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FINANCIAL ACCOUNTING AND FINANCIAL STATEMENT ANALYSIS

CONSOLIDATED FINANCIAL STATEMENTS



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^{*} final level

1. Business combinations*

This "Business combinations" section deals with enterprises that are in the process of being combined or have been combined. Several names are used such as mergers, acquisitions, takeovers, etc. These activities have made the job of an analyst very challenging. Business combinations themselves are a sub-category of 'corporate restructuring'. There may be many motivations for corporate restructuring. But the main motive is shareholders' wealth maximisation. In the long run it is expected that the wealth of the shareholder will be higher with the restructuring than without it. In this chapter, we will look at the basic accounting issues involved in two types of restructuring, acquisitions and mergers. Apart from this we will also look at consolidated financial statements, which are prepared whenever one corporate entity controls another enterprise.

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Solomon Ngahu - Reg No. 4900000001.

There is a fine distinction between the terms merger and acquisition. A merger occurs when one firm completely acquires all the net assets of another firm, by payment through eash, or by issuing securities to the shareholders of the merged entity.

An acquisition occurs when one entity called the acquire, or the target or the acquire.

This is done? motive has been clearly established as the main reason for mergers and acquisitions. Synergistic effects, however, are often given as the general reason for such activities.

Most important in any of these activities is the purchase or acquisition price and the mode of payment. The first deals with how much the acquirer will pay for the deal. Let us say Firm A with a value V(A) wants to acquire firm B with value V(B). It is expected that the combined value will be V(A+B). Let P(B) be the price which firm A is ready to pay.

Value created by merger =
$$V(A + B) - (V(A) + V(B))$$

Net cost to firm A = P(B) - V(B) (Difference between the price and the value of firm B)

Gain due to merger = value created by merger - net cost of merger
=
$$V(A+B) - (V(A) + V(B)) - (P(B) - V(B))$$

The term V(B) cancels out leaving,

Gain due to merger =
$$V(A+B) - V(A) - P(B)$$

It is therefore clear that the price of the acquisition has nothing to do with the value of the target firm, but solely with the value of the merged entity.

Example 1:

Let us say that Firm A is acquiring Firm B with the following values: V (A) = 100 units of currency, V (B) = 50 units of currency. It is expected that due to the merger of these units, the value of the combined firm V (A+B) will be 180 units of currency.

The maximum price that firm A can pay = V(A+B) - V(A) = 180 - 100 = 80 units. Please note that the price paid will have nothing to do with the value of firm B, but with what the merged entity could do to shareholder's wealth.

The second decision concerns the means of payment for the acquisition. It can be by cash, issue of debt, by issue of equity, or by a combination of these.

It is also expected that mergers and acquisitions will lead to higher valuations in the market. This has not been borne out by facts. There is no significant proof for this assertion. This can be verified by analysing the market performance of the merged entity and the financial statements of the merged entity. It is here that analysts face challenges. We will cover this in section 1.2.

1.1.1 Acquisitions*

Solomon Ngahu - Reg No. 49000007 Acquisitions deal with the buying of control of one entity by another. In most cases the control passes over when more than half the voting rights are acquired. Sometimes, even if the voting rights are not more than half, the acquirer may have considerable say in the financial and operating policies of the firm. An example is the concept of golden shares held by the British Government in British railways. Though the share of the British government is less than 50%, the government holds considerable control because of the concept of its golden shares. The existence of them means that there can be no acquisition bid for British railways, as the acquirer could never have complete control, even if it acquired more than 50% of the shares.

IFRS 3 governs acquisition accounting. The standard prescribes that the purchase method is to be used for reporting acquisitions (except for combinations of entities that were under common control). This method is covered in section 1.1.2.2. The purchase price is allocated to the identifiable assets and liabilities acquired. If the purchase price equals the fair value of net assets, there is no goodwill. If there is a difference between the purchase price and the fair value of the identifiable assets and liabilities acquired, that difference is called goodwill.

As mentioned earlier an acquisition can be by a combination of cash, debt or issue of equity. But the primary measure should be to calculate the fair value of the exchanged items. Except in the case of cash, the fair value will differ from the book values for items like equity, debt or sometimes even some of the operating assets of the acquirer. For example, if the acquisition is via 10% bonds and if the normal interest rate for the borrower is 12%, then the fair value of these bonds will be less than their book value. In the case of issue of equity, the problem is compounded. The analyst should therefore be very careful about determining the fair value of the exchanged items before coming to any conclusions.

1.1.1.1 Asset valuation in acquisitions*

Accounting for acquisition basically deals with the recording of assets and liabilities at their fair value. If there is either a 100% acquisition or in the case of a merger, the accounting treatment is straightforward. In the case of partial acquisition, the concept of minority interest arises. If the price exceeds the fair value of the net assets acquired, then the excess is called goodwill. If the fair value of net assets exceeds the price, goodwill is negative. Business combinations with negative goodwill are named "bargain purchases" by the IASB. In that case, negative goodwill is recognised immediately in profit or loss. Prior to IFRS 3, negative goodwill was carried on the balance sheet and amortised over the life of the assets acquired.

To determine the fair value of net assets, the first step is to determine the fair value of the individual components of the net assets. Guidelines for the determination of fair value are given in the following table¹:

Adopted from Epstein and Mirza. "Interpretation and Application of International Accounting Standards 2000", John Wiley, 2000, pp. 415-417.

Financial accounting and	d financial statement analysis Solomon Ngahu - Reg No. 4900000	gdj.cci
Marketable securities	Current market values	
Non marketable securities	Estimated fair values, based on comparable securities having similar characteristics	
Receivables	Present values of amounts to be received at current interest rates after adjusting for bad debts	
Inventories	Finished goods and merchandise at estimated selling price less costs of disposal and a reasonable profit Work in progress at estimated selling price less the cost of completion, disposal Raw materials at current replacement costs	
Plant and equipment	At market value determined by appraisal. In the absence of appraisal use depreciated replacement cost. Land and buildings are to be valued at market value	
Identifiable intangible assets	Fair values determined primarily as per IAS 38. In the absence of market data, use best available information and use discounted cash flow, if the cash flows clearly attributable to these assets can be obtained	
Net employee benefits or obligation for defined benefit plans	Actuarial present value of promised benefits, net of fair value of related assets	
Tax assets and liabilities	The amount of tax benefit arising from tax losses or taxes payable is to be assessed from the point of view of the combined entity or group resulting from the acquisition. The amount is recorded net of the effect of restating other assets and liabilities at fair values.	
Liabilities Onerous contract obligations	Present value determined at appropriate current interest rates Present value of amounts to be disbursed.	

All identifiable intangible assets must be recorded at their fair values. An asset is identifiable when it either arises from contractual or other legal rights, or is separable. An asset is separable if it could be sold, on its own or with other assets.

1.1.1.2 Accounting for goodwill*

Goodwill represents the excess purchase price paid over the fair value of the net assets acquired which must, according to most standards, be recognised and is subject to an annual impairment test. Apart from goodwill there can be the hidden appreciation of identifiable assets (tangible or intangible) of the subsidiary, known sometimes as the "valuation difference", resulting from the difference between the book values of the identifiable assets and their valuation at current cost or "fair value".

The residual balance, known as "goodwill", or "premium on acquisition", represents all other factors that have been taken into account in the negotiation (fixing of the price by means other than the book value, negotiation problems, etc.).

Accounting for goodwill will be developed in detail in the section on consolidated financial statements.

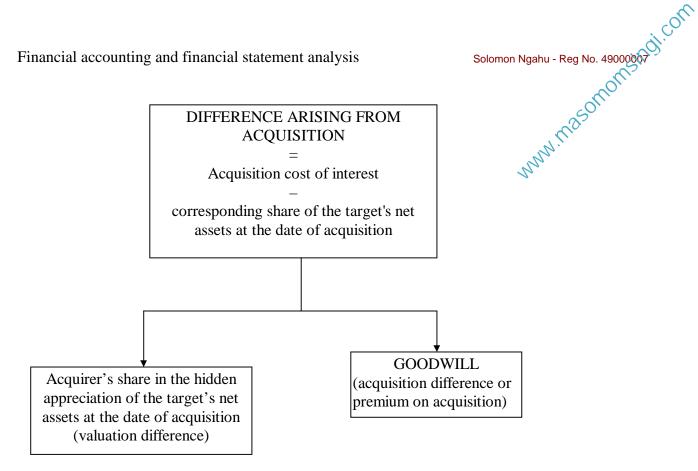


Figure 1-1: Analysis of the total difference arising from acquisition

1.1.2 Mergers*

Mergers deal with cases when one business entity is merged or amalgamated or combined with another. There are two main methods used for accounting for mergers. They are:

- the pooling (or uniting) of interests method;
- the purchase method.

