CIMA F2 Course Notes

Chapter 1

Group Accounts: Introduction

1. The concept of group accounts

Business combination

A business can expand its operation by either slowly growing organically or faster via acquisition. It does this perhaps to increase its market share by acquiring its competitors or it could be trying to integrate and secure its supply chain. The acquisition results in a **business combination** of the entities.

What is a group?

In a business combination, one entity **controls** one or more other entities. This relationship is known as a **group**. Percentage ownership is used as a guide to degree of control (or influence). An entity can achieve control by having more than 50% of the ordinary shares of another entity and hence its voting rights. The controlling entity is referred to as the **parent** (or holding company). The controlled entity is known as a **subsidiary**.

There are situations in which a parent may not own the majority of the voting rights, but control still exists. This is determined by the degree of **power** (or dominant influence). This can be exercised, for instance, to cast the majority of voting rights and appoint/remove directors.

Legally, the parent and its subsidiary remain distinct and as such they still prepare individual financial statements. However in **economic substance** they can be regarded as a single entity (a 'group'), and as such, the parent is required to prepare accounts for the group as a whole.

Groups and the basis of consolidated accounts

So, where a group relationship exists (based on economic substance), group financial statements are prepared. These are referred to as **consolidated accounts** and are prepared **in addition to** the single entity financial statements.

The purpose of consolidated accounts is to:

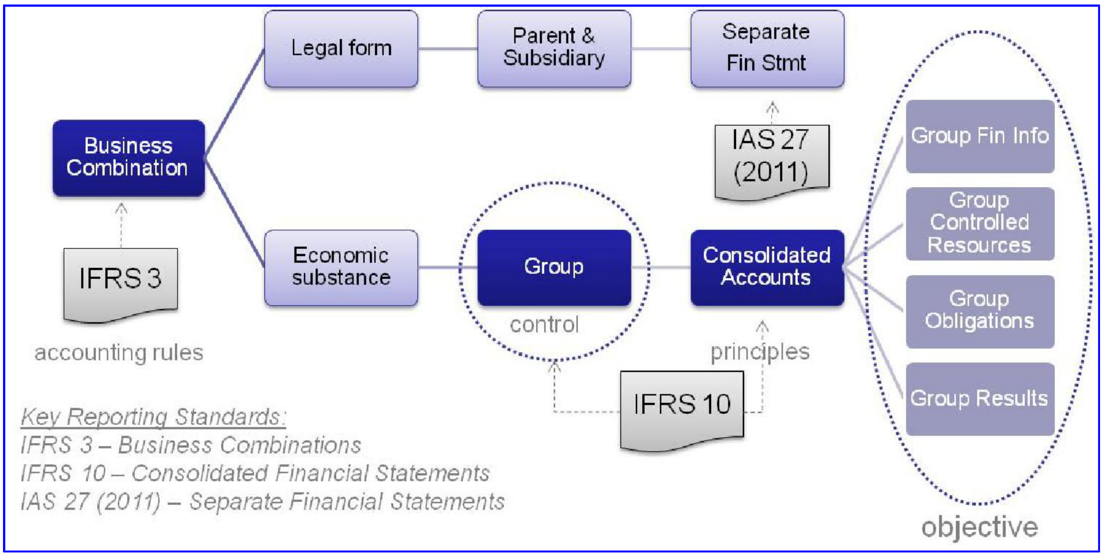
- present the financial information of both the parent and its subsidiary as a single economic unit;
- display the economic resources controlled (i.e. authority to make decisions to buy, sell or transfer assets / liabilities) by the group;
- show the financial obligations of the group (i.e. amounts owed) and
- show the results and performance of the group as a whole.

2. Guidelines for the preparation of consolidated accounts

Key Reporting Standards

A number of reporting standards dictate how a group should produce the various financial statements. These are shown in the figure below:

Fig 1. Consolidation and reporting standards



IFRS 3 - Business Combinations details the specific accounting treatment of business combinations.

IAS 27 - Separate Financial Statements (2011) handles the separate (non-consolidated) financial statements where a business combination exists. The parent must prepare separate financial statements and must record its investment in the subsidiary based on the standard's guidelines.

