Australian Accounting Review

# A Reconsideration of Consolidation Accounting Requirements and Pre-acquisition Dividends

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*This article considers the consolidation accounting consequences of the International Accounting Standards Board's decision to replace the cost method of accounting for investments in subsidiaries with a new model that requires the recognition of dividend revenue for distributions received or receivable from pre-acquisition profits. The article shows that the recognition of pre-acquisition dividends as revenue with a potential indication of impairment causes problems to consolidation accounting procedures and may reduce the information content of consolidated financial statements. The highlighted problems relate to the elimination of the investment asset against the equity of the subsidiary and the definition and measurement of non-controlling interest. A review of the due process relevant to the replacement of the cost method indicates that the standard setter may have paid insufficient regard to accounting concepts and principles.*

The purpose of this article is to reconsider consolidation procedures in light of the 2008 decision of the International Accounting Standards Board (IASB) to replace the cost method of accounting with a new model that requires the parent to recognise dividend revenue for distributions received or receivable from the pre-acquisition profits of a subsidiary. The article is motivated by the absence of any evidence that the IASB has formally considered the impact of replacing the cost method on consolidation procedures.

The reconsideration of consolidation procedures based on the IASB's new model for pre-acquisition dividends identifies four technical issues. First, the consolidation requirement to eliminate the parent's investment account against equity of the subsidiary may not be strictly adhered to. Second, group losses may be recognised as a consolidation artefact. Third, the measurement of non-controlling interest (NCI) may not accurately reflect its definition. Fourth, it becomes necessary to identify whether inter-company dividends in prior periods are from pre-acquisition profits for the purpose of measuring NCI.

Further analysis indicates that the four technical issues identified in this article are attributable to the IASB's new model for pre-acquisition dividends being inconsistent with long-standing principles applicable to consolidation accounting. Accordingly, the IASB should be encouraged to explicitly consider the consolidation consequences that have arisen from its replacement of the cost method with a view to informing users of International Financial Reporting Standards (IFRS) of the relevant technical issues. The IASB may need to undertake additional standard-setting work to solve these issues.

## An Oversight in the IASB's Comprehensive Consolidation Project?

On 12 May 2011, the IASB issued its new IFRS for consolidation accounting titled IFRS 10 *Consolidated Financial Statements*. The 2011 release of IFRS 10 has been a decade in the making. In April 2002, the IASB added a consolidation project to its agenda for the purpose of addressing both the basis on which a parent entity should consolidate investments in subsidiaries, and the procedures for consolidation.[1]

Prior to the 2011 release of IFRS 10, the IASB discussed its consolidation project in 40 meetings including joint meetings with the Financial Accounting Standards Board (FASB) of the United States (US). The new standard

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 doi: 10.1111/j.1835-2561.2012.00190.x

that has emerged from the IASB's consolidation project has a stated objective as follows: 'The objective of this IFRS is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities' (IFRS 10: para. 1).

The main innovation of IFRS 10 however, is a new control principle to identify the group subject to consolidation and comprehensive application guidance on how to apply that principle.[2] There are no other apparent changes to the extant body of consolidation accounting principles. The new standard sets out procedures for consolidation that are, in substance, the same as those that have applied since the Board first released IAS 27 in 1988.

The *Basis for Conclusions* of IFRS 10 notes that the IASB has maintained the previous accounting requirements for the preparation of consolidated financial statements without any reconsideration (para. BC9). The IASB's acknowledgement that the consolidation procedures have not been reconsidered as part of its 10-year consolidation project is a curious admission.

There are three important reasons why the IASB should have reconsidered consolidation procedures prior to releasing IFRS 10. First, the original stated purposes of the consolidation project include addressing consolidation procedures, and the IASB has not explained why that purpose has been unfulfilled. Second, a new standard that purports to have the objective of establishing consolidation principles should include a due process that involves, at least, some consideration of the consolidation procedures that are relevant for those principles. Third, amendments made by the IASB to IAS 27 *Consolidated and Separate Financial Statements* in May 2008 have consolidation accounting consequences. These amendments include the replacement of the cost method of accounting for investments in subsidiaries and the recognition of dividend revenue for distributions out of pre-acquisition profits. The IASB should have reconsidered whether the consolidation procedures carried forward into IFRS 10 remain effective after the replacement of the cost method.

## The Cost Method of Accounting for Investments in Subsidiaries

The cost method in international standards dates from June 1976 when the (then) International Accounting Standards Committee (IASC) issued IAS 3 *Consolidated Financial Statements*. In the US, the cost method can be traced to the American Accounting Association's Monograph No. 4: *The Entity Theory of Consolidated Statements,1944, page 58*. Prior to being replaced in May 2008, the cost method was described by the IASB as follows:

> The *cost method* is the method of accounting for an investment whereby the investment is recorded at cost. The investor recognises income from the investment only to the extent that the investor receives distributions from retained earnings of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of the investment and are recognised as a reduction of the cost of the investment (IAS 27 2003: para. 4).

