chapter 15

Associates and joint ventures

overview

As we explained in the previous chapter, 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. In this chapter, we focus on investments between these two extremes, namely investments in associates and joint ventures. Both such investments give the investor significant influence over the investee. In the case of joint ventures, this influence amounts to control, albeit shared with other venturers. We also refer to joint arrangements that are not entities, known by the acronym 'JANE'.

While it would be possible to account for these investments using cost or fair values, accounting standard setters have focused, instead, on two methods of accounting which are generally considered appropriate for such investments, namely proportional (or proportionate) consolidation and the equity method of accounting. We start by explaining each of these methods and demonstrate the similarities and differences between them. We then turn to current practice by explaining the provisions of the rather unhelpful legal rules now contained in the UK Companies Act 1985 and then examine the provisions of the relevant UK and international accounting standards, which are:

- FRS 9 *Accounting for Associates and Joint Ventures* (1997)
- IAS 28 *Accounting for Investments in Associates* (revised 2000)
- IAS 31 *Financial Reporting of Interests in Joint Ventures* (revised 2000)

IAS 28 is at present under review, as part of the IASB improvements project, and this is one of the six topics included in the ASB Consultation Paper, issued in May 2002, as part of the convergence programme. We draw attention to proposed changes where appropriate.

Introduction

Associated companies were the subject of the very first SSAP, issued in 1971.[1] Prior to the publication of SSAP 1, a long-term investment in another company was treated in one of two ways. Either it was a simple investment, to be treated as a fixed asset investment or it was an investment in a subsidiary, in which case it was normal to prepare a set of consolidated financial statements. Both of these treatments have been discussed at some length in the previous chapter. The main change brought about by SSAP 1 was the recognition of an intermediate category of investment, an investment in an associated company, where a long-term investment was such as to give the investor company significant influence over the

[1] SSAP 1 *Accounting for the Results of Associated Companies*, ASC, London, January 1971. This was issued as a revised SSAP 1 *Accounting for Associate Companies*, by the ASC in April 1983 and has been replaced by FRS 9 *Accounting for Associates and Joint Ventures*, issued by the ASB in November 1997.

investee company. The term associated company included both a joint venture, where significant influence took the form of joint control, and a long-term investment which carried significant influence. Although it has proved difficult to develop a precise definition, the essence of the relationship is that the investing company or group participates in and has significant influence over the commercial and financial policy decisions of the associated company, including decisions on the level of distributions.

As we shall see later in this chapter, the Companies Act 1989 introduced a new term, an associated undertaking, which it defined in an extremely unhelpful way and this made it difficult to develop standard accounting practice in this area. However, FRS 9 *Associates and Joint Ventures,* which was issued by the ASB in November 1997, has surmounted the legal obstacles to provide that standard practice in the UK.

The main methods of accounting that have been developed for investments which give the investor significant influence over the investee are proportional consolidation and the equity method of accounting. We shall explore the similarities and differences between these two methods of accounting before returning to examine the current regulatory framework, both UK and international, later in the chapter.

Possible methods of accounting

Where one company exercises significant influence over another company, it seems unhelpful to account for the investment in that company as a simple or passive investment. To take credit in the profit and loss account merely for dividends received and receivable is not sufficient where the directors of the investing company are able to influence the level of those dividends. To show the investment in the balance sheet at its historical cost gives no guide to what is happening to the underlying net assets, the use of which is influenced by the investing company's directors. In order to evaluate the stewardship of their directors, shareholders in the investing company require further information. It is also desirable to minimise the opportunities available to directors to manipulate the trend of reported profits.

One possible alternative would be to show such an investment at its fair value and then to take movements in the fair value, together with any dividends receivable, to the profit and loss account each year. This would immediately bring us into conflict with company law, which states that only realised profits should be included in a profit and loss account, but there are other major deficiencies with such a treatment. Where the shares in the investee are unquoted, the estimation of fair value will usually be a difficult task, involving subjective judgement, frequently leading to a rather unreliable value. Even where it is possible to arrive at a reliable fair value as, for example, when the shares in the investee are quoted, it may be argued that this is an inappropriate way to account for investments which are held for the long term and carry significant influence over the investee. As we have seen in Chapter 14, it is certainly not the method we use to account for a subsidiary.

If treatment as a simple investment at cost or fair value is inadequate, there would appear to be two closely related possibilities. The first is *proportional (or proportionate) consolidation*, and the second is the *equity method* of accounting and its variant, the *gross equity method*, which differs only in the level of detailed disclosure required. We shall look at each of these possibilities. In so doing we shall assume that the investee is an associate which is a company rather than an unincorporated body.

Using the method of proportional consolidation we remove the investment in the associate from the investing company's balance sheet and replace it by the proportionate share of

the assets and liabilities of that associate on a line-by-line basis together with any goodwill on acquisition. In the profit and loss account of the investing company we remove any dividends received or receivable already credited and take credit, instead, for the appropriate proportion of the revenues and expenses of the associate on a line-by-line basis. The consolidated profits would then include the appropriate proportion of the post-acquisition profits retained by the associate. It would, of course, be possible to disclose separately the amount of each revenue, expense, asset and liability included in respect of the associate although this would, inevitably, result in a rather cluttered set of financial statements.

Using the equity method of accounting we value the investment in the balance sheet at cost plus the share of post-acquisition profits retained by the associate. Thus, the carrying value of the investment in the balance sheet is increased by the appropriate proportion of the increase in net assets of the associate due to retained profits. The profit and loss account is credited, not with dividends received and receivable, but with the appropriate proportion of the profits of the associate. Conversely, it would be debited with the appropriate proportion of any losses.

The net effect on the profit and loss account under both proportional consolidation and the equity method is the same but the way in which information is disclosed is different. Under proportional consolidation, the share of revenue and expenses of the associated company are added to those of the investing entity on a line-by-line basis. Under the equity method of accounting, as currently applied, it is usual to leave the revenues and operating expenses of the investing company or group unchanged and then to take credit for the share of the associate's operating profit as a separate item, including each subsequent item of income or expense on a line-by-line basis.

Let us explore a balance sheet using each method of accounting.

The summarised balance sheets of A Limited and B Limited on 31 December 20X2 are as follows:

Summarised balance sheets on 31 December 20X2

	A Limited	*B Limited*
	£	£
Fixed assets		
Tangible assets	90 000	40 000
Investment in B Limited		
5000 shares at cost	22 000	–
Net current assets	10 000	24 000
	122 000	64 000
Share capital, £1 shares	50 000	20 000
Retained profits	72 000	44 000
	122 000	64 000

Let us assume that A purchased its 25 per cent holding in B Limited some years ago when the retained profits of B were £28 000. Provided there have been no changes in share capital, this tells us that B's summarised balance sheet at the date of acquisition was:

	£
Net assets	48 000
Share capital	20 000
Retained profits	28 000
	48 000

As we explained in the previous chapter in the context of a subsidiary, the book values of the assets and liabilities of B at the date of acquisition should be replaced by their fair values, or more precisely their value to the business, at that date. However, for ease of exposition, we shall assume that the book values at the date of acquisition were equal to their fair values. On the basis of this simplifying assumption, A has purchased a 25% interest in these net assets for £22 000 and has paid £10 000 (i.e. £22 000 less 25% of £48 000) for goodwill. We shall also assume, for the present, that goodwill has not been amortised.

