Chapter 16

Consolidation: Wholly owned subsidiaries

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The consolidation process

Before consolidating, it may be necessary to adjust subsidiary's financial statements where:

1. The subsidiary's balance date is different to the parent's. In such cases the subsidiary is required to prepare adjusted financial statements as at the parent's reporting date. **Eg- 30 June vs. 31 December**

2. The subsidiary's accounting policies are different to the parent's. In such cases the subsidiary is required to prepare adjusted accounts to ensure accounting policies consistent with the parent.

Eg- cost vs. revaluation methods of accounting for non-current assets

The consolidation process

Consolidation involves adding together the financial statements of the parent and subsidiaries and making a number of adjustments:

- Business combination valuation entries – required to adjust the carrying amounts of the subsidiary's assets and liabilities to fair value
- Pre-acquisitions entries – required to eliminate the carrying amount of the parents investment in each subsidiary against the pre-acquisition equity of that subsidiary
- Transactions between entities within the group subsequent to acquisition date (chapter 17)

Consolidation worksheets

Consolidation journals are posted into the consolidation worksheet in “adjustment” columns as follows:

Extract only

	Parent	Subsidiary			
	P Ltd. $'000	S Ltd. $'000	Adjustments		Cons. Balances
			DR	CR	
Land	400	150	XX		XX
Invt in S Ltd	120			XX	XX
Receivables	200		XX		XX
Cash	40	20			XX
	760	170			XXX
Share capital	500	100		XX	XX
Retained earnings	160	20	XX		XX
Creditors	100	50		XX	XX
	760	170			XXX

Add down for sub-totals

-All consol. journals recorded in these DR/CR columns

- Where there are a large number of journals it is common to number them 1,2,3 etc.

- Purpose- to remove the parent’s investment in the subsidiary and the effect of all interentity transactions so that the final column shows an “external view”

Consolidation worksheets

- Consolidation journal adjustments are ONLY prepared for the purpose of consolidation
- They are posted onto the consolidation worksheet only- they are NOT recorded in the books of the parent or the subsidiary
- As a result, some consolidation adjustments are repeated every time consolidated accounts are prepared

Acquisition analysis

- An acquisition analysis compares the cost of acquisition with the fair value of the identifiable net assets and contingent liabilities (FVINA) that exist at acquisition to determine whether there is:
  - Goodwill on acquisition (where cost > FVINA)
  - Bargain purchase (where cost < FVINA)
- Recall that goodwill is an unidentifiable intangible asset that is calculated as a residual value
- Also recall that net assets = assets – liabilities = shareholders equity

NOT the book value

Acquisition analysis

- The FVINA include all identifiable asset and liabilities of the subsidiary as well as the fair value of any contingent liabilities the acquiree may have.
- Recall that contingent liabilities are not recognised in subsidiaries balance sheet- rather they are recorded by way of note disclosure only. AASB3 requires them to be recognised on the acquisition of another business
- We commonly determine the FVINA with reference to the equity balances of the subsidiary, rather than the individual asset and liability balances

Example – background information

Hitech Ltd acquired all of the issued share capital of Lotech Ltd on 30 June 2011 for a cash consideration of $400,000

At that time the net assets of Lotech Ltd were represented as follows:

	$	
Share capital	300,000	
Retained earnings	50,000	
Net assets	350,000	Book value of identifiable net assets (BVINA)

Example – background information

When Hitech acquired its investment in Lotech the following information applied:

- Land held by Lotech was undervalued by $10,000
- A building held by Lotech was undervalued by $45,000. The building had originally cost $100,000 2 years ago and was being depreciated at 10% per year
- A contingent liability relating to an unsettled legal claim with a fair value of $3,000 was recorded in the notes to Lotech's financial statements

