

(W6) **Excess depreciation**

Per W3, there has been a fair value uplift in respect of PPE of $3,200,000.

This uplift will be depreciated over the four year remaining life.

The depreciation charge in respect of this uplift in the current year statement of profit or loss is $600,000 (($3,200,000/4 years) × 9/12).

(W7) **Profit attributable to the NCI**

	$000	$000
Profit of Windsor (9/12 × $3,000)	2,250	
Excess depreciation (W6)	(600)	
Goodwill impairment (W2)	(300)	
	1,350	
× 20%		
Profit attributable to the NCI		270

Step acquisitions

A step acquisition occurs when the parent company acquires control over the subsidiary in stages. This is achieved by buying blocks of shares at different times. Acquisition accounting is only applied at the date when control is achieved.

- Any pre-existing equity interest in an entity is accounted for according to:
  - IFRS 9 in the case of financial instruments
  - IAS 28 in the case of associates and joint ventures
  - IFRS 11 in the case of joint arrangements other than joint ventures.
- At the date when the equity interest is increased and control is achieved:
  1. re-measure the previously held equity interest to fair value
  2. recognise the resulting gain or loss in profit or loss for the year (or in other comprehensive income if the shares had been designated to be measured at fair value through other comprehensive income)
  3. calculate goodwill and the non-controlling interest on either a partial or full basis.

For the purposes of the goodwill calculation, the consideration will be the fair value of the previously held equity interest plus the fair value of the consideration transferred for the most recent purchase of shares at the acquisition date. You may wish to use the following proforma:

	$
Fair value of previously held interest	X
Fair value of consideration for additional interest	X
NCI at acquisition	X
Less: FV of net assets at acquisition	(X)
Goodwill at acquisition	X

- Any gains and losses recognised in other comprehensive income from the re-measurement of any previously held equity interests cannot be reclassified to profit or loss.
- Purchasing further shares in a subsidiary after control has been acquired (for example taking the group interest from 60% to 75%) is regarded as a transaction between equity holders. Goodwill is not recalculated. This situation is dealt with separately in this chapter.

e.g

Illustration 2 – Ayre, Fleur and Byrne

Ayre has owned 90% of the ordinary shares of Fleur for many years. Ayre also has a 10% investment in the shares of Byrne, which was measured at fair value through profit or loss and held in the consolidated statement of financial position as at 31 December 20X6 at $24,000 in accordance with IFRS 9 *Financial Instruments*. On 30 June 20X7, Ayre acquired a further 50% of Byrne's equity shares at a cost of $160,000.

The draft statements of profit or loss for the three companies for the year ended 31 December 20X7 are presented below:

Statements of profit or loss for the year ended 31 December 20X7

	Ayre	**Fleur**	**Byrne**
	$000	$000	$000
Revenue	500	300	200
Cost of sales	(300)	(70)	(120)
Gross profit	200	230	80
Operating costs	(60)	(80)	(60)
Profit from operations	140	150	20
Income tax	(28)	(30)	(4)
Profit for the period	112	120	16

The non-controlling interest is calculated using the fair value method. On 30 June 20X7, fair values were as follows:

- Byrne's identifiable net assets – $200,000
- The non-controlling interest in Byrne – $100,000
- The original 10% investment in Byrne – $26,000

Required:

Prepare the consolidated statement of profit or loss for the Ayre Group for the year ended 31 December 20X7 and calculate the goodwill arising on the acquisition of Byrne.

Solution

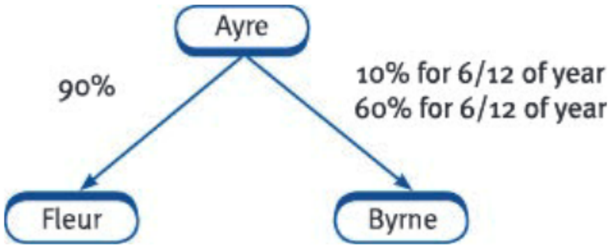
Group statement of profit or loss for the year ended 31 December 20X7

	$000
Revenue ($500 + $300 + (6/12 × $200))	900
Cost of sales ($300 + $70 + (6/12 × $120))	(430)
Gross profit	470
Operating costs ($60 + $80 + (6/12 × $60))	(170)
Profit from operations	300
Profit on derecognition of equity investment (W1)	2
	302
Income tax ($28 + $30 + (6/12 × $4))	(60)
Profit for the period	242
Profit attributable to:	
Equity holders of the parent (bal. fig)	226.8
Non-controlling interest (W2)	15.2
Profit for the period	242

Goodwill calculation

	$000
FV of previously held interest	26
FV of consideration for additional interest	160
NCI at acquisition date	100
FV of net assets at acquisition	(200)
	–––––
Goodwill	86
	–––––

(W1) **Group structure**



This is a step acquisition. The previous investment in shares must be revalued to fair value with the gain on revaluation recorded in the statement of profit or loss.

Dr Investment ($26,000 – $24,000)	$2,000
Cr Profit or loss	$2,000

The investment, now held at $26,000, is included in the calculation of goodwill.

Ayre had control over Byrne for 6/12 of the current year. Therefore 6/12 of the incomes and expenses of Byrne are consolidated in full.

