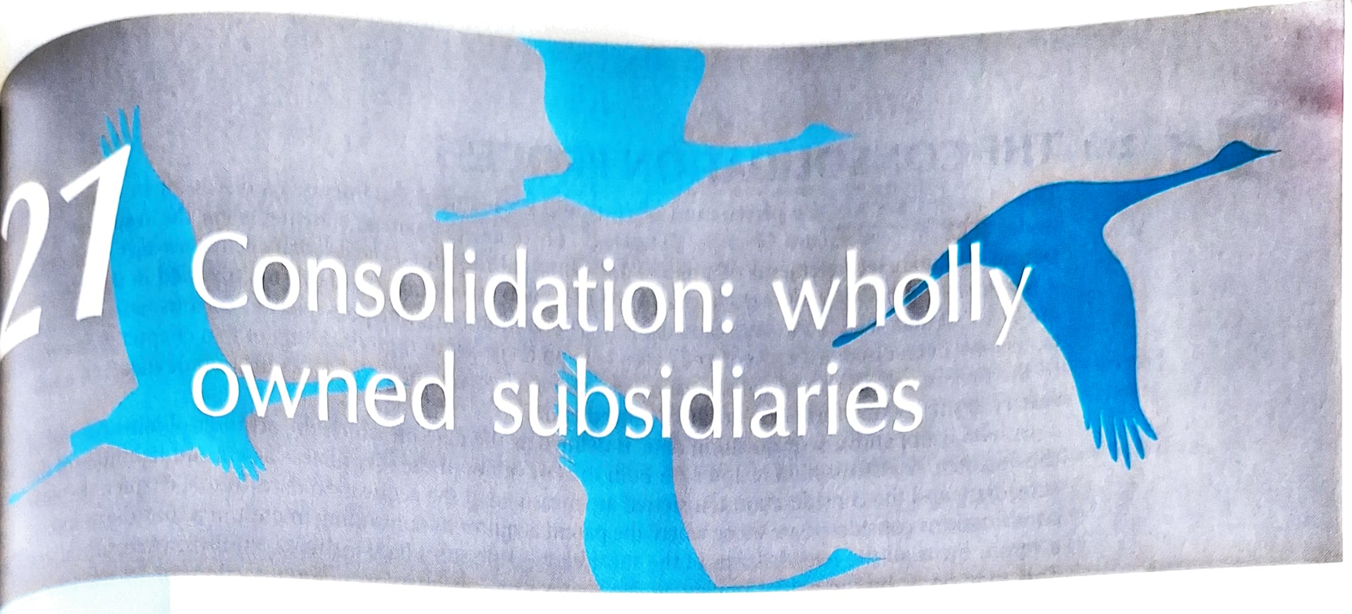

21 Consolidation: wholly owned subsidiaries

ACCOUNTING STANDARDS IN FOCUS

IFRS 3 *Business Combinations*
IFRS 10 *Consolidated Financial Statements*
IFRS 12 *Disclosure of Interests in Other Entities*

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. understand the nature of the group covered in this chapter, and the initial adjustments required in the consolidation worksheet
2. explain how a consolidation worksheet is used
3. prepare an acquisition analysis for the parent's acquisition in a subsidiary
4. prepare the worksheet entries at the acquisition date, being the business combination valuation entries and the pre-acquisition entries
5. prepare the worksheet entries in periods subsequent to the acquisition date, adjusting for movements in assets and liabilities since acquisition date and dividends from pre-acquisition equity
6. prepare the worksheet entries where the subsidiary revalues its assets at acquisition date
7. prepare the disclosures required by IFRS 3 and IFRS 12.

LO1

21.1 THE CONSOLIDATION PROCESS

This chapter discusses the preparation of consolidated financial statements. As discussed in chapter 20, under IFRS 10 *Consolidated Financial Statements* consolidated financial statements are the result of combining the financial statements of a parent and all its subsidiaries. *(The determination of whether an entity is a parent or a subsidiary is discussed in chapter 20.)* The two accounting standards mainly used in this chapter are IFRS 10 and IFRS 3 *Business Combinations*. The accounting principles relevant for business combinations have been discussed earlier *(see chapter 14)* and an in-depth understanding of that chapter is essential to the preparation of consolidated financial statements because the parent's acquisition of shares in a subsidiary is simply one form of a business combination.

In IFRS 3 Appendix A, 'acquisition date' is defined as the date on which the acquirer obtains control of the acquiree. As discussed in chapter 14, both the fair values of the identifiable assets and liabilities of the subsidiary and the consideration transferred are measured at the acquisition date. In this chapter, the only combinations considered are those where the parent acquires its controlling interest in a subsidiary and, as a result, owns all the issued shares of the subsidiary — the subsidiary is then a wholly owned subsidiary. This may occur by the parent buying all the shares in a subsidiary in one transaction, or by the parent acquiring the controlling interest after having previously acquired shares in the subsidiary.

Note, however, as discussed in chapter 20, control of a subsidiary does not necessarily involve the parent acquiring shares in a subsidiary. The consolidated financial statements of a parent and its subsidiaries include information about a subsidiary from the date the parent obtains control of the subsidiary; that is, from the acquisition date. A subsidiary continues to be included in the parent's consolidated financial statements until the parent no longer controls that entity; that is, until the date of disposal of the subsidiary.

Before undertaking the consolidation process, it may be necessary to make adjustments in relation to the content of the financial statements of the subsidiary:

- If the end of a subsidiary's reporting period does not coincide with the end of the parent's reporting period, adjustments must be made for the effects of significant transactions and events that occur between those dates, with additional financial statements being prepared where it is practicable to do so (IFRS 10 paragraphs B92–B93). In most cases where there are different dates, the subsidiary will prepare adjusted financial statements as at the end of the parent's reporting period, so that adjustments are not necessary on consolidation. Where the preparation of adjusted financial statements is unduly costly, the financial statements of the subsidiary, prepared at a different date from the parent, may be used subject to adjustments for significant transactions. However, as paragraph B93 states, for this to be a viable option, the difference between the ends of the reporting periods can be no longer than 3 months. Further, the length of the reporting periods, as well as any difference between the ends of the reporting periods, must be the same from period to period.
- The consolidated financial statements are to be prepared using uniform accounting policies for like transactions and other events in similar circumstances (IFRS 10 paragraph 19). Where different policies are used, adjustments are made so that like transactions are accounted for under a uniform policy in the consolidated financial statements.

The preparation of the consolidated financial statements involves adding together the financial statements of the parent and its subsidiaries as well as processing a number of adjustments, these being expressed in the form of consolidating journal entries:

- As required by IFRS 3, at the acquisition date the acquirer must recognise the identifiable assets acquired and liabilities assumed of the subsidiary at fair value. Adjusting the carrying amounts of the subsidiary's assets and liabilities to fair value and recognising any identifiable assets acquired and liabilities assumed as a part of the business combination but not recorded by the subsidiary is a part of the consolidation process. The entries used to make these adjustments are referred to in this chapter as the *business combination valuation entries*. As noted later *(see section 21.2)* these adjusting entries are generally not made in the records of the parent or of the subsidiary, but in a consolidation worksheet.
- Where the parent has an ownership interest (i.e. owns shares) in a subsidiary, adjusting entries are made, referred to in this chapter as the *pre-acquisition entries*. As noted in paragraph B86(b) of IFRS 10, this involves eliminating the carrying amount of the parent's investment in each subsidiary and the parent's portion of pre-acquisition equity in each subsidiary. The name of these entries is derived from the fact that the equity of the subsidiary at the acquisition date is referred to as pre-acquisition equity, and it is this equity that is being eliminated. These entries are also made in the consolidation worksheet and not in the records of the parent or subsidiary.
- The third set of adjustments to be made is for transactions between the entities within the group subsequent to the acquisition date, including events such as sales of inventory or non-current assets. These *intragroup* transactions are referred to in IFRS 10 paragraph B86(c) *(adjustments for these transactions are discussed in detail in chapter 22)*.

