Accounting for Investments in other companies: a changing landscape?

"The EU requirement for listed groups in Europe will be a significant change that impacts most Irish companies adopting IFRS from 2005. Those actively engaging in M&A will want to consider the impacts immediately. […] Consistent accounting for business combinations is important in establishing a level playing field for companies around the globe."

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[1] Heaphy, S., (2004), *New Standard to impact on Companies' Bottom-line*, http://www.accountingnet.ie/content/publish/article_529.shtml

1- Introduction: Modern times call for modern measures

Since companies began preparing consolidated accounts in the UK in the early 1920s[2], the rationale for accounting for investments in other organisations has changed considerably. New forms of business arrangements, ventures and mergers have resulted in the promulgation of fundamental legislation and professional recommendations on the practices associated with group accounting and the disclosure of consolidated statements.[3]

Nevertheless, further change is on the way. While accounting practice in the UK and Ireland has been subject to supranational scrutiny for well over a quarter of a century, the latest attempt at convergence within the single market is the most groundbreaking of them all. In requiring all listed companies within member states to comply with international accounting standards (IASs) from 2005 onwards, the EU has effectively entrusted the IASB[4] with responsibility for producing future standards.

This paper will focus on the evolution of UK GAAP relating to group accounting and consolidation measures, legislative changes and the effects of convergence and the switch to IFRSs[5]. Essentially, attempts will be made to put developments into context, whilst outlining the objectives, disclosure requirements and methods pertaining to the consolidation of subsidiaries and the techniques applied when accounting for investments in associates, joint ventures and other bodies.

2-Legal & Regulatory Change: Directives and Standards

Primarily, group and consolidated accounts are prepared to report the financial position of a parent undertaking which invests in separate entities. Simplistically, these investments would be recorded as financial assets at cost in the balance sheet of the parent company. Yet such financial reporting could exclude relevant information

[2] Nobel Industries Ltd. Was the first company in the UK to publish a consolidated balance sheet in September 1922. The notion of the holding company has its roots in the USA, the first recording dating back to 1832.

[3] Indeed, the principles of accounting have themselves undergone a radical metamorphosis, with emphasis switching from stewardship to decision making usefulness, in light of new economic phenomena and changes in corporate policy.

[4] International Accounting Standards Board. The IASB was formed in 2001 after the reorganisation of the IASC, a group founded in 1973 with responsibility for setting international accounting standards and for issuing discussion documents on international accounting issues.

[5] International Financial Reporting Standards

relating to these investments and inadequately inform shareholders of the parent's true financial position.[6]

Thus, group accounting and consolidation methods have emerged, developing significantly through time. In effect, legislation emanating from the United Kingdom and the European Union has shaped the development of UK GAAP on these matters, though the London Stock Exchange was the first body to require the publication of consolidated accounts in 1939.

The first legal requirement concerning *consolidation*[7] and group accounting in the U.K. was set out in the 1948 Companies Act.[8] Measures pertaining to the disclosure of group accounts were outlined, with a subsidiary relationship defined on the premise of majority equity ownership[9].

While numerous methods of accounting for significant investments had been formulated and consolidated accounting was already readily employed, the first professional accounting standard, SSAP 1[10], was not issued until 1971, after the creation of the ASC[11] one year earlier.

This standard introduced the basic framework for another method of accounting for investments in other companies, which was first used by Royal Dutch-Shell in 1964. This "intermediate form of accounting"[12], which filled the void between the cost-based and full-consolidation approaches, known as the *equity method*[13], though not defined in the standard, was established as a requirement when dealing with *associates*[14] and *joint ventures*[15].

SSAP 14[16], (1978), was the first definitive standard issued in relation to group accounts. It largely supported the legal requirements hitherto in force while providing guidance on the mechanics of consolidation.

[6] The related method, known as the cost based method, whereby investments in other companies are accounted for as financial assets, with any pertaining dividends recorded as income, is now only used when accounting for simple investments, where the investor has no *significant influence* over the financial and operating policies of the investee. See Appendix 11.

