**Pacemaker debrief (June 2009)**

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This article is designed to show you how to tackle a consolidated statement of financial position question using Pacemaker from the June 2009 exam.

**Consolidated financial statements overview**

In your Paper F7 exam there will always be a compulsory group accounting question where you will be required to prepare either a consolidated income statement, a consolidated statement of financial position or a combination of these statements.

The basic principle of group accounting, guides you through your preparation of an answer to this style of question. For example, when the parent company controls more than 50% of the equity share capital of another company, this is known as a subsidiary company and group accounts are required to be prepared per IAS 27, *Consolidated and separate financial statements*. When a parent acquires between 20%-50% of the share capital in another business and has significant influence over that business, it should be treated as an associate and accounted for in accordance with IAS 28, *Investments in associates*.

Aside from the basic preparation of group accounts there will be a series of common adjustments that you will need to deal with, such as fair value adjustments and intra-group transactions.

**Question technique**

The key to passing any group accounting question is to make sure that you have had sufficient past question practice by the time you get into the exam: this is often overlooked by candidates. There is no real substitute for past question practice, in fact if you had attempted Pumice from the Pilot Paper before the exam, you would be well prepared to attempt the majority of the question.

Along with question practise, there is a common approach that you may find useful when attempting a consolidated statement of financial position question.

This approach is discussed below.

With a consolidated statement of financial position question, the first thing you should consider in the exam is the group structure. It is worth setting up a working for this. This will enable you to determine which company is the parent, which company is the subsidiary, and which (if there is one) is the associate company.

In Pacemaker, notes (i) and (ii) help you to comprise this information to form the group
structure, i.e., you are told that Pacemaker purchased 116m shares in Syclop who has 145 million shares in issue; therefore, Pacemaker purchased 80% of the shares in Syclop. You are then told that Pacemaker purchased 30m shares in Vardine who has 100m shares in issue; therefore, Pacemaker purchased 30% of the shares in Vardine.

From this information, we now know that Pacemaker controls Syclop, which is, therefore, a subsidiary and that Pacemaker is deemed to have significant influence over Vardine with a 30% shareholding and is, therefore, an associate company.

It is also worth noting that the shares in Syclop were purchased two years ago, whereas the shares in Vardine were purchased six months ago. View the group structure.

Once you have established your group structure it is essential that you get the 'easy' marks out of the question, i.e., the parent and subsidiary results need to be consolidated, so now is a good time to set up the structure to your answer (see Appendix A).

There are two common errors that candidates tend to make when setting up the answer to their question.

The first mistake is made when candidates proportionately consolidate the subsidiary company, i.e., bring in 80% of the subsidiary results. This is a fundamental error and will ensure that any add together marks are lost in the exam. The principle of group accounting is that you control the subsidiary company and therefore should consolidate the subsidiary's assets and liabilities 100%.

The second mistake is where a candidate chooses to add the associate in on a line-by-line basis either in full, or on a proportionate basis. This is not how an associate should be accounted for per IAS 28, Investments in associates which specifically states that an associate should be equity accounted for (later).

When you have consolidated the basic marks of the parent and subsidiary, it is worth noting that on the question itself, there are still some balances outstanding in the subsidiary's equity section. These do not get consolidated directly, but instead form part of the goodwill, group retained earnings and non-controlling interest calculations.

At this stage you may find a net asset working helpful. To do this, take the subsidiary's equity from the face of the question into your reporting date column (share capital also belongs in the acquisition column) and find the opening retained earnings (in this question we are told the opening retained earnings at note (i)).

The initial net assets of Syclop are (working):

<table>
<thead>
<tr>
<th></th>
<th>At acquisition $m</th>
<th>At reporting date $m</th>
<th>Post-acquisition (movement) $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>145</td>
<td>145</td>
<td></td>
</tr>
</tbody>
</table>
Retained earnings  120  260  140

Now that you have your group structure, basic net assets and structure to your actual consolidation started you will be ready to tackle any adjustments given in the question.

**Adjustments required to Pacemaker**

It is advised that, before you complete any workings that you become familiar with the information contained in the notes to the individual statements.

**Note (i): Cost of investment of Syclop**

In this note, it is possible to determine the cost of the investment in Syclop required for the 'goodwill' calculation. Pacemaker purchased the shares in Syclop through both an immediate cash payment and an issue of loan notes.

The cost of this investment is therefore:

- **Cash**
  - $210m
- **Issued loan notes**
  - $(166 million shares x $100 / 200)
  - $58m
- **Total**
  - $268m

The effective double entry required for this $268m is:

- **Dr Goodwill (working)**
- **Cr Investments (face of consolidated SFP)**

**Note (ii): Cost of investment in Vardine**

In this note, it is possible to determine the cost of the investment in Vardine required for the 'investment in associate' calculation. Pacemaker purchased the shares in Vardine through a share exchange and importantly this has not yet been recorded.

