Consolidated Financial Statements – Part 3
(Relevant to PBE Paper I – Financial Accounting)

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Introduction

In the first and second part of our articles, we described the principle of control and the procedures for preparation of consolidated financial statements of a parent and its subsidiaries. In addition to interests in subsidiaries, the parent may have investments in other entities, which give rise to significance influence or joint control over the financial and operating policies of these entities. Such entities are called associates or joint arrangements respectively.

In this article, we describe how associates and joint arrangements are accounted for in the investor's individual and consolidated financial statements.

Investments in associates

HKAS 28 *Investments in Associates and Joint Ventures* defines an associate as an entity over which the investor has significance influence. For example, if A Ltd has significance influence over the financial and operating policies of B Ltd, B Ltd is an associate of A Ltd.

<u>Significance influence</u>
The key element to identify the existence of an associate is "significance influence". Significance influence is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control of those policies.

HKAS 28 provides the following guidance on determining the existence of significance influence:
(a) If an entity holds 20% or more of the voting power of the investee, it is presumed that the entity has significance influence.
(b) If an entity holds less that 20% of the voting power of the investee, it is presumed that the entity does not have significance influence unless it can be demonstrated that such influence does exist.

The existence of significance influence by an entity is usually evidenced in one or more of the following ways:
(a) representation on the board of directors or equivalent governing body of the investee;
(b) participation in policy-making processes such as decisions about dividends;
(c) material transactions between the entity and its investee;
(d) interchange of managerial personnel; or
(e) provision of essential technical information.

Equity method

HKAS 28 requires that investment in an associate should be accounted for using the equity method in the investor's financial statements. Under the equity method, the investment in an associate is initially recognized at cost and the carrying amount is increased or decreased to recognize the investor's share of the profit or loss and other comprehensive income of the investee after the date of acquisition. Distributions received from the investee reduce the carrying amount of the investment.

Example 1

A Ltd acquires 35% of the ordinary shares of B Ltd for $500,000 on 1 January 2012 and can exercise significant influence over the financial and operating policy decisions of B Ltd. B Ltd is therefore accounted for as an associate of A Ltd.

During the year ended 31 December 2012, B made a profit of $200,000 and recognized a gain on revaluation of $60,000 in other comprehensive income from the revaluation of a plant. B Ltd declared dividend of $40,000 on 31 December 2012.

Under the equity method, the investment in B Ltd is initially recognized at cost of $500,000 and is subsequently increased by A Ltd's share of post-acquisition profit (i.e. $200,000 x 35% = $70,000) and revaluation gain (i.e. $60,000 x 35% = $21,000), and is decreased by A Ltd's share of dividend receivable (i.e. $40,000 x 35% = $14,000).

The journal entries to record the investment in B Ltd at cost are as follows:

1 January 2012	$'000	$'000
Dr. Investment in an associate (B Ltd)	500	
Cr. Cash		500
To recognize the acquisition of ordinary shares of B Ltd.		

The journal entries to recognize the results of B Ltd using the equity method are as follows:

31 December 2012		
Dr. Investment in an associate (B Ltd)	91	
Cr. Profit or loss – Share of an associate's profit		70
Cr. Other comprehensive income – Share of an associate's other comprehensive income		21
To recognize the share of B Ltd's profit and other comprehensive income.		
Dr. Dividend receivable (B Ltd)	14	
Cr. Investment in an associate (B Ltd)		14
To recognize the share of B Ltd's dividend receivable.		

Therefore, the carrying amount of "Investment in an associate (B Ltd)" amounts to $577,000 (i.e. $500,000 + $91,000 – $14,000) as at 31 December 2012.

Sales transactions with associates

Where the investor sells the goods to its associates ("downstream sales") or purchases goods from its associates ("upstream sales"), HKAS 28 requires that gains and losses resulting from upstream and downstream transactions are eliminated to the extent of the investor's interest in the associate.

Joint arrangements

HKFRS 11 *Joint Arrangements* defines a joint arrangement as an arrangement over which two or more parties have joint control. From this definition, a joint arrangement has the following two key characteristics:

(a) Existence of contractual arrangement: the parties in the joint arrangement are bound by a contractual arrangement which sets out the activity, duration and obligations of the parties.