Between the date of acquisition and 31 December 20X2, B has increased its retained profits by £16 000 (i.e. £44 000 less £28 000). A's share of this retained post-acquisition profit is 25 per cent or £4000. We may therefore replace the asset 'Investment in B Limited' shown in the balance sheet of A at £22 000, by the following items:

	£
Fixed assets	
Tangible assets, 25% of 40 000	10 000
Goodwill	10 000
Net current assets 25% × 24 000	6 000
	26 000
less Retained profits (share of post-acquisition retained profits)	4 000
	22 000

Using proportional consolidation we would produce the following balance sheet, grouping like items for the investing company and associate together on a line-by-line basis.[2]

A Limited – Summarised balance sheet on 31 December 20X2
Using proportional consolidation (with workings)

		£
Fixed assets		
Intangible		
Goodwill		10 000
Tangible	(90 000 + 10 000)	100 000
		110 000
Net current assets	(10 000 + 6 000)	16 000
		126 000
Share capital (£1 shares)		50 000
Retained profits	(72 000 + 4 000)	76 000
		126 000

It would, of course, be possible to expand the balance sheet to provide an analysis of the assets and liabilities of the two companies along the following lines:

[2] As we will see later in the chapter, IAS 31 *Financial Reporting of Interests in Joint Ventures* (revised 2000), requires the use of what it calls proportionate consolidation for joint ventures, and permits the use of both of the formats, illustrated here.

A Limited – Summarised balance sheet on 31 December 20X2 using proportional consolidation (with disclosure of separate amounts for associate)

	£	£
Fixed assets		
Intangible		
Goodwill in associate		10 000
Tangible		
A Limited	90 000	
Associate	10 000	
		100 000
		110 000
Net current assets		
A Limited	10 000	
Associate	6 000	16 000
		126 000
Share capital (£1 shares)		50 000
Retained profits		
A Limited	72 000	
Associate	4 000	
		76 000
		126 000

Using the equity method of accounting, the investment is simply shown at cost plus the share of post-acquisition profits retained by the associate, that is at £26 000 (£22 000 plus £4000):

A Limited – Summarised balance sheet on 31 December 20X2 (using equity method of accounting)

	£	£
Fixed assets		
Tangible assets		90 000
Investment in associate (see below)		26 000
Net current assets		10 000
		126 000
Share capital, £1 shares		50 000
Retained profit		
A Limited	72 000	
Associate	4 000	76 000
		126 000

The carrying value of the investment may be calculated in two ways:

Cost of investment	22 000
add Share of post-acquisition profits retained by B Limited	4 000
	26 000

or

Share of net assets of B Limited	
25% of £64 000	16 000
Unamortised goodwill	10 000
	26 000

Comparison of the way in which the investment is shown using the equity method with the balance sheet using proportional consolidation makes it clear why the equity method is often referred to as a 'one-line consolidation'. The carrying value of the investment is equal to the appropriate proportion of the net assets of the associate plus any unamortised positive goodwill or less the balance of any negative goodwill.

Associates and acquisition accounting

Both proportional consolidation and the equity method of accounting are subsets of acquisition accounting, which we discussed in the context of accounting for subsidiaries in Chapters 13 and 14. It follows that many of the principles that we have discussed in the context of preparing consolidated financial statements for a parent and its subsidiaries also apply in the case of accounting for associates and joint ventures. We shall outline a number of such matters here.

Date of acquisition

Under acquisition accounting, only post-acquisition profits are included in the profit and loss account. Hence, when an interest in an associate or joint venture is acquired during a year, it will be necessary to calculate or estimate which revenues and expenses were preacquisition and which post acquisition. Only the post-acquisition revenues and expenses should be included in the profit and loss account prepared using proportional consolidation or the equity method of accounting.

Consistent accounting periods and policies

In order to produce meaningful aggregated amounts for the investor and investee, results for the same accounting periods using consistent accounting policies should be used. In practice, this may not always be possible and accounting standards can only provide limited guidance on what should be done in such circumstances.[3]

Use of fair values

As we explained in the previous chapter, the book values of the associate or joint venture are of no relevance in determining the 'cost' of assets and liabilities to the investor. For this purpose it is necessary to use fair values or, more accurately in the UK context at present, value to the business of assets and liabilities. The use of such values at the date of acquisition will usually have consequences for the subsequent measurement of profits or losses of the investee, most obviously in the area of depreciation and amortisation.

[3] See, for example, FRS 9 *Associates and Joint Ventures*, Para. 31(d).

Purchased goodwill and amortisation

As we saw in Chapter 13, it is now standard practice to amortise purchased goodwill over its expected useful economic life although, under FRS 10 *Goodwill and Intangible Assets*, there are circumstances where this is not necessary provided annual impairment reviews are conducted. The same rules apply to the treatment of purchased goodwill in associates and joint ventures.

Unrealised intercompany profits

Given the existence of significant influence of the investor over the investee, it would be wrong to include unrealised profits from intercompany trading when using proportional consolidation or the equity method of accounting. The part of such unrealised profits relating to the investor's share in the investee should be removed.[4]

The regulatory framework in the United Kingdom

The legal background

While the subject matter of SSAP 1 was associated companies, the Companies Act 1989 subsequently provided the following definitions of 'associated undertakings' and 'joint ventures':[5]

> **An 'associated undertaking' means an undertaking in which an undertaking included in the consolidation has a participating interest and over whose operating and financial position it exercises a significant influence and which is not:**
>
> **(a) a subsidiary undertaking of the parent company, or**
> **(b) a joint venture dealt with in accordance with paragraph 19.**
>
> **Where an undertaking holds 20 per cent or more of the voting rights in another undertaking, it shall be presumed to exercise such an influence over it unless the contrary is shown.**
>
> **(Paras 20(1) and 20(2))**

The above definition refers to 'a joint venture dealt with in accordance with paragraph 19'. The relevant part of this paragraph is as follows:

> **Where an undertaking . . . manages another undertaking jointly . . . that other undertaking ('the joint venture') may, if it is not –**
>
> **(a) a body corporate, or**
> **(b) a subsidiary undertaking of the parent company, be dealt with in the group accounts by the method of proportional consolidation. (Para. 19)**

This is really rather bizarre drafting, and it posed considerable problems for the ASB as it attempted to prepare a sensible standard. While the legal definition of associated undertakings always includes an incorporated joint venture, it includes an unincorporated joint venture only if the venturer chooses to apply the equity method of accounting rather than proportional consolidation. Thus, under the provisions of the Act, if a venturer chooses to apply the equity method to an unincorporated joint venture, that joint venture is an associated undertaking while, if the venturer chooses to apply proportional consolidation to that

[4] See FRS 9, Para. 31(b). The IASC Interpretation SIC – 3 *Elimination of Unrealised Profits and Losses on Transactions with Associates*, issued in July 1997, explains this requirement in more detail.
[5] Companies Act 1985, Schedule 4A, Paras 19 and 20.

unincorporated joint venture, it is not an associated undertaking because it has fallen under the provisions of Para. 19. To define a joint venture by reference to the method used to account for it posed some difficulties in attempting to develop an appropriate accounting method for joint ventures!

FRS 9 *Accounting for Associates and Joint Ventures*

In developing standard accounting practice for associates and joint ventures, the ASB has developed an approach which distinguishes investments in entities from a joint arrangement that does not fall within its definition of an entity. The crucial definition here is the FRS 9 definition of an entity, which can only be described as arcane:

> **A body corporate, partnership or unincorporated association carrying on a trade or business with or without a view to profit. The reference to carrying on a trade or business means a trade or business of its own and not just part of the trades or businesses of entities that have interests in it. (Para. 4)**

Under this definition, a limited company, certainly an entity using any sensible definition of the word, may or may not be an entity under FRS 9. If the company carries on its own trade or business, it is such an entity while, if it merely carries on part of the trades or businesses of the investors, it is not such an entity.