In this chapter, the group under discussion is one where:

- there are only two entities within the group: one parent and one subsidiary (see figure 21.1)
- both entities have share capital

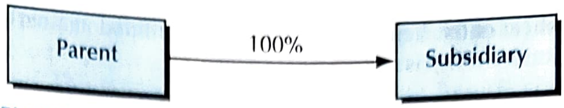

FIGURE 21.1 A wholly owned group

- the parent owns all the issued shares of the subsidiary; that is, the subsidiary is wholly owned (partially owned subsidiaries, where it is necessary to account for the non-controlling interest, are covered later (*see chapter 23*))
- there are no intragroup transactions between the parent and its subsidiary after the acquisition date.

LO2

21.2 CONSOLIDATION WORKSHEETS

The consolidated financial statements are prepared by adding together the financial statements of the parent and the subsidiary. It is the *financial statements* of the parent and the subsidiary, rather than the underlying accounts, which are added together. There are no consolidated ledger accounts. The financial statements that are added together are the statements of financial position, statements of profit or loss and other comprehensive income and statements of changes in equity prepared by the management of the parent and the subsidiary. Consolidated statements of cash flows must also be prepared, but these are beyond the scope of this book.

To facilitate the addition process, particularly where there are several subsidiaries, as well as to make the necessary valuation and pre-acquisition entry adjustments, a worksheet or computer spreadsheet is often used. From the worksheet, the external statements are prepared — the consolidated statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity.

The format for the worksheet is presented in figure 21.2, which contains the information used for the consolidation of the parent, P Ltd, and the subsidiary, S Ltd. Assume that P has paid £20 000 for all of the shares of S. At the time of acquisition S reported £15 000 in share capital and £5000 in retained earnings. Note that this simple example does not deal with goodwill or fair value adjustments, which are discussed later.

Financial statements	Parent P Ltd	Subsidiary S Ltd	Adjustments Dr		Adjustments Cr		Consolidation
Investment in S Ltd	20 000	—			20 000	1	—
Other assets	35 000	27 000					62 000
	55 000	27 000			20 000		£62 000
Share capital	30 000	15 000	1	15 000			30 000
Retained earnings	25 000	12 000	1	5 000			32 000
	55 000	27 000		20 000			£62 000

FIGURE 21.2 Consolidation worksheet — basic format

Note the following points about the worksheet:

- The first column contains the names of the accounts, as the financial statements are combined on a line-by-line basis.
- The second and third columns contain the internal financial statements of the parent, P Ltd, and its subsidiary, S Ltd. These statements are obtained from the separate legal entities. The number of columns is expanded if there are more subsidiaries within the group.
- The next set of columns, headed 'Adjustments', are used to make the adjustments required in the consolidation process. These include adjustments for valuations at acquisition date, pre-acquisition equity, and intragroup transactions such as sales of inventory between the parent and subsidiary. The adjustments, written in the form of journal entries, are recorded on the worksheet. Where there are many adjustments, each journal entry should be numbered so that it is clear which items are being affected by a particular adjustment entry. In figure 21.2 there is only one

worksheet entry, hence the number '1' is entered against each adjustment item. The worksheet adjustment entry is:

(1) Share Capital of S	Dr	15 000	
(1) Retained Earnings of S (balance at acquisition)	Dr	5 000	
Investment in S Ltd	Cr		20 000

- As noted earlier, the process of consolidation is one of adding together the financial statements of the members of the group and making various adjustments. Hence, figures for each line item in the right-hand column, headed 'Consolidation', arise through addition and subtraction as you proceed horizontally across the worksheet.
- The share capital and the retained earnings at acquisition date (on S Ltd's financial statements) are eliminated against the Investment in S Ltd (on P Ltd's financial statements).
- For example, for share capital, retained earnings and the shares in S Ltd, the effect of the adjustments are:

Share capital:	£30 000 + £15 000 − £15 000 = £30 000
Retained earnings:	£25 000 + £12 000 − £5 000 = £32 000
Investment in S Ltd:	£20 000 − £20 000 = £0

The figures in the right-hand column provide the information for the preparation of the consolidated financial statements of the group, P Ltd and S Ltd. Note that the retained earnings reported by the group include only £7 000 of the £15 000 reported by S. This is because S Ltd generated this amount in undistributed profit *since* acquisition. The subsidiary's retained earnings at acquisition amounted to £5 000 whereas at the date of consolidation this amount had increased to £12 000. Only the earnings of the subsidiary post acquisition are attributable to the group's performance and hence only £7 000 is absorbed into the consolidated retained earnings.

In preparing the consolidated financial statements, *no* adjustments are made in the accounting records of the individual entities that constitute the group. The adjusting entries recorded in the columns of the worksheet do not affect the accounts of the individual entities. They are recorded in a separate consolidation journal, not in the journals of any of the entities within the group, and are then recorded on the consolidation worksheet. Hence, where consolidated financial statements are prepared over a number of years, a particular entry (such as a pre-acquisition entry) needs to be made *every time* a consolidation worksheet is prepared, because the entry never affects the actual financial statements of the individual entities.

LO3

21.3 THE ACQUISITION ANALYSIS: DETERMINING GOODWILL OR BARGAIN PURCHASE

On acquisition involving 100% of the shares in the acquired entity, there are three main measurement tasks that should be performed at acquisition date. First, the value of consideration paid to the previous shareholders of the acquired entity must be determined. In a simple case, this is the cash amount paid. Often, however, the acquirer uses other payment methods. Under one popular method, the acquirer issues its own shares in return for the shares in the target company (or a combination of cash and shares). In this case, the fair value of the shares issued should be determined. Occasionally, the fair value of the target's shares, rather than the acquirer's, may be measured more reliably and hence used instead (paragraph 33 of IFRS 10). The fair value of the consideration given should also take into account contingent payments (payments that are made in the future to the previous shareholders of the target company if certain conditions are met). These should also be fair-valued (paragraph 37). A slight complication arises when the acquisition is done in steps (step acquisition). For example, in the first step 30% of the target's shares are acquired and in the second step an additional 70% stake is purchased. In such a case the acquirer has to combine the value of consideration transferred in the last stage with the acquisition-date fair value of the initial 30% (paragraphs 41–42). The total of these two components is then regarded as the overall value of the 100% stake assumed (*see section 21.3.2*).

The second measurement task requires the determination of the fair value of net assets (assets less liabilities) in the target's acquisition-date balance sheet. This typically involves fair-valuing of all on-balance-sheet assets and liabilities, as well as some off-balance-sheet items (e.g. intangible assets and contingent liabilities) (*see chapter 14*).

The third measurement task is to assess the value of goodwill to show in the consolidated balance sheet. As discussed in chapter 14, this is done by comparing the value of considerations transferred (plus, possibly, the value of a previously held stake) to the fair value of net assets acquired. If the fair value of consideration transferred (plus, possibly, the value of a previously held stake) exceeds that of fair value of net assets acquired, then goodwill arises. If there is no excess whereby the fair value of net assets is higher, then negative goodwill arises. This is regarded as a bargain purchase. In such a case IFRS 10 (paragraph 36) requires the acquirer to conduct a review of its calculations. If the calculations hold, the negative goodwill is recorded in income (paragraph 35).

It should be noted that any acquisition-related costs, such as finders' fees; advisory, legal, accounting, valuation and other professional or consulting fees do not enter the above calculations and they need to be expensed (paragraph 53).

We discuss next several scenarios that may arise on acquisition date.

21.3.1 Parent has no previously held equity interest in the subsidiary

In this case, the parent acquires all the shares of the subsidiary at acquisition date in one transaction. In terms of paragraph 32 of IFRS 3 and as mentioned above, goodwill arises when the consideration transferred (32(a)(i)) is greater than the net fair value of the identifiable assets and liabilities acquired (32(b)). Where the reverse occurs, a gain on bargain purchase is recognised.

An acquisition analysis is conducted at acquisition date because it is necessary to recognise the identifiable assets and liabilities of the subsidiary at fair value, and to determine whether there has been an acquisition of goodwill or a bargain purchase gain.

The first step in the consolidation process is to undertake the above acquisition analysis in order to obtain the information necessary for making both the business combination valuation and pre-acquisition entry adjustments for the consolidation worksheet. Consider the example in figure 21.3.