[7] See Appendix 2.

[8] More precisely, the 1948 Companies Act consolidated guidelines set out in the 1947 Companies Act.

[9] Legal control giving rise to the inclusion of a subsidiary was defined in the UK prior to the enactment of the 7th Directive as the ownership of a majority of shares without regard for voting rights, i.e. 50% +.

[10] SSAP 1: Accounting for Associated Companies (1971)

[11] Accounting Standards Committee. Predecessor of ASB in UK.

[12] Pierce, A., Brennan, N., (2003), pp 114

[13] See Appendix 3.

[14] See Appendices 10 and 11.

[15] See Appendix 11.

[16] SSAP 14: *Group Accounts* (1978)

Further legislative developments on the supranational front came to influence UK GAAP. The Fourth Directive of the EEC, issued in 1978, was to impact significantly on consolidation disclosure requirements. Indeed, the Seventh Directive, issued in 1982, would have far greater consequences for group accounting. Its provisions were transcribed into the legislation of each member state, altering definitions of control [17] and of subsidiary undertakings [18], introducing further disclosure requirements[19] and leading to substantial changes in UK GAAP.

Following on the 1985 UK Companies Act and the 1989 Amendment Act, which enacted the Seventh Directive, the ASB produced FRS 2[20] in 1992 to replace SSAP 14, reflecting changes in the scope of consolidation to encompass subsidiaries arising on the exercise of *dominant influence*[21] under the de facto control principle. FRS 5[22] also improved accounting measures for *quasi-subsidiaries*[23], while FRS 6[24] (which replaced SSAP 23[25]) set out guidelines for acquisition and merger accounting.

FRS 7[26], which was released in 1994, also impacted on acquisition accounting by setting down principles for determining the fair values of assets and liabilities and therefore *goodwill*[27] when accounting for a business combination.

Then, in 1997, the ASB issued FRS 9[28], superseding SSAP 1, to improve accounting for associates, joint ventures and joint arrangements that are not entities (JANEs).

Later that year FRS 10[29] was published, requiring the capitalisation of goodwill on acquisition and its amortisation over its *useful economic life*[30] through the profit and loss account and providing scope for impairment reviews.[31]

[17] The original definition of a subsidiary in the 7th Directive was based on the *de facto* or economic concept of control, whereby control is judged by reference to the economic reality of the situation. This concept was at odds with the prevailing rationale in the UK and Ireland at the time, where subsidiaries were defined by legal control based on share ownership. The revised 7th Directive provided for both concepts.

[18] See Appendix 6.

[19] For example, the 7th Directive introduced the requirement that minority interests be disclosed on the face of the balance sheet.

[20] FRS 2: *Accounting for Subsidiary Undertakings* (1992). See Appendix 7.

[21] See Appendix 7.

[22] FRS 5: *Reporting the Substance of Transactions* (1994)

[23] Subsidiaries that, legally, do not have to be consolidated because the existing legislation does not recognise the investee as a subsidiary, even if the investor exercises dominant influence. FRS 5 effectively requires that quasi-subsidiaries be consolidated as if they were legal subsidiaries.

[24] FRS 6: *Acquisitions and Mergers* (1994)

[25] SSAP 23*: Accounting for Acquisitions and Mergers*

[26] FRS 7: *Fair Values in Acquisition Accounting* (1994)

[27] See Appendix 12.

[28] FRS 9: *Associates and Joint Ventures*

Now, in 2004, companies and auditing groups in the UK and Ireland are coming to terms with the latest EU regulation, which requires all companies within member states quoted on regulated markets to comply with IASs and IFRSs by 2005.

Though, before examining the effects of this change, it is worthwhile to analyse the various methods of consolidation and how they have evolved through time.

3- Accounting for investments under UK GAAP[32]

The need to provide more adequate financial information has resulted in the formulation of several methods of accounting for the investments of undertakings. Under current UK (and IAS) GAAP, the cost-based method is only suitable when accounting for *simple investments*[33] where the investor does not exercise *significant influence* over the investee or in certain circumstances when a subsidiary is excluded from consolidation. Investments are essentially recorded at cost in the balance sheet of the investor, with any related dividends reflected in the income statement.