(W2) **Profit attributable to the NCI**

	$000	$000
Profit of Fleur in consolidated profit or loss	120	
	––––	
× 10%		12
Profit of Byrne in consolidated profit or loss (6/12 × $16)	8	
	––––	
× 40%		3.2
		––––
Profit attributable to NCI		15.2
		––––

Test your understanding 1 – Major and Tom

Major, a public limited entity, has numerous subsidiaries and has prepared consolidated financial statements for many years.

Major acquired 40% of Tom's 100,000 $1 ordinary shares on 31 December 20X4 for $90,000 in cash. This holding gave Major significant influence over Tom. The retained earnings of Tom at this date were $76,000.

Major acquired a further 20% of Tom's ordinary shares on 31 December 20X6 for $70,000 in cash. On this date, the fair value of the previous 40% holding in Tom was $105,000 and Tom's retained earnings balance was $100,000. The non-controlling interest at acquisition should be valued using the proportion of net assets method.

Required:

Discuss how to account for the purchase of the additional 20% holding in Tom in the consolidated financial statements for the year ended 31 December 20X6.

2 Disposal of a subsidiary

During the year, one entity may sell some or all of its shares in another entity causing a loss of control.

Possible situations include:

1 the disposal of all the shares held in the subsidiary

2 the disposal of part of the shareholding, leaving a residual holding after the sale, which is regarded as an associate

3 the disposal of part of the shareholding, leaving a residual holding after the sale, which is regarded as a trade investment.

The accounting treatment of all of these situations is very similar.

Disposals in the individual financial statements

In all of the above scenarios, the profit on disposal in the investing entity's individual financial statements is calculated as follows:

	$
Sales proceeds	X
Carrying amount of shares sold	(X)
Profit/(loss) on disposal	X/(X)

The profit or loss may need to be reported as an exceptional item. If so, it must be disclosed separately on the face of the parent's statement of profit or loss for the year.

There may be tax to pay on this gain, depending on the tax laws in place in the parent's jurisdiction. This would result in an increase to the parent company's tax expense in the statement of profit or loss.

Disposals in the consolidated financial statements

If the sale of shares causes control over a subsidiary to be lost, then the treatment in the consolidated financial statements is as follows:

- Consolidate the incomes and expenses of the subsidiary up until the disposal date
- On disposal of the subsidiary, derecognise its assets, liabilities, goodwill and non-controlling interest and calculate a profit or loss on disposal
- Recognise any remaining investment in the shares of the former subsidiary at fair value and subsequently account for this under the relevant accounting standard
  - A holding of 20–50% of the shares would probably mean that the remaining investment is an associate, which should be accounted for using the equity method
  - A holding of less than 20% of the shares would probably mean that the remaining investment should be accounted for under IFRS 9 *Financial Instruments*.

Where control of a subsidiary has been lost, the following template should be used for the calculation of the profit or loss on disposal:

	$	$
Disposal proceeds		X
Fair value of retained interest		X
		–––
		X
Less interest in subsidiary disposed of:		
Net assets of subsidiary at disposal date	X	
Goodwill at disposal date	X	
Less: Carrying amount of NCI at disposal date	(X)	
	–––	
		(X)
		–––
Profit/(loss) to the group		X/(X)
		–––

Illustration 3 – Rock

Rock has held a 70% investment in Dog for two years. Goodwill has been calculated using the full goodwill method. There have been no goodwill impairments to date.

Rock disposes of all of its shares in Dog. The following information has been provided:

	$
Cost of investment	2,000
Dog – Fair value of net assets at acquisition	1,900
Dog – Fair value of the non-controlling interest at acquisition	800
Sales proceeds	3,000
Dog – Net assets at disposal	2,400

Required:

Calculate the profit or loss on disposal in:

(a) **Rock's individual financial statements**

(b) **the consolidated financial statements.**

Solution

(a) **Rock's individual financial statements**

	$
Sales proceeds	3,000
Cost of shares sold	(2,000)
Profit on disposal	1,000

(b) **Consolidated financial statements**

	$	$
Sales proceeds		3,000
Interest in subsidiary disposed of:		
Net assets at disposal	2,400	
Goodwill at disposal (W1)	900	
Carrying amount of NCI at disposal (W2)	(950)	
		(2,350)
Profit on disposal		650

(W1) **Goodwill**

	$
Consideration	2,000
FV of NCI at acquisition	800
	2,800
FV of net assets at acquisition	(1,900)
Goodwill	900

(W2) **NCI at disposal date**

	$
NCI at acquisition	800
NCI % of post-acquisition net assets (30% × ($2,400 – $1,900))	150
	950

Illustration 4 – Thomas and Percy

Thomas disposed of a 25% holding in Percy on 30 June 20X6 for $125,000. A 70% holding in Percy had been acquired five years prior to this. Thomas uses the full goodwill method. Goodwill was impaired and written off in full prior to the year of disposal.

Details of Percy are as follows:

	$
Net assets at disposal date	340,000
Fair value of a 45% holding at 30 June 20X6	245,000

The carrying amount of the NCI was $80,000 at the disposal date.

Required:

Discuss the accounting treatment of the above in the consolidated financial statements.

Solution

The group's holding in Percy has reduced from 70% to 45%. Control over Percy has been lost and a profit or loss on disposal must be calculated.

The profit on disposal to be included in the consolidated statement of profit or loss is calculated as follows:

	$	$
Proceeds		125,000
FV of retained interest		245,000
		———
		370,000
Net assets recognised at disposal	340,000	
Goodwill at disposal	–	
Less: NCI at disposal date	(80,000)	
	———	
		(260,000)
		———
Profit on disposal		110,000
		———

On 30 June 20X6, the remaining investment in Percy will be recognised at its fair value of $245,000. A 45% shareholding would normally give the investor significant influence over the investee and so this would meet the definition of an associate. From 30 June 20X6, the investment will be accounted for using the equity method in the consolidated financial statements.

