

**Financial Accounting
ACC/ACF 2100**

Semester 1, 2018

Comprehensive Notes

UNIT SCHEDULE

REGULATION AND FINANCING COMPANY OPERATIONS	- 1 -
CASH FLOW STATEMENTS	- 6 -
ACCOUNTING FOR INCOME TAX	-13 -
PROPERTY, PLANT AND EQUIPMENT	- 21 -
IMPAIRMENT OF ASSETS	- 25 -
BUSINESS COMBINATIONS	- 30 -
CONSOLIDATION	- 37 -
EQUITY ACCOUNTING.....	- 50 -

Financing Company Operations: Journal Entries

2016				
March 31	Cash Trust	Dr	3 900 000	
	Application	Cr		3 900 000
	(Cash received on application: 1.3m sh x \$3)			
April 1	Application (1 200 000 sh x \$3)	Dr	3 600 000	
	Allotment (1 200 000 sh x \$3)	Dr	3 600 000	
	Share Capital	Cr		7 200 000
	(Allotment of shares)			
	Application	Dr	300 000	
	Allotment	Cr		300 000
	(Offset surplus application money)			
	Cash	Dr	3 900 000	
	Cash Trust	Cr		3 900 000
	(Transfer of trust funds)			
April 20	Cash	Dr	3 300 000	
	Allotment	Cr		3 300 000
	(Receipt of allotment money)			
	Share Capital (share issue costs)	Dr	7 000	
	Cash	Cr		7 000
	(Payment of share issue costs)			
June 15	Cash	Dr	1 276 000	
	Share Capital	Cr		1 276 000
	(Private placement of 220 000 sh at \$5.80)			
June 30	Dividend declared (RE)	Dr	213 000	
	Dividend payable	Cr		
	(Declaration of final dividend: 15c x 1.42m sh)			213 000
July 21	Dividend payable	Dr	213 000	
	Cash	Cr		213 000
	(Payment of final dividend)			

Regulation and Financing Company Operations

Financial Accounting

→ ACC2100 focuses on **company accounting**

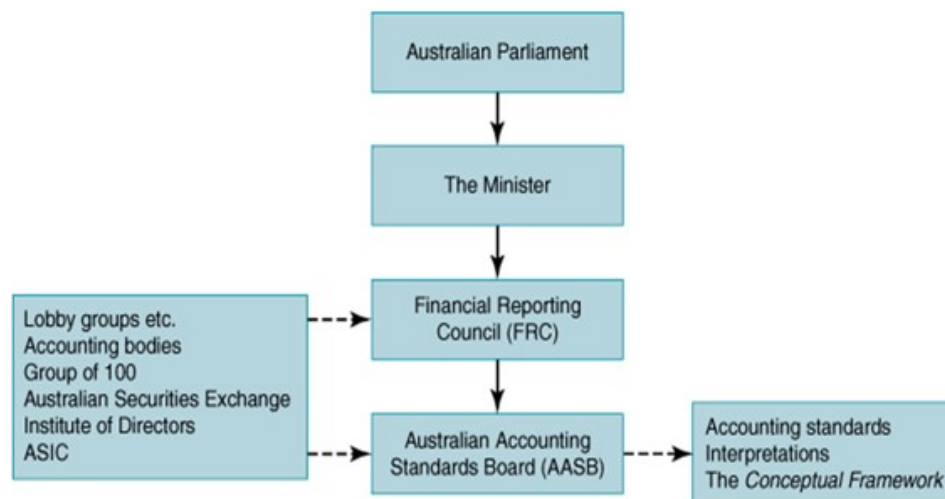
Importance of Companies:

- Companies dominate the **capital** and **product** markets
- Companies operate within a complex web of government and professional **regulation**
- Issuing **financial statements/reports** is part of the **communication** process
- Companies have their own **separate legal existence**
 - Subject to requirements of corporations law
 - Distinguishing feature is **limited liability**

Proprietary company: A company whose shares may not be offered to the public for sale; a **private company**.

- Must have at least 1 shareholder; can have up to 50.

Accounting Regulation



Financial Statements

Which Companies Need to Prepare Financial Statements?

→ **Reporting entities** need to prepare financial statements

Reporting entity: An entity where it is **reasonable to expect the existence** of **users who rely** on General Purpose Financial Reports (GPFR) for **information useful for decision making** (SAC 1).

- e.g. Public companies, large proprietary companies, some small proprietary companies

Objective of Financial Statements

- **Objective (AASB Framework):** To provide **information** to **users** to enable them to make **decisions** about the **allocation of resources**.
- The AASB develops and amends accounting standards, which are used by companies to prepare financial reports

Statutory Functions of the AASB, Under the *Australian Securities and Investments Commission Act 2001*:

- To **develop a conceptual framework** for the purpose of evaluating proposed standards;
- To **make accounting standards** under **Section 334** of the ***Corporations Act 2001***;
- To **formulate accounting standards** for other purposes;
- To participate in and contribute to the **development of a single set of accountings standards for worldwide use**; and
- To **advance and promote the main objects** of **Part 12** of the ***ASIC Act***, which include reducing the cost of capital, enabling Australia entities to compete effectively overseas and maintaining investor confidence in the Australian economy.

Annual Reports

- Financial statements
- Notes to the financial statements
- Director's declaration about the financial statements and notes
- Directors' report
- Auditor's report

Financial Reports

- Reporting entities are required to prepare GPFs in accordance with **Australian Accounting Standards**

Statements Covered in this Unit:

- Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Financial Position
- Statement of Cash Flows

Financing Company Operations

- Public companies can raise funds by issuing **shares** to the public – three types of shares:
 - **Ordinary** shares (**Equity**)
 - **Preference** shares (**Equity or Liability**)
 - **Debentures** (**Liability**)
- Disclosure document (prospectus) is issued
- Accounting treatment begins when money is received from applicants

Issues of Shares

Three ways for shares to be issued:

- **Fully subscribed:** Company receives **as much** money as expected
- **Oversubscribed:** Company receives **more** money than expected
 - Two potential reasons – Too many applicants OR applicants paid too much
 - Excess money can be **refunded** or **held** to offset future amounts payable (as per constitution)
- **Undersubscribed:** Company receives **less** money than expected
 - Company may have to refund all funds collected
 - However, company may enter into an agreement with an **underwriter** to purchase excess shares
 - This avoids having to refund money due to undersubscription
 - Underwriter **buys** remaining shares required and charges a **commission**
- The costs of underwriting and issuing shares are treated as a **reduction in equity (share capital)**
- Money received from applications are placed in a **trust account**
 - When shares are issued, money is transferred to company's bank account (or refunded from trust account to unsuccessful applicants)

Accounting for Issues of Shares

Accounts Used in Issues of Shares:

- Cash (**DR**)
- Cash Trust (**DR**)
- Application (**CR**)
- Allotment (2 or more instalments) (**DR**)
- Call (3 or more instalments) (**DR**)

Dividends

- Dividends represent a **distribution of profits** to the shareholders of the company
- Dividends can only be **paid from profits** (retained earnings)
- Power to declare dividends at any time rests with directors
- Dividends may be in the form of **cash, bonus shares** or **assets**

Accounting for Dividends

Interim Dividends:

- Declared and paid part-way through the financial year
- Not a legal debt

Dr Retained Earnings (Dividend Paid) XX

Cr Cash XX

(Payment of interim dividend)

- Note: "**RE**" can be used for **Retained Earnings**

Final Dividends:

- **Liability recorded when declared** and when **not subject to further approval**

Dr Retained Earnings (Dividend Declared) XX

Cr Dividend Payable XX

(Declaration of final dividend)

Dr Dividend Payable XX

Cr Cash XX

(Payment of final dividend)

Subsequent Issues of Shares:

Rights Issue:

- Existing shareholders have the **right to buy additional shares** in proportion to their current shareholding e.g. 1 for 5
- Issue price is usually **<** current market price
- Can be **renounceable** or **non-renounceable**
 - **Renounceable rights issue:** Shareholder can **take up** the rights issue, let it **lapse**, or **sell** it
 - **Non-renounceable rights issue:** Shareholder **cannot sell** the rights

Dr Cash XX

Cr Share Capital XX

(Rights issue to shareholders)

Bonus Issue:

- **Issue of shares to existing shareholders** in proportion to current shareholding at **no cost** to shareholders

Dr General Reserve XX
Cr Share Capital XX
(Bonus issue to shareholders)

Private Placements:

- Issue of shares (privately) to **institutional investors**
- **Faster** method of issuing shares
- Restriction – companies only allowed to issue 15% of shares privately each year (to minimise dilution of shares)

Share Options

Share Option: Gives the holder the **right to buy or sell** a certain number of shares by a **specified date** at a **stipulated price**.