On 1 July 2013, Parent Ltd acquired all the issued share capital of Sub Ltd (300 000 shares), giving in exchange 100 000 shares in Parent Ltd, these having a fair value of £5 per share. At acquisition date, the statements of financial position of Parent Ltd and Sub Ltd, and the fair values of Sub Ltd's assets and liabilities, were as follows:

	Parent Ltd	Sub Ltd	
	Carrying amount	Carrying amount	Fair value
ASSETS			
Land	£120 000	£150 000	£170 000
Equipment	620 000	480 000	330 000
Accumulated depreciation	(380 000)	(170 000)	
Investment in Sub Ltd	500 000		
Inventory	92 000	75 000	80 000
Cash	15 000	5 000	5 000
Total assets	£967 000	£540 000	£585 000
LIABILITIES AND EQUITY			
Liabilities			
Provisions	30 000	60 000	60 000
Trade and other payables	27 000	34 000	34 000
Tax payable	10 000	6 000	6 000
Total liabilities	£ 67 000	£100 000	£100 000
Equity			
Share capital	550 000	300 000	
Retained earnings	350 000	140 000	
Total equity	900 000	440 000	
Total liabilities and equity	£967 000	£540 000	

At acquisition date, Sub Ltd has an unrecorded patent with a fair value of £20 000, and a contingent liability with a fair value of £15 000. This contingent liability relates to a loan guarantee made by Sub Ltd which did not recognise a liability in its records because it did not consider it could reliably measure the liability. The tax rate is 30%.

FIGURE 21.3 Information at acquisition date

The analysis at acquisition date consists of comparing the fair value of the consideration transferred and the net fair value of the identifiable assets and liabilities of the subsidiary at acquisition date. The net fair value of the subsidiary could be calculated by revaluing the assets and liabilities of the subsidiary from the carrying amounts to fair values, remembering that under IAS 12 *Income Taxes* where there is a difference between the carrying amount and the tax base caused by the revaluation, the tax effect of such a difference has to be recognised. However, in calculating the net fair value of the subsidiary, because particular information is required to prepare the valuation and pre-acquisition entries, the calculation is done by adding the recorded equity of the subsidiary (which represents the recorded net assets of the subsidiary) and the differences between the carrying amounts of the assets and liabilities and their fair values, adjusted for tax. The book equity of the subsidiary in figure 21.3 consists of:

£300 000 capital + £140 000 retained earnings

These fair value adjustments, are recorded initially against the *business combination valuation reserve* (BCVR). This reserve is not an account recognised in the subsidiary's records, but it is recognised in the consolidation process as part of the business combination. For example, for land there is a difference of £20 000 in the fair value carrying amount and, on revaluation of the land to fair value, a business combination valuation reserve of £14 000 (i.e. £20 000 (1 − 30%)) is raised. The total of pre-tax fair value adjustments is £50 000, giving rise to deferred tax liability of £15 000.

The acquisition analysis, including the determination of the goodwill of the subsidiary, is as shown in figure 21.4.

	Sub Ltd		
	Carrying amount	**Fair value adjustment**	**Fair value**
ASSETS			
Land	£150 000	£20 000	£170 000
Equipment	310 000	20 000	330 000
Patent		20 000	20 000
Inventory	75 000	5 000	80 000
Cash	5 000		5 000
Total assets	£540 000	£65 000	£605 000
LIABILITIES			
Provisions	60 000		60 000
Trade and other payables	34 000		34 000
Contingent liability — loan guarantee		15 000	15 000
Deferred tax liability		15 000	15 000
Tax payable	6 000		6 000
Total liabilities	100 000	30 000	130 000
Net Assets	£440 000	£35 000	£475 000
Determination of goodwill:			
1 July 2013			
Consideration paid	500 000		
Less: Fair value of net assets acquired	475 000		
Goodwill	£ 25 000		

FIGURE 21.4 Acquisition analysis — no previously held equity interests

The information from the completed acquisition analysis is used to prepare the adjustment entries for the consolidation worksheet. These entries are illustrated below (*see section 21.4*).

In this book, it is assumed that the tax base of the subsidiary's assets and liabilities is unchanged as a result of the parent's acquisition of the subsidiary. In some jurisdictions, where the group becomes the taxable entity, there is a change in the tax base to the fair value amounts. In this case, no tax effect would be recognised in relation to the assets and liabilities acquired.

21.3.2 Parent has previously held equity interest in the subsidiary

The situation used in figure 21.3 will be used here with the only difference being that on 1 July 2013 Parent Ltd acquires 80% of the shares in Sub Ltd, giving in exchange 80 000 shares in Parent Ltd, these having a fair value of £5 per share. Parent Ltd had previously acquired the other 20% stake in Sub Ltd for £75 000. At 30 June 2013, this investment in Sub Ltd was recorded at £92 000. The appreciation in value was recorded in income since the investment was classified as an equity instrument and measured at fair value through income. At 1 July 2013, these shares had been reassessed to have a fair value of £100 000.

In accordance with IFRS 3 paragraph 42, Parent Ltd revalues the previously held investment to fair value, recognising the increase in profit or loss. If previously changes in fair value are recognized in other comprehensive income, then these amounts are then taken into profit or loss as a reclassification adjustment. The journal entries in Parent Ltd at acquisition date, both for the previously held investment as well as the acquisition of the remaining shares in Sub Ltd, are as follows:

Investment in Sub Ltd	Dr	8 000	
Profit or Loss	Cr		8 000
(Revaluation to fair value)			
Investment in Sub Ltd	Dr	400 000	
Share Capital	Cr		400 000
(Acquisition of shares in Sub Ltd: 80 000 at £5 per share)			

The determination of goodwill is shown in figure 21.5.

Determination of goodwill:	
1 July 2013	
Value of previously acquired 20% stake	£100 000
Consideration paid	400 000
	500 000
Less: Fair value of net assets acquired	475 000
Goodwill	£ 25 000

FIGURE 21.5 Determination of goodwill — previously held equity interests

As a result of the numbers used in this example, the goodwill number is the same as that shown in figure 21.4. There are no subsequent effects on the consolidation process because the parent had previously held an investment in the subsidiary.

LO4

21.4 WORKSHEET ENTRIES AT THE ACQUISITION DATE

As noted earlier, the consolidation process does not result in any entries being made in the actual records of either the parent or the subsidiary. The adjustment entries are made in the consolidation worksheet. Hence, adjustment entries need to be passed each time a worksheet is prepared, and these entries change over time. In this section, the adjustment entries that would be passed in a consolidation worksheet prepared *immediately after the acquisition date* are analysed.

21.4.1 Business combination valuation entries

In figure 21.3, there are three identifiable assets recognised by the subsidiary whose fair values differ from their carrying amounts at acquisition date, as well as an intangible asset and a contingent liability recognised as part of the business combination. The entries for the business combination valuations are done in the consolidation worksheet rather than in the records of the subsidiary (*see section 21.6 for a discussion on making these adjustments in the records of the subsidiary itself*).

The identifiable assets and liabilities that require adjustment to fair value can be easily identified by reference to the acquisition analyses in figures 21.4 and 21.5, namely land, equipment, inventory, patent and the unrecorded guarantee. Goodwill also has to be recognised on consolidation. These differences are all recognised using business combination valuation entries. Consolidation worksheet adjustment entries for each of these assets and the unrecorded liability are given in figure 21.6.

Business combination valuation entries

(1) Land	Dr	20 000	
Deferred Tax Liability	Cr		6 000
Business Combination Valuation Reserve	Cr		14 000
(2) Accumulated Depreciation – Equipment	Dr	170 000	
Equipment	Cr		150 000
Deferred Tax Liability	Cr		6 000
Business Combination Valuation Reserve	Cr		14 000
(3) Inventory	Dr	5 000	
Deferred Tax Liability	Cr		1 500
Business Combination Valuation Reserve	Cr		3 500
(4) Patent	Dr	20 000	
Deferred Tax Liability	Cr		6 000
Business Combination Valuation Reserve	Cr		14 000
(5) Business Combination Valuation Reserve	Dr	10 500	
Deferred Tax Asset	Dr	4 500	
Provision for Loan Guarantee	Cr		15 000
(6) Goodwill	Dr	25 000	
Business Combination Valuation Reserve	Cr		25 000

FIGURE 21.6 Business combination valuation entries at acquisition date

The total balance of the business combination valuation reserve at this stage is £60 000. It will be cancelled to zero when the pre-acquisition entries are processed. The adjustments to assets and liabilities at acquisition date could be achieved by one adjusting entry, giving a net balance to the business combination valuation reserve. However, in order to keep track of movements in that reserve as assets are depreciated or sold, liabilities paid or goodwill impaired, it is practical to prepare a valuation entry for each component of the valuation process. The valuation entries are passed in the adjustment columns of the worksheet, *which is illustrated in section 21.4.3*. Note that, in relation to entry (6) for goodwill, there is no deferred tax liability. This is because paragraph 21 of IAS 12 states that no such deferred tax liability is recognised, as goodwill is measured as a residual, and the recognition of a deferred tax liability would increase its carrying amount. Further, note that the goodwill is recognised on the consolidated balance sheet and not on the balance sheet of the acquiring company.