The pooling (or uniting) of interests method is not allowed under IFRS 3. Therefore, the purchase method needs to be applied under IFRS. Under this method, the buyer treats the merger as a purchase of the assets and assumption of the liabilities of the target firm. This method assumes that the acquirer buys the target firm. The assets and liabilities of the acquiree are incorporated into the balance sheet of the acquirer or of the new entity at fair market value. This will give rise to goodwill. The financial statements of the resulting entity are not comparable to those of the combining firms before the merger.

1.1.2.1 The pooling of interests method*

This method was applied when there was a mutual and continued sharing of risks and benefits after the merger. The acquisition had also to take place with a single transaction; the exchange of common stock.

The pooling of interests method is no longer allowed under IFRS. Nevertheless it was extensively used in the past, with the result that current balance sheets are still affected by this method. Let us see an example to understand it.

Solomon Ngahu - Reg No. 49000007 H. Christopher 2:

ABC and XYZ were merged in N. ABC acquired XYZ with a suitable exchange of common voting shares. The purchase price of XYZ was CU 3'000'000. Below are the balance sheets at the merger date, as well as the fair value of the identifiable assets of XYZ. The market price of ABC common share at the merger date was CU 600, its par value CU 100.

Use the pooling of interests method to prepare the balance sheet of the combine the process of ABC and XYZ at the merger.

	ABC	XY	Z
	(historical cost)	(historical cost)	(fair value)
Cash	1'000	500	500
Inventories	1'000	1'000	1'750
Receivables	2'000	500	500
Fixed assets (net)	4'000	1'500	2'000
Total assets	8'000	3'500	4'750
Payables	1'250	500	500
Accrued liabilities	1'250	1'000	1'000
Long-term debt	1'500	500	750
Total liabilities	4'000	2'000	2'250
Common stock	1'000	250	
Retained earnings	3'000	1'250	
Equity	4'000	1'500	2'500

In applying the pooling of interests method, financial statements are combined as though the separate companies had always constituted a single entity. Balance sheets items are thus simply added at historical cost and there is no recognition of any goodwill.

The balance sheet of the combined entity is thus obtained as follows:

	ABC (historical cost)	XYZ (historical cost)	Combined entity
Cash	1'000	500	1'500
Inventories	1'000	1'000	2'000
Receivables	2'000	500	2'500
Fixed assets (net)	4'000	1'500	5'500
Total assets	8'000	3'500	11'500
Payables	1'250	500	1'750
Accrued liabilities	1'250	1'000	2'250
Long-term debt	1'500	500	2'000
Total liabilities	4'000	2'000	6'000
Common stock	1'000	250	1'250
Retained earnings	3'000	1'250	4'250
Equity	4'000	1'500	5'500

Any expense relating to a business combination accounted for as a pooling of interests must be charged against profit or loss in the period in which the combination is effected. No new asset should be created from pooling and such costs should not therefore be capitalised.

Solomon Ngahu - Reg No. 49000007 A similar combined treatment can be given for both the statement of comprehensive income and the cash flow statements. It is obvious that this method distorts the combined picture. First of all a high growth company can merge with a low growth company and the combined figures can be misleading. This also allows companies to 'boot strap'. Here a low price multiple earnings company is merged with a high price multiple earnings company and the resultant high valuations are brought to reasonable levels. This has occurred, not as a result of any operational improvement, but by accounting manipulation. Another criticism of this method is that it takes the accounting values and not the fair market value. So any possible synergy effect is totally lost in the financial statements.

As this method carries the historical costs forward, the true costs of acquisition are never revealed. This method also assumes that the accounting policies such as inventory valuation, depreciation, amortisation, etc. are the same for both entities. This method fails to provide satisfactory analysis in situations where there are differences.

Owing to the above-mentioned factors, the use of this method was restricted to mergers where no acquirer could be identified (mergers between entities of equal size). Nowadays even these combinations must be accounted for using the purchase method.

1.1.2.2 The purchase method*

This is the preferred method for the analyst and the only one accepted under IFRS. Here assets and liabilities are restated at their fair market values, making it possible to determine whether or not the purchase consideration paid was excessive.

Under this method it should be noted that, after the merger, the merged entity is a separate entity and is not comparable with either of the entities before the merger. Let us study the basics of this method with an example.

Example 2 (continued):

The par value of ABC share is CU 100. Use the purchase method to prepare the balance sheet of the combined entity.

Price paid for the acquisition of XYZ: 3'000'000 CU Fair value of XYZ net identifiable assets: 2'500'000 CU ⇒ Goodwill 500'000 CU

Number of ABC shares issued: 3'000'000 / 600 = 5'000

With the purchase method, identifiable assets and liabilities of the acquired company are included at fair value and goodwill is recognised as a separate asset in the balance sheet of the combined entity. This balance sheet is thus:

cial accounting and financ	ial statement analys	sis	Solo	mon Ngahu - Reg No. 49000007
	ABC (historical cost)	XYZ (fair value)	Consolidated entity	mon Ngahu - Reg No. 49000007
Cash	1'000	500	1'500	N.W.
Inventories	1'000	1'750	2'750	an's
Receivables	2'000	500	2'500	70
Goodwill			500	
Other fixed assets (net)	4'000	2'000	6'000	
Total assets	8'000	4'750	13'250	
Payables	1'250	500	1'750	
Accrued liabilities	1'250	1'000	2'250	
Long-term debt	1'500	750	2'250	
Total liabilities	4'000	2'250	6'250	
Common stock	1'000		1'500	
Additional-paid-in capital			2'500	
Retained earnings	3'000		3'000	
Equity	4'000	2'500	7'000	

Working notes:

Common stock: $1'000'000 + (5'000 \times 100) = CU \ 1'500'000$

Additional paid – in capital = purchase price - par value of shares issued

 $= 3'000'000 - (5'000 \cdot 100)$

= CU 2'500'000

So far we have seen the effect of the purchase on the balance sheets only. Let us now look at the effect on the statement of comprehensive income in the year of the acquisition.

- With the pooling of interests method, the combined statement of comprehensive income is simply the addition of the statements of the combining companies.
- With the purchase method, the combined statement of comprehensive income has to be formed only from the acquisition date.

Example 2 (continued):

XYZ has prepared a partial statement of comprehensive income for the post-acquisition period. This statement as full statements for year N are given below.

	ABC —	XY	ďΖ
	full year	full year	from acquisition date
Sales	6'000	3'000	1'000
Cost of goods sold	- 4'500	- 2'400	- 800
Gross margin	1'500	600	200
Selling expenses	- 700	- 300	- 100
Depreciation	- 400	- 150	- 50
Interest	- 150	- 50	- 15
Pre-tax income	250	100	35
Income tax	- 75	- 30	- 10
Profit for the year	175	70	25
Other comprehensive income	25	- 10	0
Total comprehensive income	200	60	25

ncial accounting and financial The combined statement of compre	·		non Ngahu - Reg No. 49000000 dj. com
	Pooling of interests method	Purchase method	willo
Sales	9'000	7'000	N,
Cost of goods sold	- 6'900	- 5'300	
Gross margin	2'100	1'700	
Selling expenses	- 1'000	- 800	
Depreciation	- 550	- 450	
Interest	- 200	- 165	
Pre-tax income	350	285	
Income tax	- 105	- 85	
Profit for the year	245	200	
Other comprehensive income	15	25	
Total comprehensive income	260	225	

1.1.2.3 The identity of the acquirer in a business combination*

Under IFRS all business combinations are acquisitions and for each of these transactions an acquirer and an acquiree need to be identified. The main reason why the IASB reached the conclusion not to allow the pooling of interests method is that suitable, non-arbitrary criteria that could distinguish the uniting of interests from other acquisitions do not exist. The US standard setter banned pooling accounting as well (effective since mid 2001).

