COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | INTERMEDIATE

Video Transcription: Group Accounting – Introduction

Group accounts is a significant part of your financial reporting studies and introduces you to a number of new terms. It is easy to get overwhelmed and lost in the detail of seemingly complex calculations and processes. What I hope to do in this video is focus on the basics of group accounts, which will hopefully make the terminology and the reasons for all the calculations and processes, easier.

We produce financial statements in order to provide information that is useful for making economic decisions. To do that, we need to know what resources we have at our disposal to generate profits and how those resources, or assets, have been funded.

The assets that we have at our disposal are any assets that we are able to control, which implies that we can decide how those assets are to be used in our business model. There are two ways to control an asset – to own the asset yourself, or to own the shares in the company that owns the asset. You don't even need to own all the shares in the company, just sufficient to have the power to make key decisions, which generally is more than 50% of the voting shares.

Where the assets that you control are in a separate company, you need to prepare group accounts. Think about what happens when you buy all the shares in a company and pay cash – you would process an entry in which you debited the cost of the investment and credited bank. That tells you what you paid for the company but not what resources you control as a result of buying those shares. In your own separate company accounts, that correctly reflects the legal situation but is not particularly useful information. Group financial statements are prepared to reflect all the resources that shareholders control, irrespective of what legal entity the assets are owned by. In its simplest form, group accounts involve replacing the cost of the shares with the assets and liabilities that you now control, as a result of buying the shares.

The process of including the assets and liabilities of the company that you own is known as "consolidating" and the result is known as "consolidated" or "group accounts". As the word suggests, consolidating means bringing everything together so that consolidated or group accounts show all the assets and liabilities that you control irrespective of what legal entity owns them.

When you initially acquire the shares, you need to identify exactly what assets and liabilities are owned by the company that you have now gained control of as a result of buying those shares. If you prepared group accounts at that date, the investment would be replaced by the assets and liabilities that you acquired when you paid for the shares. If you paid more for the shares than the net amount of the assets and liabilities that you can recognise in the business, that gives rise to an asset called goodwill which is measured as the residual amount. This implies that your balance sheet will continue to balance, once you have replaced the cost of the investment with the assets, including goodwill, and liabilities that you have acquired. Please watch the video on "Business Combinations" for more focus on this aspect.

Let's recap some of the terminology we have introduced:

- **Goodwill:** It is the residual difference between the amount paid for a business and the assets and liabilities acquired. Recognised as an asset.
- **Consolidating:** It is a process of combining assets and liabilities of the company that you own with your own company
- **Group accounts:** Accounts that reflect all the assets and liabilities that are controlled irrespective of which legal entity owns them.
- **Separate company accounts:** The accounts of the investor, where the investment is recognised and not the underlying assets and liabilities.

You can control a company, and therefore its assets and liabilities, without owning all the shares in that company. If you own say 60% of the shares in a company, you would have enough votes at the shareholders' meetings, where key decisions are made, to be able to control the company. You would then be known as a controlling shareholder, and the controlled company is known as the subsidiary company. The company that controls the subsidiary is known as a parent company.

If you are the controlling shareholders with 60%, the owners of the other 40% of the shares would be known as "non-controlling shareholders". In this type of structure, you have gained control of 100% of the assets and liabilities while paying for 60% with the other 40% financed by the other or non-controlling shareholders. If you control a company, you are required to consolidate that company in your group financial statements. In your group financial statements, you will include 100% of all the assets and liabilities that you are able to control. The portion that is funded by the other or non-controlling shareholders will be reflected as a separate category of equity – they are shareholders of the group but only share in the benefits of the subsidiary company as that is the company in which they own their shares.

Let's recap some more terminology:

- **Subsidiary:** A company that you are able to control, and must consolidate in your group financial statements.
- **Parent company:** A company that has a subsidiary, or controlled, company.
- **Non-controlling interest**: The shareholders of a subsidiary company other than the controlling shareholders. Recognised as equity in the group financial statements.

A consolidated or group statement of financial position reflects all the assets and liabilities controlled by the group i.e. 100% of those in a subsidiary company, even if you only own 60% of the shares. These assets will be those that existed when the subsidiary company was acquired as well as any increase or decrease from the subsidiary as a result of subsequent gains or losses or other transactions.

