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FINANCIAL ACCOUNTING AND REPORTING

LECTURE 06

Accounting for Intangibles (AASB 138/ IAS 38)

Accounting for Business Combination (AASB 3/IFRS 3)

Consolidated Financial Statements – Wholly Owned and Controlled Entities (AASB 10/IFRS 10)

Intended Learning Outcomes

On completion of this topic, you should be able to:

- Understand what types of assets can be considered intangible assets and understand the differences between intangible and tangible assets
- Explain when expenditure on intangible assets should be recognised as an asset
- Describe when expenditure on intangible assets must be expensed
- Explain how to account for research and development expenditure
- Understand how to account for business combinations
- Describe that control, and not legal form, is the criterion for determining whether or not to consolidate an entity
- Explain what control means, and be able to explain what factors should be considered in determining the existence of control
- Understand the reasons for preparing consolidated financial statements
- Explain the basics involved in preparing consolidated financial statements
- Use a consolidation worksheet to perform relatively simple consolidations (Using Excel Spreadsheet)
- Provide the journal entries necessary to account for any goodwill or discount that arises on consolidation

Introduction to intangible assets

Intangible assets can be defined as:

- Non-monetary assets without physical substance
- Includes patents, goodwill, mastheads, brand names, copyrights, research and development, and trademarks
- The lack of physical substance does not preclude an item from being considered to be an asset
- Intangible assets, as a category, must be separately disclosed in the statement of financial position

Identifiable vs Unidentifiable Intangible Assets

Identifiable intangible assets

- A specific value can be placed on each individual asset, and they can be separately identified and sold
- For example, brand names, trademarks, research and development, patents, licences, mastheads and copyrights
- Internally generated intangibles (other than those relating to development expenditure, if certain criteria are satisfied) must be expensed as incurred
- 'Internally generated'—if developed within the organization rather than being acquired at cost from an external party

Identifiable vs unidentifiable intangible assets (cont.)

Unidentifiable intangible assets

- Intangible assets that cannot be separately identified and sold
- For example, goodwill
- The recognition of internally generated goodwill is prohibited
- The unidentifiable intangible asset of goodwill is permitted to be recognised for accounting purposes only when it has been externally acquired and not when it has been internally generated (AASB 3)

Exhibit 8.1 Intangible asset note provided in the 2018 Annual Report of Orica Ltd

8. Intangible assets

Consolidated	Goodwill $m	Patents, trademarks and rights $m	Customer contracts and relationships $m	Software $m	Other $m	Total $m
2018						
Cost	2,526.2	365.4	67.4	502.3	77.9	3,539.2
Accumulated impairment losses	(1,475.9)	–	–	(14.5)	–	(1,490.4)
Accumulated amortisation	–	(96.1)	(67.4)	(166.8)	(20.6)	(350.9)
Net carrying amount	1,050.3	269.3	–	321.0	57.3	1,697.9
Movement						
Carrying amount at the beginning of the year	1,093.3	220.3	–	224.3	39.2	1,577.1
Additions	–	–	–	114.8	23.0	137.8
Disposals	–	–	–	–	(0.2)	(0.2)
Additions through acquisition of entities (see note 15)	116.4	37.0	–	29.4	–	182.8
Amortisation expense	–	(4.9)	–	(29.3)	(10.8)	(45.0)
Impairment expense	(197.0)	–	–	(14.5)	–	(211.5)
Foreign currency exchange differences	37.6	16.9	–	(3.7)	6.1	56.9
Carrying amount at the end of the year	1,050.3	269.3	–	321.0	57.3	1,697.9

Recognition of Intangible Assets in the statement of financial position

AASB 138 Intangible Assets

- Internally generated intangible assets (except internally generated development expenditure) are not to be carried forward as assets

- Specifically, internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets

Recognition of Intangible Assets in the statement of financial position (cont.)

- Intangible assets may be recognised only upon acquisition from an external party and only when there is an associated ‘cost’
- ‘Cost’ to include purchase price (including legal fees, taxes and deducting discounts) and cost involved in getting asset ready for use
- Initial recognition of an intangible asset at an amount other than cost not permitted
- Internally generated intangibles cannot subsequently be recognised through revaluation

Recognition of Intangible Assets in the statement of financial position (cont.)

- Intangible asset must be recognised when:
  - it is probable that the future economic benefits attributable to the asset will flow to the entity
  - cost can be measured reliably
  - there is control over the future economic benefits

Depreciation for intangible asset (same rule as for depreciation of PPE)

Two different situations for intangible assets

If intangible assets have a limited and defined useful life	If intangible assets have an indefinite useful life
AMORTISATION	**NO AMORTISATION**
	Instead we do annual impairment test

So, not all intangible assets are subject to amortisation

Goodwill

Internally generated goodwill

The customer base, efficient management, reliable suppliers, employees' skills, etc. built up over a number of periods by a company

SHALL NOT be recognised as an intangible asset

Purchased goodwill

The customer base, efficient management, reliable suppliers, employees' skill, etc. that are purchased together with the organisation that built it up

CAN be recognised as an intangible asset by the purchasing company

Example: capitalising expenditure on intangible assets

During the financial year Point Leo Ltd made the following expenditures:

a) Point Leo Ltd spent $250,000 promoting the recognition of its brand name;

b) Point Leo Ltd acquired a patent (a right to produce a certain product) for a cost of $400,000; and

c) Point Leo Ltd spent $90,000 acquiring a customer database but after further consideration is not sure that the list will provide very many new customers.