21.4.2 Pre-acquisition entries

As noted in paragraph B86(b) of IFRS 10, an entry is required to eliminate the carrying amount of the parent's investment in the subsidiary against the parent's stake in the subsidiary's equity.

The investment in subsidiary on the parent's balance sheet represents the underlying assets and liabilities. As the consolidation process adds the net assets of the parent and subsidiary together to form the consolidated balance sheet, the investment in the subsidiary on the parent's balance sheet is eliminated to avoid double counting.

When the parent holds 100% of outstanding shares, this implies a full elimination of the subsidiary's equity as at the acquisition date. However, when the parent holds less than 100%, then the investment account is eliminated against the relevant portion of the subsidiary's equity on acquisition date *(see chapter 23)*. The pre-acquisition entries, then, involve two areas:

- the Investment in Subsidiary, as shown in the financial statements of the parent
- the equity of the subsidiary at the acquisition date (i.e. the pre-acquisition equity). The pre-acquisition equity is not just the equity recorded by the subsidiary but includes the business combination valuation reserve recognised on consolidation via the valuation entries.

Using the example in figure 21.3, and reading the information from the acquisition analysis in figure 21.4 (including the business combination valuation reserve for the revalued assets including goodwill and the contingent liability), the pre-acquisition entry at acquisition date is as shown in figure 21.7. The pre-acquisition entry in this figure is numbered (7) because there were six previous valuation entries.

Pre-acquisition entry			
(7) Retained Earnings (1 July 2013)	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
Investment in Sub Ltd	Cr		500 000

FIGURE 21.7 Pre-acquisition entry at acquisition date

The pre-acquisition entry is necessary to avoid overstating the equity and net assets of the group. To illustrate, consider the information in figure 21.3 relating to Parent Ltd's acquisition of the shares of Sub Ltd. Having acquired the shares in Sub Ltd, Parent Ltd records the asset 'Investment in Sub Ltd' at £500 000. This asset represents the actual net assets of Sub Ltd; that is, the ownership of the shares gives Parent Ltd the right to the net assets of Sub Ltd. To include both the asset 'Investment in Sub Ltd' and the net assets of Sub Ltd in the consolidated statement of financial position would double count the assets of the group, because the investment account is simply the right to the other assets. On consolidation, the investment account is therefore eliminated and, in its place, the net assets of the subsidiary are included in the consolidated statement of financial position.

Similarly, to include both the equity of the parent and the equity of the subsidiary in the consolidated statement of financial position would double-count the equity of the group. In the example, Parent Ltd has equity of £900 000, which is represented by its net assets including the investment in the subsidiary. Because the investment in the subsidiary is the same as the net assets of the subsidiary, the equity of the parent effectively relates to the net assets of the subsidiary. To include in the consolidated statement of financial position the equity of the subsidiary at acquisition date as well as the equity of the parent would double-count equity in relation to the net assets of the subsidiary.

The credit balance on the business combination valuation reserve is also eliminated as it represents a valuation adjustment to the net assets of Sub Ltd and is also included in the £500 000 acquisition price.

21.4.3 Consolidation worksheet

Figure 21.8 contains the consolidation worksheet prepared at acquisition date, with adjustments being made for business combination valuation and pre-acquisition entries. The right-hand column reflects the consolidated statement of financial position, showing the position of the group. In relation to the figures in this column, note the following:

- In relation to the two equity accounts — share capital and retained earnings — only the parent's balances are carried into the consolidated statement of financial position. At acquisition date, all the equity of the subsidiary is pre-acquisition and eliminated as well as the business combination reserve. With the business combination valuation reserve, the valuation entry establishes the reserve, and the pre-acquisition entry eliminates it because it is by nature pre-acquisition equity.
- The assets of the subsidiary are carried forward into the consolidated statement of financial position at fair value.
- The adjusting journal entries have equal debits and credits (as shown in the line 'Total adjustments'), which is essential if the statement of financial position is to balance.

FIGURE 21.8 Consolidation worksheet at acquisition date

Financial statements	Parent Ltd	Sub Ltd		Adjustments Dr	Adjustments Cr		Consolidation
ASSETS							
Land	£ 120 000	£ 150 000	1	£ 20 000			£ 290 000
Equipment	620 000	480 000			150 000	2	950 000
Accumulated depreciation	(380 000)	(170 000)	2	170 000			(380 000)
Investment in Sub Ltd	500 000	—			500 000	7	—
Inventory	92 000	75 000	3	5 000			172 000
Cash	15 000	5 000					20 000
Patent	—	—	4	20 000			20 000
Goodwill	—	—	6	25 000			25 000
Total assets	£ 967 000	£ 540 000					£1 097 000

(continued)

FIGURE 21.8 *(continued)*

Provisions	£ 30 000	£ 60 000			£ 15 000	5	£ 105 000
Trade and other payables	27 000	34 000					61 000
Tax payables	10 000	6 000					16 000
Deferred tax liability	—	—	5	4 500	6 000	1	
					6 000	2	
					1 500	3	
					6 000	4	15 000
Total Liabilities	£ 67 000	£ 100 000					£ 197 000
EQUITY							
Share capital	550 000	300 000	7	300 000			550 000
Retained earnings (1 July 2013)	350 000	140 000	7	140 000			350 000
	900 000	440 000					900 000
Total liabilities and equity	£ 967 000	£ 540 000					£1 097 000
Business combination valuation reserve			5	10 500	14 000	1	
			7	60 000	14 000	2	
					3 500	3	
					14 000	4	
					25 000	6	
Total adjustment				£ 75 500	£ 75 500		

21.4.4 Subsidiary has recorded dividends at acquisition date

Using the information in figure 21.3, assume that one of the trade and other payables at acquisition date is a dividend payable of £10 000. The parent can acquire the shares in the subsidiary on a *cum div.* or an *ex div.* basis.

If the shares are acquired on a *cum div. basis*, then the parent acquires the right to the dividend declared at acquisition date. In this case, if Parent Ltd pays £500 000 for the shares in Sub Ltd, then the right to receive dividend effectively reduces the consideration given by £10 000 to £490 000. The entry it passes to record the business combination is:

Investment in Sub Ltd	Dr	490 000	
Dividend Receivable	Dr	10 000	
Share Capital	Cr		500 000

In other words, the parent acquires two assets — the investment in the subsidiary and the dividend receivable. In calculating the goodwill in the subsidiary therefore, the consideration given is £490 000. Deducting the fair value of net assets received of £475 000 then results in goodwill of £15 000. The pre-acquisition entry is:

(7) Retained Earnings (1 July 13)	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	50 000	
Investment in Shares in Sub Ltd	Cr		490 000

A further consolidation worksheet entry is also required:

Dividend Payable	Dr	10 000	
Dividend Receivable	Cr		10 000

This entry is necessary so that the consolidated statement of financial position shows only the assets and liabilities of the group; that is, only those benefits receivable from and obligations payable to entities external to the group. In relation to the dividend receivable recorded by Parent Ltd, this is not an asset of the group, because that entity does not expect to receive dividends from a party external to it. Similarly, the dividend payable recorded by the subsidiary is not a liability of the group. That dividend will be paid within the group, not to entities outside the group.

If the shares are acquired on an *ex div. basis*, then the parent only acquires the shares, as the dividend will be paid to previous shareholders and not the parent company. The dividend has no effect on the acquisition analysis. If Parent Ltd had paid £500 000 for the shares in Sub Ltd on an *ex div. basis*, then the acquisition analysis is:

Net fair value of identifiable assets and liabilities of Sub Ltd	= £475 000 (see the *cum div.* basis)
Consideration transferred	= 100 000 shares × £5 = £500 000
Goodwill	= 500 000 − 475 000
	= 25 000

The pre-acquisition entry is:

Retained Earnings (1/7/13)	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
Investment in in Sub Ltd	Cr		500 000

21.4.5 Gain on bargain purchase

In figure 21.3, Parent Ltd paid £500 000 for the shares in Sub Ltd. Consider the situation where Parent Ltd paid £470 000 for these shares. The gain on bargain purchase analysis is as shown in figure 21.9.

