Group Company Accounts Mastercourse

Presented by:

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ABOUT THE SPEAKER

Steve Collings, FMAAT FCCA is the audit and technical partner at Leavitt Walmsley Associates Ltd, a firm of Chartered Certified Accountants based in Sale, Cheshire where Steve trained and qualified. Steve was admitted as a member of the Association of Accounting Technicians in 2001 and went on to qualify as a Chartered Certified Accountant in 2005. He was admitted as a Fellow Member of the AAT in 2006 and became a Fellow Member of ACCA in 2010. Steve also holds ACCA's Diploma in International Financial Reporting Standards, Diploma in International Financial Reporting Standards for Small-Medium Entities as well as ACCA's Certificates in International Financial Reporting Standards and International Auditing Standards and holds Senior Statutory Auditor status in the UK.

Steve is the author of several books on the subjects of accounting and auditing including *Interpretation and Application of International Standards on Auditing* (Wiley, March 2011), *IFRS For Dummies* (Wiley, March 2012), *Financial Accounting For Dummies* (Wiley, April 2013) and *Frequently Asked Questions in IFRS* (Wiley, April 2013). He is also the co-author of *Financial Reporting for Unlisted Companies in the UK and Republic of Ireland* (Bloomsbury Professional) and *Corporate Finance For Dummies* (Wiley) both of which are scheduled for publication in October 2013. He has also had many articles published in the professional accounting media, most notably AccountingWEB.co.uk and much of Steve's work can be seen on his personal website at www.stevecollings.co.uk.

Steve lectures professionally-qualified accountants on the areas of accounting, auditing and Solicitors Accounts Rules and was named *Accounting Technician of the Year* at the 2011 British Accountancy Awards. He has also been short-listed for *Outstanding Contribution to the Accountancy Profession* by the Association of International Accountants.

1. COURSE INTRODUCTION

The aim of this course is to build and expand on the areas covered in the AAT Level 4 Qualification. The course aims to give delegates a deeper understanding of group accounts for both public and private limited companies and practical skills which can be applied to everyday work situations. The course itself will cover group accounts for companies that have adopted International Financial Reporting Standards (IFRS) and those that still report under UK GAAP.

Starting from the basic principles of group accounts, the course will build on these basics with a view to equipping delegates to deal with more higher level consolidation issues. The course will therefore cover:

- A brief refresher on the basic principles
- An update on new IFRSs relating to group accounts
- How accounting standards inform financial reporting for umbrella companies and group company accounts
- Practical skills and techniques of consolidating group company accounts
- Areas that commonly cause issues in consolidations, including:
  - Revaluation reserves
  - Share capital
  - Issuing additional share capital
  - Dealing with dividends in group company accounts
  - Double entry principles

2. The Requirement for Group Accounts

2.1 The requirement to prepare consolidated financial statements is set out in Companies Act 2006, FRS 2 *Accounting for Subsidiary Undertakings* and IFRS 10 *Consolidated Financial Statements*. These accounting standards set out the manner in which consolidated financial statements are to be prepared and the overarching objective behind consolidated financial statements is to show the results of the group as if it were a single reporting entity - in other words to show the results of the group's trading activities with the outside world.

2.2 FRS 2, FRS 102 and IFRS 10 all require consolidated financial statements to be prepared when there is a parent- subsidiary relationship. A parent-subsidiary relationship exists when the parent has 'control' over a subsidiary. For the purposes of accounting standards, the term 'control 'is defined as follows:

'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.'

During the course, delegates will gain an understanding of the ways in which a parent obtains control of a subsidiary and the characteristics that may be present giving rise to control, despite a parent not having a controlling shareholding in numeric terms.

2.3 There are various adjustments that will be needed to arrive at a set of consolidated financial statements that show the results of a group as a single reporting entity and these are dealt with later in the course. However, in the broadest sense, all intra-group trading and the effects of intra-group trading (e.g. intra-group debtors and creditors) must be eliminated at consolidation level because failing to do so will result in the trading results of the group being mis-stated.

2.4 Under the provisions in FRS 2, a subsidiary undertaking is to be excluded from consolidation if:

(i) severe long-term restrictions substantially hinder the exercise of the parent undertaking's rights over the subsidiary undertaking's assets or management; or

(ii) the group's interest in the subsidiary undertaking is held exclusively with a view to subsequent resale and the subsidiary undertaking has not previously been consolidated.