Required:

In relation to the above expenditures, which item will be carried forward to future periods as intangible assets?

Example: capitalising expenditure on intangible assets (cont.)

- Carry forward expenditure on intangible assets
  - where such expenditure represents the acquisition of intangible assets, and
  - Where associated benefits are deemed to be 'probable'.
- Internally generated intangibles- expenditure relating to research, internally generated brands, mastheads, customer lists are not to be recognised as intangible assets.
- The expenditure on:
  - patent would be carried forward as an intangible asset
  - brand name need to be expensed.
  - customer list would be expensed because the associated benefits would not be considered to be 'probable'.

Research and development

- May account for a large proportion of expenditure for some entities
- Accounting problem: will expenditure with reasonable probability provide future benefits?
- All expenditure undertaken on the research component of research and development is to be expensed

Research and development (cont.)

Research

- Considered separately from development
- Generally precedes development
- Defined as:
  - original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding
- ***Development***
- Defined as:
  - application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services prior to the commencement of commercial production or use
  - Typically involves the commercial application of knowledge generated in earlier research phases

Research and development (cont.)

Development examples

- The design, construction and testing of preproduction and models
- The design of tools, moulds and dies involved in new technology
- The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes or systems

Research and development (cont.)

- Expenditure on research shall be recognized as an expense when incurred
- Because entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits.

Research and development (cont.)

Development expenditure can be deferred only if the entity can show all of the following:

- The technical feasibility of completing the intangible asset
- Its intention to complete the intangible asset, and use or sell it
- Its ability to use or sell the intangible asset
- The availability of adequate technical, financial and other resources to complete the development
- Its ability to measure reliably expenditure on the intangible asset during its development

Amortization of deferred development costs

- Where an intangible asset is considered to have limited life, it should be amortized over the period during which the entity is expected to benefit from this expenditure.

Example: Amortisation of research and development

Portsea Ltd is developing a new product called burble. The company spent $300,000 researching the demand of the burble. It then spent $250,000 working out whether compounds out of which burble is made will biodegrade in less than 50 years.

As a result of the knowledge gained in the preceding steps, the company designed machinery to produce the burbles. This design phase cost $600,000. It is expected that millions of burbles will be sold for a least of $10 each. All the expenditure incurred within the one reporting period.

Required:

How much of the above expenditure would qualify to be shown as an intangible asset?

Example: Amortisation of research and development (cont.)

- The first two expenditure would constitute research
  - Hence $550,000 would be expensed as incurred.
- The fund spent designing the machinery would constitute development
  - The future economic benefits are measurable with reasonable accuracy and probable
  - Therefore, $600,000 would be recognised in the statement of financial position.
  - This amount would be subject to future amortisation charges unless it could be justified that the life of the asset was indefinite.

Implication of write off research expenditure

- Major implications for reported profits of entities that are heavily involved in R&D
- Less conservative than US position, where all research and development expenditure must be expensed as incurred regardless of whether or not it generates, or is expected to generate, economic benefits

Disclosure

- AASB 138 requires disclosure for each class of intangibles
- For example
  - brand names
  - mastheads and publishing titles
  - computer software
  - licences and franchises
  - copyrights and patents, services and operating rights
  - recipes formulas models designs and prototypes
  - intangibles under development

Woolworth Ltd. Annual Report 2018, pp. 76-80

3.4 Intangible assets

3.4.1 Carrying amounts of and movements in intangible assets

2018	GOODWILL $M	BRAND NAMES $M	LIQUOR, GAMING LICENSES AND OTHER $M	TOTAL $M
Cost	4,260	251	2,274	6,785
Less: accumulated amortisation	(105)	(1)	(214)	(320)
Carrying amount at end of period	4,155	250	2,060	6,465
Movement:				
Carrying amount at start of period	4,216	256	2,061	6,533
Acquisition of businesses	17	–	18	35
Other acquisitions	–	(1)	6	5
Disposals, transfers and other	(8)	–	(7)	(15)
Amortisation	–	–	(18)	(18)
Effect of movements in foreign exchange rates	(70)	(5)	–	(75)
Carrying amount at end of period	4,155	250	2,060	6,465

SIGNIFICANT ACCOUNTING POLICIES

GOODWILL
Goodwill represents the excess of the cost of an acquisition over the fair value of the share of the net identifiable assets acquired. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses.

OTHER INTANGIBLE ASSETS
Other intangible assets are measured at cost less accumulated amortisation and impairment losses (if any). Where acquired in a business combination, cost represents the fair value at the date of acquisition.

Intangible assets with finite lives are amortised on a straight line basis over their estimated useful lives. Useful lives are reassessed each period. The useful lives of intangible assets have been assessed as follows:

Brand names	Generally indefinite useful life
Liquor and gaming licences	Indefinite useful life
Victorian gaming entitlements	Life of the gaming entitlement (10 years)
Other (primarily customer relationships and property development rights)	Indefinite and finite up to 20 years

IMPAIRMENT
Intangible assets are tested for impairment in accordance with the policy for impairment of non-financial assets disclosed in Note 3.5.