Determination of gain on bargain purchase:	
1 July 2013	
Consideration paid	£470 000
Less: Fair value of net assets acquired	475 000
Gain on bargain purchase	5 000

FIGURE 21.9 Gain on bargain purchase

As the net fair value of the identifiable assets and liabilities of the subsidiary is greater than the consideration transferred, in accordance with paragraph 36 of IFRS 3 the acquirer must firstly reassess the identification and measurement of the subsidiary's identifiable assets and liabilities as well as the measurement of the consideration transferred. The expectation under IFRS 3 is that the excess of the net fair value over the consideration transferred is usually the result of measurement errors rather than being a real gain to the acquirer. However, having confirmed the identification and measurement of both amounts paid and net assets acquired, if an excess still exists, under paragraph 34 it is recognised immediately in the consolidated (rather than the acquirer's) profit as a gain on bargain purchase. This may happen, for example, when the subsidiary is in poor financial health and the subsidiary's shareholders are forced to offer a discount to a potential buyer.

Existence of a gain on bargain purchase implies that the entry (6) in Figure 21.6 cannot be passed. However, if the subsidiary has previously recorded goodwill a business combination revaluation a business combination revaluation entry crediting goodwill and debiting business combination valuation reserve for the amount of goodwill recorded by the subsidiary would be required. The reason for this is that if the acquisition price paid by the parent is less than the subsidiary's identifiable net assets, this implies that no goodwill can exist in the subsidiary.

With a bargain purchase we replace entry (6) in Figure 21.6, as follows:

(6) Business Combination Valuation Reserve	Dr	5 000	
Gain on Bargain Purchase	Cr		5 000

The pre-acquisition entry for the situation in figure 21.9 is as shown in figure 21.10.

Pre-acquisition entry			
(7) Retained Earnings (1 July 2013)	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	30 000	
Investment in Sub Ltd	Cr		470 000

FIGURE 21.10 Pre-acquisition entry at acquisition date — gain on bargain purchase

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21.5 WORKSHEET ENTRIES SUBSEQUENT TO THE ACQUISITION DATE

At acquisition date, the business combination valuation entries result in the economic entity recognising assets and liabilities not recorded by the subsidiary. Subsequently, changes in these assets and liabilities occur as assets are depreciated or sold, liabilities paid and goodwill impaired. Movements in the subsidiary's equity also occur as dividends are paid or declared and transfers are made within equity.

21.5.1 Business combination valuation entries

In the example used in figure 21.3, there were five items for which valuation entries were made — land, equipment, inventory, patent and the guarantee (a contingent liability). In this section, a 3-year time period subsequent to the acquisition date, 1 July 2013, is analysed (giving an end of reporting period of 30 June 2016) with the following events occurring:

- the land is sold in the 2015/16 period, for net proceeds of £199 000
- the equipment is depreciated on a straight-line basis over a 5-year period
- the inventory on hand at 1 July 2013 is all sold by 30 June 2014, the end of the first year
- the patent has an indefinite life, and is tested for impairment annually, with an impairment loss of £5000 recognised in the 2014/15 period
- the liability for the guarantee results in a payment of £10 000 in June 2014, with no further liability existing
- goodwill is written down by £5000 in the 2014/15 period as a result of an impairment test *(see chapter 15 for impairment of goodwill)*.

The statements of financial position of Parent Ltd and Sub Ltd, and the fair values of Sub Ltd's assets and liabilities, as of 30 June 2016 are shown in figure 21.11.

	Parent Ltd	Sub Ltd	
	Carrying amount	Carrying amount	Fair value of net assets acquired on 1 July 2013 that are still included in Sub Ltd's balance sheet
Assets			
Land	£170 000	£50 000	
Equipment	750 000	680 000	£530 000
Accumulated depreciation	(448 000)	(456 000)	(298 000)
Patent			15 000
Investment in shares in Sub Ltd	500 000		
Inventory	52 000	75 000	
Cash	65 000	95 000	
Total assets	**£1 089 000**	**£444 000**	
Equity and Liabilities			
Provisions	40 000	40 000	
Trade and other payables	32 000	24 000	
Tax payable	12 000	16 000	
Total liabilities	**£84 000**	**£80 000**	
Equity			
Share capital	550 000	300 000	
Retained earnings	455 000	64 000	
Total equity	**£1 005 000**	**£364 000**	
Total liabilities and equity	**£1 089 000**	**£444 000**	

FIGURE 21.11 Statements of financial position at 30 June 2016

The income statements for Parent Ltd and Sub Ltd for the year ended 30 June 2016 are shown in figure 21.12.

Income statements	Parent Ltd	Sub Ltd
Revenue	120 000	95 000
Expenses	85 000	72 000
	35 000	23 000
Gain on sale of non-current assets	15 000	31 000
Profit before tax	50 000	54 000
Income tax expense	15 000	21 000
Profit for the period	35 000	33 000
Retained earnings (1 July 2015)	420 000	220 000
Retained earnings (30 June 2016)	455 000	253 000

FIGURE 21.12 Income statements at 30 June 2016

We next analyse the effect of each of these items on the consolidation process.

Equipment

Of net assets acquired on 1 July 2013, the subsidiary's statement of financial position features only the equipment and the patent. The equipment had a remaining useful life of 5 years on acquisition date. Hence, Sub Ltd recorded an annual depreciation expense of ((£480 000 – £170 000)/5 = £62 000) bringing total accumulated depreciation for acquisition date's equipment to £356 000 and net book value of £124 000.

However, from the group's perspective the initial fair value adjustment was £20 000. Hence the equipment was restated to £330 000 with zero accumulated depreciation. For the purpose of consolidated statements, therefore, subsequent annual depreciation expense is £66 000, or £4000 higher than what was booked by Sub Ltd. After 3 years the net book value of this equipment is £132 000 (£330 000 – £198 000). Note that the carrying value of the equipment at Sub Ltd's stand-alone balance sheet (£124 000) is lower than the carrying value in the consolidated balance sheet (£132 000). The difference of £8 000 reflects 40% of the fair value adjustment recorded on acquisition date, because the remaining useful life of this adjustment is 2 (out of 5) years.

Note also the effect on the group's earning. The consolidation process effectively absorbs 100% of the profit reported by the subsidiary *since* acquisition. However, the calculation of this profit, which is reflected in Sub Ltd's equity, is *not* based on acquisition date's fair values. Hence, relative to the group, over the 3-year period, Sub Ltd's pre-tax profits are higher by £12 000 owing to lower annual depreciation expense (£32 000 vs. £36 000). After tax, Sub Ltd's retained earnings are higher by £8 400. The £8 400 reduction in retained earnings is split between a reduction of £5 600 to opening retained earnings, and a reduction to the 2014/15 after-tax profit of £2 800 (£4000 depreciation less £1200 tax saving).

Valuation entry for 2015/16 is shown in figure 21.13.

(1) Accumulated Depreciation — Equipment	Dr	158 000	
Depreciation Expense	Dr	4 000	
Retained Earnings — 30 June 2015	Dr	5 600	
Equipment — Cost	Cr		150 000
Deferred Tax Liability	Cr		2 400
Tax Expense	Cr		1 200
Business Combination Valuation Reserve	Cr		14 000

FIGURE 21.13 Business combination valuation entries at 30 June 2016

Note that the total effect on consolidated retained earnings as at 30 June 2016 is a reduction of £8400 (£5600 + £4000 – £1200).

Patent

The patent was impaired in 2014/15 to £15 000. Since the patent is not recorded in Sub Ltd's stand-alone balance sheet, the impairment was recorded only in consolidated income in the previous year. Hence, Sub Ltd's retained earnings as of 30 June should be reduced by £3 500 (£5000 × 70%). Deferred tax liability should also be reduced by £1 500 and stand at £400 in the 30 June 2016 consolidated statement of financial position.