The discussion of the cost method in consolidation monographs and standards that existed prior to 2008 highlights the interconnectedness of accounting for dividends from the pre-acquisition profits of subsidiaries and consolidation procedures.

The cost method treats dividends paid to the parent entity out of the pre-acquisition reserves of the subsidiary (including retained profits to the date of acquisition) as a return of part of the original equity acquired. Therefore, the cost method is consistent with the principle that the parent's investment in a subsidiary constitutes the acquisition of a certain proportion of the subsidiary's equity at the date of acquisition. This principle underlies the IASB's consolidation procedure of eliminating the parent's investment in the subsidiary against the parent's portion of equity of the subsidiary (IRFS 10: Appendix B para. B86). This principle also underlies the application of the acquisition method in consolidation accounting (IFRS 3 *Business Combinations*: para. 4). The acquisition method recognises the fair values of each identifiable asset and liability of the subsidiary at the date of acquisition concurrent with the elimination of the parent's investment against the related equity.

Various Australian authors of tertiary education textbooks that cover consolidation accounting have commented on the cost method. In the consolidation context, the cost method is described as logical (Deegan 2010) or obvious and a matter of sound accounting practice (Johnston et al. 1973). The cost method is consistent with substance over form because, in effect, a dividend received out of pre-acquisition profits is a partial refund of the original investment rather than a return on that investment (Deegan 2010; Picker et al. 2006; Jubb et al. 2005; Eddey et al. 2001). It is also consistent with the concept of capital maintenance because dividends from pre-acquisition profits have a capital nature (Bowra and Clark 1973).

The reference to the capital nature of the pre-acquisition profits of subsidiaries is consistent with the financial concept of capital that is described by the IASB as follows: 'A financial concept of capital is adopted by most entities in preparing their financial statements. Under a financial concept of capital such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity' (Conceptual Framework for Financial Reporting 2010: para. 4.57).

Financial capital maintenance ensures that profit and distributions of profit for an entity, including a group, do not derive from the mere act of acquiring another entity's assets or acquiring an equitable interest in that other entity's net assets. The IASB explains the link between the determination of profit (or loss) and financial capital maintenance as follows:

> 'Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceed the financial (or money) amount of net assets at the beginning of the period after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power' (Conceptual Framework for Financial Reporting 2010: para. 4.59).

## The IASB's New Model of Dividend Revenue and Potential Indication of Impairment

On 22 May 2008, the IASB issued a press release announcing it had replaced the cost method. A new approach to the cost-based measurement for an investment in a subsidiary was adopted. In future, the investment would be measured using the original cost unreduced for any returns of the investment in the form of pre-acquisition dividends. In conjunction with this new approach to cost-based measurement, the recognition of dividend revenue was extended to include the right to dividends out of pre-acquisition profits.[3] The new dividend requirement inserted into IAS 27 stated the following: 'An entity shall recognise a dividend from a subsidiary, jointly controlled entity or associate in profit or loss in its separate financial statements when its right to receive the dividend is established' (IAS 27 2008: para. 38A).

In replacing the cost method, the IASB reiterated that, in accordance with IAS 36 *Impairment of Assets*, the cost of an investment in a subsidiary may need to be written down to its recoverable amount. The IASB recognised that the transfer of cash or other assets arising from a pre-acquisition dividend has the potential to reduce the recoverable amount of the investment in a subsidiary below original cost. The IASB highlighted this potential for impairment losses by inserting a new indicator of impairment in IAS 36 as follows:

> [For] an investment in a subsidiary, jointly controlled entity or associate, the investor recognises a dividend from the investment and evidence is available that:
>
> (i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or
>
> (ii) the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared. (IAS 36 2008: para. 12(h))

The IASB thereby replaced the cost method with a new model of dividend revenue and potential indication of impairment. A feature of the IASB's new model is that the profit of the parent increases (or loss reduces) whenever the amount of a pre-acquisition dividend is greater than the amount of any impairment loss recognised on the investment as a result of that dividend. The profit or loss of the parent will only correspond to what it would have been under the cost method in the special case of equality between dividend revenue and impairment loss for the pre-acquisition dividend. Therefore, the IASB's new model will result in a higher carrying value for the parent's investment in the subsidiary relative to the cost method whenever the amount of pre-acquisition dividends exceeds the net amount of impairment losses recognised.

The IASB's new model provides significant scope for the parent to minimise the recognition of impairment losses for pre-acquisition dividends thereby facilitating higher assets and higher profits in its separate financial statements. The non-automatic nature of impairment testing in IAS 36 for investments in subsidiaries means that a relevant measurement of recoverable amount may be irregular or not happen at all notwithstanding the distribution of pre-acquisition profits to the parent. In this regard, the conditions of the new indicator of impairment for investments in subsidiaries appear to be somewhat avoidable.