When a new company is created to acquire two or more pre-existing companies, one of the pre-existing companies must be designated as the acquirer.

The extract given below highlights the practical use of both the purchase method as well as the pooling of interests method.

Novartis (Switzerland)

The Group uses the purchase method of accounting to account for the acquisition of business combinations. The cost of an acquisition is measured as the fair value of the assets transferred to the seller and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. Companies acquired or disposed of during the year are included in the consolidated financial statements from the date of acquisition or up to the date of disposal.

Novartis was formed on December 20, 1996 when all the assets and liabilities of Sandoz AG and Ciba-Geigy AG were transferred by universal succession to Novartis AG. The uniting of interests method was used to account for this transaction. If it were undertaken today, the merger would require different accounting treatment.

Most companies today are groups composed of several enterprises. Apart from this almost all firms have some form of inter-corporate investments. Some of these investments are made for gaining control. A small proportion of investments are made as a part of treasure. Moreover, multinational corporations have operations in many country affiliates, subsidiaries or branches. Many of the corporate laws concerned to operations, it has been affiliate. affiliates into their own financial statements. Such adjustments to the parent company's financial statements are governed by IAS 27 (Consolidated and separate financial statements), IAS 28 (Investments in associates) and IAS 31 (Interests in joint ventures).

For the above purposes we need to understand the concept of dominant undertaking. Basically consolidated financial statements are relevant only when we are preparing the financial statements of a dominant undertaking. A group of undertakings is generally made up of a dominant company, known as the "parent company", and its subsidiaries, which it controls by holding a majority of their shares or by some other means. Control is defined as the power to obtain future economic benefits.

Associated with such a group, are other undertakings over which the parent company and its subsidiaries exercise a significant influence without actually possessing control over them.

Each of these companies constitutes a separate legal entity and prepares its own balance sheet and profit and loss account.

There are two principal reasons why the individual balance sheet of the parent company does not give an accurate picture of the financial situation. By individual, here, we refer to the unconsolidated financial statements of these firms.

- The first is that it consists only of the assets actually owned² by the company and the debts for which it is, itself, liable. It does not incorporate the assets and liabilities of the subsidiaries and therefore is not representative of the whole of the related activities over which the parent company has control.
- Secondly, unless they have been revalued³, the interests in related companies appear in the balance sheet at their acquisition cost and not at their current value.

Furthermore, the results of the parent company are not representative of the real value of that company either because, except for when the equity method⁴ of accounting is used in the individual financial statements, no consideration is taken of the income and expenses of related companies. Only the amount of dividends received is taken into account. This leads to misrepresentation of the actual profits made.

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Where the company is the lessee of certain assets leased under a finance lease it may include the assets in the balance sheet.

In some countries (in particular the United States) a company may revalue its investments each year by replacing their book value with the corresponding share of the net assets of the company held. In other countries this technique - called the equity method of accounting - is used only in consolidated accounts.

See note 3

In order to illustrate the use of consolidated financial statements, we shall consider the following example:

Example 3:

Two identical companies I and G are established at the beginning of year 1 by the issue of CU 700'000 of stock and CU 300'000 of debt. With these funds, I purchases CU 800'000 of fixed assets and CU 200'000 of goods. The shareholders of G prefer to create a company F designed to operate the business activities, company G becoming a holding company and owning the share capital in F. After the initial formation, the balance sheets of the three companies are as follows (in thousands of CU):

Balance sheet of I			B	alance she	et of G		
Fixed assets Inventories	800 200 1'000	Capital Loan	700 <u>300</u> 1'000	Shares in F	1'000 1'000	Capital Loan	700 300 1'000
				В	Balance she	eet of F	
				Fixed assets Inventories	800 200 1'000	Capital	1'000 1'000

Let us assume that, at the end of the first year of activity, I and F have each made a profit of CU 200'000 and that their balance sheets look like this (in thousands of CU):

Balance sheet of I			В	alance she	et of F		
Fixed assets Inventories	800 100	Capital Profit	700 200	Fixed assets Inventories	800 100	Capital Profit	1'000 200
Debtors	300 1'200	Loan	300 1'200	Debtors	300 1'200		1'200

Although the two companies have both undertaken exactly the same transactions, F appears to be in a better financial position than I. Its net assets (assets-liabilities) actually amount to CU 1'200'000 compared to 1'200'000 - 300'000 CU = 900'000 CU for I. However this difference is only superficial. It is due to the fact that F does not have debt itself, but through the parent company as an intermediary. The capital of F actually consists of CU 300'000 of borrowing. This debt does not appear in the balance sheet of F but in that of G. The balance sheet of the subsidiary does not therefore accurately reflect the financial structure of the group.

Now let us consider the situation of G. As long as the profit of F is not distributed in the form of a dividend, G cannot account for it unless it uses the equity method. Here the balance sheet of G remains as (in 1'000 of CU):

Balance sheet of G						
Shares in F	1'000	Capital	700			
		Loan	300			
	1'000		1'000			

Thus, considered in isolation, the balance sheet of G does not reflect the increased wealth of the group. Neither does it give any indication of the asset structure, since only the cost of acquisition of the subsidiary is shown in the balance sheet.

In order to understand the breakdown of assets under the control of a company and also itsolvent true results, it is necessary to prepare financial statements that go beyond the legal boundaries and consider the group as a single entity. This is the object of consults statements, which can be defined as follows:

"Consolidated financial statements are the financial statements of a group presented as those of a single economic entity." (IAS 27)

The preparation and presentation of consolidated financial statements forms the subject of international standards and of national regulations more or less detailed according to the accounting standards prescribed in each country.

On a global level, the IASB has drawn up three standards, each one applicable to a specific form of shareholding:

- IAS 27 concerning subsidiaries;
- IAS 28, which applies to minority shareholdings;
- IAS 31, which deals with joint ventures.

IAS 27 stipulates that all companies that control⁵ others must prepare consolidated financial statements. Exemptions are strictly limited. According to IAS 27, a parent needs not prepare consolidated financial statements if it is itself a subsidiary of another company that presents consolidated financial statements in compliance with IFRS, provided that the other shareholders are in agreement. The exempted company must also not have securities traded in a public market.

1.2.1 The scope of consolidation*

Having made the decision to prepare consolidated financial statements; the problem is then to know which companies to include in the consolidation, i.e. what are the limits of the scope of consolidation.

All accounting standards are in agreement in considering that the undertakings that have to be included in the consolidation are those over which the parent company has control. Differences exist about what is meant by 'control'.

IAS 27 gives a broad definition. In its opinion control is "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities". It is presumed to exist when the parent company owns, either directly or indirectly⁶, a majority of the voting rights. In the event of a minority shareholding, control is also assumed to exist in each of the following situations:

M ----->
$$F$$
 ----> G

M controls G without actually being a shareholder because it controls F which, in turn, controls G.

⁵ The concept of control will be discussed later (section 1.2.1.).

Control is said to be indirect when it is exercised through the medium of another company. Consider, for example, the following situation where the percentages represent the proportion of voting rights held:

undertaking. This allows, in particular, the consolidation of undertakings in which, by reason of the dispersion of the shareholdings, it is not necessary to own the majority of shares in order to direct the management.

The US position is much more restrictive. It limits the scope of consolidation to undertakings in which the parent company holds, directly or indirectly, the majority of the voting rights. This standard thereby prohibits, in principle, the consolidation of minority shareholdings (less than 50% of votes).

A company may own share call options, debt convertible into shares or other similar instruments that have the potential, if exercised or converted, to give it additional voting power or reduce the voting power of other shareholders. Such potential voting rights that are currently exercisable or convertible must be taken into account when assessing whether this company has control over another entity.

