COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | ADVANCED

# Video Transcription: Preparing a Group Statement of Changes in Equity: Part 1 & 2

UCT College of Accounting

In this video we will look at how to prepare a Group Statement of Changes in Equity.

Advanced financial accounting papers often have questions requiring preparation of a statement of changes in equity, or parts of one and almost always in a group situation. As examiners we like them as it is an efficient way of testing your understanding of a number of key principles across many areas of financial reporting, particularly those that are introduced at a more senior level, and your ability to integrate those with your prior learning.

Questions that examiners like are usually those that make students apprehensive. What I hope to do in this video is help you to tackle this type of question with confidence. To do that you need to understand the purpose of the individual statement, as well as the interaction between the different statements in a complete set of financial statements.

Let's start by thinking about what the statement is called – A Statement of Changes in Equity – the two key words are "equity" and "changes".

Essentially a "statement of changes in equity" is a table – with each column representing one class of equity, and each row highlighting the reason for the movements in equity during the year. The last row is the equity balances at the end of the financial year i.e the amounts that are recognised for each class of equity on the statement of financial position.

Next question is what columns you should have – each class of equity should have its own column. If you are starting with a correctly prepared statement of financial position, then you will easily be able to find the equity balances that you need. In both statements, the equity balances will be grouped between those that are attributable to the equity owners of the parent and those that are attributable to the non-controlling interest. The closing balances on each column will equal the balances on the Statement of Financial Position at that reporting date – with total equity being equal to the total of assets less liabilities i.e net assets at the balance-sheet date.

That is an important principle – as all changes in net assets must cause a change in equity, and therefore recognition in the statement of changes in equity, the purpose of the statement of changes in equity is to explain what has caused the movement in group net assets during the reporting period.

In exam situations, they don't always make life that easy for you – and you will probably have to prepare the "statement of changes in equity" without the advantage of a completed "statement of financial position". The first step is therefore, to make sure that you are able to identify all the classes of equity. To do, this you need to understand the definition of a liability, as equity is the residual of the assets after deducting all the liabilities. The video that we have prepared on debt versus equity should be able to help if you are not yet confident that you will make that distinction correctly. Essentially all capital contributed by shareholders and accumulated reserves will make up equity. Don't forget that in a group situation, non-controlling interest is also a class of equity.

IFRS standards provide limited guidance on how equity balances should be treated in financial statements – partly because the recognition of share capital and the extent to which reserves can be distributed is often influenced by company-law requirements, which differ from country to country.

Some IFRS standards specify that a specific reserve is required – e.g. IAS 16, "property, plant and equipment", requires a revaluation surplus when an item of PPE is revalued – IAS 2, Foreign Exchange, requires a separate reserve in which accumulated foreign exchange translation gains or losses are accumulated, known as a foreign currency translation reserve – usually referred to as an FCTR for obvious reasons.

Even where there is not a specific IFRS requirement, in exam conditions it is much easier to have a separate reserve for each class of equity – irrespective of whether or not it is required. Preparing a separate column for cash-flow hedges, group-equity adjustment and others such as share-based payment reserves and the equity component of convertible debentures, will make it much easier for you, and the marker to keep track of what is happening than if you lumped them all together in one reserve. However, remember to check if the question has given you any specific instructions relating to the specific reserves in which adjustments are recognised.

You need to understand some general principles of preparing group financial statements in order to be able to calculate the equity balances in a group scenario. The two key aspects of that are:

- Only the parent's share capital is reflected – all capital relating to the subsidiary is eliminated on consolidation. That applies irrespective of who owns the shares, whether they are ordinary or preference shares or when they were issued.
- The reserve balance recognised in relation to a subsidiary is the group's share of after – tax, post-acquisition profit.

As that is such a key principle in preparing a "statement of changes in equity", let's look at the calculation of an amount in a simple example.

Assume that A Ltd purchased 60% of B Ltd when B Ltd's land, with a cost of R10 million, was considered to have a fair value of R12 million. B Ltd did not revalue the land then, but did revalue it to R13,5 million two years later, when it recognised a revaluation gain of R3,5 million.

The group's revaluation is therefore the difference between the fair value of R13,5 million and the cost to the group of R12 million i.e. R1,5 million, the increase in fair value since acquisition. Revaluing an asset gives rise to deferred tax, in this case at the CGT rate of 18,6% – giving a reserve of 81,4% of the amount. The 40% of that after tax amount is attributed to the non-controlling interest, with the group's share of 60% recognised in the revaluation reserve – (R13,5m – R12m) x (100% - 18.6%) x 60% = R732 600.

