chapter 14

Investments and groups

overview

Investments by one entity in another take many different forms, ranging from simple or passive investments at one end of the spectrum to investments which command control of the investee's activities, assets and liabilities at the other end of the spectrum.

This chapter is divided into two sections. The first distinguishes different levels of investment and explains the treatment of investments in the financial statements of an investing company. The second examines accounting for groups using the acquisition method of accounting and pays particular attention to the treatment of acquisitions and disposals. We therefore draw upon the relevant provisions of the following UK and international accounting standards:

- FRS 2 *Accounting for Subsidiary Undertakings* (1992)
- FRS 6 *Acquisitions and Mergers* (1994)
- FRS 7 *Fair Values in Acquisition Accounting* (1994)
- IAS 22 *Business Combinations* (revised 1998)
- IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (revised 2000)

In the first section we also refer to the relevant parts of a number of other international accounting standards, namely:

- IAS 28 *Accounting for Investments in Associates* (revised 2000)
- IAS 31 *Financial Reporting of Interests in Joint Ventures* (revised 2000)
- IAS 39 *Financial Instruments: Recognition and Measurement* (revised 2000)

The international standards IAS 22, IAS 27, IAS 28 and IAS 39 are at present under review so we draw attention to likely changes where appropriate.

Introduction

Many companies hold investments in other entities and it is therefore necessary to determine how these investments are to be treated in the financial statements of the reporting entity. As we shall see, the treatment of investments in the financial statements of an individual company is relatively straightforward but, as soon as an investment is sufficient to give influence or control over the affairs of the investee, things become more complicated.

Investments may range from simple or passive investments, held to obtain dividends and potential capital growth, to those which give the investing company control over the activities, assets and liabilities of the investee. The ASB *Statement of Principles for Financial Reporting* distinguishes four different categories of investment, as shown in Table 14.1.[1]

[1] *Statement of Principles for Financial Reporting*, ASB, London, December 1999: Chapter 8, 'Accounting for interests in other entities'. In drawing up this table, we have assumed that all four categories involve investment in entities. FRS 9 *Accounting for Associates and Joint Ventures* (November 1997) also identifies a Joint Arrangement which is Not an Entity, a 'JANE', which we discuss briefly in the following chapter.

Table 14.1 Four categories of investment

Degree of influence	Control	Joint control	Significant influence	Lesser or no influence
Resulting categorisation	Subsidiary	Joint venture	Associate	Simple or passive investment

We start by examining the accounting treatment of investments in the individual financial statements of the investing company. In the UK at present, this treatment is the same whatever the degree of control or influence the investor exercises over the investee. However, as we shall see, international accounting standards at present specify different possible accounting treatments for investments with different levels of influence.

We next move to the other end of the spectrum and, in the second section of the chapter, 'Accounting for groups', we focus on situations where the investment is large enough to give control. Where this occurs, the investee is a subsidiary undertaking and, subject to certain exceptions, the investing company must prepare group accounts that, since the enactment of the Companies Act 1989, must be consolidated accounts.[2] The relevant UK standard accounting practice is contained in FRS 2 *Accounting for Subsidiary Undertakings*. We examine the definition of a group and the possible exclusion of subsidiaries from the consolidated accounts before turning to some of the questions which must be answered in accounting for the purchase and sale of subsidiaries. As we have seen in Chapter 13, the use of merger accounting is extremely rare and likely to disappear completely in future so, in this chapter, we are concerned only with acquisition accounting.

In this section, we also examine the provisions of the relevant international accounting standards and draw attention to the main differences between UK and international pronouncements. As the relevant international standards are at present under review, we draw attention to changes which are likely to occur.

We will, in the following chapter, consider the intermediate categories of investment which give partial influence over the investee, that is investments in associates and joint ventures, as well as joint arrangements that are not entities.

Investments

Individual company financial statements

The key to determining the treatment of an investment in the shares of another company in the financial statements of the investing company is *intention*. If the investment is intended to be for the long term, it will be treated as a fixed asset; if for the short term, it will be treated as a current asset. In a traditional historical cost balance sheet, a fixed asset investment is shown at its historical cost unless its value has been impaired, in which case it is written down to its recoverable amount. A current asset investment is shown at the lower of cost and net realisable value. The carrying value used for an impaired fixed asset investment

[2] Companies Act 1985, s. 227, Para. 2.

will differ from that of a current asset investment when its value in use, or present value, exceeds its net realisable value and this sensibly reflects the management decision to retain, rather than to sell, the investment.

For both types of investment it is usual to take credit in the profit and loss account of the investing company for dividends received and receivable, although dividends receivable are only recognised to the extent that they are in respect of accounting periods ended on or before the accounting year end of the investing company and have been declared prior to approval of the investing company's own financial statements. Some companies are even more prudent and take credit only for dividends received in an accounting period.

The above accounting treatments provide limited information to users of the investing company's financial statements and, in order to remedy this, some companies have taken advantage of the alternative accounting rules to show investments at their current value.[3] In such cases, any revaluation surplus must be taken to a revaluation reserve and any revaluation deficit must be taken to the revaluation reserve to the extent that that reserve contains a revaluation surplus in respect of the same investment but otherwise must be charged to the profit and loss account. Amounts credited or debited to a revaluation reserve account must, of course, be reported in the Statement of Total Recognised Gains and Losses.

In its death throes in July 1990, the ASC issued Exposure Draft 55 *Accounting for Investments,* and this made proposals in respect of both fixed asset and current asset investments. It proposed that, where a company adopts the alternative accounting rules to show fixed asset investments at a valuation, that amount should be kept up to date by an annual revaluation. However, its major proposal for change was in accounting for certain current asset investments, namely those which are 'readily marketable'. It was the view of the ASC that such investments should be stated in a balance sheet at their quoted current value and that any difference between that current value and the previous carrying value should be reflected in the profit and loss account. Hence the profit and loss account would reflect not only the dividends receivable but also any changes in the value of such an investment during an accounting year. In the view of the ASC any such change would be a realised profit or loss on the grounds that it has been reliably measured by reference to a quoted price.[4]

While many accountants applauded the ASC for attempting to ensure that such changes in value are reflected in a profit and loss account, there were severe doubts about the legality of the proposed method of accounting for readily marketable current asset investments.[5] The method which was proposed did not comply with the historical cost accounting rules, which require such current asset investments to be shown at the lower of cost and net realisable value, nor with the alternative accounting rules which require any revaluation surplus to be taken, not to the profit and loss account, but to a revaluation reserve. The ASC was well aware that its proposals could only be introduced by relying on the true and fair override or if there were to be a change of law.[6] These were, of course, the days before FRS 3, the 'Statement of Total Recognised Gains and Losses' and the *Statement of Principles for Financial Reporting* but, even with this help, the ASB has not yet been able to resolve this

[3] The rules on what is an acceptable current value differ for fixed assets and current assets respectively. (See Companies Act 1985, Schedule 4, s. C, Paras 31(3) and 31(4).) Thus, a current asset investment may be shown at its current cost, while a fixed asset investment may be shown at its market value or any other value which the directors consider to be appropriate. In the latter case, the method of valuation adopted and the reasons for adopting it must be stated.

[4] ED 55 *Accounting for Investments,* July 1990, Para. 43. As we have seen in Chapter 4, there are different ways of defining realisation. ED 55 took the view that a profit or loss made due to a change in value of a readily marketable current asset investment is realised because the value of that investment can be reliably measured. In its view, the investment did not have to be converted into cash by sale before the profit could be treated as realised.

[5] R. Macve, 'Investments: conceptual clarity *v* legal muddle', *Accountancy*, March 1991, pp. 84–5.

[6] ED 55, Preface, Paras 1.17 and 1.18.

matter although it is seeking to move matters forward with the issue of FRED 30 *Financial instruments: Disclosure and presentation*; *recognition and measurement* in June 2002. However, as we have explained in Chapter 8, implementation of the proposals of FRED 30 would have to await changes in company law.

Considerable changes will be required if convergence is to be achieved because there are at present a number of significant differences between the UK and international standards, to which we now turn.

The international accounting standards

The position under international accounting standards is more complex as various standards lay down different rules for different levels of investment.

If we start with a simple passive investment, an investment which would be classified as an *available-for-sale financial asset* under IAS 39 *Financial Instruments: Recognition and Measurement*,[7] this should be stated at fair value provided such a value may be measured reliably. The company must then decide, as a matter of policy, whether gains or losses should be taken to the profit and loss account or direct to reserves and, as we have explained above, only the latter would appear to be possible at present under UK law. If the fair value cannot be measured reliably, then the investment should be shown at its cost.

IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, specifies the treatment of investments in subsidiaries in the investor's own financial statements. It gives a choice of three methods, requiring that investments in subsidiaries should be:

(a) carried at cost;
(b) accounted for using the equity method as described in IAS 28 *Accounting for Investments in Associates* and explained in the following chapter; or
(c) accounted for as an available-for-sale financial asset as described in IAS 39 *Financial Instruments: Recognition and Measurement* and discussed in Chapter 8 and summarised briefly above.

IAS 28 *Accounting for Investments in Associates* provides exactly the same choice of valuation bases in the financial statements of the investing company for investments in associates, thus permitting them to be valued at cost, by using the equity method or at fair values. The use of the equity method in the financial statements of an investing company is not permitted under present UK law.

The final type of investment, the joint venture, is at present covered by IAS 31 *Financial Reporting of Interests in Joint Ventures,* but this is silent on the treatment of investments carrying joint control in the financial statements of the investing company.

Clearly, the current international accounting standards are more flexible than UK practice but this looks likely to change as a consequence of the convergence programme. As we explained in Chapter 3, the IASB issued exposure drafts of its proposals to amend 12 international accounting standards in May 2002 and, in the same month, the UK ASB published six FREDs together with a Consultation Paper that deals with the remaining six of these IASB exposure drafts. One of the latter international exposure drafts addresses IAS 27, which it proposes to retitle '*Consolidated and Separate Financial Statements*' while another addresses IAS 28 *Accounting for Investments in Associates.*

The revised IAS 27 would prohibit the use of the equity method of accounting for the valuation of investments in the separate financial statements of the investing company.

[7] See Chapter 8

Investments in subsidiaries, associates and joint ventures would then have to be shown in the financial statements of the investing company either at cost or at fair value and the same method would have to be applied for each category of investments.

The IASB plans to introduce the changes for accounting periods commencing on or after 1 January 2003 and this would bring the international practice on accounting for investments closer to UK practice. However, the treatment of changes in the fair values of investments, that is whether they should be included in the profit and loss account or in the statement of total recognised gains and losses, is still likely to give rise to differences for some time to come for the reasons which we have discussed.

Accounting for groups

What is a group?

Subject to certain exceptions which we discuss below, any UK company which is a parent company at its year end must prepare group accounts in addition to its individual accounts. Since the Companies Act 1989, these group accounts must be a set of consolidated accounts for the parent company and its subsidiary undertakings.[8]

Prior to the Companies Act 1989, a subsidiary had to be a company, and a parent company/subsidiary relationship was defined as existing when the parent company was a shareholder and controlled the composition of the board of directors of the other company and/or when it held more than half of the equity share capital of that other company.[9]

This definition was thus based on both control and ownership and betrayed some confusion about why group accounts were required. While ownership and control usually go hand in hand, this is not always the case and, because the definition of 'equity share capital' was widely drawn, it was possible for a company to be simultaneously the subsidiary of more than one parent company. In response to the EC Seventh Directive, which we discussed in Chapter 3, the Companies Act 1989 introduced a much clearer concept of a group for accounting purposes.

First, it required that consolidated accounts include the parent and all *subsidiary undertakings*. The latter is a new term which is not restricted to companies but includes partnerships and 'unincorporated associations carrying on trade or business with or without view to profit'.[10]

Second, it introduced a new definition of a parent/subsidiary relationship based not upon ownership but upon control. Thus the relationship between a parent undertaking and a subsidiary undertaking is now defined as follows:[11]

(2) An undertaking is a parent undertaking in relation to another undertaking, a subsidiary undertaking, if –

(a) it holds a majority of the voting rights in the undertaking, or
(b) it is a member of the undertaking and has the right to appoint or remove a majority of its board of directors, or

[8] Companies Act 1985 (as amended by the Companies Act 1989), s. 227. Before the Companies Act 1989, consolidated accounts were just one possible form which group accounts could take.
[9] Companies Act 1985, s. 736.
[10] Companies Act 1985 (as amended by the Companies Act 1989), s. 259.
[11] Companies Act 1985 (as amended by the Companies Act 1989), s. 258.