Current IAS 27 does not mention exceptions to the preceding rules. However in some countries, national standards may still admit exclusions from the scope of consolidation:

- Firstly, undertakings may be excluded from the scope of consolidation where the control is only temporary, the interest being held with a view to later resale. A typical example of this is the contract by which a company acquires the shares of another undertaking, which is searching for funds, the shares being held for a short and pre-determined period.
- The second exemption relates to shareholdings where there are severe restrictions on the exercise of control, for example, because the undertaking is in a politically highly unstable country, or else because it is being run by a court-appointed administrator as part of recovery proceedings.
- The third exception is the exclusion of subsidiaries whose activities are so different from those of the group that their inclusion in the consolidated accounts would reveal itself as contrary to the obligation of giving a true and fair view of the group. This clause generally permits an industrial or commercial group to exclude from consolidation its financial subsidiaries (banks and credit companies). This latter exception was originally rather misused, especially in the United States. Some highly geared groups were passing on, in effect, all or part of their debts to a company created specifically for that purpose and were putting forward this clause as the reason for not consolidating the subsidiary. It had the effect of greatly reducing their level of leverage, or at least that is how it appeared in the consolidated financial statements. The FASB has included a condition to put an end to the misuse of this clause. For the IASB, such exclusion is also unjustified. According to this body, it is preferable to consolidate such companies and then give information on their activities.

The annual report of Coca-Cola provides an example of exclusion from the scope of or consolidation.

Coca-Cola (USA)

Our consolidated financial statements include the accounts of the Coca-Cola Company and all subsidiaries except where control is temporary or does not rest with our Com-

1.2.2 The consolidation methods*

In order to prepare the balance sheet and statement of comprehensive income of a group, it is insufficient simply to combine the individual financial statements of the undertakings making up the group. This is shown by the following example:

Example 4:

Consider an undertaking M, which has held 60% of the share capital of F since its formation. The financial statements of the two companies at the end of financial year N are as follows:

Balance sheet of M

Fixed assets	600'000	Capital	500'000
Interest in F	180'000	Retained earnings	250'000
Receivables	220'000	Other reserves	50'000
		Shareholders' equity	800'000
		Liabilities	200'000
	1'000'000		1'000'000

Statement of comprehensive income of M

Revenues	800'000
Expenses	750'000
Profit for the year	50'000
Other comprehensive income	8'000
Total comprehensive income	58'000

Balance sheet of F

Fixed assets	300'000	Capital	300'000
Inventories	100'000	Retained earnings	80'000
Receivables	100'000	Other reserves	20'000
		Shareholders' equity	400'000
		Liabilities	100'000
	500'000		500'000

Statement of comprehensive income of F

Revenues	300'000
Expenses	280'000
Profit for the year	20'000
Other comprehensive income	5'000
Total comprehensive income	25'000

Suppose that 25% of the turnover of M results through trading with the subsidiary F, that the inventories of F are made of goods sold by M at a profit of CU 20'000 and that, at the end of the financial year, M is a trade debtor of CU 30'000 with F.

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ancial accounting and fina	ncial statement analy	/sis	Solomon Ngahu - Reg No. 49000007
The balance sheet and states balances look like this:	-	ncome obtained by the s	simple addition of the More
Fixed assets	900'000	Capital	800,000
Interest in F	180'000	Retained earnings	330'000
Inventories	100'000	Other reserves	70'000
Receivables	320'000	Shareholders' equity	1'200'000
	1'500'000	Liabilities	300'000 1'500'000

Combined statement of comprehensive income of M & F

Revenues	1'100'000
Expenses	1'030'000
Profit for the year	70'000
Other comprehensive income	13'000
Total comprehensive income	83'000

The combined financial statements do not represent the true situation of the group for three reasons.

- The first is that they do not take into account the effects of the intra-group transactions. The turnover of the group is not CU 1'100'000, contrary to that indicated by the combined profit and loss account, but only CU 900'000 since there are CU 200'000 of sales between M and F. In the same way, the actual profit of the group is only CU 50'000 since part of the net profit of M (CU 20'000) derives from intra-group sales. Finally, the combined balance sheet total is overvalued by CU 30'000, which corresponds to the debtor in M with F. In order to obtain financial statements representative of group situations it is necessary to eliminate all intra-group transactions.
- · Secondly, the combined balance sheet leaves the shareholding in the subsidiary in as an asset. As this concerns an internal shareholding of the group, it clearly should not appear in the balance sheet, which should show the situation of the group vis-à-vis third parties. This shareholding is compensated for by an entry in the shareholders funds of the subsidiary and, consequently, it too must be eliminated.
- Finally, the combined accounts add together all the amounts in the balance sheets and profit and loss accounts as though the parent company owned the whole of the subsidiary when it only owns 60%.

In order to clarify the true situation of the group, it is necessary either:

- to take into account only the group's share of the profit and shareholders funds of the subsidiaries, or
- to include the total amounts while, in return, making clear the proportion owing to other shareholders.

These options form the basis of two recognised consolidation methods, namely full consolidation and proportionate consolidation.

1.2.2.1 The proportionate consolidation*

The proportionate consolidation method consists of replacing the book value of the interest in the subsidiary by the corresponding proportion of each amount of the assets and liabilities of the subsidiaries. This results in a difference which we call the "consolidation" which, for the time being, we shall put into shareholders fund.

Let us now return to the properties of the subsidiaries of the subsidiaries.

existence of intra-group transactions. Applying the proportionate consolidation method will result in the following financial statements:

Example 4 (continued):

Consolidated balance sheet of M (before elimination of intra-group transactions)

Fixed assets	780'000	Capital	500'000
[600'000 + 60% (300'000)]		Retained earnings	250'000
Inventories [60% (100'000)	60'000	(including profit of M 50'000)	
Receivables		Other reserves	50'000
[220'000 + 60% (100'000)]	280'000	(including other CI of M 8'000)	
		Consolidation difference	60'000
		Consolidated equity	860'000
		Liabilities [200'000 + 60% (100'000)]	260'000
	1'120'000		1'120'000

Consolidated statement of comprehensive income of M (before elimination of intra-group transactions)

Revenues [800'000 + 60% (300'000)]	980'000
Expenses [750'000 + 60% (280'000)]	918'000
Consolidated profit for the year	62'000
Other comprehensive income $[8'000 + 60\% (5'000)]$	11'000
Consolidated total comprehensive income	73'000

The difference between the profit figure in the balance sheet and that in the statement of comprehensive income is due to the fact that the former represents the profit of the parent company only, while the latter also includes the group share in the profit of the subsidiary. This difference will disappear when it is broken down, as we shall see later.

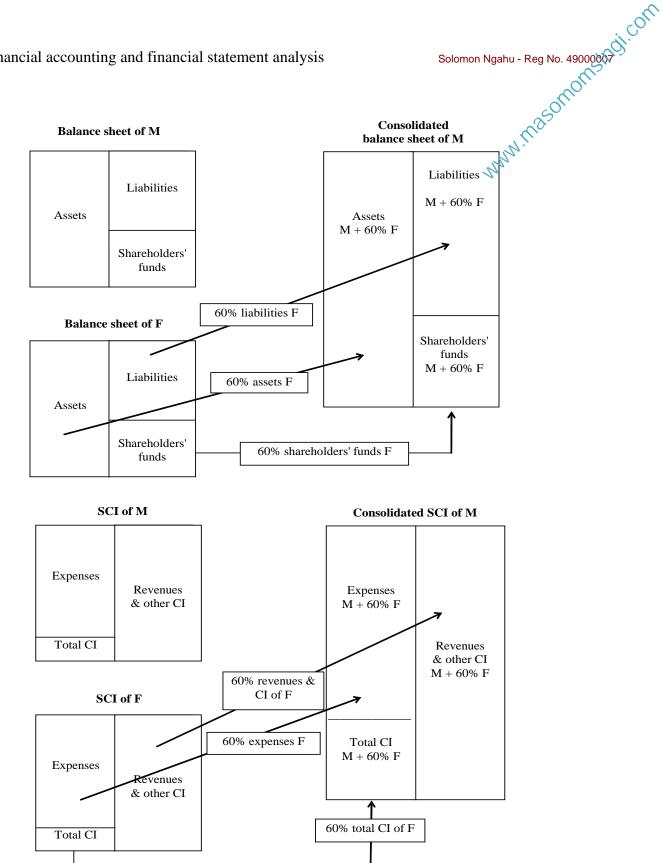


Figure 1-2: Proportionate consolidation

1.2.2.2 Full consolidation*

The full consolidation method consists of replacing the book value of the interest in the subsidiary by the whole of the assets and liabilities of the subsidiary, while separately disclosing the share not owned by the group.

The latter represents the non-group (or "minor" or net assets, of the subsidiary.