CRITICAL ACCOUNTING ESTIMATES

ESTIMATION OF USEFUL LIFE OF ASSETS
Assessments of useful lives and estimates of remaining useful lives require significant management judgement. Brand names are generally assessed as having an indefinite useful life on the basis of brand strength, ongoing expected profitability and continuing support. Brand names incorporate complementary assets such as store formats, networks and product offerings. Liquor and gaming licences (excluding Victorian gaming entitlements) have been assessed to have an indefinite useful life on the basis that the licences are expected to be renewed in line with ongoing regulatory requirements.

Conclusion

- This topic specifically explains how to account for intangible assets generally, and research and development.
- Intangible assets considered to be non-monetary assets without physical substance and include patents, goodwill, mastheads, brand names, copyrights, research and development, and trademarks.
- General rule is that expenditure associated with internally generated intangible assets (excluding development expenditure) is to be expensed as incurred.
- Development expenditure may be carried forward as an asset to the extent that future economic benefits are deemed probable, and such benefits are measurable with reasonable accuracy.
- The next week's lecture will focus on business combination and accounting for group structure.

Introduction to business combinations

- According to AASB 3, a ***'business combination'*** is defined as:

A transaction or other event in which an acquirer obtains control of one or more businesses

Accounting for business combinations

- The revised standard adopts the ***"acquisition method"***
- Acquisition method requires ***four steps***:

1. Identifying the acquirer;
2. Determining the acquisition date;
3. Recognising and measuring:
   - the identifiable assets acquired, the liabilities assumed; and
   - any non-controlling interest in the acquiree; and
4. Recognising goodwill or a gain from a bargain purchase

Identifying the acquirer

- AASB 3 requires one of the combining entities to be identified as the acquirer.
- An acquirer might ***obtain control of an acquiree*** in a variety of ways. These include:
  - transferring cash, cash equivalents or other assets
  - incurring liabilities
  - issuing equity interests
  - providing more than one type of consideration, or
  - without transferring consideration, including by contract alone

Determining the acquisition date

- AASB 3 identifies the acquisition date
  - *as the date on which the acquirer obtains control of the acquiree*

- Basically, this is the date that acquirer legally transfers the consideration, acquires the assets and assumes liabilities of the acquiree – closing date.

Recognising and measuring the identifiable assets acquired and the liabilities assumed

- At the acquisition date, the acquirer is required to recognise:
  - goodwill separately from the identifiable assets acquired
  - the liabilities assumed, and
  - any non-controlling interest in the acquiree

- By applying the recognition principles it is possible for the acquirer to recognise assets and liabilities that the acquiree had not previously recognised in its own financial statements

Recognising and measuring goodwill

- Goodwill is defined in AASB 3 Business Combinations as:
  - An asset representing future economic benefits arising from assets acquired in a business combination that are not individually identified and separately recognised.
- Goodwill is not individually identified and separately recognised
- The acquirer shall, at the acquisition date:
  - recognise goodwill acquired in a business combination as an asset, and
  - initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised

Recognising and measuring goodwill (cont.)

Fair value of consideration transferred	XXX
plus Amount of non-controlling interest	XXX
plus Fair value of any previously held equity interest in the acquiree	XXX
	XXX
less Fair value of identifiable assets acquired and liabilities assumed	XXX
Goodwill on acquisition date	XXX

Calculated in the manner shown above, the net figure for goodwill will be a positive number. If the number is negative, then rather than it being considered as goodwill, the amount would be considered as a gain on bargain purchase

Consideration transferred

- In a business combination the ***consideration transferred is measured at fair value***.
- The fair value of consideration transferred is calculated as:
  - the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer

Example 1 — Calculation of goodwill on acquisition

On 1 July 2023, Ying Ltd acquired for cash all the issued share capital of Yang Ltd for an amount of $650 000.

On the date of the acquisition, the assets, liabilities and contingent liabilities of Yang Ltd are as follows:

	Carrying amount ($)	Fair value ($)
Cash	15 000	15 000
Accounts receivable	68 000	68 000
Inventory	112 000	131 000
Land	360 000	420 000
Plant	220 000	240 000
Loans payable	(170 000)	(170 000)
Accounts payable	(58 000)	(58 000)
Contingent liabilities	–	(46 000)

Example 1— Calculation of goodwill on acquisition (cont.)

Fair value of consideration transferred			$650 000
Less: Fair value of identifiable assets acquired and liabilities assumed			
	Cash	15 000	
	Accounts receivable	68 000	
	Inventory	131 000	
	Land	420 000	
	Plant	240 000	
	Loans payable	(170 000)	
	Accounts payable	(58 000)	
	Contingent liabilities	(46 000)	
	Total fair value of net assets acquired		$600 000
Goodwill on acquisition date			*$50 000*

Recognising and measuring goodwill (cont.)