The distinction which the ASB makes can only lead to confusion and undoubtedly gives rise to problems in practice in deciding whether a body corporate, partnership or unincorporated association is carrying on its own trade or business or parts of the trades and businesses of the entities which have interests in it!

Nevertheless, on the basis of the above definition, FRS 9 distinguishes investments in entities, that is associates and joint ventures, from a 'joint arrangement that is not an entity'. Although the term is not used in the standard, the latter has, perhaps not surprisingly, attracted the acronym 'JANE'.

The standard provides definitions of the three categories of investment which it has identified and then clearly specifies the required accounting treatment for each category:[6]

> **An *associate* is an entity (other than a subsidiary) in which another entity (the investor) has a participating interest and over whose operating and financial policies the investor exercises a significant influence.**
>
> **A *joint venture* is an entity in which the reporting entity holds an interest on a long-term basis and is jointly controlled by the reporting entity and one or more other venturers under a contractual arrangement.**
>
> **A *joint arrangement that is not an entity* is a contractual arrangement under which the participants engage in joint activities that do not create an entity because it would not be carrying on a trade or business of its own. A contractual arrangement where all significant matters of operating and financial policy are predetermined does not create an entity because the policies are those of its participants, not of a separate entity.**

The required accounting treatment for each of these is shown in Table 15.1.

From Table 15.1, it may be seen that the ASB does not permit the use of proportional consolidation for associates and joint ventures. It considers that use of such a method is wrong because

[6] FRS 9 *Associates and Joint Ventures*, ASB, London, November 1997, was preceded by a Discussion Paper and an Exposure Draft FRED 11, both with the same title, in July 1994 and March 1996 respectively. For definitions see FRS 9, Para. 4, and for the required accounting treatment, FRS 9, Paras 18–29.

Table 15.1 Required accounting treatment of associates, joint ventures and JANEs

Entities	*Required treatment*
Associate	Equity method
Joint venture	Gross equity method
Joint arrangement that is not an entity (JANE)	Account for shares of individual assets, liabilities, results and cash flows

it combines assets and liabilities over which the investor only has significant influence, with assets and liabilities under the full control of the investor. As we shall see later in this chapter, this is not the view taken in the international accounting standard on joint ventures.

The difference between the gross equity method and the equity method is merely presentational in that the gross equity method provides more detailed disclosure of the share of the investee's turnover, gross assets and gross liabilities.

The method specified for a JANE is to require the investor to account directly for its share of the assets, liabilities, results and cash flows of the joint arrangement. This will frequently produce the same results as proportional consolidation in practice although this will not be the case where the venturer holds the individual assets and liabilities in the joint arrangement in different proportions.

To illustrate the approach of FRS 9, let us first take a situation where the investing company, C Limited, has subsidiaries and prepares consolidated financial statements. C Limited also has an associate, D Limited, in which it holds 30 per cent of the equity shares. Abbreviated consolidated financial statements for the group, excluding the incorporation of D as an associate, together with the financial statements of D Limited for the year ended 31 December 20X2 are given below.

Summarised profit and loss accounts for the year ended 31 December 20X2

	C Limited Consolidated P&L a/c	*D Limited Associate P&L a/c*
	£	£
Turnover	1 040 000	710 000
Cost of sales	670 000	230 000
Gross profit	370 000	480 000
Operating expenses	134 000	170 000
Operating profit	236 000	310 000
Dividend received from D Limited	24 000	–
	260 000	310 000
Interest payable	50 000	40 000
Profit from ordinary activities before tax	210 000	270 000
Taxation	80 000	60 000
Profit after tax	130 000	210 000
Minority interest	10 000	–
	120 000	210 000
Dividends paid and proposed	40 000	80 000
Retained profit for the year	80 000	130 000

Movement on reserves for the year ended 31 December 20X2

	C Limited Consolidated accounts	*D Limited Associate*
	£	£
Retained profits at 1 January 20X2	400 000	240 000
Retained profit for the year	80 000	130 000
Retained profits on 31 December 20X2	480 000	370 000

The profit and loss account of C Limited, and hence the consolidated profit and loss account, includes the dividend of £24 000 receivable from D Limited and this amount has been disclosed at the net amount in accordance with standard practice.

Summarised balance sheets on 31 December 20X2

	C Limited Consolidated accounts	*D Limited Associate*
	£	£
Fixed assets – at net book values		
Goodwill (on consolidation)	70 000	–
Tangible assets	493 000	420 000
Investment in associate:		
45 000 shares (30%) at cost	97 000	–
Net current assets	280 000	360 000
	940 000	780 000
less Long-term loans	100 000	150 000
	840 000	630 000
less Deferred taxation	80 000	60 000
	760 000	570 000
Share capital £1 shares	200 000	150 000
Share premium	40 000	30 000
Retained profits	480 000	390 000
	720 000	570 000
Minority interests	40 000	–
	760 000	570 000

C Limited acquired its 30 per cent interest in D Limited on 1 January 20X1 when the reserves of D comprised a share premium account of £30 000 and retained profits of £60 000. On the basis of the simplifying assumption that book values were equal to fair values at the date of acquisition, goodwill of £25 000 would have been recognised:[7]

	£	£
Cost of investment		97 000
less Share of net assets:		
Share capital	150 000	
Share premium	30 000	
Retained profits	60 000	
30% of	240 000	72 000
Purchased goodwill		25 000

[7] In addition to this simplifying assumption, we are implicitly assuming that there have been no changes to share capital or share premium since acquisition.

We shall assume that this goodwill, relating to the associate, had an expected useful economic life of five years and that it is being amortised over that period using the straight-line method.[8]

Let us focus first on the consolidated profit and loss account which, at present, includes £24 000 in respect of the dividend received or receivable from D. Using the equity method, this must be removed and replaced by the share of the associate's profit, whether or not this has been distributed. Under the provisions of FRS 9, the share of profit must be included after the group operating profit and then on a line-by-line basis.

	D Limited	*30% share*
	£	£
Operating profit	310 000	93 000
Interest payable	40 000	12 000
Profit from ordinary activities before tax	270 000	81 000
Taxation	60 000	18 000
Profit after tax	210 000	63 000

Inclusion of the share of these figures in the consolidated profit and loss account, together with the amortisation of goodwill, produces the following results:

Summarised consolidated profit and loss account for the year ended 31 December 20X2 (including results of associate)

	£	£
Turnover		1 040 000
Cost of sales		670 000
Gross profit		370 000
Operating expenses		134 000
Group operating profit		236 000
Share of operating profit of associate	93 000	
less Amortisation of goodwill	5 000	88 000
		324 000
Interest payable:		
Group	50 000	
Associate	12 000	62 000
Profit from ordinary activities before taxation		262 000
Taxation:		
Group	80 000	
Associate	18 000	98 000
		164 000
Minority interest		10 000
		154 000
Dividends paid and proposed		40 000
Retained profit for the year		114 000

We have brought in the share of profits amounting to £63 000 to replace the dividend receivable of £24 000. Thus we have taken credit for an extra £39 000, which is the share of the profit retained by the associate in respect of the year. We have also recognised the amortisation of the goodwill of the associate.

[8] It is worth noting that the goodwill which arose in respect of the purchase of subsidiaries would have already been amortised, if appropriate, in preparing the consolidated financial statements shown in the first column above.

When we turn to the movement on reserves, we must include the share of the post-acquisition profits retained by the associate less the accumulated amortisation of goodwill. The following statement includes the relevant workings.