The net asset condition at paragraph 12(h)(i) of IAS 36 can be avoided if a subsidiary borrows from another group company in order to distribute pre-acquisition profits. Intra-group borrowings are not required to be included in net assets for the purpose of the comparison with the carrying amount of the investment because they are eliminated on consolidation. Another weakness in the net asset condition is that an investment representing a 60% ownership interest in a subsidiary would give rise to a mismatched comparison with the carrying amounts of 100% of the subsidiary's net assets that are included in the consolidated financial statements.

The comprehensive income condition at paragraph 12(h)(ii) of IAS 36 can also be avoided if a subsidiary enters into transactions with another group company that have the effect of increasing the comprehensive income of the subsidiary. Alternatively, the comprehensive income condition can be avoided if pre-acquisition dividends are timed in periods where the subsidiary has increased its reserves when accounting for revaluations of property, plant, available-for-sale financial assets and cash flow hedges.

In the event that impairment testing of the investment is required by virtue of the new impairment indicator, an impairment loss will only arise if the carrying amount of the investment exceeds its recoverable amount. The determination of the value-in-use for an investment in a subsidiary is the present value of the expected future cash flows to be derived from the investment based on an appropriate risk-adjusted discount rate. Notwithstanding the theoretical basis of present value as a measurement rule, such calculations are notoriously flexible to the assumptions used and the estimates of future net cash flows and discount rates. Therefore, the foibles of measurement for the recoverable amount of an investment in a subsidiary may also allow the parent to minimise the amount of any impairment loss relative to revenue recognised from the pre-acquisition dividend.

In light of the weaknesses in the impairment indicator and the measurement of recoverable amount generally, the IASB's new model may frequently produce a disparity between the amounts of dividend revenue and impairment loss recognised in respect of an investment in a subsidiary. This disparity has consolidation accounting consequences, that is, it impacts on consolidation accounting procedures. In the ordinary course, the carrying amount of an investment in a subsidiary is eliminated against the pre-acquisition reserves of that subsidiary. If there is a reduction in pre-acquisition reserves that is not accompanied by an equal reduction of the investment carrying amount, then a difference arises and this difference must be accounted for somewhere on consolidation.

## The Consolidation Accounting Consequences of the IASB's New Model

This section presents four simplified examples to illustrate the consolidation accounting consequences of the IASB's new model of dividend revenue and potential indication of impairment applicable to pre-acquisition dividends.

The first example considers the consolidation of a parent and subsidiary in circumstances where a pre-acquisition dividend is distributed to the parent shortly after the acquisition of the subsidiary. This example demonstrates that the description in IFRS 10 of the consolidation procedure to eliminate the investment account may be rendered inaccurate by the IASB's new model.

The second example is identical to the first except that the pre-acquisition profits of the subsidiary are allowed to pass from the subsidiary to the parent and then to the owners of the parent, that is, pre-acquisition profits reach the shareholders of the parent as dividends. This example demonstrates how group losses may be created as a consolidation artefact because of the IASB's new model.

The third example considers the consolidation of an extended group structure with direct and indirect ownership interests. This example demonstrates that the measurement of NCI may not adequately reflect the definition of NCI in IFRS 10 due the IASB's new model allowing a double counting of pre-acquisition profits.

The fourth example analyses the effect on the measurement of NCI in an extended group structure when intercompany dividend revenues arise from distributions of pre-acquisition profits. This example demonstrates that the IASB's new model creates a new imperative of keeping track of inter-company dividend revenues from pre-acquisition profits.

The four examples in this section show the results of consolidations based on the assumption that pre-acquisition dividends are not accompanied by impairment losses for investments in subsidiaries. Notwithstanding this assumption, and subject to materiality, the discussion of the consolidation consequences in each example will generalise to other cases where the amount of revenue recognised from a pre-acquisition dividend is greater than the recognised impairment loss.[4]

The outcome of revenue recognition greater than impairment loss may arise because of the non-mandatory nature of impairment testing, the scope to avoid the net asset and comprehensive income conditions of the relevant indicator of impairment, and the flexible nature of estimates used in recoverable amount measurement.

The four examples also assume that a company can distribute the profit of the current period or the accumulated balance of profits at the beginning of the period. It is possible that there may be jurisdictional restrictions on dividend distributions other than profits.[5]

### Example 1: IFRS 10 description of consolidation procedure to eliminate investment is inaccurate

On 1 January 20×1, Parent Ltd (Parent) acquires 100% of the ordinary voting shares of Child Ltd (Child) for a cash consideration of \$10.001 million. There is no goodwill in respect of this acquisition. Immediately after the acquisition, the balance sheets of the two companies are as follows:

| | Parent $'000 | Child $'000 |
|---|---|---|
| Retained profits | – | 10 000 |
| Share capital | 15 000 | 1 |
| *Shareholders' equity* | 15 000 | 10 001 |
| Investment in Child | 10 001 | – |
| Other assets | 4 999 | 10 001 |
| *Net assets* | 15 000 | 10 001 |

During 20×1, the first year after the acquisition, Child distributes the entire amount of its pre-acquisition retained profits to Parent as a dividend, that is, $10 million. There are no other transactions for either company.

