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Today's Agenda

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1 Consolidated financial statements

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- Accounts that show the total financial results of a group of companies for a particular period, rather than the separate results of each company.
 - The consolidated accounts of the holding company, subsidiaries and associates.

1.1 Important terms

1. **Parent company:** The company which holds the controlling interest in the others is known as the 'parent company'.
2. **Subsidiary company:** The companies which are controlled by the parent company are known as 'subsidiaries'. The parent company owns a majority stake in the subsidiary company.
3. **Associate company :** An associated undertaking is one which is not a subsidiary, but which is subject to significant influence (but not control) by the parent. The parent holds 20 to 50 % of the associate company.
4. **Joint Venture:** A joint venture (JV) is a business arrangement in which two or more parties agree to pool their resources for the purpose of accomplishing a specific task.
5. **Non controlling interest :** Non-controlling interest, also known as a minority interest, is an ownership position wherein a shareholder owns less than 50% of outstanding shares and has no control over decisions.

1.1 Important terms

6. **Controlling Interest** : A controlling interest is when a shareholder holds a majority of a company's voting stock.
7. **Goodwill** : Goodwill is an intangible asset that is associated with the purchase of one company by another. The value of a company's brand name, solid customer base, good customer relations, good employee relations, and proprietary technology represent some reasons why goodwill exists.

Goodwill is calculated as:

cost of acquisition – book value of shares acquired

1.2 Why to prepare Consolidated financial statements?

- In many cases, however, the business activities of the group members are closely related to one another, with group members supplying others with products or components or different group members manufacturing complementary product ranges. It is also common for group members to provide fellow members with finance.
- Even in the case of industrial conglomerates, where there is no direct link between the businesses of the members, all of the companies are under the control of the same senior management.
- It would be illogical for most purposes to view the group as being anything other than a single economic entity.
- The shareholders of the parent will certainly be more interested in the performance of the group as a whole than they will be in that of the parent taken on its own.
- The parent is required to publish a set of consolidated financial statements which reflect the economic reality of the group's existence.

1 Example

Max Hardware and Max Electronics are owned by Mr Max. As these are separate entries, Mr Max would like to prepare the consolidated financial statements and evaluate the financial position of the group.

Balance Sheet of Max Hardware

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital account		4258567.00	Fixed assets		880000.00
			Office furniture	880000.00	
Current liabilities		669764.45			
Duties & taxes	36661.31		Current assets		5342254.77
Sundry creditors	633103.14		Closing stock	1771223.80	
			Sundry debtors	2742170.73	
Profit & Loss a/c		1293923.32	Cash in hand	52913.00	
Current period	1293923.32		Bank accounts	775947.24	
Total		6222254.77	Total		6222254.77

1 Example

Balance sheet of Max Electronics

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital account		2000000.00	Fixed assets		350000.00
			Office furniture	200000.00	
Current liabilities		3473864.00	Office computers	150000.00	
Duties & taxes	316560.00				
Sundry creditors	3157304.00		Current assets		6561747.72
			Closing stock	1242976.72	
Profit & Loss a/c		1437883.72	Sundry debtors	4567140.00	
Opening balance	197000.00		Cash in hand	28880.00	
Current period	1240883.72		Bank accounts	722751.00	
Total		6911747.72	Total		6911747.72

1 Example

Consolidated Balance sheet

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital account		6258567.00	Fixed assets		1230000.00
			Office furniture	1080000.00	
Current liabilities		4143628.45	Office computers	150000.00	
Duties & taxes	353221.31				
Sundry creditors	3790407.14		Current assets		11904002.49
			Closing stock	3014200.52	
Profit & Loss a/c		2731807.04	Sundry debtors	7309310.73	
Opening balance	197000.00		Cash in hand	81793.00	
Current period	2534807.04		Bank accounts	1498698.24	
Total		13134002.49	Total		13134002.49

2 Goodwill on Consolidation

Any amount paid in excess of the nominal value of the shares and reserves acquired by a parent is known as 'goodwill'.

In theory, this is the amount which the parent is paying for such intangibles as:

- the reputation of the subsidiary
- its customer base
- its loyal workforce.



Goodwill is calculated as:

cost of acquisition – book value of shares acquired

Treatment of goodwill:

- Goodwill arises where an undertaking is purchased for more than the fair value of its net assets. The goodwill normally has a limited useful economic life and should be amortised on a systematic basis over that life in accordance with FRS 10. It would also be subject to impairment as referred to in FRS 11.

2 Example

Premier's "separate" (before consolidating) balance sheet immediately after purchasing 100% of Sledge's stock shows ownership of all of the stock of Sledge and that Premier paid \$400,000 for this investment. The \$400,000 flowed from Premier to the former owners of Sledge (not directly to Sledge). Sledge's balance sheet shows Sledge's total equity of \$300,000.

Goodwill = cost of acquisition – book value of shares acquired
= \$400000 – \$300000
= 100000

2.1 Negative goodwill

Negative goodwill arises where an entity is purchased for less than the fair value of its net assets.

