COMPLEX

RELEVANT TO ACCA QUALIFICATION PAPER P2

THE SUBJECT OF COMPLEX GROUP ACCOUNTING IS EXAMINED IN PAPER P2 AND STUDENTS SHOULD ENSURE THEY ARE VERY FAMILIAR WITH THE ACCOUNTING TREATMENT REQUIRED.

In this article I am going to illustrate complex group accounting by working through a past exam question updated to incorporate the new ideas developing around group accounting. So this article looks at the 35 marks of computation required in Question 1 of the Paper P2 exam.

As you should be aware, Graham Holt, the P2 examiner, has written two articles on the impact of IFRS 3 (revised 2008) on group accounting. The first of these, published in *Student Accountant*, in February 2009 explained the effect of the new IFRS on changes in ownership and has since been examined in some detail in the Paper P2 exams during 2009. The second article published in April 2009 explained the effect of the new IFRS on complex groups. Given that both this article and the April 2009 article cover complex groups, you might feel most comfortable with the subject of complex group accounting if you review this article in conjunction with that one.

To give you an example of how the subject of complex groups might appear in an exam question on this subject, I have taken a real group accounting question from the equivalent paper in December 2002 and included the issues raised by the April 2009 article.

The original question was called Rod, so I have called the adjusted version Rodney. Here it is:

The following draft statements of financial position relate to Rodney, a public limited company, Del, a public limited company, and Trigger, a public limited company, as at 30 November:

TABLE 1: DRAFT STATEMENTS OF FINANCIAL POSITION

	Rodney $m	Del $m	Trigger $m
Non-current assets			
Tangible	1,230	505	256
Investment in Del	640	-	-
Investment in Trigger	160	100	-
	2,030	605	256
Current assets			
Inventory	300	135	65
Trade receivables	240	105	49
Cash at bank and in hand	90	50	80
	630	290	194
Total assets	2,660	895	450
Equity			
Share capital	1,500	500	200
Share premium	300	100	50
Revaluation reserve	-	-	70
Retained earnings	625	200	60
	2,425	800	380
Non-current liabilities	135	25	20
Current liabilities	100	70	50
Total equity and liabilities	2,660	895	450

Studying Paper P2?
Performance objectives 11 and 12 are relevant to this exam

GROUPS

It is the group's policy to value the non-controlling interest at fair value.

The following information is relevant to the preparation of the group financial statements:

(i) Rodney had acquired 80% of the ordinary share capital of Del on 1 December three years ago, when the retained earnings of Del were $100m. The fair value of the non-controlling interest was $154m at acquisition. The fair value of the net assets of Del was $710m at that date. Any fair value adjustments related to inventory and these had been realised by the current year end. There had been no new issues of shares in the group since the current group structure was created.

(ii) Rodney and Del had acquired their holdings in Trigger on the same date as part of an attempt to mask the true ownership of Trigger. Rodney acquired 40% and Del acquired 25% of the ordinary share capital of Trigger two years ago. The fair value of the non-controlling interest in Trigger was $149m at acquisition. The retained earnings of Trigger on that date were $50m and those of Del were $150m. There was no revaluation reserve in the books of Trigger at acquisition. The fair values of the net assets of Trigger at acquisition were not materially different from their carrying values.

(iii) The group operates in the pharmaceutical industry and incurs a significant amount of expenditure on the development of products. These costs were formerly written off to the income statement as incurred but then reinstated when the related products were brought into commercial use. The reinstated costs are shown as 'Development Inventory'. The costs do not meet the development criteria in IAS 38, *Intangible Assets* for classification as intangibles and it is unlikely that the net cash inflows from these products will be in excess of the development costs. In the current year, Del has included $20m of these costs in inventory.

(iv) Del had purchased a significant amount of new production equipment early in the year. The cost before trade discount of this equipment was $50m. The trade discount of $6m was taken to the income statement. Depreciation is charged on the straight-line basis over a six-year period.

(v) The policy of the group is now to state tangible non-current assets at depreciated historical cost. The group changed from the revaluation model to the cost model under IAS 16, *Property, Plant and Equipment* at the current year start and restated all of its tangible non-current assets to historical cost in that year except for the tangible non-current assets of Trigger. These had been revalued by the directors of Trigger on the first day of the current year. The values were incorporated in the financial records creating a revaluation reserve of $70m.

The tangible non-current assets of Trigger were originally purchased on 1 December two years before the current year end, at a cost of $300 million. The assets are depreciated over six years on the straight-line basis. The group does not make an annual transfer from revaluation reserves to the retained earnings in respect of the excess depreciation charged on revalued tangible non-current assets. There were no additions or disposals of the tangible non-current assets of Trigger for the two years to the current year end.

(vi) The goodwill resultant from the Del acquisition was impairment tested at the first and second year end after acquisition and again at the current year end. The first and second impairment reviews revealed no impairment. However, the current review identified a recoverable value of $809m for Del. There has been no impairment in Trigger's goodwill since acquisition.

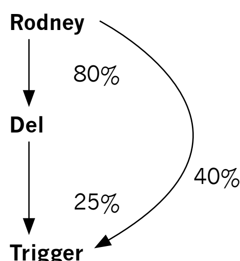
Required

Prepare a consolidated statement of financial position of the Rodney Group as at 30 November.

See page 3 to view a draft answer.

DRAFT ANSWER

The starting point for group accounting questions is to establish the group structure. This is especially important when dealing with a complex group.



Trigger ownership

Direct	40%
Indirect (80% x25%)	20%
	60%

Trigger NCI

Therefore	40%

Net assets

In order to calculate the correct goodwill figure, we need to establish the net assets at acquisition of both subsidiaries. This can often be complicated as there are accounting adjustments that need to be made first. Net assets at acquisition are as shown in **Table 1**.

