Group Accounts Mastercourse

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Course Overview

- Terminology issues
- A brief refresher on the basic principles
- How accounting standards influence consolidated financial statements
- Consolidating the income statements
- Consolidating the balance sheets
- Disposals of undertakings
- Associates and joint ventures
- Problematic areas

Key Terminology References

- Balance sheet = statement of financial position
- Profit and loss account = income statement/statement of profit or loss/statement of comprehensive income
- Cash flow statement = statement of cash flows
- Debtors = receivables
- Creditors = payables
- Minority interests = non-controlling interests
- Accounts = financial statements
- Year-end = reporting period
- Profit and loss account reserves = retained earnings

Requirements for Group Accounts

- Legislative requirements set out in Companies Act 2006
- FRS 2 *Accounting for Subsidiary Undertakings*
- IFRS 10 *Consolidated Financial Statements*
- FRS 102 Section 9 *Consolidated and Separate Financial Statements*
- Consolidate when there is a **parent-subsidiary** relationship
- How do we determine a parent-subsidiary relationship exists?
- The key factor is:

CONTROL

Control

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

Exemptions from Consolidation

- CA06 and FRS 2 provide exemption from preparing consolidated accounts if:
  - ✓ Sub is a wholly-owned/majority-owned undertaking and the immediate parent is established under the law of an EEA state (exemption conditional on compliance with further conditions in section 400); or
  - ✓ Sub is a wholly-owned/majority-owned undertaking and the immediate parent is not established under the law of an EEA state (exemption conditional on compliance with further conditions in section 401); or
  - ✓ All subsidiary undertakings are permitted/required to be excluded from consolidation in accordance with section 402.

Exemptions from Consolidation

- FRS 2 provides the following exemptions from consolidating a subsidiary:
  - ✓ Severe long-term restrictions substantially hinder the exercise of the parent undertaking's rights over the subsidiary undertaking's assets/management; or
  - ✓ Group's interest in the sub is held exclusively with a view to subsequent resale and the sub has not previously been consolidated.
- FRS 102 provides exemptions from consolidation at paragraph 9.3

Exemptions from Consolidation

- IFRS 10 contains the following exemptions from consolidation:
  - ✓ Parent is a wholly-owned sub/partially-owned sub and all its owners (including those not normally entitled to vote) have been informed about, and do not mind, the parent presenting consolidated financial statements.
  - ✓ Its debt and equity instrument are not traded in a public market.
  - ✓ It did not file (nor in the process of filing) its financial statements with a securities exchange commission or other regulatory organisation to issue any class of instruments in a public market.
  - ✓ Ultimate/intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS.

New Accounting Standards

- A new suite of standards were issued by the IASB in May 2011
- The suite comprised of **three** new standards and **two** amended standards
- New standards cover all aspects of:
  - ✓ Group accounting
  - ✓ Consolidation
  - ✓ Joint arrangements
  - ✓ Equity accounting
  - ✓ Related disclosure of interest in other entities

New Accounting Standards

New IFRS	Replaced IFRS
IFRS 10 *Consolidated Financial Statements*	IAS 27 *Consolidated and Separate Financial Statements*, and SIC-12 *Consolidated Special Purpose Entities*
IFRS 11 *Joint Ventures*	IAS 32 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled entities – Nonmonetary Contributions by Venturers*
IFRS 12 *Disclosure of Interests in Other Entities*	None. Previously the disclosure requirements relating to interests in other entities were contained in each separate standard.
IAS 27 *Separate Financial Statements*	IAS 27 *Consolidated and Separate Financial Statements*
IAS 28 *Investments in Associates and Joint Ventures*	IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*

Consolidation: Basic Principles

- Why are consolidated financial statements produced?
- How to achieve the objective of consolidated financial statements (the elimination process)
- How to determine ‘control’
- Control is not based **purely** on numeric benchmarks – it is based on substantive rights
- Generally control (and hence a parent-subsidiary relationship) is obtained when:
  - ✓ Parent holds more than 50% of the voting rights in the subsidiary; OR
  - ✓ When the parent has the ability to direct the financial and operating policies of the subsidiary.

Consolidation: Basic Principles

- Therefore the FIRST step is to identify if there is control and hence a parent-sub relationship. If not then there is no requirement to prepare consolidated financial statements
- Key point to consider is to determine the STATUS of the investment
- The status of the investment is ALWAYS based on control
- For ‘D’-shaped groups you will need to work out the parent’s indirect interest in the sub-subsidiary

Consolidation: Basic Principles

- The DATE OF ACQUISITION will also play a crucial factor in determining the date a parent establishes *actual* control
- A parent has control over a sub-subsidiary at the LATER of the following:
  - The date the parent acquired the subsidiary
  - The date the subsidiary acquired the sub-subsidiary

Illustration

- P bought 80% of S on 31 March 2011.
- S Bought 70% of T on 31 July 2013.