- ACC2100 deals with **company-issued share options** – issued at **no cost** to the recipient, or at a **specified price**
- **"Share Options"** account is used when issued at a price

Redeemable Preference Shares

- Preference shares can be classified as equity, liability, or both
 - Depends on whether liability definition is satisfied
 - Consider whether redeemable, cumulative, participating
- **Redeemable preference shares** – Can be redeemed out of **profits**, or from **proceeds of a new issue** of shares
 - Can be redeemed at a **premium**
 - **"Shareholders' redemption"** account is used

Cash Flow Statements

Benefits of Cash Flow Information

- Cash flow information provides **information about the historical changes in cash** (and equivalents) during the period – i.e.:
- **Ability to generate cash:** Ability, certainty and timing
 - **Evaluating financial structure:** Staying liquid and solvent while meeting obligations and paying dividends
 - Understanding **reasons for the difference between profit/(loss) and net cash flow from operations**
 - **Predict future cash flows**
 - **Comparing entities':**
 - Operating performance
 - Present value of future cash flows

Format of the Cash Flow Statement

- ❓ Appendices to **AASB 107** provide examples of acceptable formats
- ❓ Cash flows are classified as being from:
 - **Operating** activities;
 - **Investing** activities; and
 - **Financing** activities
- ❓ **Netting** of cash flows is usually not permitted
- ❓ Certain individual cash flows must be disclosed as **separate** line items:
 - **Interest** and **dividends** received or paid
 - **Tax** paid
- **Operating cash flows** – May be reported using either:
 - **Direct method** – Discloses classes of gross cash receipts and payments
 - **Indirect method** – Discloses:
 - Classes of gross cash receipts and payments
 - Non-cash items
 - Items relating to investing or financial activities (non-operating items)
 - The effects of accruals
 - The direct method is encouraged by **AASB 107**

Cash and Cash Equivalents

	Definition	Conditions	Examples
CASH	Cash on hand Demand deposits	None	Notes and coins held in cash box Deposits held by other entities available on demand
CASH EQUIVALENTS	Short-term highly liquid investments	Readily convertible to cash <i>and</i> Short-term investments (normally 3 months or less) <i>and</i> An insignificant risk of changes in value	Bank bills Non-bank bills Deposits on short-term money market

Classifying Cash Flows

- ❓ **AASB 107** requires that all cash flows be classified into the categories of **operating**, **investing** and **financing** activities

Operating Activities (O): Relate to the **principal revenue-producing activities** of an entity.

- Include the production, sales and delivery of the company's product as well as collecting payment from its customers – this could include purchasing raw materials, building inventory, advertising and shipping the product

Investing Activities (I): Relate to the **acquisition and disposal of long-term assets** and **other investments** not included in cash equivalents.

- Include purchases or sales of assets (assets can be land, building, equipment, marketable securities, etc.), loans made to suppliers or received from customers, payments related to mergers and acquisitions and dividends received

Financing Activities (F): Relate to **changes in the size and composition of the contributed equity** and **borrowings** of the entity.

- Include the inflow of cash from investors, as well as the outflow of cash to shareholders as dividends as the company generates income
- Other activities which impact the long-term liabilities and equity of the company are also listed in the financing activities

Interest and Dividends

- ❓ **AASB 107** **does not prescribe** how interest and dividends should be classified (i.e. O/I/F), but does require them to be separately disclosed and classified consistently across periods

📖 Textbook approach:

- Interest received – Investing
- Interest paid – Operating
- Dividends received – Investing
- Dividends paid – Financing

Operating Activities

Operating Activities: The principle revenue-producing activities of an entity.

→ Includes:

- Cash inflows from:
 - Sale of goods / rendering of services
 - Royalties, fees, commissions
 - Interest received (may be investing)
 - Dividends received (may be investing)
- Cash outflows to:
 - Suppliers and employees for goods and services
 - Government for income taxes
 - Lenders for interest (may be financing)

Investing Activities

Investing Activities: Activities involving the acquisition/disposal of long-term assets and other investments.

→ Includes:

- Cash inflows from:
 - Sale of non-current assets (PPE, intangibles, share investments)
 - Repayment of loans advanced to other parties
 - Interest received (may be operating)
 - Dividends received (may be operating)
- Cash outflows to:
 - Acquire non-current assets (PPE, intangibles, share investments)
 - Lend money to other parties

Financing Activities

Financing Activities: Activities that result in **changes to equity capital** and **borrowings**.

→ **Includes:**

- **Cash inflows from:**
 - Issuing shares and other equity instruments
 - Issuing debentures and other borrowings
- **Cash outflows to:**
 - Buy back shares
 - Redemption of preference shares
 - Repay debentures and other borrowings
 - Pay dividends (may be operating)

Preparing the Cash Flow Statement

🔍 Techniques to compile cash flow information:

- **Cash books / cash records approach**
 - **Identifies cash flows directly from the information stored** in the accounting system for cash transactions
 - Requires a **detailed analysis of the cash book entries** or cash records of the entity relating to the reporting period
- **Reconstruction of accounts approach**
 - Derives the cash flows indirectly from the **accrual accounting data**
- **Statement of financial position approach**
 - Derives the cash flows indirectly from the **accrual accounting data**.

Reconstruction of Accounts Approach

→ Identifies cash flows by **reconstructing certain statement of financial position accounts**

Steps:

1. **Record the opening and closing balances** of the account
2. Include the entries in the account that relate to **non-cash transactions and events** for the period

3. **Determine the missing item** in the account – the cash necessary to arrive at the closing balance

🔗 Formulae can be used as an alternative for some accounts

🔗 For example, to calculate the cash flows from:

○ **Operating activities:**

- Cash receipts from customers → **Accounts Receivable** T account
- Cash paid to suppliers → **Inventory** and **Accounts Payable** T account
- Cash paid to employees → **Provision for Employee Benefits** T account
- Cash paid for other operating expenses → Other accrual accounts such as **Prepayments** or **Expenses Payable**

○ **Investing activities:**

- Purchase of equipment → **Plant and Equipment** T account
- Proceeds on sale of equipment → **Sale of Equipment** T account
- Purchase of investments → **Investments** T account
- Interest received → **Interest Receivable** T account

○ **Financing activities:**

- Dividends paid → **Retained Earnings** T account

Additional Issues

🔗 **Sales revenue:** Reflects sales made during the year **irrespective of whether the customers have paid** for the sale

🔗 **Cash received in current year:** **Includes sales made in the prior year** that are not collected until the current year and **excludes sales made in the current year** where the cash will be received in a future year

○ Therefore, the cash flows are determined with reference to the movement in **Accounts Receivable**

○ Other factors affecting the **Accounts Receivable** account include:

- Settlement discounts given to customers
- Bad debts written off during the period

🔗 **Payments to suppliers:** Reflects payments made during the year for:

- **Inventory** purchases
- All other **supplies and services** purchased

- **Includes:**
 - Payments for prior year purchases
 - Current year (pre)payments that will be expensed in future years
- **Excludes:**
 - Current year purchases where the cash will be paid in a future year
 - Expenses recognised in the current year that were (pre)paid in prior years
- Payments to suppliers is often calculated in two steps:

1. Payments inventory

- Determined by reference to the movement in **Accounts Payable**
- Need to consider **settlement discounts** given by suppliers

2. Payment for all other supplies and services

- Determined by **identifying expenses** in the Income Statements and adjusting for the effect of movements in prepayment and accrual accounts during the year
- **If movement in SOFP is DR – Add** to expenses
- **If movement in SOFP is CR – Deduct** from expenses

? Cash purchases of non-current assets

- Include effects of **valuation adjustments** and **impairments**

• Dividends paid in the current year – May include:

- **Interim** dividend paid this year
- **Final** dividend declared from previous period that is paid this year

? Income tax paid

- Determined from **income tax expense** and **changes in current tax liability and deferred tax asset**

Reconciliation of Profit to Net Cash from Operating Activities

? Under the indirect method, profit/(loss) is adjusted for:

- **Non-cash items – Depreciation or amortisation** expenses
- **Non-operating items –** Gain or loss from **sale** of plant and equipment
- **Changes in accrual assets and liabilities for the period – Accounts receivable, accounts payable and inventory**

Example:

	2017
Profit for the period	\$39 000
Add: Non-cash expenses:	
Depreciation – plant and equipment	20 000
Add/(Less): Non-operating items	
Loss on sale of equipment	2 000
Interest revenue	(1 000)
Add/(Less): Changes in accrual assets and liabilities	
Increase in accounts receivable	(9 000)
Decrease in inventories	2 000
Decrease in prepayments (insurance)	2 000
Increase in accounts payable	6 000
Increase in wages and salaries payable	2 000
Decrease in other expenses payable	(1 000)
Net cash from operating activities	<u>\$62 000</u>

Note Disclosures

- ❑ Additional information is required to be disclosed in the notes attached to the statement of cash flows
 - Note to **reconcile cash and cash equivalents** to items in the Statement of Financial Position
 - Note disclosing details of the **acquisition or disposal of businesses**
 - Note disclosing **non-cash financing and investing activities**

Limitations of the Cash Flow Statement

- ❑ **Earnings vs net cash flows** from operating activities
- ❑ **Only past cash flows** are reported, which may not be a good predictor of future cash flows
- ❑ **Non-cash transactions and events excluded**, although relevant to financial affairs of the entity
- ❑ **Liquidity/solvency evaluation not adequately addressed**
- ❑ May be subject to **management manipulation**
- ❑ **Difference across companies** in classification of cash equivalents
- ❑ **Costly to convert accrual accounting data** required using direct method
- ❑ **Disclosure in the notes**
- ❑ Direct method of determining cash flows from operating activities **costlier** to apply than indirect method

Accounting for Income Tax

Accounting for Income Tax

Income tax: Amount paid to the government.

