Principles of consolidated financial statements

Chapter learning objectives

Upon completion of this chapter you will be able to:

• describe the concept of a group as a single economic unit
• explain the objective of consolidated financial statements
• explain the definition of a subsidiary according to IAS 27
• apply the IAS 27 definition of a subsidiary
• explain why directors may not wish to consolidate a subsidiary
• list the circumstances where it is permitted not to consolidate a subsidiary
• explain the need for using coterminous year ends and uniform accounting policies when preparing consolidated financial statements
• explain why it is necessary to eliminate intra-group transactions
• identify the effect that the related party relationship between a parent and subsidiary may have on the subsidiary’s entity statements and the consolidated financial statements.
1 The concept of group accounts

What is a group?

If one company owns more than 50% of the ordinary shares of another company:

- this will usually give the first company ‘control’ of the second company
- the first company (the parent company, P) has enough voting power to appoint all the directors of the second company (the subsidiary company, S)
- P is, in effect, able to manage S as if it were merely a department of P, rather than a separate entity
- in strict legal terms P and S remain distinct, but in economic substance they can be regarded as a single unit (a ‘group’).
Although from the legal point of view, every company is a separate entity, from the economic point of view several companies may not be separate.

In particular, when one company owns enough shares in another company to have a majority of votes at that company’s annual general meeting (AGM), the first company may appoint all the directors of, and decide what dividends should be paid by, the second company.

This degree of control enables the first company to manage the trading activities and future plans of the second company as if it were merely a department of the first company.

International accounting standards recognise that this state of affairs often arises, and require a parent company to produce consolidated financial statements showing the position and results of the whole group.

**Group accounts**

The key principle underlying group accounts is the need to reflect the economic substance of the relationship.

- P is an individual legal entity.
- S is an individual legal entity.

P controls S and therefore they form a single economic entity – the Group.
The purpose of consolidated accounts is to:

- present financial information about a parent undertaking and its subsidiary undertakings as a single economic unit
- show the economic resources controlled by the group
- show the obligations of the group, and
- show the results the group achieves with its resources.

Business combinations consolidate the results and net assets of group members so as to display the group’s affairs as those of a single economic entity. As already mentioned, this conflicts with the strict legal position that each company is a distinct entity. Applying the single entity concept is a good example of the accounting principle of showing economic substance over legal form.

**Consolidated financial statements under the entity concept**

This is by far the most common form of group accounts. Consolidated financial statements are prepared by replacing the cost of investments with the individual assets and liabilities underlying that investment. If the subsidiary is only partly owned, all the assets and liabilities of the subsidiary are consolidated, but the non-controlling shareholders’ interest in those net assets is presented.

The **single economic unit concept** focuses on the existence of the group as an economic unit rather than looking at it only through the eyes of the dominant shareholder group. It concentrates on the resources controlled by the entity.

**Expandable text - Group financial statements**

Group financial statements could be prepared in various ways, but in normal circumstances much the best way of showing the results of a group is to imagine that all the transactions of the group had been carried out by a single equivalent company and to prepare a statement of financial position, an income statement and a statement showing other comprehensive income for that company.

Such statements are called consolidated financial statements. Note that consolidated statements of cash flow are outside the F7 syllabus.

There are three IFRSSs within the F7 syllabus relevant to the preparation of consolidated financial statements:
Each company in a group prepares its own accounting records and annual financial statements in the usual way. From the individual companies’ financial statements, the parent prepares consolidated financial statements.

2 Definitions

IAS 27 Consolidated and Separate Financial Statements uses the following definitions:

- **subsidiary** – an entity that is controlled by another entity (known as the parent)
- **control** – the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Control is usually based on ownership of more than 50% of voting power, but other forms of control are possible.

**Expandable text - Other forms of control**

IAS 27 gives four other situations in which control exists – when the parent has power:

- over more than half the voting rights by virtue of an agreement with other investors
- to govern the financial and operating policies of the entity under a statute or an agreement
- to appoint or remove the majority of the members of the board of directors
- to cast the majority of votes at a meeting of the board of directors.
Hercules is considering an investment in Samson, the capital structure of which is as follows: 10,000 A voting ordinary shares, 10,000 B non-voting ordinary shares. Both classes of shares have the same dividend rights.

Describe the appropriate group accounting for Samson if:

(i) Hercules purchases 6,000 A ordinary shares.
(ii) Hercules purchases 10,000 B and 4,000 A ordinary shares.

Solution

(i) Hercules has purchased 6,000 of the 10,000 voting A shares but no non-voting B shares.