(c) it has the right to exercise a dominant influence over the undertaking –

(i) by virtue of provisions contained in the undertaking's memorandum or articles, or

(ii) by virtue of a control contract, or

(d) it is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking.

...

(4) An undertaking is also a parent undertaking in relation to another undertaking, a subsidiary undertaking, if it has a participating interest in the undertaking and –

(a) it actually exercises a dominant influence over it, or

(b) it and the subsidiary undertaking are managed on a unified basis.

While subsection (2) is concerned with the existence of legal power of control, the rather wider subsection (4) reflects the very different definition of a group prevalent in Germany, namely a definition which rests on the existence of the *de facto* control rather than *de jure* control.

The more precise definition of a group introduced by the Companies Act 1989 helps us to keep clearly in our minds that the purpose of consolidated accounts is to show the assets and liabilities under common control and how these are being used. It also helps accountants to ensure that some of the many off-balance-sheet finance schemes which have exploited the previous definition of a subsidiary do now find their way on to the consolidated balance sheet. Indeed, as we have seen in Chapter 9, FRS 5 *Reporting the Substance of Transactions*, has attempted to go even further than this in requiring the inclusion of quasi-subsidiaries in the consolidated accounts.[12] Accountants in the UK are now much more aware of the need for such provisions following the collapse of the US corporation Enron in 2001. This spectacular collapse was undoubtedly delayed because of the company's use of numerous Special Purpose Entities which were not included in the consolidated financial statements.

The compass of group accounts

Group accounts must take the form of a set of consolidated accounts, the only exception now being where such a set of consolidated accounts would not give a true and fair view.[13] Thus a parent company must usually prepare a set of consolidated accounts showing the results and state of affairs of itself and all its subsidiary undertakings as a single economic entity.[14]

The law does, however, exempt the parent company from preparing group accounts in certain circumstances and permits the exclusion of subsidiary undertakings from the consolidated accounts in other circumstances. We shall deal with each in turn.

In view of the stated desire of successive governments to reduce the burdens on business, the law exempted a parent company from the need to prepare group accounts where the group qualifies as a small or medium-sized group, provided that it is not what is described as an ineligible group.[15] As with the definitions of small and medium-sized companies, the definitions for small and medium-sized groups are framed by reference to turnover, balance sheet total (assets) and number of employees.[16]

[12] See Chapter 9, pp. 212–13.
[13] Companies Act 1985, s. 227.
[14] Companies Act 1985, s. 228.
[15] Companies Act 1985, s. 248. A group is ineligible if any of its members is a public company, a banking company, an insurance company or an authorised person under the Financial Services Act 1986.
[16] Companies Act 1985, s. 249

In addition to these exemptions based on size, a parent company does not have to prepare group accounts where it is itself an intermediate holding company with an immediate parent company in the EU, provided consolidated financial statements are prepared at a higher level in the group. There are a number of conditions which must be satisfied if this exemption is to apply, in particular, the higher-level consolidated accounts must be prepared in accordance with law based on the EC Seventh Directive and must be filed with the UK parent's individual accounts together with certified translations, where appropriate.[17]

Where a parent company is not able to take advantage of the above exemptions, it must prepare consolidated accounts for all the companies in the group which are under the control of the parent company. However, the law *permits* the exclusion of subsidiary undertakings from the consolidated accounts in the following circumstances:[18]

> (3) . . . a subsidiary undertaking may be excluded from consolidation where –
>
> (a) severe long-term restrictions substantially hinder the exercise of the rights of the parent company over the assets or management of that undertaking, or
> (b) the information necessary for the preparation of group accounts cannot be obtained without disproportionate expense or undue delay, or
> (c) the interest of the parent company is held exclusively with a view to subsequent resale and the undertaking has not previously been included in consolidated group accounts prepared by the parent company.
>
> ...
>
> (4) Where the activities of one or more subsidiary undertakings are so different from those of other undertakings to be included in the consolidation that their inclusion would be incompatible with the obligation to give a true and fair view, those undertakings shall be excluded from consolidation.
>
> This subsection does not apply merely because some of the undertakings are industrial, some commercial and some provide services, or because they carry on industrial or commercial activities involving different products or provide different services.

FRS 2 takes a more restricted view and specifically states that neither disproportionate expense nor undue delay can justify excluding material subsidiary undertakings from the consolidated accounts. However, whereas the law *permits* the exclusion of subsidiary undertakings from the consolidated accounts, FRS 2 *requires* their exclusion in certain circumstances and specifies the required accounting treatment for such excluded subsidiaries.[19] Thus, Para. 25 of FRS 2 states that a subsidiary *should* be excluded from consolidation in three circumstances:

(a) where severe long-term restrictions substantially hinder the exercise of the rights of the parent company over the assets or management of the subsidiary undertaking;
(b) where the interest in the subsidiary undertaking is held exclusively with a view to subsequent resale and the subsidiary undertaking has not previously been consolidated in group accounts prepared by the parent company;
(c) where the subsidiary undertaking's activities are so different from those of other undertakings to be included in the consolidation that its inclusion would be incompatible with the obligation to give a true and fair view.

[17] Companies Act 1985, s. 228.
[18] Companies Act 1985, s. 229.
[19] FRS 2 *Accounting for Subsidiary Undertakings*, Paras 25–30.

Table 14.2 Attitude to exclusion of subsidiary

	Companies Act 1985	*FRS 2*
Inability to exercise control	Permits	Requires
Disproportionate expense or undue delay	Permits	Forbids
Subsidiary acquired for resale	Permits	Requires
Different activities where inclusion would be incompatible with true and fair view	Permits	Requires*

*But extremely rare in practice.

All three of these required exclusions follow from the legal provisions quoted above, except that the circumstances envisaged under (c) are in practice, extremely rare. In particular, the explanation to the standard emphasises that any differences between banking and insurance companies/groups and other companies/groups, or between profit and not-for-profit undertakings, is not sufficient of itself to justify non-consolidation.[20]

Having specified the circumstances under which subsidiary undertakings should be excluded, FRS 2 specifies the accounting treatment to be applied to such subsidiaries and the information to be disclosed. The required accounting treatment may be summarised as follows:[21]

(a) *Severe long-term restrictions.* If the parent company is denied control but retains significant influence over the excluded subsidiary, use the equity method of accounting. The equity method of accounting, which is the required method of accounting for associates and joint ventures, is described in the following chapter.

If the parent does not even retain significant influence, treat the excluded subsidiary as a fixed asset investment showing it at the carrying value at which it would have appeared if the equity method had been in use when the restrictions came into force.[22] Subsequently take credit only for dividends actually received.

In either case, it is essential to write down the investment if there has been impairment.

(b) *Subsidiary held exclusively with a view to resale.* This should be treated as a current asset and shown at the lower of cost and net realisable value.

(c) *Different activities.* In the rare circumstances where a subsidiary undertaking is excluded for this reason, the investment should be recorded in the consolidated financial statements using the equity method of accounting, and a separate set of financial statements for the subsidiary should be included with the consolidated financial statements.[23]

Changes in the composition of a group

Consolidated accounts for a group are prepared to show the results of the group as a single economic entity. It follows that, subject to the cancellation of intercompany balances and the removal of unrealised intercompany profit, the consolidated profit and loss account should include the profits or losses of all companies in the group for the relevant periods during

[20] FRS 2, Para. 78e.

[21] FRS 2, Paras 27–32.

[22] This carrying value may be the cost of the investment if the restriction existed at the date of acquisition (FRS 2, Para. 27).

[23] Certain other disclosures are required in respect of subsidiaries, both included and excluded. Readers are referred to the Companies Act 1985, Schedule 5 and to FRS 2, Paras 31–34.

which they were members of the group. The consolidated balance sheet should show the combined assets and liabilities of companies which are members of the group at the accounting year end. This simple requirement gives rise to many accounting problems where there is an acquisition or disposal of a subsidiary during the course of a year.

The first problem is to decide exactly when an acquisition or disposal occurs. The negotiations which lead to such an event are often long and drawn out, involving preliminary discussions, agreement in principle, a drawing up of terms, an offer, an unconditional acceptance and then payment of the consideration. In the 1970s various of these possible events were selected as fixing the date of acquisition or disposal and often the selection of the date appeared to have been influenced by a desire to show the largest possible profit in the consolidated accounts. Thus, when a new profit-making subsidiary is acquired, the earlier the selected date of acquisition, the greater the profits which will be included in the consolidated profit and loss account. Similarly, when the shares in a loss-making subsidiary are sold, the earlier the date of disposal, the less the losses which serve to reduce the consolidated profits.

In order to remove discretion about the choice of possible date, FRS 2 defines the effective date of acquisition or disposal as the date on which control is obtained or relinquished.[24] Control usually passes when an offer becomes unconditional and, in the case of a public offer of shares, this will be the date when the necessary number of acceptances has been obtained.

The consolidated profit and loss account must include the profits of any new subsidiary from the date of acquisition, as defined above, to the end of the accounting year and the profits or losses of any subsidiary sold from the beginning of the accounting year to the date of disposal. As we have seen in Chapter 11, FRS 3 *Reporting Financial Performance*, specifically requires the disclosure of the aggregate results of continuing operations, acquisitions (as a component of continuing operations) and discontinued operations.[25]

Let us look first at the treatment of acquisitions and then consider some of the various types of disposal that may occur.

Treatment of an acquisition

Fair values and goodwill

When a company acquires a subsidiary undertaking, it pays a price to obtain control of the assets and liabilities of that subsidiary. In the balance sheet of the parent company it is necessary to record the investment at its cost while, in the consolidated balance sheet, it is necessary to recognise the individual assets and liabilities of that subsidiary.

When a subsidiary is acquired for cash, the determination of the cost of the investment is easy but, when shares in a subsidiary are acquired in exchange for an issue of shares or other securities in the parent company or where part of the consideration is deferred or contingent on some future event, the determination of the cost may not be so clear cut.

Where the consideration is an issue of shares, it is necessary to determine the fair value[26] of the shares and, if this exceeds the nominal value of the shares, to record a share premium or, where merger relief is available, a merger reserve.[27]

Similarly, where other securities are issued, these should be valued at their fair value. Fair value is the market price of the securities when control is obtained or, if the securities are unquoted, the best approximation to the market price.

24 FRS 2, Para. 45.
25 FRS 3 *Reporting Financial Performance*, ASB, October 1992, Para. 14.
26 See Chapter 5, pp. 99–100.
27 See Chapter 13, p. 371.

Where the consideration is deferred or contingent, a reasonable estimate of its fair value should be included.[28] This would be provided by the expected value of the amount payable, that is the present value of the amounts expected to be paid in future.

In preparing a consolidated balance sheet it is necessary to replace the investment in the subsidiary by the whole of the underlying assets and liabilities of the subsidiary showing any minority interest therein. Under the historical cost convention, these assets and liabilities must be included at their historical cost to the group and, for this purpose, the amounts at which they appear in the subsidiary's own balance sheet are, of course, irrelevant. Indeed the group may not recognise certain assets and liabilities which appear in the subsidiary's balance sheet and may recognise assets and liabilities which do not appear in the subsidiary's own balance sheet at all.

The difficulty which must be faced here is that the parent company has not bought the individual assets and liabilities of the subsidiary. It has paid a global price to obtain control over a collection of assets and liabilities and, in order to prepare a consolidated balance sheet, it is necessary to allocate the global price to the individual assets and liabilities using the concept of fair value.

The difference between the cost of the investment and the appropriate proportion of the sum of the fair values of the individual 'identifiable' assets and liabilities recorded will provide the amount of goodwill. The ASB follows the law in using the adjective 'identifiable' but, although we shall continue to use this adjective, it does seem to be rather inappropriate. Many assets such as a good management team, a considerable research potential or a regional monopoly may be identifiable but are not usually recognised in the consolidated accounts except as part of the goodwill figure.