- Amount of company tax payable in Australia is currently **30% of taxable profit** (NOT accounting profit)
- Income tax expense is not merely equal to the current tax liability, but is also a function of the company's **deferred tax liabilities and assets**

Income Tax in the Financial Reports

- **Statement of financial position**
 - Disclose current tax and deferred tax balances
- **Statement of profit or loss and comprehensive income**
 - Income tax expense (includes current and deferred tax)
- **Current/deferred tax recognised directly against equity**
 - e.g. Deferred tax on the revaluation of land

Difference Between Accounting and Income Tax Treatments

Item	Accounting	Income Tax
Basis for treatment	Accruals basis	Principally cash basis
Profit	Revenue - Expenses = Accounting Profit <i>AASBs</i> and the <i>Corporations Act</i> determine the appropriate accounting treatment of transactions	Taxable Income (TI) - Tax Deductions (TD) = Taxable Profit The <i>Income Tax Assessment Act</i> determines the tax treatment of transactions
Employee benefits e.g. annual leave (or Provisions e.g. for warranties)	Liability recognised and expense accrued when debt owed to employees	Recognised as TD when leave is paid to employees
Prepaid expenses e.g. insurance, rent, interest, royalties	Recorded as an asset when pre-paid and expensed as incurred	Recognised as TD when paid
Cash received in advance of services	Liability recognised for unearned revenue and then allocated to revenue as services are performed	Recognised as TI when cash received

Bad/doubtful debts	Allowance is contra asset and expense recorded when debt is doubtful	Recognised as a TD when debts are written off as bad
Fines, penalties and entertainment costs	Recognised as an expense when payable	Not deductible
Depreciation of a depreciable asset	Recognised as expense based on useful life of asset	Recognised as TD based on pre-determined rates Common for assets to be depreciated over a shorter life for tax purposes
R&D costs (expense)	Recognised as an expense based on the amount of the expenditure	Concessional deduction allowed equal to 125% of the expenditure
Development costs (intangible asset)	Capitalised (asset) and amortised	Recognised as TD when paid
Tax losses	No recognition Subject to conditions e.g. reduced by exempt income	Carried forward and offset against future TI

- All of these differences can have:
 - **Current** tax consequences
 - **Deferred** (future) tax consequences

→ **Taxable income ≠ Accounting income**

- Accounting income **not received is not taxable**
- Some income is **exempt** from tax

→ **Taxable deductions ≠ Accounting expenses**

- Accounting and tax depreciations **rates may differ**
- Some expenses are not deductible
- Some expenses are not deductible until a future period

Current Tax Consequences

- Taxable profit may be greater/less than accounting profit, resulting in higher/lower tax payments

Current Tax Worksheet

- Using a current tax worksheet, we make **adjustments** to accounting profit (or loss) to allow for differing treatments of revenue and expense items recorded during the year, to **calculate taxable profit** and **current tax liability**

Reconciling Items	Adjustment to Profit Before Tax
1. Revenues or gains that are not equal to assessable incomes	Subtract
2. Expenses or losses that are not equal to deductions	Add back
3. Assessable incomes that are not equal to revenues or gains	Add in
4. Deductions that are not equal to expenses or losses	Subtract

- **ACC2100** does not cover the "condensed" worksheet

→ **Taxable Profit x Tax Rate = Current Tax Liability**

→ **Dr Income Tax Expense XX**
Cr Current Tax Liability XX
(Recognition of current tax liability)

Prior Period Tax Adjustments

- Income tax returns often completed with a **time lag** relative to financial reports
- This means that tax payable may be greater or smaller than the current tax liability recorded (under or over provision)
- It must be worked out **what caused the difference** and adjust the appropriate amounts
 - Current and/or deferred tax amounts

Payment of Income Tax

- Company income tax is paid under the **PAYG (pay as you go)** system in quarterly instalments
- Companies must lodge quarterly **business activity statements (BAS)** and pay tax based on the "instalment rate"
- **Current tax liability** represents the last quarterly payment (i.e. amount owing at year end), so any tax paid for previous quarterly instalments must be taken into account

Income Tax Losses

- **Tax losses are created when: Tax deductions > Taxable income + Exempt income**
- The **ITA Act** allows tax losses to be **carried forward and used as a deduction** against future taxable profit

- Tax losses provide future deductions and (subject to recognition criteria) create **Deferred Tax Assets (DTA)**

Dr Deferred Tax Asset XX
Cr Income Tax Expense XX
(Recognition of deferred tax asset)

- **Exempt income** cannot contribute to carry forward losses
 - e.g. If tax loss is \$10,000 and exempt income is \$2,000, the allowable carry forward tax loss would be \$8,000
- **Recognition of DTA from tax losses** is required if future taxable profits are probable
 - Strong evidence that taxable profits are **soon to emerge**
 - Usually requires **taxable temporary differences**
- Recoupment occurs when **taxable profit is earned**
- Recovery of tax loss **reduces taxable profit**
- **Reduce DTA** when tax loss recovered

Dr Income Tax Expense XX
Cr Deferred Tax Asset XX
(Recovery of tax loss)

Deferred Tax Consequences

Deferred Tax Consequences: Arise when the **period in which revenue and expenses are recognised** for **accounting** is **different** from the period in which items are recognised for **tax**.

- Principally due to the **accruals vs cash** basis of recognising transactions
- These differences are called **Temporary Differences**

Temporary Differences

AASB 112 – Temporary Difference (TD): The **difference** between the **carrying amount** of an asset or liability in the statement of financial position and its **tax base**.

Two types of temporary differences:

Taxable Temporary Difference (TTD): A temporary difference which result in **taxable amounts in future periods** when the carrying amount of the asset or liability is recovered or settled.

Deductible Temporary Differences (DTD): A temporary difference which result in **amounts that are deductible in future periods** when the carrying amount of the asset or liability is recovered or settled.

Taxable Temporary Differences (TTDs):

- Taxable amounts in future periods higher
- The company will pay **more tax in future periods**
- Recognised as **Deferred Tax Liabilities (DTL)**

→ **TTD x Tax Rate = DTL**

Deductible Temporary Differences (DTDs):

- Deductible amounts in future periods higher
- The company will pay less tax in future periods
- Recognised as **Deferred Tax Assets (DTA)**

→ **DTD x Tax Rate = DTA**

Excluded Temporary Differences:

- Certain temporary differences are **excluded** from being recognised
- **AASB 112** prohibits temporary differences being recognised in relation to:
 - Goodwill
 - Buildings that are not deductible for tax

Calculating Temporary Differences

- The carrying amounts of an entity's assets and liabilities are **different** from the amounts that would arise if a balance sheet was prepared for tax authorities

Carrying Amount (CA): **Asset and liability balances** (net of accumulated depreciation allowances) **based on accounting balance sheet**.

Tax Base (TB): **Asset and liability balances** that would appear in a "**tax balance sheet**" i.e. carrying amount from tax perspective.

- Temporary differences are calculated as:

CA - TB = TTD or DTD

Tax Bases of Assets and Liabilities

Calculating the tax base of an asset:

- **Taxable economic benefits from recovery:**
→ **TB = Deductible amount in future**

- No taxable economic benefits from recovery (e.g. Accounts Receivable):
→ $TB = CA$

Journal Entry:

Dr Deferred Tax Asset XX
Cr Income Tax Expense XX

OR

Dr Income Tax Expense XX
Cr Deferred Tax Asset XX

Calculating the tax base of a liability:

- General rule:
→ $TB = CA - \text{Deductible amount in future}$
- Unearned revenue:
→ $TB = CA - \text{Untaxed future revenue}$

Journal Entry:

Dr Income Tax Expense XX
Cr Deferred Tax Liability XX

OR

Dr Deferred Tax Liability XX
Cr Income Tax Expense XX

Summary of Temporary Differences

	Taxable Temporary Difference TTD x Tax Rate = DTL	Deductible Temporary Difference DTD x Tax Rate = DTA
Assets	$CA > TB$	$CA < TB$
Liabilities	$CA < TB$	$CA > TB$

Deferred Tax Worksheet

Example:

KERRY LTD Deferred Tax Worksheet as at 30 June 2017					
(1)	(2) Carrying amount	(3) Future deductible amount*	(4) Tax base	(5) Taxable temporary differences	(6) Deductible temporary differences
Assets					
Plant (net of accum depn)	\$ 75 000	\$ 50 000	\$ 50 000	\$ 25 000	\$ —
Land – revalued	500 000	220 000	220 000	280 000	—
Accounts receivable	40 000	—	40 000	—	—
Interest receivable	15 000	—	—	15 000	—
Prepaid insurance	9 000	—	—	9 000	—
Development asset	130 000	—	—	130 000	—
Research costs	—	120 000	120 000	—	120 000
Loan receivable	100 000	—	100 000	—	—
Inventory	80 000	80 000	80 000	—	—
Liabilities					
Accounts payable	75 000	—	75 000	—	—
Interest payable	3 000	3 000	—	—	3 000
Fines payable	20 000	—	20 000	—	—
Provision for employee benefits	16 000	16 000	—	—	16 000
Provision for warranty	8 000	8 000	—	—	8 000
Unearned revenue	25 000	25 000	—	—	25 000
Loan payable	170 000	—	170 000	—	—
Temporary differences				\$459 000	\$172 000
Deferred tax liability (30%)				\$137 700	
Deferred tax asset (30%)					\$ 51 600

*Untaxed future revenue rather than deductible amount for the liability of unearned revenue.