IFRS 10 - Consolidated Financial Statements (2011) defines control and the guiding principles for consolidated accounts.

Note. Group consolidation guidelines were formerly part of IAS 27 (2008), but were incorporated into IFRS 10 (issued in May 2011). IAS 27 (2011) now only covers 'separate financial statements'.

3. Parent's separate financial statements

General approach

Under IAS 27, when the parent invests in a subsidiary it must show this investment in its separate (non-consolidated) financial statement. The cost of the investment is recorded on the face of its Statement of Financial Position (SOFP) at either:

- cost or
- fair value.

In this case, fair value is defined as a rational and unbiased estimate of the potential market price of the subsidiary. In our examples, we will assume the cost of investment is recorded at cost.

Illustration

The statements of financial position of P Ltd and S Ltd at 31 December 20X8 are as follows:

	P Ltd $'000	S Ltd $'000
ASSETS		
Non-current assets		
Property, plant and equipment	320	80
	320	80
Current assets		
Inventories	100	50
Trade receivables	80	10
Cash	300	100
	480	160
	800	240
EQUITY AND LIABILITIES		
Equity		
Share capital	300	75
Retained earnings	100	25
	400	100
Current liabilities		
Trade payables	350	120
Income tax payable	50	20
	400	140
	800	240

P Ltd purchases100% of the shares of S Ltd at par for $100,000 cash.

Example

Show the parent's post acquisition Statement of Financial Position.

Solution

Method:

1. Show the investment in S Ltd at cost.
2. Reduce the cash balance by the investment.

3. Leave all other assets and liabilities unchanged.

The investment in S Ltd will be recorded as follows:

	$'000	$'000
DR Investment in S Ltd	100	
CR Cash		100

P Ltd's statement of financial position will now comprise the following:

	P Ltd $'000
ASSETS	
Non-current assets	
Property, plant and equipment	320
Investment in S Ltd	100
	420
Current assets	
Inventories	100
Trade receivables	80
Cash	200
	380
	800
EQUITY AND LIABILITIES	
Equity	
Share capital	300
Retained earnings	100
	400
Current liabilities	
Trade payables	350
Income tax payable	50
	400
	800

4. Group financial statements

Control and consolidation

Where there is control (normally as a result of owning more than 50% of the voting rights of an entity), a parent and subsidiary relationship will exist, hence a group. The group is seen as a single entity.

With the establishment of control, the parent will be required (as per IFRS 10) to produce an extra set of accounts, known as group or consolidated financial statements. It is issued to shareholders of the parent only. IFRS 3 Business Combinations outlines the accounting treatment when an acquirer obtains control of a business.

Note. Under IFRS10, control is not necessarily just about ownership! It is also related to power and influence. For examination purposes control is usually established based on ownership of more than 50% of voting power.

The basic principle behind consolidation is that the group statement shows all the assets and liabilities of the parent and subsidiary.

The method

To produce the group statements, we basically replace the parent's investment in the subsidiary with its share of net assets.

Two steps are required:

Step1. Eliminate cost of investment:

- Cancel the cost of investment in the parent's books with the shares plus reserves which represent this investment (at the acquisition date) in the subsidiary's books.

Step 2: Aggregate the statements of financial position:

- This is done by combining the asset and liabilities of parent and subsidiary.
- With regards to the Capital Account:
    - The Equity is that of the parent
    - The Reserves (at acquisition date) is that of the parent only.

This accounting treatment is part of the 'acquisition method' as per IFRS 3 and not IFRS 10 which only uses a 'principles based' approach to consolidation (e.g. uniform accounting policies and same accounting periods for parent and subsidiary). The above consolidation method is best understood by the following example.

Example

In our earlier illustration, P Ltd has control of S Ltd as it owns 100% of its shares. So how would the group's financial position appear?

Solution

Well, applying step 1 we eliminate the $100,000 cost of investment with the subsidiary's equity and reserves. We then apply step 2 by summing the assets and liabilities of the parent and subsidiary and we include only the equity of the parent and the reserves (at acquisition date) of the parent.