Test your understanding 2 – Padstow

Padstow purchased 80% of the shares in St Merryn four years ago for $100,000. On 30 June it sold all of these shares for $250,000. The net assets of St Merryn at the acquisition date were $69,000 and at the disposal date were $88,000. Fifty per cent of the goodwill arising on acquisition had been written off in an earlier year. The fair value of the non-controlling interest in St Merryn at the date of acquisition was $15,000. It is group policy to account for goodwill using the full goodwill method.

Required:

(a) **Calculate the profit or loss arising to the parent entity on the disposal of the shares.**

(b) **Calculate the profit or loss arising to the group on the disposal of the shares.**

Test your understanding 3 – Hague

Hague has held a 60% investment in Maude for several years, using the full goodwill method to value the non-controlling interest. Half of the goodwill has been impaired prior to the date of disposal of shares by Hague. Details are as follows:

	$000
Cost of investment	6,000
Maude – Fair value of net assets at acquisition	2,000
Maude – Fair value of a 40% investment at acquisition date	1,000
Maude – Net assets at disposal	3,000
Maude – Fair value of a 25% investment at disposal date	3,500

Required:

(a) **Assuming a full disposal of the holding and proceeds of $10 million, calculate the profit or loss arising:**

(i) **in Hague's individual financial statements**

(ii) **in the consolidated financial statements.**

(b) **Assuming a disposal of a 35% holding and proceeds of $5 million:**

(i) **calculate the profit or loss arising in the consolidated financial statements**

(ii) **explain how the residual shareholding will be accounted for.**

Presentation of disposed subsidiary in the consolidated financial statements

There are two ways of presenting the results of the disposed subsidiary:

(i) Time-apportionment line-by-line

In the consolidated statement of profit or loss, the income and expenses of the subsidiary are consolidated up to the date of disposal. The traditional way is to time apportion each line of the disposed subsidiary's results.

The profit or loss on disposal of the subsidiary would be presented as an exceptional item.

(ii) Discontinued operation

If the subsidiary qualifies as a discontinued operation in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* then its results are aggregated into a single line on the face of the consolidated statement of profit or loss. This is presented immediately after profit for the period from continuing operations.

This single figure comprises:

– the profit or loss of the subsidiary up to the disposal date

– the profit or loss on the disposal of the subsidiary.

Test your understanding 4 – Kathmandu

The statements of profit or loss and extracts from the statements of changes in equity for the year ended 31 December 20X9 are as follows:

Statements of profit or loss for the year ended 31 December 20X9

	Kathmandu group	Nepal
	$	$
Revenue	553,000	450,000
Operating costs	(450,000)	(400,000)
Operating profits	103,000	50,000
Investment income	8,000	–
Profit before tax	111,000	50,000
Tax	(40,000)	(14,000)
Profit for the period	71,000	36,000

Extracts from SOCIE for year ended 31 December 20X9

	Kathmandu group	Nepal
	$	$
Retained earnings b/f	100,000	80,000
Profit for the period	71,000	36,000
Dividend paid	(25,000)	(10,000)
Retained earnings c/f	146,000	106,000

There were no items of other comprehensive income during the year.

Additional information

- The accounts of the Kathmandu group do not include the results of Nepal.
- On 1 January 20X5 Kathmandu acquired 70% of the shares of Nepal for $100,000 when the fair value of Nepal's net assets was $110,000. Nepal has equity capital of $50,000. At that date, the fair value of the non-controlling interest was $40,000. It is group policy to measure the NCI at fair value at the date of acquisition.
- Nepal paid its 20X9 dividend in cash on 31 March 20X9.
- Goodwill has not been impaired.

Required:

(a) **Prepare the group statement of profit or loss for the year ended 31 December 20X9 for the Kathmandu group on the basis that Kathmandu plc sold its holding in Nepal on 1 July 20X9 for $200,000. This disposal is not yet recognised in any way in Kathmandu group's statement of profit or loss. Assume that Nepal does not represent a discontinued operation per IFRS 5.**

(b) **Explain and illustrate how the presentation of the group statement of profit or loss would differ from part (a) if Nepal represented a discontinued activity per IFRS 5.**

(c) **Prepare the group statement of profit or loss for the year ended 31 December 20X9 for the Kathmandu group on the basis that Kathmandu sold half of its holding in Nepal on 1 July 20X9 for $100,000 This disposal is not yet recognised in any way in Kathmandu group's statement of profit or loss. The residual holding of 35% has a fair value of $100,000 and leaves the Kathmandu group with significant influence over Nepal.**

3 Control to control scenarios

In this chapter, we have looked at:

- share purchases that have led to control over another company being obtained
- share sales that have led to control over another company being lost.

However, some share purchases will simply increase an entity's holding in an already existing subsidiary (e.g. increasing a holding from 80% to 85%). Similarly, some share sales will not cause an entity to lose control over a subsidiary (e.g. decreasing a holding from 80% to 75%).

These 'control to control' scenarios will now be considered in more detail.