The equity that will be recognised will be that which is applicable to the shareholders of the parent company, as well as any non-controlling interest, also sometimes known as outside shareholders of the subsidiary company.

Remember the definition of gains and losses “increases or decreases in net assets other than those relating to transactions with shareholders, in their capacity as shareholders”. As the Statement of Financial Position includes 100% of the controlled assets and liabilities, it should not surprise you to know that the Statement of Comprehensive Income includes 100% of all the gains and losses of the parent, and all controlled companies. The profit is 100% of gains minus losses, recognised in the income statement.

If the parent only owns 60% of the shares in the subsidiary, when the subsidiary pays a dividend, 60% of the amount will go to the parent and 40% of the amount to the non-controlling interest. Any gains and losses of the subsidiary will be split between 60% attributable to the controlling shareholder, which implies the ultimate benefit for the shareholders of the parent company, whereas the other 40% will be for the benefit of the non-controlling interest.

This implies that the profit and comprehensive income that is recognised, i.e. 100% of all gains minus losses, must be attributed or split between the controlling shareholders and the non-controlling shareholders. This is not a charge against profits, it relates to transactions with shareholders and therefore by definition not an expense or loss. This is displayed on the Statement of Comprehensive Income.

The amount attributable to the parent or controlling shareholder is then recognised in the appropriate equity balance such as retained income or revaluation surplus, whereas the amount attributable to the non-controlling interest is included in the non-controlling equity balance. In some cases, a shareholder may have a substantial but not controlling interest in another company. If you owned 40% of the shares in the company, you would have some say over that company’s decision-making but would not be able to dictate or control it. If you don’t control a company, you cannot recognise any of the assets and liabilities or gains and losses of that company. You cannot show a resource as an asset, if you are not able to control it.

If your shareholding is sufficiently large enough to make your voice heard, the term used in IFRS is “significant influence”, then simply accounting for the investment on the same basis as you would for 100 shares in Woolworths Group does not reflect the reality of the relationship. s a result, an additional method for representing the results of the type of shareholding where you have significant influence but not control, was introduced. That process is known as “equity accounting”, and essentially involves recognising your share of profits and other gains and losses when they are earned.

This results in the recognition of your share of equity, as it is earned, as opposed to when it is distributed as a dividend. The company in which you have invested is known as an associated company, as it is a company with which you have a close association as a result of you significant shareholding. Equity accounting is generally used for companies in which you have a shareholding of between 20% and 50% i.e. significant but without control. Recognition of the profits increases the carrying value of the investment and receipt of a dividend decreases the investment.

Let's recap the new terminology introduced:

- **Significant influence:** Shareholding that is sufficiently large enough to enable shareholder to influence but not control decision-making. Generally, between 20% and 50%.
- **Associate company:** An investment over which you have significant influence.
- **Equity accounting:** It is the process of recognising the investor's share of gains and losses when they are earned rather than when they are distributed.

Technically consolidated accounts include only the consolidation of subsidiaries, whereas group accounts include consolidations as well as equity accounted associates, and another type of investment known as a joint venture. Referring to group accounts is better as it would include all types, if relevant.

The consolidation process involves starting by adding together the results of the parent company and each subsidiary company and then making the adjustments necessary to avoid double counting, adjustments arising from the business combination process and the attribution to the non-controlling shareholders. You need to be able to keep track of these adjustments. These are recorded in the form of consolidation journal entries – also known as pro-forma journal entries, which are the subject of a separate video.

Remember to watch the other three intermediate videos that are closely linked to this – business combinations, which looks at the initial accounting when you first get control of a subsidiary; the one on "basic" pro forma journal entries; and the one on basic adjustments. As you progress in your studies, you will hopefully benefit from some additional group accounting videos at the advanced level.

Spend time on understanding the basic principles now – and remember to apply those principles to work out for yourself what should be included in group accounts. Don't fall into the trap of focussing on the process of preparing group accounts – you need to understand the principles and purpose of the accounts, and then the process will become obvious to you.