The legal regulations and accounting standards referred to in the previous section ensure that the cost-method is no longer permitted when accounting for subsidiaries, associates, joint ventures or JANEs.

In fact, the *acquisition*[34]method of consolidation is predominately used when accounting for subsidiaries. Consolidation entails combining the accounts of the parent and its individual subsidiaries as though a single entity were in existence. Amounts are aggregated on a line-by-line basis, with adjustments made for minority interests and inter-company transactions. FRS 6 also allows for the use of the *merger method*[35]*,* on a restricted basis, which is much easier to apply and attractive in that generally, distributable reserves are greater.

Unfortunately, prior to the promulgation of the Seventh Directive, the definition of a subsidiary was quite crude, based primarily on share ownership. This allowed companies to avoid fully-consolidating investments by maintaining holdings

[29] FRS 10: *Goodwill and Intangible Assets*

[30] See Appendix 12.

[31] Previously, goodwill could be written off to reserves.

[32] See Appendices 1-5 & 12 for analytical comparisons and definitions of various methods.

[33] Simple investments refer to "holdings of less than 20%" of the shares of another company. Pierce, A., Brennan, N., (2003), p 15

[34] Under the acquisition method, consolidated accounts are an extension of the parent company accounts. The figure for investment in subsidiary in the balance sheet of the parent is replaced by the underlying net assets of the subsidiary.

[35] See Appendix 12.

of equity under the 50% threshold. With the incorporation of the *de facto* control principle, the definition of a subsidiary was widened, with greater emphasis placed on voting rights and dominant influence. FRS 2 strengthened consolidation requirements in this regard.

In relation to associates and joint ventures, SSAP 1 advocated the use of the equity method, where “the investor’s share of the investee’s net assets is included as a single item in the investor’s balance sheet”[36]. No minority interest is thus shown. This one-line method of consolidation may also be used to account for subsidiaries in the absence of dominant influence. Where significant influence is exerted, (which constitutes the existence of an associate), this method must be employed under FRS 9.

While this standard did not effectively alter accounting for associates, new measures were taken to emphasise significant influence over the traditional 20% ownership floor and in relation to joint ventures. The latter are thus accounted for under current UK GAAP using the *gross equity method*[37]*,* which, for disclosure purposes, differs only from the equity method when presenting turnover and the investment in investee.

Paragraphs 8 and 9 of FRS 9 also make provision for JANEs. The standard requires the use of a “variation of *proportional consolidation*[38]”,[39] whereby only the group’s share of the assets and liabilities is recorded. The Seventh directive banned the use of this method when accounting for subsidiaries, and the ASB rejects its use with respect to joint ventures under FRS 9[40].

In essence, the methods of accounting for investments in other companies under UK GAAP are quite complex and have evolved over time, reflecting changes in the macroeconomic environment and the need to provide sterner regulation in order to reduce the scope for circumvention. Yet, where do international standards differ?

[36] Pierce, A., Brennan, N., (2003), pp 115.

[37] See appendix 4.

[38] See appendix 5.

[39] Pierce, A., Brennan, N., (2003), pp 317.

[40] See appendix 5.

4- Implications of the move to IAS GAAP

Current UK and IAS GAAP relevant to group accounts are quite similar in terms of disclosure, though some substantial differences do exist. For example, both sets of standards require that the incorporation of subsidiaries should be based on voting control, (FRS 2, IAS 27[41]), that *significant influence* must be exercised if associates are to be recognised, (FRS 9, IAS 28[42]), that group accounts should have *coterminous year-ends*, apply *uniform accounting policies* and recognise net assets attributable to the minority interest as a separate item in the balance sheet[43], (FRS 2, IAS 27), etc.