- Consistent with the requirements of paragraph 48 of AASB 138 Intangible Assets that internally generated goodwill not be recognised as an asset, no goodwill would be brought to account by Yang Ltd
- Only purchased goodwill, and not internally generated goodwill, is recognised for accounting purposes
- The purchased goodwill will be brought to account by Ying Ltd as part of the consolidation process and will appear in the consolidated financial statements

Goodwill impairment testing

- Goodwill amortisation now prohibited and goodwill is now required to be subject to impairment testing
- After initial recognition, the acquirer is to measure goodwill acquired in a business combination at cost less any accumulated impairment losses
- Goodwill acquired in a business combination is not to be amortised.
- Instead, the acquirer is to test it for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired
- An impairment loss pertaining to goodwill is to be recognised in the profit and loss

Accounting Policy : Business Combinations
Commonwealth Bank Annual Report

- Business combinations are accounted for using the acquisition method. At the acquisition date, the cost of the business is the fair value of the purchase consideration, measured as the aggregate of the fair values of assets transferred, equity instruments issued, or liabilities incurred or assumed at the date of exchange.

- Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured at fair value on the acquisition date.

- Goodwill represents the excess of the fair value of the purchase consideration over the fair value of the Group's share of assets acquired and liabilities and contingent liabilities assumed on the date of acquisition. If there is a deficit instead, this discount on acquisition is recognised directly in the consolidated Income Statement, but only after a reassessment of the identification and measurement of the net assets acquired.

Conclusion

- We explain the background of business combination and basic steps involved in the acquisition method of accounting.
- We also learn how to calculate goodwill on acquisition and explain the impairment testing of goodwill. The next topic will focus on accounting for group structure.

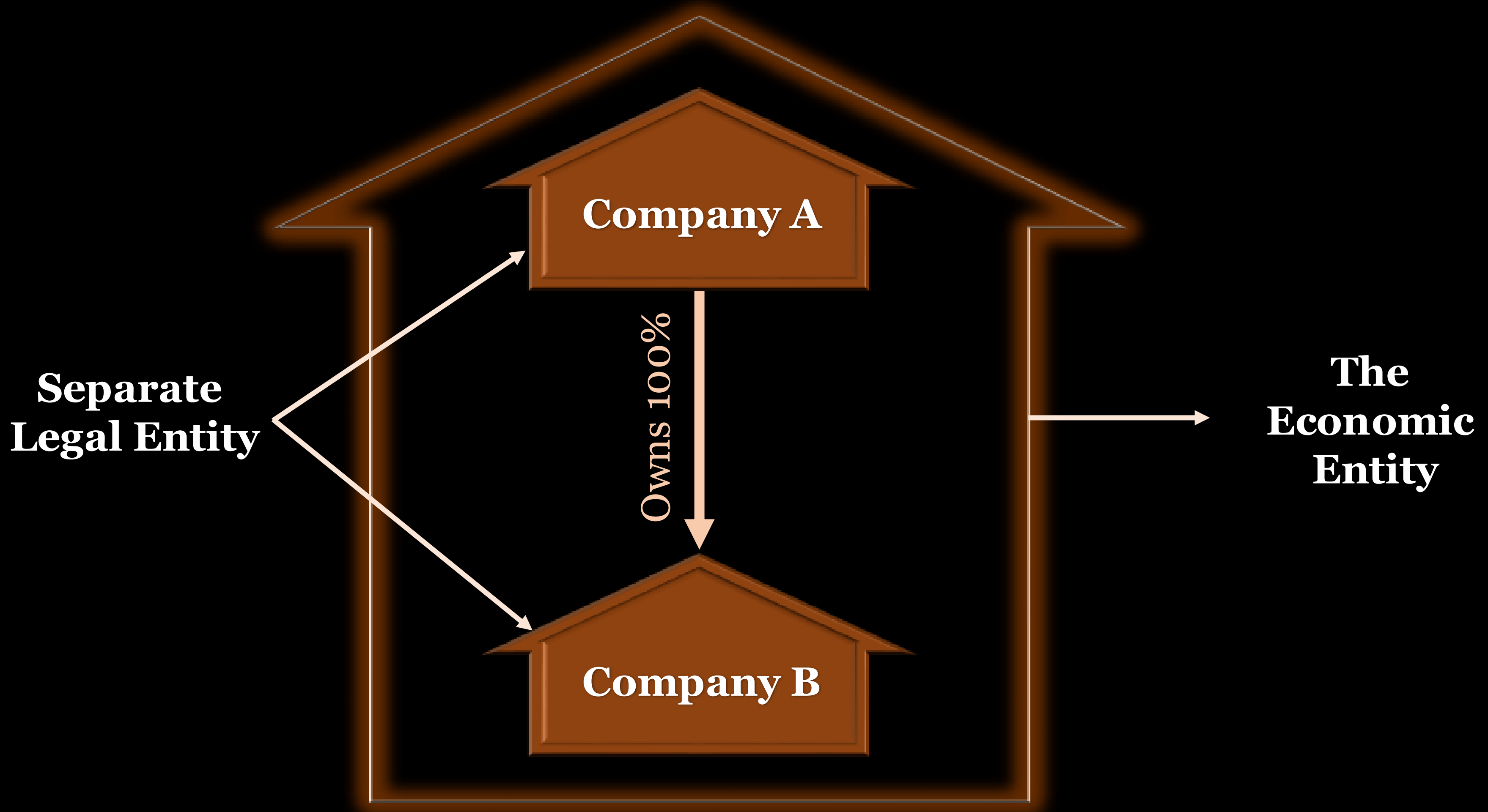
Preparation of Consolidated Financial Statements – Wholly Owned and Controlled Entities