FRS 7 *Fair Values in Acquisition Accounting* (September 1994), provides standard accounting practice for determining which assets and liabilities of the subsidiary should be recognised in the consolidated accounts and how they should be valued:

> **The identifiable assets and liabilities to be recognised should be those of the acquired entity that existed at the date of acquisition. (Para. 5)**
>
> **The recognised assets and liabilities should be measured at fair values that reflect the conditions at the date of the acquisition. (Para. 6)**

The standard makes it clear that certain assets and liabilities not recognised in the accounts of the subsidiary should be recognised at acquisition. Examples are pension surpluses and deficiencies, as well as contingent assets. However it also makes it quite clear that certain provisions which have sometimes been recognised in the past should not be made in future. This is in line with the thinking subsequently embodied in FRS 12 *Provisions, Contingent Liabilities and Contingent Assets*, which we have discussed in Chapter 7.[29] The banned provisions include those for reorganisation and integration costs expected to be incurred as a result of an acquisition, as well as provisions for expected future losses (FRS 7, Para. 7). The existence of such provisions results in post-acquisition costs bypassing the profit and loss account and, as we have seen in Chapter 7, such provisions have been difficult to police in practice. There is considerable agreement that, in the case of some groups, excessive provisions appear to have been made and now all such provisions have been banned.

Once the identifiable assets and liabilities have been listed, it is then necessary to obtain their fair values. Fair values are defined as follows:

[28] Further guidance is provided by FRS 7 *Fair Values in Acquisition Accounting*, ASB, September 1994.
[29] FRS 12 *Provisions, Contingent Liabilities and Contingent Assets*, ASB, London, September 1998.

The amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale. (FRS 7, Para. 2)

While this would imply the estimation of a value based upon a hypothetical transaction, the standard makes it clear that the fair value of tangible fixed assets and stocks and work-in-progress should not exceed their recoverable amounts. Recoverable amount is defined in turn as the greater of the net realisable value of an asset and, where appropriate, its value in use (Para. 2).

Although it does not use the term, FRS 7 sensibly requires us to include the assets acquired at their 'value to the business'. The value to the business of tangible fixed assets and stocks and work-in-progress, which has been discussed in Chapter 5, is given by the formula shown in Figure 14.1. However, as we have seen in Chapter 5, this is not the concept of fair value as understood at present by the IASB, so the move towards convergence may lead to a reduction in the use of the more relevant 'value to the business model' in future.

The replacement cost of the remaining service potential of a fixed asset should be based upon the market value, if assets similar in type and condition are bought and sold on an open market, or at depreciated replacement cost, reflecting the acquired business's normal buying process and the sources of supply and prices available to it.[30]

Whereas the fair values of short-term and certain long-term debtors and creditors will be equal to their face values, it will be necessary to discount any long-term debtors and creditors which do not carry interest at the current market rate.

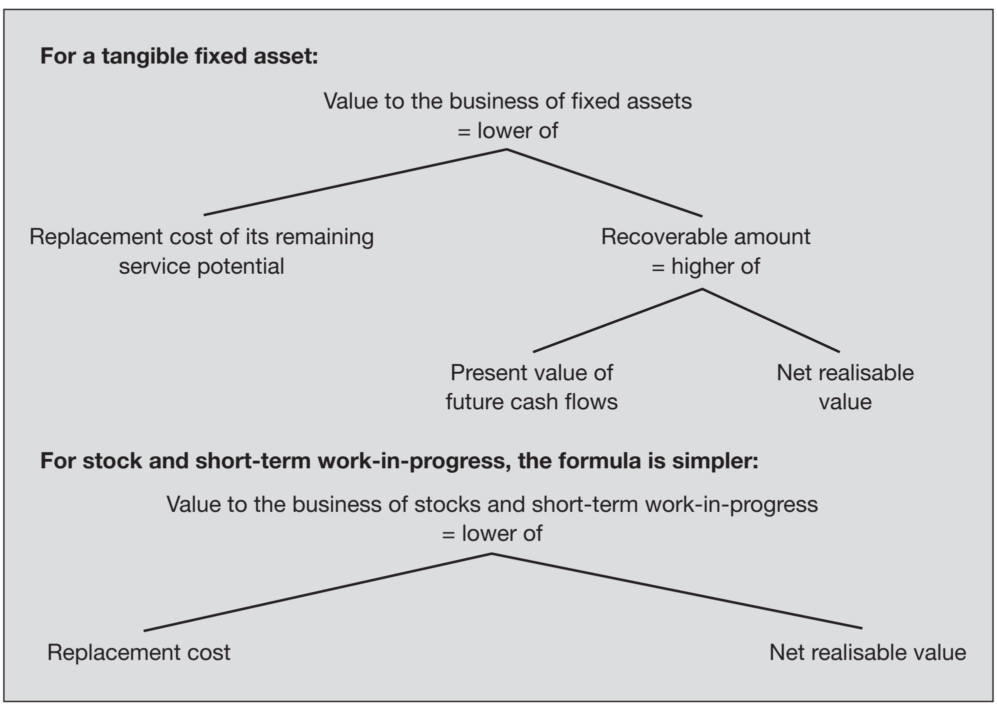

Figure 14.1 Determination of fair value as applied by the ASB

[30] FRS 7, Para. 9.

To help users of accounts to understand what has happened, company law requires companies to publish a table showing, for each class of assets and liabilities, the book values before an acquisition, the fair values at the date of acquisition and an explanation for any significant adjustment made together with the goodwill on acquisition.[31]

An example of the table required by law is given in Table 14.3.

Table 14.3 Example of table required by company law

	Book value at acquisition	*Fair value adjustments*	*Fair value to the group*
	£000	£000	£000
Tangible fixed assets	420	140	560
Current assets	340	50	390
Creditors due within one year	(190)	–	(190)
Creditors due in more than one year	(200)	(30)	(230)
Provisions for liabilities and charges	(50)	(10)	(60)
	320	150	470
Goodwill			130
Consideration paid			600

FRS 6 requires that the fair value adjustments are analysed between (a) revaluations, (b) adjustments to achieve consistency of accounting policies and (c) any other significant adjustments.[32] While this required disclosure is very sensible, it may be argued that adjustments under (b) are not really fair value adjustments at all.

In practice, the identification and valuation of assets and liabilities may take a considerable time. FRS 7 stipulates that all adjustments to fair values and purchased goodwill should be fixed by the date when the consolidated accounts for the first *full* financial year following the acquisition are approved by the directors.[33]

Before we look at a more complete example of an acquisition, let us examine the further complication caused when a subsidiary undertaking is acquired in stages. To take an example, one company may purchase 10 per cent of the equity shares of a company and then purchase a further 70 per cent of the shares at a later date. As control is only obtained at the time the latter purchase is made, the law requires that the combined cost of the 80 per cent should be matched against that percentage of the sum of the fair values of the identifiable assets and liabilities to determine goodwill at the date on which control is obtained.[34]

This method will lead to a rather dubious figure for goodwill in that the price paid for the earlier purchase related to the fair value of the net assets and goodwill at the date of that purchase rather than their value at the much later date when control was obtained. However FRS 2 sees it as a practical means of applying acquisition accounting.[35]

The standard does recognise, however, that it will not always be appropriate and requires the use of the true and fair override to depart from the legal rule in certain circumstances. One example where this would be appropriate would be when the earlier purchase was suffi-

31 Companies Act 1985, Schedule 4A, Para. 12(5).
32 FRS 6, Para. 25.
33 FRS 7, Para. 25.
34 Companies Act 1985, Schedule 4A, Para. 9.
35 FRS 2, Para. 89.

cient to constitute the investee an associate for which equity accounting was appropriate. The application of the equity method of accounting requires the use of fair values at the initial purchase date and use of the legally specified approach, explained above, at a subsequent purchase which brings control would result in the post-acquisition profits and gains of the associate being reclassified as goodwill. In these circumstances, the standard requires that goodwill be calculated in stages, summing the differences between the cost of each purchase and the appropriate proportion of the fair value of the identifiable assets and liabilities at the date of each purchase. Such an approach would, of course, require the use of the true and fair override and the consequential disclosure that this had occurred.

The standard also deals with the situation where a company increases its stake in a subsidiary thus reducing or perhaps eliminating the minority interest.[36] In such a case it is essential to revalue the identifiable assets and liabilities in the subsidiary at the date of the increase in shareholding.

We have seen that the consolidated profit and loss account must include the results of a new subsidiary from the date of acquisition to the end of the accounting year and that the consolidated balance sheet must include the assets and liabilities of the new subsidiary which is a member of the group at the year end. This general statement is best explored in the context of an example.

Example 14.1

Let us take a company J Limited, which has many subsidiaries and makes up its financial statements to 31 December each year. J acquires a new wholly owned subsidiary, K Limited, during the year to 31 December 20X1. Control is obtained on 1 July 20X1. Summarised consolidated financial statements of the J group (excluding K) and financial statements for K Limited are given below:[37]

Summarised profit and loss accounts for the year ended 31 December 20X1

	J Group	*K Limited*
	£000	£000
Turnover	2000	500
less Expenses	1500	420
Profit from ordinary activities before tax	500	80
less Taxation	200	36
	300	44
less Minority interest	40	
	260	44
add Extraordinary profit (net of taxation and minority interest)	30	20
	290	64
less Dividends proposed	100	
	190	64

[36] FRS 2, Para. 90.

[37] While the authors appreciate that FRS 3 has resulted in the virtual disappearance of the extraordinary item, we have included extraordinary profits in this and later examples for completeness.

Summarised balance sheets on 31 December 20X1

	J Group	*K Limited*
	£000	£000
Fixed assets		
Goodwill – at cost less amortisation	100	–
Tangible fixed assets	500	156
Investment in K Ltd – 40 000 shares at cost	200	–
Net current assets	300	100
	1100	256
less Long-term loans	170	50
	930	206
Share capital (£1 shares)	250	40
Revaluation reserve (created 1 July 20X1)	–	20
Retained profits	500	146
	750	206
Minority interests	180	–
	930	206

As K Limited was acquired on 1 July 20X1, the date on which control passed, it is necessary to value the identifiable assets and liabilities at their fair values on that date. In practice it is extremely helpful if their fair values are incorporated in the individual financial statements of the subsidiary and this has been done in the balance sheet of K Limited to produce a revaluation reserve on 1 July 20X1 of £20 000.

We also need to calculate the cost of purchased goodwill and to estimate its useful economic life. In order to calculate this goodwill, we need to know the sum of the fair values of the identifiable assets and liabilities on 1 July 20X1. As these fair values have been incorporated in the financial statements of K, they are equal to the sum of the share capital and reserves of K at the date of acquisition, which may be calculated as follows:

K Limited

Net assets on 1 July 20X1	£000	£000
Share capital		40
Revaluation reserve		20
Retained profits		
On 1 January 20X1	82	
1 January to 30 June 20X1, $\frac{1}{2} \times$ £44 000	22	104
		164

J Limited has paid £200 000 to acquire net assets which have an aggregate fair value of £164 000 on 1 July 20X1. Hence it has paid £36 000 for goodwill. If we assume, for simplicity, that the estimated useful life of this purchased goodwill is six years, then the annual amortisation, using the straight-line method, will be £6000 and hence the amortisation for the six months 1 July to 31 December 20X1 will be £3000.

The consolidated profit and loss account must include the results of K Limited from 1 July 20X1 to 31 December 20X1 together with the amortisation of its goodwill. If we assume that the sales and operating profit of K Limited accrued evenly over the year and that the extraordinary profit did not arise until October 20X1, the consolidated profit and loss account must include the following post-acquisition profits of K from 1 July 20X1 to 31 December 20X1:

			Post-acquisition
	£000	£000	£000
Turnover	$500 \times \frac{1}{2}$		250
less Expenses	$420 \times \frac{1}{2}$	210	
Amortisation of goodwill		3	213
			37
less Taxation	$36 \times \frac{1}{2}$		18
			19
add Extraordinary profit			20
			39

The consolidated profit and loss account with relevant workings, will appear as follows:[38]

Consolidated profit and loss account for the year ended 31 December 20X1

	£000	£000
Turnover		
J Group (excluding K)	2000	
K, $\frac{1}{2} \times$ £500 000	250	2250
Expenses		
J Group (excluding K)	1500	
K, $\frac{1}{2} \times$ £420 000	210	
Amortisation of goodwill in K	3	1713
Profit from ordinary activities before tax		537
less Taxation		
J Group (excluding K)	200	
K, $\frac{1}{2} \times$ £36 000	18	218
		319
less Minority interest (no change as new subsidiary is wholly owned)		40
		279
add Extraordinary profit (net of taxation and minority interest)		
J Group (excluding K)	30	
K (all post-acquisition)	20	50
		329
less Dividends proposed		100
Retained profit for the year		229

[38] We have assumed that the extraordinary profit of K Limited remains extraordinary within the context of the group.