However, grounds for the exclusion of subsidiaries from the consolidated accounts do differ, with dissimilar activities not recognised as a basis for non-consolidation under IAS 27.[44] Definitions of control vary slightly[45] and, under IAS 27, minority interests may be calculated on the pre-acquisition carrying amounts of the net assets of the subsidiary[46] and in certain circumstances debit balances attributable to the minority are not charged[47], though consolidation adjustments for intra-group transactions and balances are comparable with FRS 2.

The equity method is advocated by both FRS 9 and IAS 28 when dealing with associates, though FRS 9 criteria on associates are much more restrictive.[48] One particularly important difference between UK and IAS GAAP becomes evident when accounting for joint ventures. While FRS 9 advocates use of the gross equity method, IAS 31[49] sets proportionate consolidation as the benchmark method, with the equity

[41] IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*

[42] IAS 28 *Accounting for Investments in Associates*

[43] Both FRS 2 and IAS 27 require that the aggregate of capital and reserves attributable to minority shareholders be disclosed in the balance sheet separately from shareholders funds.

[44] See Appendix 8.

[45] See Appendices 7 and 9.

[46] The benchmark treatment adopted by IAS 27 with regard to the calculation of minority interests is to base the amount attributable on the pre-acquisition carrying amounts of the net assets of the subsidiary. An alternative given is to apply fair values. However, FRS 2 requires the minority interest to be based on fair values. Ernst & Young, (1998), pp 264-265.

[47] FRS 2 requires all minority interest debit balances to be recorded in consolidated financial statements, but under IAS 27, if losses attributable to the minority exceed its holding, any excess may not be recorded once the minority is obliged to "make good the losses".
Pierce, A., Brennan, N., (2003), pp 316.

[48] For Example, "FRS 9 requires that the investor be actively involved and influential in the investee through participation in policy decisions." Pierce, A., Brennan, N., (2003), pp 301.

[49] IAS 31: *Financial Reporting of Interests in Joint Ventures*

method as an alternative. Indeed, FRS 9 rejects proportionate consolidation in this instance on the grounds that it is “misleading”.[50]

Possibly one of the more significant changes that will impact on companies will be the elimination of the *pooling of interests* or *merger method* under IFRS 3[51]. Under UK GAAP, (FRS 6), this method was permitted but seldom applied in practice. Indeed, IAS 22[52], the forerunner to IFRS 3, had also provided scope for its use.

Undoubtedly, the greatest impact of IFRS 3 concerns goodwill. The standard eliminates the expensing of goodwill through the income statement, except in the event of impairment. The amortisation process is replaced with annual testing for impairment, in line with US GAAP.

Furthermore, the new standard will bring IAS 22 into line with FRS 7 in that all assets and liabilities acquired by the investor will be measured at fair value.[53]

Conclusion: Convergence and Improvement

Even a brief analysis of the history of accounting standards related to group accounts illustrates how requirements have repeatedly proved insufficient and why continuous improvement is necessary to ensure that a true and fair view of the holding company’s financial situation is recorded.

Whilst the purveyors of UK GAAP have eventually succeeded in providing quality standards with regard to numerous sub-sections of this significant issue, ambiguities exist in areas such as goodwill and merger accounting. While IAS GAAP is predominately consistent with UK GAAP, it will, over time, hopefully encompass the best standards from all over the world.

Indeed, the evolution of legislation and professional standards concerning consolidation, group accounting, subsidiaries, associates and other entities in these islands has largely strengthened the financial reporting framework. The work of the IASB should eradicate any remaining weaknesses, even if debates on control and ownership wrangle on in the future.

[50] See Appendix 5.

[51] IFRS 3: *Business Combinations* (2004)

[52] IAS 22: *Business Combinations*

[53] IAS 22 had provided the investor with the option of recording these at a combination of fair value and pre-acquisition carrying amount.

Appendix 1: Various Methods of Consolidation

Source: Pierce, A., Brennan N., (2003), pp 314 -315.