Table 1 and Table 2 set out consolidations for 31 December 20×1 and 31 December 20×2, that is, the consolidations where the pre-acquisition dividend occurs in the current year and prior year, respectively. Panel A of each table shows the consolidation if there is no impairment loss recognised with the pre-acquisition dividend whereas panel B shows the consolidation if an impairment loss is recognised equal to the full amount of the pre-acquisition dividend. Therefore, panel A is consistent with the IASB's new model for pre-acquisition dividends whilst panel B is consistent with the cost method that was replaced.

The main result of the first example is shown at panel A of Table 2. The inequality between dividend revenue and impairment loss allows pre-acquisition profits of Child to be transferred to the retained profits of Parent. On consolidation, the investment in Child must then be eliminated against equity (retained profits) of Parent. *Prima facie* this approach is inconsistent with the required consolidation procedure stated in IFRS 10 as follows: 'Offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (IFRS 3 explains how to account for any related goodwill)' (IFRS 10: Appendix B, para. B869(b)).

The current drafting of IFRS 10 suggests that the equity of the subsidiary rather than the equity of the parent is eliminated against the investment on consolidation. The references to the carrying amount of the investment and equity of each subsidiary are indicative of current balances, that is, balances existing at the date of consolidation. The current drafting is, at least, inaccurate by omission. It does not adequately describe the elimination of the investment when pre-acquisition profits have travelled back through the group to the parent.

In contrast, panel B of Table 2 illustrates that the elimination of the investment is consistent with the IFRS 10 consolidation procedure if the carrying amount of the investment is reduced by the full amount of the pre-acquisition dividend as in the cost method. In this case, Parent's investment is offset only against the equity of Child.

Another issue arising from the IASB's new model of dividend revenue and potential indication of impairment is highlighted in panel A of Table 1 and Table 2. The group discloses no consolidated profits attributable to the owners of Parent but it is clear from the separate financial statements of Parent that there are profits of $10 million residing in a group company that may be distributable to these owners.[6] There is a disconnection here between the information in the consolidated financial statements and economic substance. The shareholders of the parent may not be informed about the substance of financial affairs if the parent does not present its separate financial statements with the consolidated financial statements, which is currently permitted in Australia.

It is worth noting that dividends distributed from post-acquisition profits do not create a disconnection between the reported profits of the parent and the consolidated profits of the group that are attributable to the owners of the parent. On a conceptual level, there do not appear to be any grounds why such a difference should arise when dividends are distributed from pre-acquisition profits.

In contrast to the consolidations under the IASB's new model, panel B of Table 1 and Table 2 illustrates that the consolidated profits attributable to the owners of the parent remain aligned with the profits in the separate financial statements of the parent (i.e., they are both $Nil) if the carrying amount of the investment is reduced by the full amount of the pre-acquisition dividend as in the cost method.

**Example 2: Group losses recognised as a consolidation artefact**

The second example is identical to the first except with the additional assumption that the pre-acquisition dividend received by Parent is immediately distributed to its shareholders.

Where there is no impairment loss on the investment the $10 million pre-acquisition dividend increases Parent's profit and can be distributed as a dividend to the owners of Parent. In effect, there can be back-to-back dividends, that is, dividend from Child to Parent and then dividend from Parent to the owners of Parent.

Where there is a full impairment loss on the investment the dividend does not increase Parent's profit and the distribution to the owners of Parent is by way of a return of capital. Therefore, the balance of Parent's share capital reduces from $15 million to $5 million because of a $10 million distribution that is a return of capital.

Table 3 sets out the consolidation for 31 December 20×1 where the distributions occur in the current year whilst Table 4 shows the consolidation for 31 December 20×2 where the distributions relate to the prior year.

 