It is the voting shares that give Hercules the influence in Samson. With 60% of the voting shares Hercules should control Samson. Samson should therefore be treated as a subsidiary.

(ii) Hercules has purchased 4,000 of the 10,000 voting A shares and 10,000 non-voting B shares.

As Hercules has less than 50% of the voting share this time it probably will not be able to control Samson. Samson will not be a subsidiary.

IAS 27 requires that consolidated financial statements shall include all subsidiaries of the parent. There are two exceptions to this rule:

<table>
<thead>
<tr>
<th>Reason for exclusion</th>
<th>Accounting treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of effective control</td>
<td>The excluded subsidiary should be accounted for (as an investment) in accordance with IAS 39.</td>
</tr>
<tr>
<td>Subsidiary held for resale</td>
<td>Held as current asset investment at the lower of carrying amount and fair value less costs to sell.</td>
</tr>
</tbody>
</table>
**Lack of effective control**

It has been argued that a subsidiary operating under long-term restrictions, so severe that the parent cannot exercise effective control, should be excluded from consolidation. IFRS 3 requires exclusion, but for a different reason. If an investor does not have effective control over an investee, then the investee cannot be classified as a subsidiary in the first place. If the subsidiary operates under severe long-term restrictions which are so serious that the parent has lost control over its investment then it no longer meets the definition of a subsidiary. This might occur in practice where a foreign subsidiary is subject to interference by the relevant government, perhaps taking the form of blocking remittances back to the parent.

**Subsidiary held for resale**

If on acquisition a subsidiary meets the criteria to be classified as ‘held for sale’ in accordance with IFRS 5, then it must still be included in the consolidation but accounted for in accordance with that standard. The parent's interest will be presented separately as a single figure on the face of the consolidated statement of financial position, rather than being consolidated like any other subsidiary.

This might occur when a parent has acquired a group with one or more subsidiaries that do not fit into its long-term strategic plans and are therefore likely to be sold. In these circumstances the parent has clearly not acquired the investment with a view to long-term control of the activities, hence the logic of the exclusion.

**Reasons for wanting to exclude a subsidiary**

The directors of a parent company may not wish to consolidate some subsidiaries due to:

- poor performance of the subsidiary
- poor financial position of the subsidiary
- differing activities of the subsidiary from the rest of the group.

These reasons are not permitted according to IFRSs.
Non-coterminous year ends

Some companies in the group may have differing accounting dates. In practice such companies will often prepare financial statements up to the group accounting date for consolidation purposes.

For the purpose of consolidation, IAS 27 allows use of financial statements made up to a date not more than three months earlier or later than the parent’s reporting date, with due adjustment for significant transactions or other events between the dates.

Related parties

Two parties are considered to be related if:

• one party has the ability to control the other party, or
• one party has the ability to exercise significant influence over the other party, or
• the parties are under common control.

Therefore:

• a company that is a subsidiary is a related party of its parent company
• this means that the financial statements may have been affected by related party transactions.
The types of transaction that may occur between parent and subsidiary (related parties) and their impact on the financial statements of the individual company and the group are:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Potential impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales and purchases</td>
<td>Favourable prices, affecting profits. Advantageous settlement terms, affecting</td>
</tr>
<tr>
<td></td>
<td>receivables and payables days.</td>
</tr>
<tr>
<td>Finance</td>
<td>Favourable rates of interest, affecting profits.</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>Favourable terms for cost or financing.</td>
</tr>
<tr>
<td>Provision of services</td>
<td>At minimal or no cost, affecting profits.</td>
</tr>
<tr>
<td>Guarantees for loans and overdrafts</td>
<td>Without which they wouldn’t have been granted.</td>
</tr>
</tbody>
</table>

Such transactions may or may not be at ‘arm’s length’, i.e. on normal commercial terms. Even where related party transactions are at arm’s length, it is still important to realise that they are related party transactions.

This is because it is quite possible that they would not have occurred but for the relationship.

**Related party transactions**

A parent company may purchase all of its machinery from one of its subsidiaries on normal commercial terms. Whilst this may appear perfectly proper, it may mean that, but for the custom of its parent, the subsidiary’s sales and profits would have been much less.
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Chapter summary

*GROUP DEFINITIONS*

PARENT = CONTROLLING ENTITY

Show position of group as single economic entity by way of group accounts.

SUBSIDIARY = CONTROLLED ENTITY

Exclusions from consolidation acceptable where
- lack of effective control
- subsidiary held for resale.

Principles of consolidation
- non-coterminous year ends
- uniform accounting policies
- elimination of intra-group transactions.