Investor acquired 50% of investee for €185 when investee's revenue reserves were €150. The balance sheets were as follows:

	Investor		Investee
	€		€
Fixed Assets	820		420
Investment in Investee	185		
Current Assets		260	
Creditors		-120	
Net Current Assets	625		140
	1,630		**560**
Share Capital	700		200
Reserves	930		360
	1,630		**560**

Solution: Group Balance Sheets

	Acquisition	Equity	Gross Equity	Proportional
Fixed Assets	1,240	820	820	1,030
Investment in Investee		290		
Share of Gross Assets			340	
Share of Gross Liabilities			-60	
Goodwill	10		10	10
Net Current Assets	765	625	625	695
	2,015	**1,735**	**1,735**	**1,735**
Share Capital	700	700	700	700
Reserves	1,035	1,035	1,035	1,035
	1,735	1,735	1,735	1,735
Minority Interest	280			
	2,015	**1,735**	**1,735**	**1,735**

Appendix 2: Consolidation

Definition, FRS 2, Paragraph 5:

> *The process of adjusting and combining financial information from the individual financial statements of a parent undertaking and its subsidiary undertakings to prepare consolida ted financial statements that present financial information of the group as a single economic entity.*

Appendix 3: Equity Accounting; Definitions

FRS 2, Paragraph 8:

A method of accounting for an investment that brings into the consolidated profit and loss account the investor's share of the investment undertaking's results and that records the investment in the consolidated balance sheet at the investor's share of the investment undertakings net assets including any goodwill arising to the extent that it has not already been written off.

FRS 9, Paragraph 4:

A method of accounting that brings an investment into the investor's financial statements initially at cost, identifying any goodwill arising. The carrying amount of the investment is adjusted in each period by the investor's share of the results of the investee less any amortisation or write-off for goodwill, the investor's share of any relevant gains or losses, and any other changes in the investee's net assets including distributions to its owners, for example by dividend. The investor's share of its investee's results is recognised in its profit and loss account. The investor's cash flow statement includes the cash flows between the investor and its investee, for example relating to dividends and loans.

Appendix 4: Gross Equity Method

Definition, FRS 9, Paragraph 4:

A form of equity method under which the investor's share of the aggregate gross assets and liabilities underlying the net amount included for the investment is shown on the face of the balance sheet and, in the profit and loss account, the investor's share of the investee's turnover is noted.

Appendix 5: Proportionate Consolidation

Definition, IAS 31, Paragraph 2,

Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is combined on a line-by-line basis with similar items in the venturer's financial statements or reported as separate line items in the venturer's financial statements.

Rejection of use of proportionate consolidation for joint ventures under UK GAAP, FRS 9, Appendix III, paragraph 13:

> *The Board rejects proportional consolidation for joint ventures because it believes that it can be misleading to represent each venturer's joint control of a joint venture as being in substance equivalent to its having sole control of its share of each of that entity's assets, liabilities and cash flows. The key features of control are that the controlling party has the ability to direct or deploy what it controls without consultation and ability to take the benefit from what it directs or deploys without question of entitlement.*

Appendix 6: EU 7th Directive, Article 1;

1. A MEMBER STATE SHALL REQUIRE ANY UNDERTAKING GOVERNED BY ITS NATIONAL LAW TO DRAW UP CONSOLIDATED ACCOUNTS AND A CONSOLIDATED ANNUAL REPORT IF THAT UNDERTAKING (A PARENT UNDERTAKING) :

(A) HAS A MAJORITY OF THE SHAREHOLDERS' OR MEMBERS' VOTING RIGHTS IN ANOTHER UNDERTAKING (A SUBSIDIARY UNDERTAKING) ; OR

(B) HAS THE RIGHT TO APPOINT OR REMOVE A MAJORITY OF THE MEMBERS OF THE ADMINISTRATIVE , MANAGEMENT OR SUPERVISORY BODY OF ANOTHER UNDERTAKING (A SUBSIDIARY UNDERTAKING) AND IS AT THE SAME TIME A SHAREHOLDER IN OR MEMBER OF THAT UNDERTAKING ; OR