(b) Joint control: there is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. In other words, no single party is in a position to control activity unilaterally.

<u>Types of joint arrangement</u>

The classification of a joint arrangement depends on the rights and obligations of the parties to the arrangements. HKFRS 11 identifies two types of joint arrangement as follows:

(a) Joint operations: a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.

(b) Joint ventures: a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

<u>Joint operations</u>

Joint operations usually do not involve the establishment of a separate entity. Each joint operator should recognize its own assets, liabilities, income and expenses, including its share of those incurred in joint operations. In other words, each joint operator records all assets, liabilities, income and expenses for joint operations and then determines the profit shared among each joint operator. Final settlement is to be made between joint operators.

Example 2

JA Ltd and JO Ltd enter into a joint arrangement to manufacture and sell textiles. JA Ltd is responsible for purchasing the materials while JO Ltd is responsible for selling the finished products. Each party has an equal profit share in the joint arrangement.

The joint arrangement with JO Ltd is a joint operation as no separate and distinct entity is established. JA Ltd and JO Ltd are joint operators which jointly operate the textiles business and share the profit or loss of the joint arrangement equally. Each party has its own rights to the assets and obligations for the liabilities relating to the arrangement.

<u>Joint ventures</u>

Under this type of joint arrangement, a new and separate entity was established. Each joint venturer should recognize its interest in a joint venture as an investment and should account for that investment using the equity method in accordance with HKAS 28.

Example 3

JA Ltd and JB Ltd decide to set up a new company JV Ltd to manufacture and sell textiles. According to the contractual agreement between JA Ltd and JB Ltd, each party owns 50% of shares of JV Ltd. All the significant operating and financial activities must be approved by both JA Ltd and JB Ltd together.

The joint arrangement with JB Ltd is a joint venture as a separate company JV Ltd was set up to carry out the business. JA Ltd and JB Ltd are joint venturers which each own a 50% share of the joint venture. Each party is entitled to have the rights to net assets of the joint venture on liquidation.

Accounting for associates and joint ventures in consolidated financial statements

If the entity has subsidiaries, associates and joint ventures at the same time, the principles for the preparation of consolidated financial statements are as follows:

(a) First, prepare the consolidated financial statements by combining the financial statements of the parent and its subsidiaries using the acquisition method. The procedures required for the acquisition method and consolidation adjustments were discussed in parts 1 and 2 of this series of articles.

(b) Second, apply the equity method to incorporate the results of associates and joint ventures.

Application of the equity method in the consolidated financial statements

When applying the equity method in the consolidated financial statements, the following principles should be noted:

(a) Income from the investments in associates and joint ventures are accounted for based on the group's shares of post-acquisition profit and other comprehensive income of the associates and joint ventures. They are presented separately in the consolidated statement of comprehensive income as "share of associates' and joint ventures' profits" and "share of associates' and joint ventures' other comprehensive income" respectively.

(b) Investments in associates and joint ventures are initially recognized at cost and adjusted thereafter for the post-acquisition profit and other comprehensive income of the associates and joint ventures. They are presented separately under non-current assets in the consolidated statement of financial position.

A comprehensive example

Using same information of a comprehensive example in part 2 of our article, published in October 2013, (http://www.hkiaat.org/index.php/services/index/199/) in addition to its acquisition of Sunrich, Prime purchased 30% of the ordinary shares of Sky Ltd ("Sky") and 50% of the ordinary shares of Star Ltd ("Star") for $800,000 and $500,000 in cash respectively on 1 January 2012 when the retained earnings of Sky and Star were $2,500,000 and $1,600,000 respectively. Sky and Star are accounted for as an associate and a joint venture of Prime respectively.