Valuation entry for 2015/16:

(2) Patent	Dr	15 000	
Retained Earnings — 30 June 2015	Dr	3 500	
Deferred Tax Liability	Cr		4 500
Business Combination Valuation Reserve	Cr		14 000

Land

The land was sold in 2015/16. Because Sub Ltd recorded a gain that is based on lower carrying value than what was recorded in the 30 June 2015 consolidated balance sheet, its 2015/16 profit is higher by £14 000 (£20 000 × 70%). Therefore, this should be deducted from Sub Ltd's income for the year.

Valuation entry for 2015/16:

(3) Gain on Sale of Land	Dr	20 000	
Tax Expense	Cr		6 000
Business Combination Valuation Reserve	Cr		14 000

Inventory

The inventory was sold in 2013/14. Because Sub Ltd recorded gross profit that is based on lower carrying value than what was recorded in the 1 July 2013 consolidated balance sheet, its 2013/14 profit is higher by £3500 (£5000 × 70%).

Valuation entry for 2015/16:

(4) Retained Earnings — 30 June 2015	Dr	3 500	
Business Combination Valuation Reserve	Cr		3 500

Contingent liability

The guarantee liability was originally stated at £15 000 on the acquisition date consolidated balance sheet. Since in 2013/14 the settlement involved a payment of only £10 000, the group needs to record a pre-tax gain of £5 000. Sub Ltd's income statement in 2013/14 recorded a pre-tax loss of £10 000, because in its stand-alone balance sheet on 1 July 2013 no liability was recognised for the guarantee. Hence there is a difference of £15 000 between Sub Ltd's income and the group's income. Sub Ltd's retained earnings need to be increased by £10 500 (£15 000 × 70%) in the consolidation process.

Valuation entry for 2015/16:

(5) Business Combination Valuation Reserve	Dr	10 500	
Retained Earnings — 30 June 2015	Cr		10 500

The above analysis is summarised in the tables below:

Analysis of effect of acquisition-date adjustments on subsequent balance sheet

			Effect on		
	(1)	(2)	(3)	(4)	(5)
	Balance sheet 30 June 2016	Balance sheet 1 July 2013	Deferred tax liability 30 June 2016	Deferred tax liability 1 July 2013	Retained earnings 30 June 2016
Equipment	−150 000	−150 000			
Accumulated Depreciation	158 000	170 000			
	8 000	20 000	2 400	6 000	(8 400)
Land	0	20 000	0	6 000	(14 000)
Patent	15 000	20 000	4 500	6 000	(3 500)
Inventory	0	5 000		1 500	(3 500)
Contingent Liability — Guarantee	0	(15 000)	0	(4 500)	10 500
Total	**£23 000**	**£50 000**	**£6 900**	**£15 000**	**£(18 900)**

Analysis of effect of acquisition-date adjustments on 2015/16 profit

	(1) Balance sheet 30 June 2016	(2) Balance sheet 30 June 2015	Effect on (3) Deferred tax liability 30 June 2016	(4) Deferred tax liability 1 July 2013	(5) After-tax profit 2015/16
Equipment	−150 000	−150 000			
Accumulated Depreciation	158 000	162 000			
	8 000	12 000	2 400	3 600	(2 800)
Land	0	20 000	0	6 000	(14 000)
Patent	15 000	15 000	4 500	4 500	0
Inventory	0	0	0	0	0
Contingent Liability — Guarantee	0	0	0	0	0
Total	**£23 000**	**£47 000**	**£6 900**	**£14 100**	**£(16 800)**

Note:
Column (3) = 30% of column (1)
Column (4) = 30% of column (2)
Column (5) = [column (1) − column (2)] − [column (3) − column (4)]

Goodwill

Impairment tests for goodwill are undertaken annually. Goodwill is written down by £5000 in the 2014/15 period as a result of an impairment test. In the consolidation worksheet prepared at 30 June 2015, the business combination valuation entry will recognise the loss and reduction in goodwill. Because goodwill impairment is not tax deductible (i.e. it is a permanent difference) there is no effect on deferred tax liability or tax expense.

Valuation entry for 2015/16:

(6) Retained Earnings — 30 June 2015	Dr	5 000	
Goodwill	Dr	20 000	
Business Combination Valuation Reserve	Cr		25 000

21.5.2 Pre-acquisition entry

With the above entries (1)–(6) recorded, the final entry is to eliminate the investment in Sub Ltd account against the equity of the subsidiary as it was on acquisition date:

(7) Retained Earnings	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
Investment in Sub Ltd	Cr		500 000

We are now ready to prepare the consolidated statement of financial position and income statement (see figure 21.14).

21.5.3 Dividends paid/payable from subsidiary equity

Prior to July 2008, IAS 27 *Consolidated and Separate Financial Statements* described a cost method in relation to accounting for a parent's investment in a subsidiary. The equity of the subsidiary was then classified into pre-acquisition and post-acquisition components based upon whether the equity existed before or after the acquisition date. Dividends from pre-acquisition equity were accounted for as a recovery of a parent's investment in a subsidiary and recognised as a reduction in the cost of the investment. Dividends from post-acquisition equity were accounted for by a parent as revenue.

In 2008, the IASB made amendments to IAS 27. These amendments deleted the definition of the cost method from IAS 27 and required that all dividends paid or payable by a subsidiary were to be accounted for as revenue by the parent.

	Parent Ltd	Sub Ltd	Adjustments				Consolidation
				Dr	Cr		
Assets							
Land	£ 170 000	£ 50 000					£ 220 000
Equipment	750 000	680 000			150 000	1	1 280 000
Accumulated depreciation	(448 000)	(456 000)	1	158 000			(746 000)
Patent			2	15 000			15 000
Investment in Sub Ltd	500 000				500 000	7	
Inventory	52 000	75 000					127 000
Cash	65 000	95 000					160 000
Goodwill			6	20 000			20 000
Total assets	£1 089 000	£ 444 000					£1 076 000
Liabilities							
Provisions	40 000	40 000					80 000
Trade and other payables	32 000	24 000					56 000
Tax payable	12 000	16 000					28 000
Deferred tax liability					2 400	1	6 900
					4 500	2	
Total liabilities	£ 84 000	£ 80 000					£ 170 900
Equity							
Share capital	550 000	300 000	7	300 000			550 000
Retained earnings:							
Revenues	120 000	95 000					215 000
Expenses	85 000	72 000	1	4 000			161 000
	35 000	23 000					54 000
Gain on sale of non-current assets	15 000	31 000	3	20 000			26 000
Profit before tax	50 000	54 000			1 200	1	80 000
Income tax expense	15 000	21 000			6 000	3	28 800
Profit for the period	35 000	33 000		24 000	7 200		51 200
Retained earnings (30 June 2015)			1	5 600	10 500	5	
			2	3 500			
			4	3 500			
			6	5 000			
	420 000	31 000	7	140 000			303 900
Retained earnings (30 June 2016)	455 000	64 000					355 100
Total equity	£1 005 000	£ 364 000		£481 600	£ 17 700		£ 905 100
Total liabilities and equity	£1 089 000	£ 444 000		£481 600	£ 24 600		£1 076 000
Business combination valuation reserve			5	10 500	14 000	1	
			7	60 000	14 000	2	
					14 000	3	
					3 500	4	
					25 000	6	
Total adjustments				£745 100	£745 100		

FIGURE 21.14 Consolidation worksheet at 30 June 2016

In 2011, the International Accounting Standards Board (IASB®) issued a new IAS 27 *Separate Financial Statements*. Paragraph 12 of this standard states:

> An entity shall recognise a dividend from a subsidiary, a joint venture or an associate in profit or loss in its separate financial statements when its right to receive the dividend is established.

Under IAS 27, all dividends paid or payable by the subsidiary to a parent are recognised as revenue in the profit or loss of the parent. In relation to dividends, there is no need to classify the equity of the subsidiary into pre-acquisition and post-acquisition equity. Effectively, all dividends are accounted for as if they are paid from post-acquisition equity.

