ACCOUNTING FOR INVESTMENTs

- Under this section we will mainly concentrate on the rest of the following standards
  - IFRS10 and IFRS3, IAS21 in preparation of financial reports of a group
  - IAS 28 to Account for Investment in Associate and Joint ventures
  - IFRS 11 to Account for Joint Arrangements
  - IFRS 12 to Account for disclosure of interests in Other Entities

INTRODUCTION

Many companies make investments by buying shares in other companies. These investments can be at different levels (eg 1%, 10%, 25%, 80%, 100% of the shares of the other company) which give different degrees of "power".

INTRODUCTION CONT…

- Specific accounting methods and requirements have arisen for dealing with these different levels of investment. These are contained in a number of accounting standards.

2 OBJECTIVES

After completing this topic you should be able to:

1. Record an investment in an individual company's own accounts;
2. Describe the deficiencies of individual accounts in dealing with subsidiaries;
3. Outline alternative methods of accounting for subsidiaries and the method required by accounting standards;

This section acts only as an introduction to this topic. More formal definitions, scrutiny of standards and application of techniques will be covered in subsequent lectures on group accounting

3 INITIAL RECORDING OF AN INVESTMENT

An investment arises when one company (the investor) buys shares in another company or undertaking (the investee). The investor is acquiring a new asset and will have to pay for this (the payment is often referred to as the "consideration"). The basic double-entry is:

Dr Investment

Cr Bank (or other form of consideration)

Example 1

Alpha Ltd buys 25,000 TZS 1 ordinary shares of Beta Ltd at TZS 4 each for cash.

This will be recorded in the accounts of Alpha as:

	Dr	Cr
	TZS	**TZS**
Investment in Beta Ltd	100,000	
Bank		100,000

being investment in Beta.

Note that although the nominal value of the shares is TZS1 the price paid for each share is TZS 4. The price that a buyer is willing to pay depends on many factors including:

- The investor’s perceptions of the future
- Prospects of the investee
- The net assets of the investee
- The past trading record of the investee
- Possible synergies between the two parties

If one company pays for the shares in another by issuing new ordinary shares of its own then the credit entry would be to share capital (and usually also share premium).

Assume that Alpha issues 20,000 of its 25p ordinary shares to acquire the 25,000 ordinary shares in Beta (the market value of each Alpha 25p share is £5).

The entry would be:

Dr	Investment	£100,000	
Cr	Share capital		£5,000
Cr	Share premium		£95,000

being issue of ordinary shares to acquire shares in Beta.

- The shares have cost Alpha the same (£100,000) but the cost has been funded by the issue of shares rather than cash. The relevant figure for the investment is £100,000 as that is the value of the shares given by Alpha.
- A combination of types of consideration can be given eg cash, debentures, preference shares, ordinary shares

- The shares in the investee are usually bought from existing shareholders (perhaps through the stock exchange). It is important to realise that the investee's balance sheet is unaffected as the transaction is between the investor and the existing shareholders of the investee. All the investee has to do is record the change in its register of members.