Movement on reserves for the year ended 31 December 20X2

	£	£
Retained profits on 1 January 20X2:		
Group		400 000
Share of post-acquisition profits in associate:		
30% × (240 000 – 60 000)	54 000	
less Accumulated amortisation of goodwill: 1 year × 5000	(5 000)	49 000
		449 000
Retained profit for the year		114 000
Retained profits on 31 December 20X2		
Group	480 000	
Share of post-acquisition profits in associate:		
30% × (370 000 – 60 000)	93 000	
less Accumulated amortisation of goodwill: 2 years × 5000	(10 000)	
	563 000	563 000

By the end of the year 20X2, we have therefore increased consolidated reserves by £83 000, the share of the post-acquisition profits retained by the associate less the accumulated amortisation of purchased goodwill, and must increase the carrying value of the investment in the consolidated balance sheet by this amount to keep it in balance. The carrying value therefore becomes £180 000, which is the cost of £97 000 plus £83 000.

Summarised consolidated balance sheet on 31 December 20X2

	£
Fixed assets	
Goodwill	70 000
Tangible assets	493 000
Investment in associate	180 000
	743 000
Net current assets	280 000
	1 023 000
Long-term loan	100 000
	923 000
Deferred taxation	80 000
	843 000
Share capital	200 000
Share premium	40 000
Reserves: per Movement on reserves	563 000
	803 000
Minority interest	40 000
	843 000

The carrying value of the investment in the associate may be analysed as follows:

		£
Share of net assets in balance sheet of D: 30% × 570 000		171 000
Unamortised goodwill		
Cost of goodwill	25 000	
less Amortised – 2 years at 5000	10 000	15 000
		186 000

As we outlined earlier in the chapter, in order for the inclusion of these amounts to be meaningful, it is necessary for the accounting periods and policies of the associate to coincide with those of the group. In addition, adjustment may be necessary to remove the effect of any unrealised profits made from trading between the group and the associate.

Joint ventures and the gross equity method

As we explained earlier in this section, FRS 9 requires the use of the 'gross equity method' for joint ventures. This method is defined as follows:[9]

> **A form of equity method under which the investor's share of the aggregate gross assets and liabilities underlying the net amount included for the investment is shown on the face of the balance sheet and, in the profit and loss account, the investor's share of the turnover is noted.**

Thus the method is exactly the same as the equity method except that a little more disclosure is required. The additional information required is illustrated in the following pro-forma consolidated profit and loss account and balance sheet incorporating both a joint venture and an associate. Headings relating to the joint venture are shown in italics.

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

		£	£
Turnover: group and share of joint venture		*X*	
less Share of joint venture's turnover		X	
Group turnover			X
Cost of sales			X
Gross profit			X
Operating expenses			X
Group operating profit			X
Share of operating profit in:	*Joint venture*	*X*	
	Associate	X	X
			X
Interest payable			
Group		(X)	
Joint venture		*(X)*	
Associate		(X)	X
Profit on ordinary activities before tax			X
Tax on profit on ordinary activities:			
Group, *joint venture* and associate			X
Profit on ordinary activities after tax			X
Minority interests			X
Profit on ordinary activities after tax and minority interests			X
Dividends			X
Retained profit for group and its share of *joint venture* and associate			X

[9] FRS 9, Para. 4.

Consolidated balance sheet on 31 December 20X2

	£	£	£
Fixed assets			
Tangible assets		X	
Investments			
Investment in joint venture:			
Share of gross assets	X		
Share of gross liabilities	(X)	X	
Investment in associate		X	X
Current assets			
Stock		X	
Debtors		X	
Cash at bank and in hand		X	
		X	
Creditors: amounts due within one year		(X)	
Net current assets			X
Total assets less current liabilities			X
Creditors: amounts due after more than one year			(X)
Provisions for liabilities and charges			(X)
			X
Capital and reserves			
Called up share capital			X
Share premium account			X
Profit and loss account			X
Shareholders' funds			X
Minority interests			X
			X

Approach where no consolidated financial statements are prepared

In the above examples we have assumed that consolidated financial statements have been prepared so that it was possible to apply the equity method or gross equity method of accounting in those consolidated statements. It is, of course, possible for a company without a subsidiary to have an investment in an associate or joint venture. In such a case, it is not possible to apply the equity method or gross equity method in the investing company's financial statements and yet there are no consolidated financial statements available for that purpose.

In order to comply with FRS 9[10] the investing company:

> **should present the relevant amounts for associates and joint ventures either by preparing a separate set of financial statements or by showing the relevant amounts, together with the effects of including them, as additional information to its own financial statements.**

In the former case, the treatment will be as illustrated above. In the the latter case, one or more supplementary notes to the company's own financial statements will be necessary. Thus there must be a note to the balance sheet showing what the carrying value of the investment would be using the equity method and, in the case of a joint venture, the share of the

[10] FRS 9, Para. 48.

gross assets and gross liabilities making up that value. There must also be a note to the profit and loss account showing the effect of applying the equity method of accounting.

On the basis of the following summarised profit and loss accounts for the year ended 31 December 20X2 of E plc and F Limited, a possible note to the profit and loss account of E plc, which has 25 per cent of the shares in its associate, F Limited, is illustrated below.

Summarised profit and loss accounts for the year ended 31 December 20X2

	E plc	*F Ltd*
	£	£
Operating profit	240000	140000
Dividends received and receivable from F Limited	10000	–
	250000	140000
Taxation	80000	60000
Profit on ordinary activities after tax	170000	80000
Dividends paid and payable	100000	40000
Retained profit for the year	70000	40000

A possible note to the profit and loss account might run as follows:

Note to the profit and loss account of E plc

The effect of applying the equity method of accounting to the investment in the associate F Limited is as follows:

	£	£
Share of profit of associate		
(25% of 140000)		35000
Share of taxation of associate		
(25% of 60000)		15000
		20000
add Profit of E plc		
Per profit and loss account	170000	
less Dividends from associate	10000	160000
Profit from ordinary activities after taxation		180000
less Dividends paid and payable		100000
Retained profit for the year		80000
Retained in investing company	70000	
Retained in associate (25% × 40000)	10000	
	80000	

Such a note could be easily expanded to provide the relevant disclosure for an investment in a joint venture.

Large investments in associates and joint ventures

In order to ensure that users have adequate information to interpret a set of financial statements, FRS 9 requires the disclosure of the name of each principal associate and joint venture, together with details of the proportional shareholding, its accounting period and an indication of the nature of its business. The equity method is then applied to all investments

in associates and the gross equity method to all investments in joint ventures, either in the consolidated financial statements, where these are prepared, or as supplemenary information in the investing company's own financial statements.

Both the equity method and the gross equity method provide only very summarised information about the results, assets and liabilities of the investee entity and, hence, when the investee is particularly large in relation to the investing group or company, FRS 9 requires additional disclosure. It lays down thresholds that attempt to capture the relative size of the investee in the context of the investing group or company and require comparison, between the investor's share of the investee and that of the investor, of the following:

- gross assets
- gross liabilities
- turnover
- operating results on a three-year average.

Additional disclosure is then required in three circumstances:

(i) where the *aggregate* of the investor's share in its associates exceeds a 15 per cent threshold;
(ii) where the *aggregate* of the investor's share in its joint venture exceeds a 15 per cent threshold;
(iii) where the investor's share in any *individual* associate or joint venture exceeds a 25 per cent threshold.

