Accounting for Associates, Joint Ventures & Business Combinations

UK GAAP v IFRS

Aim of Presentation

To demonstrate the key differences between IFRS and UK GAAP in accounting for:

- Associates
- Joint Ventures
- Business Combinations

Associates

Definition of an associate

UK GAAP	**IFRS**
An entity (other than a subsidiary or JV) in which the investor has a PARTICIPATING INTEREST and EXERCISES significant influence	An entity (other than a subsidiary or JV) in which the investor HAS significant influence

Accounting for an associate - Bats Ltd

Bats Ltd acquires a 30% holding in Balls Ltd:

- Cost £250K
- Net assets of Balls Ltd £500K
- Fair value of net assets £600K

Bats Ltd (cont)

After acquisition Balls Ltd recognised the following:

- Turnover £220K
- Operating profit £110K
- Interest payable £10K
- Tax payable £30K
- Dividends payable £9K

Bats Ltd (cont)

Using the equity method Bats Ltd interest in Balls Ltd is as follows:

Share of fair value of net assets	£180,000
Goodwill	£70,000
Share of after tax profit	£21,000
Elimination of dividend received	(£2,700)
	£268,300

Bats Ltd (cont)

Balls Ltd net assets at the year end is a follows:

Net assets at start of year	£500,000
Profit after tax	£70,000
Dividends	(£9,000)
	£561,000

Bats Ltd (cont)

Bats Ltd interest at the year end is made up as follows:

Share of net assets	£168,300
Goodwill	£70,000
Share of fair value adjustments	£30,000
	£268,300

Bats Ltd Consolidated Balance Sheet Extract

UK GAAP

	£
Fixed asset investments	
Investment in associate	198,300
Goodwill	66,500
	264,800

IFRS

	£
Non-current assets	
Investment in associate	268,300

Bats Ltd Consolidated Profit & Loss account extract

UK GAAP

	£
Group operating profit	XXXXX
Share of operating profit of:	
Associates	33,000
Profit on ordinary activities before interest	XXXXX
Interest	XXXXX
Profit on ordinary activities before tax	XXXXX

Extract of notes to accounts:

Turnover	
Share of associates turnover	£66,000
Interest payable	
Group	XXXX
Associate	3,000
Taxation	
Group	XXXX
Associate	9,000

IFRS

	£
Operating profit	XXXXX
Finance costs	XXXXX
Share of associate's profit after tax	21,000
Profit on ordinary activities before tax	XXXXX

Joint Ventures

Definition of a Joint Venture

UK GAAP

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

IFRS

A contractual agreement whereby two or more parties undertake an economic activity that is subject to joint control

Types of Joint Ventures

UK GAAP

1) **Jointly controlled entities –** the arrangement is carried on through a separate entity

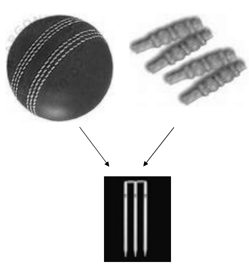
2) **J.A.N.E –** Joint ARRANGEMENT that is not an entity

IFRS

1) **Jointly controlled entities –** same as UK GAAP
2) **Jointly controlled operations –** each venturer uses its own assets for a specific project
3) **Jointly controlled assets –** a project carried on with assets that are jointly owned

Example of a Jointly Controlled Entity

Balls Ltd and Bails Ltd each have a 50% equity interest in Stumps Ltd and there is a contractual agreement giving rise to joint control. The joint venture was created to make stumps and sell all 3 companies products in one pack.



Accounting for Jointly Controlled Entities

UK GAAP

Equity method as for associates

IFRS

Equity method is permitted, however PROPORTIONATE CONSOLIDATION is the benchmark treatment

Proportionate Consolidation

The venturer's share of assets, liabilities, income and expenses are combined on a line by line basis with the venturer's own similar items.

Stumps Ltd

The balance sheet of Stumps Ltd is as follows:

	£
Non-current assets	
Property, Plant & Equipment	2,800
Current assets	
Trade receivables	2,400
Inventories	1,600
Current liabilities	(3,600)
	3,200
Equity	3,200

The Income Statement of Stumps Ltd is as follows:

	£
Revenue	830
Cost of Sales	(210)
Gross profit	620
Administration expenses	(290)
Operating profit	330
Investment income	10
Profit before tax	340
Tax	(180)
Profit after tax	160

Consolidated Balance Sheet

Equity Method

	£
Non-current assets	
Property, Plant & Equipment	XXXX
Investment in joint venture	1,600
Current assets	
Trade receivables	XXXX
Inventories	XXXX
Other	XXXX
Current liabilities	XXXX
	XXXX
Equity	XXXX

Proportionate Consolidation

	£
Non-current assets	
PPE – Own	XXXX
- Joint venture	1,400
Current assets	
Trade debtors – Own	XXXX
- Joint venture	1,200
Inventories – Own	XXXX
- Joint venture	800
Other – Own	XXXX
Current liabilities – Own	XXXX
- Joint venture	(1,800)
	XXXX
Equity	XXXX

Consolidated Income Statement

Equity Method

	£
Group operating profit	XXXX
Share of operating profit of:	
Joint ventures	165
Profit on ordinary activities before interest	XXXX
Interest	XXXX
Profit on ordinary activities before tax	XXXX

Extract of notes to accounts:

Revenue	£
Share of joint ventures revenue	415
Interest	
Group	XXXX
Joint venture	5
Taxation	
Group	XXXX
Joint venture	90

Proportionate Consolidation

	£
Revenue – Own	XXXX
- Joint venture	415
Cost of sale – Own	(XXXX)
- Joint venture	(105)
Gross profit	XXXX
Admin expenses – Own	(XXXX)
- Joint venture	(145)
Operating profit	XXXX
Investment income – Own	XXXX
- Joint venture	5
Interest payable	(XXXX)
Profit before tax	XXXX
Tax – Own	(XXXX)
- Joint venture	(90)
Profit after tax	XXXX

Example of a Jointly Controlled Operation

Balls Ltd and Bails Ltd jointly control the project of making souvenirs for the 2007 Ashes tour

Accounting for Jointly Controlled Operations

UK GAAP

Account for own assets, liabilities and cash flows as per the JV agreement

IFRS

A venturer should recognise in its financial statements:

- The assets it controls and the liabilities its incurs
- The expenses it incurs and its share of the income it earns

Example of a Jointly Controlled Asset

Balls Ltd and Bails Ltd purchase a machine which is capable of making cricket bats. Balls Ltd contributes 60% of the purchase price of the machine, takes about 60% of the output from the machine and sells the bats to existing customers as a complementary product to its cricket balls whilst bearing 60% of the costs of running the machine. Bails Ltd contributed the remaining 40% of the purchase price, uses the other 40% of output and bears 40% of the expenses.

Accounting for Jointly Controlled Assets

UK GAAP

Account for own assets, liabilities and cash flows as per the JV agreement

IFRS

A venturer should recognise in its financial statements:

- Its share of jointly controlled assets
- Its share of liabilities incurred
- Its share of income from sales
- Its share of expenses incurred

Business Combinations

Definition of a business combination

The bringing together of separate entities into one reporting entity.

Accounting for business combinations

UK GAAP

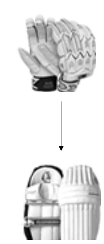
Acquisition accounting – this is very similar to the purchase method under IFRS and is used unless merger accounting is appropriate

IFRS

Purchase method – I.e. fair values are applied to assets, liabilities, equity instruments and costs directly attributable to the business combination including professional fees and costs of issuing equity.

Accounting for a business combination – Gloves Ltd

- Gloves Ltd acquires 100% of Pads Ltd.
- The consideration offered to Pads Ltd shareholders was 400,000 shares in Gloves Ltd for the 410,000 shares in Pads Ltd.
- The value at the acquisition date of the 400,000 £1 shares was £6.4m.
- The fair value of Pads Ltd net assets is £6.1m (£90,000 above their Net Book Value)



Gloves Ltd (cont)

The balance sheet of Pads Ltd at acquisition was as follow:

	£
Net assets	6,010
Share capital	410
Accumulated profit	5,600
	6,010

The profit & Loss account for the year of Pads Ltd was as follows:

	£
Turnover	6,000
Cost of Sales	(4,500)
Operating profit	1,500
Tax	(500)
Retained profit	1,000

Gloves Ltd (cont)

The balance sheet of Gloves Ltd at the year end is as follows:

	£
Net assets	5,000
Share capital	500
Accumulated profit	4,500
	5,000

The profit & loss accounts of Gloves Ltd for the year is as follows:

	£
Turnover	10,000
Cost of Sales	(5,000)
Operating profit	5,000
Tax	(1,500)
Retained profit	3,500

Gloves Ltd (cont) – Consolidated Balance Sheet

Acquisition accounting

	£
Goodwill on consolidation	300
Net assets	11,600
	11,900
Share capital	900
Accumulated profits	5,000
Merger reserve	6,000
	11,900

Merger accounting

	£
Net assets	11,510
	11,510
Share capital	900
Accumulated profits	10,600
Other reserves	10
	11,510

Glove Ltd (cont) – Consolidated Profit & Loss account

Acquisition accounting

	£
Turnover	13,000
Cost of sales	(7,250)
Operating profit	5,750
Tax	(1,750)
Retained profit	4,000

Merger accounting

	£
Turnover	16,000
Cost of sales	(9,500)
Operating profit	6,500
Tax	(2,000)
Retained profit	4,500

Acquisition accounting v Merger accounting summary

Acquisition accounting

- Results are included from the date of acquisition
- Fair values are used
- Goodwill can arise on consolidation

Merger accounting

- Results are included as if the companies had always been combined
- No fair value adjustments are made
- No goodwill arises

Key differences in accounting for business combinations

Acquisition accounting (UK)

- Costs for issuing equity & debt securities are not included in the costs of the acquisition
- A restructuring provision is not permitted
- Goodwill arising on acquisition will require an annual amortisation charge over a maximum of 20 years
- Negative goodwill is treated as a negative fixed asset

Purchase method (IFRS)

- The fair value of costs of issuing equity that are directly attributable to the business combination are included in the costs of the acquisition
- A restructuring provision is permitted if an obligation exists
- Goodwill arising on acquisition will require an annual impairment review
- Negative goodwill is recognised immediately to the income statement

Summary

Associates – UK GAAP more detailed disclosure
- UK GAAP annual amortisation of goodwill

Joint Controlled Entities – Proportionate consolidation V Equity method

Business Combinations – Purchase method / Acquisition accounting V Merger accounting