Increasing a shareholding in a subsidiary (e.g. 80% to 85%)

When a parent company increases its shareholding in a subsidiary, this is not treated as an acquisition in the group financial statements. For example, if the parent holds 80% of the shares in a subsidiary and buys 5% more, then the relationship remains one of a parent and subsidiary. However, the NCI holding has decreased from 20% to 15%.

The accounting treatment of the above situation is as follows:

- The NCI within equity decreases
- The difference between the consideration paid for the extra shares and the decrease in the NCI is accounted for within equity (normally, in 'other components of equity').

Note that **no profit or loss** arises on the purchase of the additional shares. Goodwill is **not recalculated**.

The following proforma will help to calculate the adjustments required to NCI and other components of equity:

	$	
Cash paid	X	Cr
Decrease in NCI	(X)	Dr
	–––––	
Decrease/(increase) to other components of equity	X/(X)	Dr/Cr (bal. entry)
	–––––	

The decrease in NCI will represent the proportionate reduction in the carrying amount of the NCI at the date of the group's additional purchase of shares. For example, if the NCI shareholding reduces from 30% to 20%, then the carrying amount of the NCI must be reduced by one-third.

Test your understanding 5 – Gordon and Mandy

Gordon has owned 80% of Mandy for many years.

Gordon is considering acquiring more shares in Mandy. The NCI of Mandy currently has a carrying amount of $20,000, with the net assets and goodwill having a carrying amount of $125,000 and $25,000 respectively.

Gordon is considering the following two scenarios:

(i) Gordon could buy 20% of the Mandy shares leaving no NCI for $25,000, or

(ii) Gordon could buy 5% of the Mandy shares for $4,000 leaving a 15% NCI.

Required:

Calculate the adjustments required to NCI and other components of equity.

Sale of shares without losing control (e.g. 80% to 75%)

From the perspective of the group accounts, a sale of shares which results in the parent retaining control over the subsidiary is simply a transaction between shareholders. If the parent company holds 80% of the shares of a subsidiary but then sells a 5% holding, a relationship of control still exists. As such, the subsidiary will still be consolidated in the group financial statements. However, the NCI has risen from 20% to 25%.

The accounting treatment of the above situation is as follows:

- The NCI within equity is increased
- The difference between the proceeds received and the increase in the non-controlling interest is accounted within equity (normally, in 'other components of equity').

Note that **no profit or loss** arises on the sale of the shares. Goodwill is **not recalculated**.

The following proforma will help to calculate the adjustments required to NCI and other components of equity:

	$	
Cash proceeds received	X	Dr
Increase in NCI	(X)	Cr
Increase/(Decrease) to other components of equity	X/(X)	Cr/Dr (bal. entry)

The increase in the NCI will be the share of the net assets (always) and goodwill (fair value method only) of the subsidiary at the date of disposal which the parent has effectively sold to the NCI.

- For example, if the NCI shareholding increases from 20% to 30%, then the carrying amount of the NCI must be increased by 10% of the subsidiary's net assets and, if using the fair value method, goodwill.

Illustration 5 – No loss of control – Juno

Until 30 September 20X7, Juno held 90% of Hera. On that date it sold a 10% interest in the equity capital for $15,000. At the date of the share disposal, the carrying amount of net assets and goodwill of Hera were $100,000 and $20,000 respectively. At acquisition, the NCI was valued at fair value.

Required:

Discuss the treatment of the above in the Juno Group's financial statements?

Solution

Juno's shareholding has decreased from 90% to 80%. Juno still exercises control over Hera and therefore Hera continues to be a subsidiary.

No gain or loss on the sale of the shares is recognised in the consolidated financial statements. Goodwill is not recalculated. Instead, the transaction is accounted for in equity, as an increase to the non-controlling interest.

	$
Cash proceeds	15,000 Dr
Increase in NCI: 10% × ($100,000 + $20,000)	(12,000) Cr
	–––––
Increase in other components of equity (bal. fig)	3,000 Cr
	–––––

The non-controlling interest should be increased by $12,000. The difference between the proceeds received and the increase in the non-controlling interest is $3,000 and this will be recognised as an increase to the equity attributable to the owners of Juno.

Test your understanding 6 – David and Goliath

David has owned 90% of Goliath's ordinary shares for many years. On the last day of the reporting period, David sold 5% of Goliath's ordinary shares for $5,000 (leaving it with a holding of 85%).

At the date of the sale, net assets and goodwill of Goliath were carried in the consolidated financial statements at $70,000 and $20,000 respectively. The NCI of Goliath at acquisition was valued at fair value.

Required:

Discuss how the share sale should be accounted for in the consolidated financial statements of the David group?

Test your understanding 7 – Pepsi

Statements of financial position for three entities at the reporting date are as follows:

	Pepsi	**Sprite**	**Tango**
	$000	$000	$000
Assets	1,000	800	500
Investment in Sprite	326	–	–
Investment in Tango	165	–	–
	–––––	–––––	–––––
Total assets	1,491	800	500
	–––––	–––––	–––––

Equity			
Ordinary share capital ($1)	500	200	100
Retained earnings	391	100	200
	–––––	–––––	–––––
	891	300	300
Liabilities	600	500	200
	–––––	–––––	–––––
Total equity and liabilities	1,491	800	500
	–––––	–––––	–––––

Investment in Sprite

Pepsi acquired 80% of Sprite when Sprite's retained earnings were $25,000, paying cash consideration of $300,000. It is group policy to measure NCI at fair value at the date of acquisition. The fair value of the NCI holding in Sprite at acquisition was $65,000.