Readers are referred to the standard itself for precise details of the disclosure required in each case.[11]

Summary of the UK position

Where an investment is large enough to give the investor significant influence or joint control over the affairs of the investee, it is clearly not adequate to show that investment at cost and to take credit only for the dividends receivable. Some alternative is necessary, and it is possible to identify three such alternative accounting treatments for associates and joint ventures:

(a) to show the investment at its fair value and to take changes in fair value, as well as dividends receivable, to the profit and loss account;
(b) to use proportional (proportionate) consolidation;
(c) to use the equity method of accounting.

While, as we have seen in Chapter 8, the ASB is in favour of the use of fair values for many financial instruments, it recognises that the determination of the fair value of unquoted investments may be extremely difficult and unreliable in practice. It also recognises that, even if the shares of the investee are quoted, accounting for the investee by the recognition of movements in the fair value of its shares is hardly the best way of measuring the performance of a long-term associate or joint venture over which the investor exercises significant influence or joint control.

The method of proportional consolidation is simple to understand but is rejected by the ASB on the grounds that it results in the aggregation of assets and liabilities of associates and joint ventures, which are not controlled, with the assets and liabilities of the parent company

[11] FRS 9, Para. 58.

and subsidiaries, which are controlled by the parent company. In accordance with the provisions of Chapter 2 of its *Statement of Principles for Financial Reporting*, the ASB takes the view that a consolidated balance sheet should only show the assets and liabilities under direct and indirect control, that is those of the parent and any subsidiary companies.[12] As we shall see in the final section of this chapter, the IASB does not feel itself constrained in this way.

Having rejected the use of fair values and proportional consolidation, the ASB is left with the equity method of accounting as its preferred candidate for associates and joint ventures. We have seen that, under this method, the level of detailed disclosure may be varied quite considerably and the ASB introduces its own variant of the equity method, the gross equity

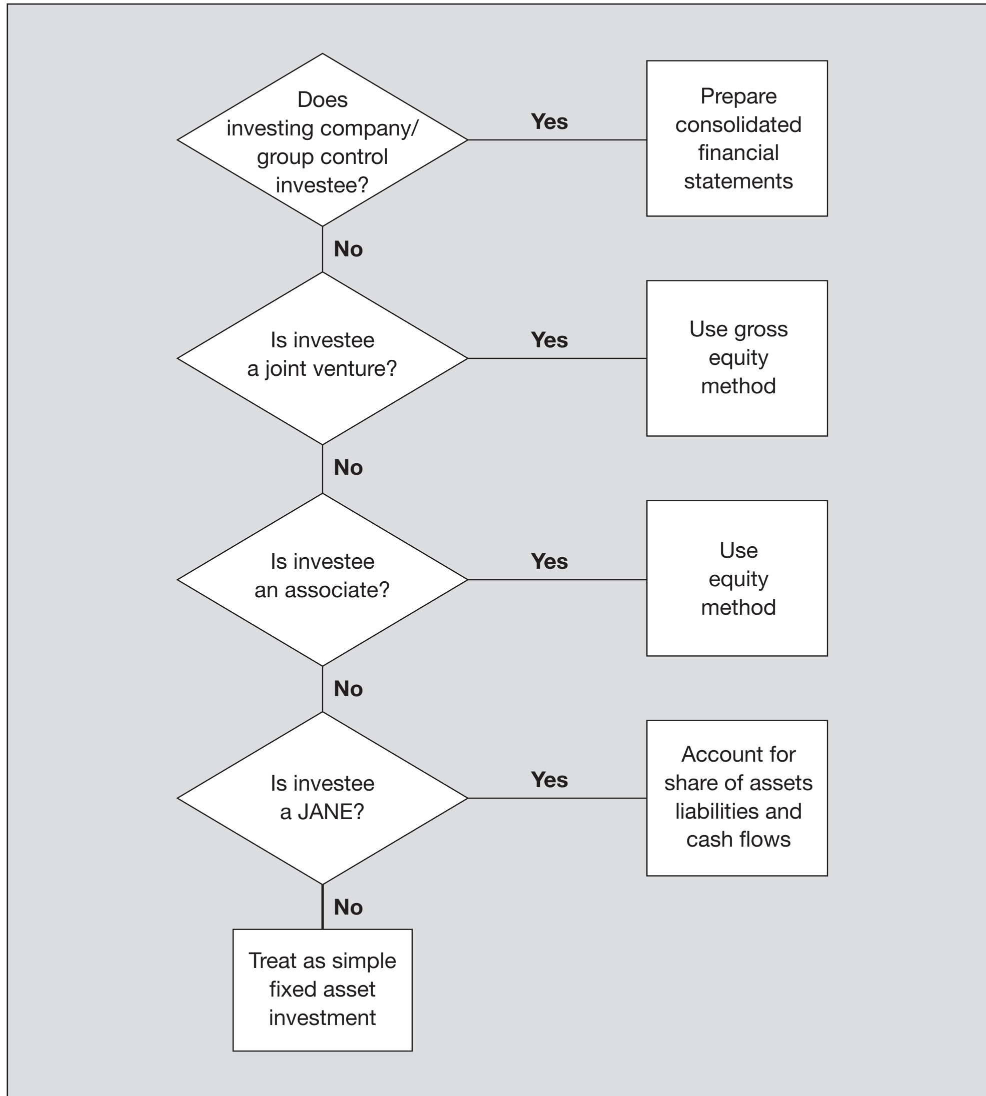

Figure 15.1 Treatment of fixed asset investments

[12] An exception is made for JANEs where the investor is required to account directly for its share of assets, liabilities, results and cash flows.

method, for joint ventures. It also increases the detailed disclosure requirements for both associates and joint ventures once certain thresholds are breached. The level of the thresholds and the extent of the detailed disclosure required are practical matters to which accounting theory has little to contribute at present.

Figure 15.1 provides a summary of the accounting treatment of fixed asset investments in the UK.

The international accounting standards

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

- IAS 28 *Accounting for Investments in Associates* (revised 2000)
- IAS 31 *Financial Reporting of Interests in Joint Ventures* (revised 2000)

Associates

IAS 28 requires the use of the equity method of accounting for associates in the consolidated financial statements of the investor. There are two exceptions: first, when it is intended to dispose of the investment in the near future and, second, when the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. In such circumstances, the investment should be dealt with in accordance with IAS 39 *Financial Instruments: Recognition and Measurement,* under which it should be shown at its fair value or, if that cannot be measured reliably, at its cost.[13]

The international accounting standard does not require the additional disclosure specified by FRS 9 when certain thresholds are passed.

Where the investing company does not prepare consolidated financial statements, IAS 28 states that:

> It is appropriate that such an investor provides the same information about its investments in associates as those enterprises that issue consolidated financial statements.[14]

This could be taken to require that the equity method should be applied in the investor's own financial statements. While this is permitted under the international standard at present, the proposed revision of IAS 27, which encompasses the treatment of investments in subsidiaries, associates and joint ventures in the separate financial statements of the investing company, would prohibit this treatment in future.[15] Neither UK company law nor FRS 9 permit the use of the equity method in an investor's individual financial statements and, hence, the proposed amendment to the international standard would bring UK and international practice closer together.

Joint ventures

The definition of joint venture in IAS 31 is much wider than that of FRS 9. IAS 31 defines a joint venture in terms of contractual arrangements and distinguishes between jointly con-

[13] IAS 28 *Accounting for Investments in Associates* (revised 2000), Para. 8.
[14] *Ibid.*, Para. 15.
[15] See Chapter 14, pp. 406–7.

trolled operations, jointly controlled assets and jointly controlled entities. As we have seen, FRS 9 restricts the term joint venture to an entity and deals separately with joint arrangements that are not entities (JANEs).