The following are the consolidated financial statements of Prime group (after incorporating the investment in Sky and Star) and separate financial statements of Sky and Star for the year ended 31 December 2012:

Statements of financial position as at 31 December 2012

	Prime group $'000	Sky $'000	Star $'000
ASSETS			
Non-current assets			
Property, plant and equipment	14,560	11,100	13,450
Goodwill	10,119	–	–
Investment in an associate (Sky)	*800*	–	–
Investment in a joint venture (Star)	*500*	–	–
Total non-current assets	25,979	11,100	13,450
Current assets			
Inventories	1,316	990	1,380
Trade receivables	730	540	660
Cash and bank	*4,750*	1,450	2,340
Total current assets	6,796	2,980	4,380
Total assets	32,775	14,080	17,830
EQUITY AND LIABILITIES			
Equity attributable to owners of the parent			
Ordinary share capital	18,000	9,000	12,000
Retained earnings	9,638	3,410	3,670
	27,638	12,410	15,670
Non-controlling interests	2,307	-	-
Total equity	29,945	12,410	15,670
Current liabilities			
Trade payables	2,830	1,670	2,160
Total current liabilities	2,830	1,670	2,160
Total equity and liabilities	32,775	14,080	17,830

Statements of comprehensive income for the year ended 31 December 2012

	Prime's Group $'000	Sky $'000	Star $'000
Revenue	14,390	9,800	13,690
Cost of sales	(5,384)	(4,670)	(8,740)
Gross profit	9,006	5,130	4,950
Other income	1,650	-	-
Other operating expenses	(3,540)	(3,570)	(1,990)
Profit before tax	7,116	1,560	2,960
Income tax expense	(1,430)	(650)	(890)
Profit and total comprehensive income for the year	5,686	910	2,070
Profit and total comprehensive income attributable to:			
Owners of the parent	5,278		
Non-controlling interests	408		
	5,686		

Required:

Prepare the consolidated statement of comprehensive income of Prime group for the year ended 31 December 2012 and the consolidated statement of financial position as at that date after incorporating the results of Sky and Star.

Solution:

The journal entries to recognize the results of Sky and Star using the equity method are as follows:

31 December 2012	$'000	$'000
Dr. Investment in an associate (Sky)	273	
Cr. Consolidated profit or loss – Share of an associate's profit ($910,000 x 30%)		273
To recognize the share of Sky Ltd's post-acquisition profit.		
Dr. Investment in a joint venture (Star)	1,035	
Cr. Consolidated profit or loss – Share of a joint venture's profit ($2,070,000 x 50%)		1,035
To recognize the share of Star Ltd's post-acquisition profit.		

The consolidated financial statements of Prime group after the incorporating the results of Sky and Star are as follows:

The Prime group

Consolidated statement of financial position
as at 31 December 2012

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment	14,560
Goodwill	10,119
Investment in an associate ($800,000 + $273,000)	1,073
Investment in a joint venture ($500,000 + $1,035,000)	1,535
Total non-current assets	27,287
Current assets	
Inventories	1,316
Trade receivables	730
Cash and bank	4,750
Total current assets	6,796
Total assets	34,083
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Ordinary share capital	18,000
Retained earnings ($9,638,000 + $273,000 + $1,035,000)	10,946
	28,946
Non-controlling interests	2,307
Total equity	31,253

Current liabilities	
Trade payables	2,830
Total current liabilities	2,830
Total equity and liabilities	34,083

The Prime group
Consolidated statement of comprehensive income
for the year ended 31 December 2012

	$'000
Revenue	14,390
Cost of sales	(5,384)
Gross profit	9,006
Other income	1,650
Other operating expenses	(3,540)
Share of an associate's profits	273
Share of a joint venture's profits	1,035
Profit before tax	8,424
Income tax expense	(1,430)
Profit and total comprehensive income for the year	6,994
Profit and total comprehensive income attributable to:	
Owners of the parent ($5,278,000 + $273,000 + $1,035,000)	6,586
Non-controlling interests	408
	6,994

Conclusion

Students preparing for PBE Paper I – Financial Accounting must possess the relevant skills and knowledge to enable them to prepare consolidated financial statements of a parent and its subsidiaries using the acquisition method. They are also expected to possess the basic knowledge of accounting for associates and joint ventures in the consolidated financial statements using the equity method.