2.5 As stated above, FRS 2, FRS 102 and IFRS 10 all require a parent entity to prepare consolidated financial statements when there is a parent-subsidiary relationship in existence. The consolidated financial statements must include all subsidiaries, however under FRS 2 there are exemptions from preparing consolidated financial statements as follows:

- The parent undertaking is a wholly-owned subsidiary undertaking and its immediate parent undertaking is established under the law of an EEA State. Exemption is conditional on compliance with certain further conditions set out in section 400(2). A parent undertaking is not exempt if any of its securities are admitted to trading on a regulated market of any EEA State.

- The parent undertaking is a majority-owned subsidiary undertaking and meets all the conditions for exemption as a wholly-owned subsidiary undertaking set out in section 400(2) as well as the additional conditions set out in section 400(1)(b).

- The parent undertaking is a wholly-owned subsidiary of another undertaking and that parent undertaking is not established under the law of an EEA State. Exemption is conditional on compliance with certain further conditions set out in section 401(2). The exemption does not apply to a parent undertaking if any of its securities are admitted to trading on a regulated market of any EEA State.

- The parent undertaking is a majority-owned subsidiary undertaking and meets all of the conditions for exemptions as a wholly-owned subsidiary undertaking set out in section 401(2) as well as the additional conditions set out in section 401(1)(b).

- All of the parent undertaking's subsidiary undertakings are permitted or required to be excluded from consolidation by section 405.

IFRS 10 sets out the following criteria that must be met in order that a parent need not present consolidated financial statements:

- The parent itself is a wholly-owned subsidiary or it is a partially-owned subsidiary of another entity and all of its owners, including those not normally entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.

- Its debt and equity instruments are not traded in a public market.

- It did not file, nor is it in the process of filing, its financial statements with a securities exchange commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

- Its ultimate or intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS.

2.6 A new suite of standards were issued by the International Accounting Standards Board (IASB) in May 2011. This suite of standards comprised three new standards and two amended standards and cover all aspects of group accounting and consolidation, joint arrangements, equity accounting and related disclosure of interests in other entities. Disclosure of unconsolidated structured entities is also addressed for the first time in the history of IFRS. The new standards are as follows:

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.*

2.7 There are certain definitions contained within the accounting standards that delegates need an awareness of which are outlined below:

Term	Definition
Consolidated financial statements	The financial statements of a group prepared by consolidation.
Consolidation	The process of adjusting and combining financial information from the individual financial statements of a parent undertaking and its subsidiary undertakings to prepare consolidated financial statements that present the financial information for the group as a single economic entity.
Control	The ability of an undertaking to direct the financial and reporting policies of another undertaking with a view to gaining economic benefits from its activities.
Dominant influence	Influence that can be exercised to achieve the operating and financial policies desired by the holder of the influence, notwithstanding the rights or influence of any other party.
Equity method	A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets.
Group	A parent undertaking and its subsidiary undertakings.
Interest held on a long-term basis	An interest which is held other than exclusively with a view to resale.
Interest in another entity	An interest in another entity refers to contractual and non-contractual involvement that exposes an entity to variability of returns from the performance of the entity.
Minority interest (non-controlling interest)	The interest in a subsidiary undertaking included in the consolidation that is attributable to the shares held by or on behalf of persons other than the parent undertaking and its subsidiary undertakings.
Parent	An entity that controls one or more entities.
Power	Existing rights that give the current ability to direct the relevant activities.
Protective rights	Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.
Separate financial statements	Financial statements presented by a parent or an investor with joint control of, or significant influence over an investee, in which the investments are accounted for at cost or in accordance with FRS 26 *Financial Instruments: Recognition and Measurement*, IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement)* or FRS 102.
Subsidiary	An entity that is controlled by another entity.

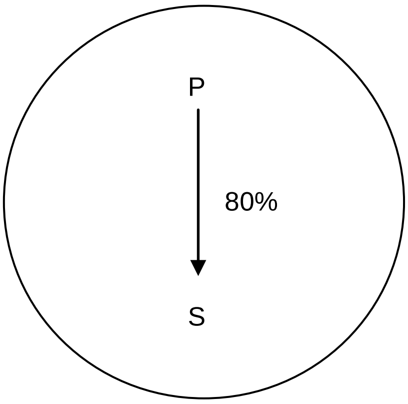
3. Basic Principles of Consolidation

Identifying a subsidiary - simple group structures

3.2 The basic principle involved in identifying a subsidiary is identifying when the parent has *control* over the subsidiary. A key point to note here is that control is based on substantive rights. However, an investor that only holds protective rights does not have the power to direct the activities of the entity. The substantive rights need to be exercisable when the decision regarding the direction of the relevant activities needs to be made. However, for the purposes of this course control is obtained when:

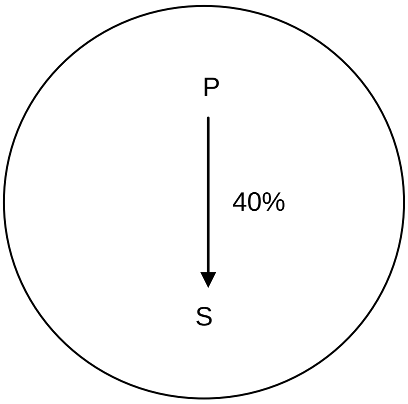
- The parent holds more than 50% of the voting rights in the subsidiary; or
- When the parent has the ability to direct the financial and operating policies of the subsidiary.