The balance sheet and statement of comprehensive income appear as follows, before the elimination of intra-group transactions:

Example 4 (continued):

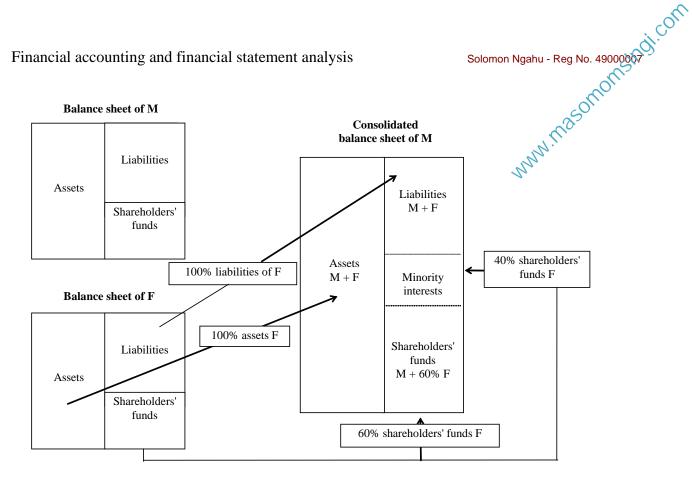
Consolidated balance sheet of M (before elimination of intra-group transactions)

Fixed assets [600'000 + 300'000]	900'000	Capital	500'000
Inventories	100'000	Retained earnings	250'000
Receivables [220'000 + 100'000]	320'000	(including profit of M 50'000)	
		Other reserves	50'000
		(including other CI of M 8'000)	
		Consolidation difference	60'000
			860'000
		Minority interests	160'000
		Consolidated equity	1'020'000
		Liabilities [200'000 + 100'000]	300'000
	1'320'000		1'320'000

Consolidated statement of comprehensive income of M (before elimination of intra-group transactions)

Revenues [800'000 + 300'000]	1'100'000
Expenses [750'000 + 280'000]	1'030'000
Consolidated profit for the year	70'000
- part of M: $50'000 + 60\% (20'000) = 62'000$	
- part of minority interests: 40% (20'000) = 8'000	
Other comprehensive income	
- part of M: $8'000 + 60\%$ (5'000) = 11'000	13'000
- part of minority interests: 40% (5'000) = 2'000	
Total comprehensive income	
- part of M: $62'000 + 11'000 = 73'000$	83'000
- part of minority interests: $8'000 + 2'000 = 10'000$)

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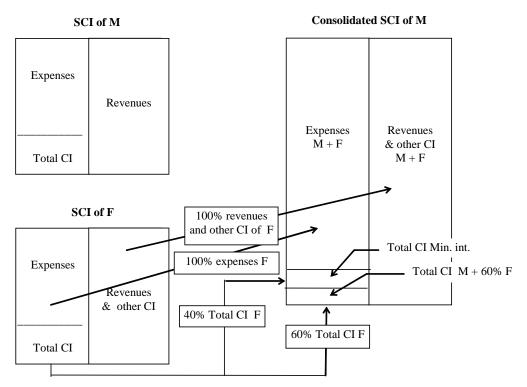


Figure 1-3: Full consolidation

1.2.2.3 The equity method*

This method consists of replacing the book value of the parent company's shareholding by the relevant proportion of the subsidiary's net assets; the other items in the parent company's balance sheet remain unchanged.

Example 4 (continued):

If M holds 60% of the shares 65-240'000 CII

Replacing the book value of the shareholding (CU 180'000) by this amount results once more in a consolidation difference of 240'000 - 180'000 = 60'000 CU.

The consolidated financial statements of M therefore appear as follows:

Consolidated balance sheet of M (before elimination of intra-group transactions)

Fixed assets	600'000	Capital	500'000
Investment in F	240'000	Retained earnings	250'000
Receivables	220'000	(including profit of M 50'000)	
		Other reserves	50'000
		(including other CI of M 8'000)	
		Consolidation difference	60'000
		Consolidated equity	860'000
		Liabilities	200'000
	1'060'000		1'060'000

Consolidated statement of comprehensive income of M (before elimination of intra-group transactions)

Revenues	800'000
M's share in the profit of associated companies	12'000
[60% (20'000)]	
Expenses	750'000
Consolidated profit for the year	62'000
Other comprehensive income [8'000 + 60% (5'000)]	11'000
Consolidated total comprehensive income	73'000

The equity method is not strictly speaking a method of consolidation, since the assets and liabilities of the subsidiary are not added to those of the parent company and the group's investment in the subsidiary remains in the balance sheet.

It is actually equivalent to a simple revaluation of the group's interests. That is why, in a number of countries, the use of this method is not restricted to consolidated accounts. Companies can also use it in their individual accounts.

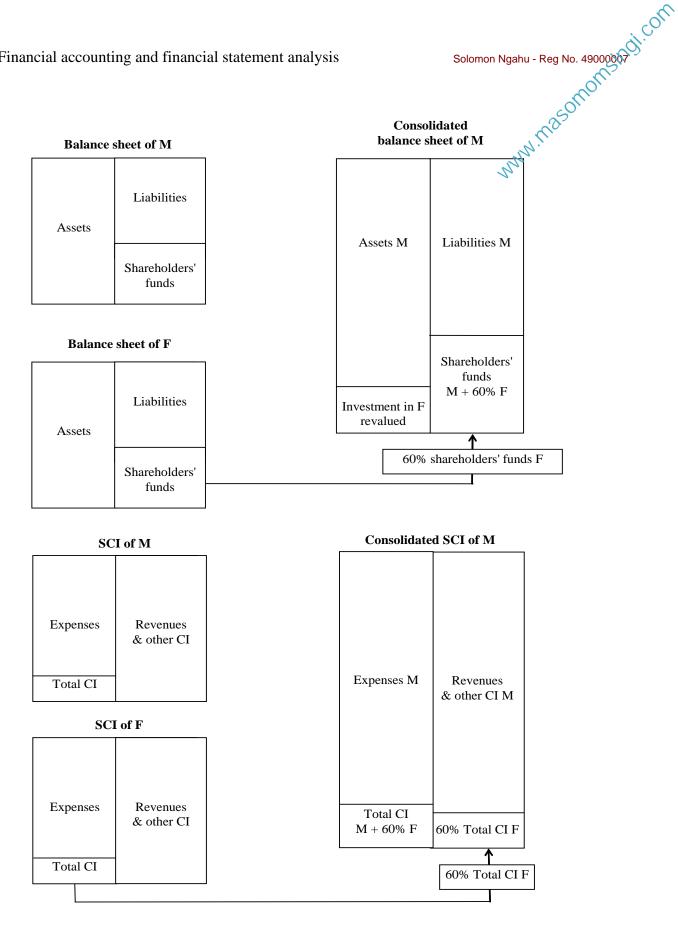


Figure 1-4: Equity method

1.2.3 The nature of the difference arising from consolidation*

e amount of the Each time the book value of the parent company's interest differs from the amount of the group's share in the subsidiary net assets, a difference arises when consolidating. This difference represents the group's share in the increased wealth or value of the subsidiary since acquisition.

Example 4 (continued):

Since M's interest was acquired at the time of F's formation, the increased value of F since that date corresponds to the retained earnings (CU 80'000) and other reserves (CU 20'000), making a total of CU 100'000.

M's share in this increased value is 100'000 x 60% = 60'000 CU, which corresponds to the difference arising from consolidation.