The tax rate is 30%

Acquisition analysis - no previously held equity interest

		$	
Cost of acquisition		400,000	1 - Per slide 8
Book value of net assets			
- Share capital	300,000		Per slide 8
- Retained earnings	50,000		
Total book value of net assets BVINA A	350,000		
Fair value adjustments			
- After tax increase in land	7,000		10,000 x (1-30%) = 7,000 — Per slide 9
- After tax increase in building	31,500		45,000 x (1-30%) = 31,500 — Per slide 9
- After tax recognition of provision for legal claim	(2,100)		(3,000) x (1-30%) = (2,100) — Per slide 9
Total fair value adjustments B	36,400		
FVINA A + B	386,400		
X %age acquired	100%	386,400	2
Goodwill/(bargain purchase) on acquisition 1 - 2		13,600	If +ve- goodwill If –ve- bargain purchase

Parent has previously held equity interest

- Where control is achieved in stages the previously held equity instruments in the acquiree must be adjusted to fair value prior to performing the acquisition analysis.
- This will require additional entries to be made in the parents books.
- Consolidation entries will remain unchanged.
- Example: Hitech acquired 85% of Lotech on 30 June 2005 and the remaining 15% on 30 June 2011.

Worksheet entries at acquisition date - Business combination valuation entries

- If the BV of subsidiary assets and liabilities ≠ FV, or if a contingent liability exists, it is necessary to make "business combination valuation" adjustments. These adjustments:
  - increase or decrease subsidiary's recorded assets and liabilities book values to fair value;
  - recognise previously unrecognised assets (eg internally generated intangibles); or
  - recognise subsidiary's contingent liabilities as liabilities at fair values
- Business Combination Valuation Reserve (BCVR) account is used to record these adjustments. The BCVR is similar to the Asset Revaluation Surplus (ARS) account

Worksheet entries at acquisition date - Business combination valuation entries

- While it is possible for these adjustments to be made directly in the books of the subsidiary, it is likely and common for these adjustments to be made on consolidation
- In some cases, other accounting standards prevent the adjustment from being made in the subsidiaries books.
  - AASB 102 requires all inventory to be recorded at the lower of cost or NRV therefore where the FV of inventory is higher than the cost, such an adjustment may not be made in the subsidiaries books
  - AASB 138 does not allow the subsidiary to recognise internally generated goodwill.

Worksheet entries at acquisition date - Business combination valuation entries

- Where the BCVR entry is done in the ARS account in the subsidiary's books it is recorded in the G/L and therefore automatically carries forward to future periods once entered

  BUT

  Where the entry is done in the BCVR on consolidation (ie on the worksheet) it must be manually carried forward to future periods

BCVR adjustments at acquisition date

Land

- Land is undervalued by $10,000
- Accordingly, the business combination valuation adjustment required on consolidation at 30 June 2011 (the date of acquisition) is:

DR	Land		10,000		
	CR	DTL		3,000	30%
	CR	BCVR		7,000	70%

This entry will be posted onto the consolidation worksheet- refer slide 20 (Ref 1)

BCVR adjustments at acquisition date

Buildings

- Buildings must be increased by $45,000.
- The buildings in the statement of financial position need to change as follows

	In sub's books AT PRESENT		On consol. REQUIRED
Buildings at cost	100,000	→	125,000
Accum. depreciation	(20,000)		0
Book value	80,000		125,000

10% depreciation p.a for 2 years

of $45,000

The FV of the asset is considered to be the cost of the asset to the group

BCVR adjustments at acquisition date

Buildings

- The business combination valuation adjustments required (on consolidation) at 30 June 2011 (the date of acquisition) are:

		DR	CR
DR Accum depreciation		20,000	
CR Buildings			20,000
DR Buildings		45,000	
CR DTL	30%		13,500
CR BCVR	70%		31,500

A SINGLE JOURNAL CAN BE PREPARED AS FOLLOWS:

		DR	CR
DR	Buildings	25,000	
DR	Accum depn	20,000	
CR	DTL		13,500
CR	BCVR		31,500

Both of these journals will be posted onto the consolidation worksheet- refer slide 20 (Ref 2)

