Advanced Group Accounting (RIKA)

Block 5

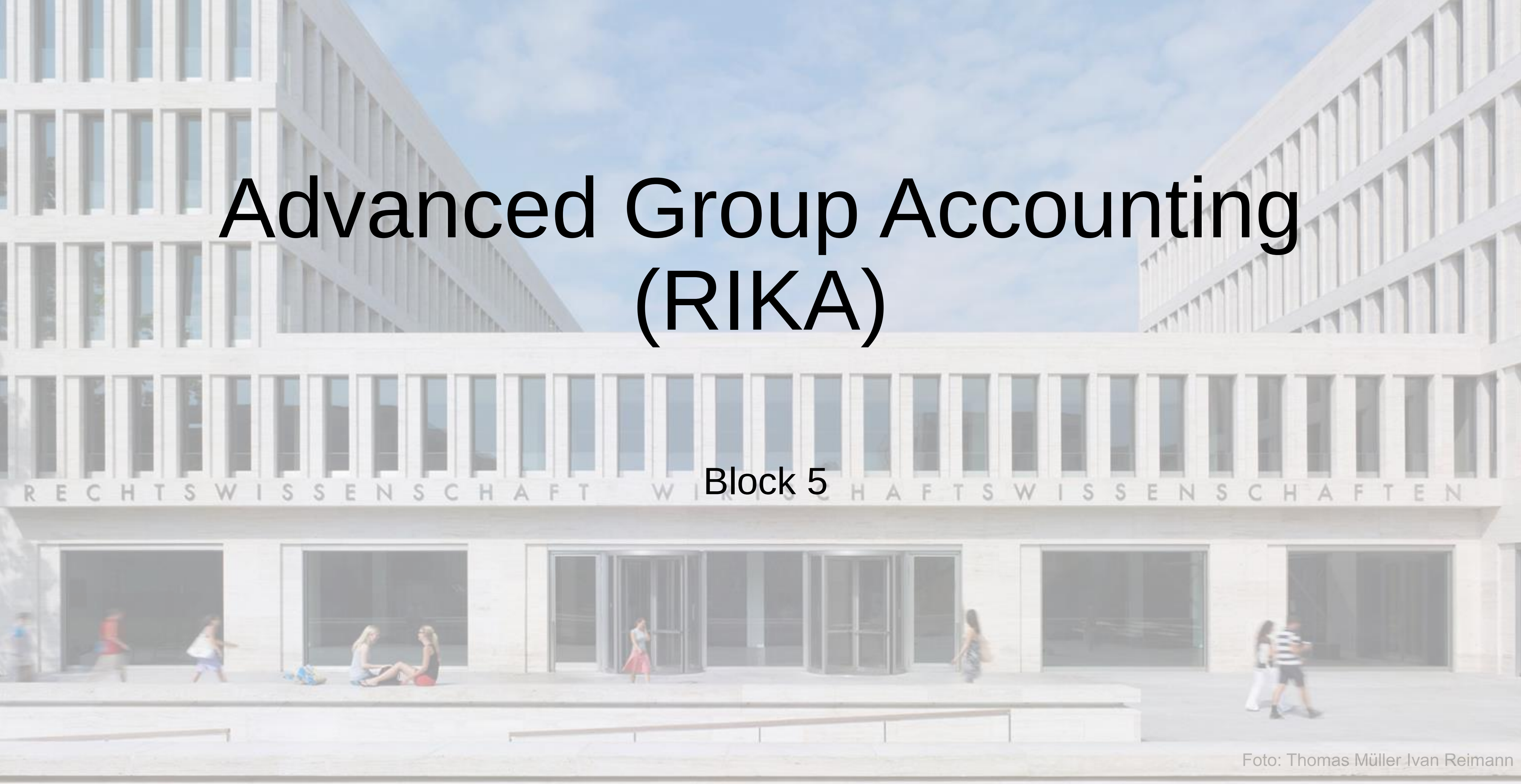


Foto: Thomas Müller Ivan Reimann

Course Structure

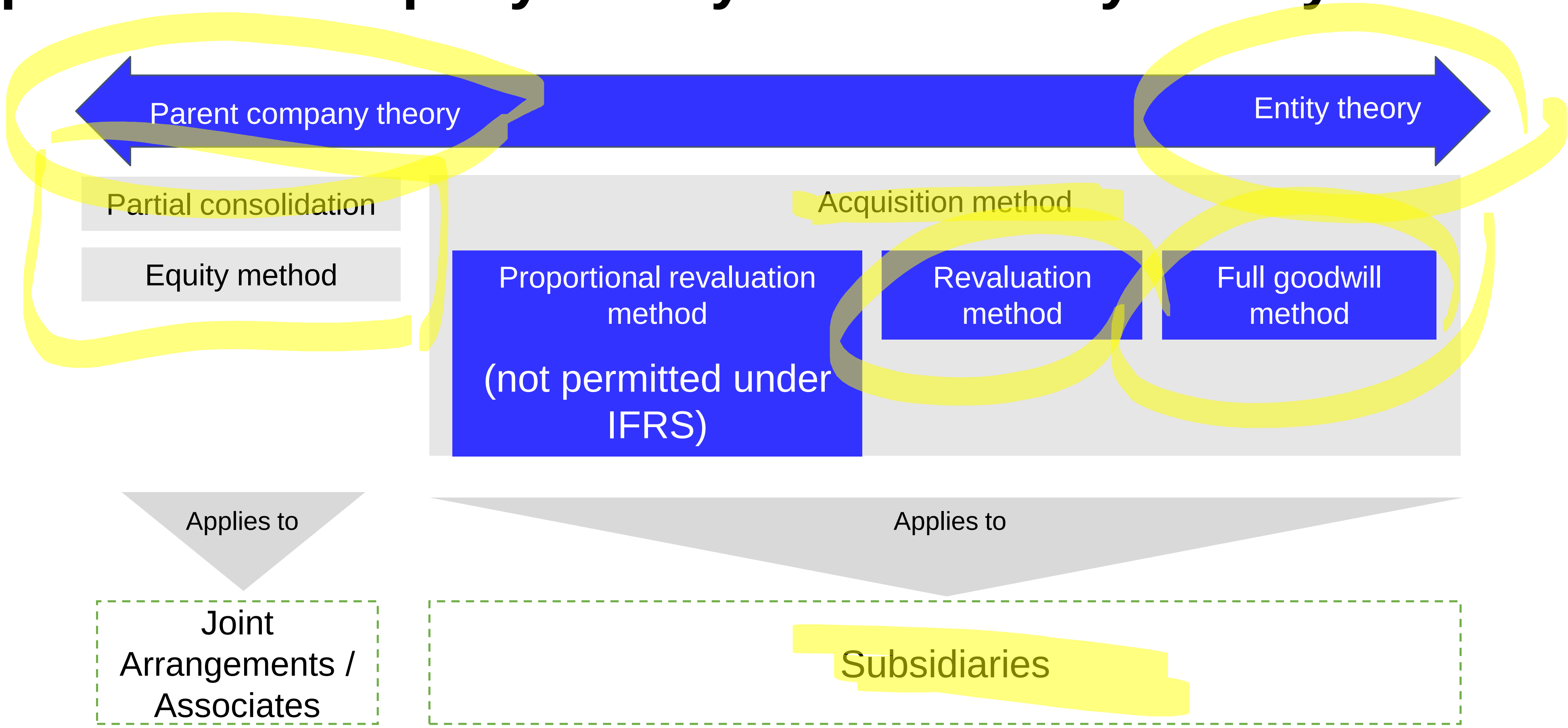
Block	Topic
	Preparation: recap double-entry bookkeeping (online, self-study)
1	Key Concepts
2	Acquisition Method
3	Consolidation
4	Subsequent Consolidation Goodwill Impairment
5	**Joint Arrangement and Investments at Equity** **Changes in Control**
6	Analyzing Consolidated F/S

Course Structure

Block	Topic
5	Joint Arrangement and Investments at Equity Changes in Control
5.1	**Joint Arrangement and Investments at Equity**
5.2	Changes in Control

- How do we account for investments that are not subsidiaries?