In the consolidated balance sheet, the difference arising from consolidation can thus be broken down into its constituent parts:

- group's share in the subsidiary's retained earnings: 80'000 x 60% = 48'000
- group's share in the subsidiary's other reserves: 20'000 x 60% = 12'000 60'000

This results in the following presentation:

• with proportionate consolidation:

Consolidated balance sheet of M (before elimination of intra-group transactions)

Fixed assets	780'000	Capital	500'000
[600'000 + 60% (300'000)]		Consolidated retained earnings	298'000
Inventories [60% (100'000)	60'000	(including: consolidated profit	
Receivables	280'000	62'000)	
[220'000 + 60% (100'000)]		Consolidated other reserves (including other CI 11'000)	62'000
		Consolidated equity	860'000
		Liabilities [200'000 + 60% (100'000)]	260'000
	1'120'000	1	1'120'000

• with full consolidation:

Consolidated balance sheet of M (before elimination of intra-group transactions)

Fixed assets [600'000 + 300'000]	900'000	Capital	500'000
Inventories	100'000	Consolidated retained earnings	298'000
Receivables [220'000 + 100'000]	320'000	(including: M's part in consolidated profit 62'000)	
		Consolidated other reserves	62'000
		(including M's part in other CI	
		11'000)	
			860'000
		Minority interests	160'000
		Consolidated equity	1'020'000
		Liabilities [200'000 + 100'000]	300'000
	1'320'000		1'320'000

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• with the equity method:				20,
	Consolidated ba	alance sheet of M	4	0
	(before elimination of in	tra-group transactions)	41	
Fixed assets	600'000	Capital	"Va"	500'000
Investment in F	240'000	Consolidated retained ea	rnings 🗥 🔭	298'000
Receivables	220'000	(including: consolidate	d profit	
		62'000)		
		Consolidated other reser	ves	62'000
		(including other CI 11'	000)	
		Consolidated equity		860'000
		Liabilities		200'000
	1'060'000			1'060'000

The apportionment of the difference arising from consolidation allows the same profit and other comprehensive income figures to appear in both the balance sheet and the statement of comprehensive income.

It is important to note that the net assets or shareholders' funds (excluding minority interests) are the same whichever method is used. Their amount, which represents the book value of the group's wealth, corresponds to the net assets of the consolidating company plus its share in the subsidiaries increased wealth or value since the date of the acquisition of the interests:

Example 4 (continued):

Net assets / shareholders funds of M: 800'000

+ M's share in the increased value of F since the acquisition of the shareholding:

> Retained earnings: 80'000 Other reserves: 20'000

> > $100'000 \cdot 60\% = 60'000$

860'000 = Consolidated net assets / shareholders funds:

1.2.4 Uses of each method*

The methods of consolidation are not simply used at random. Each one has a well-defined area of application.

For controlled undertakings, the only recognised method is full consolidation.

The use of proportionate consolidation is much more limited. It is restricted to undertakings subject to joint control, commonly known as joint ventures.

According to the IASB, which has a standard (IAS 31) devoted entirely to this type of undertaking, a joint venture is defined as "a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control". The IASB states that such control requires that none of the parties be in a position to independently control the activities carried out.

According to current IAS 31, interests in joint ventures must be accounted for using the proportionate consolidation or the equity method. Proportionate consolidation is not used in the United States, except in the oil and gas sector/partnerships. Instead, joint ventures are accounted for by the equity method.

From 2013 onwards, the proportionate consolidation will no longer be allowed by the IFRS. All joint ventures will have to be consolidated using the equity method.

The equity method is applied to joint ventures that are not consolidated using proportional consolidation, and to other undertakings over which the parent "significant influence" without actually possession.

The rules of application may be summarised as:

Undertakings controlled by the parent company	Full consolidation
Joint control	Up to 2012: Proportionate consolidation or equity method From 2013 onwards: Equity method
Undertakings over which the parent company exercises a significant influence	Equity method
Other undertakings	Fair value (for listed shares) Cost (for unlisted shares)

Below are extracts from annual reports, which show that the main difference between companies is on how they account for joint ventures.

Boeing (USA)

The consolidated financial statements include the accounts of all majority-owned subsidiaries. Investments in joint ventures in which the Company does not have control, but has the ability to exercise significant influence over the operating and financial policies, are accounted for under the equity method.

Sony (Japan)

The consolidated financial statements include the accounts of Sony Corporation and those of its majority-owned subsidiary companies. [...] Investments in which Sony has significant influence or ownership of more than 20% but less than or equal to 50% are accounted for under the equity method.

Vivendi (France)

The companies' financial statements are consolidated according to three methods:

- the consolidated financial statements include the accounts of the parent company and its directly or indirectly controlled subsidiaries;
- the financial statements of jointly controlled companies are included in the consolidated financial statements using proportionate consolidation;
- when the ownership interests range between 20% and 50% and these interests do not give exclusive or joint power to control the affiliates, but also when the group exercises significant influence, investments are accounted for by the equity method.

- Solomon Ngahu Reg No. 49000000001. Communities of the consolidation procedure*

 The consolidation procedure is generally split into five steps. (Figure 1-5).

 Step one is to adjust the individual financial statements of each group company so as to ensure consistency of the methods of valuation and presentation at the group level. The accounting policies applied to the consolidated financial statements are chosen to parent company.

 Step two applies to foreign undertakings, where it is a financial statements into the currency to the consolidated financial statements into the currency to the consolidated financial statements into the currency to the consolidated financial statements are chosen to step two applies to foreign undertakings, where it is a financial statements into the currency to the consolidated financial statements are chosen to state the consolidated fin

 - companies. This will involve adding together either the whole or the proportion based on the interest owned by the parent company, depending on the method of consolidation used (full or proportionate consolidation). The shareholdings accounted for by the equity method are excluded from this step.
- Step four requires the elimination of intra-group transactions and balances, i.e. those transactions and balances between companies included in the consolidation.
- Finally, step five involves the elimination of the investment against the subsidiary's equity, which constitutes the main purpose of consolidation. This produces the difference arising from consolidation.

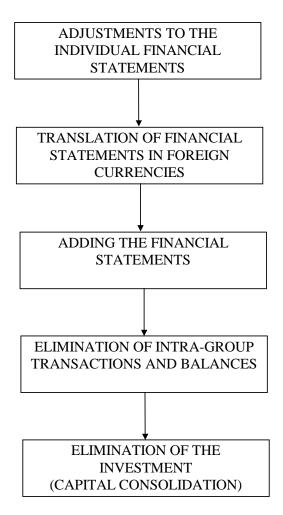


Figure 1-5: The consolidation procedure

1.2.5.1 Adjustments to the individual financial statements*

Companies within a group may not necessarily all follow the same accounting policies when preparing their financial statements. For example, some may depreciate fixed assets by the straight-line method whilst others may use the reducing balance method preparation, some may use the "first in, first out" (FIFO) "

"weighted average cost". The use of the "
allowed under IAS 2 "
companies" companies may choose and which are compatible with generally accepted accounting principles or IFRS.

The need for uniformity of accounting methods used in the preparation of consolidated accounts is unanimously acknowledged. At the international level, IAS 27 states, "consolidated financial statements should be prepared using uniform accounting methods".

The preparation of consolidated financial statements thus requires a statement of the accounting policies permitted in the consolidation, as well as their methods of application. These are accurately described in a "consolidation or accounting manual" drawn up by the parent company. The financial statements of group undertakings, which do not comply with these, are then adjusted in order to ensure uniformity within the group accounts.

Uniformity adjustments: The uniformity adjustments depend on the diversity of accounting policies used by group companies. In most cases they arise from:

- Depreciation: standardisation of methods (straight line or reducing balance) and of the depreciation period for each category of fixed assets;
- Inventories: standardisation of methods of identifying inventories held (FIFO, LIFO, weighted average cost) and of the valuation methods (inclusion of indirect costs, etc.);
- Finance leases (leasing, long-term leases, etc.): whether or not to account for leased property as an asset of the lessee;
- Research and development expenditure: whether to account for it in current expenses or as a capitalised asset;
- Borrowing costs: whether or not to capitalise the interest element incurred in financing.

Other adjustments: We are all aware that, in practice, the choice of accounting policies used in individual accounts does not always reflect the economic reality of the situation.

Therefore, in addition to the uniformity adjustments made necessary by the disparity of accounting methods within the group, there are other adjustments that need to be made in order to reflect the true substance over form, and to represent the true and fair financial situation of the group more accurately.

Elimination of hidden reserves: Certain companies may try, particularly at the fiscal year end, to conceal part of their profits and wealth by voluntary under-valuation of assets or overvaluation of liabilities, thereby creating what are commonly known as "hidden reserves". This practice is condemned internationally, with IAS 1 stating that "The principle of prudence does not justify the creation of secret or hidden reserves".

In some countries, however, the creation of hidden reserves is perfectly legal. The question is whether or not these reserves may and should be held in consolidated financial statements.