That amount will then be added to similar calculations for revaluation surplus from other group companies, with 100% of any amount recognised in the parent, being included. It is worth noting that the amount recognised in the revaluation surplus is based on the amount included in comprehensive income, attributable to the equity holders of the parent, irrespective of how it might have been reflected in comprehensive income. If there are equity accounted associates and joint ventures, the group statements may include equity accounted for in other comprehensive income. If that consists of revaluation gains on PPE, it is closed off to the revaluation surplus; foreign currency gains are taken to the FCTR etc.
Now that we know how to calculate an equity balance, we can focus on how we are going to present the changes in equity or, focusing on the other side of the double entry, the causes of the changes in net assets during the reporting period.

The changes in equity can be grouped into three different categories, with the statement of changes in equity structured in a way that highlights those different categories. The three categories are:

1. Changes in net assets or equity that arise from gains and losses during the reporting period.
2. Changes in net assets that arise from transactions with shareholders in their capacity as shareholders.
3. Those changes that do not change total equity – but do change individual reserve balances within equity.

**1. Gains and Losses**

Total comprehensive income is the total increase in net assets arising from gains and losses. If you have prepared a statement of profit or loss and other comprehensive income, then you already know the change in equity arising from gains and losses. If you have calculated the amounts that are attributable to the equity holders and non-controlling interest, you will then know how that amount is split between the group's share and the non-controlling interest's share. A properly completed statement of profit or loss and other comprehensive income will give you the amounts that you need for this component of the statement of changes in equity – you need the profit, the other comprehensive income and the total comprehensive income – with each of those amounts split, or attributed to the equity holders of the parent (or what is often referred to as the "group's share" and the non-controlling interest.)

If you are not given a "statement of comprehensive income" or are not required to prepare one, you are going to have to calculate these amounts before you can prepare a "statement of changes in equity".

Be careful here – this may be a major component of the question, as calculating those amounts will require you to take into account all the adjustments that you need to do to calculate group profit (inter-company adjustments, group fair value adjustments etc.) You will also have to consider all the deferred tax adjustments as well as the attribution of those amounts between the group and non-controlling interest. Once you have the correct group amounts for comprehensive income, recognising those in a statement of changes in equity is not difficult.

Total comprehensive income is the total increase in net assets, and therefore equity. This is the amount that is included in the "total" column on the right-hand side, which is the total amount of equity. (1) That is then split between the NCI share (2) and the equity owners of the parent's share (3) Done separately for profit (4, 5, 6) and other comprehensive income (7, 8) as IAS 1 requires separate disclosure of those amounts on each class of equity.

No further analysis is required of the amount attributed to the NCI i.e the share of profit, other comprehensive income and total will be disclosed, without considering the nature of the gains or losses (5, 8 & 2). The portion attributable to the equity owners of the parent, often referred to as the group's portion then needs to be allocated to the correct class of equity, based on the nature of the gains and losses (6 & 8).

Profit is always taken to retained earnings, but you need to be more careful with other comprehensive income. While most items of other comprehensive income are taken to reserves other than retained earnings that is not actually a requirement. For example, IAS 19 on employee benefits requires remeasurement gains on post-retirement employee schemes to be recognised in other comprehensive income – most companies would recognise those gains in retained earnings, after taking into account the related tax. Revaluation gains on PPE will go to a revaluation surplus (remember, that is only the group's share net of tax, the groups share of the translation gains will go to the foreign currency translation reserves, including that which relates to equity accounted amounts (11). The total of the group's share needs to be recognised in the appropriate column. Remember that what we are doing here is allocating the group's share of other comprehensive income to the appropriate reserves – we are starting with the gains and losses attributed to the group and then identifying the reserves that those amounts are closed off to.

IAS 1 requires some details of those amounts – but that can be given in the notes so is ignored here.

**2. Transactions with Shareholders in their Capacity as Shareholders**

We have looked at the increase in net assets relating to gains and losses. Transactions with shareholders in their capacity as shareholders are specifically excluded from the definition of gains and losses, and therefore need to be considered separately.

There are three types of transactions with shareholders that can give rise to a change in net assets or total equity

A – Contributions by owners or shareholders,
B – Distributions to owners and
C – Changes in ownership interests that do not result in a loss of control.