IFRS 10 requires the following treatment of negative goodwill:

- It should be separately disclosed on the face of the balance sheet, immediately below the goodwill heading and followed by a subtotal showing the net amount of positive or negative goodwill.
- Negative goodwill up to the fair values of the non-monetary assets, for example fixed assets, acquired should be recognised in the profit and loss account in the periods in which the non-monetary assets are recovered, whether through depreciation or sale.
- Any negative goodwill in excess of the fair values of the non-monetary assets acquired should be recognised in the profit and loss account in the periods where the benefit is expected to be felt.

2.1 Example

Company XYZ faced growing competition and incurred debt obligations that it could not cover. The board of directors sold the company for \$288,000, which was lower than its fair market value. The table below reports consolidated information from Company XYZ's financial statements:

Information from Company XYZ's Financial Reports		
Particulars	Purchase Value	Market Value
Cash	\$90,000	\$90,000
Accounts Receivable	\$18,000	\$28,000
Inventory	\$72,000	\$72,000
Net PP&E	\$115,000	\$120,000
Intangible Assets	\$20,000	\$40,000
Total Assets	\$315,000	\$350,000
Total Liabilities	\$27,000	\$27,000
Net Assets	\$288,000	\$323,000

3 Non – Controlling Interest

 The value of the share capital and reserves provided by the subsidiary's minority shareholders is called the 'non-controlling interest'.

Treatment of Non – Controlling Interest :

- The non-controlling interest must be shown separately in the statement of financial position, in the equity section, after the capital and reserves attributable to equity holders.

3 Example

Equity	\$
Capital and reserves attributable to equity holders of the company	
Share capital	40000
Other reserves	15000
Retained earnings	80000
	135000
Non Controlling Interest	10000
Total equity	145000



Question

Company L acquired 85% of the shares outstanding of Company M. Thus, the remaining shares held by minority shareholders were 15%. At the end of the year, Company M reported revenues of \$ 500,000 and expenses of \$ 300,000, whereas Company L reported revenues of \$ 1,000,000 and expense of \$ 400,000.

Net income of Company L and M can be computed as under:

Particular	Parent Company L	Subsidiary Company M
Revenues	\$1,000,000	\$500,000
Expenses	\$400,000	\$300,000
Net income	\$600,000	\$200,000

Solution

Allocation of net income of Company M, between controlling and non-controlling interest, is as under:

Particulars	Amount	
Net Income	200,000	
Controlling Interest	170000	$200,000 \times (85\%)$
Non-Controlling Interest	30000	$200,000 \times (15\%)$

Solution

Consolidated net income can be computed as under:

Particular	Parent Company L	Subsidiary Company M
Consolidated Net Income		
Revenues	1,000,000	500,000
Expenses	400,000	300,000
Subsidiary Net Income	200,000	200,000
Consolidated Net Income (ADD):	800,000	1,000,000
Net income to Controlling Interest		
Consolidated Net Income	800,000	1,000,000
Non-Controlling Interest	-30,000	-30,000
Net Income to Controlling Interest (ADD):	770,000	970,000
Parent's Net Income	600,000	600,000
Controlling Interest	170,000	170,000
Net Income to Controlling Interest (ADD):	770,000	770,000

4 Associate companies



An associated undertaking is one which is not a subsidiary, but which is subject to significant influence (but not control) by the parent. The parent company owns only a minority stake of the associate company

Accounts of the associate company:

The fact that the parent can merely exert influence means that it would not be appropriate to include the value of its assets in the consolidated financial statements. It would also be inappropriate to treat the associate as a simple investment.

Instead, compromise is reached by including the parent's share of the associate's results:

- The consolidated statement of profit or loss – regardless of whether it receives these by way of dividend.
- The consolidated statement of financial position includes the parent's share of the associate's assets and liabilities.

The entries in both the statement of profit or loss and statement of financial position are single line entries, which state the total amounts attributable to associate companies.

4.1 Difference between Associate and Subsidiary

Basis of difference	Associate Company	Subsidiary Company
% of holding	Parent company holds minimum 20% but not more than 50% of the total voting power	Parent company holds more than 50% of the total voting power
Controlling Power	Here parent company has a significant influence to participate in the financial and operating decisions of the associate company.	The parent company has controlling power to participate in the financial and operating decisions of the subsidiary



Question

Identify and state reasons whether the following companies are associates or subsidiaries of Mahindra and Mahindra Limited:

1. Mahindra and Mahindra Limited has 26.04% holding in Tech Mahindra Ltd.
2. Mahindra and Mahindra Limited has 100% holding in Mahindra Retail Limited.
3. Mahindra and Mahindra Limited has 51% holding in Mahindra Auto Steel Private Limited.