Required:

Determine the date of acquisition.

Solution:

31 July 2013

Illustration

- P bought 80% of S on 31 March 2009.
- S already owned T.

Required:

Determine the date of acquisition

Solution:

31 March 2009

Consolidating the Accounts

- Once a parent-subsidiary relationship has been established, each entity's 'separate' financial statements will be consolidated with those of the parent
- This course will take a detailed look at the preparation of the consolidated:
  - Profit and loss account (income statement)
  - Balance sheet (statement of financial position)

Consolidated Profit and Loss Account

- Not particularly complex (although in real life, some are inherently more complex than others)
- Method is fairly simplistic: simply consolidate line-by-line up to the levels of PAT
- After PAT the amounts attributable to the parent and the NCI are shown, hence:
  - ❑ Up to PAT: amalgamate on a line-by-line basis
  - ❑ NCI: NCI share of subsidiary's PAT

Consolidated Profit and Loss Account

- Eliminate intra-group transactions (sales, cost of sales, administration expenses etc.)
- Keep in mind the objective of consolidated financial statements to help understand WHY
- Eliminate dividends from sub from group investment income
- Eliminate interest paid from sub to parent or vice versa from investment income and interest payable
- Practical point: use a consolidation schedule

Consolidated Profit and Loss Account

- Refer to Case Study number 1 taken from the D10 DFS sitting

Consolidated Profit and Loss Account: Other Point

- Remember to time-apportioned mid-year acquisitions
- P has a year-end of 31 December 2013. On 1 July 2013 it acquired 100% of S. Extracts from S's financial statements are as follows:

Revenue	100,000
Cost of sales	40,000
Administration expenses	30,000

Consolidated Profit and Loss Account: Other Point

Required

Determine the amounts to be included in P Group consolidated P&L account for S

Consolidated Balance Sheet

- Inherently more tricky than the consolidated P&L account
- Assets and liabilities section reflects the net assets under the control of the parent
- Equity section reflects the split of ownership between parent and NCI

Consolidated balance sheet

Area	Method
Assets	Amalgamate line-by-line
Liabilities	Amalgamate line-by-line
Share capital	Parent company only
Reserves	Group reserves comprise:
	- Parent’s reserves
	- Share of sub post-acq profit/loss
Goodwill	Capitalise/amortise/impairment test
NCI	NCI share of net assets at y/e

Goodwill

- Excess of the purchase price over the net assets acquired
- IFRS 3 revised in 2008 to allow 2 methods of goodwill calculation
  - ✓ Gross method (new)
  - ✓ Proportionate method (traditional)
- Under the new method we bring in the fair value of NCI's and the template working is:

	£
Fair value of consideration transferred	X
PLUS fair value of NCI	X
LESS fair value of net assets at acq	(X)
Goodwill at acquisition	X

Goodwill

- Under the proportionate method, template calculation is:

	£
Cost of investment	X
LESS share of net assets acquired	(X)
Goodwill at acquisition	X

- Refer to case study 2

Intra-Group Trading

- All items should cancel (intra-group debtors and creditors)
- If they do not cancel check in-transit items (cash and stock particularly)
- In-transit items are adjusted by adding them into stock/cash and amending the intra-group balance in the accounts of the receiving company prior to consolidation (this is where a consolidation schedule is a good idea)
- Intra-group dividends (paid and payable/receivable) are cancelled
- Balance of intra-group dividends should represent the amounts payable to NCI only

PURP Adjustments

- Eliminate the URP of y/e stock from the CBS and from the reserves of the company making the intra-group sale
- Refer to case study 3

Acquiring Subsidiary Companies

- Consolidation starts from the DATE OF ACQUISITION
- The date of acquisition is the date that control is obtained by the parent (care needs to be taken here)
- Sub’s accounting policies should be the same as the parent
- If sub uses different accounting policies in its individual financial statements, adjustments will need to be made on consolidation (e.g. sub values stock using FIFO but parent uses AVCO)
- Accounting period ends should be the same (wherever practicable)
- If sub uses a different date, interim financial statements need to be prepared up to date of parent’s y/e for use in the consolidation