A – Contributions by owners or shareholders will include an increase in share capital of the parent company, as well as the recognition of non-controlling interest when control of a company is acquired. That reflects the equity financing provided by the shareholders other than the parent when control of the assets and liabilities of the subsidiary is acquired. Remember to measure the non-controlling interest on the basis that the group has selected for that acquisition, as the column, on the statement of changes in equity, must explain the amount that is recognised on the "statement of financial position". IFRS 3, Business Combinations, gives the choice of measurement at net asset value or fair value on an acquisition by acquisition basis. (16)

Also remember that if you lose control of a company, any related non-controlling interest should be derecognised and that should be reflected in the "statement of changes in equity".

B – The most obvious example of distribution to owners is the declaration of dividends – as those relate to equity instruments, they are not an expense, and should be included in the equity transaction section of the statement. As non-controlling interest is also a class of equity, the dividends declared to non-controlling shareholders are also recognised as a distribution to shareholders (17). If you think about this from a net asset perspective, the group's assets are not affected by the 60% of the subsidiary's dividend paid to the parent, as those resources stay within the group – no change in net assets implies that there is no change in equity, so no adjustment to the "statement of changes in equity". The amount paid to the non-controlling 40% plus the amount paid to the equity owners of the parent gives rise to a reduction in group net assets and therefore equity. You have probably seen the same principle applied in recognising dividends in a group cash flow statement.

Another example of a distribution to owners is the repurchase of issued share capital, usually referred to as a share buy-back. In some cases, the shares are bought by the parent company, in which case the issued capital needs to be cancelled and, therefore, the share capital is reduced. In most cases, the shares are purchased by a subsidiary, which is often a trust formed to acquire shares to supply them, when needed, to directors who have share options. In that case, the share capital of the parent is not impacted – and the cost of the shares acquired will be recognised separately as treasury shares (18). A debit balance reflecting the cost of the shares held internally.

C – Changes in ownership interest that do not give rise to a change in control, arise where the parent and non-controlling shareholders' percentage of shareholding change in a subsidiary company. The easiest way to tackle this type of transaction is to consider the overall impact on equity, which is the total impact on group net assets, then identify the overall impact on non-controlling interest, with the balancing amount being recognised as a group equity adjustment.

**3. Other Changes to Equity**

As the "statement of changes in equity" reconciles the opening and closing balances of each class of equity, any change in the amount recognised for that reserve, needs to be reflected. As IAS 16 permits the revaluation surplus to be released to retained income as the asset is depreciated, that is going to change both the revaluation surplus and the retained income balance and therefore needs to be recognised on the statement.

Before calculating the amount that is released – you need to remember that principle that only the group's share of after tax amount is included in the reserve and therefore influences the amount that can be released.

If the additional or revaluation depreciation in a 60% held subsidiary is R10 000, the release of the revaluation reserve will be R10 000 x 72% (i.e. after deferred tax at the usage rate) x 60% i.e. R4 320. That would be reflected in the statement of changes in equity as a reduction in the revaluation surplus and an increase to retained income of the calculated amount of R4 320.

| Equity attributable to owners of parent | | | | | NCI | Total |
|---|---|---|---|---|---|---|
| | | Retained income | Revaluation surplus | Total | | |
| | | 4 320 (20) | (4 320)(20) | | | |

Note that totals and non-controlling interest are not impacted – this is simply a transfer between two classes of equity with no overall impact.

There are a few other aspects to consider when you are preparing a statement of changes in equity:

- Comparatives are required and should be given unless a question makes it absolutely clear that they are not required.
- The opening equity will be the equity as presented in the prior-year, financial statements. IAS 8, Accounting Policies, changes in Accounting Estimates and Errors, provides guidance on the limited circumstances when the opening equity can be restated, which implies that an amount is recognised as an adjustment to the opening balance as opposed to being recognised in other comprehensive income. (21)
- Remember to go and have a look at the specific disclosure requirements for a statement of changes in equity in IAS 1 (IAS: 106 - 110). Unfortunately the illustrative examples in IAS 1 do not give all the disclosures that the standard requires – remember that the requirements in the standard are important.

To complete it properly, you need to total each column and cross-cast – while it is satisfying to get all to balance, it is probably not the most efficient way of earning marks if you are under time-pressure. Marks are allocated more heavily towards aspects that apply principles than to repetitive type calculations – so put your efforts into demonstrating that you understand those principles. Specifically make sure that you identify all the categories of equity that you should include, that you calculate the equity balances correctly, as we have discussed, and that you use the information that you already have, efficiently. Also remember that you are doing a number of calculations to get the amounts that you are disclosing, so make sure that you are providing sufficient workings for the marker to follow how you have calculated the numbers.