(AASB 10/IFRS 10)

Rationale for consolidating the accounts of different legal entities

- Purpose of providing consolidated financial statements is to show the results and financial position of a group as if it were operating as a single economic entity
- Effects of all intragroup transactions are eliminated
- The consolidated statement of comprehensive income will show the financial results derived from operations with parties external to the group of entities
- The consolidated statement of financial position will show the total assets controlled by the economic entity and the total liabilities owed to parties outside the economic entity

A simple parent and subsidiary relationship



Australian Accounting Standards that govern the preparation of consolidated financial statements (cont.)

AASB 10

- The consolidated financial statements are to include all subsidiaries of the parent

Note per AASB 10

- Even where control is only temporary, the consolidated statements should incorporate the results of a subsidiary (entity controlled by a parent entity) during the time for which control existed, even if this was only for a small part of the year

If control is lost during a period (AASB 10)

- Income and expenses of a subsidiary are to be included in the consolidated financial statements until the date on which the parent ceases to control the subsidiary

Concept of control

- The definitions of ‘control’ and ‘subsidiary’ are central to determining the entities to be consolidated and the nature of the group
- The definition of a subsidiary directly relies upon the concept of ‘control’.
- A subsidiary is defined in AASB 127 as:
  - an entity that is controlled by another entity
- AASB 10 defines control as requiring three elements, these being:
  - power over the investee,
  - exposure, or rights, to variable returns from its involvement with the investee, and
  - the ability to use its power over the investee to affect the amount of the investor’s returns.

Situations in which control might exist

- An investor has power over an investee when the investor has rights to direct the relevant activities
  - i.e. the activities that significantly affect the investee's return.
- A number of situations could lead to control, including:
  - where a majority of voting rights are held by the investor (i.e., the majority of ordinary shares in a company)
  - where less than a majority of the voting rights are held by the investor (but perhaps where the balance of the voting rights are widely dispersed among many different owners)
  - where the investor holds some potential voting rights in the investee

Concept of control (cont.)

- In considering ‘capacity to control’ we must consider potential voting rights
- Potential voting rights are financial instruments that do not in themselves have voting rights but they can potentially be converted into ordinary shares.
  - i.e., share options, preference shares
- An increase in voting rights would increase the potential for an investor to control the investee

Delegated power

- Whether to consolidate an entity is whether any power to be exerted over the entity is being used in the context of an agency relationship, or whether the power is being exercised to benefit the investor directly.
  - The Board decided to base its principal/agent guidance on the thinking developed in agency theory.
  - Jensen and Meckling (1976) define an agency relationship as ‘a contractual relationship in which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.
  - If an entity has power, but is acting under the direction of another entity––perhaps as an ‘agent’ of that other entity–– then control would not be deemed to exist and the entity would not be required to consolidate the entity over which it had power.