Movement on profit and loss account reserve for the year ended 31 December 20X1

	£000
Balance on 1 January 20X1 (old J Group only) (£500 000 – £190 000)	310
Retained profit for the year per consolidated profit and loss account	229
Balance on 31 December 20X1	539

Note that the retained profits brought forward do not include any profits in respect of K; after all, K did not become a member of the group until 1 July 20X1 so all retained profits before that date are pre-acquisition and represented by the net assets purchased on that date.

On the assumption that no major discontinuance is planned for K, the results of the new subsidiary will be included as part of the results of continuing operations and disclosed separately in accordance with the provisions of FRS 3.[39]

We next turn to the preparation of the consolidated balance sheet on 31 December 20X1. As K is a member of the group on that date, the balance sheet must include all of its assets and liabilities together with the purchased goodwill on acquisition shown at its cost less amortisation, that is at £36 000 less £3000.

The consolidated balance sheet on 31 December 20X1, together with appropriate workings, will appear as follows:

J Group
Summarised consolidated balance sheet on 31 December 20X1

		£000	£000
Fixed assets			
Intangible			
Goodwill	– Old J group	100	
	K	33	133
Tangible	– Old J group	500	
	K	156	656
Net current assets	– Old J group	300	
	K	100	400
			1189
less Long-term loans	– Old J Group	170	
	K	50	220
			969
Share capital, £1 shares			250
Retained profits, per consolidated profit and loss account			539
			789
Minority interest, as before			180
			969

[39] FRS 3, Para. 14.

Now that we have examined the basic principles for dealing with the acquisition of a new subsidiary, readers should be in a position to cope with various complications. Thus, the acquisition of a loss-making subsidiary or one in which profits do not arise evenly over the period should give few problems. Similarly, the acquisition of a partially owned subsidiary requires little modification to the approach we have adopted above.

Treatment of disposals

Just as companies acquire shares in subsidiaries, so too do they dispose of shares in subsidiaries. When we turn to disposals we may distinguish various categories of sales to outsiders[40] depending upon the shareholding, if any, which is retained:

(a) sale of total shareholding;
(b) sale of part of shareholding such that the investee company remains or becomes
  (i) a subsidiary;
  (ii) an associate;
  (iii) a simple investment.

In all cases it is necessary to recognise that different treatments are required in the individual accounts of the company making the sale and in the consolidated accounts.

We shall illustrate the principles involved in the context of a sale of the total shareholding and will then look briefly at partial disposals.

Sale of total shareholding

In the accounting records of the company which makes the sale, it is necessary to match the carrying value of the investment with the proceeds of sale to determine the profit or loss on disposal.

The disposal may, of course, have taxation consequences but, once the investing company has recognised the profit or loss and made any necessary provision for taxation, that is the end of the matter as far as that company is concerned.

When we turn to the consolidated accounts, matters are a little more complicated. In accordance with standard practice in the UK, as embodied in FRS 6, post-acquisition profits of a subsidiary are credited to the consolidated profit and loss account year by year, whether or not they are distributed as dividend to the investing company. Hence, year by year, we recognise profits which are retained by the subsidiary company and so increase the net assets shown in the consolidated balance sheet by these amounts.

In the consolidated financial statements, the profit or loss on disposal usually differs from that shown in the investing company's own profit and loss account. In the consolidated accounts, the profit or loss on disposal will be the difference between the sale proceeds and the appropriate share of the underlying net assets of the subsidiary at the date of sale plus any goodwill on acquisition which has not been written off in the consolidated profit and loss account. Thus the difference between the profit on disposal shown in the investing company's records and that in the consolidated financial statements will depend on the change in the net assets of the subsidiary since acquisition. To the extent that the net

[40] Intra-group sales may also occur. In addition, a parent company may lose control of a subsidiary even without a sale of shares where, for example, a rights offer by the investee is taken up by other shareholders but not by the existing parent. FRS 2 describes such a loss of control as a 'deemed disposal' and the principles involved in such a case are the same as those described in the text.

assets of the subsidiary have grown, due to the profits made and retained between acquisition and disposal, these have been recognised in the consolidated profit and loss account as part of the group's results.

Let us start with a very simple example. L Limited has two wholly owned subsidiaries, M Limited and N Limited. The respective summarised balance sheets on 31 December 20X1 are given below.

Summarised balance sheets on 31 December 20X1

	L £	*M* £	*N* £
Net assets	110 000	60 000	70 000
Investments in subsidiaries, at cost			
20 000 shares in M Limited	45 000		
30 000 shares in N Limited	70 000		
	225 000	60 000	70 000
Share capital, £1 shares	100 000	20 000	30 000
Retained profits	125 000		
at date of acquisition		10 000	20 000
post acquisition		30 000	20 000
	225 000	60 000	70 000

If we assume, for simplicity, that there are no fair value adjustments and that goodwill has not been amortised, the summarised consolidated balance sheet, with relevant workings, on 31 December 20X1, would appear as follows:

Summarised consolidated balance sheet on 31 December 20X1

	£	£
Goodwill		
M (£45 000 – £30 000)	15 000	
N (£70 000 – £50 000)	20 000	35 000
Other net assets		
(£110 000 + £60 000 + £70 000)		240 000
		275 000
Share capital, £1 shares		100 000
Retained profits		
L	125 000	
M post acquisition	30 000	
N post acquisition	20 000	175 000
		275 000

From this consolidated balance sheet we can see that the consolidated retained profits have been credited with £30 000 of post-acquisition profit retained by M and £20 000 post-acquisition profit retained by N. Thus, since acquisition, the net assets of these two companies have increased by £30 000 and £20 000, respectively, due to the making and retention of profits.

Let us now suppose that L sells its shareholding in M for £100 000 on 1 January 20X2. In the books of L it is necessary to compute the profit or loss on disposal by matching the carrying value of the investment, here its cost, against the sale proceeds. Sale proceeds are £100 000 and the cost was £45 000 so that the profit on disposal is £55 000.

In order to concentrate on principles, we shall postpone consideration of taxation until later in the chapter. The profit and loss account of L for the year ended 31 December 20X2 will therefore include the profit on disposal of shares in the subsidiary amounting to £55 000.

As the investment in M was sold on the very first day of 20X2, we shall prepare the consolidated profit and loss account for the year ended 31 December 20X2 by aggregating the profit and loss account items of L and N, the two companies in the group for this year. Concentrating only on the essential figures, we may produce a draft consolidated profit and loss account as follows:

Profit and loss accounts – year to 31 December 20X2

	L	*N*	*Total*
	£	£	£
Operating profit	80 000	60 000	140 000
less Taxation	40 000	20 000	60 000
			80 000
add Profit on disposal of shares in M	55 000		55 000
			135 000
add Retained profits brought forward			
L	125 000		
N (post acquisition)		20 000	145 000
Retained profits carried forward			280 000

Notice that the retained profits figure of £145 000 brought forward in this consolidated profit and loss account does not agree with the retained profits figure carried forward in the previous year's financial statements and shown in the consolidated balance sheet on 31 December 20X1 as £175 000. The difference is, of course, the £30 000 post-acquisition retained profits of M Limited, which ceased to be a member of the group on 1 January 20X2. We cannot now say that this £30 000 never existed. What has happened is that we have previously taken credit, in the consolidated financial statements but not in the parent company's financial statements, for profits of £30 000 which are represented in the net assets of company M. Any proceeds received for the shares are in respect of the underlying net assets at the date of disposal. What we must do is to return our profits brought forward to £175 000 by adding £30 000 and correspondingly to reduce the profit on disposal:

Workings for consolidated profit and loss account – year to 31 December 20X2

	Total	*Adjustment*	*Draft consolidated P and L account*
	£	£	£
Operating profit	140 000		140 000
less Taxation	60 000		60 000
	80 000		80 000
add Profit on disposal of shares	55 000	–30 000	25 000
	135 000		105 000
add Retained profits brought forward	145 000	+30 000	175 000
Retained profits carried forward	280 000		280 000

Notice that we have not changed the retained profits carried forward. These relate to L and its subsidiary N, the only two companies in the group at the year end. All we have done is to rearrange the items in the consolidated profit and loss account in order to give a true and fair view of what has happened:

	£	£
Sale proceeds		100 000
less Net assets of M at date of disposal	60 000	
Goodwill on acquisition	15 000	75 000
Profit on disposal		25 000

For ease of exposition, we have assumed that purchased goodwill has not been amortised. If goodwill had been amortised in the consolidated profit and loss account, only the unamortised amount applicable to M would be deducted in calculating the profit on disposal. To the extent that goodwill has been amortised in the past, it has already reduced consolidated retained profits.

The consolidated balance sheet on 31 December 20X2 poses no problems. At that date L has one subsidiary, N, and hence the consolidated balance sheet will be an aggregation for those two companies only.

Let us now complicate the example by assuming that the disposal occurs not on 1 January 20X2 but during the year to 31 December 20X2, for simplicity on 30 June 20X2. Let us assume that the proceeds on that date are £110 000 producing profit on disposal in the profit and loss account of L amounting to £65 000. Let us also assume that the profits of M arise evenly throughout the year.

M Limited

Summarised profit and loss account for the year to 31 December 20X2

	£
Operating profit	44 000
less Taxation	20 000
	24 000
add Retained profits brought forward	40 000
Retained profits carried forward	64 000

As explained above, we must make adjustments in the consolidated financial statements to show the results as far as the group is concerned. First, we must restore the retained profits brought forward to £175 000 and reduce the profit on disposal by £30 000, as we did before. However, we must, in addition, make a second adjustment. The operating profit and taxation figures included in the total column above relate only to L and N. However, the group consisted of L, N and M for the first six months of the year. The profits made and retained by M during those first six months should therefore be included in the group profits. Such profits are, of course, represented by net assets at the date of disposal and hence we must also reduce our profit on disposal. The appropriate adjustment will be as follows:

		£
Operating profits	$\frac{1}{2} \times$ £44 000	22 000
less Taxation	$\frac{1}{2} \times$ £20 000	10 000
		12 000

Our consolidated profit and loss account will therefore be arrived at as follows:

Draft consolidated profit and loss account of L Limited and its subsidiaries M Limited and N Limited for the year ended 31 December 20X2

	Total (L and N) as above	*Adjustments*	*Draft consolidated P and L account*
	£	£	£
Operating profit	140 000	+22 000	162 000
less Taxation	60 000	+10 000	70 000
	80 000	+12 000	92 000
add Profit on disposal of shares in subsidiary	65 000	−12 000 −30 000	23 000
	145 000		115 000
add Retained profits brought forward	145 000	+30 000	175 000
Retained profits carried forward	290 000		290 000

Notice again that the retained profit carried forward relates only to L and N, the companies in the group on 31 December 20X2. The profit on disposal amounts to £23 000 and may be explained as follows:

	£	£
Sales proceeds		110 000
less Net assets at date of disposal:		
On 31 December 20X1	60 000	
Increase in 6 months to 30 June 20X2	12 000	
	72 000	
Goodwill on acquisition	15 000	87 000
Profit on disposal		23 000

We have now examined the basic approach to the accounting treatment of disposals. Before we explore partial disposals, let us consider first the treatment of taxation and, second, the disclosure of the disposal in the consolidated profit and loss account.

Taxation

Under the UK taxation system, a chargeable gain or loss will occur when an investing company sells shares. Assuming that there is a gain, the profit in the accounts of the selling company will be reduced by taxation.

When we turn to the consolidated profit and loss account the treatment is, as in the examples above, a little more complicated.

Let us take the last example in the previous section and assume that company L faces a liability to taxation at 25 per cent on the chargeable gain. Thus, on the gain of £65 000 in the accounts of L, the taxation would be £16 250 so that our profit on disposal in the profit and loss account of L would be as follows:

	£
Profit on disposal of shares in subsidiary	65 000
less Taxation	16 250
	48 750

When we turn to the consolidated profit and loss account, an analysis of the component parts of the profit on disposal would be as follows:

	£
Sales proceeds	110 000
less Cost of investment	45 000
	65 000
Recognised in consolidated accounts:	
Post-acquisition profits retained:	
to 31 December 20X1	30 000
6 months to 30 June 20X2	12 000
	42 000
Profit on disposal	23 000
	65 000

What is happening is that, although the post-acquisition profits have already borne corporation tax, they are being taxed again as a result of the disposal. It may therefore be argued that we should recognise this by apportioning the taxation charge to the three components:

	£		£
Post-acquisition profit			
to 31 December 20X1	30 000	× 25%	7 500
6 months to 30 June 20X2	12 000	× 25%	3 000
Profit on disposal	23 000	× 25%	5 750
	65 000		16 250

The second and third elements of this tax charge relate to the current year and should be included as part of the taxation expense in the consolidated profit and loss account. The first element relates to the retained profits brought forward and some accountants would argue that it should be treated as an adjustment to reserves. However, such a treatment appears to be inconsistent with FRS 3 and, in the view of the authors, all three elements should be included as part of the tax charge in the consolidated profit and loss account. All three elements have arisen because of the disposal during the current year and should be reflected in the consolidated profit and loss account, even though this may result in a relatively high tax expense in relation to the profits included.