BCVR adjustments at acquisition date

Contingent Liability

- Recognising a contingent liability for the first time will result in a liability that has a carrying amount but no tax base. Such adjustments result in a Deferred Tax Asset (DTA)
- The business combination valuation adjustment required on consolidation at 30 June 2011 (the date of acquisition) in relation to the contingent liability is:

		DR	CR
DR BCVR	70%	2,100	
DR DTA	30%	900	
CR Provision for legal claim			3,000

This entry will also be posted onto the consolidation worksheet- refer slide 20 (Ref 3)

BCVR adjustments at acquisition date

Goodwill

- Goodwill arising on the acquisition is $13,600.
- The business combination valuation adjustment required on consolidation at 30 June 2011 (the date of acquisition) in relation to the goodwill is as follows:

	DR	CR
DR Goodwill	13,600	
CR BCVR		13,600

- There is not tax effect arising on the recognition of goodwill as goodwill gives rise to an excluded tempreary difference

This entry will also be posted onto the consolidation worksheet- refer slide 20 (Ref 4)

BCVR adjustments at acquisition date

The consolidation journals will be posted onto the consolidation worksheet at 30 June 2011 (the date of acquisition) as follows:

	Hitech Ltd. $'000	Lotech Ltd. $'000	Adjustments DR		Adjustments CR		Group
Cash in bank	460	200					660
Deferred Tax Asset			0.9				0.9
Land	-	200	10	1			210
Building		100	25	2			125
Accumulated Depreciation	-	(20)	20				-
Investment in Lotech Ltd	400	-					400
Goodwill	-	-	13.6	4			13.6
	860	480					1,409.5
Creditors	160	130					290
Deferred Tax Liability						3 + 13.5	16.5
Provision for legal claim					3	3	3
Share capital	600	300					900
Retained earnings	100	50					150
BCVR			2.1			7 + 31.5+13.6	50
	860	480	1, 2, 3, 4				1,409.5

Note consolidated balances

Goodwill, provision and BCVR exist on consolidation only (NIL balance in parent & sub's books).

Pre-acquisition entry at acquisition date

- Equity balances that existed in the subsidiary prior to acquisition date are referred to as pre-acquisition equity. All movements after the date of acquisition are referred to as post-acquisition
- You cannot have an investment in yourself, nor can you have equity in yourself. From a consolidated viewpoint, these items should not exist i.e. they must be eliminated to avoid double counting
- By acquiring 100% of the share capital of Lotech, Hitech effectively gained control of all of the individual assets and liabilities of Lotech. It is these balances that should be reflected in the consolidated statement of financial position

Pre-acquisition entry at acquisition date

- The pre-acquisition entry eliminates the asset "Investment in subsidiary" (in the parent's books) against the pre-acquisition equity (in the subsidiary's books)
- The pre-acquisition entry required in our example is:

DR	Share capital	300,000	
DR	Retained earnings	50,000	
DR	BCVR	50,000	
	CR Investment in Lotech		400,000

These figures are taken from the acquisition analysis (refer back to slide 10)

Pre-acquisition entry at acquisition date

	Hitech S'000	Lotech S'000	Adjustments DR	Adjustments CR	Group
Land	-	200	10		210
Building		100	25		125
Accumulated Depreciation	-	(20)	20		0
Deferred tax asset			0.9		0.9
Goodwill	-	-	13.6		13.6
Investment in Lotech Ltd	400	-		400	0
Cash in bank	460	200			660
	860	480			1,009.5
Creditors	160	130			290
Deferred Tax Liability				3 + 13.5	16.5
Contingent liability				3	3
Share capital	600	300	300		600
Retained earnings	100	50	50		100
BCVR			2.1 + 36.4	7 + 31.5	0
	860	480			1,009.5

Note values

In the equity section of the statement of financial position the sub's balances have been eliminated in full-group balances = parent's balances

Acquisition analysis – other issues

- Note also the impact of the following on the acquisition analysis (covered in textbook but not lecture notes):
  - Where subsidiary has recorded goodwill at acquisition date (p. 770)
  - Where subsidiary has recorded dividends at acquisition date (p.771)

Referred to as cum. divs

Gain on bargain purchase

- A gain on bargain purchase is rare and AASB 10 recommends re-assessment and confirmation of net asset fair values before such a gain is recognised
- Assume Hitech paid $360,000 for Lotech.