	P Ltd	S Ltd	Step 1	Step 2	P Group

	$'000	$'000			$'000
ASSETS					
Non-current assets					
Property, plant and equipment	320	80		320+80	400
Investment in S Ltd	100	-	(100)		-
	420	80			400
Current assets					
Inventories	100	50		100+50	150
Trade receivables	80	10		80+10	90
Cash	200	100		200+100	300
	380	160			540
	800	240			940
EQUITY AND LIABILITIES					
Equity					
Share capital	300	75	(75)		300
Retained earnings	100	25	(25)		100
	400	100			400
Current liabilities					
Trade payables	350	120		350+120	470
Income tax payable	50	20		50+20	70
	400	140			540
	800	240			940

Parent's exemption from preparation of group financial statements

Consolidation exemption conditions

A parent does not need to present consolidated financial statements **if and only if** the following conditions are met:

- the parent itself is a wholly owned subsidiary (i.e. it's 100% owned by another entity) or a partially-owned subsidiary (i.e. it's more than 50% owned by another entity) and its owners have no objections;
- the ultimate parent company produces consolidated financial statements;
- the parent's debt or shares are not traded in a public market;
- the parent has lost control of a subsidiary;
- the parent's subsidiary is temporal and is classed as 'held for sale' under IFRS 5 - Non-Current Assets Held for Sale and Discontinued Operations i.e. the subsidiary is just bought purely for sale within a year and as such has never been consolidated. A subsidiary that has previously been consolidated does not qualify for this exemption.

Disclosures when exempt from consolidation

In accordance to IFRS 10, when exemption from the preparation of consolidated financial statements is permitted, IAS 27 Separate Financial Statements (revised) requires that the following disclosures are made:

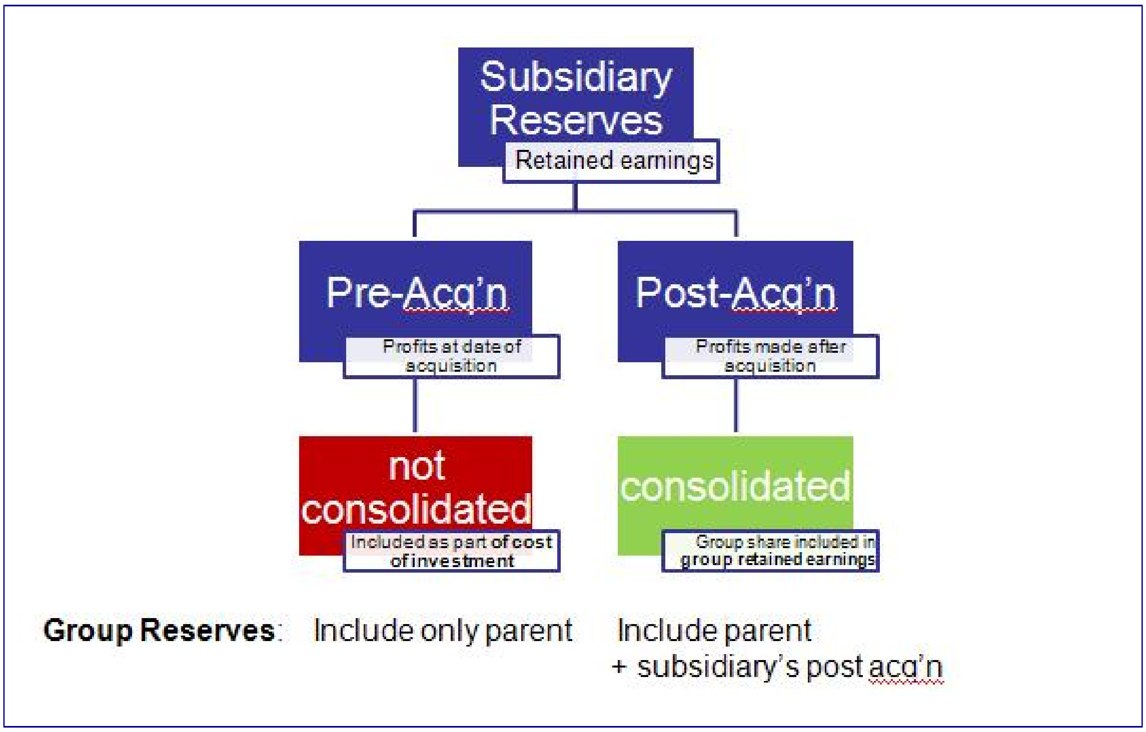
- the fact that separate financial statements have been presented and reasons for this (if not required by law);
- a list of significant investments (subsidiaries, associates, joint ventures etc.) including percentage share ownership, principle place of business (and country of incorporation if different);
- the method (e.g. equity method, proportional consolidation etc.) by which those investments listed above have been accounted for in its separate financial statements.