**Table 1** **Consolidation for 20×1 with pre-acquisition dividend to Parent in current period**

| | Panel A: No impairment loss recognised | | | | | | Panel B: Full impairment loss recognised | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Elimination entries | | | | | | Elimination entries | | | |
| | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 |
| Dividend revenue | 10 000 | – | 10 000 | *(2)* | | – | 10 000 | – | 10 000 | *(2)* | | – |
| Impairment loss | – | – | | | | – | (10 000) | – | | *(1)* | 10,000 | – |
| *Net profit* | 10 000 | – | | | | – | – | – | | | | – |
| Retained profits (beg) | – | 10 000 | 10 000 | *(1)* | | – | – | 10 000 | 10 000 | *(1)* | | – |
| Dividend paid | – | (10 000) | | *(2)* | 10 000 | – | – | (10 000) | | *(2)* | 10,000 | – |
| Retained profits (end) | 10 000 | – | | | | – | – | – | | | | – |
| Share capital | 15 000 | 1 | 1 | *(1)* | | 15 000 | 15 000 | 1 | 1 | *(1)* | | 15 000 |
| *Shareholders' equity* | 25 000 | 1 | | | | 15 000 | 15 000 | 1 | | | | 15 000 |
| Investment in Child | 10 001 | – | | *(1)* | 10 001 | – | 1 | – | | *(1)* | 1 | – |
| Other assets | 14 999 | 1 | | | | 15 000 | 14 999 | 1 | | | | 15 000 |
| *Net assets* | 25 000 | 1 | 20 001 | | 20 001 | 15 000 | 15 000 | 1 | 20 001 | | 20 001 | 15 000 |

Panel A:

*(1) Elimination of investment in subsidiary*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Dr. | Retained profits | 10 000 | |
| Cr. | Investment in Child | | 10 001 |

*(2) Elimination of pre-acquisition dividend*

| | | | |
|---|---|---|---|
| Dr. | Dividend revenue | 10 000 | |
| Cr. | Dividend paid | | 10 000 |

Panel B:

*(1) Elimination of investment in subsidiary*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Dr. | Retained profits | 10 000 | |
| Cr. | Impairment loss | | 10 000 |
| Cr. | Investment in Child | | 1 |

*(2) Elimination of pre-acquisition dividend*

| | | | |
|---|---|---|---|
| Dr. | Dividend revenue | 10 000 | |
| Cr. | Dividend paid | | 10 000 |

**Table 2** **Consolidation for 20×2 with pre-acquisition dividend to Parent in prior period**

| | Panel A: No impairment loss recognised | | | | | | Panel B: Full impairment loss recognised | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Elimination entries | | | | | | Elimination entries | | | |
| | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 |
| *Net profit* | – | – | | | | – | – | – | | | | – |
| Retained profits (beg) | 10 000 | – | 10 000 | *(1)* | | – | – | – | | | | – |
| Dividend paid | – | – | | | | – | – | – | | | | – |
| Retained profits (end) | 10 000 | – | | | | – | – | – | | | | – |
| Share capital | 15 000 | 1 | 1 | *(1)* | | 15 000 | 15 000 | 1 | 1 | *(1)* | | 15 000 |
| *Shareholders' equity* | 25 000 | 1 | | | | 15 000 | 15 000 | 1 | | | | 15 000 |
| Investment in Child | 10 001 | – | | *(1)* | 10 001 | – | 1 | – | | *(1)* | 1 | – |
| Other assets | 14 999 | 1 | | | | 15 000 | 14 999 | 1 | | | | 15 000 |
| *Net assets* | 25 000 | 1 | 10 001 | | 10 001 | 15 000 | 15 000 | 1 | 1 | | 1 | 15 000 |

Panel A:

*(1) Elimination of investment in subsidiary*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Dr. | Retained profits | 10 000 | |
| Cr. | Investment in Child | | 10 001 |

Panel B:

(1) Elimination of investment in subsidiary

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Cr. | Investment in Child | | 1 |

Panels A and B again show the position where there is no impairment and full impairment, respectively.

The main result of the second example is shown in panel A of Table 4. It is not possible in this scenario to comply with the IFRS consolidation procedure for eliminating the investment against the equity of the subsidiary. The back-to-back dividends cause the pre-acquisition profits to be no longer available in the accounts of Child or Parent. Accordingly, the investment in Child cannot be offset against the pre-acquisition profits, and because of this a loss of $10 million arises on the elimination of the investment. The loss of $10 million is a consolidation artefact. It arises only in the consolidated accounts but has no relation to the contribution made by Parent or Child to the financial performance of the group. The investment in Child has

**Table 3 Consolidation for 20×1 with pre-acquisition profits distributed to owners of Parent in the current period**

| | Panel A: No impairment loss recognised | | | | | | Panel B: Full impairment loss recognised | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Elimination entries | | | | | | Elimination entries | | | |
| | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 |
| Dividend revenue | 10 000 | – | 10 000 | *(2)* | | – | 10 000 | – | 10 000 | *(2)* | | – |
| Impairment loss | – | – | | | | – | (10 000) | – | | *(1)* | 10 000 | – |
| *Net profit* | 10 000 | – | | | | – | – | – | | | | – |
| Retained profits (beg) | – | 10 000 | 10 000 | *(1)* | | – | – | 10 000 | 10 000 | *(1)* | | – |
| Dividend paid | (10 000) | (10 000) | | *(2)* | 10 000 | (10 000) | – | (10 000) | | *(2)* | 10 000 | – |
| Retained profits (end) | – | – | | | | (10 000) | – | – | | | | – |
| Share capital | 15 000 | 1 | 1 | *(1)* | | 15 000 | 5 000 | 1 | 1 | *(1)* | | 5 000 |
| *Shareholders' equity* | 15 000 | 1 | | | | 5 000 | 5 000 | 1 | | | | 5 000 |
| Investment in Child | 10 001 | – | | *(1)* | 10 001 | – | 1 | – | | *(1)* | 1 | – |
| Other assets | 4 999 | 1 | | | | 5 000 | 4 999 | 1 | | | | 5 000 |
| Net assets | 15 000 | 1 | 20 001 | | 20 001 | 5 000 | 5 000 | 1 | 20 001 | | 20 001 | 5 000 |