(C) HAS THE RIGHT TO EXERCISE A DOMINANT INFLUENCE OVER AN UNDERTAKING (A SUBSIDIARY UNDERTAKING) OF WHICH IT IS A SHAREHOLDER OR MEMBER , PURSUANT TO A CONTRACT ENTERED INTO WITH THAT UNDERTAKING OR TO A PROVISION IN ITS MEMORANDUM OR ARTICLES OF ASSOCIATION , WHERE THE LAW GOVERNING THAT SUBSIDIARY UNDERTAKING PERMITS ITS BEING SUBJECT TO SUCH CONTRACTS OR PROVISIONS . A MEMBER STATE NEED NOT PRESCRIBE THAT A PARENT UNDERTAKING MUST BE A SHAREHOLDER IN OR MEMBER OF ITS SUBSIDIARY UNDERTAKING. THOSE MEMBER STATES THE LAWS OF WHICH DO NOT PROVIDE FOR SUCH CONTRACTS OR CLAUSES SHALL NOT BE REQUIRED TO APPLY THIS PROVISION ; OR

(D) IS A SHAREHOLDER IN OR MEMBER OF AN UNDERTAKING , AND :

(AA) A MAJORITY OF THE MEMBERS OF THE ADMINISTRATIVE , MANAGEMENT OR SUPERVISORY BODIES OF THAT UNDERTAKING (A SUBSIDIARY UNDERTAKING) WHO HAVE HELD OFFICE DURING THE FINANCIAL YEAR , DURING THE PRECEDING FINANCIAL YEAR AND UP TO THE TIME WHEN THE CONSOLIDATED ACCOUNTS ARE DRAWN UP , HAVE BEEN APPOINTED SOLELY AS A RESULT OF THE EXERCISE OF ITS VOTING RIGHTS ; OR

(BB) CONTROLS ALONE , PURSUANT TO AN AGREEMENT WITH OTHER SHAREHOLDERS IN OR MEMBERS OF THAT UNDERTAKING (A SUBSIDIARY UNDERTAKING) , A MAJORITY OF SHAREHOLDERS' OR MEMBERS' VOTING RIGHTS IN THAT UNDERTAKING . THE MEMBER

STATES MAY INTRODUCE MORE DETAILED PROVISIONS CONCERNING THE FORM AND CONTENTS OF SUCH AGREEMENTS.
THE MEMBER STATES SHALL PRESCRIBE AT LEAST THE ARRANGEMENTS REFERRED TO IN (BB) ABOVE.
THEY MAY MAKE THE APPLICATION OF (AA) ABOVE DEPENDENT UPON THE HOLDING'S REPRESENTING 20 % OR MORE OF THE SHAREHOLDERS' OR MEMBERS' VOTING RIGHTS.
HOWEVER , (AA) ABOVE SHALL NOT APPLY WHERE ANOTHER UNDERTAKING HAS THE RIGHTS REFERRED TO IN SUBPARAGRAPHS (A) , (B) OR (C) ABOVE WITH REGARD TO THAT SUBSIDIARY UNDERTAKING .
2 . APART FROM THE CASES MENTIONED IN PARAGRAPH 1 ABOVE AND PENDING SUBSEQUENT COORDINATION , THE MEMBER STATES MAY REQUIRE ANY UNDERTAKING GOVERNED BY THEIR NATIONAL LAW TO DRAW UP CONSOLIDATED ACCOUNTS AND A CONSOLIDATED ANNUAL REPORT IF THAT UNDERTAKING (A PARENT UNDERTAKING) HOLDS A PARTICIPATING INTEREST AS DEFINED IN ARTICLE 17 OF DIRECTIVE 78/660/EEC IN ANOTHER UNDERTAKING (A SUBSIDIARY UNDERTAKING) , AND :
(A) IT ACTUALLY EXERCISES A DOMINANT INFLUENCE OVER IT ; OR
(B) IT AND THE SUBSIDIARY UNDERTAKING ARE MANAGED ON A UNIFIED BASIS BY THE PARENT UNDERTAKING .