5. Pre and post acquisition reserves

Subsidiary and group reserves

As seen from the previous example, the pre-acquisition reserves of the subsidiary are not consolidated. This is because they are included as part of the cost of investment. Thus, only the parent's reserves appear in the group reserves. However, post-acquisition, the group's share of the subsidiary post-acquisition earnings must be added to the parent's reserves to give the total group reserves.

Fig. Treatment of reserves



A simple example will illustrate the treatment of reserves.

Example

P Ltd acquired all of the shares of S Ltd for a cost of $80,000 on 31 Dec 20X4. The retained earnings on 31 Dec 20X4 for P and S were $35,000 and $15,000 respectively. As of 31 Dec 20X6, the retained earnings for P and S were $60,000 and $20,000 respectively. What are the group's retained earnings reported in the consolidated statement of financial position at: (i) 31 Dec 20X4 and (ii) 31 Dec 20X6?

Solution

Let's consider case (i), 31st Dec 20X4 is the acquisition date so we only include the parent's reserves of $35,000.

For case (ii), we must include, in the group reserves, the group's share of S Ltd's post acquisition reserves which amount to $5,000 which is the difference between the pre- and post- acquisition reserves of S Ltd.

So the total group reserves as of 31st Dec 20X6 is given by the parent's reserves of $60,000 plus $5,000, giving group reserves of $65,000.

P Group Reserves	31/12/X4 $'000 (i)	31/12/X6 $'000 (ii)
P Ltd : Retained Earnings	35	60
S Ltd : Retained Earnings	-	5
	35	65

6. Acquisition accounting: goodwill and fair values

Normally, the cost of investment made by the parent for the control of a subsidiaries net assets is at a premium to the value of these assets. In addition, the group controlled assets and liabilities are consolidated at their current market price as opposed to their book value in the subsidiary's accounts. Once again, it is IFRS 3's 'acquisition method' that handles the accounting treatment for the premium paid and the market value applied.

Goodwill on acquisition

When a controlling investment is made, the parent is in effect investing in the net assets of the subsidiary. The value of the subsidiary will normally exceed the value of the net assets. The difference is goodwill and represents the assets not shown in the subsidiary's financial statements, such as customer service and reputation.

Goodwill on acquisition is calculated by comparing the value of the subsidiary acquired to its net assets and for a fully owned subsidiary it is calculated as below.

Cost of investment (= value of subsidiary) :	X
Fair value of net assets acquired :	(X)
Goodwill on acquisition :	X

If the goodwill on acquisition is positive, then it is known as **positive goodwill**. If it is negative, then it is known as **negative goodwill**. IFRS 3 requires goodwill recognition in the consolidated financial statements.

Treatment of goodwill

Negative goodwill is to be recognised immediately in the consolidated income statement. The positive goodwill will appear as an intangible non-current asset and will not change unless **impairment** is identified. Goodwill is impaired if the carrying value of the subsidiary (including goodwill) exceeds the fair value of the subsidiary. If the goodwill is impaired, it will be held net of impairment losses.

Example

Pepper Ltd acquired 100% of the ordinary share capital of Salt Ltd for $85,000. The fair value of the net assets at the acquisition date was $80,000. (i) What goodwill arises on acquisition? (ii) How would the goodwill appear in the consolidated statements?

Solution

(i) The goodwill on acquisition is $5,000 and is calculated as follows:

	$'000
Cost of investment :	85
Fair value of net assets acquired :	(80)
Goodwill on acquisition :	5

(ii) The goodwill on acquisition will appear as an intangible non-current asset in the consolidated statement of financial position.