  (Acquisition analysis on following page)
- Pre-acquisition entry at 30 June 2011 is:

	Dr	Cr
DR Share capital	300,000	
DR Retained earnings	50,000	
DR BCVR	36,400	
CR Investment		360,000
CR Gain on bargain purchase (P&L)		26,400

Gain on bargain purchase

		$
Cost of acquisition		360,000
Book value of net assets		
- Share capital	300,000	
- Retained earnings	50,000	
Total book value of net assets	350,000	
Fair value (BCVR) adjustments		
- After tax increase in land	7,000	
- After tax increase in building	31,500	
- After tax recognition of provision for legal claim	(2,100)	
Total fair value adjustments	36,400	
FVINA	386,400	
X %age acquired	100%	386,400
Gain on bargain purchase on acquisition		(26,400)

No change

- ve therefore gain - cost < FVINA

Worksheet entries subsequent to acquisition date

- So far, we have considered the consolidation journals required if a consolidation was being prepared on the acquisition date
- How do these journals change if a consolidation is being prepared on a later date?
- The business combination valuation adjustment entries may differ due to transactions and events occurring since acquisition
- The pre-acquisition entry may also be affected by a number of events

Worksheet entries subsequent to acquisition date – BCVR - land

- What if, during the year ended 30 June 2013 the land was sold for $250,000?
- On sale, Lotech Ltd recognised the following journal

DR Cash	250,000	
CR Gain on Sale		50,000
CR Land		200,000

- From a group viewpoint, the Gain on sale was $40,000 (not $50,000) as the carrying value of the land on consolidation was $210,000

	Lotech	consol.
Proceeds	250	250
Book value	(200)	(210)
Profit on sale	50	40

Therefore need to decrease gain on sale on consolidation by $10,000. Requires DR to debit to gain in sale account.

Worksheet entries subsequent to acquisition date – BCVR - land

Until land is sold (30 June 2011 & 30 June 2012)

DR Land	B/S	10,000	
CR DTL	B/S		3,000
CR BCVR			7,000

In the year the land is sold (30 June 2013)

DR Gain on sale	P/L	10,000 ↓ TT	
CR ITE	P/L		3,000 ↓ ITE
CR Transfer from BCVR (R/E)			7,000

In future years (2014 >)

- No BCVR entry required (no effect on retained earnings)
- However, an adjustment is required to the pre-acquisition entry (refer slide 39)

Inventory adjustments are accounted for in a similar way to land- refer page 777 of text

Worksheet entries subsequent to acquisition date – BCVR - buildings

- A consequential depreciation adjustment is required in relation to depreciable assets that are revalued to fair value on acquisition of a subsidiary
- Required as the subsidiary is continuing to depreciate the asset based on its cost, which is lower than the fair value
- From a consolidated perspective, the depreciation charge is understated
- In relation to the buildings, the adjustment is calculated as shown on the following slide

Worksheet entries subsequent to acquisition date – BCVR - buildings

	Lotech	Group	Difference
Carrying amount at date of acquisition	80,000	125,000	45,000
Remaining useful life	8 years	8 years	8 years
Annual depreciation	10,000	15,625	5,625

5,625pa additional depreciation expense required on consolidation

Worksheet entries subsequent to acquisition date – BCVR - buildings

- On 30 June 2012 (1 year after acquisition) the original entry on slide 17 PLUS the following entries are required:

	DR	CR	
DR Depreciation expense	5,625		↓ TT
CR Accum depreciation		5,625	

- Over the next eight years we are also required to progressively reverse the DTL created with the original valuation adjustment. The following journal must also be processed on consolidation