Panel A:

*(1) Elimination of investment in subsidiary*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Dr. | Retained profits | 10 000 | |
| Cr. | Investment in Child | | 10 001 |

*(2) Elimination of pre-acquisition dividend*

| | | | |
|---|---|---|---|
| Dr. | Dividend revenue | 10 000 | |
| Cr. | Dividend paid | | 10 000 |

Panel B:

*(1) Elimination of investment in subsidiary*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Dr. | Retained profits | 10 000 | |
| Cr. | Impairment loss | | 10 000 |
| Cr. | Investment in Child | | 1 |

*(2) Elimination of pre-acquisition dividend*

| | | | |
|---|---|---|---|
| Dr. | Dividend revenue | 10 000 | |
| Cr. | Dividend paid | | 10 000 |

**Table 4 Consolidation for 20×2 with pre-acquisition profits distributed to owners of Parent in the prior period**

| | Panel A: No impairment loss recognised | | | | | | Panel B: Full impairment loss recognised | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Elimination entries | | | | | | Elimination entries | | | |
| | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 | Parent Ltd $'000 | Child Ltd $'000 | Dr. $'000 | Ref | Cr. $'000 | Group $'000 |
| *Net profit* | – | – | 10 000 | *(1)* | | (10 000) | – | – | | | | – |
| Retained profits (beg) | – | – | | | | – | – | – | | | | – |
| Dividend paid | – | – | | | | – | – | – | | | | – |
| Retained profits (end) | – | – | | | | (10 000) | – | – | | | | – |
| Share capital | 15 000 | 1 | 1 | *(1)* | | 15 000 | 5 000 | 1 | 1 | *(1)* | | 5 000 |
| *Shareholders' equity* | 15 000 | 1 | | | | 5 000 | 5 000 | 1 | | | | 5 000 |
| Investment in Child | 10 001 | – | | *(1)* | 10 001 | – | 1 | – | | *(1)* | 1 | – |
| Other assets | 4 999 | 1 | | | | 5 000 | 4 999 | 1 | | | | 5 000 |
| *Net assets* | 15 000 | 1 | 10 001 | | 10 001 | 5 000 | 5 000 | 1 | 1 | | 1 | 5 000 |

Panel A:

*(1) Elimination of investment in subsidiary*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Dr. | Loss on consolidation | 10 000 | |
| Cr. | Investment in Child | | 10 001 |

Panel B:

*(1) Elimination of investment in subsidiary*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 1 | |
| Cr. | Investment in Child | | 1 |

to be eliminated on consolidation. It cannot be offset against the share capital of Parent and there is insufficient equity of Child which means a loss on consolidation must be recognised.[7]

Panel A of Table 3 and Table 4 illustrates that a peculiar reporting outcome for the group can emerge from the IASB's new model of dividend revenue and potential indication of impairment. The IFRS consolidation procedure for the elimination of the investment is ineffective because below-the-line dividend distributions create losses and/or accumulated losses for the group. This is something of a reversal of the norm, that is, the recognition of profits usually precedes the recognition of dividends.

In contrast to the consolidations under the IASB's new model, panel B of Table 3 and Table 4 shows that the IFRS consolidation procedure for the elimination of the investment is effective if the carrying value of

 

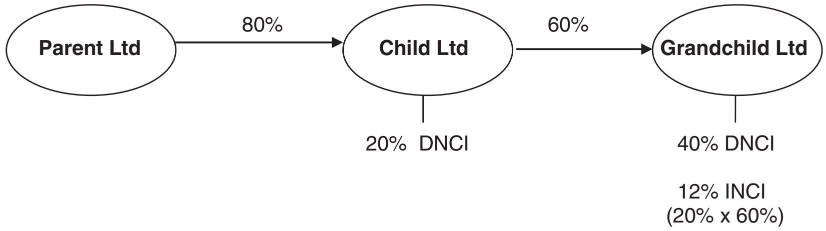


**Figure 1** **Ownership interests in the group**

the investment is reduced by the full amount of the pre-acquisition dividend as in the cost method.

**Example 3: Measurement of NCI contrary to IFRS 10 definition**

On 1 January 20×1, Parent acquires 80% of the ordinary voting shares of Child for a cash consideration of \$10 million. On the same date, Child acquires 60% of the ordinary voting shares of Grandchild Ltd (Grandchild) for a cash consideration of \$6 million. Figure 1 illustrates the group that is established by the two acquisitions including the direct non-controlling interest (DNCI) and indirect non-controlling interest (INCI) in the group.