Exposure to variable returns

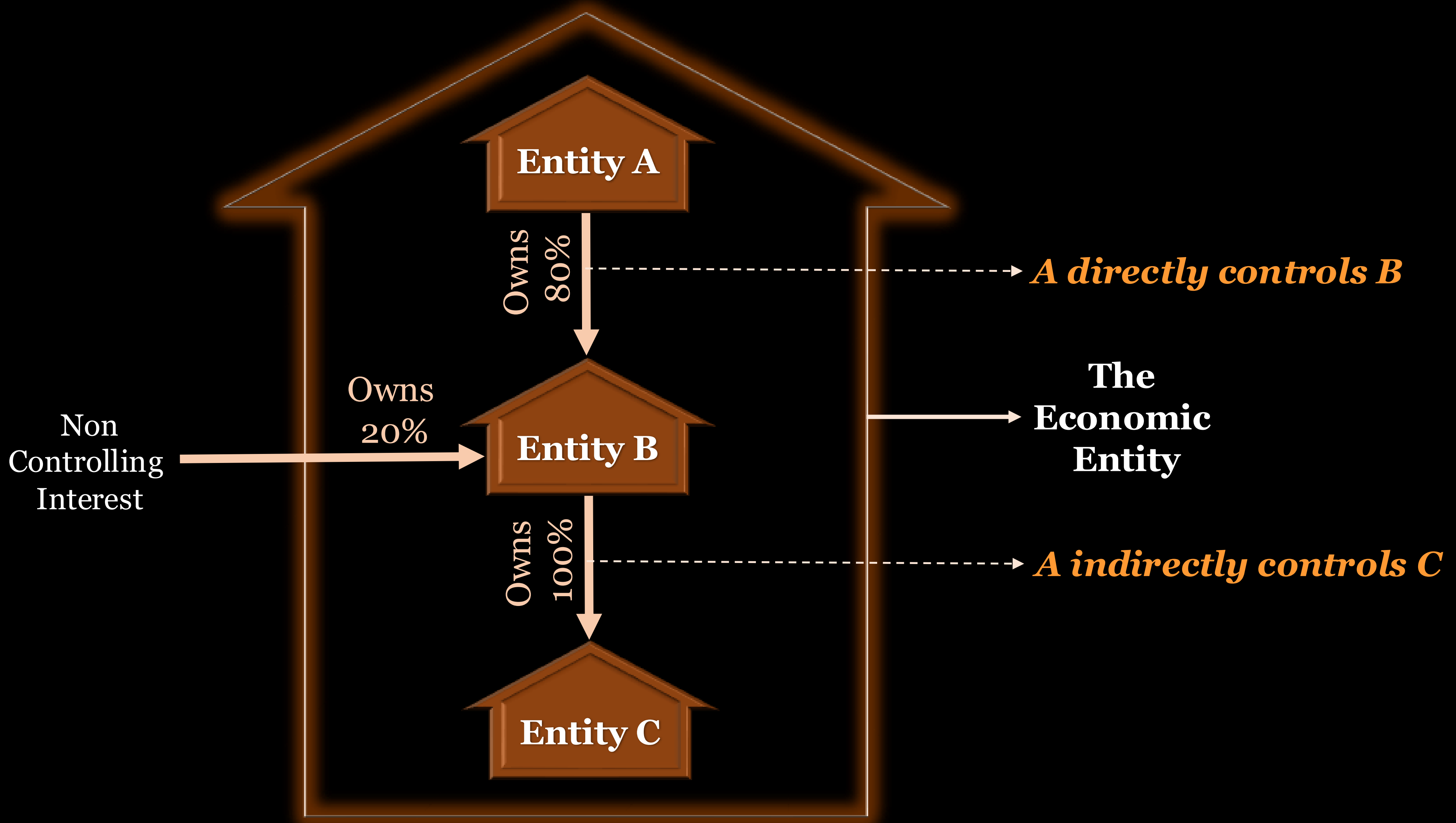
- There is an expectation that the investor will be exposed to variable returns from its involvement with the investee. Specifically, paragraph 15 of AASB 10 states:
  - An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance. The investor's returns can be only positive, only negative or both positive and negative.

  - Ability to influence variable return
    - Investor has the ability to affect those returns through its power over the investee

Direct and indirect control

- Consider the following diagram and consider:
  - Does Entity A control Entity C?
  - Which control would be considered to be direct and which control would be considered to be indirect?
  - What does the non-controlling interest represent?
  - We need to remember that the 'economic entity' comprises the parent entity and all of its subsidiaries, regardless of whether the subsidiary is directly controlled by the parent entity, or indirectly controlled by virtue of an indirect equity interest

Direct and indirect control



Accounting for the consolidation of separate legal entities (cont.)

First step in consolidation process

- Substitute the assets and liabilities of the subsidiary for the investment account, which currently exists in the parent company
- Where the net assets do not equal the value of the investment, this will lead to a difference on consolidation, i.e. the goodwill acquired

Elimination of pre-acquisition shareholders' equity

- The investment account in the subsidiary will be eliminated in full against the pre-acquisition shareholders' funds of the subsidiary
- This will avoid the double counting of assets, liabilities and shareholders' funds of the subsidiary
- Consolidation worksheet used to facilitate consolidation process
- So, a typical consolidation journal entry to eliminate investment in subsidiary would be recorded in a consolidation journal and posted to a consolidation worksheet

- Journal entry

Dr	Share capital
Dr	Retained earnings
Dr	Goodwill
Cr	Investment in Subsidiary Ltd

Example 1—A simple consolidation

Parent Ltd acquires all the issued capital of Subsidiary Ltd for a cash payment of $500 000 on 30 June 2023. The statements of financial position of both entities immediately following the purchase are:

	Parent Ltd ($000)	Subsidiary Ltd ($000)
Current assets		
Cash	10	5
Accounts receivable	150	55
Non-current assets		
Plant	800	500
Land	200	100
Investment in Subsidiary Ltd	500	-
Total Assets	1660	660

	Parent Ltd ($000)	Subsidiary Ltd ($000)
Current liabilities		
Accounts payable	60	30
Non-current liabilities		
Loans	400	150
Shareholders' equity		
Share capital	1000	200
Retained earnings	200	280
Total Liabilities and Equity	1660	660

Example 1—A simple consolidation (cont.)

Required:

Provide the consolidated statement of financial position for Parent Ltd and Subsidiary Ltd as at 30 June 2023.