Recognition of DTAs:

- Deferred tax assets relating to temporary differences and tax losses are recognised only if:
 - There are **sufficient taxable temporary differences** for the entity to use against the deductible temporary differences; or
 - If it is **probable** that the entity will have **sufficient future taxable profit** (against which the tax benefit can be offset)
- **May reverse over time** e.g. with a decrease in provision for employee benefits

Recognition of DTLs:

- Deferred tax liabilities **must be recognised in full**
- **May reverse over time** e.g. when plant becomes fully depreciated for tax purposes, but not accounting purposes

Example:

	30 June 2017		30 June 2018		30 June 2019		30 June 2020	
	Accounts	Tax	Accounts	Tax	Accounts	Tax	Accounts	Tax
Cost	100 000	100 000	100 000	100 000	100 000	100 000	100 000	100 000
Accum depn	25 000	50 000	50 000	100 000	75 000	100 000	100 000	100 000
Carrying amount	75 000		50 000	—	25 000		—	
Tax base		50 000				—		—
Taxable temporary difference	25 000		50 000		25 000		—	
DTL (30%)	7 500		15 000		7 500		—	

Offsetting Deferred Tax Accounts

- DTAs and DTLs can be **offset against each other** and the **net amount recognised** in the Statement of Financial Position

Example:

Deferred Tax Asset \$5,000

Deferred Tax Liability \$7,000

- Journal entry shows **net balance** of \$2,000

Dr Income Tax Expense 2,000

Cr Deferred Tax Liability 2,000

(Recognition of deferred tax)

Change in Tax Rate

- When a new tax rate is enacted, the new rate is applied:
 - When **calculating current tax liability**
 - When **calculating adjustments** to deferred tax accounts
 - **New Balance = Opening Balance x ((1 – N)/O)**
 - **N** = New Tax Rate
 - **O** = Old Tax Rate
 - To **carry forward deferred tax balances** from previous years

Property, Plant and Equipment

Property, Plant and Equipment: Definition

AASB 116 para. 6 – Property, Plant and Equipment (PPE): Tangible assets that are –

- (a) held for use in the production or supply of goods and services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than one period.

- PPE assets are divided into classes (bundles of assets used for the same function)
- PPE assets are initially measured at cost:
 - Purchase price
 - Directly attributable costs
 - Costs of dismantling
- Depreciation is a systematic process of allocation and must reflect the pattern in which the future economic benefits are expected to be consumed by the entity

Measurement Subsequent to Initial Recognition

- **AASB 116** allows a choice of two possible measurement models:
 1. Cost model
 2. Revaluation model
- **Cost Model:** Measuring the value of assets as the initial amount (cost) of an asset less its accumulated depreciation
- Accounting policy choice of this decision based primarily on relevance of information
- The policy that is chosen must be applied to a whole class of assets i.e. one model per class of assets
- Policy choice can be changed, but only if it results in more relevant/reliable information

The Revaluation Model

- **AASB 116** allows the revaluation model to be used for classes of assets
- Measurement basis is **Fair Value (FV)** – note that this can only be used where a market exists for the PPE
- Frequency of revaluations is not specified

- However, it must be performed with sufficient regularity such that the **carrying amount** of assets is not materially different from their **FV**
- **Revaluation** is performed on a **class basis**
- **Accounting** is performed on an **asset-by-asset basis**
- **Gains from PPE revaluation** go to **OCI** and straight to **Equity**
- **Losses from PPE revaluation** go to **P/L Statement** – to satisfy **Conservatism** accounting principle

Four Aspects of the Revaluation Model

1. Revaluation increases
2. Revaluation decreases
3. Reversing previous decreases
4. Reversing previous increases

Revaluation Increases

Preliminary Step: Before recording the revaluation, **ensure that all depreciation is recorded** for the PPE item up until the current date

Step 1: **Write off** accumulated depreciation

Dr Accumulated Depreciation XX

Cr *PPE Item* XX

(Removal of existing accumulate depreciation prior to revaluation)

Step 2: **Record the revaluation increase** in **Other Comprehensive Income (OCI)**

Dr *PPE Item* XX

Cr Gain on Revaluation – OCI XX

*(Revaluation of *PPE Item* to fair value)*

Step 3: Record the **tax effect** of the revaluation

- When the CA of an asset is **increased**, a **TTD** is created, because $CA > TB$
- In this case, a **DTL** must be recorded

Dr Income Tax Expense – OCI XX

Cr Deferred Tax Liability XX

(Tax effect of revaluation gain (Gain on Revaluation x Tax Rate))

Step 4: Transfer the **net gain to equity**

Dr Gain on Revaluation – OCI XX
Cr Income Tax Expense – OCI XX
Cr Asset Revaluation Surplus – *PPE Item* XX
(Accumulation of net revaluation gain in equity)

Revaluation Decreases

Preliminary Step: Before recording the revaluation, **ensure that all depreciation is recorded** for the PPE item up until the current date

Step 1: **Write off** accumulated depreciation

Dr Accumulated Depreciation XX
Cr *PPE Item* XX
(Removal of existing accumulate depreciation prior to revaluation)

Step 2: **Record the revaluation decrease** as an **expense** in **Profit and Loss**

Dr Loss on Devaluation – P&L XX
Cr *PPE Item* XX
(Devaluation of plant to fair value)

Step 3: Record the **tax effect** of the revaluation

- When the CA of an asset is **decreased**, a **DTD** is created, because $CA < TB$
- In this case, a **DTA** must be recorded, but in the **deferred tax worksheet only**, as the tax effect relates to P/L (not OCI)

Record tax effect in tax worksheets

Reversing Previous Decreases

Preliminary Step: Before recording the revaluation, **ensure that all depreciation is recorded** for the PPE item up until the current date

Step 1: **Write off** accumulated depreciation

Dr Accumulated Depreciation XX
Cr *PPE Item* XX
(Removal of existing accumulated depreciation prior to revaluation)

Step 2: **Record the increase** by reversing the previous decrease (limit = previous decrease)

Recording gain on revaluation:
Dr *PPE Item* XX
Cr Gain on Revaluation – P&L XX
(Revaluation of plant to fair value)

Reversing tax effect:
Record tax effect in tax worksheets

Step 3: Record any increases beyond the previous decrease – this is accounted for in the same way as an initial increase

Record additional increases using Steps 2-4 under "Revaluation Increases"

Reversing Previous Increases

Preliminary Step: Before recording the revaluation, ensure that all depreciation is recorded for the PPE item up until the current date

Step 1: Write off accumulated depreciation

Dr Accumulated Depreciation XX
Cr *PPE Item* XX
(Removal of existing accumulated depreciation prior to revaluation)

Step 2: Record the decrease by reversing the previous increase (limit = previous increase)

Recording devaluation:
Dr Loss on Devaluation – OCI XX
Cr *PPE Item* XX
*(Devaluation of *PPE Item* to fair value)*

Reversing tax effect of OCI component of revaluation:
Dr Deferred Tax Liability XX
Cr Income Tax Expense – OCI XX
(Tax effect of devaluation loss)

Transferring previous gain from equity:
Dr Income Tax Expense – OCI XX
Dr Asset Revaluation Surplus – *PPE Item* XX
Cr Loss on Revaluation – OCI XX
(Removal of net revaluation gain from equity)

Step 3: Record any decreases beyond the previous increase – this is accounted for in the same way as an initial decrease

Record additional increases using Steps 2-3 under "Revaluation Decreases"

Impairment of Assets

- Entities are required to conduct impairment tests to **ensure their assets are not overstated**
- An **impairment loss** results when **Carrying Amount (CA) > Recoverable Amount (RA)**
- Recovery can be from:
 1. **Disposal** of the asset; or
 2. **Future use** of the asset
- **Not all assets** require this test – exclusions include:
 - Inventories
 - Deferred tax assets (DTAs)
 - Assets held for resale
 - The specific requirements in relation to these assets are covered in the **AASBs** that deal with these balances

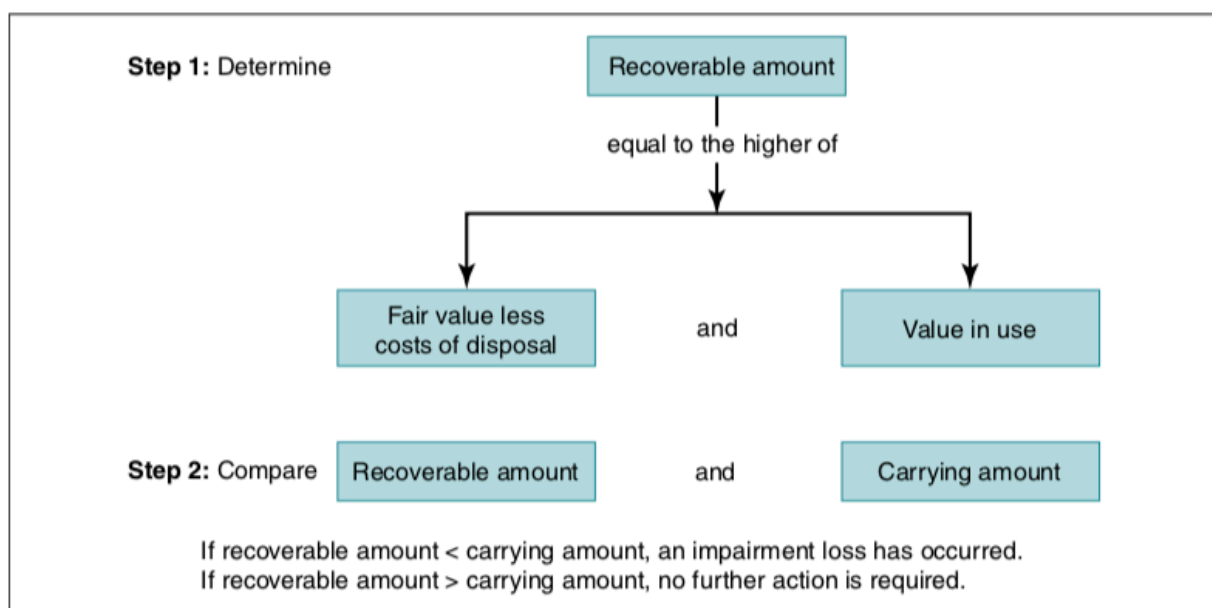


Figure 13.2 The impairment test

When to Undertake an Impairment Test

- For most assets it is **not necessary** to conduct impairment tests every year
- Assets must be tested for impairment when there is an **indication (or evidence) of impairment**
- The following assets must be tested **annually** for impairment, as they are more likely to be overstated:

- Intangibles with indefinite useful lives
- Intangibles not yet available for use
- Goodwill acquired in a business combination

Impairment Test for an Individual Asset

Step 1 – Determine Recoverable Amount:

Recoverable Amount = Higher of Fair Value less Costs to Sell and Value in Use

Step 2 – Compare Recoverable Amount and Carrying Amount:

- If $RA < CA$: **Impairment loss** has occurred
- If $RA > CA$: **No further action** is required
- As per above, an impairment loss is recognised where $CA > RA$
 - Where RA is the higher of FV-CD and VIU
- **Cost Model:** Where the asset is accounted for under the cost model, the **impairment loss is recognised immediately in profit or loss**
- **Revaluation Model:** Where the asset is accounted for under the revaluation model, the **impairment loss is treated as a revaluation decrease**

Cost Model

Dr Impairment Loss XX

Cr Accumulated Depreciation & Impairment Loss XX

- **Note:**
 - We **do not reverse the balance of Accumulated Depreciation**
 - This **account is renamed Accumulated Depreciation & Impairment Loss**

Impairment of Cash-Generating Units (CGUs)

CGUs Excluding Goodwill

- Many individual assets **do not generate cash inflows in their own right** e.g. a machine in a factory works in conjunction with the other assets in the factory
- Therefore, sometimes it is **not possible to determine the RA** for an individual asset
- Instead, we need to determine the **RA of the Cash-Generating Unit (CGU)** to which the asset belongs

AASB 136 – Cash-Generating Unit (CGU): The **smallest identifiable group of assets** that generates cash flows that are **largely independent** of the cash inflows from the other assets

or groups of assets.

- Impairment test is applied to the **CGU**, not the individual asset
- Impairment loss arises when the **CA of the CGU Assets > RA**
- Principles for determining RA are the **same for CGUs** as for individual assets

Accounting for the Impairment Loss:

- Loss is allocated to **each asset** in CGU on **pro-rata basis**
- Based on the CA of each asset / the total CA amount of the CGU assets
- Losses are accounted for in the same way as for individual assets discussed earlier

- **Limits:** The CA of an individual asset **cannot be reduced below the highest of:**
 - FV - CD (if determinable);
 - VIU (if determinable); or
 - Zero

CGUs Including Goodwill

- The asset goodwill can only arise in a **business combination**
 - Cannot be internally generated, revalued or amortised
 - Subject to impairment testing
- Goodwill is a **residual balance**, consisting of assets that cannot be individually identified or separately recognised
 - It is not possible to determine FV-CD or VIU for goodwill
 - When goodwill is recognised in a business combination it must be allocated to one or more CGUs
- Goodwill can only be tested for impairment at the **CGU level**
- Where a **CGU has goodwill allocated** to it, the CGU must be tested for impairment **at least annually**
 - If **CA < RA: No impairment**, goodwill remains unadjusted
 - If **CA > RA: Impairment loss** has occurred
- When an **impairment loss** arises in CGU with goodwill:
 - **Reduce the carrying amount** of the CGU's goodwill (to zero if necessary)
 - **Allocate the remainder of the loss** to the other assets of the CGU on a **pro-rata basis**

Reversal of an Impairment Loss

- Recognised losses are **reassessed annually**
- Can recognise a **reversal of an impairment loss**
 - **Accounting depends** on whether the reversal relates to an individual asset, a CGU, or goodwill
- Previously recognised impairment losses in relation to individual assets **can be reversed up to RA**
- **Limits:** The new CA **cannot be higher** than the CA that **would have been determined had no impairment loss been previously recognised**

- However, an impairment loss recognised for goodwill is **not to be reversed in a later period**

Reversal of an Impairment Loss for CGUs

- The reversal of any impairment loss relating to a CGU is **allocated across the assets of the CGU** (excluding goodwill) on a **pro-rata basis**
- The reversals for specific assets will be accounted for in the **same way as for individual assets**
- **Limits:** The CA of an asset **cannot be increased** above the lower of:
 - Its **RA** (if determinable)
 - The **CA** that would have been determined had no impairment loss been recognised in prior periods
- Any excess from the above situation is **allocated across the remaining assets** in the CGU on a **pro-rata basis**

Business Combinations

Nature of a Business Combination

AASB 3 – Business Combination: A transaction or other event in which an acquirer obtains control of one or more businesses.

- "Control" is defined in **AASB 10**
- **Control exists when an investor:**
 - Is exposed, or has rights, to variable returns from its involvement with the investee; and
 - Has the ability to affect those returns;
 - Through its power over the investee
- A "business" is not just a group of assets – it is:
 - An integrated set of activities and assets
 - Capable of being conducted/managed to provide a return
 - In the form of dividends, lower costs or other economic benefits

Four General Forms of Business Combinations (A Ltd and B Ltd):

1. A Ltd acquires all assets and liabilities of B Ltd
B Ltd continues as a company, holding shares in A Ltd
2. A Ltd acquires all assets and liabilities of B Ltd
B Ltd liquidates
3. C Ltd is formed to acquire all assets and liabilities of A Ltd and B Ltd
A Ltd and B Ltd liquidate
4. A Ltd acquires a group of net assets of B Ltd (that constitutes a business)
B Ltd continues to operate

Accounting for Business Combinations

- **AASB 3** prescribes the acquisition method in accounting for a business combination

Steps in Accounting for Business Combinations:

1. Identify an acquirer
2. Determine the acquisition date
3. Recognise and measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest* in the acquiree
4. Recognise and measure goodwill or a gain from bargain purchase

* **Non-controlling Interest:** Do not have to purchase all the shares in B Ltd to obtain control e.g. A Ltd acquires 60% of shares in B Ltd; the other 40% of B Ltd shares are held by the NCI.

Accounting in the Records of the Acquirer

- In a business combination, the acquirer has to consider:
 - The recognition and measurement of the identifiable assets acquired and the liabilities assumed (Step 3)
 - The recognition and measurement of goodwill or a gain from a bargain purchase (Step 4)
- **Note:** In Chapter 12, we do not consider in detail business combinations in which the acquirer purchases shares in the acquiree
 - Parent-Subsidiary relationships are covered in detail in Chapters 18-22.

Step 1: Identifying the Acquirer

- The business combination is viewed from the perspective of the acquirer

Acquirer: The entity that obtains control of the acquiree.

- In most cases, this step is straight forward, and in other cases, judgement may be required
- Control is discussed in detail in Chapter 18.

Step 2: Determining the Acquisition Date

AASB 3 Appendix A – Acquisition Date: The date on which the acquirer obtains control of the acquiree.

- Determining the correct acquisition date is important as the following are affected by the choice of acquisition date:
 - The fair values of net assets acquired
 - Consideration given, where the consideration takes a non-cash form
 - Measurement of the non-controlling interest
 - Measurement of the FV of equity holding acquired prior to gaining control (e.g. an initial 20% holding)

Step 3: Recognition and Measurement of Assets Acquired and Liabilities Assumed

Recognition:

- Fair value allocation **occurs at acquisition date** and requires the recognition of:
 - **Identifiable assets** acquired
 - **Liabilities** assumed
 - **Contingent liabilities**
 - Any **non-controlling interest** in the acquiree
 - **Goodwill**
- **FVINA** = Fair value of identifiable net assets (including contingent liabilities)
 - Recognise all **identifiable assets** acquired and **liabilities** assumed **regardless of the probability** of inflows and outflows
 - Therefore, FV of certain **contingent liabilities** are included in FVINA
 - **Probability** is dealt with in the **measurement of FV**

Recognition – Contingent Liabilities:

- **AASB 3** requires that contingent liabilities which **can be measured reliably** are recognised by the acquirer
 - Therefore, contingent liabilities where a **present obligation** exists;
 - But that **do not qualify recognition** in the acquiree's books under **AASB 137**;
 - **May be recognised** by the acquirer as part of a business combination
- Possible obligations are not recognised in a business combination

Fair Value of a Contingent Liability: The **amount that a third party would charge to assume** the contingent liability.