3.3 Consider the following group structure:



In this group structure, P owns 80% of the voting rights in S. If a parent company holds more than 50% of the voting rights in another entity that gives rise to control, hence a parent-subsidiary relationship and therefore P is required to prepare consolidated financial statements which consolidated the results of S with P.

3.4 Consider the following group structure:



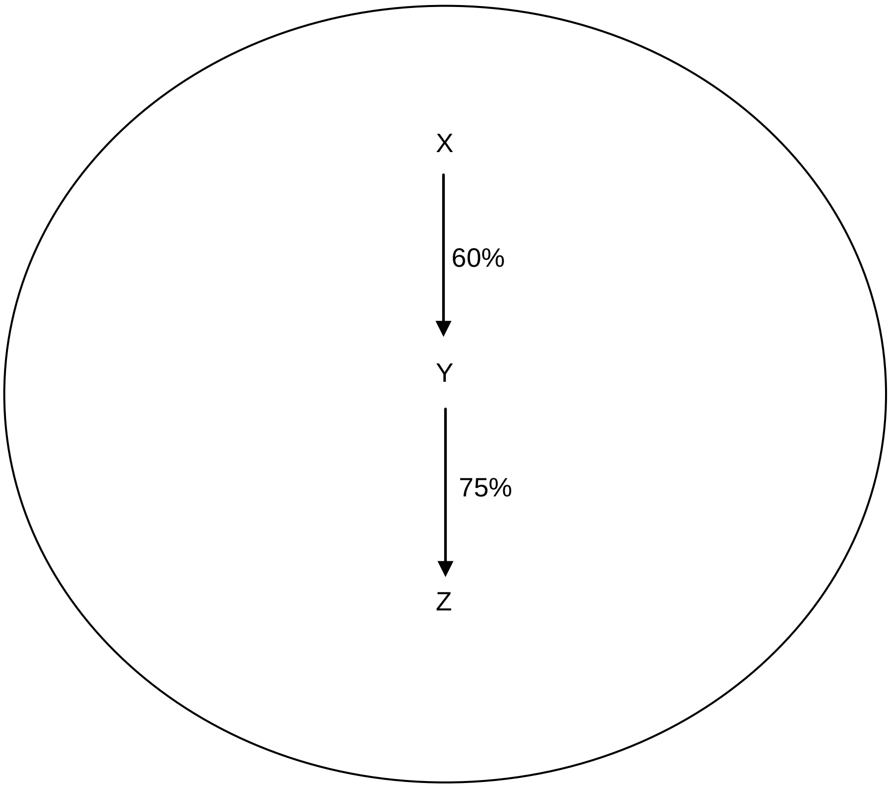
In this group structure, P owns 40% of the voting rights in S and therefore, from a numerical benchmark perspective, control does not exist. Where control does not exist, the investment is treated as either an associate (in accordance with FRS 9 *Associates and Joint Ventures*, IAS 28 *Investments in Associates and Joint Ventures* or FRS 102.

However, if P was able to direct the financial and operating policies of S (even with a 40% holding), control will exist and give rise to a parent-subsidiary relationship, hence the results of S will be consolidated with those of P even though P only owns 40%. **It is important to keep in mind that control can be obtained by the parent even with an ownership interest of <u>less than 51%</u>**. Remember - control is based on substantive rights.

Identifying a subsidiary - more complex group structures

3.5 In real life, group structures can be fairly complicated - especially with larger groups where holdings can be both direct and indirect.