The benchmark treatment of joint ventures under IAS 31 is proportionate, what we have called proportional, consolidation while the allowed alternative treatment is the equity method of accounting. However, the international standard makes it very clear that the IASB, or more precisely the IASC, considers the equity method to be very much second best:[16]

> This Standard does not recommend the use of the equity method because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity, that is control over the venturer's share of the future economic benefits.

This proportionate method may be applied using one of two possible formats along the lines of those that we have illustrated earlier in the chapter. Thus the venturer may either combine its share of each asset, liability, revenue and expense of the jointly controlled entity with similar items in its consolidated financial statements on a line-by-line basis or, alternatively, include its share of each class of assets, liabilities, revenue and expenses as separate lines in the consolidated financial statements.

As we saw, FRS 9 requires the use of the equity method, in its gross equity variant, for joint ventures so, here again, the UK standard requires application of the allowed alternative treatment, rather than the benchmark treatment, of the international accounting standard.

Given the aversion of the ASB to the use of proportional consolidation and the aversion of the IASB to the use of the equity method for joint ventures, it is not easy to see how convergence will be achieved in this area.

Proposed changes

The exposure draft, issued by the IASB as part of its improvements project in May 2002, proposes a number of changes to the above. We have already drawn attention to some of these proposed changes in both Chapter 14 and this chapter but will draw attention to two proposals here.

First, the exposure draft proposes to exclude from the scope of IAS 28 and IAS 31 investments, which would otherwise be classified as associates and joint ventures, when these are held by venture capital organisations, mutual funds, unit trusts and similar entities. It considers that, in the case of such investors, it is more appropriate to measure investments in associates and joint ventures at their fair values, in accordance with the provisions of IAS 39, *Financial Instruments: Recognition and Measurement,* where these are well established in the particular industry.

Second, it proposes to tighten up the situations where investments in associates and joint ventures should be excluded from treatment using the equity method of accounting or proportionate consolidation. At present, both IAS 28 and IAS 31 state that investments should not be accounted for using the equity method and proportionate consolidation in two situations:[17]

(a) when the investment is acquired and held exclusively with a view to its subsequent disposal in the near future; or

[16] IAS 31 *Financial Reporting of Interests in Joint Ventures* (revised 2000), Para. 33.
[17] See IAS 28, Para. 8, and IAS 31, Para. 35.

(b) where it operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

The IASB now proposes that such investments should only be excluded where the investment is acquired and held exclusively with a view to its subsequent disposal *within twelve months from acquisition*. It takes the view that, where an associate or joint venture operates under severe long-term restrictions, it is unlikely that significant influence over the investee actually exists. While the time horizon for the exclusion of temporary associates and joint ventures would be tightened to 12 months, there would be no change resulting from the proposals in respect of long-term restrictions: investments subject to severe long-term restrictions would still be excluded, albeit on the basis of a different criterion, and shown at fair values in accordance with the provisions of IAS 39.

Summary

In this chapter, we looked at accounting for investments which carry significant influence over or joint control over another entity, namely associates and joint ventures. For such investments, it is not sufficient to show them at cost or, except in special circumstances, at fair value. It is certainly not possible merely to take credit for dividends receivable when the level of those dividends may be influenced by the investor. We also looked at what FRS 9 calls Joint Arrangements which are Not Entities (JANEs) although these fall within the definition of a joint venture under IAS 31.

The two methods of accounting which standard setters consider to be appropriate for investments which carry significant influence or joint control are proportional (proportionate) consolidation or the equity method of accounting. We therefore explored each of these methods and demonstrated the similarities and differences between them.

We next examined the rather unhelpful provisions of UK company law in this area and saw how FRS 9 requires the use of the equity method to account for associates and the use of the gross equity method to account for joint ventures, while requiring something akin to proportional consolidation for JANEs. FRS 9 requires more detailed disclosure from joint ventures, i.e. it requires the gross equity method, and even more disclosure in respect of both associates and joint ventures, once certain size thresholds are crossed.

Finally, we examined the relevant international accounting standards, IAS 28 and IAS 31. These require the use of the equity method for associates and favour the use of proportionate consolidation for joint ventures. While IAS 31 does permit the use of the equity method for joint ventures as an allowed alternative treatment, the standard makes it very clear that the IASB (or, more precisely, its predecessor, the IASC) considers this method to be very much second best.

Thus we have seen that, although the required UK and international treatment of associates is similar, the preferred treatment of joint ventures is rather different.

Recommended reading

J.R. Edwards, *A history of financial accounting*, Routledge, London 1989.

T. Grundy, 'Acquisitions, joint ventures, alliances and divestment', *Business Digest*, issue 036, ICAEW, May 2000.

R. Ma, R.H. Parker and G. Whittred, *Consolidated accounting*, Longman, Cheshire, 1991.

C. Nobes, 'An Analysis of the International Development of the Equity Method', *Abacus*, Vol. 38, No.1, February 2002, pp. 16–45.

Readers are also referred to the latest edition of *UK and International GAAP* by Ernst & Young, which provides much greater detailed coverage of the subject matter of this chapter. At the time of writing the latest edition is the 7th, A. Wilson, M. Davies, M. Curtis and G. Wilkinson-Riddle (eds), Butterworths Tolley, London, 2001. The relevant chapter is 7, Associates, joint ventures and JANEs'.

Questions

15.1 Both the *Statement of Principles for Financial Reporting* and individual Accounting Standards make it clear that the treatment in consolidated financial statements of investments in other undertakings is dependent on the extent of the control or influence the investing entity is able to exercise over the other undertaking. Port plc has investments in three other undertakings:

- On 15 May 1990, Port plc purchased 40 million 50p equity shares in Harbour Ltd. The called-up equity share capital of Harbour Ltd on 15 May 1990 was 50 million 50p equity shares.
- On 15 June 1991, Port plc purchased 30 million £1 equity shares in Inlet Ltd. The called-up equity share capital of Inlet Ltd on 15 June 1991 was 75 million £1 equity shares. The remaining equity shares in Inlet Ltd are held by a large number of investors – none with more than 5 million equity shares.
- On 15 July 1992, Port plc purchased 25 million 50p equity shares in Bay Ltd. The called-up equity share capital of Bay Ltd on 15 July 1992 was 80 million 50p equity shares. Another investor owns 50 million equity shares in Bay Ltd. This investor takes an active interest in directing the operating and financial policies of Bay Ltd and on a number of occasions has required Bay Ltd to follow policies that do not meet with the approval of Port plc.

Equity shares in all of the companies carry one vote per share at general meetings. No party can control or influence the composition of the board of directors of any of the companies other than through its ownership of equity shares. There have been no instances where shareholders in any of the companies have acted together to increase their control or influence. None of the companies has issued any additional equity shares since Port plc purchased its interests.

Extracts from the profit and loss accounts of the four companies for their year ended 30 June 2001 are given below:

	Port plc	*Harbour Ltd*	*Inlet Ltd*	*Bay Ltd*
	£000	£000	£000	£000
Turnover	65 000	45 000	48 000	40 000
Cost of sales	(35 000)	(25 000)	(26 000)	(19 000)
Gross profit	30 000	20 000	22 000	21 000

Note 1
Port plc manufactures a product that is used by Harbour Ltd and Inlet Ltd. During the year ended 30 June 2001, sales of the product to Harbour Ltd and Inlet Ltd were:

- to Harbour Ltd – £8 million;
- to Inlet Ltd – £7.5 million.