Fair values of net assets acquired

Fair value is the price that would be received to transfer (i.e. sell) an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The purpose of a fair value exercise in group accounting is to apportion the consideration given by the parent (to purchase the shares in the newly acquired entity) to the net assets of the newly acquired entity for consolidation purposes. This reflects the "cost" to the group at acquisition and ensures an accurate measurement of goodwill. An adjustment is required if the subsidiary's book values are not equal to their fair values.

Inclusion of fair values in consolidated accounts

Fair value adjustment will need to be made to the capital account (equity and reserves) to bring the net assets to fair value and on the face of the statement of financial position (SOFP).

(1) Adjustment to capital account:

	At acquisition $'000	At reporting date $'000
Equity + Reserves	X	x
Fair value adjustments	X	x
Fair value depreciation adjustments	-	(x)
	X	x

(2) At the reporting date make adjustments on the face of the SOFP when adding across assets and liabilities.

Example

The following summarised statements of financial performance are for H Ltd and S Ltd as at 31 Dec 20X8.

	H Ltd $'000	S Ltd $'000
ASSETS		
Non-current assets at book value	2,000	500
Investment in S Ltd	1,500	-
Current assets	600	800
	4,100	1,300
EQUITY AND LIABILITIES		
Equity		
Share capital ($1 ordinary)	3,000	300
Retained earnings	1,000	900
Current liabilities	100	100
	4,100	1,300

H Ltd purchased 100% of the ordinary shares in S Ltd on 31 December 20X8 for $1.5m. It is estimated that the non-current assets of S Ltd possessed a fair value of $700,000 on the 31 December 20X8 but that there was no difference between the book values and fair values of the company's net current assets at that date. Show the consolidated statement of financial position as at 31 December 20X8.

Solution

Method:

1. Apply fair value adjustment to the subsidiary's capital account (equity and reserves) and its net assets.

2. Calculate the goodwill on acquisition (difference between cost of investment and the fair value of net assets acquired).

3. Eliminate the cost of investment with the subsidiary's equity and reserves goodwill.

4. Aggregate the assets and liabilities of the parent and subsidiary.

	H Ltd $'000	S Ltd $'000	Step 1	Step 2	Step 3	Step 4	H Group $'000
ASSETS							
Goodwill				+100			100
Non-current assets	2,000	500	+200			2,000 +500 +200	2,700
Investment in S Ltd	1,500	-			(1,500)		-
Current assets	600	800				600+800	1,400
	4,100	1,300					4,200
EQUITY AND LIABILITIES							
Equity							
Share capital	3,000	300			(300)		3,000
Retained earnings	1,000	900	+200		(1100)		1,000
Current liabilities	100	100				100+100	200
	4,100	1,300					4,200

Workings

Step 1 workings: Fair value adjustment

	Book value $'000	Fair Value, FV $'000	FV Adjustment $'000
Non-current assets	500	700	+200

Step 2 workings : Goodwill on acquisition

Goodwill on acquisition = cost of investment – fair value of net assets

Where fair value, FV of net assets is represented by the subsidiary's equity and reserves adjusted for fair value

==> equity, $300k + reserves, $900k + FV adj, $200k = $1,400k

Thus, goodwill on acquisition = $100k (=$1,500k – $1,400k)

7. Chapter Summary

So in summary…

- A group is formed when **control** is established (usually based on > 50% ownership). A **parent** (controlling entity) and a **subsidiary** (controlled entity) result.

- The **cost of the investment** in the subsidiary can be shown in the parent's separate financial statements at **cost or fair value** (IAS 27)

- Group financial statements are based on **economic substance** (as opposed to legal form) and show the group as **a single business entity**.

- IFRS 10 defines **control** and the **guiding principles** for consolidated accounts consolidation (e.g. uniform accounting policies and same accounting periods). Conditions to allow **exemption** from consolidation are also detailed.

- **Pre-acquisition reserves** of the subsidiary are not consolidated as they are part of the cost of investment. However, post-acquisition, the group's share of the subsidiary post-acquisition earnings must be added to the parent's reserves to give the total **group reserves**.

- IFRS 3 details the specific **accounting treatment** (i.e. the 'acquisition method') to handle various aspects of the consolidated accounts (e.g. business combination, treatment of **goodwill** and use of **fair values** for assets and liabilities of the group).