The cost of the investment in Vardine is:

- **Share exchange**
  - $(75m shares x $1.60)
  - $120m

The effective double entry required for this $120m is:

- **Dr Investment in associate (working)**
- **$120m**
Cr Share capital (face of consolidated SFP)  
(75m shares x $1 (nominal value))  
$75m
Cr Share premium (face of consolidated SFP)  
(75m shares x 60 c (premium element))  
$45m

Note (iii): Available for sale investments

Both Pacemaker and Sardine have their own available for sale investments which need to be accounted for in accordance with IAS 39, *Financial Instruments: Recognition and Measurement* by bringing the investments into the statement of financial position at their fair value while the movement is taken to equity.

When dealing with the adjustment to the investments it is advised to treat each separately as the movement in Pacemaker's investment is attributable entirely to group equity, whereas the movement in the Syclop's investment is attributable in part to the group and part to the non-controlling interest.

Movement in Pacemaker's investment:

Total investments per Pacemaker SFP  
$345m
Cost of investment in subsidiary (per note (i))  
($268m)
Balance on available for sale b/fwd  
$77m
Balance at year end (per note (iii))  
$82m
Increase in carrying value of investments  
$5m

The effective double entry required for this $5m is:

Dr Investments (face of consolidated SFP)  
Cr Group retained earnings (working)

Movement in Syclops investment:

The effective double entry required for this $3m is:

Investments per Syclop SFP  
$40m
Balance at year end (per note (iii))  
$37m
Decrease in carrying value of investment  
$3m

Dr Group retained earnings (80%) (working)  
$2.4m
Dr Non-controlling interest (20%) (working)  
$0.6m
Cr Investments (face of consolidated SFP)  
$3m
Exam tip: As this is a subsidiary adjustment, you can update your net asset working for the debit entries instead which will automatically provide you with the 80:20 split (see solution at Appendix B).

**Note (iv): Non-controlling interest policy**

This note gives you information about the group policy of valuing non-controlling interests that is required for both your goodwill working and your non-controlling interest working.

**Note (v): Fair value adjustments**

IFRS 3, *Business Combinations* requires that both the purchase consideration and net assets of the subsidiary be recorded at fair values to ensure that an accurate figure for goodwill, non-controlling interests, assets and liabilities is shown in the group accounts.

There are two fair value adjustments within this note, they are both depreciating fair value adjustments and are common within the Paper F7 exam. With fair value adjustments, the easiest thing to do is update the subsidiary’s net asset working and the non-current asset line in the statement of financial position (if not already updated by the subsidiary in the post-acquisition period).

The effective double entry required for the initial fair value adjustment is:

Dr Non-current asset (face of consolidated SFP)  
Cr Net assets (working)

The effective double entry required for the depreciation/amortisation of the fair value adjustment is:

Dr Net assets (working)  
Cr Non-current assets (face of consolidated SFP)

(Please see the solution at Appendix B to identify the fair value adjustments being processed).

**Note (vi): Unrealised profit**

Another common adjustment in the group accounts question surrounds the area of unrealised profit. Unrealised profit arises when there have been intra-group sales and purchases and some of the goods are left in the inventory of one of the group companies at the year end.

Exam focus: Ensure you are confident who the selling company is as it will affect the
adjustment required.

In Pacemaker, Pacemaker has sold goods to Syclop during the year and Syclop still has $56m of these goods left in inventory. This has a twofold impact whereby Pacemaker has overstated profit within the group and Syclop is overstating the inventory (asset) value within the group. This unrealised profit element needs to be eliminated.

Unrealised profit:

$56m left in inventory x 40/140 = $16m

The effective double entry required for this $16m is:

Dr Group retained earnings (working)
Cr Inventory (face of consolidated SFP)

**Note (vii): Associate profit**

This information gives detail on how the associate profit has been earned during the year. It is important as we have only held the investment in Vardine for six months and therefore when preparing the working for group retained earnings and the investment in associate, the group share of the six months post-acquisition profit should be used.

Vardine has earned profit for the year of $100m, $20m of this was earned in the first six months, and therefore, $80m must have been earned in the last six months.

The group share of this profit is $80m x 30% = $24m

The effective double entry required for this $24m is:

Dr Investment in associate (working)
Cr Group retained earnings (working)

**Completing the consolidation**

Now that the adjustments are familiar you can construct and complete your net assets, goodwill, non-controlling interest, group retained earnings and investment in associate workings and the actual consolidated statement of financial position (Appendix B).

So in summary, when dealing with a consolidated statement of financial position question, getting the structure to your answer right is vital. Leave space for your answer and set up a group structure working to determine the nature of the group, and then get the easy marks by setting up your proforma answer and consolidating the assets and liabilities of the parent and subsidiary. Once you have done this, review the adjustments
and use them to help construct your key workings of net assets, goodwill, non-
controlling interests, group retained earnings and (if there is one) an investment in
associate working.

As with any exam question, there may be information that you are unsure of. Such
information should not prevent you from answering the majority of the question so
ensure that you do the things that you can do and if there are areas of confusion, ignore
them and move on to the next point.