Opening and closing stocks of this product in the financial statements of Harbour Ltd and Inlet Ltd (all purchased from Port plc at cost plus 25% mark up, unchanged during the year) were as follows:

Company	*Closing stock*	*Opening stock*
	£000	£000
Harbour Ltd	3 000	2 400
Inlet Ltd	2 500	Nil

At 30 June 2001, there were no amounts payable by Harbour Ltd and Inlet Ltd in respect of stocks purchased from Port plc before 30 June 2001.

Note 2
There was no other trading between the companies other than the payment of dividends.

Required:
(a) **State the alternative treatments of investments in consolidated financial statements that are set out in the *Statement of Principles for Financial Reporting* and UK Accounting Standards. Do NOT describe the mechanics of the methods.** (6 marks)
(b) **Identify the correct treatment of the investments in Harbour Ltd, Inlet Ltd and Bay Ltd in the consolidated financial statements of Port plc.** (5 marks)
(c) **Compute the consolidated turnover, cost of sales and gross profit of the Port group for the year ended 30 June 2001. You should ensure that your computations are fully supported by relevant workings.** (4 marks)
(d) **Compute the adjustments that need to be made in respect of the transactions described in Note 1 above when preparing the consolidated balance sheet of Port plc at 30 June 2001. You should explain the rationale behind each adjustment you make.** (5 marks)

CIMA, Financial Reporting – UK Accounting Standards, November 2001 **(20 marks)**

15.2 (a) FRS 9, *Associates and Joint Ventures*, deals not only with the accounting treatment of associated companies and joint venture operations but covers certain types of joint business arrangements not carried on through a separate entity. The main changes made by FRS 9 are to restrict the circumstances in which equity accounting can be applied and to provide detailed rules for accounting for joint ventures.

Required:
(i) **Explain the criteria which distinguish an associate from an ordinary fixed asset investment.** (6 marks)
(ii) **Explain the principal difference between a joint venture and a 'joint arrangement' and the impact that this classification has upon the accounting for such relationships.** (4 marks)

(b) The following financial statements relate to Baden, a public limited company.

Profit and loss account for year ended 31 December 1998

	£m	£m
Turnover		212
Cost of sales		(170)
Gross profit		42
Distribution costs	17	
Administrative costs	8	(25)
		17
Other operating income		12
Operating profit		29
Exceptional item		(10)
Interest payable		(4)
Profit on ordinary activities before tax		15
Taxation on profit on ordinary activities		(3)
		12
Ordinary dividend – paid		(4)
Retained profit for year		8

Balance sheet as at 31 December 1998

Fixed assets – tangible	30	
goodwill	7	37
Current assets	31	
Creditors: amounts falling due within one year	(12)	
Net current assets		19
Total assets less current liabilities		56
Creditors: amounts falling due after more than one year		(10)
		46
Capital and Reserves		
Called up share capital –		
Ordinary shares of £1		10
Share premium account		4
Profit and loss account		32
		46

(i) Cable, a public limited company, acquired 30% of the ordinary share capital of Baden at a cost of £14 million on 1 January 1997. The share capital of Baden has not changed since acquisition when the profit and loss reserve of Baden was £9 million.

(ii) At 1 January 1997 the following fair values were attributed to the net assets of Baden but not incorporated in its accounting records.

	£m	
Tangible fixed assets	30	(carrying value £20m)
Goodwill (estimate)	10	
Current assets	31	
Creditors: amounts falling due within one year	20	
Creditors: amounts falling after more than one year	8	

(iii) Guy, an associated company of Cable, also holds a 25% interest in the ordinary share capital of Baden. This was acquired on 1 January 1998.

(iv) During the year to 31 December 1998, Baden sold goods to Cable to the value of £35 million. The inventory of Cable at 31 December 1998 included goods purchased from Baden on which the company made a profit of £10 million.

(v) The policy of all companies in the Cable Group is to amortise goodwill over four years and to depreciate tangible fixed assets at 20% per annum on the straight line basis.

(vi) Baden does not represent a material part of the group and is significantly less than the 15% additional disclosure threshold required under FRS 9 Associates and Joint Ventures.

Required:

(i) **Show how the investment in Baden would be stated in the consolidated balance sheet and profit and loss account of the Cable Group under FRS9 *Associates and Joint Ventures*, for the year ended 31 December 1998 on the assumption that Baden is an associate.** (9 marks)

(ii) **Show how the treatment of Baden would change if Baden was classified as an investment in a joint venture.** (6 marks)

ACCA, Financial Reporting Environment (UK Stream), June 1999 **(25 marks)**

15.3 Wester Ross plc has acquired holdings in the following companies:

Ullapool Ltd – 75% of the ordinary share capital acquired on 1 February 2000 financed by the issue of 2 million £1 ordinary shares of Wester Ross plc at £7 per share and £6 million in cash.

Wester Ross plc also acquired 30% of the preference share capital at the same date for £1 million cash.

Glenelg Ltd – 30% of the ordinary share capital acquired on 10 March 1998 for £2 million cash.

The draft balance sheets of the companies at 31 October 2000 were:

	Wester Ross plc	*Ullapool Ltd*	*Glenelg Ltd*
	£000	£000	£000
Fixed assets			
Freehold property	15000	8000	2000
Fixtures and fittings	27000	10000	1000
Investments	9000	–	–
Current assets			
Stocks	4000	2500	500
Debtors	8500	1700	400
Cash	–	700	–
Current liabilities	(5000)	(1300)	(200)
Long-term liabilities	(5500)	(1000)	(300)
	53000	20600	3400

	Wester Ross plc	*Ullapool Ltd*	*Glenelg Ltd*
	£000	£000	£000
Capital and Reserves			
Ordinary shares of £1 each	35 000	12 000	1 500
Preference shares of £1 each	5 000	3 000	300
Revaluation reserve	10 000	2 000	–
Other reserves	–	1 000	–
Profit and loss account	3 000	2 600	1 600
	53 000	20 600	3 400

Additional information

(1) Wester Ross plc's investments were acquired when the reserves of the companies were:

	Ullapool Ltd	*Glenelg Ltd*
	£000	£000
Revaluation reserve	1 500	–
Other reserves	500	–
Profit and loss account	2 000	600

There have been no changes to the share capital of the above companies since their acquisition.

(2) The fair value of the freehold property in Glenelg Ltd was £1.5 million above book value at the date of acquisition; all of this related to the land element of the property.

(3) Wester Ross plc has not yet accounted for the shares issued in acquiring Ullapool Ltd but has fully accounted for the cash element of the consideration for both Ullapool Ltd and Glenelg Ltd.

(4) Glenelg Ltd sold various items of fixtures and fittings to Wester Ross plc for £750 000 on 31 March 2000. The assets originally cost £1 million in the year ended 31 October 1995 and are being depreciated over 10 years on a straight-line basis. Wester Ross plc is depreciating the assets over their remaining useful economic life.

(5) It is group policy to:

- amortise goodwill over 10 years with a full year's charge in the year of acquisition
- charge a full year's depreciation on fixed assets in the year of acquisition and none in the year of disposal.

Requirements

(a) **From the above data, calculate the following amounts for the consolidated balance sheet of Wester Ross plc as at 31 October 2000:**
   (i) **Goodwill arising on the acquisitions of Ullapool Ltd and Glenelg Ltd;**
   (ii) **Investment in associate;**
   (iii) **Profit and loss account balance.** (10 marks)

(b) **Explain the purpose of group accounts and the concepts underlying their preparation.** (8 marks)

ICAEW, Financial Reporting, December 2000 **(18 marks)**

15.4 Ayr plc acquired holdings in two companies as follows:

Brodick Ltd – 80% of the ordinary share capital purchased on 1 December 1999 for £5 million.
– 20% of the preference share capital purchased on 1 June 2001 for £500 000.