Appendix 7: FRS 2, Definitions:

Definition of Subsidiary: FRS 2, Paragraph 14:

An undertaking is a parent undertaking of a nother, the subsidiary undertaking, if any of the following apply

(a) It holds a majority of the voting rights in the undertaking.
(b) It is a member of the undertaking and has the right to appoint or remove directors holding a majority of the voting rights at m eetings of the board on all, or substantially all matters.
*(c) It has a right to exercise a **dominant influence** over the undertaking*
  (i) by virtue of the provisions contained in the undertaking's memorandum or articles; or
  (ii) by virtue of a control contract. The control contract must be in writing and be of a kind authorised by the memorandum or articles of the controlled undertaking. It must also be permitted by the law under which that undertaking is established.
(d) Is a member of the undertaking and controls alone, pu rsuant to an agreement with other shareholders or members, a majority of voting rights in the undertaking.
*(e) It has a **participating interest** in the undertaking and :*
  *(i) it actually exercises a **dominant influence** over the undertaking; or*
  *(ii) it and the undertaking a re **managed on a unified basis**.*

(f) A parent undertaking is also treated as the parent undertaking of the subsidiary undertakings of its subsidiary undertakings.

Dominant Influence, FRS 2, Paragraph 7:

Influence that can be exercised to achieve the operating and financial policies desired by the holder of the influence, notwithstanding the rights or influence of any other party.

(a) ...the right to exercise a dominant influence means that the holder has a right to give directions with respect to the operating and financial policies of another undertaking with which its directors are obliged to comply, whether or not they are for the benefit of that undertaking.
(b) The actual exercise of dominant influence is the exercise of an influence that achieves the result that the operating and financial policies of the undertaking influenced are set in accordance with the wishes of the holder of the influence and for the holder's benefit whether or not those wishes are explicit. The actual exercise of dominant influence is identified by its effect in practice rather than by the way in which it is exercised.

Control, FRS 2, Paragraph 6:

The ability of an undertaking to direct the financial and operating policies of another undertaking with a view to gaining economic benefits from its activities.

Managed on a unified basis, FRS 2, Paragraph 12:

Two or more undertakings are managed on a unified basis if the whole of the operations of the undertakings are integrated and they are managed as a single unit. Unified management does not arise solely because one undertaking manages another.

Appendix 8: Grounds for the exclusion of subsidiaries from group accounts

Under the UK Companies Act, subsidiaries may be excluded from the consolidated accounts where:

(a) their activities are sufficiently different from those of the rest of the group;
(b) there are severe long-term restrictions over the parent's rights;
(c) they are held with a view to subsequent re-sale;
(d) obtaining the information needed would involve disproportionate expense or undue delay; or
(e) they are immaterial (in aggregate).

Under IAS 27, a subsidiary should only be excluded from consolidation when:

> *(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disclosure in the near future; or*
>
> *(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.*

IAS 27 also stipulates that subsidiaries with dissimilar activities should be consolidated.

FRS 2 does allow for exclusion on the grounds of incompatible activities. Neither standard makes reference to immateriality. This is thus permissible.

Appendix 9: IAS 27, Paragraph 6, Definitions;

Subsidiary:

> *A subsidiary is an enterprise that is controlled by another enterprise (known as the **parent.**)*

Parent:

> *A parent is an enterprise that has one or more **subsidiaries**.*

Control:

> *Control…is the power to govern the financial and operating policies of an enterprise as to obtain benefits from its activities.*

Appendix 10: IAS 28

Definition of an Associate, paragraph 3:

> *An associate is an enterprise in which the investor has significant influence and is neither a subsidiary nor a joint venture of the investor.*

Appendix 11: FRS 9, Paragraph 4, Definitions;

An associate:

> *An entity (other than a subsidiary) in which another entity (the investor) has a **participating interest** and over whose operating and financial policies the investor exercises a **significant influence**.*

Participating Interest:

> *An interest held in shares of another entity on a long-term basis for the purpose of securing a contribution to the investor's activities by the exercise of control or*

influence arising from or related to that interest. The investor's interest must, therefore, be a beneficial one and the benefits expected to arise must be linked to the exercise of its significant influence over the investee's operating and financial policies. An interest in the shares of another entity includes an interest convertible into an interest in shares or an option to acquire shares.