- Reflects the **expectations about possible cash flows**
- Not simply the expected maximum/minimum cash flow

Recognition – Intangible Assets:

- The **AASB 3** recognition requirements, based on Framework definitions, can result in the **recognition of intangible assets** excluded by **AASB 138**
 - Where the asset **can be measured reliably**
 - e.g. Trademarks, customer lists, royalty agreements, patented technology, etc.
- **FV of an intangible:** Reflects market expectations about the **probability of future economic benefits** flowing to the entity

- e.g. If the expected benefits are \$1,000 and the probability of receiving the benefits is 90%, the fair value will be \$900

Measurement:

- **AASB 3** requires that assets acquired and liabilities and contingent liabilities assumed are **measured at FV**
 - Fair value is basically a **market-based measure**, determined using **judgement** and **estimation**
- The determination of FV for all assets and liabilities **takes time**
 - Acquirer has **12 months from acquisition date** to determine fair values
 - At first balance date after acquisition, the fair values may only be **provisionally determined** – a **best estimate**
 - Finalisation of fair values will result in **adjustments to goodwill**

Step 4: Goodwill/Gain on Bargain Purchase

Consideration Transferred:

- Consideration transferred is **measured at fair value at the date of acquisition**, calculated as the **sum of**:
 - **Assets transferred** by the acquirer;
 - **Liabilities incurred** by the acquirer to the former owners e.g. settlement via a series of cash payments; and
 - **Equity instruments** issued by the acquirer
- Consideration paid by the acquirer may consist of:
 - Cash
 - Non-monetary assets
 - Equity instruments
 - Liabilities undertaken
 - Cost of issuing debt/equity instruments
 - Contingent consideration

Contingent Consideration:

- In some cases, the agreement will provide for **additional (or repayment of) consideration, contingent on a future event**
 - e.g. Where an acquirer issues shares as part of their consideration, the agreement may require an additional payment **IF** the value of shares falls below a certain amount within a specified period of time

- If the adjustment is **probable** and **can be measured reliably**, then the amount **should be included in the calculation of the cost of acquisition**

Acquisition Related Costs:

- Acquisition related costs that are **directly attributable** to a business combination **do not form part of the consideration transferred** (expense as incurred)
 - cf. Requirements of **AASB 116 PPE** and **AASB 138 IA**, where such costs are capitalised into the cost of acquisition
- e.g. Administrative, advisory, legal, accounting, valuation, professional fees, etc.

Goodwill:

Goodwill: An **asset** representing **economic benefits** from other assets acquired in a business combination that **could not be individually identified or separately recognised** in the combination.

- **AASB 3** requires that the goodwill is:
 - Recognised as an **asset**
 - Measured at its cost **at date of acquisition**

Goodwill = Consideration Transferred – Acquirer's Interest in FVINA

- Goodwill is **considered to be a residual**, and as such is affected by:
 - The **way consideration is measured**
 - **What is recognised in FVINA** and **how it is measured**

Gain on Bargain Purchase:

Gain on Bargain Purchase: Arises when the **acquirer's interest** in the FVINA **exceeds** the **consideration transferred**.

- The existence of a gain on bargain purchase is an **anomalous transaction** – it **should be a rare event**
 - e.g. Forced to sell or excellent bargaining skills
- In the event of a gain on bargain purchase, the **acquirer is required to reassess** if it has correctly:
 - Identified all the assets acquired and liabilities assumed
 - Measured at FV all the assets acquired and liabilities assumed
 - Measured the consideration transferred
- If a bargain purchase remains, it is **recognised immediately as a gain in P&L**

Shares Acquired in an Acquiree

- Often the **acquirer invests in shares** of the acquiree
- Accounting depends on the acquirer-acquiree relationship
 - **AASB 9 Financial Instruments** applies, unless the acquiree is a Subsidiary, Associate, Joint Venture or Joint Arrangement
- **AASB 9** requires the investment to be accounted for at **FV of the consideration**

Accounting Treatment (in acquirer's books at acquisition):

Dr Investment in A XX

Cr Cash XX

- At initial recognition, **AASB 9** requires the acquirer to make an **irrevocable choice** regarding where to record **subsequent movements in fair value** – in **P&L** or **OCI**

Consolidation

Introduction to Consolidation

- Consolidated financial statements:
 - Involves the **preparation of a single set of financial statements** for a group of companies
 - Involves **combining the financial statements** of the individual entities in a group
 - The reports show the **financial position** and **financial performance** of the group of entities
 - Presented **as if they were a single economic entity**
- Relevant standards:
 - **AASB 10 Consolidated Financial Statements**
 - **AASB 3 Business Combinations**

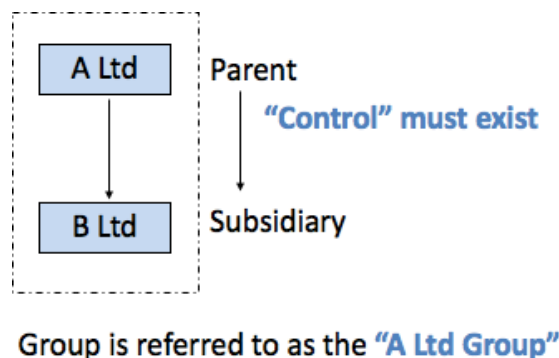
Consolidated Financial Statements

Consolidated Financial Statements: The financial statements of a **group** in which the assets, liabilities, equity, income, expenses and cash flows of the **parent and its subsidiaries** are presented as those of a **single economic entity**.

Group: A **parent** and its **subsidiaries**.

Parent: An entity that **controls** one or more entities.

Subsidiary: An entity that **is controlled** by another entity.



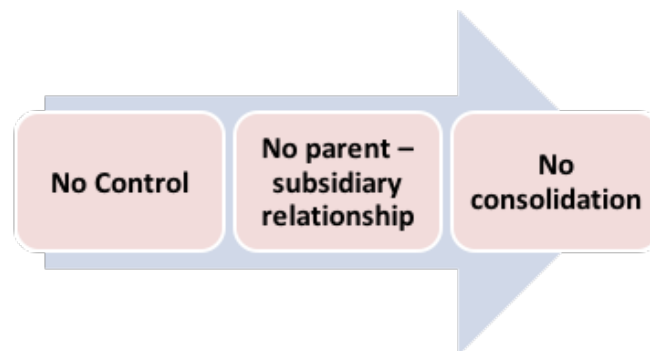
Control as Criterion for Consolidation

- **Control** is the criterion for identifying when a parent-subsidary relationship exists
- Significant **judgement is often required** in determining whether or not control exists

Three Elements of Control:

1. **Power** over the investee
2. **Exposure, or rights, to variable returns** from its involvement with the investee
3. The **ability to use its power** over the investee to **affect the amount of the investor's returns**

→ **All three** elements must be present for control to exist



Power Over the Investee

Power: **Existing rights** that give the **current ability to direct** the relevant activities.

- **Power arises from rights**, most of which arise from a **legal contract** – examples include:
 - Voting rights
 - Rights to appoint, reassign or remove members of the investee's key management personnel
 - Rights to appoint or remove another entity that participates in management decisions
 - Rights to direct the investee or enter into, or veto any changes to, transactions that affect the investee's returns
- Rights must be **substantive** – the holder must have the **practical ability to exercise** the rights
- If a right is purely protective, no rights are implied and the holder **does not** have power
- Power is the **ability to direct**, rather than actually directing
- The ability to direct must be **current**
 - e.g. Consider the impact of an investor that holds call options
- It must be **relevant activities** that are being directed
 - That is, activities of the investee that significantly affect the investee's returns

Level of Share Ownership

- Share ownership normally provides **voting rights**
 - Power is presumed to exist where an investor owns **more than 50%** of the voting rights of an entity, unless there is evidence to the contrary
- Voting rights of **less than 50% can** result in an investor having power over an investee – consider the following factors:
 - **Dispersion of other shareholders** – Probability of shareholders attending meeting lessened by location and by size of share parcels
 - **Attendance at AGMs** – e.g. If only 60% of eligible voters attend meeting, 31% can control meeting
 - **Existence of contracts** – Power by agreement with other investors
 - **Level of disorganisation or Apathy of other shareholders**

Exposure or Rights to Variable Returns

- The second element of the control definition requires that the investor has the **rights to variable returns** from the investee

Examples of returns:

- Dividends
- Obtaining scarce raw materials on priority basis
- Gaining access to subsidiary's distribution network, patents
- Economies of scale
- Denying or regulating access to subsidiary's assets to competitors

→ The returns must have the **potential to vary** according to the performance of the entity

Ability to Use Power to Affect Returns

- The third element of control requires that the parent has the **ability to increase its benefits and limit its losses** from the subsidiary activities

The Consolidation Process

Pre-Consolidation

- Before consolidating, it may be necessary to **adjust the 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
 - e.g. 30 June vs 31 December

2. The subsidiary's **accounting policies** are different to the parent's – in such cases the subsidiary required to prepare adjusted accounts to ensure accounting policies are consistent with the parent
 - e.g. Cost vs Revaluation methods of accounting for PPE.

Consolidation Process

- Consolidation involves **combining financial statements of individual entities** to show financial position and performance of group **as if it were a single entity**
- Consolidated financial statements are prepared by:
 1. **Aggregating (combining)**, line by line, like items of assets, liabilities, equity, income and expenses
 2. **Adjusting** these combined figures for inter-group transactions between entities within the group

Process:

0. Combining process
1. Acquisition analysis
2. Business combination valuation entries
3. Pre-acquisition entries
4. Intragroup transactions
5. Non-controlling interest

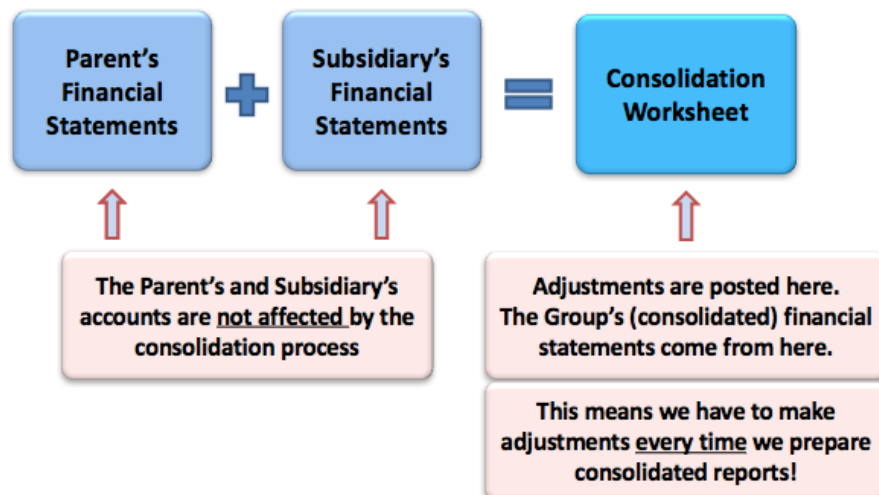
Step 0: Combining Process

- It is the **financial statements** of the parent and the subsidiary that are added together
 - Not the underlying accounts – this is done in a separate **consolidation worksheet**
 - The individual accounts of the parent and subsidiaries are not affected
- The financial statements added together are the:
 - Statement of Financial Position
 - Statement of Profit or Loss and Other Comprehensive Income
 - Statement of Changes in Equity
 - Statement of Cash Flows