At the reporting date, Pepsi purchased an additional 8% of Sprite's equity shares for cash consideration of $26,000. This amount has been debited to Pepsi's investment in Sprite.

Investment in Tango

Pepsi acquired 75% of Tango when Tango's retained earnings were $60,000, paying cash consideration of $200,000. The fair value of the NCI holding in Tango at the date of acquisition was $50,000.

At the reporting date, Pepsi sold 10% of the equity shares of Tango for $35,000. The cash proceeds have been credited to Pepsi's investment in Tango.

Required:

Discuss how to account for the purchase of the additional 8% holding in Sprite’s equity shares and the sale of the 10% holding in Tango’s equity shares.

4 Subsidiaries acquired exclusively with a view to resale

A subsidiary acquired exclusively with a view to resale is not exempt from consolidation. However, if it meets the 'held for sale' criteria in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*:

- it is presented in the financial statements as a disposal group classified as held for sale. This is achieved by amalgamating all its assets into one line item and all its liabilities into another
- it is measured, both on acquisition and at subsequent reporting dates, at fair value less costs to sell.

The 'held for sale' criteria in IFRS 5 include the requirements that:

- the subsidiary is available for immediate sale
- the sale is highly probable
- it is likely to be disposed of within one year of the date of its acquisition.

A newly acquired subsidiary which meets these held for sale criteria automatically meets the criteria for being presented as a discontinued operation.

Illustration 6 – IFRS 5

David acquires Rose on 1 March 20X7. Rose is a holding entity with two wholly-owned subsidiaries, Mickey and Jackie. Jackie is acquired exclusively with a view to resale and meets the criteria for classification as held for sale. David's year-end is 30 September.

On 1 March 20X7 the following information is relevant:

- the identifiable liabilities of Jackie have a fair value of $40m
- the acquired assets of Jackie have a fair value of $180m
- the expected costs of selling Jackie are $5m.

On 30 September 20X7, the assets of Jackie have a fair value of $170m.

The liabilities have a fair value of $35m and the selling costs remain at $5m.

Discuss how Jackie will be treated in the David Group financial statements on acquisition and at 30 September 20X7.

Solution

On acquisition the assets and liabilities of Jackie are measured at fair value less costs to sell in accordance with IFRS 5:

	$m
Assets	180
Less selling costs	(5)
	175
Liabilities	(40)
Fair value less costs to sell	135

At the reporting date, the assets and liabilities of Jackie are remeasured to update the fair value less costs to sell.

	$m
Assets	170
Less selling costs	(5)
	165
Liabilities	(35)
Fair value less costs to sell	130

The fair value less costs to sell has decreased from $135m on 1 March to $130m on 30 September. This $5m reduction in fair value must be presented in the consolidated statement of profit or loss as part of the single line item entitled 'discontinued operations'. Also included in this line is the post-tax profit or loss earned/incurred by Jackie in the March – September 20X7 period.

The assets and liabilities of Jackie must be disclosed separately on the face of the statement of financial position. Jackie's assets will appear below the subtotal for the David group's current assets:

	$m
Non-current assets classified as held for sale	165

Jackie's liabilities will appear below the subtotal for the David group's current liabilities:

	$m
Liabilities directly associated with non-current assets classified as held for sale	35

No other disclosure is required.

5 Disposal of an associate

When significant influence over an associate is lost - most likely as a result of a share sale – then the investment in the associate is derecognised. Any shares retained are likely to fall within the scope of IFRS 9 *Financial Instruments* and should be recognised at fair value.

A profit or loss on disposal will arise in the consolidated statement of profit or loss. This is calculated as follows:

	$
Disposal proceeds	X
Fair value of retained interest	X
Carrying amount of associate at disposal	(X)
Profit/(loss) to the group	X/(X)

Test your understanding 8 – Raven

Raven purchased 25% of the ordinary shares of Sword's ordinary shares on 1 January 20X1 for $1 million, giving Raven significant influence over Sword. On this date, Sword had retained earnings of $3 million.

On 30 June 20X2, Raven sold 20% of Sword's ordinary shares (leaving it with a 5% holding) for $2 million. The balance on Sword's retained earnings on this date was $3.8 million. Sword has never had any other components of equity.

A 5% holding in the ordinary shares of Sword was worth $0.5 million on 30 June 20X2 and $0.6 million on 31 December 20X2.

Required:

Discuss the accounting treatment of the above in the year ended 31 December 20X2.

6 Group reorganisation

What is a reorganisation?

A group reorganisation (or restructuring) is any of the following:

(a) the transfer of shares in a subsidiary from one group entity to another

(b) the addition of a new parent entity to a group

(c) the transfer of shares in one or more subsidiaries of a group to a new entity that is not a group entity but whose shareholders are the same as those of the group's parent

(d) the combination into a group of two or more companies that before the combination had the same shareholders

(e) the acquisition of the shares of another entity that itself then issues sufficient shares so that the acquired entity has control of the combined entity.

Reorganisations and individual financial statements

A parent may reorganise the structure of its group by establishing a new entity as its parent. In this case, as long as certain criteria are met, the new parent records the cost of the original parent in its separate financial statements as the carrying amount of **'its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation'** (IAS 27, para 13). The criteria that must be met are as follows:

- **'The new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent**

- **The assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation**
- **The owners of the original parent before the reorganisation have the same absolute and relative interests in the net assets of the original group and the new group immediately before and after the reorganisation'** (IAS 27, para 13).