If we assume that the assets in Subsidiary Ltd are fairly valued, and there are no contingent liabilities to consider, then goodwill acquired by Parent Ltd would be determined as:

Fair value of purchase consideration	\$500 000
Less: Fair value of identifiable assets acquired and liabilities assumed	\$480 000
Goodwill on acquisition	\$20 000

Example 1—Elimination entry

The consolidation entry to eliminate the investment in Subsidiary Ltd would be:

Dr	Share capital	200 000	
Dr	Retained earnings	280 000	
Dr	Goodwill	20 000	
Cr	Investment in Subsidiary Ltd		500 000

(to eliminate investment in Subsidiary Ltd and to recognise the goodwill on acquisition)

- The above entry would be posted to the consolidation worksheet and the final column of the worksheet would provide the information to present the consolidated statement of financial position
- The above entry is not made in the journal of either Parent Ltd or Subsidiary Ltd but rather in a separate consolidation journal, which is then posted to the consolidation worksheet

Consolidation worksheet (Using Excel Spreadsheet)

	Parent Ltd ($000)	Subsidiary Ltd ($000)	Eliminations and Adjustments Dr.	Eliminations and Adjustments Cr.	Consolidated Statement ($000)
Current assets					
Cash	10	5	-	-	15
Accounts receivable	150	55	-	-	205
Non-current assets					
Plant	800	500	-	-	1300
Land	200	100	-	-	300
Investment in Subsidiary Ltd	500	-	-	500	-
Goodwill on acquisition	-	-	*20*	-	*20*
Total Assets	1660	660	-	-	1840
Current liabilities					
Accounts payable	60	30	-	-	90
Non-current liabilities					
Loans	400	150	-	-	550
Shareholders' equity					
Share capital	1000	200	200	-	1000
Retained earnings	200	280	280	-	200
Total Liabilities and Equity	1660	660	500	500	1840

Recognition of gain on bargain purchase

- Formerly referred to as a ‘discount on acquisition’
- Possible (though not common) for a company to gain control of an entity for an amount less than the fair value of the proportional share of the net assets acquired (acquired at a discount)

Recognition of gain on bargain purchase (cont.)

- Where an entity is acquired at a discount AASB 3 (par. 36) requires the following:
  - If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised exceeds the cost of the business combination, the acquirer shall:
    a) 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
    b) recognise immediately in profit and loss any excess remaining after that reassessment

- Pursuant to AASB 127 we are to treat the gain on bargain purchase as part of profit or loss

- Eliminate investment in subsidiary acquired at discount

Journal entry to eliminate

Dr	Share capital
Dr	Retained earnings
Cr	Gain on bargain purchase
Cr	Investment in Subsidiary Ltd

Example 2: Acquisition of a subsidiary at a discount

Assume the same information as in example 1, except that this time Parent Ltd acquires subsidiary Ltd for $400,000.

Fair value of purchase consideration	$400,000
Fair value of net assets acquired	$480,000
Gain on bargain purchases	$80,000

Required:

Provide the consolidation worksheet for Parent Ltd and its controlled entity for the year ending 30 June 2023.

Example 2: Acquisition of a subsidiary at a discount (cont.)

- Gain on bargain purchase need to be included in the profit or loss for the reporting period
- Where Parent Ltd has acquired Subsidiary Ltd for $400,000, the elimination of the investment in Subsidiary Ltd would be recorded as:

Dr	Share capital	200,000	
Dr	Retained earnings	280,000	
Cr	Gain on bargain purchase		80,000
Cr	Investment in Subsidiary Ltd		400,000

(to eliminate the investment in Subsidiary Ltd and to recognize the bargain purchase on acquisition)

Consolidation worksheet

	Parent Ltd	Subsidiary Ltd	Eliminations and Adjustments		Consolidated Statement
	($000)	($000)	Dr.	Cr.	($000)
Current assets					
Cash	110	5	-	-	115
Accounts receivable	150	55	-	-	205
Non-current assets					
Plant	800	500	-	-	1300
Land	200	100	-	-	300
Investment in Subsidiary Ltd	400	-	-	400	-
Total Assets	1660	660	-	-	1920
Current liabilities					
Accounts payable	60	30	-	-	90
Non-current liabilities					
Loans	400	150	-	-	550
Shareholders' equity					
Share capital	1000	200	200	-	1000
Retained earnings	200	280	280	80	280
Total Liabilities and Equity	1660	660	480	480	1920

Subsidiary's assets not recorded at fair values

- If subsidiary's assets not recorded at fair value then adjustments will be required so that a reliable figure for goodwill (or 'gain on bargain purchase') can be calculated
- AASB 3 stipulates either:
  - Revalue the identifiable assets in the accounting records of the subsidiary before consolidation or
  - We would first recognise a revaluation of the non-current assets in the consolidation worksheet and
  - Then eliminate the investment in the subsidiary against the pre-acquisition shareholders' funds of the subsidiary

Subsidiary's assets not recorded at fair values (cont.)

Adjustment on consolidation

- assets to fair value

  Dr Asset

- to revalue Non-current assets

  Cr Revaluation surplus

- to eliminate the investment in the subsidiary, as well as the revaluation reserve created in the previous entry

  Dr Share capital
  Dr Retained earnings
  Dr Revaluation surplus
  Dr Goodwill
  Cr Investment in subsidiary

Example 3: Consolidation where subsidiary's assets are not recorded at fair value

Assume the same information as provided in Example 1, except this time Parent Ltd acquires Subsidiary Ltd for $550,000. At this date, all assets were fairly valued except for land, which had a fair value of $130,000. The tax rate is 30 per cent.

Required:

Provide the journal entries necessary to consolidate Parent Ltd and its controlled entity for the period ended 30 June 2023 assuming Subsidiary Ltd revalued its land.