Recap: Parent company theory versus entity theory

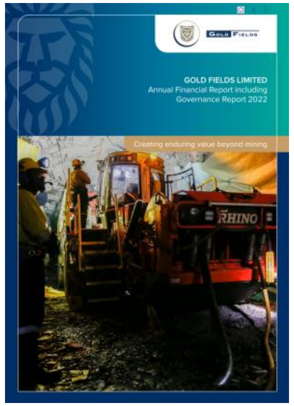


Accounting for Joint Arrangements (IFRS 11) and for Associates (IAS 28)

Associate: investor has **significant influence**	Joint Arrangement: two or more parties have **joint control**.	
	Parties sharing control have rights to the **net assets** of a legally independent company	Parties sharing control have rights to **assets/liabilities** relating to the arrangements
Associate	**Joint venture**	**Joint operation**
Equity Method		**Consolidation in proportion to rights**

↳ "50 %" consolidation

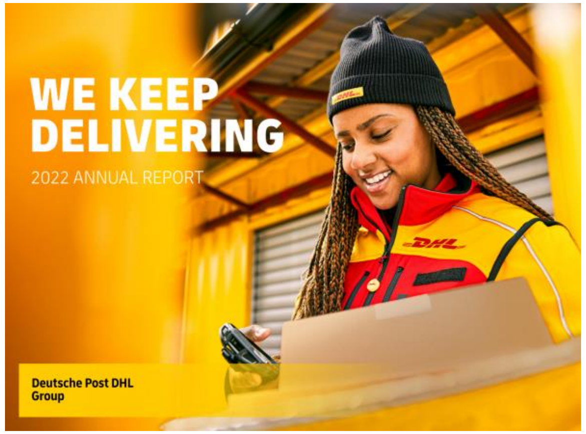
Joint Operations - Examples



16. INTEREST IN JOINT OPERATION

On 13 December 2016, Gold Fields purchased 50% of the Gruyere Gold Project and entered into a 50:50 unincorporated joint operation with Gold Road Resources Limited ("Gold Road") for the development and operation of the Gruyere Gold Project in Western Australia, which comprises the Gruyere gold deposit as well as additional resources including Central Bore and Attila/Alaric.

The Gruyere project was successfully completed during 2019, with first gold produced in June 2019. Commercial levels of production were achieved at the end of September 2019.



2.3 Joint operations

Joint operations are consolidated in accordance with IFRS 11, based on the interest held.

Aerologic GmbH (Aerologic), Germany, a cargo airline domiciled in Leipzig, is the only joint operation in this regard. Aerologic has been assigned to the Express segment. It was jointly established by Lufthansa Cargo AG and Deutsche Post Beteiligungen Holding GmbH, which each hold 50% of its capital and voting rights. Aerologic's shareholders are simultaneously its customers, giving them access to its freight aircraft capacity. Aerologic mainly serves the DHL Express network from Monday to Friday, and flies for the Lufthansa Cargo network at weekends. Individual aircraft are also used exclusively by the two respective shareholders. In contrast to its capital and voting rights, the company's assets and liabilities, as well as its income and expenses, are allocated based on this user relationship.

Joint Ventures and Associates: significant influence

- IAS 28.2: Significant influence is the **power to participate in the financial and operating policy decisions** of the investee but is not control or joint control over those policies.

- IAS 28.6 ff.: If an investor holds, directly or indirectly (e.g. through subsidiaries), **20%** or more of the voting power of the investee, it is presumed that the investor has significant influence

Joint Ventures and Associates: applying the equity method

- Basic idea:

Initial Measurement	Subsequent Measurement
▪ Cost of the investment	▪ Adjust for post-acquisition changes in investor's share in investee's net assets ▪ Considering depreciation of hidden reserves

→ No consolidation: individual assets/liabilities of investee are not brought onto the consolidated balance sheet!

→ Economic activities are presented in only one line in balance sheet ("Investments accounted for under the equity method") and in the statement of profit/loss ("Income from investments accounted for under the equity method")

→ Additional disclosures required in the notes

Exercise: Joint Ventures and Associates: equity method

→ investment book value

Fact Pattern:

M AG has purchased for 1,100 CU 40% of the shares of L GmbH as of 01.01.20X1.

Questions:

a) Please apply the equity method to value the investment in M AG's consolidated financial statements in 20X1 using the following information:

- L GmbH as of 31.12.20X0 → 40% → 500
  Share capital and reserves: 2,000 CU
  Hidden reserves (remaining useful life: 10 years): 500 CU

- L GmbH as of 31.12.20X1
  Distribution of 20X0's profit (100 CU)
  New profit generated in 20X1: 200 CU

b) Please give the appropriate journal entries for 20X1.

