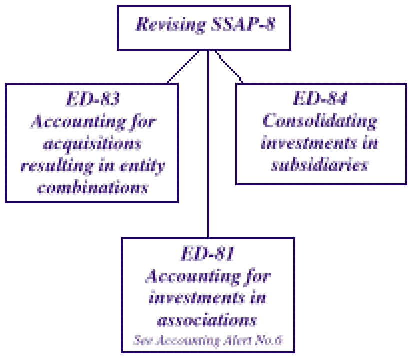
publications

Deloitte Touche Tohmatsu

Accounting Alert

A Focus on Technical Accounting Issues - Issue Number 8



ED-84 misses the mark

We don't need to dig into an accounting concept to see why, and for whose benefit, consolidated financial statements are prepared.

The group financial statements are distributed to the shareholders of the parent company, together with the parent's own financial statements. The consolidated financial statements are of prime importance to the **parent's shareholders** – they provide vital information on how their capital has been used:

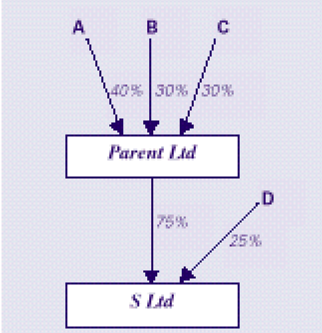
- to acquire assets, and
- to earn profits

presented from **their** point of view.

The fact that the minority interest has provided a portion of the major risk capital of some or all of the subsidiaries is taken into account in a unique way in the group financial statements.

Certainly, the minority interest is a part of equity, but under present worldwide standards, it is the parent shareholders' share capital which is disclosed as the share capital of the group – we would go so far as to say that the parent's shareholders are also the group's shareholders!

The minority shareholders do not even receive copies of the group financial statements – their only concern is how their capital has been used in the subsidiaries in which they have part ownership.



Who uses Parent Ltd's group financial statements?

Why do the users need group financial statements?

Does D (or D's creditors) have any interest in Parent's group financial statements?

Do the usual consolidation techniques fulfil that need?

How would A, B and C like to have D's interests interwoven with their own?

Or would they rather have the interest of D treated

- as a separate and single item within equity
- with Parent Ltd shareholders' interests clearly defined?

The creditors of the holding company are interested in the group as a whole – but the parent, not the group, is the legal entity, with which they deal and to which they can look for payment of debts. However, the creditors are interested in the consolidated financial statements to determine the parent's total wealth and total financial performance **as presented from the parent's point of view.**

ED-84 adopts the 'entity' approach in attempting to rewrite the 'textbook' on consolidations – and to report on the whole group as if the parent's shareholders and the minority shareholders were one homogeneous group of people, with identical interests in the whole group.

Group financial statements as presently prepared provide vital information to the shareholders and potential shareholders of the parent entity. To tamper with this presentation to satisfy a selected accounting concept would be a grave error which **must** be avoided.

ED-84, after an excellent start, loses the plot as from paragraph 5.31. In that respect it needs some serious redrafting.

Any comments on this, or any article in *Accounting Alert* please contact Hilton Shuttleworth on (09) 303 0847.

The end of 'pooling'

Under ED-83, **no** entity combinations, with the exception of some intra-group reconstructions and possibly some other arrangements which fall outside the scope of the exposure draft, may be accounted for using the pooling of interest's method. This is a change from the present SSAP-8 position, which allows the pooling of interests method to be applied when none of the parties involved can be identified as an acquirer and a number of stipulated conditions apply.

'Pooling' is mandatory under certain conditions in terms of International, UK, USA and other countries' standards. The FRSB proposes to nevertheless prohibit this method for the following reasons:

This means that in cases where a genuine uniting of interests does occur between two entities of similar size, where the owners of the combining entities become the owners of the continuing entity:

- the appropriateness of the **pooling of interests** method is under review in several jurisdictions, and is prohibited in Australia, and
- there is a potential to structure acquisition transactions to support an individual justification for the adoption of the pooling of interests method.

This means that in cases where a genuine uniting of interests does occur between two entities of similar size, where the owners of the combining entities become the owners of the continuing entity:

- one of the entities will have to be selected as the identified enquirer
- the assets of those entity (ies) selected as the acquiree (s) will be recognised in the continuing entity as fair values, and
- goodwill (or discount) on acquistion will be identified with the resulting amortisation expense where goodwill arises

From an accounting viewpoint, it is advisable to identify the continuing entity as the acquirer. Reverse acquisitions (ie where the acquiree is the continuing entity) give rise to complex accounting problems.

Goodwill amortisation

no change to 20 year absolute maximun period of amortisation

D-83 retains the absolute maximum period of 20 years for the amortisation of goodwill. However, there is a "rebuttable assumption" that the useful life of goodwill will not exceed 10 years.

The justification of a period in excess of 10 years requires "a persuasive indication" that the useful life does extend over the longer period. "This may be the case when goodwill is clearly related to an identifiable asset or group of assets", for example, when the principal identifiable asset in the acquisition is a broadcasting licence with a term longer than 10 years.

This is much stronger wording than SSAP-8, which states that the amortisation period "is unlikely to exceed 10 years". Interestingly the IASC exposure draft [E61] has moved from a maximum period of 20 years to a rebuttable assumption that the period does not exceed 20 years. Understandably, the New Zealand FRSB is concerned that the IASC's proposed position could result in inappropriately prolonged amortisation periods.