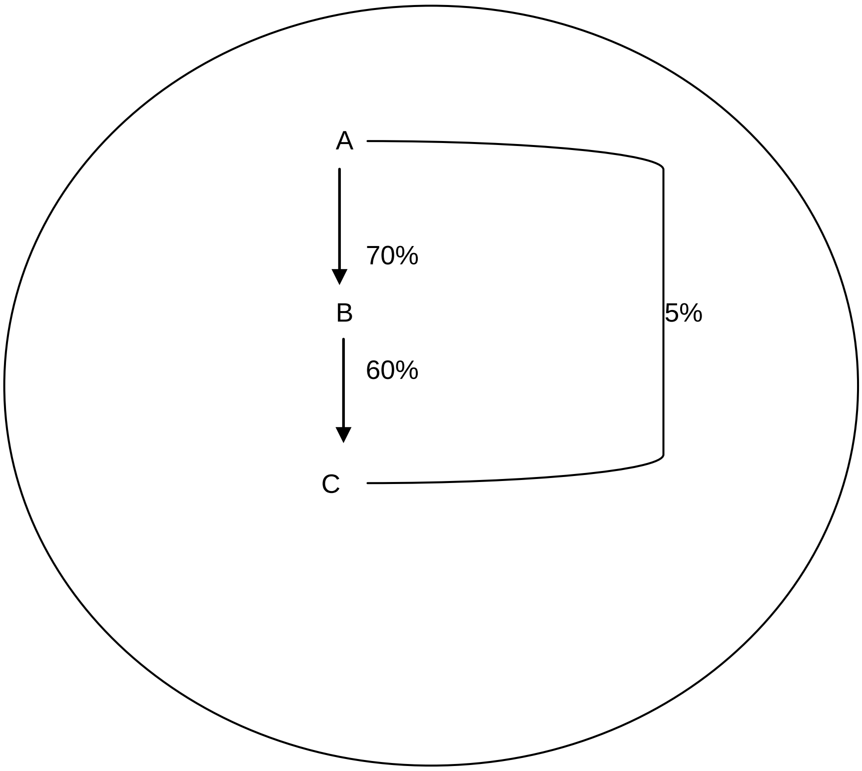
Consider this group structure:



In this group structure, you can see that X owns 60% of Y (and therefore Y is a subsidiary of X because of that control). Y owns 75% of Z (and therefore Z is a subsidiary of Y because of that control). The question arises as to whether X controls Z. In such structures, Z will be a subsidiary of X on the grounds that X controls Z through its control of Y and therefore Z is a subsidiary of X. You work out X's *effective* ownership as follows:

60% x 75% = 45% of Z ***Note: this is a useful tool to bring to the consolidation but it is irrelevant in determining the status of the investment. STATUS IS ALWAYS BASED ON CONTROL.***

3.6 Consider the following group structure:



In this particular type of group structure (often referred to as a 'D'-shaped group), A's *indirect* and *direct* ownership interest will need to be deciphered. Clearly as A owns 70% of B, B becomes a subsidiary of A. As B owns 60% of C, C becomes a subsidiary of B. The question arises as to the ownership interest of A and C. Here is how that is established:

The *indirect* interest is calculated as:

70% x 60%	=	42%
The *direct* interest is:		5%
A ownership interest	=	47%
Minority interest (non-controlling interest)	=	53%

3.7 The key to identifying subsidiaries in a complex group structure is based on establishing control. To establish control, the holdings of the parent and of other group companies should be considered in aggregate. In addition, the date of acquisition should be considered to be the date the parent company establishes *actual* control.

The parent has control over a sub-subsidiary at the *later* of the following dates:

- The date the parent acquired the subsidiary.
- The date the subsidiary acquired the sub-subsidiary.

Consider these examples:

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

   The date of acquisition of T is 31 July 2013.

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

   The date of acquisition of T is 31 March 2009.

Consolidation basics - consolidated profit and loss account

3.8 Once you have established a parent-subsidiary relationship exists, each entity within the group will prepare its own set of financial statements (the 'separate' financial statements). The parent will then consolidate the separate financial statements with those of its own (subject to consolidation adjustments) to arrive at a set of consolidated (group) financial statements that show the results of the group as a single trading entity.

3.9 The preparation of the consolidated profit and loss account does not pose any real difficulties. You simply consolidate line-by-line up to the levels of profit after tax. After profit after tax, the amounts attributable to the parent and the minority interests (non-controlling interests) are shown, so:

Up to profit after taxation:	amalgamate on a line-by-line basis
Minority interests:	minority share of subsidiary's profit after tax

Intra-group sales

All intra-group sales are eliminated from both turnover (revenue) and cost of sales of the group. If there are any provisions for unrealised profit, then charge the change in the provision in the year to the cost of sales of the company making the intra-group sale.

Intra-group dividends and interest

Eliminate dividends from subsidiary from group investment income and full amount of interest from investment income and interest payable.

Refer to Case Study number 1.