Carluke Ltd – 30% of the ordinary share capital purchased on 1 April 2001 for £1.5 million.

The draft profit and loss accounts of the companies for the year ended 30 November 2001 were:

	Ayr plc	*Brodick Ltd*	*Carluke Ltd*
	£000	£000	£000
Turnover	4000	2000	1500
Cost of sales	(2800)	(1400)	(1050)
	1200	600	450
Distribution costs	(200)	(100)	(50)
Administrative expenses	(400)	(250)	(100)
	600	250	300
Taxation	(180)	(80)	(90)
Profit after taxation	420	170	210
Dividends – preference	(40)	(50)	–
– ordinary	(200)	(70)	(100)
	180	50	110

Additional information

(1) The reserves of Brodick Ltd and Carluke Ltd were:

	Date	*Revaluation reserve*	*Profit and loss*
		£000	£000
Brodick Ltd	1 December 1999	400	300
	1 June 2001	500	200
Carluke Ltd	1 April 2001	–	70

The ordinary dividends of Carluke Ltd all relate to the post-acquisition period.

(2) There have been no changes in the companies' share capitals since acquisition. These are:

	Brodick Ltd	*Carluke Ltd*
	£000	£000
Ordinary shares of £1 each	5000	3000
Preference shares of £1 each	2000	–

The preference dividends of Brodick Ltd were paid in two equal instalments on 31 May 2001, and 30 November 2001.

(3) On 1 December 1999, the value of the tangible fixed assets of Brodick Ltd was £200 000 higher than their net book value. This was due to the land element of freehold property.

(4) On 30 June 2001, Carluke Ltd sold £200 000 of goods to Ayr plc. Carluke Ltd operates a standard mark up of 25% on all sales. On 30 November 2001, Ayr Ltd still had 75% of these goods in stock.

(5) It is group policy to amortise goodwill over ten years with a full year's charge in the year of acquisition.

(6) Ayr plc has not yet accounted for any dividends receivable.

Requirements

(a) Calculate the following amounts as they would appear in the consolidated profit and loss account of Ayr plc for the year ended 30 November 2001:
  (i) Income from investment in associated undertakings
  (ii) Minority interests
  (iii) Profit after taxation. (13 marks)
  Note: Make all calculations to the nearest £000.

(b) Explain the rationale for the accounting treatment in (a) (i) and (ii) above. (5 marks)

ICAEW, Financial Reporting, December 2001 **(18 marks)**

15.5 Ardrossan plc acquired holdings in two companies as follows:

Barmulloch Ltd – 75% of the ordinary share capital purchased on 1 August 2000 for £4 million.

Cumbernauld Ltd – 25% of the ordinary share capital purchased on 1 August 1999 for £1 million.

The draft balance sheets of the companies as at 31 July 2002 were:

	Ardrossan plc	*Barmulloch Ltd*	*Cumbernauld Ltd*
	£000	£000	£000
Fixed assets	4 500	2 500	1 500
Investments	5 000	–	–
Current assets			
Stock	1 400	900	600
Trade debtors	1 200	700	400
Dividends receivable	45	–	–
Cash at bank	450	–	200
	3 095	1 600	1 200
Current liabilities			
Bank overdraft	–	(400)	–
Trade creditors	(1 300)	(600)	(300)
Proposed dividends	(200)	(60)	–
Net current assets	1 595	540	900
Debentures 2006	(500)	–	–
	10 595	3 040	2 400
Ordinary shares of £1 each	8 000	3 000	2 000
Revaluation reserve	1 500	500	200
Profit and loss account	1 095	(460)	200
	10 595	3 040	2 400

Additional information

(1) The reserves of Barmulloch Ltd and Cumbernauld Ltd at the following dates were:

	Date	*Revaluation Reserve*	*Profit and Loss Account*
		£000	£000
Barmulloch Ltd	1 August 2000	200	600
Cumbernauld Ltd	1 August 1999	200	100
Cumbernauld Ltd	1 August 2001	200	160

Assume profits accrued evenly in the year ended 31 July 2002.

(2) On 1 February 2002, Ardrossan plc sold its entire holding of shares in Cumbernauld Ltd for £1.3 million cash. This transaction has not yet been recorded in the accounts of Ardrossan plc. For any tax due on this transaction, assume a corporation tax rate of 30% and ignore indexation allowance.

(3) It is group policy to amortise any goodwill arising on consolidation over ten years with a full year's charge in the year of acquisition and none in the year of disposal.

(4) The trade creditors of Ardrossan plc include £25 000 payable to Barmulloch Ltd. The trade debtors of Barmulloch record the same amount as a debt receivable. None of these transactions. resulted in any stock at the year end.

Requirements

(a) **Calculate any profit or loss arising on the disposal of Cumbernauld Ltd to be included in the consolidated accounts of Ardrossan plc.** (4 marks)

(b) **Prepare the consolidated balance sheet of Ardrossan plc as at 31 July 2002.** (12 marks)

(c) **Explain the basis of your calculations in (a), making appropriate reference to accounting standards and concepts.** (4 marks)

ICAEW, Financial Reporting, September 2002 **(20 marks)**

15.6 Aberdeen plc acquired shares in two other companies as follows:

Date of acquisition	*Company*	*Percentage of equity shares acquired*	*Goodwill arising on acquisition*	*Company's profit and loss at acquisition*
1 November 2000	Berwick Ltd	75%	£400 000	£1 200 000
1 May 2002	Coupar Ltd	30%	£150 000	£850 000

The summarised draft profit and loss accounts of the companies for the year ended 31 October 2002 were:

	Aberdeen plc	*Berwick Ltd*	*Coupar Ltd*
	£000	£000	£000
Turnover	10 500	7 500	4 400
Cost of sales	(7 350)	(5 000)	(3 200)
Gross profit	3 150	2 500	1 200
Other operating expenses	(1 700)	(1 100)	(450)
Profit before taxation	1 450	1 400	750
Taxation	(430)	(420)	(200)
Profit after taxation	1 020	980	550
Dividends proposed	(500)	(400)	(200)
Retained profit	520	580	350

Additional information

(1) It is group policy to amortise purchased goodwill over five years with a full year's charge in the year of acquisition.

(2) On 1 October 2002, Berwick Ltd sold goods to Aberdeen plc. These goods had a sales value of £200 000, Berwick Ltd having applied a mark up of 25%. As at 31 October 2002, Aberdeen plc still held £140 000 of these goods in stock.

(3) Aberdeen plc has not yet accounted for any dividends receivable from Berwick Ltd or Coupar Ltd. The dividends from Coupar Ltd all relate to the post-acquisition period.

(4) Aberdeen plc requires Coupar Ltd to bring its depreciation methods in line with group accounting policies. The directors have estimated that this would reduce the profit of Coupar Ltd for the year ended 31 October 2002 by £200 000. Ignore any effect on the taxation charge.

(5) The directors of Aberdeen plc propose a transfer of £100 000 to a general reserve and this should be accounted for.

(6) The retained profit brought forward at 1 November 2001 for the three companies was:

	£000
Aberdeen plc	2400
Berwick Ltd	1800
Coupar Ltd	600

Requirement

Prepare the consolidated profit and loss account, statement of reserves and disclosure note for Profit attributable to the members of Aberdeen plc, for the year ended 31 October 2002.

ICAEW, Financial Reporting, December 2002 **(15 marks)**