Solution

Exercise: Joint Ventures and Associates: equity method

Solution

Exercise: Joint Ventures and Associates: equity method

Investm. Book value = PP = 1100

Book value of EQ = 40% × 2000

= 800

Hidden reserves = 40% × 500

= 200

Goodwill = 100

Solution

Exercise: Joint Ventures and Associates: equity method

a) Please apply the equity method…

Initial measurement and purchase price allocation:

Investment book value			1,100 CU
thereof	Hidden reserves	0.4*500 =	200 CU
	Book value of equity	0.4*2,000 =	800 CU
	Goodwill	1,100 - 0.4*2,000 - 0.4*500 =	100 CU

Subsequent valuation:

Investment book value as of 01.01.20X1	1,100 CU
+ proportionate profit 20X1 (=0.4*200)	+80 CU
- proportionate distribution (=0.4*100)	-40 CU
- depreciation of hidden reserves (=200/10)	-20 CU
Investment book value as of 31.12.20X1	1,120 CU
(Hidden reserves =	180 CU)
(Goodwill =	100 CU)

10 yrs

80 - 20 = 60

Solution

Exercise: Joint Ventures and Associates: equity method

b) Please give the appropriate journal entries for 20X1.

Journal Entries

(1) Dr. Investment in L	60		
		Cr. Income from inv. in L	60
(2) Dr. Cash	40		
		Cr. Investment in L	40

Real-world example: Volkswagen Group

€ million	Note	2022	2021
Sales revenue	**1**	**279,232**	**250,200**
Cost of sales	2	–227,005	–202,959
Gross result		**52,228**	**47,241**
Distribution expenses	3	–19,840	–19,228
Administrative expenses	4	–11,689	–10,420
Other operating income	5	19,238	14,731
Other operating expenses	6	–17,812	–13,049
Operating result		**22,124**	**19,275**
Share of the result of equity-accounted investments	7	2,395	2,321
Interest income	8	1,325	810
Interest expenses	8	–442	–1,818
Other financial result	9	–3,359	–463
Financial result		**–81**	**851**
Earnings before tax		**22,044**	**20,126**
Income tax income/expense	10	–6,208	–4,698
Current		–5,262	–4,612
Deferred		–946	–86
Earnings after tax		**15,836**	**15,428**

- Source: Volkswagen AG Annual Report (2022), p. 277.

Real-world example: Volkswagen Group

€ million	Note	Dec. 31, 2022	Dec. 31, 2021
Assets			
Noncurrent assets			
Intangible assets	12	83,241	77,689
Property, plant and equipment	13, 33	63,890	63,695
Lease assets	14, 33	59,380	59,699
Investment property	14	610	615
Equity-accounted investments	15	12,668	12,531
Other equity investments	15	3,489	3,000
Financial services receivables	16	86,944	84,954
Other financial assets	17	13,832	9,156
Other receivables	18	3,095	2,895
Tax receivables	19	394	635
Deferred tax assets	19	12,921	13,393
		340,464	**328,261**
Current assets			
Inventories	20	52,274	43,725
Trade receivables	21	18,581	15,521
Financial services receivables	16	61,549	56,498
Other financial assets	17	15,167	12,584
Other receivables	18	7,896	7,473
Tax receivables	19	1,732	1,618
Marketable securities and time deposits[1]	22	37,206	22,532
Cash and cash equivalents[1]	23	29,172	39,723
Assets held for sale		733	674
		224,309	**200,347**
Total assets		**564,772**	**528,609**

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Real-world example: Volkswagen Group

Key Figures

VOLKSWAGEN GROUP

	2022	2021	%
Volume Data[1] in thousands			
Deliveries to customers (units)	8,263	8,882	−7.0
Vehicle sales (units)	8,481	8,576	−1.1
Production (units)	8,717	8,283	+5.2
Employees at Dec. 31	675.8	672.8	+0.4

1 Volume data including the unconsolidated Chinese joint ventures. These companies are accounted for using the equity method. Prior-year deliveries updated to reflect subsequent statistical trends.

INTERESTS IN JOINT VENTURES

From a Group perspective, the joint ventures FAW-Volkswagen Automotive Company Ltd., Changchun/China, SAIC-Volkswagen Automotive Company Ltd., Shanghai/China, and SAIC-Volkswagen Sales Company Ltd., Shanghai/China, were material at the reporting date due to their size.

