Consolidated Financial Statements – Part 1
(Relevant to PBE Paper I – Financial Accounting)

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Introduction

Many large entities achieve growth and expansion by investment in the shares of other entities. Those entities may acquire part or all of the share capital in the other entities, called subsidiaries, associates, or joint ventures. When one or more entities are controlled by another entity, the latter entity (known as the parent) is required to prepare consolidated financial statements.

The preparation of consolidated financial statements is one of the most essential topics in PBE Paper I: Financial Accounting. Consolidated financial statements cover a wide range of accounting issues. This, the first of three articles, describes the principle of control and the basic consolidation procedures. The second part will deal with the preparation of consolidated financial statements involving key consolidation adjustments such as fair value adjustments and intra-group transactions between a parent and its subsidiary. The final part will address how associates and joint ventures are accounted for in the consolidated financial statements by using the equity method.

Scope and Definitions

HKFRS 10 "Consolidated Financial Statements" requires an entity that is a parent to present consolidated financial statements. A parent and subsidiary are defined in HKFRS 10 as follows:

(a) Parent – An entity that controls one or more entities.
(b) Subsidiary – An entity that is controlled by another entity.

For example, if P Ltd controls S Ltd (say, through holding more than half of the S Ltd's ordinary share capital), P Ltd is the parent of S Ltd and S Ltd is a subsidiary of P Ltd. P Ltd and S Ltd together form a group.

A group is defined in HKFRS 10 as a parent and its subsidiaries. Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Principle of Control

HKFRS 10 establishes a parent-subsidiary relationship based on the principle of control.

Under HKFRS 10, a parent controls a subsidiary when it is exposed, or has rights, to variable returns from its involvement with the subsidiary and has the ability to affect those returns through its power over the subsidiary.

In assessing whether power exists, the parent should consider substantive rights that give it the current ability to direct the subsidiary's relevant activities, i.e. the activities that significantly affect the subsidiary's returns. In the most straightforward case, a parent that holds a majority of voting rights (i.e. more than 50% of voting shares) has power over the subsidiary.

In addition, even if less than a majority of the voting rights are acquired, HKFRS 10 provides that the parent can also have power over its subsidiary. When assessing whether such voting rights are sufficient to give it power, a parent should consider all facts and circumstances, including the size of the parent's holding relative to those of other vote holders, potential voting rights held by the parent and rights arising from other contractual arrangements.

The following example demonstrates the case where a parent has power over an entity that gives it control over the entity, despite holding less than a majority of the voting rights.

Example 1
Big Ltd acquires 45% of the voting ordinary shares of Small Ltd. The remaining voting ordinary shares in Small Ltd are held by thousands of shareholders, none individually holding more than 1% of the voting shares.

Required:
Does Big Ltd have the power over Small Ltd?

Solution:
In this case, on the basis of the absolute size of its holding (45% voting rights) and the relative size of the other shareholdings (widely dispersed shareholding of not more than 1%), it is concluded that Big Ltd has a sufficiently dominant voting interest to give it power over Small Ltd.

To establish control, a parent not only needs to have the ability to use its power over the subsidiary, but must also have exposure, or rights, to variable returns from its involvement with the subsidiary when the parent's returns from its involvement have the potential to vary as a result of the subsidiary's performance. Returns can be in the forms of dividends, remuneration for servicing the subsidiary, residual interests in the subsidiary's assets and liabilities on its liquidation, tax benefits, cost savings, etc.

Consolidation Procedures
The basic principle for the preparation of consolidated financial statements is to combine the like items of assets, liabilities, equity, income and expenses of the parent and its subsidiaries on a line-by-line basis after certain consolidation adjustments – generally involving the elimination of intra-group transactions and balances.

Basic consolidation procedures involve the following steps:
(a) Eliminate intra-group transactions and balances
(b) Determine and measure non-controlling interests
(c) Determine and recognize goodwill arising from the acquisition of the subsidiary
(d) Prepare the consolidated financial statements by combining like items in the financial statements of the parent and its subsidiary

The following example demonstrates the technique required to prepare a simple consolidated statement of financial position. (Note: More complicated illustrations involving consolidation adjustments such as fair value adjustments, intra-group transactions and balances, etc., will be covered in the second article.)

Example 2

On 1 January 2012, Success Ltd ("Success") paid $10 million in cash to acquire 70% of ordinary share capital of Bright Ltd ("Bright") when the ordinary share capital and retained earnings of Bright were $3,000,000 and $1,450,000 respectively. Bright is classified as a subsidiary of Success.

The draft statements of financial position of Success and Bright for the year ended 31 December 2012 are shown as follows:

	Success	Bright
	$'000	$'000
Property, plant and equipment	13,150	3,160
Investment in Bright	10,000	–
Inventories	2,680	1,280
Trade receivables	1,320	850
Cash and bank	1,560	1,140
Total assets	28,710	6,430
Ordinary share capital	20,000	3,000
Retained earnings at 1 January 2012	3,420	1,450
Profit for the year	4,140	1,000
Trade payables	1,150	980
	28,710	6,430

Required:

Prepare the consolidated statement of financial position of the Success group as at 31 December 2012.