This could, if desired, be isolated as taxation related to discontinued operations although, as we shall see below, this is not actually required by FRS 3.

Disclosure

In order to provide the results of the group, it is necessary to include as part of the consolidated profits those relating to the subsidiary M from the beginning of the year to the date of disposal. It is also necessary to include the profit on disposal of the subsidiary.

FRS 3 requires certain disclosures in the consolidated profit and loss account, namely that:

> The aggregate results of each of continuing operations, acquisitions (as a component of continuing operations) and discontinued operations should be disclosed separately.[41]

The relevant analysis of turnover and operating profit must be included on the face of the consolidated profit and loss account but an analysis of other statutory format headings between turnover and operating profit must be included either on the face of the consolidated profit and loss account or in the notes to the financial statements.

If we assume that the sale of M falls within the FRS 3 definition of discontinued operations, an appropriate presentation for the relevant part of the consolidated profit and loss account for the L group would be as follows:

Consolidated profit and loss account – year to 31 December 20X2

	Continuing operations	*Discontinued operations*	*Total*
	£	£	£
Turnover			
Expenses – in accordance with statutory formats		Analysed appropriately	
Operating profit	140 000	22 000	162 000
Profit on disposal of discontinued operations	–	23 000	23 000
Profit on ordinary activities	140 000	45 000	185 000
Taxation	60 000		
(10 000 + 16 250)		26 250	86 250
Profit on ordinary activities after tax	80 000	18 750	98 750

FRS 3 does not require an analysis of the taxation charge between continuing operations and discontinued operations. We have included it for completeness.

Partial disposals

Where one company sells part of a holding in a subsidiary undertaking, the principles applied are the same as those illustrated above. However, the precise treatment depends upon the nature of the remaining investment. The investee may remain a subsidiary or the holding may be sufficient to make it an associate, otherwise it becomes a simple investment.

In all cases, it is essential to maintain a clear distinction between the entries in the accounting records of the selling company and those in the consolidation working papers.

In the records of the investing company it is necessary to match the appropriate proportion of the carrying value of the investment against the proceeds of disposal to produce a profit or loss on disposal. This may be subject to taxation but, now that we have explained the treatment of tax, we shall ignore it for the remainder of this chapter.

When we turn to the consolidated accounts, the position is somewhat different. We shall explore in detail the treatment where a subsidiary is retained and then look more briefly at the situation where an associate or a simple investment is retained.

[41] FRS 3 *Reporting Financial Performance*, ASB, October 1992, Para. 14.

Retention of subsidiary

At the beginning of the year the consolidated retained profit will include the post-acquisition profits of all subsidiaries based on the respective holdings of those subsidiaries at that particular date. In order to give a true and fair view of the operations of the year, the consolidated profit and loss account must include the appropriate portion of profits or losses of all companies which were members of the group during the year. The consolidated balance sheet at the end of the year will be an aggregation of the balance sheets of all companies in the group as at that date.

This is best illustrated with an example. P Limited acquired an 80 per cent interest in Q Limited many years ago when the reserves of Q were £20 000. The summarised balance sheets of the two companies, together with a summarised consolidated balance sheet on 31 December 20X1, were as follows:

Summarised balance sheets on 31 December 20X1

	P	*Q*	*Consolidated*
	£	£	£
Goodwill on consolidation			32 000
Investment in Q Limited: 32 000 shares at cost	80 000		
Other net assets	220 000	100 000	320 000
	300 000	100 000	352 000
Share capital, £1 shares	100 000	40 000	100 000
Retained profits	200 000		232 000
At date of acquisition		20 000	
Post acquisition		40 000	
Minority interest			20 000
	300 000	100 000	352 000

P sells 4000 shares in Q on 30 June 20X2 for £16 000. This produces a profit in the records of P amounting to £6000, as shown below, and leaves P with a 70 per cent shareholding in Q.

Sale of shares in subsidiaries

20X2		£	20X2		£
June 30	Investment account, cost of shares sold $\frac{1}{8} \times$ £80 000	10 000	June 30	Sale proceeds	16 000
	Profit on disposal	6 000			
		16 000			16 000

The consolidated profit and loss account must include the result of Q as an 80 per cent owned subsidiary for the first six months of the year and as a 70 per cent owned subsidiary for the second six months. Our consolidated balance sheet on 31 December 20X2 will, of course, be based upon the 70 per cent holding at that date.

A simple approach is to prepare initially a consolidated profit and loss account on the basis of the holdings at the end of the year. Assuming that there are no unrealised profits on intercompany trading and that we have the individual profit and loss accounts as shown in the first two columns, we may proceed as follows:

Workings for consolidated profit and loss account for the year ended 31 December 20X2

	P	*Q*	*Consolidated*
	£	£	£
Operating profit	50 000	20 000	70 000
less Taxation	20 000	8 000	28 000
	30 000	12 000	42 000
less Minority interest, 30% × £12 000			3 600
			38 400
add Profit on disposal of shares in Q Limited	6 000		6 000
			44 400
add Retained profit brought forward	200 000		
Post-acquisition group share (70% × £40 000)		28 000	228 000
Retained profit carried forward			272 400

As in the previous section, we may now make adjustments to show what has happened as far as the group is concerned. First, we must restore the retained profits brought forward to the figure shown in the consolidated balance sheet on 31 December 20X1 by adding £4000 and reduce the profit on disposal accordingly. Second, we must recognise that the minority interest was 20 per cent rather than 30 per cent for the first half of the year. Thus we must reduce the minority interest figure and also reduce the profit on disposal figure by 10 per cent of the profits of the first six months, which have of course increased the net assets underlying the shares sold. Assuming that the profits of Q arose evenly, we must therefore reduce the minority interest by £600 (10% × $\frac{1}{2}$ × £12 000).

Workings for consolidated profit and loss account for the year ended 31 December 20X2

	Total based on 70% holding as above	*Adjustment*	*Draft consolidated P and L account*
	£	£	£
Operating profit	70 000		70 000
less Taxation	28 000		28 000
	42 000		42 000
less Minority interest	3 600	–600	3 000
	38 400		39 000
add Profit on disposal of shares in Q Limited	6 000	–600	
		–4 000	1 400
	44 400		40 400
add Retained profits brought forward	228 000	+4 000	232 000
Retained profits carried forward	272 400		272 400

Having made these adjustments, the operating profits of £39 000 after minority interest may be analysed as follows:

	£	£
Operating profit after taxation		
P (£50 000 – £20 000)		30 000
Q		
6 months to 30 June 20X2, 80% × ($\frac{1}{2}$ × £12 000)	4 800	
6 months to 31 December 20X2, 70% × ($\frac{1}{2}$ × £12 000)	4 200	9 000
Per consolidated profit and loss account		39 000

With some rearrangement and additional information on turnover and expenses, readers should be in a position to prepare a consolidated profit and loss account for the group.

As before, the closing consolidated balance sheet poses no problems. At 31 December 20X2 P has one subsidiary, Q, in which it has a 70 per cent interest.

Retention of an associate

Where a parent company sells shares in a subsidiary but retains a holding sufficient to give significant influence over the investee, it retains an associate. In the individual financial statements of the parent we match the relevant proportion of the cost of the investment against the proceeds of disposal to produce a profit or loss on disposal which may attract a taxation liability.

In the consolidated profit and loss account, we must recognise that the group has a subsidiary for part of the year but an associate for the remainder of the year. Thus for the first part of the year we must include all of the relevant profits of the subsidiary, subject to deducting any minority interests, together with the profit or loss on disposal. For the second part of the year we must include the appropriate proportion of the profits of the associate using the equity method of accounting.[42]

In the consolidated balance sheet at the year end, the investment in the associate will appear at its cost, less goodwill written off, plus the appropriate share of post-acquisition retained profits of that associate.

Retention of simple investment only

The treatment in the parent company's financial statements is exactly the same as for other disposals. However, the consolidated profit and loss account must include the whole of the profits of the subsidiary up to the date of disposal, subject to any minority interest, together with the relevant profit or loss on disposal. Subsequently there is only a simple investment so credit should be taken only for dividends received and receivable and the investment should be shown at the same value at which it appears in the parent company's own balance sheet.

While this sounds straightforward, it does give rise to the need to remove from the consolidated profit and loss account reserve the share of post-acquisition retained profit included in relation to the simple investment retained.

To give an example, let us suppose that a parent company disposes of 90 per cent of the equity shares in a wholly owned subsidiary, thus retaining a 10 per cent holding.

[42] The equity method of accounting is explained and discussed in the following chapter.

The consolidated profit and loss account reserve will have included 100 per cent of the retained profits of the subsidiary from the date of acquisition to the date of disposal and these will be reflected in the net assets of the subsidiary at the date of disposal. Whereas the post-acquisition retained profits relating to the 90 per cent holding sold will be taken into account in calculating the profit on disposal, those relating to the remaining 10 per cent holding must be removed if the investment is to be shown at its cost. Thus it would be necessary to have an adjustment to the consolidated profit and loss account reserve to remove the share of post-acquisition retained profits in respect of the remaining holding in a company which was previously a subsidiary.

In the consolidated balance sheet the investment would appear at its historical cost unless the directors had decided to revalue it at a higher amount or it had suffered impairment. As is the case with all disposals, preparation of the consolidated balance sheet poses few problems.

Having explored some of the major issues of accounting for groups in the UK, we now examine the international accounting standards on this subject.

The international accounting standards

There are two main international accounting standards which are relevant to the subject matter of this section of the chapter:

- IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (revised 2000)
- IAS 22 *Business Combinations* (revised 1998)

Both of these standards are under review so, as well as explaining the provisions of the current standards, we will draw attention to proposed changes.

IAS 27 defines the parent company subsidiary relationship in similar, although not identical, terms to UK company law and FRS 2, and requires the consolidation of subsidiaries. It exempts parent companies which are wholly owned or virtually wholly owned themselves from the need to publish consolidated financial statements and requires that subsidiaries be excluded from the consolidated financial statements when control is intended to be temporary or when the subsidiary operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent. Unlike FRS 2, it does not require the exclusion of subsidiaries from the consolidated financial statements when there is a fundamental difference between the activities of the parent company and those of the subsidiary although, as we have explained earlier in the chapter, exclusion for this reason is extremely rare in the UK.

As we explained earlier in the chapter, an exposure draft of a revised IAS 27 was issued by the IASB in May 2002 as part of its improvements project. This proposes that wholly owned or virtually wholly owned parent companies would only be exempted from the need to publish consolidated accounts if none of their securities was publicly traded and if the immediate parent company or ultimate parent company publishes consolidated financial statements prepared in accordance with international financial reporting standards. It would require exclusion of a subsidiary from consolidation only where control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal *within 12 months from acquisition*. It takes the view that the existence of severe long-term restrictions casts doubt upon whether control exists and hence whether there is a subsidiary company at all.

IAS 27 makes no reference to the consolidation of quasi-subsidiaries which, as we have seen in Chapter 9, is required by FRS 5 *Reporting the Substance of Transactions*, in the UK. However Interpretation SIC 12,[43] *Consolidation – Special Purpose Entities* (June 1998), does require the consolidation of such entities under the control of the parent and the existence of this requirement undoubtedly boosted the standing of the IASB when the US corporation Enron collapsed in 2001 after failing to consolidate such Special Purpose Entities, a procedure which appeared not to be necessary under the voluminous US GAAP!

The mechanics of consolidation specified in international accounting standards are very similar to those in the UK. However IAS 22, *Business Combinations*, which we examined in the previous chapter, introduces a fundamental difference in the way in which assets, liabilities and minority interests are measured when using the acquisition method in consolidated financial statements which we will now explain and illustrate.