The above rule also applies when an entity that is not a parent establishes a new entity as its parent.

Reorganisations and consolidated financial statements

Assuming that all subsidiaries are 100% owned, a group reorganisation generally has no impact on the consolidated financial statements. This is because assets and investments are being moved around within the group.

7 Exam focus

Question 1 in the SBR exam will always test group accounting but will not ask for the production of full consolidated financial statements. Candidates will be required to produce extracts from these statements and to explain the numbers that they have produced. You should attempt the SBR specimen papers and past exam papers (included in the Exam Kit) to ensure you are comfortable with this style of requirement. The following question also provides relevant practice.

Test your understanding 9 – Liesel

Liesel Group has a reporting date of 31 December 20X1 and prepares its financial statements in accordance with IFRS Standards. The directors of Liesel require advice about the impact of a number of share transactions on the consolidated financial statements.

Rosa

Six years ago, Liesel purchased 85% of the ordinary shares of Rosa. The non-controlling interest at acquisition was measured at fair value. On 31 December 20X1, Liesel sold a 5% holding in Rosa for $9 million, and therefore reduced its stake to 80%. At this date, the goodwill and net assets of Rosa were carried at $8 million and $120 million respectively. The directors of Liesel have posted the following accounting entry in the consolidated financial statements:

Dr Cash	$9m
Cr Profit or loss	$9m

Hans

Several years ago Liesel purchased 70% of the ordinary shares of Hans for $105 million. At the acquisition date the carrying amount of the net assets of Hans was $100 million. The identifiable net assets of Hans were carried at fair value with the exception of freehold non-depreciable land which had a carrying amount of $5 million and a fair value of $15 million. The non-controlling interest was measured at its fair value of $36 million.

On 1 October 20X1, Liesel sold a 40% holding in the ordinary shares of Hans for $72 million. The cash received has been recognised in the consolidated financial statements and the other side of the entry has been posted to a suspense account. The directors believe that the remaining 30% holding gives Liesel significant influence over Hans. The fair value of the 30% holding on 1 October 20X1 was $51 million. Extracts from the individual (non-consolidated) financial statements of Hans for the year ended 31 December 20X1 are provided below:

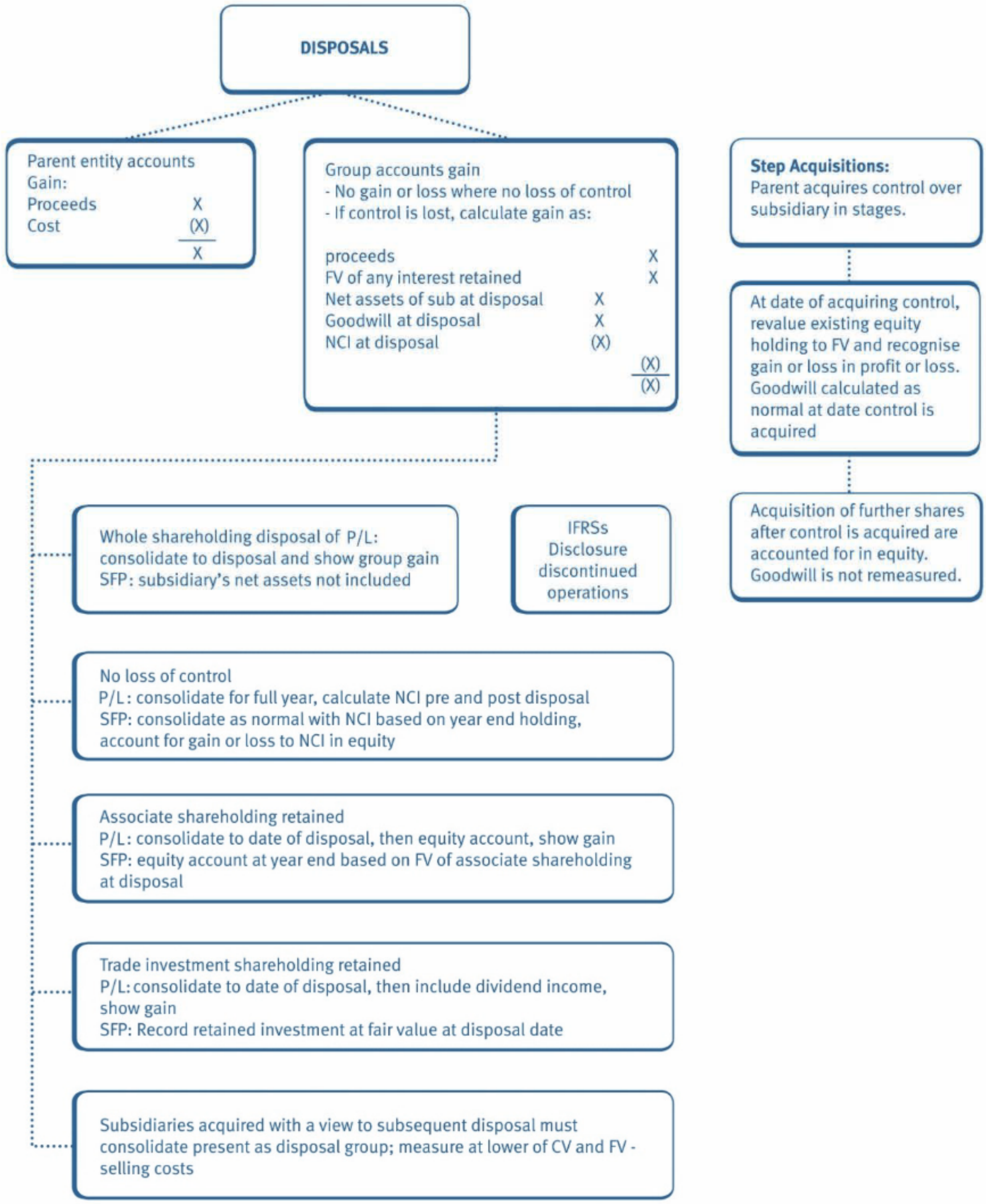
	$m
Share capital	8
Retained earnings as at 1 January 20X1	130
Profit for year ended 31 December 20X1	20