Solution:

The preparation of the consolidated statement of financial position of the Success group involves the following steps:

(a) Determine and measure non-controlling interests

Non-controlling interests (NCI) is defined in HKFRS 10 as the equity in a subsidiary not attributable, directly or indirectly, to a parent. NCI is generally measured at its proportionate share of the subsidiary's identifiable net assets.

	Bright	Bright
	1/1/2012	31/12/2012
	Date of acquisition	Year-end
	$'000	$'000
Ordinary share capital	3,000	3,000
Retained earnings at 1 January 2012	1,450	1,450

Profit for the year	–	1,000
Total net assets	4,450	5,450
NCI (30%)	1,335	1,635

The consolidated journal entry (JE1) to record NCI's share of post-acquisition profit (i.e. profit earned after the date of acquisition) of Bright is:

		$'000	$'000
Dr.	Profit for the year (Bright)	300	
	Cr. NCI ($1,000,000 x 30%)		300

To recognize NCI's share of post-acquisition profit of Bright.

(b) Determine goodwill arising from the acquisition of the subsidiary

Goodwill arising from the acquisition of a subsidiary, referred as goodwill under HKFRS 3 "Business Combinations", is defined as an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

Two main reasons why a parent acquires a subsidiary with goodwill are:

(a) To reduce operating costs through synergies and economies of scale expected from combining the net assets and operations of the parent and the subsidiary.

(b) To generate favourable returns from the expected growth in the earnings potential of the subsidiary.

HKFRS 3 requires that the parent should recognize goodwill as of the acquisition date measured as the excess of:

(a) the aggregate of the consideration transferred (i.e. the carrying amount of parent's investment in the subsidiary) and the amount of any non-controlling interest in the subsidiary; over

(b) the net of the acquisition-date amounts of the assets acquired and liabilities assumed in the subsidiary.

	$'000
Investment in Bright	10,000
NCI at 1 January 2012	1,335
	11,335
Less: Identifiable net assets of Bright at 1 January 2012	(4,450)
Goodwill at 1 January 2012 (the acquisition date)	6,885

The consolidated journal entry (JE2) to record goodwill is:

		$'000	$'000
Dr.	Ordinary share capital (Bright)	3,000	
Dr.	Retained earnings (Bright)	1,450	
Dr.	Goodwill	6,885	
	Cr. NCI		1,335
	Cr. Investment in Bright		10,000

To recognize goodwill arising from the acquisition of Bright.

(c) Combine like items in the financial statements of the parent and the subsidiary

	Success	Bright	Adjustments Dr.	Adjustments Cr.	Total
	$'000	$'000	$'000	$'000	$'000
Property, plant and equipment	13,150	3,160			16,310
Investment in Bright	10,000	–		JE(2)10,000	–
Goodwill	–	–	JE(2) 6,885		6,885
Inventories	2,680	1,280			3,960
Trade receivables	1,320	850			2,170
Cash and bank	1,560	1,140			2,700
Total assets	28,710	6,430			32,025
Ordinary share capital	20,000	3,000	JE(2) 3,000		20,000
Retained earnings, at 1 January 2012	3,420	1,450	JE(2) 1,450		3,420
Profit for the year	4,140	1,000	JE(1) 300		4,840
Non-controlling interests				JE(1) 300 JE(2) 1,335	1,635
Trade payables	1,150	980			2,130
	28,710	6,430			32,025

The consolidated statement of financial position of the parent and the subsidiary (as a group) is presented in accordance with HKAS 1 "Presentation of Financial Statements" as follows:

The Success group
Consolidated statement of financial position
as at 31 December 2012

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment	16,310
Goodwill (Note 1)	6,885
Total non-current assets	23,195
Current assets	
Inventories	3,960
Trade receivables	2,170
Cash and bank	2,700
Total current assets	8,830
Total assets	32,025
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Ordinary share capital	20,000
Retained earnings ($3,420,000 + $4,840,000)	8,260
	28,260
Non-controlling interests (Note 2)	1,635

Total equity	29,895
Current liabilities	
Trade payables	2,130
Total current liabilities	2,130
Total equity and liabilities	32,025

Notes:

(1) The parent should measure goodwill at the amount recognized at the acquisition date less any accumulated impairment losses. In this case, it has been assumed that no impairment of goodwill has occurred for the year.

(2) Non-controlling interest is presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

Exemption from Consolidation

While HKFRS 10 requires a parent to present consolidated financial statements, it permits a parent to be exempt from this requirement if the parent fulfils all the following conditions:

(a) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(b) its debts or equity instruments are not traded in a public market;

(c) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and

(d) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards.

Conclusion

Students sitting for PBE Paper I: Financial Accounting must possess the relevant skills and knowledge for preparing consolidated financial statements. The next article in this series will describe and illustrate certain key consolidation adjustments required in preparing consolidated financial statements, including fair value adjustments, intra-group transactions and balances, cash in transit, etc.