A subsidiary company is consolidated using acquisition accounting, which should apply from the date on which the parent company achieves control of it. This method results in the line-by-line consolidation of the subsidiary’s net assets and the recognition of a goodwill asset and non-controlling interests. The recent revisions to IAS27, “Consolidated and separate financial statements”, place greater emphasis on the change in control as a significant economic event. This has resulted in changes to how step acquisitions and disposals are treated in group accounts.

Where an entity purchases shares in another entity and later buys additional shares in it, the second purchase is referred to as a step acquisition. When a step acquisition occurs, there are two possible situations that need to be considered:

- The purchasing entity owns a controlling shareholding prior to the step acquisition. The parent-subsidiary relationship exists already, so the stake owned by the non-controlling-interest shareholders (NCIs) is simply reduced as a result of the latter transaction. Under IAS27, step acquisitions that give the purchasing entity a controlling stake are accounted for by revaluing the existing holding to fair value at the date on which that entity achieves control and becomes a parent, with any subsequent gain or loss being recorded within profit. Acquisition accounting is then used from that date.

Let’s tackle the sample question in the panel to demonstrate how to deal with such a scenario. On January 1, 2009 company X’s cumulative shareholding in company Y becomes 60 per cent, so this is when it achieves control and Y will be consolidated as a subsidiary. The revised IFRS3, “Business combinations”, requires that goodwill includes the cost of the parent’s investment at fair value, so the fair value of both the 20 per cent holding and the 40 per cent holding as at January 1, 2009 should be considered. The cost of X’s investment in Y will, therefore, be £50,000 + £150,000 = £200,000, which is the solution to requirement A.

X’s previous holding of 20 per cent has been remeasured from its cost of £40,000 to its fair value of £50,000, so a gain of £10,000 will be recognised in the consolidated income statement (CIS) and also within consolidated retained earnings, which is the solution to requirement B(i). In effect, the transaction is being accounted for as if X has disposed of its 20 per cent holding, which cost £40,000, for “proceeds” of £50,000 and then acquired a 60 per cent holding at a cost of £200,000. In this case, the 20 per cent investment will have been accounted for in accordance with IAS39, “Financial instruments: recognition and measurement”, in X’s individual financial statements. If the investment has been classed as “available for sale” under this standard, X will have revalued the investment to its fair value of £50,000 as at January 1, 2009 and recorded the gain of £10,000 within reserves (equity). On consolidation, this gain is removed from reserves and recorded within profit.

If X’s initial 20 per cent holding enabled it to exert significant influence over Y, it’s necessary to note this assumption. Y would have been treated as an associate, therefore, and equity accounting would be used in the consolidated accounts. Consequently, on January 1, 2009 the investment in the associate would have a carrying value in the consolidated statement of financial position of the cost of investment plus its share of post-acquisition profits. In this case it’s: £40,000 + (20% x £30,000) = £46,000. Consequently, the gain arising in the CIS will be the fair value of the previous holding minus the carrying value of that holding: £50,000 – £46,000 = £4,000, which is the solution to requirement B(ii).

If the step acquisition occurs part-way through the financial year, it will be necessary when preparing the CIS to time-apportion the results of the investee and equity account for the proportion of the year in which it’s an associate and use acquisition accounting for the proportion in which it’s a subsidiary.

A step acquisition will reduce the NCIs’ holding in cases where the initial investment gave the parent a controlling shareholding, so the investee has already been consolidated.
as a subsidiary. As a result, there is no change in the subsidiary status of the investee when the subsequent share purchase occurs. There is simply a change in the proportions of ownership between the parent and the NCIs at the step acquisition. In effect, the parent is buying shares from the NCIs. Since this is a transaction between shareholders, no gain or loss arises and so there is no effect on profit. But a difference may need recording within equity.

Let’s now consider another example of an acquisition. On January 1, 2007 Pumpkin acquired 70 per cent of Squash for £45,000 when Squash’s net assets had a fair value of £50,000. The fair value of the NCIs’ holding at this time was £17,500. On January 1, 2009 Squash’s net assets are worth £80,000. Pumpkin’s policy is to measure goodwill gross and so to value the NCIs’ holding at fair value at acquisition. Pumpkin gained control of Squash on January 1, 2007, so from this date Squash is consolidated as a subsidiary.

Goodwill is calculated as the cost of Pumpkin’s investment plus the fair value of the NCIs’ holding minus the fair value of 100 per cent of Squash’s net assets:

\[
\text{£45,000 + £17,500} - \left(\frac{30}{50}\times £26,500\right) = £12,500.
\]

The NCIs’ stake will be recognised at acquisition at its fair value of £17,500 and will increase by their share of post-acquisition profits – ie, the growth in Squash’s net assets. So at January 1, 2009 it will be: £17,500 + (30\% \times £26,500) = £22,500.

Let’s suppose that Pumpkin buys another 15 per cent of Squash’s shares on January 1, 2009, paying £15,000 for them. In so doing, it reduces the NCIs’ proportion of equity from 30 per cent to 15 per cent. Using the information given, we can calculate the increase or decrease in the value of the NCIs’ holding to be recorded within equity as follows:

\[
£15,000 – (15\% \times 30\% \times £26,500) = £1,750.
\]

This figure will be recorded as a decrease within equity, since Pumpkin has in effect paid a premium to acquire the shareholding from the NCIs. For exam purposes, £1,750 may be charged to retained earnings even though it doesn’t technically represent a loss.