Acquiring Subsidiary Companies

- Where this is not practicable, use sub's financial statements for its last financial year PROVIDING that the y/e or p/e is not more than 3 months from the parent's y/e (before and after)
- Provide for any changes in the intervening period that will materially affect the view given by the group's financial statements by way of a consolidation adjustment

Adjustments at Acquisition

- Adjustments are made at the acquisition date to reflect:
  - ✓ Fair values
  - ✓ Accounting policy alignments
- The above adjustments will alter the net assets at acquisition and also affect:
  - ✓ Net assets at the balance sheet date; and
  - ✓ Post-acq reserves of the sub (due to, for example, increased depreciation, release of provisions, increased stock etc.)

Goodwill at Acquisition

- Can be both positive and negative
- Be careful with accounting standards for positive goodwill!
  - IFRS 3 – capitalise and test for impairment
  - FRS 10 – capitalise and amortise systematically (over 20 years or less)
  - FRS 10 – test for impairment if infinite life or UEL > 20 years
  - FRS 102 – amortise over a 5-year period if directors cannot ascertain a reliable UEL
  - FRS 102 – test for impairment if UEL > 5 years

Goodwill at Acquisition

- Positive goodwill is shown as a separate intangible asset on the face of the balance sheet
- Negative goodwill arises when FV of assets and liabilities exceed acquisition cost (bargain purchase)
- Again, care needed where negative goodwill arises under accounting standards
- Under IFRS 3:
  - ✓ Re-examine FV calcs to ensure that the goodwill is genuine; and
  - ✓ If genuine, recognise the negative goodwill immediately as income in the CIS

Goodwill at Acquisition

- Under FRS 10:
  - ✓ FV of assets should be tested for impairment
  - ✓ FV of the acquired liabilities should be checked carefully to ensure none have been omitted/understated
- Negative goodwill remaining is shown separately on the face of the BS, immediately below goodwill heading and followed by subtotal showing net amount of positive and negative goodwill
- Negative goodwill up to FV of non-monetary assets acquired is recognised in P&L in the periods in which the non-monetary assets are recovered (either through sale or depreciation)

Goodwill at Acquisition

- Under FRS 102:
  - ✓ Reassess the identification/measurement of the acquiree's assets/liabilities/provisions for contingent liabilities and measurement of the cost of the combination
  - ✓ Recognise and separately disclose the resulting excess on BS at acq date below goodwill and followed by subtotal showing net amount of goodwill and the excess
  - ✓ Recognise subsequently the excess up to FV of NMA acquired in P&L in the periods the NMA are to be recovered.

Impairment Reviews: Goodwill

- IFRS 3 = review annually (as no amortisation is charged)
- FRS 10 = review if UEL infinite or if goodwill being amortised more than 20 years
- FRS 102 = review where goodwill is deemed to have an infinite life

UK Specific: Small Groups

Group Size	Turnover	Balance Sheet (gross assets)
Small	£6.5m net £7.8m gross	£3.26m net £3.9m gross
Medium	£25.9m net £31.1m gross	£12.9m net £15.5m gross

UK Specifics: Small Groups

- For small groups in UK, no requirement to prepare consolidated financial statements (note where consolidated FS are prepared for medium-sized groups, they are required to be filed at Co Ho)
- Additional disclosures in the parent's financial statements relating to investments in subsidiary companies:
  - ✓ Name of sub
  - ✓ Nature of business
  - ✓ Country of incorporation
  - ✓ Class and % of shares held
  - ✓ Aggregate capital and reserves (current and previous year)
  - ✓ Profit (loss) for the year (current and previous year
- If y/e not same as parent, subsidiary's y/e will need disclosure

Disposal of Interests

- Sub is consolidated up to the date parent loses control
- Various reasons why parent loses control – main one being outright disposal
- Deemed disposals can also result in a loss of control (see later)
- Consolidated P&L should include the trading results of sub up to date of disposal and appropriately disclosed as a 'discontinued operation'
- Any gain/loss on disposal is included in the P&L account

Disposal of Interests

- P&L on disposal is the difference at the DISPOSAL DATE between:
  - ✓ Proceeds of the sale; and
  - ✓ Group's share of the sub's net assets disposed of, together with any premium or discount on acq (apportioned where necessary to that element of the net assets sold) that has not been written off through the P&L account
- Refer to Case Study 4

Partial Disposals

- Partial disposals are where the parent loses some, but not all, its ownership interest
- After the partial disposal, there are 3 possible outcomes:
  - Sub remains as a sub
  - Sub becomes and associate
  - Sub becomes an investment