Consolidation basics - consolidated balance sheet

3.10 The preparation of the consolidated balance sheet (consolidated statement of financial position) is inherently more complex than the consolidated profit and loss account (income statement or statement of profit or loss). The assets and liabilities section of the balance sheet reflects the net assets under the control of the parent, whereas the capital and reserves section (ie equity) reflects the split of ownership between parent and minority interest.

Basic method – acquisitions

3.11 The basic method of preparing the consolidated balance sheet is as follows:

Area	**Method**
Assets	Amalgamate on a line-by-line basis
Liabilities	Amalgamate on a line-by-line basis
Share capital	Group share capital is that of the parent only
Reserves	Group reserves comprise: - Parent reserves - Share of subsidiary's post-acquisition profit/loss

Goodwill	Capitalise and carry out an impairment review
Minority interests (non-controlling interests)	Minority share of net assets at balance sheet date

Goodwill calculation

3.12 Goodwill is the excess of the purchase consideration paid and the net assets that the parent has acquired in a subsidiary – in a nutshell, goodwill is merely a balancing figure!

3.13 In 2008, the International Accounting Standards Board amended IFRS 3 *Business Combinations* to allow two ways of goodwill calculation: the 'gross' method and the 'proportionate' method.

Under the gross method, on the date of acquisition you compare the fair value of the entire subsidiary company (including the minority (non-controlling) interests) with the fair value of the net assets acquired. Using this method produces a goodwill figure that is attributable to both the parent's interest in the subsidiary and the minority (non-controlling) interest's share of the goodwill. However, in order to be able to use the gross method of goodwill, you will need to know the fair value of the minority (non-controlling) interests. The template calculation is as follows:

	£
Fair value of consideration transferred	X
Plus fair value of minority (non-controlling) interest	X
Less fair value of net assets at acquisition	(X)
Goodwill at acquisition	X

Under the proportionate method of goodwill calculation, the template calculation is as follows:

	£
Cost of investment	X
Less share of the fair value of identifiable net assets acquired	(X)
Goodwill at acquisition	X

Refer to Case Study number 2.

Intra-group trading balances

3.14 These should cancel. If they do not, this is probably due to cash or stock in transit. In transit items should be adjusted for by adding them into stock/cash and amending the intra-group balance in the accounts of the receiving company prior to consolidation.

Intra-group dividends

3.15 Once each company has recognised dividends payable and receivable, intra-group amounts should be cancelled, leaving a balance for the consolidated balance sheet representing the amounts payable to minority (non-controlling) interests.

Provision for unrealised profit

3.16 Provision should be made by eliminating the unrealised profit element of year-end stock from the consolidated balance sheet stock value and from the reserves of the company making the intra-group sale. Full charge is therefore made, where appropriate, against the minority (non-controlling) interests.

Refer to Case Study Number 3.

4. Acquisition of Subsidiary Companies

Date of acquisition

4.1 Consolidation should start from the date of acquisition. The effective date of acquisition of a subsidiary is the date that control is obtained by the parent.

Accounting policies

4.2 Amounts included within the consolidation should be based on uniform accounting policies. If a subsidiary uses different policies in its individual financial statements, adjustment needs to be made on consolidation.

Non-coterminous accounting periods

4.3 Subsidiaries should, wherever practicable, use the same accounting date and accounting period as the parent.

If a subsidiary uses a different date, interim financial statements should be prepared to the parent's accounting date for use in the consolidation.

If this is not practicable, use the subsidiary's financial statements for its last financial year, providing that the year did not end more than three months from the parent's year-end (before or after).

In this case any changes that have taken place in the intervening period that materially affects the view given by the group's financial statements should be taken into account by adjustments in the preparation of the consolidated financial statements.

Adjustments at acquisition

4.4 Adjustments should be made at the date of acquisition to reflect:

(i) fair values
(ii) accounting policy alignments

These adjustments alter the net assets at acquisition, and also affect:

(i) net assets at the balance sheet date; and
(ii) post-acquisition reserves of the subsidiary (for example increased depreciation, release of provisions, increase inventories).

Goodwill on acquisition (positive and negative)

4.5 Positive goodwill arises when the acquisition costs exceeds the aggregate fair values of the identifiable assets and liabilities. It appears as a separate category of intangible asset on the balance sheet.

Under the provisions in IFRS 3 *Business Combinations*, positive goodwill is not amortised, but is instead subjected to annual impairment reviews.

Under FRS 10 *Goodwill and Intangible Assets*, purchased goodwill is capitalised and amortised systematically through the profit and loss account (usually over 20 years or less). Impairment reviews must be undertaken, particularly if the goodwill is regarded as having an infinite life and is therefore not being amortised. Internally generated goodwill must not be capitalised.