The directors of Liesel Group are unsure how they should have treated the investment in Hans in the consolidated financial statements for the year ended 31 December 20X1.

Required:

Explain, with calculations, how the above share transactions should be dealt with in the consolidated financial statements for the year ended 31 December 20X1.

8 Chapter summary



Test your understanding answers

Test your understanding 1 – Major and Tom

Acquisition of Tom

Major has increased its holding in Tom from 40% to 60% and so has achieved control in stages. IFRS 3 *Business Combinations* states that the previous investment must be revalued to fair value with any gain or loss presented in the statement of profit or loss.

The prior 40% holding gave Major significant influence over Tom. This means that Tom would previously have been classified as an associate and accounted for using the equity method. The investment in Tom would have initially been recognised at its cost of $90,000. Major would subsequently have recognised its share of Tom's profits and other comprehensive income. As such, by 31 December 20X6, the investment in Tom would have been carried at $99,600 ($90,000 + 40% × ($100,000 – $76,000)) in the consolidated financial statements.

On the date that control is achieved, this previous investment will be revalued to its fair value of $105,000 and included in the goodwill calculation. A gain of $5,400 ($105,000 – $99,600) is recorded in profit or loss.

Now that control has been achieved, Major must measure and recognise Tom's identifiable net assets at fair value in the consolidated financial statements. Major must also recognise goodwill arising on the acquisition. This is calculated as follows:

	$
Fair value of previously held interest	105,000
Fair value of consideration for additional interest	70,000
NCI at acquisition (40% × $200,000)	80,000
Less: FV of net assets at acquisition ($100,000 share cap + $100,000 ret. earns.)	(200,000)
Goodwill at acquisition	55,000

Test your understanding 2 – Padstow

(a) **Profit to Padstow**

	$000
Sales proceeds	250
Cost of shares sold	(100)
Profit on disposal	150

(b) **Consolidated accounts**

	$000	$000
Sales proceeds		250
Net assets at disposal date	88.0	
Goodwill at disposal date (W1)	23.0	
Less: NCI at disposal date (W2)	(14.2)	
		(96.8)
Profit on disposal		153.2

(W1) **Goodwill**

	$000
Consideration	100.0
NCI at acquisition	15.0
FV of net assets at acquisition	(69.0)
Goodwill at acquisition	46.0
Impairment ($46 × 50%)	(23.0)
Goodwill at disposal date	23.0

(W2) **NCI at disposal date**

	$000
NCI at acquisition	15.0
NCI % of post-acq'n net assets movement (20% × ($88.0 – $69.0))	3.8
NCI % of impairment (20% × $23.0 (W1))	(4.6)
	14.2

Test your understanding 3 – Hague

(a) **Full disposal**

(i) **Profit in Hague's individual financial statements**

	$000
Sale proceeds	10,000
Cost of shares	(6,000)
Profit on disposal	4,000

(ii) **Profit in consolidated financial statements**

	$000	$000
Sale proceeds		10,000
FV of retained interest		nil
CV of subsidiary at disposal:		
Net assets at disposal:	3,000	
Goodwill at disposal (W1)	2,500	
Less: NCI at disposal date (W2)	(400)	
		(5,100)
Profit on disposal		4,900

(W1) **Goodwill**

	$000
Consideration	6,000
NCI at acquisition	1,000
FV of NA at acquisition	(2,000)
Goodwill at acquisition	5,000
Impaired (50%)	(2,500)
Goodwill at disposal	2,500

(W2) **NCI at disposal date**

	$000
NCI at acquisition	1,000
NCI share of post-acquisition net assets (40% × ($3,000 – $2,000))	400
Less: NCI share of goodwill impairment (40% × $2,500) (W1)	(1,000)
	400

(b) **Disposal of a 35% shareholding**

(i) **Profit in consolidated financial statements**

	$000	$000
Disposal proceeds		5,000
FV of retained interest		3,500
		8,500
CV of subsidiary at disposal date:		
Net assets at disposal	3,000	
Goodwill at disposal (W1)	2,500	
Less: NCI at disposal date (W2)	(400)	
		(5,100)
Profit on disposal		3,400

(ii) After the date of disposal, the residual holding will be accounted for using the equity method in the consolidated financial statements:

– The statement of profit or loss will show the group's share of the current year profit earned by the associate from the date significant influence was obtained.

– The statement of financial position will show the carrying value of the investment in the associate. This will be the fair value of the retained shareholding at the disposal date plus the group's share of the increase in reserves from this date.