In this section of the chapter we have discussed the acquisition method of accounting and have, in particular, explained the need to use fair value, or more precisely in the UK context value to the business, in order to arrive at the historical cost of the separately identified assets and liabilities of a subsidiary to be included in the consolidated financial statements. Although IAS 22 and FRS 7 use the same term, 'fair value', IAS 22 actually requires the use of fair values while FRS 7 *Fair Values in Acquisition Accounting*, requires the use of the concept known as value to the business.[44]

Leaving this difference on one side, FRS 2 requires us to measure all of the assets and liabilities of a subsidiary at their fair values. Any minority interest in the subsidiary will then be measured as the relevant proportion of the aggregate of those fair values.

While this is the allowed alternative treatment under IAS 22, it is not the benchmark treatment. The benchmark treatment requires the use of fair values to the extent to which the subsidiary is owned by the group but requires that the minority interest be based upon the book values of assets and liabilities in the balance sheet of the subsidiary at the date of acquisition. This is best illustrated by means of an example.

Let us suppose that S plc acquires a 90 per cent interest in T plc. The aggregate book value of the net assets in the balance sheet of T at the date of acquisition is £400 000 and the sum of the fair values of those net assets is £600 000.

In accordance with UK practice and the allowed alternative treatment of the international accounting standard, the net assets would be shown at £600 000 and the minority interest would be shown at £60 000, that is 10 per cent of £600 000. However, under the benchmark treatment of IAS 22, the net assets and minority interest would be calculated as follows:

Carrying value of net assets:		£
S's interest	90% of £600 000	540 000
Minority interest	10% of £400 000	40 000
		580 000
Minority interest at date of acquisition		
10% of £400 000		40 000

[43] The Standing Interpretations Committee (SIC) was formed by the IASC in January 1997 and reconstituted in December 2001. Its role is to interpret international standards and provide timely guidance on financial reporting issues and it has issued some 33 Interpretations, which carry the prefix SIC. As we explained in Chapter 3, its name has now been changed to the International Financial Reporting Interpretations Committee.

[44] FRS 7, Para. 45.

This benchmark treatment results in strange carrying values for the individual assets and liabilities of the subsidiary in the consolidated financial statements and makes subsequent accounting for the group extremely complicated. However, it is the method which has long been part of US GAAP and became the benchmark treatment of IAS 22 in spite of considerable opposition from other countries. As we explained in Chapter 13, IAS 22 is at present under review and it is hoped that the benchmark treatment of that standard will disappear. There is no doubt in the minds of the authors that the allowed alternative treatment of IAS 22, that is the UK treatment, results in the provision of more sensible figures for users of consolidated financial statements.

Summary

In this chapter, we first examined the accounting treatment of investments in the financial statements of the investing company and then looked in much more detail at the subject of accounting for subsidiaries.

In the first section, we identified investments which give different levels of influence over the investee. These range from, at one end of the spectrum, a passive or simple investment through associates and joint ventures to investments which are sufficient to give control and hence create a parent/subsidiary relationship, We have seen that, in the UK, the rules for the treatment of all these investments in the investor's single-entity financial statements are the same while, under international accounting standards, the present treatment varies depending upon the level of influence which the investment carries. We have seen that changes in the international rules have been proposed which would prohibit the use of the equity method in the investor's single-entity financial statements.

In the second section, we explored the circumstances when consolidated financial statements must be prepared and when subsidiaries must be excluded from those consolidated financial statements. We then examined the mechanics of consolidation using the acquisition method of accounting. We concentrated heavily on the treatment of the acquisition of a new subsidiary, with the need to use fair values to arrive at the 'historical costs' of the assets and liabilities acquired, and on the disposal of shares in subsidiaries.

We saw that the ASB and the IASB interpret the term fair values in different ways and we have pointed out that UK practice adopts the allowed alternative treatment for the use of fair values, rather than the benchmark treatment of IAS 22. Both IAS 22 and IAS 27 are being revised and, while no change to the concept of fair value is expected, it seems likely that the benchmark treatment of fair values and minority interests will not survive the reviews.

Recommended reading

G.C. Baxter and J.C. Spinney, 'A closer look at consolidated financial statement theory', *CA Magazine*, January and February 1975.

R. Bryant, *Developments in group accounts*, 4th edn, Accountants Digest No. 425, ICAEW, London, 2000.

S.J. Gray (ed.), *International Group Accounting: Issues in European Harmonization*, 2nd edn, Routledge, London, 1993.

S.M. McKinnon, *Consolidated Accounts: The Seventh EEC Directive*, A.D.H. Newham (ed.), Arthur Young McClelland Moores, London, 1983.

C. Nobes, *Some Practical and Theoretical Problems of Group Accounting*, Deloitte Haskins & Sells, London, 1986.

A. Simmonds, A. Mackenzie and K. Wild, *Accounting for Subsidiary Undertakings*, Accountants Digest No. 288, ICAEW, London, Autumn 1992.

C. Swinson, *Group Accounting*, Butterworths, London, 1993.

P.A. Taylor, *Consolidated Financial Reporting*, Paul Chapman, London, 1996.

In addition to the above, readers are referred to the latest edition of *UK and International GAAP* by Ernst & Young, which provides much greater detailed coverage of this and other topics in this book. At the time of writing the most recent edition is the 7th, A. Wilson, M. Davies, M. Curtis and G. Wilkinson-Riddle (eds), Butterworths Tolley, London 2001. The relevant chapters are 5 and 14.

Questions

14.1 The accountancy profession has developed a range of techniques to measure and present the effects of one company owning shares in another company.

Briefly describe each of these techniques and how the resulting information might best be presented.
(The Companies Act 1985 disclosure requirements are not required.)

ACCA Level 2, The Regulatory Framework of Accounting, December 1986 **(20 marks)**

14.2 You are group financial accountant of a diverse group of companies. The board of directors has instructed you to exclude from the consolidated financial statements the results of some loss-making subsidiaries as they believe inclusion will distort the performance of other more profitable subsidiaries.

You are required to write a memorandum to the board of directors explaining the circumstances when a subsidiary can be excluded and the accounting treatment of such excluded subsidiaries.

CIMA, Advanced Financial Accounting, November 1993 **(15 marks)**

14.3 Fair value is a concept underlying external financial reporting.

You are required
(a) **to explain why fair value accounting is required;** (4 marks)
(b) **to explain how the fair value concept is applied;** (5 marks)
(c) **to list three areas of application of fair value accounting.** (6 marks)

CIMA, Advanced Financial Accounting, November 1991 **(15 marks)**

14.4 Relevant balance sheets as at 31 March 1994 are set out opposite:

	£000 *Jasmin (Holdings) plc*	£000 *Kasbah plc*	£000 *Fortran plc*
Tangible fixed assets	289 400	91 800	7 600
Investments			
Shares in Kasbah (at cost)	97 600		
Shares in Fortran (at cost)	8 000		
	395 000		
Current assets			
Stock	285 600	151 400	2 600
Cash	319 000	500	6 800
	604 600	151 900	9 400
Creditors: amounts falling due within one year	289 600	238 500	2 200
Net current assets	315 000	(86 600)	7 200
Total assets less current liabilities	710 000	5 200	14 800
Capital and reserves			
Called up share capital			
Ordinary £1 shares	60 000	20 000	10 000
10% £1 Preference shares		4 000	
Revaluation reserve	40 000		1 200
Profit and loss reserve	610 000	(18 800)	3 600
	710 000	5 200	14 800

You have recently been appointed chief accountant of Jasmin (Holdings) plc and are about to prepare the group balance sheet at 31 March 1994.

The following points are relevant to the preparation of those accounts.

(a) Jasmin (Holdings) plc owns 90% of the ordinary £1 shares and 20% of the 10% £1 preference shares of Kasbah plc. On 1 April 1993 Jasmin (Holdings) plc paid £96 million for the ordinary £1 shares and £1.6 million for the 10% £1 preference shares when Kasbah's reserves were a credit balance of £45 million.

(b) Jasmin (Holdings) plc sells part of its output to Kasbah plc. The stock of Kasbah plc on 31 March 1994 includes £1.2 million of stock purchased from Jasmin (Holdings) plc at cost plus one-third.

(c) The policy of the group is to revalue its tangible fixed assets on a yearly basis. However the directors of Kasbah plc have always resisted this policy preferring to show tangible fixed assets at historical cost. The market value of the tangible fixed assets of Kasbah plc at 31 March 1994 is £90 million. The directors of Jasmin (Holdings) plc wish you to follow the requirements of FRS 2 'Accounting for Subsidiary Undertakings' in respect of the value of tangible fixed assets to be included in the group accounts.

(d) The ordinary £1 shares of Fortran plc are split into 6 million 'A' ordinary £1 shares and 4 million 'B' ordinary £1 shares. Holders of 'A' shares are assigned 1 vote and holders of 'B' ordinary shares are assigned 2 votes per share. On 1 April 1993 Jasmin (Holdings) plc acquired 80% of the 'A' ordinary shares and 10% of the 'B' ordinary shares when the profit and loss reserve of Fortran plc was £1.6 million and the revaluation reserve was £2 million. The 'A' ordinary shares and 'B' ordinary shares carry equal rights to share in the company's profit and losses.

(e) The fair values of Kasbah plc and Fortran plc were not materially different from their book values at the time of acquisition of their shares by Jasmin (Holdings) plc.

(f) Goodwill arising on acquisition is amortised over five years.

(g) Kasbah plc has paid its preference dividend for the current year but no other dividends are proposed by the group companies. The preference dividend was paid shortly after the interim results of Kasbah plc were announced and was deemed to be a legal dividend by the auditors.

(h) Because of its substantial losses during the period, the directors of Jasmin (Holdings) plc wish to exclude the financial statements of Kasbah plc from the group accounts on the grounds that Kasbah plc's output is not similar to that of Jasmin (Holdings) plc and that the resultant accounts therefore would be misleading. Jasmin (Holdings) plc produces synthetic yarn and Kasbah plc produces garments.

Required

(a) **List the conditions for exclusion of subsidiaries from consolidation for the directors of Jasmin (Holdings) plc and state whether Kasbah plc may be excluded on these grounds.** (4 marks)

(b) **Prepare a consolidated balance sheet for Jasmin (Holdings) Group plc for the year ending 31 March 1994. (All calculations should be made to the nearest thousand pounds.)** (18 marks)

(c) **Comment briefly on the possible implications of the size of Kasbah plc's losses for the year for the group accounts and the individual accounts of Jasmin (Holdings) plc.** (3 marks)

ACCA, Accounting and Audit Practice, June 1994 **(25 marks)**

14.5 Balmoral plc acquired 75% of the ordinary share capital and 30% of the preference share capital of Glenshee Ltd for £2 million on 1 November 1994. The draft profit and loss accounts for the companies for the year ended 31 October 1998 were:

	Balmoral plc	*Glenshee Ltd*
	£000	£000
Turnover	2500	800
Changes in stocks of finished goods and work-in-progress	200	(100)
Own work capitalised	150	–
Raw materials and consumables	(1000)	(300)
Staff costs	(400)	(50)
Depreciation	(350)	(110)
Profit before taxation	1100	240
Taxation	(340)	(70)
Profit after taxation	760	170

Additional information

(1) The share capital and reserves of Glenshee Ltd at 1 November 1994 were:

	£000
Ordinary shares of £1 each	1500
10% preference shares of £1 each	500
Share premium account	100
Profit and loss account	400

There have been no subsequent changes to the share capital.

(2) The share capital of Balmoral plc comprises £2 million of 50p ordinary shares.
(3) The fair value of Glenshee Ltd's fixed assets was £200 000 higher than their net book value at 1 November 1994 and they have a useful economic life of 10 years.
(4) On 31 July 1998, Glenshee Ltd sold goods to Balmoral plc for £50 000 on the basis of cost plus a mark-up of one-third. By 31 October 1998, £40 000 of the goods remained in Balmoral plc's stock.
(5) Neither company has paid dividends in the year but both have proposed a final ordinary dividend of 5p per share and Glenshee Ltd proposes to pay the preference dividend in full. These proposed dividends are yet to be accounted for.
(6) Any goodwill arising is to be amortised over 10 years.