Under FRS 102 goodwill will be amortised over a period of five years if the directors cannot ascertain a useful economic life (note the difference between FRS 10 where the default period is 20 years).

4.6 Negative goodwill arises when the aggregate fair values of the identifiable assets and liabilities of the entity exceeds the acquisition cost.

Under IFRS 3, if negative goodwill arises, groups must:

1st Re-examine fair value calculations to ensure that the goodwill is genuine; and
2nd If genuine, recognise the negative goodwill immediately as income in the consolidated income statement.

4.7 Under FRS 10, if an acquisition appears to give rise to negative goodwill, the fair value of the acquired assets should be tested for impairment and the fair values of the acquired liabilities checked carefully to ensure that none have been omitted or understated. Any negative goodwill remaining after the fair values of the assets and liabilities have been checked should be recognised and separately disclosed on the face of the balance sheet, immediately below the goodwill heading and followed by a subtotal showing the net amount of the positive and negative goodwill. Negative goodwill up to the fair values of the non-monetary assets acquired should be recognised in the profit and loss account in the periods in which the non-monetary assets are recovered, whether through depreciation or sale.

Under FRS 10, any negative goodwill in excess of the fair values of the non-monetary assets acquired should be recognised in the profit and loss account in the periods expected to benefit.

Under the new FRS 102, which is mandatory for accounting periods commencing on or after 1 January 2015, if any negative goodwill arises, the acquirer shall:

(a) Reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination.

(b) Recognise and separately disclose the resulting excess on the face of the statement of financial position on the acquisition date, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.

(c) Recognise subsequently the excess up to the fair value of non-monetary assets acquired in profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired shall be recognised in profit or loss in the periods expected to benefit.

Impairment reviews of goodwill

4.8 IFRS 3 *Business Combinations* requires that purchased goodwill should be capitalised and not amortised, but instead reviewed at least annually for impairment.

4.9 FRS 10 requires an impairment review to be undertaken when the goodwill has a useful economic life of more than 20 years (or an infinite life).

4.10 FRS 102 requires an impairment review to be undertaken where goodwill is deemed to have an infinite life.

5. Small Groups in the UK

5.1 Under the Companies Act 2006, there is no requirement to prepare group accounts for a group that qualifies as small. The following table outlines the size criteria for 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

Small groups will not have an average employee head count of more than 50 and a medium-sized group will not have an average employee head count of more than 250.

5.2 Where reference to 'net' and 'gross' are made this is in relation to intra-group trading. Gross means that intra-group trading has been eliminated, whilst net means that they have been eliminated.

Whilst group accounts are not required for small groups in the UK, there are additional disclosures required in the notes to the financial statements for the parent company which are as follows:

- the name of the subsidiary;
- nature of business;
- the country of incorporation;
- class of shares and % held;
- aggregate capital and reserves (current year and last year); and
- profit/(loss) for the year (current year and last year)

If the year- or period-end is not the same as the parent, the subsidiary's year- or period-end will also need disclosure.

6. Disposal of Interests

6.1 The main consideration where disposals of interests are concerned is that a subsidiary should be consolidated up to the date the parent loses control.

Typically, an undertaking ceases to be a subsidiary of another when the group sells it or reduces its percentage interest in the undertaking. Equally, a parent may lose control over the undertaking because of changes in the rights it holds or in those held by another party in that undertaking or because there is a change in some other arrangement that gave the parent its control.

6.2 A reduction in percentage interest may arise from a direct disposal or from a deemed disposal and a gain or loss will normally arise on both a disposal and a deemed disposal.

The most common transaction that results in an undertaking ceasing to be a subsidiary is an outright disposal. The consolidated profit and loss account should include the trading results of the undertaking up to the date of its ceasing to be a subsidiary and appropriately disclosed as a discontinued operation. Any gain or loss arising on disposal would be included in the profit and loss account.

The profit or loss on disposal of all, or part, of a subsidiary will be the difference at the date of sale between:

1. The proceeds of the sale; and
2. The group's share of the subsidiary undertaking's net assets disposed of, together with any premium or discount on acquisition (apportioned if necessary to that element of the net assets sold) that has not been written off through the profit and loss account.

Refer to case study number 4.

Partial disposals – subsidiary to subsidiary

6.3 Where a partial disposal occurs, and the parent still retains control (hence the subsidiary remains a subsidiary (albeit with reduced ownership interest by the parent), the minority (non-controlling) interests in that subsidiary should be increased by the carrying amount of the net identifiable assets that are now attributable to the minority (non-controlling) interests. However, no amount for goodwill that arose on the initial acquisition of the group's interest in that subsidiary should be attributed to the minority (non-controlling) interests.