- To facilitate the addition process, a consolidation worksheet is used – for example:

Financial statements	Parent P Ltd	Subsidiary S Ltd	Adjustments				Consolidation
				Dr	Cr		
Retained earnings	25 000	12 000	1	5 000			32 000
Share capital	30 000	15 000	1	15 000			30 000
	55 000	27 000					62 000
Shares in S Ltd	20 000	—			20 000	1	—
Other assets	35 000	27 000					62 000
	55 000	27 000		20 000	20 000		62 000

- **No adjustments are made in the accounting records** of the individual entities
- **Consolidated financial statements** are an **additional set** of financial statements prepared using the consolidation worksheet every time a consolidation worksheet is prepared



Step 1: Acquisition Analysis

Acquisition Analysis: Compares the **cost of acquisition** with the **fair value of identifiable net assets and contingent liabilities** (FVINA) that exist at acquisition to determine whether there is:

Recall:

- Goodwill on acquisition (where **Cost > FVINA**)
- Gain on bargain purchase (where **Cost < FVINA**)

Goodwill: An **asset** representing **economic benefits** from other assets acquired in a business combination that **could not be individually identified or separately recognised** in the combination.

Net Assets = Assets – Liabilities = Shareholders Equity

- FVINA includes:
 - All **identifiable assets and liabilities** of the subsidiary
 - FV of any **contingent liabilities** the acquiree may have
 - Contingent liabilities are **not recognised** in the subsidiary's balance sheet
 - Rather, they are recorded by way of **note disclosure only**
 - **AASB 3** requires them to be recognised on the acquisition of another business
- ☐ FVINA is commonly determined with reference to the **equity** balances of the subsidiary, rather than the individual asset and liability balances
- ☐ **Note:** Parent has **no previously held equity interest** in the subsidiary

At 1 July 2016:

Net fair value of identifiable assets and liabilities of Sub Ltd	= \$300 000 + \$140 000 (recorded equity) + (\$170 000 – \$150 000)(1 – 30%) (BCVR – land) + (\$330 000 – \$310 000)(1 – 30%) (BCVR – equipment) + (\$80 000 – \$75 000)(1 – 30%) (BCVR – inventory) + \$20 000(1 – 30%) (BCVR – patent) – \$15 000(1 – 30%) (BCVR – provision for guarantee) = \$475 000
Consideration transferred	= 100 000 shares × \$5 = \$500 000
Goodwill	= \$500 000 – \$475 000 = \$25 000

❓ Step 2: BCVR Entries

- ❓ Business combination valuation adjustments are required when:
 - BV (CA) of subsidiary assets and liabilities **does not equal FV**
 - A **contingent liability** exists
- ❓ The **Business Combination Valuation Reserve (BCVR)** (equity) account is used to record these adjustments
 - To increase or decrease the **subsidiary's recorded assets and liabilities** book values to fair value
 - To recognise **previously unrecognised assets** (e.g. internally generated intangibles) at fair value
 - To recognise **subsidiary's contingent liabilities** as liabilities at fair value
- ❓ The Business Combination Valuation Reverse (BCVR) is similar to the Asset Revaluation Surplus (ARS)

Subsidiary Books vs Consolidation Worksheet:

- It is possible for some of the BCVR adjustments to be made **directly in the books of the subsidiary** (in ARS account)
 - **AASB 116:** Allows for the use of **fair value basis** for measurement of PPE
- 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 any increase of inventory to FV cannot be made in the subsidiary's books

- **AASB 138:** Does not allow the subsidiary to recognise **internally generated goodwill**
- As a result, it is more likely that these adjustments will be made via **BCVR entries in the consolidation worksheet**
- Where the valuation adjustment 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
- However, where the valuation adjustment is done as part of the **BCVR entries on consolidation** (in the worksheet), it **must be manually carried forward to future periods** because adjustments must be posted every time consolidated reports are prepared

BCVR Entries Subsequent to Acquisition Date:

- A **consequential depreciation adjustment** is required in relation to depreciable assets that are revalued to fair value on acquisition of a subsidiary
- **Subsidiary** depreciates the asset based on its **cost**
- **Group** depreciates the asset based on its **fair value**
- From a **consolidated (group's) perspective**, the **depreciation charge is understated**
- **Assets on hand** at acquisition may have been **sold / written off**
- Need to consider **effect on any BCVR entries**

Step 3: Pre-Acquisition Entries

- ❓ **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
- ❓ Remember the group is considered a single economic entity
- ❓ From a consolidated viewpoint, these items should not exist and **must be eliminated** to avoid double counting
- ❓ **Elimination entries** are posted to the consolidation worksheet

Worksheet Entries at Acquisition Date:

Subsidiary – Record Goodwill at Acquisition Date:

- **Goodwill is deducted** in the determination of the FVINA

- Goodwill is not an identifiable asset and **must be deducted from the total equity of the subsidiary**
- Goodwill on the business combination is then determined

Gain on Bargain Purchase:

- A gain on bargain purchase is rare
- **AASB 10** recommends **re-assessment and confirmation** of net asset fair values before such a gain is recognised
- Recognised as **income (P/L)** in the year the acquisition occurs

Subsidiary – Record Dividends at Acquisition Date:

- If there is a dividend payable when the parent acquires the shares in the subsidiary, they will either be **cum div.** or **ex div.**
 - **Cum Div.:** Indicates that the parent **acquires the right** to receive the dividend.
 - **Ex Div.:** Indicates that the parent **does not acquire the right** and the dividend is paid to the previous shareholders.
 - This will impact on the determination of the **consideration transferred**

Worksheet Entries Subsequent to Acquisition Date:

- The pre-acquisition entry is required **every time** the consolidated reports are prepared
- It **does not change**, unless there has been a **change in pre-acquisition equity**, such as:
 - **Transfers from the BCVR**
 - e.g. On the sale of an asset
 - **Transfers between pre-acquisition retained earnings and other reserves**
 - Such transfers are dealt with in the same way as BCVR transfers
 - **Bonus share dividends paid from pre-acquisition equity**

Step 4: Intragroup Transactions

Intragroup Transactions:

- Occur **between entities** within the group
- **Each separate legal entity** records these transactions in their accounts
- The effects of such transactions will be included in the consolidated accounts when the separate financial statements are added together

→ These transactions **must be eliminated** on consolidation

- From a group viewpoint a transaction **has not occurred** with an entity outside of the group
- Eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows
- Need to account for any **tax effect** that arises on temporary differences

→ Adjustments will also be **required in future periods**

Sales of Inventory:

Original Parent Records:

Dr Cash XX
 Cr Sales XX
Dr Cost of Sales XX
 Cr Inventory XX

Original Subsidiary Records:

Dr Inventory XX
 Cr Cash XX

Unrealised Profit in Closing Inventory – Consolidation Worksheet Adjustment:

Dr Sales (Total Intragroup Sales) XX
 Cr Cost of Sales XX
 Cr Inventory (Unrealised Profit) XX
Dr DTA (Unrealised Profit x TR) XX
 Cr Income Tax Expense XX

Transfers Between Inventory and PPE:

- When **items are transferred between entities** within a group, it is possible that the transferring entity will classify the asset differently
- Possible scenarios include:
 - Transfers from inventory to PPE
 - Transfers from PPE to inventory

Intragroup Services:

- Often, within a group, one entity (normally the parent) provides **services** (such as accounting, HR or IT) to the other entities (normally the subsidiaries) to **reduce duplication**

- The provider normally charges a **management fee** to the user – this **must be eliminated** on consolidation:

Dr Services Revenue XX
Cr Services Expense XX

- If **payable/receivable balances** also exist, these balances **must also be eliminated** on consolidation:

Dr Services Payable XX
Cr Services Receivable XX

Intragroup Borrowings:

- The consolidation journal entry to eliminate intragroup balances in payable and receivable accounts is:

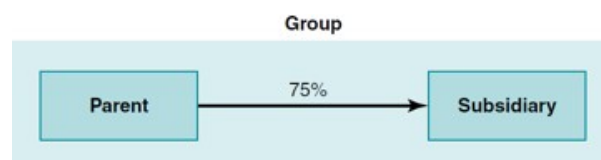
Dr Payable (Loan) XX
Cr Receivable (Loan) XX

- To eliminate interest revenue and expense recorded during the year by each entity:

Dr Interest Revenue XX
Cr Interest Expense XX

Step 5: Non-Controlling Interest

- ❓ Up until now we have looked at the situation where the parent has 100% share ownership in the subsidiary
- ❓ We will now examine the situation where this **ownership is less than 100%**
 - Parents has a **partial interest** in the subsidiary
 - There is **non-controlling interest**
 - For example:



Non-Controlling Interest (NCI) – AASB 10 Consolidated Financial Statements: Equity in a subsidiary **not attributable, directly or indirectly, to a parent.**

- NCI is to be identified and presented **within equity**, separately from the parent shareholders' equity

- ❓ NCI is regarded as a **contributor of equity** to the group (not a liability)
- ❓ NCI receives a share of the consolidated equity and therefore participates in the residual equity of the group
- ❓ **AASB 3** allows two methods to measure NCI, which impacts upon the measurement and treatment of goodwill:

Full Goodwill Method: NCI measured at **fair value** on the basis of market price for shares not acquired by the parent.