Paragraphs BC14 to BC20 of IAS 27, as issued in 2011, discuss the reasons for the accounting for dividends received from a subsidiary, a joint venture or an associate. BC14 notes that one of the driving forces for the current accounting for dividends was the problem of classifying equity into pre- and post-acquisition components on first-time adoption of IFRS® Standards by entities. To reduce any risk from removing the cost method and any possible overstatement of income by a parent, the IASB looked at the impairment testing of the investment account recorded by the parent. As a result, as part of the internal sources of information used to determine whether there is any indication of impairment of an asset, paragraph 12(h) of IAS 36 *Impairment of Assets* states:

> for an investment in a subsidiary, joint venture or associate, the investor recognises a dividend from the investment and evidence is available that:
>
> (i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or
>
> (ii) the dividend exceeds the total comprehensive income of the subsidiary, joint venture or associate in the period the dividend is declared.

Bonus share dividends

Bonus share dividends involve a subsidiary issuing shares instead of a cash dividend to shareholders. There are no entries in the records of the parent as a result of this transaction. Hence, the IASB's amendments to IAS 27 do not apply to this transaction. The effect to be adjusted for in the pre-acquisition entry is that this transaction results in moving pre-acquisition equity from one account to another, with no change in total pre-acquisition equity.

Assume that in the 2013/14 period the subsidiary pays a dividend of £3000 by the issue of bonus shares. The entries passed in the parent and the subsidiary as a result of the dividend are:

Parent	**Subsidiary**			
No entry required	Bonus Dividend Paid	Dr	3 000	
	Share Capital	Cr		3 000

No entry is required by the parent because its share of wealth in the subsidiary is unchanged by the bonus share issue. The pre-acquisition entries for the 2013/14 period are shown in figure 21.15.

Retained Earnings (1 July 2013)	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
Investment in Subsidiary	Cr		500 000
Share Capital	Dr	3 000	
Bonus Dividend Paid	Cr		3 000

FIGURE 21.15 Dividend provided for in the current period.

The effect of the bonus dividend is to increase the share capital of the subsidiary by £3000 and to reduce the retained earnings by the same amount. There is no overall change in the pre-acquisition equity of the subsidiary, just a transfer from one equity account to another. Accordingly, there is no change in the balance of the investment account in the records of the parent.

The pre-acquisition entry in subsequent periods is:

Retained Earnings (opening balance) [£140 000 – £3000]	Dr	137 000	
Share Capital	Dr	303 000	
Business Combination Valuation Reserve	Dr	60 000	
Investment in Subsidiary	Cr		500 000

21.5.4 Pre-acquisition reserve transfers

From time to time the subsidiary may transfer retained earnings to reserves, or make transfers from reserves to retained earnings. These do not cause any change in the total pre-acquisition equity but simply change the composition of that equity. Therefore, there is no change in the investment account recorded by the parent entity. In fact, the parent is unaffected by these transfers. However, the parent needs to decide if for consolidation purposes such transfers should be reflected in consolidated equity. With such approval, there is not anything to account for in the consolidation purpose. For example, if the subsidiary makes a transfer out from retained earnings to a restricted reserve, and this is approved, or even instructed, by the parent, the restricted reserve should appear in the consolidated balance sheet. In what follows, however, we would assume this is not the case.

Assume for the cases illustrated below that the pre-acquisition entry for the year ending 30 June 2014, apart from the effect of reserve transfers, is as follows:

Retained Earnings (1/7/13)	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
Investment in Subsidiary	Cr		500 000

Case 1: Transfers from retained earnings to other reserves

Assume that in the 2013/14 period the subsidiary transfers £4 000 to general reserve from retained earnings. The entry passed in the subsidiary as a result of the transfer is:

Retained Earnings	Dr	4 000	
General Reserve	Cr		4 000

The pre-acquisition entries for the 2013/14 period are shown in figure 21.16.

Retained Earnings (1 July 2013)	Dr	140 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
Investment in Subsidiary	Cr		500 000
General Reserve	Dr	4 000	
Retained Earnings	Cr		4 000

FIGURE 21.16 Transfer to general reserve in the current period

As both the transfer to general reserve and the general reserve accounts are pre-acquisition in nature, they are eliminated as part of the pre-acquisition entry. The pre-acquisition entry in subsequent periods is:

Retained Earnings (opening balance) [£140 000 – £4000]	Dr	136 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
General Reserve	Dr	4 000	
Investment in Subsidiary	Cr		500 000

In this case and in the following cases, the only equity account in which movements (transfers to and from) are specifically identified is retained earnings. Movements within the general reserve account are not specifically noted. This is because, as illustrated in figure 21.13, the retained earnings account and changes therein are used to connect the statement of profit or loss and other comprehensive income accounts and the statement of financial position accounts. In preparing the consolidated statement of changes in equity, where movements in all equity accounts are disclosed, adjustments for pre-acquisition transfers must be taken into account. Whether such adjustments are necessary can be seen from viewing the consolidation worksheet and the adjustments made to individual equity accounts. A similar issue arises in preparing other notes to the consolidated financial statements, such as for property, plant and equipment, where movements such as additions and disposals must be disclosed.

Case 2: Transfers to retained earnings from other reserves

This case uses the information in case 1, in which a £4 000 general reserve was created. Assume that in the 2014/15 period the subsidiary transfers £1 000 to retained earnings from general reserve. The entry passed in the subsidiary as a result of the transfer is:

General Reserve	Dr	1 000	
Retained Earnings	Cr		1 000

The pre-acquisition entries for the 2014/15 period are shown in figure 21.17.

Retained Earnings (1 July 2014)	Dr	136 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
General Reserve	Dr	4 000	
Investment in Subsidiary	Cr		500 000
Retained Earnings	Dr	1 000	
General Reserve	Cr		1 000

FIGURE 21.17 Transfer from general reserve in the current period

Since both the transfer from general reserve and general reserve accounts are pre-acquisition in nature, they are eliminated as part of the pre-acquisition entry. The pre-acquisition entry in subsequent periods is:

Retained Earnings (opening balance) [£140 000 – £4000 + £1000]	Dr	137 000	
Share Capital	Dr	300 000	
Business Combination Valuation Reserve	Dr	60 000	
General Reserve	Dr	3 000	
Investment in Subsidiary	Cr		500 000

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21.6 REVALUATIONS IN THE RECORDS OF THE SUBSIDIARY AT ACQUISITION DATE

IFRS 3 does not discuss whether the valuation of the assets of the subsidiary at acquisition date should be done in the consolidation worksheet or in the records of the subsidiary. It is expected that most entities will make their adjustments in the consolidation worksheet, for two reasons:

- Adjustments for assets such as goodwill and inventory are not allowed in the actual records of the subsidiary. Goodwill is not allowed to be revalued because it would amount to the recognition of internally generated goodwill, and inventory cannot be written to an amount greater than cost.
- The revaluation of non-current assets in the records of the subsidiary means that the subsidiary has effectively adopted the revaluation model of accounting for those assets. As discussed in chapter 11, IAS 16 *Property, Plant and Equipment* requires the assets to be recorded at amounts not materially different from fair value. For entities wanting to measure assets using the cost model, the revaluation of subsidiary assets would be undertaken in the consolidation worksheet.

Note that the business combination valuation entries applied in the consolidation worksheet for property, plant and equipment assets in this chapter are of the same form as those applied for property, plant and equipment in chapter 11. The revaluation surplus created in the financial statements of the subsidiary will be eliminated as part of the pre-acquisition entries and the underlying asset will be shown on the consolidated statement of financial position at fair value. Hence, the consolidated financial statements at acquisition date are the same regardless of whether revaluation occurs on consolidation or in the records of the subsidiary. In future periods, differences will arise because there is no requirement for valuations done in the consolidation worksheet to be updated for subsequent changes in the fair values of the assets.

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21.7 DISCLOSURE

Paragraphs B64–B67 of Appendix B to IFRS 3 cover the disclosure of information about business combinations. These paragraphs require an acquirer to disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that occurred during the reporting period, as well as those that occur between the end of the reporting period and when the financial statements are authorised for issue. Examples of disclosures required by these paragraphs are given in figure 21.18.