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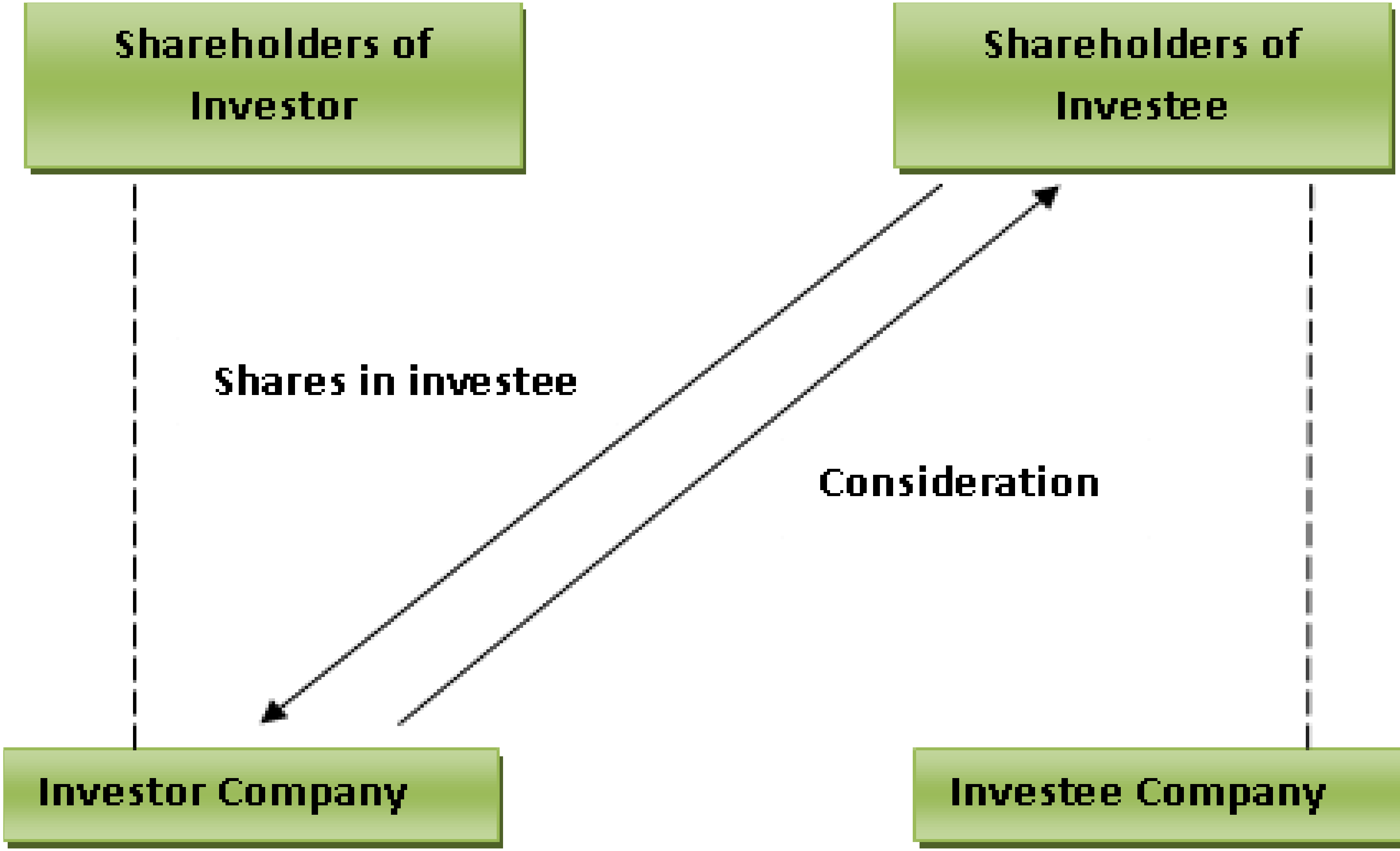
Shareholders of Investor
Shareholders of Investee
Shares in investee
Consideration
Investor Company
Investee Company

Investor buys shares from existing shareholders

Once the investment has been made the investor must decide how to classify it in its balance sheet. If the intention is to retain the investment only for the short term then it should be classified as a current asset investment, otherwise it will be a non-current investment

4 ACCOUNTING IN THE INVESTOR'S OWN ACCOUNTS

Balance sheet – the investment initially is recorded at cost until either it is sold or an impairment occurs when it should be written down. Cost includes directly attributable acquisition costs. The investment can remain at this amount or can be accounted for under IAS 39 i.e. revalued to fair value every year

Profit and loss account – only dividends received and receivable will be included as these are the amounts that are realised from the investor’s point of view. It is prudent to record only dividends actually received, but if a dividend has been declared by the investee but has not been received it would normally be accrued as a dividend receivable.

The treatment below should be adopted in the investor company's own accounts irrespective of the level or the classification of investment in the other company.

The journal entry is:

Dr Bank (for dividends received)

Debtors (for dividends receivable)

Cr Profit and loss – investment income

Being recording of investment income

Example 2

Gamma Ltd owns 100% of the ordinary shares of Delta Ltd. Delta paid a dividend of TZS 65,000 on 15 October 2012 and declared a dividend of TZS 110,000 at 31 December 2012. The directors of Gamma Ltd are confident that the dividend will be paid and have no intention of selling the shares in Delta Ltd.