TABLE 1: NET ASSETS OF DEL AND TRIGGER AT ACQUISITION

	Del		*Trigger*	
	Acq	Year end	Acq	Year end
Share capital	500	500	200	200
Share premium	100	100	50	50
Profits reserve	100	200	50	60
FVA (inventory) (balancing figure)	10	0		
Inventory error (iii)		(20)		
Discount error (iv) (5/6 x 6)		(5)		
Transfer (v) (70/5)				14
	710	775	300	324

Net assets notes

The following explanatory notes are just that and are certainly not required in the exam.

Inventory error (iii)

Reinstatement of costs that have previously been written off to the income statement is never permissible. The development inventory must be written off. The correcting double entry is:

Dr	retained earnings	20
Cr	inventory	20

Discount error (iv)

The erroneous recognition of the discount in the income statement has caused a corresponding overstatement of non-current assets of $6m at the beginning of the year. As NCA are depreciating, the error is also depreciating. Over the year $1m of error has dropped off the b/s into the i/s as depreciation. So only $5m is still left on the b/s in net assets at the year end. The correcting double entry is shown in **Table 2**.

TABLE 2: CORRECTING DOUBLE ENTRY, DISCOUNT ERROR

Dr	discount (i/s)	6	(to remove the erroneous discount)
Cr	tangibles (b/s)	5	(to get the NCA back to where they should be)
Cr	depreciation charge (i/s)	1	(to strip out the overdepreciation)

REINSTATEMENT OF COSTS THAT HAVE PREVIOUSLY BEEN WRITTEN OFF TO THE INCOME STATEMENT IS NEVER PERMISSIBLE. THE DEVELOPMENT INVENTORY MUST BE WRITTEN OFF.

Transfer (v)
Trigger's accounting policy for property, plant and equipment (PPE) must be consistent with that of the parent. The revaluation of NCA must be removed and the assets reverted back to historic cost. To remove it correctly there must be two corrections. This is because Trigger has made two mistakes. First, we must recognise the realisation of the reserve and put through the transfer that Trigger has ignored. Second, we must remove the remainder of the revaluation reserve and reduce the tangibles back to their historical net book value. Revaluation reserves should be realised over their lives. The life of the Trigger tangibles was six years at the point of purchase. But the revaluation is one year after purchase and so the revaluation reserve has a life of only five years from revaluation. The first of those five years is this year. So one-fifth of the $70m must be realised, therefore $14m is transferred to retained earnings, leaving $56m in the revaluation reserve. This is set against the $256m in tangibles. The revised balance is $200m, which is where it would have been had Trigger not put through the revaluation. After all, the tangibles are two years through a six-year life and had originally cost $300m. The correcting double entry is shown in **Table 3**.

Exam tip – there are always going to be difficult areas in the exam. Have a go, but if you feel you are getting bogged down, then move on. Do not waste too much time trying to deal with an adjustment that you are unsure about.

Once the net assets have been ascertained, then the goodwill can be calculated as shown in **Table 4**.

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TABLE 3: CORRECTING DOUBLE ENTRY

Dr	revaluation reserve	70	(to remove the offending reserve)
Cr	retained earnings	14	(to transfer a fifth of the reserve)
Cr	tangibles	56	(to remove the remainder of the reserve)

TABLE 4: NET ASSETS OF DEL AND TRIGGER AT ACQUISITION

Goodwill	Del $m	Trigger $m
Fair value of consideration	640	
Trigger direct		160
Trigger indirect (80% x 100)		80
Fair value of NCI	154	149
Fair value of net assets	(710)	(300)
Goodwill at acq	84	89
Impairment (below)	(50)	-
Goodwill at year end	34	89

To calculate the impairment loss in Del, we must compare the carrying value of Del with the recoverable amount of $809m, given in the question.

Carrying value:	
Net assets at year end (from NA working)	775
Goodwill (from above)	84
	859
Impairment (balance)	(50)
Recoverable value	809

The split of goodwill between parent and non-controlling interest (NCI) is not required.

NCI

The NCI in the statement of financial position relates to the investment in Del and the investment in Trigger. It is calculated as shown in **Table 5**.

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TABLE 5: NCI IN THE STATEMENT OF FINANCIAL POSITION

NCI in Del	$m
Fair value of NCI at acquisition	154
Less indirect holding adjustment	
(NCI share of investment in Trigger) 20% x 100	(20)
NCI share of post acquisition retained earnings (20% x (775 – 710))	13
NCI share of goodwill impairment (20% x 50)	(10)
	137
NCI in Trigger	
Fair value of NCI at acquisition	149
NCI share of post acquisition retained earnings (40% x (324 – 300))	9.6
	158.6
Total NCI	295.6
Group retained earnings	
Rodney	625.0
Less impairment (80% x50)	(40.0)
Del (80% x (775 – 710)	52.0
Trigger (60% x (324 – 300)	14.4
	651.4

GROUP STATEMENT OF FINANCIAL POSITION

	$m
Non-current assets	
Goodwill (34 + 89)	123
Tangible (1,280 + 505 – 5 discount + 256 – 56 revaluation)	1,930
Current assets	
Inventory (300 + 135 + 65 – 20 development)	480
Receivables (240 + 105 + 49)	394
Bank (90 + 50 + 80)	220
	3,147
Equity	
Share capital	1,500.0
Share premium	300.0
Reserves	651.4
Non-controlling interest	295.6
Non-current liabilities (135 + 25 + 20)	180.0
Current liabilities (10 + 70 + 50)	220.0
	3,147.0