FIGURE 21.18 Disclosure of business combinations

IFRS 3 paragraph

Note 4. Business combinations

On 20 October 2013, Libra Ltd acquired 100% of the voting shares of Pisces Ltd, a listed company specialising in the manufacture of electronic parts for sound equipment. The primary reason for the acquisition was to gain access to specialist knowledge relating to electronic systems. Control was obtained by acquisition of all the shares of Pisces Ltd. *B64(a), (b), (c)* *B64(d)*

To acquire this ownership interest, Libra Ltd issued 600 000 ordinary shares, valued at £2.50 per share, which rank equally for dividends after the acquisition date. The fair value is based on the published market price at acquisition date. *B64(f)(iv)*

The total consideration transferred was £1 800 000 and consisted of: *B64(f)*

	£'000
Shares issued, at fair value	1 500
Cash paid	240
Cash payable in 2 years' time	60
Total consideration transferred	1 800

The fair values and the carrying amounts of the assets acquired and liabilities assumed in Pisces Ltd as at 20 October 2013 were *B64(f)*

	Fair value £'000	Carrying amount £'000
Property, plant and equipment	1 240	1 020
Receivables	340	340
Inventory	160	130
Intangibles	302	22
Goodwill	54	0
	2 096	1 512
Payables	152	152
Provisions	103	103
Tax liabilities	41	41
	296	296
Fair value of net assets of Pisces Ltd	1 800	

Goodwill in Pisces Ltd can be attributed to the synergies existing within the company, and relate to the high level of training given to the staff as well as the professional expertise of the employees. Further, there exist in-process research activities in Pisces Ltd for which it was impossible to determine reliable fair values for the separate recognition of intangible assets. *B64(e)*

Pisces Ltd earned a profit for the period from 20 October 2013 to 30 June 2014 of £520 000. This has been included in the consolidated statement of profit or loss and other comprehensive income for the year ended 30 June 2014. *B64(q)(i)*

None of the above information has been prepared on a provisional basis. *B67*

The consolidated profit is shown in the consolidated statement of profit or loss and other comprehensive income at £5 652 000, which includes the £520 000 contributed by Pisces Ltd from 20 October 2013 to the end of the period. If Pisces Ltd had been acquired at 1 July 2013, it is estimated that the consolidated entity would have reported: *B64(q)(ii)*

	£'000
Consolidated revenue	36 654
Consolidated profit	6 341

In relation to the business combination in the 2012/13 period when Libra Ltd acquired all the shares in Orion Ltd, an adjustment was made in the current period relating to the provisional measurement of specialised equipment held by Orion Ltd. A loss of £250 000 was recognised in the current reporting period because of the write-down of this equipment. *B67(a)(iii)*

FIGURE 21.18 *(continued)*

Included in the current period profit are gains on the sale of land acquired as a part of the business combination with Pisces Ltd. The gain amounted to £100 000 and arose due to an upsurge in demand for inner-city properties.		*B67(e)*

Goodwill *B67(d)*

	£'000
Gross amount at 1 July 2013	120
Accumulated impairment losses	(15)
Carrying amount at 1 July 2013	105
Goodwill recognised in current period	54
Carrying amount at 30 June 2014	159
Gross amount at 30 June 2014	174
Accumulated impairment losses	(15)
Carrying amount at 30 June 2014	159

IFRS 12 *Disclosure of Interests in Other Entities* also requires disclosures in relation to a parent's interest in its subsidiaries. Figure 21.19 illustrates some of these disclosures.

Note 5. Subsidiaries	IFRS 12 paragraph
Aries Ltd has a 40% interest in Virgo Ltd. Although it has less than half the voting power, Aries Ltd believes it has control of the financial and operating policies of Virgo Ltd. Aries Ltd is able to exercise this control because the remaining ownership in Virgo Ltd is diverse and widely spread, with the next single largest ownership block being 11%.	*9(b)*
Aries Ltd has invested in a special purpose entity established by Pictor Ltd. Pictor Ltd established Cetus Ltd as a vehicle for distributing the sailing boats it makes. Aries Ltd currently owns 60% of the shares issued by Cetus Ltd. However, because of the limited decisions that the board of Cetus Ltd can make owing to the constitution of that entity, Aries Ltd believes that it does not have any real control over the operations of Cetus Ltd, so it sees its role in Cetus Ltd as that of an investor.	*9(a)*
Aries Ltd has a wholly owned subsidiary, Gemini Ltd, which operates within the electricity generating industry. The end of its reporting period is 31 May. Gemini Ltd continues to use this date because the government regulating authority requires all entities within the industry to provide financial information to it based on financial position at that date.	*11*
Aries Ltd has a wholly owned subsidiary, Hercules Ltd, in the country of Mambo. Because of constraints on assets leaving the country recently imposed by the new military government, there are major restrictions on the subsidiary being able to transfer funds to Aries Ltd.	*10(b)(i)*

FIGURE 21.19 Disclosures concerning subsidiaries

Disclosures in relation to subsidiaries are set out in IFRS 12 *Disclosure of Interests in Other Entities*, issued in 2011. *These are discussed in chapter 20.* Note, however, the following extract from paragraph 10.

An entity shall disclose information that enables users of its consolidated financial statements

(a) to understand:
  (i) the composition of the group; and
  (ii) the interest that non-controlling interests have in the group's activities and cash flows (paragraph 12); and
(b) to evaluate:
  (i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group (paragraph 13);
  (ii) the nature of, and changes in, the risks associated with its interests in consolidated structured entities (paragraphs 14–17) . . .

SUMMARY

This chapter covers the preparation of the consolidated financial statements for a group consisting of a parent and a wholly owned subsidiary. Because of the requirements of IFRS 3 to recognise the identifiable assets acquired and liabilities assumed of an acquired entity at fair value, an initial adjustment to be made on consolidation concerns any assets or liabilities for which there are differences between fair value and carrying amount at the acquisition date. Further, although some intangible assets and liabilities of the subsidiary may not have been recognised in the subsidiary's records, they are recognised as part of the business combination.

The preparation of the consolidated financial statements is done using a consolidation worksheet, the left-hand columns of which contain the financial statements of the members of the group. The adjustment columns contain the consolidation worksheet entries that adjust the right-hand columns to form the consolidated financial statements. The adjustment entries have no effect on the actual financial records of the parent and its subsidiaries.

At acquisition date, an acquisition analysis is undertaken. The key purposes of this analysis are to determine the fair values of the identifiable assets and liabilities of the subsidiary, and to calculate any goodwill or gain on bargain purchase arising from the business combination. From this analysis, the main consolidation worksheet adjustment entries at acquisition date are the business combination valuation entries (to adjust carrying amounts of the subsidiaries' assets and liabilities to fair value) and the pre-acquisition entries.

In preparing consolidated financial statements in periods after acquisition date, the consolidation worksheet will contain valuation entries and pre-acquisition entries. However, these entries are not necessarily the same as those used at acquisition date. If there are changes to the assets and liabilities of the subsidiaries since acquisition date, or there have been movements in pre-acquisition equity, changes must be made to these entries.

Discussion questions

1. Explain the purpose of the pre-acquisition entries in the preparation of consolidated financial statements.
2. When there is a dividend payable by the subsidiary at acquisition date, under what conditions should the existence of this dividend be taken into consideration in preparing the pre-acquisition entries?
3. Is it necessary to distinguish pre-acquisition dividends from post-acquisition dividends? Why?
4. If the subsidiary has recorded goodwill in its records at acquisition date, how does this affect the preparation of the pre-acquisition entries?
5. Explain how the existence of a bargain purchase affects the pre-acquisition entries, both in the year of acquisition and in subsequent years.

Exercises

STAR RATING ★ BASIC ★★ MODERATE ★★★ DIFFICULT

Exercise 21.1 ACCOUNTING FOR ASSETS AND LIABILITIES

★ Mensa Ltd has acquired all the shares of Cancer Ltd. The accountant for Mensa Ltd, having studied the requirements of IFRS 3 *Business Combinations*, realises that all the identifiable assets and liabilities of Cancer Ltd must be recognised in the consolidated financial statements at fair value. Although he is happy about the valuation of these items, he is unsure of a number of other matters associated with accounting for these assets and liabilities. He has approached you and asked for your advice.

Required

Write a report for the accountant at Mensa Ltd advising on the following issues:

1. Should the adjustments to fair value be made in the consolidation worksheet or in the accounts of Cancer Ltd?
2. What equity accounts should be used when revaluing the assets, and should different equity accounts such as income (similar to recognition of an excess) be used in relation to recognition of liabilities?
3. Do these equity accounts remain in existence indefinitely, since they do not seem to be related to the equity accounts recognised by Cancer Ltd itself?