Test your understanding 4 – Kathmandu

(a) **Consolidated statement of profit or loss – full disposal**

	$
Revenue ($553,000 + (6/12 × $450,000))	778,000
Operating costs ($450,000 + (6/12 × $400,000))	(650,000)
Operating profit	128,000
Investment income ($8,000 – ($10,000 × 70%))	1,000
Profit on disposal (W1)	80,400
Profit before tax	209,400
Tax ($40,000 + (6/12 × $14,000))	(47,000)
Profit for the period	162,400
Attributable to:	
Equity holders of Kathmandu (bal. fig)	157,000
Non-controlling interest (W5)	5,400
	162,400

There were no items of other comprehensive income during the year.

(b) **Group statement of profit or loss – discontinued operations presentation**

	$
Revenue	553,000
Operating costs	(450,000)
Operating profit	103,000
Investment income ($8,000 – (70% × $10,000))	1,000
Profit before tax	104,000
Tax	(40,000)
Profit for the period from continuing operations	64,000
Profit from discontinued operations (($36,000 × 6/12) + $80,400 (W1))	98,400
	162,400

Attributable to:	
Equity holders of Kathmandu (bal. fig)	157,000
Non-controlling interest (W5)	5,400
	———
	162,400
	———

There were no items of other comprehensive income during the year.

Notice that the post-tax results of the subsidiary up to the date of disposal are presented as a one-line entry in the group statement of profit or loss. There is no line-by-line consolidation of results when this method of presentation is adopted.

(c) **Consolidated statement of profit or loss – partial disposal**

	$
Revenue ($553,000 + (6/12 × $450,000)	778,000
Operating costs ($450,000 + (6/12 × $400,000))	(650,000)
	———
Operating profit	128,000
Investment income ($8,000 – (70% × $10,000)	1,000
Income from associate (35% × $36,000 × 6/12)	6,300
Profit on disposal (W6)	80,400
	———
Profit before tax	215,700
Tax ($40,000 + (6/12 × $14,000))	(47,000)
	———
Profit for the period	168,700
	———

There were no items of other comprehensive income during the year.

Attributable to:	
Equity holders of Kathmandu (bal. fig)	163,300
Non-controlling interest (W5)	5,400
	———
	168,700
	———

(W1) **Profit on full disposal (part a)**

	$	$
Proceeds		200,000
Interest in subsidiary disposed of:		
Net assets at disposal (W2)	138,000	
Goodwill at disposal (W3)	30,000	
NCI at date of disposal (W4)	(48,400)	
		(119,600)
Profit on disposal		80,400

(W2) **Net assets of Nepal at disposal**

	$
Share capital	50,000
Retained earnings b/f	80,000
Profit up to disposal date (6/12 × $36,000)	18,000
Dividend paid prior to disposal	(10,000)
Net assets at disposal	138,000

(W3) **Goodwill**

	$
Consideration	100,000
FV of NCI at date of acquisition	40,000
FV of net assets at date of acquisition	(110,000)
Goodwill	30,000

(W4) **NCI at disposal date**

FV of NCI at date of acquisition	40,000
NCI share of post-acquisition net assets (30% × ($138,000 (W2) – $110,000)	8,400
	48,400

(W5) Profit attributable to NCI

	$	$
Profit of Nepal (6/12 × $36,000)	18,000	
× 30%	18,000	
Profit attributable to NCI		5,400

(W6) Profit on part disposal (part c)

	$	$
Proceeds		100,000
FV of retained interest (per question)		100,000
		200,000
Net assets at disposal (W2)	138,000	
Goodwill at disposal date (W3)	30,000	
NCI at date of disposal (W4)	(48,400)	
		(119,600)
Profit on disposal		80,400

Test your understanding 5 – Gordon and Mandy

(i) **Purchase of 20% of Mandy shares**

	$	
Cash paid	25,000	Cr
Decrease in NCI ((20%/20%) × 20,000)	(20,000)	Dr
Decrease in other components of equity	5,000	Dr

(ii) **Purchase of 5% of Mandy shares**

	$	
Cash paid	4,000	Cr
Decrease in NCI ((5%/20%) × 20,000)	(5,000)	Dr
Increase in other components of equity	(1,000)	Cr

Test your understanding 6 – David and Goliath

David has reduced its holding in Goliath from 90% to 85%. Goliath is a subsidiary of David both before and after the sale. As such, no gain or loss arises in the consolidated financial statements and goodwill is not remeasured.

In the consolidated financial statements, the transaction is accounted for in equity, as an increase to the non-controlling interest. The difference between the $5,000 proceeds received and the increase to the non-controlling interest of $4,500 (W1) is recognised as an increase of $500 (W1) to group equity.

(W1) **Sale of 5% of Goliath shares**

	$	
Cash proceeds	5,000	Dr
Increase in NCI (5% × ($70,000 + $20,000)	(4,500)	Cr
Increase in other components of equity	500	Cr

Test your understanding 7 – Pepsi

Purchase of additional 8% of Sprite

The purchase has increased Pepsi's holding in Sprite from 80% to 88%. Sprite was a subsidiary before and after the purchase so there has been no change in control status. This means that no gain or loss arises on the transaction in the group financial statements and goodwill is not remeasured.

The transaction is accounted for in equity as a decrease in the non-controlling interest. The decrease in NCI will represent the proportionate reduction in the carrying amount of the NCI at the date of Pepsi's additional purchase of shares.

The difference between the consideration paid of $26,000 and the decrease in the non-controlling interest of $32,000 (W1) amounts to $6,000. This will be recorded as an increase to other components of equity.