Solution

1. Tech Mahindra Ltd is an associate company of Mahindra and Mahindra Limited as it holds 26.04% of the stake in the company.
2. Mahindra Retail Limited is an subsidiary of Mahindra and Mahindra Limited as it holds 100% of the stake in the company and controls majority of voting rights.
3. Mahindra Auto Steel Private Limited is an subsidiary of Mahindra and Mahindra Limited as it holds 51% of the stake in the company.

5 Accounts of Insurance companies



The preparation of insurance company accounts is complicated by two special features:

- The underlying contracts (liabilities) fall due outside the accounting period and are uncertain in size.
- Premature transfer of 'profit' to shareholders may endanger the financial stability of the company and the ability to meet future liabilities.

5.1 Important terms

1. **Technical accounts:** The technical account reflects, like a trading account. The technical account includes as operating costs the costs of acquiring contracts, the change in deferred acquisition costs, and most administrative expenses, less a deduction for any reinsurance commissions receivable.
2. **Non – technical accounts:** The non-technical account was referred to as a profit and loss account. The non-technical account brings in the balance on the general business technical account, miscellaneous income or expenses and the charge for taxation.
3. **New business strain:** New business strain is the strain on the business created due to inadequate premium amounts in initial years, which are not enough to cover for the expenses, commissions and statutory reserves.
4. **Claims equalization provision:** An equalization reserve is a cash fund maintained by an insurance company, which is only to be accessed in the event of an unexpected claims loss.

5.2 Estimation of liabilities and timing of profit

- Estimated values for future liabilities must be assessed, either on a statistical basis or by expert judgment. For long-term (life and pensions) business this is often entrusted to actuaries.
- Premiums already received in respect of such liabilities need to be identified and held until the liabilities have expired.
- Additional sums may have to be set aside to meet any anticipated worsening in claims experience or any failure by third parties to honor their commitments towards meeting eventual liabilities.
- Therefore, the provisions made for future liabilities are likely to be conservative in nature, with the result that current profit is under-stated.
- This conflicts with the basic accounting principle that the accounts should show a 'true and fair' view of the position of the company.
- This feature is exacerbated by the profit profile of long-term contracts, whereby business written initially causes a financial strain due to the costs of setting up the contracts and establishing adequate initial reserves.

5.2 Estimation of liabilities and timing of profit

- However, the product design will provide for these initial costs to be subsequently recovered, and will also aim to provide an overall return to the company. The question arises as to when (and how) this profit should be reported.
- A further problem is introduced by the taxation environment whereby particular classes of business may operate under different tax rules. This may require that the overall activities of the company are allocated to separate sub-funds for tax purposes.

5.3 Statement of profit or loss

The statement of profit or loss will typically appear in three forms –

- Revenue ('technical') accounts for general insurance
- Revenue account for long-term (life) insurance businesses
- 'Non-technical' statement of profit or loss.

5.3.1 Technical accounts

Each revenue account will take the form:

- Earned premiums (net of reinsurance)
 - + Investment income
 - + Realized capital gains
 - Claims incurred (net of reinsurance) or benefits payable
 - Net operating expenses incurred (including investment expenses)
-

Balance on revenue account

5.3.1 Technical accounts

- The investment income and realized capital gains are those earned on the investments held to cover the insurance liabilities. There may need to be transfers from the reserves to cover the actual liabilities which are payable.
- There may be additional items in the revenue account depending, for example, on company practice, accounting standards, regulatory requirements, or the purpose of the accounts.
- For long-term business, they could include transfer to (or from) the 'fund for future appropriations' (i.e. all funds the allocation of which – either to policyholders or shareholders – has not been determined by the end of the financial year).
- For general insurance or long-term business, unrealized gains or losses on investments might be included.

5.3.2 Non-technical accounts

The balances on the revenue accounts are then transferred to the 'non-technical' statement of profit or loss.

- Balance on general insurance revenue account
- + Balance on long-term insurance revenue account
- + Investment income
- + Realized and unrealized gains (losses) on investments
- + Profit (or loss) from other ordinary activities before tax
- Tax on profit (or loss) from all activities

Profit or loss for the financial year

5.3.2 Non-technical accounts

- Investment income and capital gains are those earned on investments relating to shareholders' funds / free reserves.
- 'Other ordinary activities' would be other business activities of the company that are not general or long-term insurance business.

5.4 Statement of financial position

Assets

- Assets held to cover insurance liabilities
- Assets representing free reserves
- Reinsurers' share of technical provisions
- Trade receivables arising out of direct insurance operations (policyholders, shareholders)
- Trade receivables arising out of reinsurance operations
- Prepayments and accrued income

5.4 Statement of financial position

Liabilities

- Fund for future appropriations
- Technical provisions:
 1. long-term insurance business provisions, including the actuarially estimated value of the company's liabilities including bonuses already declared and after deducting the actuarial value of future premiums.
 2. general insurance business provisions, including unexpired risk reserves and outstanding claims reserves.
- Shareholders' fund
- In insurance company accounts, the assets less the liabilities equals the shareholders' funds. Insurance company accounts will be considered in more detail in the relevant Specialist subjects.