Impairment tests

The carrying value of goodwill is to be reviewed at each reporting date.

- impairment loses will be recognised immediately
- reversals of impairment loses will "be reversed in a subsequent reporting period if, and only if, the specific external event that caused the recognition of the impairment has reversed".

Examining the numbers

The example compares the consolidated statements of financial position under the "equity transaction treatment" and the "step-by-step" approach. The comparative consolidated statements of financial position immediately after the second acquisition under the two treatments were as follows:

Equity	Step-by-step	Equity transaction
Parent equity	1000	1000
Post acquisition retained earnings of subsidiary	720	720
Post acquisition asset revaluation reserve of subsidiary	810	-
Deficiency on purchase of equity from minority		(110)
	2530	**1610**
Net assets		
Net identifiable assets	2430	1530
Goodwill	100	80
	2530	**1610**

The radically different "equity transactions treatment", as proposed in ED-84, requires careful examination:

Firstly, the item "deficiency on purchase of equity from minority" does not make sense –

- How can there be a deficiency of 100, when assets worth 200 (10% of fair value of 2000) were acquired for 220?
- What does the word 'deficiency' mean in this context? Presumably, this is an arm's length transaction, so the parent would have paid a fair price, so how can a deficiency arise? The premium paid was 20, and that must relate to the fair value of the subsidiary's unidentifiable assets - namely goodwill.

Secondly, goodwill is understated by 20 (see previous point) and net identifiable assets are understated from the point of view of the parent's shareholders which at this final stage are the only shareholders in the group.

The commentary relative to the example in the discussion paper gives two reasons for adopting the "equity transaction treatment".

Reason number one

"The entity concept of consolidation established by the Statement of Concepts … establishes minority interest as a component of group equity as it does not meet the definition of a liability".

The stated conclusion is that one part of the equity of the group cannot trade with another part of the equity to give rise to goodwill or a revenue or expense item to the group.

However, as admitted in the Discussion Paper, "the (group) financial statements are usually prepared for the purpose of the parent equity holders". Surely the widely accepted parent concept approach is more appropriate, whilst conforming with the Statement of Concepts to the extent that total equity includes minority interest.

If there is to be such a radical change to financial reporting, this must be a world-wide decision, and we should wait for a lead from the IASC.

Reason number two

"The step-by-step treatment can lead to measurement anomalies. If the acquisition of the remaining interest is accounted for under the step-by-step treatment, a significant increase in group net assets can result from the revaluation of subsidiary assets which would otherwise not have been revalued".

This is a strange reason for justifying the use of the "equity transaction treatment". The IASC (in IAS-22 and E61) allows two alternative treatments, both of which are on the step-by-step basis:

- The **alternative** treatment of the IASC is shown in the ED-84 Discussion Paper under the 'step-by-step' heading in the comparative table (see above)
- The **benchmark** treatment of the IASC results in the assets being recognised at cost.

The benchmark treatment of the IASC retains the historical cost approach, whilst the alternative treatment results in a revaluation – take your pick – so where is the justification for ignoring International (and the rest of the world) GAAP?

Goodwill measurement

Under ED-84, no difference on acquisition will be recognised as goodwill on acquisition in respect of additional purchases of shares after control has been achieved and no adjustment is made to goodwill when shares in the subsidiary are sold without loss of control.

Under accepted consolidation procedures, any goodwill which is recognised in the statement of financial position of the investee, is not carried into the consolidation, but is replaced in the group financial statements by the cost of goodwill to the group (being the amount paid by the parent on acquisition).

This means that the only goodwill relating to subsidiaries which is recognised in the consolidated financial statements is:

- the parent's share of the value of the subsidiary's unidentifiable assets (ie goodwill), and
- cost of control [(ie the amount, paid by the parent, in excess of the fair value of the net assets (including the aforementioned goodwill) of the subsidiary, in order to gain control].

In order to correctly reflect the **parent's share** of the subsidiary's goodwill, it is necessary to increase the carrying value of that asset on acquiring additional ownership or to decrease the carrying value when the ownership proportion is reduced. This applies whether or not control is achieved prior to the increased holding and whether or not control is relinquished as a result of the reduced holding.

Identification of a subsidiary

In ED-84, **control** is the determining factor in identifying a subsidiary:

- capacity to exercise a power of an ownership form
  - capacity: the ultimate capacity to determine the decision making of an entity, regardless of whether that capacity is actively exercised or not
  - power of an ownership form refers to power held through mechanisms associated with ownership (as distinct from control of a regulatory, purchase or lending form), to extract economic benefits arising from an entity's operation
  - power must be unilateral; it is not shared or divided
  - power element usually exists through the ability to select and terminate management
  - power in private sector usually results from majority interest in voting rights
  - power in public sector is often specified by legislation or executive authority or by administrative arrangements
- or a previously exercised ownership form which established a policy-guiding irreversible mechanism
- with a current or future entitlement to a significant portion of the net ownership benefits arising
  - ownership benefits arise from the ownership power mechanism or from legislation and are usually received by way of distribution of earnings or net assets
- power and benefits : the two elements of control
  - benefits are dependent on the power element.

future benefits is an essential part of the definition of an asset in the Statement of Concepts for General Purpose Financial Reporting, therefore the assets of an investee cannot be recognised by the group unless the group receives benefits, in addition to the power element, in respect of those assets.