Subsidiary to Subsidiary

- Following a partial disposal, parent still retains control (i.e. ownership interest is still > 50%)
- NCI are increased by the carrying amount of net identifiable assets now attributable to them BUT…
- No amount for goodwill that arose on initial acquisition of the group's interest in the sub is attributed to the NCI
- Refer to Case Study 5

Subsidiary to Associate

- Following the disposal, the parent loses control but still retains a SIGNIFICANT INFLUENCE
- The term ‘significant influence’ is defined as:

The power to participate in the financial and operating policy decisions of the investee but it is not control or joint control over those policies

- Significant influence usually occurs when the investor has a holding of between 20 and 50% of the net assets (but numeric benchmarks are not always indicative of this – see later)

Subsidiary to Associate

- Where disposal results in ownership interest of less than 51%, investment is not accounted for as a subsidiary but as an associate hence equity accounted
- Equity accounting is dealt with in IAS 28/FRS 9/FRS 102 (covered later in the course)
- Refer to Case Study 6

Subsidiary to Investment

- Following the disposal, the parent's ownership interest is reduced to the extent that it neither has control nor significant influence (usually due to a holding of less than 20%)
- Undertaking is accounted for as an investment
- Refer to Case Study 7

Deemed Disposals

- An undertaking may cease to be a sub of the parent, or the group may reduce its OI as a result of a DEEMED DISPOSAL.
- Such a disposal may arise where:
  - ✓ The group does not take up its full allocation of rights in a rights issue
  - ✓ The group does not take up its full share of a scrip dividend
  - ✓ Another party exercises its options or warrants
  - ✓ The sub issues shares to other non-group parties
- Deemed disposals have the same effect as changes in ownership by disposal and are accounted for in the same way

Deemed Disposals

- If the parent still retains control of sub following a deemed disposal, transaction is accounted for as one between equity owners hence no gain/loss recognised in the CP&L
- Refer to Case Study 8 (2 scenarios)

Accounting for Associates

- Associates are distinct from subsidiaries
- No ‘control’ therefore no parent-sub relationship
- Investor has ‘significant influence’ over the undertaking and therefore the undertaking is an associate
- Numerically significant influence can be obtained with a holding in the net assets of the undertaking of between 20 and 50%
- Numeric benchmarks are NOT prescriptive and SI can be evidence by other means:

Accounting for Associates

- Interchange of managerial personnel;
- Material transactions between the investor and the investee;
- Participation in the policy-making process;
- Provision of essential technical information; or
- Representation on the board of directors, or equivalent governing body

Accounting for Associates

- Accounting standards that deal with associates are:
  - ✓ IAS 28 *Investments in Associates and Joint Ventures*
  - ✓ FRS 9 *Associates and Joint Ventures*
  - ✓ FRS 102 Section 14 *Investments in Associates*
- Investor will ‘equity account’ the investment
- On initial recognition, investor will:

DR investment (balance sheet)

CR cash

Accounting for Associates

- After initial recognition, the associate will:

  DR investment (B/S)

  CR income from associate (P&L)

  For a PROFIT making associate – **OR**

  CR investment (B/S)

  DR income from associate (P&L)

  For a LOSS making associate

- Refer to Case Studies 9 and 10

Accounting for Associates

- For loss-making associates the investment will eventually reduce to zero
- At this point, the investor does NOT recognise any future losses
- Refer to Case Study 11

Dividends from Associates

- Dividends are a RETURN ON INVESTMENT
- An investor can receive both a profit from its associate and a dividend
- Dividends are not added to profit in the investor's individual financial statements but REDUCE the value of the investment in the investor's balance sheet
- Refer to Case Study 11

Associates: Consolidated Accounts

- In the CBS:
  - ✓ Account for dividends payable/receivable fully in the individual company accounts
  - ✓ Include the dividend debtor (amounts owed to the investor) from the associate
  - ✓ Do NOT cancel inter-co balances for dividends as the associate is not part of the group (no parent-sub relationship)
- In the CP&L
  - ✓ Do NOT include dividends from associates
  - ✓ Include the investor' share of associate's PAT (but before dividends) as 'Income from associate'

Joint Ventures

- A JV is an economic arrangement between 2 (or more) parties
- All parties need to give UNANIMOUS consent to decisions relating to the financial and operating policies of the JV
- It is a contractual relationship where both parties have joint control
- Not necessarily restricted by a legal structure – it is the contractual arrangement that gives joint control between the venturers
- Why form a JV?