There is no goodwill in respect of either acquisition. Immediately after the acquisitions the balance sheets of the three companies are as follows:

| | Parent \$'000 | Child \$'000 | Grandchild \$'000 |
|---|---|---|---|
| Retained profits | – | – | 9 900 |
| Share capital | 15 000 | 12 500 | 100 |
| *Shareholders' equity* | 15 000 | 12 500 | 10 000 |
| Investment in subsidiary | 10 000 | 6 000 | – |
| Other assets | 5 000 | 6 500 | 10 000 |
| *Net assets* | 15 000 | 12 500 | 10 000 |

During 20×1, the first year after the group formation, Grandchild distributes its pre-acquisition retained profits of \$9.9 million to shareholders as a dividend. Child's share of this dividend is \$5.94 million, that is, 60% of \$9.9 million. Child then distributes \$5.94 million of the profits to its shareholders. Parent's share of this dividend is \$4.752 million, that is, 80% of \$5.94 million. There are no other transactions for the companies.

Table 5 sets out the consolidation for 31 December 20×1 assuming that the back-to-back dividends result in the recognition of dividend revenue but no impairment losses on the investments in subsidiary accounts. Consistent with IFRS 3, NCI at the date of acquisition is determined using DNCI of 20% in Child's identifiable net assets and DNCI of 40% in Grandchild's identifiable net assets.[8]

The NCI is determined using the consolidation requirements the IASB contends have been maintained in IFRS 10 as follows:[9]

> Non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the parent's ownership interests in them. Non-controlling interests in the net assets consist of:
>
> (i) the amount of those non-controlling interests at the date of the original combination calculated in accordance with IFRS 3; and
> (ii) the non-controlling interests' share of changes in equity since the date of the combination (IAS 27, 2008, Para. 18(c)).[10]

The main result of the third example is that the amount recognised for NCI as shown in the consolidation worksheet and separate proof, that is, \$1.352 million, is not in accordance with the IFRS 10 definition of NCI because of a double counting of pre-acquisition profits. The definition of NCI in IFRS 10 is as follows: 'Equity in a subsidiary not attributable, directly or indirectly to a parent' (IFRS 10 2010: Appendix A).

This IASB definition makes it clear that NCI has the character of being the residual in the equity of a subsidiary, that is, the equity that remains after the parent interest. In the third example, the subsidiaries have share capital at the reporting date but no retained profits. Therefore, the NCI in the equity of the subsidiaries is the NCI in the share capital of the subsidiaries.

The proof in Table 5 shows that the NCI in the share capital equals \$2.54 million. However, the amount of NCI recognised from the application of IFRS 10 consolidation requirements amounts to \$1.352 million, which is \$1.188 million less than it should be based on the IFRS 10 definition of NCI. Accordingly, the measurement of NCI does not adequately reflect its IFRS definition when pre-acquisition profits are transferred from Grandchild to Child and then from Child to Parent.

It is apparent from journal (4) in Table 5 that the reduction of the NCI amounting to \$1.188 million arises because the distribution of pre-acquisition profits of Grandchild is double counted to the extent of the INCI of 12%. The DNCI in Grandchild is allocated a proportionate share of the pre-acquisition dividend

 

**Table 5 Consolidation for 20×1 with indirect NCI and pre-acquisition dividend**

| | Parent Ltd $'000 | Child Ltd $'000 | Grandchild Ltd $'000 | Elimination entries Dr. $'000 | Ref | Cr. $'000 | NCI entries Dr. $'000 | Ref | Cr. $'000 | Group $'000 |
|---|---|---|---|---|---|---|---|---|---|---|
| Dividend revenue | 4 752 | 5 940 | – | 4 752 | *(2)* | | | | | – |
| | | | | 5 940 | *(6)* | | | | | |
| Impairment loss | – | – | – | | | | | | | – |
| *Net profit* | 4 752 | 5 940 | – | | | | | | | – |
| Retained profits (beg) | – | – | 9 900 | 5 940 | *(5)* | | 3 960 | *(7)* | | – |
| Dividend paid | | (5 940) | (9 900) | | *(2)* | 4 752 | | *(4)* | 1 188 | – |
| | | | | | *(6)* | 5 940 | | *(8)* | 3 960 | |
| Retained profits (end) | 4 752 | – | – | | | | | | | – |
| Share capital | 15 000 | 12 500 | 100 | 10 000 | *(1)* | | 2 500 | *(3)* | | 15 000 |
| | | | | 60 | *(5)* | | 40 | *(7)* | | |
| NCI | – | – | – | | | | 1 188 | *(4)/(3)* | 2 500 | 1 352 |
| | | | | | | | 3 960 | *(8)/(7)* | 4 000 | |
| *Shareholders' equity* | 19 752 | 12 500 | 100 | | | | | | | 16 352 |
| Investment in subsidiary | 10 000 | 6 000 | – | | *(1)* | 10 000 | | | | – |
| | | | | | *(5)* | 6 000 | | | | |
| Other assets | 9 752 | 6 500 | 100 | | | | | | | 16 352 |
| *Net assets* | 19 752 | 12 500 | 100 | 26 692 | | 26 692 | 11 648 | | 11 648 | 16 352 |