	DR	CR	
DR DTL	1,687.5		
CR ITE		1,687.5	↓ ITE ↓

Worksheet entries subsequent to acquisition date – BCVR - buildings

- On 30 June 2013 (two years after acquisition) the original entry on slide 17 PLUS the following entries are required:

	DR	CR	
DR Depreciation expense	5,625		2013 expense
DR Retained earnings	5,625		2012 expense
CR Accum depreciation		11,250	2012 + 2013

	DR	CR	
DR DTL	3,375		2012 + 2013
CR ITE		1,687.5	2013 adj
CR Retained earnings		1,687.5	2012 adj

Worksheet entries subsequent to acquisition date – BCVR - contingent liability

- On 1 January 2012 the legal claim was settled for $2,000.
- On settlement, Lotech Ltd will recognise the following journal

DR Expense - legal fees	2,000	
CR Cash		2,000

- As the liability no longer exists, it should not continue to be carried forward on consolidation. The business combination valuation adjustment must recognise the settlement and any gain/(loss) on settlement.

Liability recognised 3,000
Cost to settle 2,000
Gain on settlement 1,000 - overprovision

Worksheet entries subsequent to acquisition date – BCVR - contingent liability

Until settlement (30 June 2011)

DR BCVR	2,100	
DR DTA (B/S)	900	
CR Provision for legal claim (B/S)		3,000

In the year the liability is settled (30 June 2012)

DR Transfer from BCVR	2,100		
DR ITE (P/L)	900		
CR Expense – legal fees (P/L)		2,000	Remove expense in sub's books
CR Gain on settlement (P/L)		1,000	Overprovision

In future years (2013 >)

- No BCVR entry required (no effect on retained earnings)
- However, an adjustment is required to the pre-acquisition entry (refer slide 39)

Worksheet entries subsequent to acquisition date – BCVR – goodwill impairment

- On acquisition the balance of goodwill was $13,600
- On 30 June 2012, goodwill is assessed to have a recoverable value of $13,000. The goodwill is considered to be impaired. It is therefore necessary to reduce the value of goodwill
- This would be done by preparing the journal on slide 19 PLUS the following journal at 30 June 2012:

DR Impairment expense	600 (P/L)	
CR Goodwill – accum impairment losses		600 (B/S)

- In future years the following entry would be required:

DR Retained earnings	600	
CR Goodwill – accum. Impairment losses		600

Changes to pre-acquisition entry

- The pre-acquisition entry is required every time a consolidation is completed and does not change, except under the following circumstances
  - When a bonus share dividend is paid from pre-acquisition equity;
  - Transfers between pre-acquisition retained earnings and reserves (including BCVR, general reserve)

Changes to pre-acquisition entry – transfers of pre acquisition reserves

- When a transfer of pre-acquisition reserves is made subsequent to acquisition a change is required to the pre-acquisition elimination entry
- Consider the sale of the land in the example which was subject to a fair value adjustment
- The journals on the following slide show how the sale of the land would have affected the pre-acquisition entry
- Note that other types of reserve transfers (eg general reserves) are dealt with in the same way as BCVR transfers

Changes to pre-acquisition entry – transfers of pre-acquisition reserves

In the year the land is sold (30 June 2013)

	DR	CR
DR Share capital	300,000	
DR Retained earnings	50,000	
DR BCVR	50,000	
CR Investment		400,000
DR Transfer from BCVR(R/E)	7,000	
CR BCVR		7,000

In future years (2014 onwards)

	DR		CR
DR Share capital	300,000		
DR Retained earnings	57,000	50,000 + 7,000	
DR BCVR	43,000	50,000 – 7,000	
CR Investment			400,000

Other issues

- Also covered in chapter 16
  - 16.6 Revaluations in the records of the subsidiary at acquisition date
  - 16.7 Disclosures
  - 16.8 Reverse acquisitions

END SHOW