Required:

What accounting entries will be made by Gamma Ltd for the year to 31 December 2012?

15.10.12		**TZS**	**TZS**
Dr Bank		65,000	
Cr	P/L – investment income		65,000
being dividend received			

31.12.12			
Dr Debtors – dividends receivable		110,000	
Cr	P/L – investment income		110,000
being accrued dividends receivable			

5 INVESTMENTS GIVING CONTROL OR INFLUENCE

Any additional accounting requirements for investments will depend on the relationship between the investor and the investee. The relationship between the two will be determined by the degree of control or influence the investor has over the investee. This is usually linked to the percentage shareholding.

There are four levels or categories of investment:

(i) Ordinary investment

(ii) Investment in an associate

(iii) Investment in a joint venture

(iv) Investment in a subsidiary

(i)Ordinary or simple investment

Where the investor does not exercise **significant influence** over the operating and financial policies of the other entity. This is normally a holding of **less than 20%.**

(ii) Investment in an associate

Where the investor does exercise **significant influence** over the operating and financial policies of the other entity, which is normally through holdings of **20% or more, but less than 50%.**

(iii) Investment in a joint venture

Where the investor **shares control** (through a contractual arrangement) jointly with others.

(iv) Investment in a subsidiary

Where the investor **controls** the operating and financial policies of the other entity, normally through holdings of **more than 50%.**

- **Control** is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. This usually arises through owning over 50% of the voting shares (normally the ordinary shares) in the company. By having the majority of votes a majority of the board of directors can be appointed by the investor and this gives day-to-day control. There are other ways of securing control which are dealt with in a later lectures on group accounting.

- An investor may have **joint control** through a contractual arrangement with one or more other venturers. Here all the venturers will have to agree on key operating and financial policies. No single joint venturer is in a position to control unilaterally the enterprise

- **Significant influence** is the power to participate in the operating and financial policy decisions of entity, but is not control of these. Over time the investee will generally implement policies that are consistent with the strategy of the investor and avoid implementing policies that are contrary to the investor's interests. This degree of influence usually arises from holding between 20% and 50% of the shares of the other entity. The investor usually has at least one representative on the board of the investee.

6 REQUIREMENT FOR ADDITIONAL INFORMATION

- Most investments held by commercial companies are in subsidiaries. As mentioned above, a **subsidiary** is controlled by the investing company which is referred to as the **parent** or **holding company**. In this situation it is possible for the directors of the parent to effectively hide significant information from the shareholders.

7 LEGAL AND PROFESSIONAL REQUIREMENTS FOR GROUP ACCOUNTS

A group is a parent and all its subsidiaries.

The problem of accounting for groups only arose when businesses started operating as groups. This occurred firstly in the USA and around the time of the First World War in the UK. Nobel Industries (the forerunner of ICI) in 1920 was the first company in the UK to draw up a consolidated balance sheet. The Stock Exchange required the publication of consolidated accounts for new issuers of shares in 1939. The first legislative requirement was in 1947 and successive Companies Acts have continued and extended the requirements. Current statutory requirements are in the CA 1985.

- A parent adopting IAS is required by IFRS 10 'Consolidated financial statements,' to prepare consolidated financial statements (with certain exceptions).
- There are a number of other IASs which deal wholly or partly with group accounting issue. These include IAS 21, 28, 31 and 39 and IFRS 3. These will be covered in relevent sections.

- IFRS 10 replaces those parts of IAS 27 that relate to consolidated financial statements (IAS 27 revised now concentrates on separate financial statements only), and SIC 12 in its entirety.
- IFRS 10 uses control as the single basis for consolidation, and requires that all 3 of the following are in place in order to establish control and so consolidate an investee:

- **Power over the investee**
  Power is the ability to direct those activities which significantly affect the investee's returns. It arises from rights, which may be straightforward (eg through voting rights) or complex (eg through one or more contractual arrangements).
- **Exposure, or rights, to variable returns from involvement with the investee**
  Returns must have the potential to vary as a result of the investee's performance and can be positive, negative or both.
- **The ability to use power over the investee to affect the amount of the investor's returns.**

- When assessing whether control exists, an investor with decision making rights should establish whether it is acting as a principal or agent of other parties. An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