Real-world example: Volkswagen Group

€ million	FAW-Volkswagen Automotive Company	SAIC-Volkswagen Automotive Company[1]	SAIC-Volkswagen Sales Company
2022			
Equity interest in %	40	50	30
Noncurrent assets	11,021	7,003	937
Current assets	13,941	6,459	3,656
of which cash and cash equivalents	8,355	1,243	525
Noncurrent liabilities	1,112	593	128
of which financial liabilities[2]	25	2	24
Current liabilities	14,832	9,831	4,091
of which financial liabilities[2]	30	2,135	13
Net assets	9,018	3,039	374
Sales revenue	47,986	22,844	25,112
Depreciation and amortization	2,333	1,899	25
Interest income	316	45	7
Interest expenses	2	24	3
Earnings before tax from continuing operations	5,711	1,391	453
Income tax expense	1,510	80	126
Earnings after tax from continuing operations	4,201	1,311	328
Earnings after tax from discontinued operations	–	–	–
Other comprehensive income	161	26	–
Total comprehensive income	4,361	1,337	328
Dividends received[3]	1,527	683	100

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Course Structure

Block	Topic
5	Joint Arrangement and Investments at Equity Changes in Control
5.1	Joint Arrangement and Investments at Equity
5.2	**Changes in Control**

- How do we capture changes in a parent company's equity share after initial consolidation?

Step Acquisitions – Accounting Implications

Percentage of share | **Transactions** | **Consolidation**

3 – Subsidiary (control)
→ Full consolidation
→ IFRS 3/IFRS 10

50%

2 – Associate (significantly influenced)
→ Equity method
→ IFRS 11/IAS 28

20%

1 – Investment/ financial asset (passive)
→ At cost
→ IAS 39/IFRS9

- Change of consolidation method
- Determine the date of the initial consolidation

- No change of consolidation method
- Adjustments of non-controlling interest

Step Acquisitions - Overview

- Step acquisition
  - Acquisition in which the change of control occurs in several steps.
  - First time consolidation at the time of the change in control.
  - IFRS 3.41:

    An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on 31 December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 per cent interest in Entity B, which gives it control of Entity B. This IFRS refers to such a transaction as a business combination achieved in stages, sometimes also referred to as a step acquisition.

- Problem
  - Difference between the value of shares consolidated at cost or at equity to the fair value at the time of the change of control.
- Solution
  - IFRS: Recognition as profit or loss

Step Acquisition - Example

- **Scenario:**

Parent (Entity A):

t_1	1. tranche: 35%	Costs: 500
t_2	2. tranche: 40%	Costs: 1000

Subsidiary (Entity B):

t_1	Equity (Fair Value)	1,500
t_2	Equity (Fair Value)	2,000

Step Acquisition - Example

In t_2 change of control → revaluation of equity:

Fair Value of Equity in t_2 2,000

35% (1.tranche)	40% (2. tranche)	25% Non-controlling interest
35% of 2,000 = 700	40% of 2,000 = 800	25% of 2,000 = 500
Costs = 500	Cost = 1,000	
Increase in value = 200	Difference= 200	
IFRS 3: profit 200	Goodwill: 200	

Step Acquisition – Journal Entries

Journal entries t_1

(1)	Dr. AfS financial assets	500	Cr. Cash	500

Journal entries t_2

(2)	Dr. AfS financial assets	200	Cr. OCI (AfS revaluation)		200
(3)	Dr. Net assets of Entity B	2000	Cr.	Cash	1000
	Goodwill	200		AfS financial assets	700
				NCI	500
(4)	Dr. OCI (AfS revaluation)	200		Cr. Gain (P&L)	200

Notes:

(1) Purchase of 1st stake in Entity B for 500

(2) Revalue 1st stake to FV under IAS 39

(3) Purchase of 2nd stake in Entity B for 1,000; consolidation

(4) “Recycling”

Disposal of Subsidiaries – Loss of Control

IFRS 3.B98: If a parent loses control of a subsidiary, it shall:

a) derecognise:
   (i) the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost; and
   (ii) the carrying amount of any non-controlling interest in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them).

b) recognise:
   (i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;
   (ii) if the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and
   (iii) any investment retained in the former subsidiary at its fair value at the date when control is lost.

c) reclassify to profit or loss, or transfer directly to retained earnings if required by other IFRSs, the amounts recognised in other comprehensive income in relation to the subsidiary on the basis described in paragraph B99.

d) recognise any resulting difference as a gain or loss in profit or loss attributable to the parent.