Refer to case study number 5.

Partial disposals – subsidiary to associate

6.4 Where a partial disposal occurs, and the parent loses control but retains significant influence, the disposal is accounted for and the undertaking is no longer treated as a subsidiary, but rather as an associate and therefore equity accounted.

Refer to case study number 6.

Partial disposals – subsidiary to investment

6.5 When a parent disposes of ownership interest in a subsidiary to such an extent that it owns less than 20% of the voting rights (and does not therefore even have significant influence), the undertaking is accounted for as a simple investment.

Refer to case study number 7.

Deemed disposals

6.6 An undertaking may cease to be a subsidiary of a parent, or the group may reduce its ownership interest as a result of a deemed disposal. A deemed 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 subsidiary issues shares to other non-group parties.

6.7 Deemed disposals have the same effect as changes in ownership by disposal and should be accounted for in the same way.

However, if a parent still retains control of a subsidiary following a deemed disposal, the transaction is accounted for as a transaction between shareholders. No gain or loss is recognised in the consolidated profit and loss account.

Refer to case study number 8.

7. Accounting for Associates

7.1 When an investor usually holds between 20 and 50% of the voting rights in an undertaking, the investor is said to have 'significant influence' over that undertaking and therefore the undertaking becomes an associate of the investor (there is no control relationship and therefore no consolidated financial statements are required). This lack of control sets associates apart from subsidiaries and joint ventures.

However, be careful with numeric benchmarks, because significant influence (like control) can be obtained in a variety of ways, for example significant influence can arise if the following are evident:

- 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.

7.2 IAS 28 *Investments in Associates and Joint Ventures*, FRS 9 *Associates and Joint Ventures* and FRS 102 at Section 14 *Investments in Associates* all deal with the accounting for associates.

If an investor has an interest in an associate, but no subsidiaries, it must use the equity method of accounting for the associate.

Accounting for an associate in the investor's own accounts

7.3 To make the initial recognition, the investor will:

DR investments (balance sheet)
CR cash

Being initial recognition of investment in associate

7.4 When the associate makes a profit or loss, the investor will do the following:

For a *profit*, debit the investment in the balance sheet and credit income from associate in the profit and loss account.

For a *loss*, credit the investment in the balance sheet and debit income from associate.

Refer to case study 9.

7.5 For loss-making associates, there may come a time when the value of all the losses reduces an investment to zero. At this point, the investor does not recognise any future losses.

Refer to case study 10.

Dividends from associates

7.6 Dividends are a return on an investment that an investor receives. An investor receives its share of the associate's profit or loss and may, in addition, receive a dividend from the associate.

At first glance is may seem that dividends are simply added to profit – however this is not correct. Dividends actually *reduce* the value of the investment in the balance sheet (the debit is taken to cash at bank), this is because of the characteristics of a dividend (a return on investment).

Refer to case study 11.

Associates – consolidated financial statements aspects

7.7 In the consolidated balance sheet:

- Account for dividends payable/receivable fully in the individual company financial statements.
- Include the receivable (an amount owed to the investor) for dividends owed to the investor from the associate(s).
- *Do not* cancel inter-company balances for dividends because the associate is not part of the group – there is no parent-subsidiary relationship, hence no requirement for the elimination of inter-company balances.

7.8 In the consolidated profit and loss account, *do not* include dividends from the associate. You include the investor's share of the associate's profit after tax (but before dividends) under equity accounting as 'income from associate'.

8. Joint Ventures

8.1 A joint venture is an economic arrangement between two (or more) parties. Both parties need to give unanimous consent to decisions concerning both the financial and operating policies of the joint venture.

A joint venture is a contractual arrangement when two, or more, parties come together and form an economic activity in which both parties have control. A joint venture is not actually restricted by a legal structure, but a contractual arrangement must be in place that gives joint control between the venturers.

8.2 A party may enter into a joint venture for various reasons, such as:

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

8.3 Under UK accounting standards, there are three types of joint venture:

- Jointly controlled operations
- Jointly controlled assets
- Jointly controlled entities.

8.4 Under IFRS, IFRS 11 *Joint Arrangements*, jointly controlled assets no longer exist and the standard only differentiates between joint operations and joint ventures. A joint operation is an arrangement whereby the parties that have joint control have rights to the assets and obligations for the liabilities. A joint venture is an arrangement whereby the parties that have joint control have rights to the net assets.

For the purposes of this course, we shall cover all three types of joint venture as the new UK GAAP (FRS 102) still deals with jointly controlled assets.