Requirements

(a) **Prepare the consolidated profit and loss account of Balmoral plc for the year ended 31 October 1998.** (10 marks)
(b) **Discuss the benefits of consolidated accounts to the users of published financial statements.** (5 marks)

ICAEW, Financial Reporting, December 1998 **(15 marks)**

14.6 Highland plc owns two subsidiaries acquired as follows:

1 July 1991 — 80% of Aviemore Ltd for £5 million when the book value of the net assets of Aviemore Ltd was £4 million.

30 November 1997 — 65% of Buchan Ltd for £2 million when the book value of the net assets of Buchan Ltd was £1.35 million.

The companies' profit and loss accounts for the year ended 31 March 1998 were:

	Highland plc	*Aviemore Ltd*	*Buchan Ltd*
	£000	£000	£000
Sales	5000	3000	2910
Cost of sales	(3000)	(2300)	(2820)
Gross profit	2000	700	90
Net operating expenses	(1000)	(500)	(150)
Other income	230	–	–
Interest payable and similar charges	–	(50)	(210)
Profit/(loss) before taxation	1230	150	(270)
Taxation	(300)	(50)	–
Profit/(loss) after taxation	930	100	(270)
Dividends proposed	(200)	(50)	–
	730	50	(270)

Additional information

(1) On 1 April 1997, Buchan Ltd issued £2.1 million 10% loan stock to Highland plc. Interest is payable twice yearly on 1 October and 1 April. Highland plc has accounted for the interest received on 1 October 1997 only.

(2) On 1 July 1997, Aviemore Ltd sold a freehold property to Highland plc for £800 000 (land element – £300 000). The property originally cost £900 000 (land element – £100 000) on 1 July 1987. The property's total useful economic life was 50 years on 1 July 1987 and there has been no change in the useful economic life since. Aviemore Ltd has credited the profit on disposal to 'Net operating expenses'.

(3) The fixed assets of Buchan Ltd on 30 November 1997 were valued at £500 000 (book value £350 000) and were acquired in April 1997. The fixed assets have a total useful economic life of ten years. Buchan Ltd has not adjusted its accounting records to reflect fair values.

(4) All companies use the straight-line method of depreciation and charge a full year's depreciation in the year of acquisition and none in the year of disposal.

(5) Highland plc charges Aviemore Ltd an annual fee of £85 000 for management services and this has been included in 'Other income'.

(6) Highland plc has accounted for its dividend receivable from Aviemore Ltd in 'Other income'.

(7) It is group policy to amortise goodwill arising on acquisitions over ten years.

Requirement
Prepare the consolidated profit and loss account for Highland plc for the year ended 31 March 1998.

ICAEW, Financial Reporting, May 1998 **(13 marks)**

14.7 You are the management accountant of Complex plc, a listed company with a number of subsidiaries located throughout the United Kingdom. Your assistant has prepared the first draft of the financial statements of the group for the year ended 31 August 1999. The draft statements show a group profit before taxation of £40 million. She has written you a memorandum concerning two complex transactions which have arisen during the year. The memorandum outlines the key elements of each transaction and suggests the appropriate treatment.

Transaction 1
On 1 March 1999, Complex plc purchased 75% of the equity share capital of Easy Ltd for a total cash price of £60 million. The Directors of Easy Ltd prepared a balance sheet of the company at 1 March 1999. The total of net assets as shown in this balance sheet was £66 million. However, the net assets of Easy Ltd were reckoned to have a fair value to the Complex group of £72 million in total. The Directors of Complex plc considered that a group reorganisation would be necessary because of the acquisition of Easy Ltd and that the cost would be £4 million. This reorganisation was completed by 31 August 1999. Your assistant has computed the goodwill on consolidation of Easy Ltd shown opposite.

	£ million	£ million
Fair value of investment		60
Fair value of net assets	72	
Less: reorganisation provision	(4)	
	68	
Group share		(51)
Goodwill relating to a 75% investment		9
Goodwill relating to a 25% investment ($\frac{25}{75}$)		3

Your assistant has recognised total goodwill of £12 million (£9 million + £3 million). The goodwill attributable to the minority shareholders (£3 million) has been credited to the minority interest account. The reorganisation costs of £4 million have been written off against the provision which was created as part of the fair value exercise.

Transaction 2

On 15 May 1999, Complex plc disposed of one of its subsidiaries – Redundant Ltd. Complex plc had owned 100% of the shares in Redundant Ltd prior to disposal. The goodwill arising on the original consolidation of Redundant Ltd had been written off to reserves in line with the Accounting Standard in force at that time. This goodwill amounted to £5 million.

The subsidiary acted as a retail outlet for one of the product lines of the group. Following the disposal, the group reorganised the retail distribution of its products and the overall output of the group was not significantly affected.

The loss on disposal of the subsidiary amounted to £10 million before taxation. Your assistant proposes to show this loss as an exceptional item under discontinued operations on the grounds that the subsidiary has been disposed of and its results are clearly identifiable. The loss on disposal has been computed as follows:

	£ million
Sales proceeds	15
Share of net assets at the date of disposal	(25)
Loss on disposal	(10)

Your assistant has noted that unless the goodwill had previously been written off, the loss on disposal would have been even greater.

Requirements

Draft a reply to your assistant which evaluates the suggested treatment and recommends changes where relevant. In each case, your reply should refer to the provisions of relevant Accounting Standards and explain the rationale behind such provisions.

The allocation of marks is as follows:

Transaction 1 (10 marks)

Transaction 2 (8 marks)

CIMA, Financial Reporting, November 1999 **(18 marks)**

14.8 Mull plc acquired shares in two companies as follows:

Skye Ltd
Ordinary shares – 8 million acquired on 1 June 1996 for £4.50 each.
Preference shares – £500 000 8% redeemable preference shares acquired, at par, on 1 June 1996.
At the date of acquisition the retained profits of Skye Ltd were £10 million.

Arran Ltd
Ordinary shares – 1 million acquired on 1 June 1998 for £6 each.
At the date of acquisition the retained profits of Arran Ltd were £5 million and the revaluation reserve was £11 million.
The draft balance sheets for the above companies at 31 May 1999 show:

	Mull plc £000	*Skye Ltd* £000	*Arran Ltd* £000
Fixed assets			
Freehold property	40 000	20 000	10 000
Plant and equipment	–	–	5 700
Fixtures and fittings	10 500	5 900	5 200
Investment in Skye Ltd	36 500	–	–
Investment in Arran Ltd	6 000	–	–
	93 000	25 900	20 900
Current assets			
Stock	19 000	13 000	11 000
Debtors	22 500	7 000	10 000
Cash in hand and at bank	1 000	570	780
	42 500	20 570	21 780
Creditors: amounts falling due within one year			
Bank overdraft	5 600	–	8 400
Creditors	18 400	9 600	7 500
Corporation tax payable	4 000	5 400	2 300
Proposed dividends	2 000	1 500	–
	30 000	16 500	18 200
Net current assets	12 500	4 070	3 580
Net assets	105 500	29 970	24 480
Capital and reserves			
Called up share capital			
Ordinary shares of £1 each	50 000	10 000	4 000
8% Redeemable preference shares	–	2 000	–
Revaluation reserve	10 600	–	11 000
Profit and loss account	44 900	17 970	9 480
	105 500	29 970	24 480

Additional information

(1) Skye Ltd has continued to account for its assets at their book value though their fair values on 1 June 1996 were:

Freehold land – £2.5 million above book value

Fixtures and fittings – £1.5 million below book value with an estimated remaining useful economic life of 5 years

The fair values of all other assets and liabilities for both Skye Ltd and Arran Ltd approximated to their book values.

(2) Skye Ltd's corporation tax payable at 31 May 1999 includes £1.4 million related to its year ended 31 May 1996. The company had originally provided £500 000 as the estimated liability as at 31 May 1996. Mull plc incorporated this estimate when establishing the fair values of Skye Ltd's net assets on acquisition. However, following a protracted Inland Revenue investigation, the final liability was agreed on 31 May 1999 at £1.4 million, £900 000 higher than the estimate.

(3) Skye Ltd paid its preference dividend during the year. All proposed dividends relate to ordinary shares. Mull plc has not yet accounted for any dividends receivable.

(4) Any goodwill arising is amortised over 10 years on the straight-line basis.

Requirements

(a) **Prepare the consolidated balance sheet of Mull plc as at 31 May 1999.** (11 marks)
Note: **You are not required to produce any disclosure notes.**

(b) **Briefly explain your accounting treatment of items (1) and (2) above, referring to the provisions of FRS 7, *Fair values in acquisition accounting*, where appropriate.** (4 marks)

ICAEW, Financial Reporting, June 1999 **(15 marks)**

14.9 You are the management accountant of Faith plc. One of your responsibilities is the preparation of the consolidated financial statements of the company. Your assistant normally prepares the first draft of the statements for your review. The assistant is able to prepare the basic consolidated financial statements reasonably accurately. However, he has little idea of the principles underpinning consolidation and is unsure how to account for changes in the group structure. In these circumstances he asks you for guidance prior to beginning his work.

The profit and loss accounts of Faith plc, Hope Ltd and Charity Ltd for the year ended 30 September 2000 are given below:

	Faith plc	*Hope Ltd*	*Charity Ltd*
	£ million	£ million	£ million
Turnover	2000	1000	1200
Cost of sales	(1100)	(600)	(600)
Gross profit	900	400	600
Other operating expenses	(350)	(150)	(180)
Operating profit	550	250	420
Investment income	68		
Interest payable	(80)	(35)	(45)
Profit before taxation	538	215	375
Taxation	(160)	(65)	(114)
Profit after taxation	378	150	261
Proposed dividends	(160)	(70)	(100)
Retained profit for the year	218	80	161
Retained profit – 1 October 1999	780	330	526
Retained profit – 30 September 2000	998	410	687

Notes to the profit and loss accounts

Note 1 – Investments

Faith plc has made investments in the other two companies as follows:

- On 1 July 1993, Faith plc purchased 50% of the equity shares of Hope Ltd for a cash payment of £220 million. The net assets of Hope Ltd on 1 July 1993 had a fair value of £400 million. This value did not differ significantly from the carrying value in the balance sheet of Hope Ltd. The profit and loss account at that date showed a credit balance of £200 million. This investment gave Faith plc a reasonably significant influence over the operating and financial policies of Hope Ltd. However, on more than one occasion since 1 July 1993, the other shareholders have combined to prevent Hope Ltd embarking upon a course of action that was proposed by Faith plc.
- On 1 October 1999, Faith plc purchased a further 30% of the equity shares of Hope Ltd for a cash payment of £179 million. The net assets of Hope Ltd on 1 October 1999 had a fair value of £530 million. This value did not differ significantly from the carrying value in the balance sheet of Hope Ltd. This additional investment gave Faith plc control over the operating and financial policies of Hope Ltd.
- On 1 October 1999, Faith plc made a medium-term loan of £100 million to Hope Ltd. The rate of interest chargeable on that loan was 12% per annum. Both companies have correctly reflected that interest in their financial statements.
- On 1 January 1992, Faith plc purchased 70% of the equity shares of Charity Ltd for a cash payment of £460 million. The net assets of Charity Ltd on 1 January 1992 had a fair value of £600 million. This value did not differ significantly from the carrying value in the balance sheet of Charity Ltd. The profit and loss account at that date showed a credit balance of £300 million. This investment gave Faith plc control over the operating and financial policies of Charity Ltd.

The accounting policy for goodwill adopted by Faith plc is to amortise it over a 20-year period. Faith plc charges a full year's amortisation in the year of investment but no amortisation in the year the investment is sold.

Note 2 – Disposal

The business of Charity Ltd is significantly different from that of Faith plc and Hope Ltd. Following Faith plc's additional investment in Hope Ltd, the directors of Faith plc took a strategic decision to concentrate on the core business of the group. Following this decision, Faith plc sold all its shares in Charity Ltd for £750 million on 31 May 2000. The proceeds of sale were credited to a suspense account in the books of Faith plc. No further entries have been made in connection with the sale. The tax department estimates that taxation of £30 million will be payable in connection with the sale. A balance sheet was drawn up for Charity Ltd immediately prior to the sale of its shares by Faith plc. This showed net assets of £1000 million. The profits of Charity Ltd accrued evenly throughout the year ended 30 September 2000.

Note 3 – Inter-company trading

Following its securing control over the operating and financial policies of Hope Ltd, Faith plc began to supply Hope Ltd with a component that Hope Ltd was formerly purchasing from an outside supplier. For the year ended 30 September 2000, sales of this product from Faith plc to Hope Ltd totalled £60 million. In setting the selling price, Faith plc added a mark-up of one-third to the cost price. On 30 September 2000, the stocks of Hope Ltd included £20 million in respect of supplies of the component purchased from Faith plc.