Disposal of Subsidiaries – Discontinued Operations

- IFRS 5.32: A discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale, and
  - represents a separate major line of business or geographical area of operations,
  - is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or
  - is a subsidiary acquired exclusively with a view to resale.

- IFRS 5 prescribes that a business held for sale is …
  - carried at the lower of its carrying amount and fair value less costs to sell, and
  - presented separately on the balance sheet.

Loss of Control – Exercise

Fact Pattern:

- X AG purchases 75% of Y GmbH‘s shares at a price of 900 at Dec 31, 20X1.
- Therefore, Y GmbH‘s fair value (100%) is assumed to equal 1,200.
- Book value of equity equals 500 with hidden reserves of 300.
- Hidden reserves (300) of Y GmbH are depreciated over three years.
- Goodwill (non-controlling interest at revalued equity: 300) and full goodwill (full goodwill method: 400) are not impaired.
- Y GmbH made a profit of 50 in 20X2.

After performing the subsequent consolidation at Dec 31, 20X2 and measuring the non-controlling interest at their proportionate share of revalued equity, X AG sells its shares in Y GmbH‘s capital at 1,200.

Question:

Please account for the loss of control!

Subsequent Consolidation (Recap)

31.12.20X2	X		Y		Reval.		Sum		Consolidation		Consolidated	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
LTA												
Inv. in Y												
Goodwill												
STA												
Equity												
Profit												
non-controlling interest												
Debt												
Sum												

Subsequent Consolidation (Recap)

31.12.20X2	X		Y		Reval.		Sum		Consolidation		Consolidated	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
LTA	1,800		550		300 (1)		2,650			100 (4)	2,550	
Inv. in Y	900						900			900 (2)	---	
Goodwill									300 (2)		300	
STA	1,000		350				1,350				1,350	
Equity		2,100		500		300 (1)		2,900	600 (2) 200 (3a)			2,100
Profit		150		50				200	75 (4) 12.5 (5)			112.5
non-controlling interest									25 (4)	200 (3a) 12.5 (5)		187.5
Debt		1,450		350				1,800				1,800
Sum	3,700	3,700	900	900			4,900	4,900			4,200	4,200

Subsequent Consolidation (Recap)

Journal entries

(1) to (3) redo initial consolidation

(4) to (5) subsequent consolidation

(1) Revaluation
(2) Consolidation of X‘s share of Y GmbH‘s revalued equity and the resulting goodwill.
(3a) non-controlling interest‘ share of Y GmbH‘s revalued equity
(3b) Minority goodwill
(4) Depreciation of hidden reserves
(5) non-controlling interest‘ share of Y GmbH‘s profit

Loss of Control

31.12.20X2	Consolidated		Loss of Control		Consolidated after sale	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
LTA	2,550					
Inv. in Y	---					
Goodwill	300					
STA	1,350					
Equity		2,100				
Profit		112.5				
non-controlling interest		187.5				
Debt		1,800				
Sum	4,200	4,200				

Loss of Control

31.12.20X2	Consolidated		Loss of Control		Consolidated after sale	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
LTA	2,550			750	1,800	
Inv. in Y	---					
Goodwill	300			300	---	
STA	1,350		1,200	350	2,200	
Equity		2,100				2,100
Profit		112.5		337.5 (residual)		450
non-controlling interest		187.5	187.5			---
Debt		1,800	350			1,450
Sum	4,200	4,200			4,000	4,000

Disposal of Subsidiaries

IFRS 10.25: If a parent loses control of a subsidiary, the parent:

a) derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial positions

b) recognises any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRSs. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.

c) recognises the gain or loss associated with the loss of control attributable to the former controlling interest.

Block 5: Key take-aways

- The intensity of the relation between a parent company and different other entities in the corporate group varies. These differences are captured in the accounting treatment.
  - Subsidiary: full consolidation
  - Joint arrangement, joint ventures, associates: equity method

- The equity method is a “one-line consolidation” approach. It does not allow users to see through to the underlying fundamentals of the investee.

- Changes in control can arise because of changes in the parent company’s ownership shares. Necessary one-time adjustments are accounted for in profit/loss.