Since there’s no change in the subsidiary status of the investment at the date of the step acquisition, goodwill remains unchanged. It will continue to be recorded at £12,500 (subject to any impairment losses).

If a CIS is being prepared and the step acquisition occurs part-way through the financial year, although Squash will be consolidated as a subsidiary for the whole period, it will be necessary to time- apportion Squash’s results in calculating the profit attributable to the NCIs.

In cases where a parent sells shares in its subsidiary, it is again necessary to consider whether there is any change in control. There are two relevant disposal scenarios to consider under IAS27:

- The NCIs’ shareholding increases, but the parent retains control.
- The parent loses its controlling stake.

Like a step acquisition by an existing parent that simply reduces the NCIs’ shareholding, a disposal that increases their stake entails no change in the subsidiary status of the investment. It is merely a transaction between shareholders, so there is no gain or loss arising, although there may be a difference to record within equity.

Let’s suppose that on January 1, 2009 Pumpkin instead disposes of 10 per cent of its Squash shares for a consideration of £10,000. We can use this information to calculate the increase or decrease to be recorded within equity. Pumpkin now owns 60 per cent of Squash and the NCIs’ holding has increased to 40 per cent. In effect, Pumpkin is selling 10 per cent of the subsidiary to the NCIs. The increase in the value of the NCIs’ stake is calculated as 10 per cent of the subsidiary’s carrying value – ie, its net assets (already calculated as £80,000) plus goodwill (already calculated as £12,500). The change in equity, therefore, is: £10,000 – (10\% \times £92,500) = £750.

This figure will be recorded as an increase within equity, since Pumpkin has in effect gained on the disposal. For exam purposes, £750 may be credited to retained earnings even though it doesn’t technically represent a gain.

Once again, if a CIS is being prepared and the disposal happens part-way through the financial year, it will be necessary to time-apportion Squash’s results in calculating the profit attributable to the NCIs.

In cases where a parent disposes of enough shares to lose control of a subsidiary,

If there’s no change in subsidiary status at the step acquisition, goodwill remains unchanged

### 1 The gain or loss arising on Pumpkin’s disposal of shares in Squash

<table>
<thead>
<tr>
<th></th>
<th>£</th>
<th>£</th>
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</thead>
<tbody>
<tr>
<td><strong>Proceeds</strong></td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td><strong>Fair value of Pumpkin’s residual holding in Squash</strong></td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td><strong>Less the carrying value of the subsidiary:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value of net assets at disposal</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill at disposal</td>
<td>12,500</td>
<td></td>
</tr>
<tr>
<td>Value of NCIs’ holding at disposal</td>
<td>(26,500)</td>
<td></td>
</tr>
<tr>
<td><strong>Gain on disposal</strong></td>
<td>66,000</td>
<td></td>
</tr>
<tr>
<td><strong>(0,000)</strong></td>
<td>9,000</td>
<td></td>
</tr>
</tbody>
</table>
the parent-subsidiary relationship is ended. Consequently, the net assets, goodwill and the NCIs' holding should all be removed and compared against the disposal proceeds to calculate any gain or loss arising on disposal.

If a residual interest is retained, the transaction is accounted for as if the parent has disposed of the whole subsidiary and re-acquired the remaining interest at fair value. The fair value, therefore, is included as part of the gain or loss on disposal and becomes the "cost" of the remaining interest for any subsequent accounting.

Let's now suppose that Pumpkin instead disposes of 30 per cent of Squash's shares on January 1, 2009 for cash proceeds of £35,000, ending the parent-subsidiary relationship in the process. The fair value of its remaining 40 per cent holding has been determined as £40,000. Using this information, we can calculate the gain or loss to be recorded within profit using table 1. The figure that emerges (£9,000 in this case) will be reported as an exceptional gain in the CIS and so is reported after operating profit.

Overall, the transaction is treated as though the whole investment in Squash of 70 per cent has been disposed of for £75,000 – ie, the fair value of the proceeds received for 30 per cent (£35,000) and the fair value of the 40 per cent holding (£40,000). The residual holding is then re-acquired at a "cost" of £40,000. Since a 40 per cent holding could be presumed to allow Pumpkin to retain a significant influence, Squash should be treated as an associate and equity accounting should be applied.

If the disposal occurs part-way through an accounting period, the results of Squash need to be time-apportioned so that they are consolidated up to the date of disposal and equity accounted thereafter.

My next article will cover how to deal with complex group structures. In the meantime, try the following question to test your understanding. The answer will appear in CIMA's student e-magazine, Velocity (www.cimaglobal.com/velocity). The summarised financial statements of three entities – P, S and R – for the year ended December 31, 2009 are shown in tables 2 and 3. On January 1, 2006 P acquired 80 per cent of the equity share capital of S for $140,000. At the same time it acquired 75 per cent of the equity share capital of R for $70,000. On this date the balances on the retained earnings of S and R were $75,000 and $30,000 respectively, while the fair values of S's and R's non-controlling interests were $35,000 and $22,000 respectively. It is P's policy to measure goodwill gross and so to record non-controlling interests at fair value at acquisition. There has been no impairment to the goodwill of either S or R since the acquisition date.

On January 1, 2006 P acquired a further 5 per cent of the equity shares of S for $10,000. This additional investment is recorded in P's books at its cost.

On October 1, 2009, P disposed of 50 per cent of R's equity shares for cash proceeds of $90,000. At this time it was determined that the fair value of the remaining interest was $25,000. P has yet to record this disposal in its individual financial statements.

You are required to prepare the CIS and the consolidated statement of financial position for the P group for the year ended December 31, 2009.

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