Requirements

(a) **Write a memorandum to your assistant that explains the impact of the changes in the group structure during the year on the consolidated profit and loss account. Your memorandum should include instructions regarding:**
- **the change of treatment of Hope Ltd caused by the additional share purchase;**
- **the profits of Charity Ltd that need to be included in the consolidated profit and loss account for the year ended 30 September 2000;**
- **the treatment of the sales proceeds that are currently credited to a suspense account;**
- **any separate disclosures that are necessary on the face of the consolidated profit and loss account as a result of the sale of the shares.**

Your memorandum should include references to appropriate Accounting Standards. (12 marks)

(b) **Prepare the consolidated profit and loss account of Faith plc for the year ended 30 September 2000. You should start with turnover and end with retained profit carried forward. Your consolidated profit and loss account should be in a form suitable for publication.** (30 marks)

CIMA, Financial Reporting, November 2000 **(42 marks)**

14.10 You are the management accountant of Pulp plc, a company incorporated in the United Kingdom. Pulp plc prepares consolidated financial statements in accordance with UK Accounting Standards. The company has a number of investments in other entities but its two major investments are in Fiction Ltd and Truth Ltd. The profit and loss accounts of all three companies for the year ended 31 December 2000 (the accounting reference date for all three companies) are given below.

	Pulp plc	*Fiction Ltd*	*Truth Ltd*
	£000	£000	£000
Turnover	30 000	32 000	28 000
Cost of sales	(15 000)	(16 000)	(14 000)
Gross profit	15 000	16 000	14 000
Other operating expenses	(8 000)	(8 500)	(6 000)
Operating profit	7 000	7 500	8 000
Investment income	2 850		
Interest payable	(1 000)	(1 200)	(1 000)
Profit before taxation	8 850	6 300	7 000
Taxation	(1 900)	(1 900)	(2 000)
Profit after taxation	6 950	4 400	5 000
Dividends paid 30 June 2000	(3 000)	(2 000)	(1500)
Retained profit	3 950	2 400	3 500
Retained profit – 1 January 2000	9 500	8 900	9 000
Retained profit – 31 December 2000	13 450	11 300	12 500

Note 1 – Investment by Pulp plc in Fiction Ltd

On 1 January 1995, Pulp plc purchased, for £13 million, 4 million £1 equity shares in Fiction Ltd. The balance sheet of Fiction Ltd at the date of the share purchase by Pulp plc (based on the carrying values in the financial statements of Fiction Ltd) showed the following balances:

	£000
Tangible fixed assets	7 000
Other net assets	3 000
	10 000
Share capital (£1 equity shares)	4 000
Share premium account	3 000
Profit and loss account	3 000
	10 000

Pulp plc carried out a fair value exercise on 1 January 1995 and concluded that the tangible fixed assets of Fiction Ltd at 1 January 1995 had a fair value of £8 million. All of these fixed assets were sold or scrapped prior to 31 December 1999. The fair values of all the other net assets of Fiction Ltd on 1 January 1995 were very close to their carrying values in Fiction Ltd's balance sheet.

Note 2 – Investment by Pulp plc in Truth Ltd

On 1 January 1994, Pulp plc purchased, for £12 million, 6 million £1 equity shares in Truth Ltd. The balance sheet of Truth Ltd at the date of the share purchase by Pulp plc showed the following balances:

	£000
Share capital (£1 equity shares)	8 000
Share premium account	4 000
Profit and loss account	2 000
Net assets	14 000

Pulp plc carried out a fair value exercise on 1 January 1994 and concluded that the fair values of all the net assets of Truth Ltd were very close to their carrying values in Truth Ltd's balance sheet.

Note 3 – Accounting policy regarding purchased goodwill

Pulp plc amortises all purchased goodwill over its estimated useful economic life. For the acquisitions of Fiction Ltd and Truth Ltd, this estimate was 20 years.

Note 4 – Sale of shares in Truth Ltd

On 1 April 2000, Pulp plc sold 2.8 million shares in Truth Ltd for a total of £10 million. Taxation of £500 000 was estimated to be payable on the disposal. The profit and loss account of Pulp plc that is shown above does **NOT** include the effects of this disposal. The write-off by Pulp plc of goodwill on consolidation of Truth Ltd for the year ended 31 December 2000 should be based on the shareholding retained **after** this disposal. The profits of Truth Ltd accrued evenly throughout 2000.

Note 5 – Administration charge

Pulp plc charges Fiction Ltd an administration charge of £100 000 per quarter. This amount was also charged to Truth Ltd but only until 31 March 2000. The charges are included in the turnover of Pulp plc and the other operating expenses of Fiction Ltd and Truth Ltd. Apart from these transactions and the payments of dividends, there were no other transactions between the three companies.

Your assistant normally prepares a first draft of the consolidated financial statements of the group for your review. He is sure that the change in the shareholding in Truth Ltd must have some impact on the method of consolidation of that company but is unsure exactly how to reflect it. He is similarly unsure how the proceeds of sale should be included in the consolidated financial statements.

Required

(a) **Write a memorandum to your assistant that explains the effect of the disposal of shares in Truth Ltd on the consolidated financial statements of Pulp plc for the year ended 31 December 2000. Do not explain the mechanics of the consolidation in detail. You should refer to the provisions of relevant Accounting Standards.** (10 marks)

(b) **Prepare the working schedule for the consolidated profit and loss account of the Pulp group for the year ended 31 December 2000. Your schedule should start with turnover and end with retained profit carried forward. You should prepare all calculations to the nearest £000. Do NOT produce notes to the consolidated profit and loss account.** (30 marks)

CIMA, Financial Reporting – UK Accounting Standards, May 2001 **(40 marks)**

14.11 (a) On 1 October 1999 Hepburn plc acquired 80% of the ordinary share capital of Salter Ltd by way of a share exchange. Hepburn plc issued five of its own shares for every two shares it acquired in Salter Ltd. The market value of Hepburn plc's shares on 1 October 1999 was £3 each. The share issue has not yet been recorded in Hepburn plc's books. The summarised financial statements of both companies are:

Profit and loss accounts: Year to 31 March 2000

	Hepburn plc		*Salter Ltd*	
	£000	£000	£000	£000
Turnover		1200		1000
Cost of sales		(650)		(660)
Gross profit		550		340
Operating expenses		(120)		(88)
Debenture interest		nil		(12)
Operating profit		430		240
Taxation		(100)		(40)
Profit after tax		330		200
Dividends – interim	(40)			
– final	(40)	(80)		nil
Retained profit for the year		250		200

Balance sheets: as at 31 March 2000

Fixed Assets				
Land and buildings		400		150
Plant and Machinery		220		510
Investments		20		10
		640		670
Current Assets				
Stock	240		280	
Debtors	170		210	
Bank	20		40	
c/f	430	640	530	670

Balance sheets: as at 31 March 2000 (continued)

	Hepburn plc		*Salter Ltd*	
	£000	£000	£000	£000
b/f	430	640	530	670
Creditors: amounts falling due within one year				
Trade creditors	170		155	
Taxation	50		45	
Dividends	40		nil	
	(260)		(200)	
Net Current Assets		170		330
		810		1000
Creditors: amounts falling due after more than one year				
8% Debentures		nil		(150)
Net Assets		810		850
Capital and Reserves				
Ordinary shares of £1 each		400		150
Profit and loss account		410		700
		810		850

The following information is relevant:

(i) The fair values of Salter Ltd's assets were equal to their book values with the exception of its land, which had fair value of £125 000 in excess of its book value at the date of acquisition.

(ii) In the post-acquisition period Hepburn plc sold goods to Salter Ltd at a price of £100 000, this was calculated to give a mark-up on cost of 25% to Hepburn plc. Salter Ltd had half of these goods in stock at the year end.

(iii) Consolidated goodwill is to be written off as an operating expense over a five-year life. Time apportionment should be used in the year of acquisition.

(iv) The current accounts of the two companies disagreed due to a cash remittance of £20 000 to Hepburn plc on 26 March 2000 not being received until after the year end. Before adjusting for this, Salter Ltd's debtor balance in Hepburn plc's books was £56 000.

Required
Prepare a consolidated profit and loss account and balance sheet for Hepburn plc for the year to 31 March 2000. (20 marks)

(b) At the same date as Hepburn plc made the share exchange for Salter Ltd's shares, it also acquired 6000 'A' shares in Woodbridge Ltd for a cash payment of £20 000. The share capital of Woodbridge Ltd is made up of:

Ordinary voting A shares	10 000
Ordinary non-voting B shares	14 000

All of Woodbridge Ltd's equity shares are entitled to the same dividend rights; however during the year to 31 March 2000 Woodbridge Ltd made substantial losses and did not pay any dividends.

Hepburn plc has treated its investment in Woodbridge Ltd as an ordinary fixed asset investment on the basis that:

- it is only entitled to 25% of any dividends that Woodbridge Ltd may pay;
- it does not any have directors on the Board of Woodbridge Ltd; and
- it does not exert any influence over the operating policies or management of Woodbridge Ltd.

Required
Comment on the accounting treatment of Woodbridge Ltd by Hepburn plc's directors and state how you believe the investment should be accounted for. (5 marks)

***Note*: you are not required to amend your answer to part (a) in respect of the information in part (b).**

ACCA, Financial Reporting (UK Stream), Pilot Paper **(25 marks)**

14.12 The balance sheets of United plc, Blue Ltd and Green Ltd at 30 September 2002, the accounting date for all three companies, are given below:

	United plc		*Blue Ltd*		*Green Ltd*	
	£000	£000	£000	£000	£000	£000
Fixed assets:						
Intangible assets (*Note 1*)					1 200	
Tangible assets	25 000		22 000		20 000	
Investments (*Note 2*)	23 900		–		–	
		48 900		22 000		21 200
Current assets:						
Stocks	8 000		7 000		7 500	
Debtors (*Note 3*)	8 500		7 200		7 400	
Cash	900		600		500	
	17 400		14 800		15 400	
Creditors: amounts falling due within one year (*Note 3*)	(9 200)		(7 900)		(7 300)	
Net current assets		8 200		6 900		8 100
Total assets less current liabilities		57 100		28 900		29 300
Creditors: amounts falling due after more than one year		(12 000)		(10 000)		(9 000)
		45 100		18 900		20 300
Capital and reserves:						
Called up share capital (£1 ordinary shares)		20 000		10 000		10 000
Share premium account		5 000		4 000		3 000
Profit and loss account		20 100		4 900		7 300
		45 100		18 900		20 300

Notes to the financial statements

Note 1

The intangible fixed asset of Green Ltd represents capitalised development expenditure. United plc writes off such expenditure as it is incurred. At the date of its acquisition by United plc, the balance sheet of Green Ltd contained capitalised development expenditure of £400 000.

Note 2

Details of the investments by United plc are as follows:

Company	*Number of ordinary shares acquired*	*Date of acquisition*	*Price paid*	*Reserves balance of acquired company at date of acquisition*
Blue Ltd	8 million	1 October 1994	£14.8 million	£2 million
Green Ltd	7.5 million	1 October 1995	£13.5 million	£3 million

The following additional information is relevant:

- All shares carry one vote at annual general meetings.
- No fair value adjustments were necessary as a result of the acquisition of either company.
- Goodwill on acquisition is written off over 10 years.
- On 30 September 2002, United plc disposed of 2 million shares in Blue Ltd for proceeds of £4.4 million. Upon receiving the cash, United plc credited the proceeds of disposal to its investments account. Apart from this, United plc has made no other entries in respect of the disposal. Taxation of £200 000 is expected to be payable on the disposal.
- Neither Blue Ltd or Green Ltd has issued shares since the dates of acquisition by United plc.

***Note* 3**

United plc provides goods and services to Blue Ltd and Green Ltd and the debtors of United plc at 30 September 2002 contained the following balances:

- Receivable from Blue Ltd £500 000.
- Receivable from Green Ltd £400 000.

The above amounts agreed to the amounts recognised in the trade creditors of Blue Ltd and Green Ltd. There were no goods in the stock of Blue Ltd or Green Ltd at 30 September 2002 that had been purchased from United plc.

Required

Prepare the consolidated balance sheet of United plc at 30 September 2002. Marks will be given for workings and explanations that support your figures.

CIMA, Financial Reporting – UK Accounting Standards, November 2002 **(20 marks)**