IAS 27 definitions

- **Subsidiary:** an entity that is controlled by another entity (parent).
- **Control:** The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control is usually based on ownership of more than 50% of voting power but other forms of control are possible.

IAS 27 gives four other situations in which control exists.

- When the parent company has power to govern financial and operating policies of the entity under a statute or an agreement.
- The parent has more than half of the voting rights by virtue of an agreement with other investor.
- The parent has power to appoint or remove the majority of the members of the Board of Directors.
- The parent has power to cast the majority of votes at a meeting of the Board of Directors.

Circumstances where it is permitted not to consolidate a subsidiary.

(1) **Lack of effective control:** A subsidiary operating under long term restrictions, so severe that the parent cannot exercise effective control should be excluded from consolidation. If an investor does not have effective control over an investee, then the investee cannot be classified as a subsidiary.
If the subsidiary operates under severe long term restrictions which are so serious that the parent has lost control over its investment then it no longer meets the definition of a subsidiary. This may occur in practice where a foreign subsidiary is subject to interference by the relevant government perhaps taking the form of blocking remittances back to the parent.

Accounting treatment where there is lack of effective control

The excluded subsidiary should be accounted for as (an investment) in accordance with IAS 39.

(2) **Subsidiary held for resale:** if on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5, then it must still be included

- **Eliminating intra-group transactions:** Intra-group transactions must be eliminated on consolidation in order to achieve the main objective of group financial statements i.e. to show the position of the group as if it were a single economic entity.

  A group cannot trade with itself nor can it make a profit out of itself. In a similar way it can not increase its sales or its net assets by transferring assets and liabilities between members of the group.

- IFRS 3 does not refer to this as negative good will however this is the commonly used term.
- It arises due to a misstatement of the fair values of assets and liabilities and the standard requires that the calculation is reviewed.
- After such a review any negative good will remaining is credited directly to the income statement.

Illustration

Statement of financial position at 31 Dec 2009.

	Faye	Garbo
Non current assets		
Property plant and equipment	33.000	20.000
Investments (shares in Garbo at cost)	12.000	
Current assets	5.000	15.000
	50.000	**35.000**
Equity and liabilities		
Capital and reserves		
Called up share capital (Shs.1 ordinary shares)	10.000	4.000
Share premium	5.000	-
Retained earnings	6.000	12.000
	21.000	16.000
Non current liabilities		
8% loan notes	20.000	9.000
Current liabilities	9.000	10.000
	50.000	**35.000**

On 1st Jan 2003 Faye acquired 3.000 shares of Garbo. At that date the balance on Garbo retained earnings was 8.000.= and the fair value of the non controlling interest was Shs.3.500.=.

An impairment review at year end showed a fall in the value of good will of Shs.1.800.=.

Required: Prepare a consolidated statement of financial position of Faye at 31st Dec 2009 assuming that it is a group practice to value the NCI using the full good will method.

Note: The NCI is valued using the proportion of net Assets method

Review Exercise

Calculate the unrealized profit in each of the following scenarios

H owns 80% of S. In separate years transfers are

a) From H to S shs 20,000, Mark up 25% half of the good are still in inventory

b) From S to H shs 150,000. Mark up 50% and 20% in Inventory

c) From H to S shs 120,000, Mark up 1/3, third still in inventory

d) From S to H shs 65,000, mark up 30% third in Inventory

Given below are the income statements for Paris and its subsidiary London for the year ended 31 December 20X5

	Paris ($000)	London ($000)
Sales revenue	3,200	2,560
Cost of sales	(2,200)	(1,480)
Gross profit	1,000	1,080
Distribution costs	(160)	(120)
Administrative expenses	(400)	(80)
	440	880
Investment income	160	
	600	880
Taxation	(400)	(480)
Net profit for the year	**200**	**400**

Additional information

- Paris paid $ 1.5 million on 31 December 20X1 for 80% of London's ordinary share capital of $800,000. The balance on London's retained earnings was $600,000 at that time.
- Good will impairments at 1 January 20X5 amounted to $152,000. A further impairment of $38,000 was found to be necessary at the year end. The profit element included in London's closing inventory was $30,000.
- Paris made sales to London, at a selling price of $600,000 during the year. Not all of the goods had been sold externally by the year end. The profit element included in London's closing inventory was $30,000.
- The figure for investment income in Paris's income statement comprises the parent company's share of the subsidiary's total dividend for the year.

<u>**Required**</u>

Prepare a consolidated income statement for the year ended 31st December 20X5 for the Paris group.