- Where an investee is controlled, it is consolidated. IFRS 10 guidance on the consolidation process does not differ from that given by IAS 27 (2008). In other words:

- The parent company should prepare consolidated financial statements using uniform accounting policies;
- Like items of the parent’s and subsidiaries’ assets, liabilities, equity, income and expenses are combined;
- The carrying amount of the parent’s investment in each subsidiary and the parent’s portion of equity of each subsidiary is offset, with any related goodwill accounted for in accordance with IFRS 3;

- Intra-group assets, liabilities, equity, income, expenses and cash flows are eliminated in full, as are any unrealised profits;
- Non-controlling interests are presented within equity;
- Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are accounted for within equity
- Where control is lost, a gain or loss on disposal arises, and the carrying value of any remaining investment is revalued to fair value.

Why consolidated accounts?

IFRS10
Consolidated Financial Statements

Users of the financial statements of a parent are usually **concerned with**, & need to be informed about, the financial position, results of operations & changes in financial position of the **group as a whole**. This need is served by consolidated financial statements, which present financial info about the group as that of a single enterprise without regard for the legal boundaries of the separate legal entities.

- In December 2003, the IASB amended and renamed IAS 27 with a new title—***Consolidated and Separate Financial Statements***. The amended IAS 27 also incorporated the guidance contained in two related Interpretations (SIC-12 *Consolidation-Special Purpose Entities* and SIC-33 *Consolidation and Equity Method—Potential Voting Rights and Allocation of Ownership Interests*).

- In June 2008, the IASB amended IAS 27. This amendment, which related to accounting for
- non-controlling interests and the loss of control of subsidiaries, was done in conjunction with amendments to IFRS 3 ***Business Combinations***.

- In May 2011 the IASB issued IFRS 10 ***Consolidated Financial Statements*** to replace IAS 27.
- IFRS 12 *Disclosure of Interests in Other Entities*, also issued in May 2011, replaced the disclosure requirements in IAS 27. IFRS 10 incorporates the guidance contained in two related Interpretations (SIC-12 *Consolidation-Special Purpose Entities* and SIC-33 *Consolidation*).

- **In June 2012**, IFRS 10 was amended by *Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* (Amendments to IFRS 10, IFRS 11 and IFRS 12). These amendments clarified the transition guidance in IFRS 10. Furthermore, these amendments provided additional transition relief in IFRS 10, limiting the requirement to present adjusted comparative information to only the annual period immediately preceding the first annual period for which IFRS 10 is applied.

EXCEMPETION FROM CONSOLIDATION

- A parent need not present consolidated financial statements if it meets all of the following conditions: [IFRS 10:4(a)]

1. It is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements
2. Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)
3. It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and
4. Its ultimate or any intermediate parent of the parent produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10

General principles

1. **Parent coy** accounts will show investment **at cost to parent**
2. Group accounts will ***instead*** show assets & liabilities acquired **AT MARKET VALUE**
3. Cost of investment likely to be more than market value of individual or identifiable net assets bought
4. Positive goodwill is an asset – shown in group accounts
5. Negative goodwill – not a negative asset, or a liability, but taken to I.S. immediately

6. Shareholders of the parent control the entire group, so only show parent company share capital in group
7. Profits made by subsidiary ***before*** it was acquired were not made by the group – so only parent pre-acquisition reserves shown in group
8. Profits made by subsidiary ***after*** is was acquired were made by the group – so both parent and sub post-acquisition reserves shown in group accounts
9. Goodwill tested for annual impairment

How to calculate fair values

- Tangible assets
  - FV based on market value
  - Depreciated replacement cost if no market value available
- Intangible assets
  - FV based on market value
  - Best arm's-length estimate if no market value

How to calculate fair values (cont)

Inventories

- Finished goods
  - Selling price less cost of sale and reasonable profit
- Work-in-progress
  - Selling price less cost to complete, cost of sale and reasonable profit
- Raw materials
  - Current replacement cost

How to calculate fair values (cont)

- Monetary assets and liabilities
  - Amount to be received or disbursed
  - Discounted if significant

- Marketable securities
  - Current market values
- Non-marketable securities
  - Estimated value based on performance