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Solomon Ngahu - Reg No. 49000007 Apart from psychological considerations, three reasons may justify the creation of hidden reserves. These are:

- the wish to pay less tax;
- the desire to pay a constant dividend, although the establishment of hidden reserves is not necessary for this since dividends may also be deducted from declared reserves;
- the wish not to attract the attention of competing companies by publishing abnormally high results that might attract new competition.

On consolidation, these reasons become irrelevant. Consolidated financial statements are not actually taken into account for fiscal purposes, but are ranked equally with dividends, which are not decided on the group earnings but rather on the individual earnings of each company. Finally, holding hidden reserves in consolidated financial statements would be harmful to companies by making their borrowing costs higher in international markets. It seems obvious, then, that the preparation of consolidated financial statements requires the elimination of hidden reserves included in the individual accounts.

Revaluation of fixed assets: In times of inflation, the historic cost principle generally leads to undervaluing the wealth of an undertaking. As a result several companies have adopted the practice of revaluing some of the items most affected by price increases, i.e. tangible fixed assets.

IAS 16 authorises this practice. In the United States, however, no revaluations are permitted, other than in the particular case of the assets of subsidiaries located in countries with hyperinflation.

Revaluation increases the total comprehensive income of the current financial year but it has no impact on profit as the revaluation difference is accounted for directly in the shareholders funds (revaluation reserve). Note, however, that revaluation of a depreciable asset reduces the profit of the following financial years on account of increases in future depreciation.

1.2.5.2 Elimination of intra-group transactions and balances*

Companies belonging to the same group often have transactions between themselves (purchases/sales, loans/borrowings, etc.), which are recorded in their individual accounts. These transactions should be eliminated in full on consolidation so that only those transactions external to the group appear in the consolidated financial statements.

Eliminations having no effect on the consolidated profit: We need to eliminate the debtors and creditors balances between group companies, as well as the income and expenses. These eliminations are **compulsory** if they are significant.

Elimination of intra-group profit: Each time a transaction occurs between companies in a group at an amount other than cost price, it results in the creation of a profit or a loss to one of the companies concerned.

In the case of a **profit**, standards stipulate that it should be **eliminated** on consolidation. It is the same for internal losses unless, under IAS 27, they have a definitive character, in which case they should not be eliminated. Although this provision is not included in other standards, one may consider it to be of universal application as a direct consequence of the prudence principle.

Solomon Ngahu - Reg No. 490000007

The internal loss of CU 20 incurred by A will only be eliminated in full if the market value of the solomon of the s Not all the profits of transactions between group companies are to be eliminated. The elimination only applies to those included in group balances at the financial year-end.

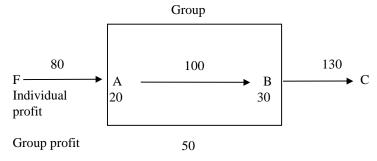
Consider two companies A and B belonging to the same group. A sells CU 100 of goods to B which it has purchased for CU 80 from a supplier F outside the group. At the financial year-end, two situations may arise:

B has resold the goods to a company C outside the group for CU 130

The profits recorded are:

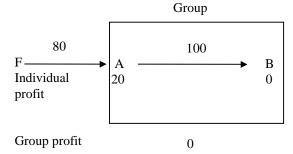
- in A: 100 80 = 20 CU
- in B: 130 100 = 30 CU

Adding together the accounts of A and B leads to a profit of 20 + 30 = 50 CUwhich corresponds to the profit realised by the group:



Hence there is no elimination to make since the profit has been realised.

2nd case: B has not resold the goods. In this case, the group has not realised any profit.



Thus it is necessary to eliminate the unrealised profit recorded by A (20 CU).

At the financial year-end, this profit is included in the inventories held by B, these stocks having been valued at B's purchase cost, i.e. CU 100, although the price paid by the group is only CU 80.

Usually, the principal eliminations to be made are:

- profits included in inventories and fixed assets (goods, raw materials, or fixed assets purchased from a group company),
- intra-group dividends (dividends received from another company in the group).

1.2.5.3 Capital consolidation*

res replacing the 1. This stage constitutes the main objective of consolidation. It involves replacing the book value (usually the acquisition cost) of the interest in the subsidiary with the corresponding proportion of the subsidiary's net assets, or shareholders' funds, at the date of consolidation.

The resulting difference is what is known as the "difference arising from consolidation".

Difference arising from consolidation = acquisition cost of the investment corresponding share of the subsidiary's net assets at the date of consolidation (after adjustments and elimination of intra-group transactions and balances).

Example 7:

M holds a 60% interest in company F of which the net assets at 31/12/N are CU 800'000, after having eliminated intra-group transactions and balances.

If the investment had been acquired for CU 350'000, the difference arising from consolidation at 31/12/N would be $350'000 - (800'000 \cdot 60\%) = -130'000$ CU

The difference arising from consolidation should be broken down into two elements:

- the difference arising from the initial, or first, consolidation, i.e. the consolidation difference existing at the date of acquisition of shares in the subsidiary.
- the difference owing to the change in the subsidiary's net assets since the date effective control was gained (profit less dividends).

Supposing that the interest in F had been acquired on 31/12/N-3 and that at that date the value of the net assets, or shareholders' funds, of F amounted to:

Capital 500'000 CU Retained earnings 25'000 CU 525'000 CU

The difference arising from the initial consolidation (positive) is equal to: $350'000 - (525'000 \cdot 60\%) = 35'000 \text{ CU}$

The preceding difference arising from consolidation (CU -130'000), calculated as at 31/12/N, may therefore be analysed as:

Difference arising from initial consolidation 35'000 CU M's share of the change in F's net assets since

the date of acquisition (difference) -165'000 CU -130'000 CU

Difference arising from initial consolidation = acquisition cost of the investment corresponding share of the subsidiary's net assets at the date of acquisition of the investment.

1.2.6 Analysis of the difference arising from initial consolidation*

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ding share of the company of the com Each time the interest has been acquired at a price different to the corresponding share of the subsidiary's net assets at that date, a difference arising from initial consolidation arises which may be explained in several ways.

The first cause of the difference arises from accounting principles. The amount of the net assets depends on the method of asset valuation. In the subsidiary's individual financial statements, assets are valued at historical cost, even though the price paid for the interest is clearly more in line with current values. In particular, intangible assets created by the subsidiary (goodwill, trademarks, brands, etc.) do not figure in the balance sheet. As a result, there is an amount of hidden appreciation, which justifies the payment of a premium.

The price of the interest in the subsidiary may also be determined by means other than the accounting figures. Several alternative valuation methods exist, based on profitability or stock exchange valuation, which may lead to very different valuations compared with the book value. Legal argument elsewhere encourages various approaches to the determination of price. Furthermore, from a theoretical point of view, the value of an investment does not depend (unless it is in the process of liquidation) on the book values of the undertaking, but on its expectations of future profitability.

The price may also take into account the purchaser's own considerations, especially the effects of synergy likely to give rise to an increase in the parent company's profitability. In addition, the circumstances surrounding the negotiation and the views of the management may induce the purchaser to pay a higher price than the current value of the investment, or, on the other hand, to realise a bargain.

From an accounting point of view, it is considered that the difference arising from the initial consolidation has only two components. We only actually distinguish between:

- The **hidden appreciation of identifiable assets** (tangible or intangible) of the subsidiary, known sometimes as the "valuation difference", resulting from the difference between the book values of the identifiable assets and their valuation at current cost or "fair value",
- A residual balance, known as "goodwill", or the "premium on acquisition", which includes all the other factors (fixing of the price by means other than the book value, negotiation problems, etc.).