- NCI receives a share of goodwill

Partial Goodwill Method: NCI is measured at their **proportionate share** of acquiree's identifiable net assets.

- NCI does not receive a share of goodwill
- The only goodwill recognised is that acquired by the parent
- Only **partial goodwill method** will be used

NCI and the Consolidation Process:

- Acquisition analysis
 - Consider FV acquired by the parent
- Business combination valuation entries
 - Revalue assets not recorded at FV
 - No BCVR entry for goodwill
- Pre-acquisition entries
 - Need to eliminate parent's share
 - Account for goodwill/gain on bargain purchase
- Intragroup transactions
 - Need to eliminate intragroup transactions, and also consider the effect on NCI

NCI and Intragroup Transactions:

- The full effect of intragroup transactions is adjustment on consolidation – the only **exception is dividends**
- Where NCI exists, dividends paid or declared by the subsidiary are paid proportionately to the parent and the NCI

- Only the **dividend received by the parent** is **eliminated on consolidation**
- The calculation of the NCI is based on a **share of consolidated equity**
- Consolidated equity is determined as the sum of equity of the parent and subsidiary after adjusting for intragroup transactions that affect **subsidiary** equity
- For a transaction to require adjustment to the calculation of the **NCI share** of equity it must:
 - Result in the **subsidiary** recording a profit or loss
 - The transaction must result in **unrealised profits**
 - Only upstream transaction i.e. **subsidiary to parent**
- **Note:** The flow of the transaction does not affect the adjustment for the effects of the transaction, but does affect whether the NCI calculation needs adjusting

Accounting for NCI – Method:

- 🔗 Alternative method to textbook, resulting in one entry for NCI, rather than many
1. Calculate NCI share of subsidiary's **share capital** at date of consolidation
 2. Calculate NCI share of subsidiary's **reserves** at date of consolidation
 3. Calculate NCI share of **BCVR**
 4. Calculate NCI share of subsidiary's **adjusted opening retained earnings**
 5. Calculate NCI share of subsidiary's **adjusted operating profit after tax** for current year
 6. Calculate NCI share of **dividends** paid and provided by subsidiary during the current year
 7. Calculate NCI share of **any other transfers** in or out of subsidiary's retained earnings during the current year

Equity Accounting

Investments

- ❑ Entities often hold **equity investments** in other entities
- ❑ The accounting method depends on the **nature** of the investment and the **relationship** between the investor and the investee
 - **Subsidiaries** – **Line-by-line consolidation method** as per **AASB 10 Consolidated Financial Statements**
 - **Associates and Joint Ventures** – **Equity method** of accounting as per **AASB 128 Investments in Associates and Joint Ventures**
 - **Other investments in equity instruments** – **Fair value method** as per **AASB 9 Financial Instruments**

Identifying Associates and Joint Ventures

Associates

Associate – AASB 128 (para. 3): An entity over which the investor has **significant influence**.

Significant Influence: The power to **participate** in the **financial and operating policy decisions** of the investee but is **not control or joint control** over those policies.

Three Types/Levels of Control:

- Control or dominance
 - **Significant influence**
 - Joint control
- ❑ **Participation** as opposed to domination (control)
 - ❑ It is the capacity to participate that is required (not actual participation)
 - ❑ Holding **20% or more** of the voting power leads to the presumption of **significant influence**
 - ❑ **Indicators of significant influence include:**
 - Board representation
 - Participation in decisions about dividends / profit retentions
 - Material transactions between the investor and investee
 - Exchange of managerial staff
 - Provision of / dependence on technical information

Joint Ventures

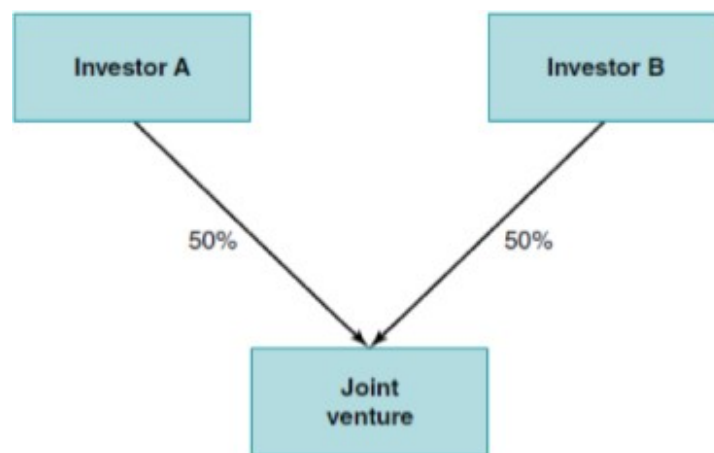
➤ **AASB 128 (para. 3):**

Joint Arrangement: An arrangement of which **two or more parties** have **joint control**.

□ **Two types** – Joint ventures and joint operations

Joint Control: Exists only when decisions about the relevant activities require the **unanimous consent** of the parties sharing control.

Joint Venture: A joint arrangement whereby the parties that have joint control of the arrangement have **rights to the net assets** of the arrangement.



Equity Method of Accounting

Rationale for the Equity Method

❓ Associates and Joint Ventures (JVs):

- Are accounted for using the **"equity" method**, commonly referred to as the "single-line" method or "one-line consolidation" method
- The asset **Investment in Associates and JVs** is initially recognised at cost – as a single-line item in the Statement of Financial Position
- ❓ The asset is subsequently adjusted for the post-acquisition change in the investor's share of the investee's net assets
- ❓ The State of P/L & OCI will include a line for both:
 - **Share of profit (loss) of Associates and JVs**; and
 - **Share of OCI of Associates and JVs**

Application of the Equity Method

? If the investor is not a parent:

- **Equity method** is applied in the investor's books

? If the investor is a parent:

- **Cost method** is used in the investor's books
- Equity method is **applied on consolidation**
- Consolidation worksheet contains:
 - Consolidation journals relating to subsidiaries
 - Equity journals relating to associates

	Initial investment in associate (cost)
+/-	Investor's share of profits (losses)
+/-	Investor's share of items of OCI
-	Distributions by the investee (e.g. dividends)
+/-	Investor's share of increases (decreases) in investee's net assets (other than P/L, OCI or distributions)
=	Equity accounted carrying amount

Goodwill and FV Adjustments

- ? Only record goodwill in cases where there is a **business combination**

Applying Equity Method in the First Year:

- The equity method requires the recognition of the investor's share of **post-acquisition equity**
- When determining consideration, an investor would consider:
 - The recorded equity of the investee (book value of net assets)
 - The differences between the CAs of the investee's assets and liabilities and their FVs
 - The FVs of any unrecorded assets and liabilities of the investee
 - Any goodwill existing in the investee
- The **initial carrying amount of the investment** reflects all these amounts
- To determine the "real post-acquisition equity" of the investee, an **acquisition analysis** is undertaken at acquisition date

- Many of the procedures appropriate to the application of the equity method are similar to the consolidation procedures applied to subsidiaries
- The equity method requires adjustments to the investor's share of post-acquisition equity for:
 - **Goodwill** – This is included in the carrying amount of the investment and cannot be amortised
 - **Excess** (similar to gain on bargain purchase where FVINA > consideration) – Must be recognised as income
 - **Fair value adjustments** on acquisition
- Appropriate **adjustments** must be made to investor's share of the profit or loss after acquisition, such as:
 - A FV adjustment for machinery and the associated adjustment to future depreciation expenses
 - A FV adjustment to the cost of inventory sales
 - Impairment losses on goodwill
- Not all recorded profits represent post-acquisition equity:
 - Profit made by the investee, based on the carrying amount of inventory rather than its FV, will be overstated from the investor's perspective
 - To the extent overstated, such profit is not post-acquisition equity
 - In fact, it has been paid for in the consideration paid

Applying Equity Method Across Multiple Years:

- Applying the equity method will depend on the situation of the investor entity
- If the investor does not prepare consolidated accounts:
 - There is no issue – the equity method is recorded in the investor's records and is reflected in the accounts
- If the investor prepares consolidated accounts:
 - The equity method is applied in the consolidated worksheet
 - An entry is required for the period from acquisition to the start of the current year (i.e. previous years)
 - Entries are required to account for the current year

Inter-Entity Transactions

Transactions Between Investor and Associate:

- The **investor's share of any unrealised profits must be adjusted** against the share of associate profits for the year
 - Applies to both upstream and downstream transactions
 - Is performed on an after-tax basis
 - Adjustments are made to **Share of P/L of Associates and JVs** and **Investment in Associates and JVs**
- Relates to unrealised profit:
 - In closing inventory
 - In opening inventory
 - On the transfer of non-current assets

Share of Losses of the Associate

- ❑ The investor's share of losses of an associate is recognised, but only to the point where the carrying amount of the investment in the associate is zero
- ❑ The share of losses may be offset against other investments the investor has in the associate
 - e.g. Long-term receivables
 - Done in reverse order or seniority or priority in liquidation
- ❑ If, after reporting losses, an associate earns a profit
 - The investor can recognise a share of profits, but only after the share of profits exceeds the share of past losses not recognise