Jointly controlled operations

8.5 In a jointly controlled operation, 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 (that it uses in the joint operation)
- Incurs its own expenses
- Raises its own finance.

8.6 The contractual arrangements outline how the venturers share the goods or service outputs of the joint operation (together with any revenues from their sale, and any common expenses) in order that the venturer can recognise these in its own separate financial statements, such as:

- The assets it controls
- The liabilities it incurs
- The expenses it incurs
- Its share of the income earned from the sale of goods or services from the joint venture.

Illustration

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 shows 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.

Accounting standards treat the operations as if the venturer conducted them independently. The venturer has to account for its share of the income earned from the jointly controlled operation and this share is determined in accordance with the contractual arrangement (usually 50:50).

Jointly controlled assets

8.7 When an asset is jointly controlled, each venturer must 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.

Illustration

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

8.8 A jointly controlled entity is an incorporated company or an unincorporated setup (for example, a partnership) that is jointly controlled by the venturers.

Illustration

A and B set up a housing development company (A & B Properties) and each transfers in assets and liabilities to combine their activities. The contractual arrangement is that both A and B have joint control and decisions relating to the financial and operational policies of the company have to be unanimous. This is the definition of a jointly controlled entity.

8.9 In terms of accounting, FRS 102 and IFRS 11 no longer allow a jointly controlled entity to be accounted for by way of proportionate consolidation. There is only one permissible method and that is equity accounting. For the purposes of this course, we shall only consider equity accounting as a method of accounting for a jointly controlled entity.

If the joint venture makes a profit, increase the investment in the balance sheet by debiting the profit share to the investment in the balance sheet and credit the profit and loss account.

8.10 If the joint venture makes a loss, reduce the value of the investment in the balance sheet by crediting the investment with the value of the loss and debiting the profit and loss account with the value of the loss.

See case study 12.

9. Problem Areas for Consolidated Financial Statements

9.1 There are many challenging areas where consolidated financial statements are concerned, particularly where disposals of subsidiary companies take place during the year. Outlined below are some of the more common issues that preparers face when putting together a set of consolidated financial statements:

Share capital

Remember that in the consolidated financial statements, it is only the parent's share capital that is included, not the parent and subsidiary.

Dividends

In the consolidated statement of profit or loss (profit and loss account), dividends are the parent company dividends only.

Ownership interest less than 100%

When less than 100% of the shares of the acquired entity are owned by the acquirer, a complication arises in the preparation of consolidated financial statements, and a non-controlling interest (minority interest) must be determined and presented. Non-controlling interests must be presented in the consolidated statement of financial position (balance sheet) within equity, separately from the equity of non-controlling interests (the owners of the parent).

Goodwill

Following the revisions to IFRS 3 *Business Combinations*, companies reporting under IFRS have two options of calculating goodwill for their consolidated financial statements - the proportionate (traditional) method and the gross (the new) method. For the gross method the fair value of the non-controlling interests must be determined. Companies preparing consolidated financial statements under FRS 2 *Accounting for Subsidiary Undertakings* and FRS 10 *Goodwill and Intangible Assets* will account for goodwill using the proportionate method.

Pre- and post-acquisition reserves

Confusion often surrounds the issue of pre- and post-acquisition reserves. Pre-acquisition reserves form part of the goodwill calculation; post-acquisition reserves form part of the group retained earnings.

Control

Many accountants place total reliance on the numeric benchmark test to determine whether the investor has control or not (i.e. if a 49% holding, no control so equity account the investor as an associate). Control is determined by status and substantive rights - it may be the case that the investor holds less than 51% of the voting rights in an undertaking, but has the ability to direct the financial and operating policies of the entity - in which case there IS control and hence a parent-subsidiary relationship and the requirement to prepare consolidated financial statements (if not a small group).

Deemed disposals

If the subsidiary (for example) issues more shares to a third party investor, this will dilute the ownership interest of the parent. It is important therefore to assess the ownership interest following the deemed disposal to ascertain if control still exists as it may be the case that the additional share issue has diluted the parent's holding to such an extent that the subsidiary becomes an associate or a simple investment.

Intra-group transactions

There is a requirement in FRS 2, IFRS 10 and FRS 102 for all intra-group trading (and the effects thereof) to be eliminated on consolidation. In addition any intra-group debtors and creditors must also be eliminated on consolidation so as to show the results of the group as a single economic entity. If intra-group trading (and the effects of intra-group trading) are not eliminated on consolidation, this can seriously distort the figures by over-stating income, expenses, assets and liabilities. Where intra-group balances do not cancel each other out, it is important that the differences are found in order that the balances can be eliminated on consolidation.