Joint Ventures

- To benefit from the partners' complementary skills;
- To benefit from economies of scale;
- To share costs;
- To improve profits; or
- To share the risks of a project.

Joint Ventures

- Under UK accounting standards (FRS 9 and FRS 102 Section 15) there are 3 types of JV:
  1. Jointly controlled operations
  2. Jointly controlled assets
  3. Jointly controlled entities
- IFRS 11 issued in May 2011 does not deal with the issue of jointly controlled assets anymore – the standard only differentiates between joint operations and joint ventures
- This course will cover all 3 types of JV as the new UK GAAP (FRS 102) still deals with jointly controlled assets

Jointly Controlled Operations

- In a JCO, each venturer:
  - ✓ Uses its own resources
  - ✓ Carries out its own part of a joint operation separately from the activities of the other venturer(s)
  - ✓ Owns and controls its own resources (used in the JV)
  - ✓ Incurs its own expenses
  - ✓ Raises its own finance
- The contractual arrangements how the JV will share the goods/service outputs of the operation as well as the share of revenues and expenses
- This contractual arrangement is crucial because it will dictate how the venturer recognises in its own financial statements:

Jointly Controlled Operations

1. The assets it controls
2. The liabilities it incurs
3. The expenses it incurs
4. Its share of the income earned from the sale off goods/services from the JV

Jointly Controlled Operations: Example

A and B both agree to develop and manufacture a new brand of high-speed aeroplane. A agrees to develop and manufacture the engines and B agrees to develop and manufacture the body of the aeroplane. Each venturer pays the costs and takes a share of the revenue from the sale of the aeroplanes as per the agreement. In its individual financial statements, each venturer will show the assets that it controls and the liabilities that it has incurred together with the expenses that it incurs and its share of the income from the sale of the aeroplanes.

Jointly Controlled Operations: Example

Accounting standards will treat the operations as if the venturer has conducted them independently. Venturer will account for its share of the income earned from the JCO in accordance with the contractual arrangement (often 50:50)

Jointly Controlled Assets

- Each venturer will recognise:
  - ✓ Its share of the jointly controlled asset(s)
  - ✓ Any liabilities that it has incurred on behalf of the joint venture
  - ✓ Its share of any joint liabilities incurred by the joint venture
  - ✓ Its share of income and expenses incurred by the joint venture
  - ✓ Any expense it has incurred in respect of its interest in the joint venture in its own financial statements

Jointly Controlled Assets: Example

A and B jointly own a property. Each party takes a share of the rents and bears a share of the running costs of the property. The shared items are the property itself, revenue from rents received, maintenance costs of the property, depreciation of the property and a share of the liabilities incurred jointly with other venturers. The separate costs that A and B incur are loan interest to finance their share of the property.

Accounting standards require the venturers to apportion its share of revenues, expenses, assets and liabilities. The venturer must recognise its share in its own financial statements and its accounting records.

Jointly Controlled Entities

- JC entities are incorporated entities or it can be an unincorporated setup (e.g. a partnership)
- It is jointly controlled by the venturers
- Accounting for JCE's is done by way of equity accounting
- Proportionate consolidation is no longer permissible in IFRS 11 and FRS 102
- Where an entity does use PC it should switch to equity accounting (which is also a change in accounting policy, hence retrospective application)
- This course will only deal with equity accounting a JCE

Jointly Controlled Entities

- If the JV makes a profit, increase the investment in the balance sheet by debiting the profit share to the investment and credit the P&L account
- If the JV makes a loss, reduce the value of the investment by CR investment with the share of the loss and DR P&L account
- Refer to Case Study 12

Problem Areas

- Some of the more challenging areas for accountants and consolidated accounts are in relation to:
  - Share capital
  - Dividends
  - Ownership interest < 100%
  - Goodwill
  - Pre- and post-acquisition reserves (where they go)
  - Defining control
  - Dealing with a deemed disposal
  - Intra-group transactions and the elimination thereof

Key Tips

- Bear in mind no requirement in UK to prepare group accounts for SMALL groups
- Keep detailed working papers (e.g. a consolidation schedule and supporting information) as auditors may want to see these
- Don't be afraid to go 'back to basics' when dealing with a consolidation as they can get tricky
- Make sure you tackle the consolidation (especially complex consolidations) in a logical manner
- Keep up to date with developments in UK GAAP as these sometimes change where consolidations are concerned (e.g. withdrawing the use of proportionate consolidation)

- Questions?

- Thank you