Companies legislation provides that a holding of 20% or more of the shares of an entity is to be presumed to be a participating interest unless the contrary is shown. The presumption is rebutted if the interest is either not long-term or not beneficial.

Exercise of Significant Influence:

The investor is actively involved and is influential in the direction of its investee through its participation in policy decisions covering aspects of policy relevant to the investor, including decisions on strategic issues such as:

(a) the expansion or contraction of the business, participation in other entities or changes in products, markets and activities of the investee; and
(b) determining the balance between dividend and investm ent.

Companies legislation provides that an entity holding 20% or more of the voting rights in another entity should be presumed to exercise a significant influence over that entity unless the contrary is shown. For the purpose of applying the presumption, the shares held by the parent and its subsidiaries in that entity should be aggregated. The presumption is rebutted if the investor does not fulfil the criteria for the exercise of significant influence set out above.

A Joint Venture:

An entity in which the reporting entity holds an interest on a long -term basis and is ***jointly controlled*** *by the reporting entity and one or more other venturers under a contractual arrangement.*

Joint Control

A reporting entity jointly controls a venture with one or more other entities if none of the entities alone can control that entity but altogether can do so and decisions on financial and operating policy essential to the activities, economic performance and financial position of that venture require each venturer' s consent.

Joint arrangements that are not entities (JANES)

A contractual arrangement under which the participants engage in joint activities that do not create an entity because it would not be carrying on a trade or business of its own. A contractual arrangement where all significant matters of operating and financial policy are predetermined does not create an entity because the policies are those of its participants, not of a separate entity.

Appendix 11: FRS 10; Definitions

Purchased Goodwill, FRS 10, paragraph 2;

> *The difference between the cost of an acquired entity and the aggregate of the fair values of that entity's* ***identifiable assets and liabilities****.*

Identifiable assets and liabilities, FRS 10, Paragraph 2;

> *The assets and liabilities of an entity that are capable of being disposed of or settled separately, without disposing of a business of the entity.*

Appendix 12: Merger Accounting

Definition of merger, FRS 6, Paragraph 2:

> *A business combination that results in the creation of a new reporting entity formed from the combining parties, in which the shareholders of the combining entities come together in a partnership for the mutual sharing of the risks and benefits of the combined entity and in which no party to the combination in substance obtains control over any other, or is otherwise seen to be dominant, whether by virtue of the proportion of its shareholders' rights in the combined entity, the influence of its directors or otherwise.*

Definition of "Uniting of Interests", IAS 22, P aragraph 8:

> *A uniting of interests is a business combination in which the shareholders of the combining enterprises combine control over the whole, or effectively the whole, of their net assets and operations to achieve a continuing mutual sharing in the risks and benefits attaching to the combined entity such that neither party can be identified as the acquirer.*

Comparison: Merger Vs Acquisition Method: Share for Share Exchange
Source: Pierce, A., Brennan, N.,(2003), pp 149

Parent acquired all 80 shares of subsidiary by issuing 80 of its own shares. Both Parent and Subsidiary shares are worth €3 each. Balance sheets of Parent and Subsidiary immediately before acquisition were as follows:

	Parent	**Subsidiary**
	€	€
Net Assets	**150**	**110**
Share Capital	100	80
Share Premium	-	-
Revenue Reserves	50	30
	150	**110**

Solution:

(a) Parent’s own balance sheet after the combination under both methods:

	Acquisition	Merger
Net Assets	150	150
Investment in Subsidiary	240	80
	390	**230**
Share Capital	180	180
Share Premium	160	-
Revenue Reserves	50	50
	390	**230**

(b) Parent Group’s consolidated balance sheet after the combination:

	Acquisition	Merger
Net Assets	260	260
Goodwill	130	-
	390	**260**
Share Capital	180	180
Share Premium	160	-
Revenue Reserves	50	80
	390	**230**

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