Example 3: Consolidation where subsidiary's assets are not recorded at fair value (cont.)

If Subsidiary Ltd revalued its land at the date of its acquisition by Parent Ltd, the journal entry in the books of Subsidiary Ltd would have been:

30 June 2023

Dr	Land	30,000	
Cr	Gain on revaluation (in OCI)		30,000

(to revalue the asset to fair value and recognised the associated gain in OCI)

Dr Income tax expense (in OCI)	9,000	
Cr Deferred tax liability		9,000

(to recognise the deferred tax effect associated with the revaluation)

Dr Gain on revaluation (in OCI)	30,000	
Cr Income tax expense		9,000
Cr Revaluation surplus		21,000

- As the revaluation surplus is a part of pre-acquisition reserves of the subsidiary it need to be taken into account when calculating goodwill.

Example 3: Consolidation where subsidiary's assets are not recorded at fair value (cont.)

- Goodwill is calculated to be $49,000.

Share capital	$200,000
Retained earnings	$280,000
Revaluation surplus	$21,000
Total pre-acquisition capital and reserves	$501,000
Fair value of consideration	$550,000
Goodwill	$49,000

The consolidation entry to eliminate the investment in Subsidiary Ltd would be:

30 June 2019

Dr	Share capital	200,000	
Dr	Retained earnings	280,000	
Dr	Revaluation surplus	21,000	
Dr	Goodwill	49,000	
Cr	Investment in subsidiary		550,000

Consolidation after the date of acquisition

- Pre-acquisition shareholders' funds of the subsidiary are eliminated on consolidation
- Typically provides for goodwill on consolidation
- In period following acquisition,
  - subsidiary will generate profits or losses—to the extent that these results have been generated in the period after acquisition, they should be reflected in the results of the economic entity and be included within the consolidated equity
- Post-acquisition earnings (unlike pre-acquisition earnings) are considered to be part of the earnings of the economic entity

Woolworth Annual Report, 2018

Notes to the Consolidated Financial Statements
for the year ended 24 June 2018

1 BASIS OF PREPARATION

1.1 Basis of preparation

Woolworths Group Limited (the 'Company') is a for-profit company which is incorporated and domiciled in Australia. The Financial Report of the Company is for the 52-week period ended 24 June 2018 and comprises the Company and its subsidiaries (together referred to as the 'Group'). The comparative period is for the 52-week period ended 25 June 2017.

The Financial Report was authorised for issue by the directors on 20 August 2018.

The Consolidated Financial Statements are presented in Australian dollars and amounts have been rounded to the nearest million dollars unless otherwise stated, in accordance with ASIC Corporations (Rounding in Financial/Directors' Reports) Instrument 2016/191.

The Consolidated Financial Statements have been prepared on the historical cost basis except for financial assets at fair value through other comprehensive income, derivative assets and liabilities, and certain financial liabilities which have been measured at fair value, as explained in the accounting policies.

The accounting policies have been applied consistently to all periods presented in these financial statements, unless otherwise stated.

The Group has entered into significant new agency arrangements. As a result, the Group has re-presented the comparative period sales for certain legal form agency arrangements, that have historically been presented on a gross basis, as net. That is, the Group's share of an agency sale is recognised as 'revenue from the sales of goods and services' at the time the sale is made.

Certain other comparative amounts have also been re-presented to conform with the current period's presentation to better reflect the nature of the financial position and performance of the Group.

STATEMENT OF COMPLIANCE

The Consolidated Financial Statements of the Group are general purpose financial statements which have been prepared in accordance with the *Corporations Act 2001* (Cth), and Australian Accounting Standards and Interpretations.

Compliance with Australian Accounting Standards ensures that the Financial Report complies with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). Consequently, this Financial Report has been prepared in accordance with and complies with IFRS as issued by IASB.

1.2 Significant accounting policies

This section sets out the significant accounting policies upon which the Group's Consolidated Financial Statements are prepared as a whole and significant accounting policies not otherwise described in the Notes to the Consolidated Financial Statements. Specific accounting policies are described in their respective Notes to the Consolidated Financial Statements. This section also shows information on new accounting standards, amendments and interpretations, and whether they are effective in 2018 or later years.

1.2.1 Basis of consolidation

The Consolidated Financial Statements of the Company incorporate the assets, liabilities and results of all subsidiaries as at 24 June 2018. Subsidiaries are all entities over which the Group has control. The Group controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power to direct the activities of the entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date that control ceases.

Intra-group balances and transactions, and any unrealised gains and losses arising from intra-group transactions, are eliminated in preparing the Consolidated Financial Statements.

Conclusion

- Consolidated financial statements provide a single set of financial statements that represent the financial position and performance of the group as if it were operating as a single economic entity
- ‘Control’ is the determining factor in deciding which organisations should be included in the consolidation process.
- All controlled entities to be included in the consolidation process regardless of legal form and field of activities
- Investment in subsidiary must be offset on consolidation against the pre-acquisition capital and reserves of the subsidiary
- Consolidation entries are to be performed in a separate consolidation worksheet/journal and NOT in the accounts of the separate legal entities
- The next week’s lecture will concentrate on accounting for intragroup transactions.