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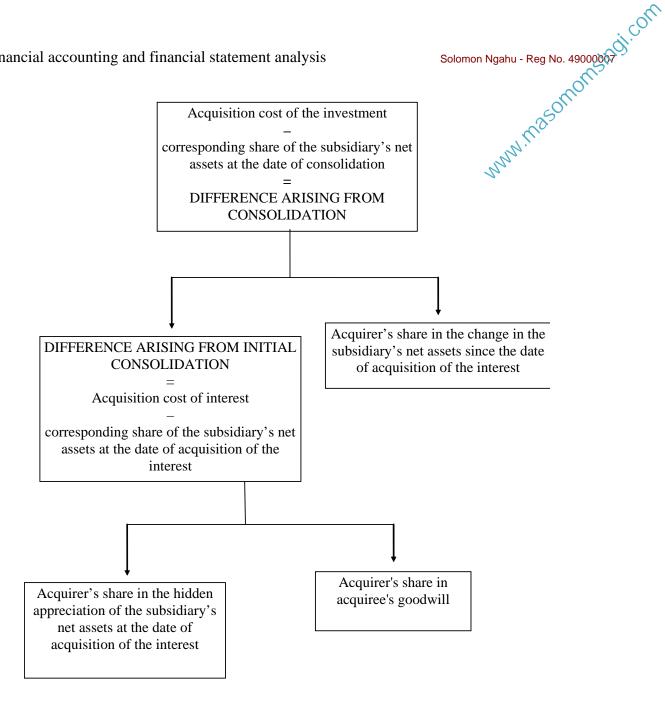


Figure 1-6: Analysis of the total difference arising from consolidation

The above diagram has been repeated for the benefit of proper understanding, even though it has already been partly presented in section 1.1.2.3.

The identifiable assets of the subsidiary are valued at the date of acquisition of the interest and the hidden appreciation established at this time is added to the book value of the corresponding items so that they appear in the consolidated balance sheet at their "fair value" at this date.

The assets concerned comprise all the target's assets, which may be independently or separately identified and valued. These are principally tangible fixed assets, but intangibles that can be separately disposed of and valued (trademarks, brands, patents, etc.) must also be included.

Example 7 (continued):

Solomon Ngahu - Reg No. 49000007 Suppose that at the date of acquisition of the interest in F (31.12.N-3), the current value of the buildings of F amounted to CU 330'000, while they appeared in F's balance sheet at that time for:

Gross amount	400'000 CU
 Accumulated depreciation 	<u>-100'000 CU</u>
Net amount	300'000 CU

There was a hidden appreciation of CU 30'000 relating to these buildings, of which 60% relates to the parent company M and 40% to the minority shareholders.

Assuming that F's tax rate is 30%, the difference arising from the initial consolidation (CU 35'000) may be broken down as follows:

M's share of the (after tax) hidden appreciation: 70% (18'000) = 12'600 CU M's share in F's goodwill (difference) 22'400 CU 35'000 CU

Therefore, we have:

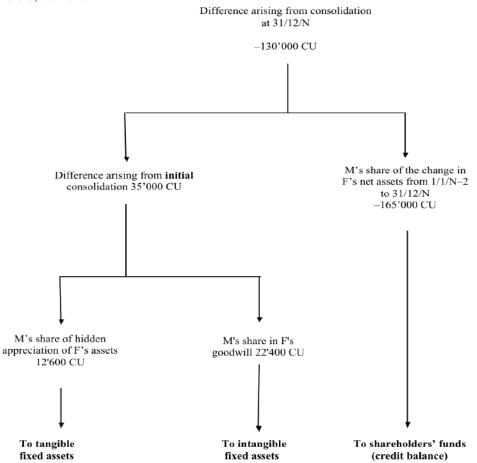


Figure 1-7: Hidden appreciation and the determination of goodwill

When it proves impossible to determine the current values of the subsidiary's assets at the date of acquisition, or if necessary, when the subsidiary is first consolidated, some standards allow for the difference arising from the initial consolidation to be considered entirely as goodwill. IFRS 3 does not allow this.

Goodwill can be positive or negative. The way it is accounted for depends on its sign.

1.2.7 Valuing minority interests*

According to IFRS 3, non-controlling (i.e. minority) interests may be measured.

- either at fair value
- or at their share of the acquiree's identifiable net assets.

In the latter case, no goodwill is recognised for minority interests.

Inversely, when minority interests are measured at fair value, they include a part of acquiree's goodwill.

The following example illustrates both solutions.

Example 7 (continued)

At the acquisition date, F's identifiable net assets were:

carrying amount 525'000 hidden appreciation of buildings (after tax): 70% (30'000) = 21'000 546'000

If minority interests are measured accordingly, they amount to $546'000 \times 40 \% = 218'400 \text{ CU}$ and goodwill is limited to 22'400 CU, i.e. M's share of F's non-identifiable net assets.

But minority interests may also be measured at fair value.

The best estimate of F's fair value is the market price of its shares. Let us assume that the market price of all F shares at the acquisition date was 560'000 CU.

The non-controlling interests can be measured at $560'000 \times 40 \% = 224'000 \text{ CU}$, which can be decomposed as follows:

non-controlling interests in F's identifiable net assets	218'400
non-controlling interests in F's goodwill (difference)	5'600
	224'000

If shares F are not listed, minority interests may be measured on the basis of the acquisition price paid by M:

M paid 350'000 CU to acquire 60% of F's shares. The fair value of Company F at the acquisition date may thus be estimated at $350'000 \times 100/60 = 583'333$ CU.

The non-controlling interests at the acquisition date are thus $583'333 \times 40\% = 233'333$ CU. This amount can be decomposed as follows:

non-controlling interests in F's identifiable net assets	218'400
non-controlling interests in F's goodwill: 22'400 x 40/60 =	14'933
	233'333

In the former case, goodwill is limited to 22'400 CU and entirely attributable to M. In the other cases, goodwill amounts to 22'400 + 5'600 = 28'000 or 22'400 + 14'933 = 37'333 and it must be partitioned between M and minority interests.

The consolidated balance sheet at the acquisition date will thus show the following amounts:

Consolidated balance sheet as of 31.12.N-3

	Solution 1	Solution 2	Solution 3
Assets:			
Goodwill	22'400	28'000	37'333
Consolidated equity:			
Minority interests	218'400	224'000	233'333

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1.2.8.1 Treatment of positive goodwill*

Goodwill is positive when the acquisition cost of the investment exceeds the acquirer's interest in the fair value of the identifiable assets and liabilities of the acquired entity.

Positive goodwill is recognised as an asset. For many years it had to be described useful life. Rules have changed with the adoption of IFR of standard, goodwill no longer has to be depression mpairment loss when necessary.

AS 36 provider

IAS 36 provides detailed and sophisticated rules for testing the impairment of goodwill. In short:

- Goodwill must, at the acquisition date, be allocated to the acquirer's cash-generating units that are expected to benefit from the synergies of the combination.
- Each year, each cash-generating unit is tested for impairment by comparing its carrying amount, including goodwill, with its recoverable amount.
- If the carrying amount of the unit exceeds its recoverable amount, the entity must recognise an impairment loss that is allocated to the assets that compose the unit in the following order:
- 1) goodwill,
- 2) other assets pro rata on the basis of their carrying amount.

Example 8:

In N, Company A acquired 60% of Company T. The resulting goodwill was CU 300'000. Its allocation to the cash-generating units of Company A was:

- Unit 1 150'000
- Unit 2 100'000
- Unit 3 50'000 300'000

On 31.12.N, the carrying amounts and recoverable amounts of these cash-generating units are (CU '000):

	Unit 1	Unit 2	Unit 3	Total
Carrying amount:				
Goodwill	150	100	50	300
Other assets	800	600	400	1'800
Total	950	700	450	2'100
Recoverable amount	750	650	480	1'880
Impairment loss	200	50	0	250

Company A must recognise an impairment loss of CU 200'000 on Unit 1 and CU 50'000 on Unit 2. These impairment losses will be allocated as follows:

- Unit 1:

Goodwill
Other assets
50
200

Unit 2:
Goodwill

Finally, the carrying amounts on 31.12.N will be:

	Unit 1	Unit 2	Unit 3	Total
Carrying amount:				
Goodwill	0	50	50	100
Other assets	750	600	400	1'750
Total	750	650	450	1'850

In companies that do not comply with IFRS, positive goodwill may also:

- be systematically depreciated over its useful life,
- or even directly deducted from equity on acquisition.

These alternative treatments may have a significant impact on net income and the balance sheet structure.

1.2.8.2 Treatment of negative goodwill*

Goodwill is negative when the acquisition cost of the investment is less than the acquirer's interest in the fair value of the identifiable assets and liabilities of the acquired entity. In IFRS 3, acquisitions that result in a negative goodwill are called "bargain purchases".

Such cases are rare. According to IFRS 3 if negative goodwill has been identified one should undertake the following:

- reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and
- recognise immediately in profit or loss any excess remaining after that reassessment.

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