(1) *Elimination of P's investment in C*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 10 000 | |
| Cr. | Investment in subsidiary | | 10 000 |

(2) *Elimination of pre-acquisition dividend from C to P*

| | | | |
|---|---|---|---|
| Dr. | Dividend revenue | 4 752 | |
| Cr. | Dividend paid | | 4 752 |

(3) *20% Direct NCI in C's pre-acquisition equity*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 2 500 | |
| Cr. | NCI | | 2 500 |

(4) *20% Direct NCI in C's pre-acquisition dividend*

| | | | |
|---|---|---|---|
| Dr. | NCI | 1 188 | |
| Cr. | Dividend paid | | 1 188 |

(5) *Elimination of C's investment in G*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 60 | |
| Dr. | Retained profits | 5 940 | |
| Cr. | Investment in subsidiary | | 6 000 |

(6) *Elimination of pre-acquisition dividend from G to C*

| | | | |
|---|---|---|---|
| Dr. | Dividend revenue | 5 940 | |
| Cr. | Dividend paid | | 5 940 |

(7) *40% Direct NCI in G's pre–acquisition equity*

| | | | |
|---|---|---|---|
| Dr. | Share capital | 40 | |
| Dr. | Retained earnings | 3 960 | |
| Cr. | NCI | | 4 000 |

(8) *40% Direct NCI in G's pre-acquisition dividend*

| | | | |
|---|---|---|---|
| Dr. | NCI | 3 960 | |
| Cr. | Dividend paid | | 3 960 |

*Proof of NCI*

| | Child | Grandchild | NCI |
|---|---|---|---|
| Retained profits (beg) | – | 9 900 | |
| Direct NCI | 20% | 40% | |
| | – | 3 960 | 3 960 |
| Dividend paid | (5 940) | (9 900) | |
| Direct NCI | 20% | 40% | |
| | (1 188) | (3 960) | (5 148) |
| Share capital | 12 500 | 100 | |
| Direct NCI | 20% | 40% | |
| | 2 500 | 40 | 2 540 |
| Total NCI | | | 1 352 |

amounting to $3.96 million, that is, 40% of $9.9 million. If the profit of Child is then distributed as a dividend to its shareholders, the INCI in Grandchild is then allocated a proportionate share of the distribution of pre-acquisition profits amounting to $1.188 million, that is, 12% of $9.9 million. The double counting of the distribution of pre-acquisition profits to NCI, in effect, reduces the DNCI in the share capital of the subsidiaries. Accordingly, the measurement of the NCI in the group is understated by the amount of $1.188 million.

There is something intrinsically wrong with the outcome of applying the IFRS 10 consolidation requirements in the third example. Grandchild's pre-acquisition dividend of $9.9 million has given rise to elimination entries and NCI entries based on 112% of $9.9 million. The investment in Grandchild is eliminated against 60%, the DNCI in Grandchild is allocated 40% and the INCI in Grandchild is allocated 12%. The resultant balance of NCI is consistent with there being a return of share capital to the outside shareholders in the group even though this is not the economic substance.

It is not apparent how the IASB could change the consolidation requirements of IFRS 10 to remove the double counting that is illustrated in the third example. The dividend distribution of Child must be allocated to the DNCI in Child in the amount of $1.188 million, that is, 20% of $5.94 million, because otherwise dividends paid to the owners of Parent will be overstated in the group accounts.

Double counting the distribution of pre-acquisition profits of Grandchild against NCI is a consequence of the replacement of the cost method with the IASB's new model of dividend revenue and potential indication of impairment. In contrast, the double counting problem does not arise if the carrying amount of the investment is reduced by the full amount of the pre-acquisition dividend as in the cost method. The consolidation based on a model of dividend revenue with full impairment yields NCI of $2.54 million, which is consistent with the IFRS 10 definition of NCI.[11] If Grandchild's pre-acquisition dividend does not increase Child's profits, then the pre-acquisition profits cannot be distributed as back-to-back dividends to reach the INCI in Grandchild.

The third example can be extended to consider the consolidation if the dividend of $4.752 million from Child to Parent is then distributed as a dividend to the owners of Parent. In this case, the consolidated balance sheet will show accumulated losses of $4.752 million attributable to the owners of Parent.[12] The dividend to the owners of Parent creates accumulated losses for the group. These accumulated losses bear no relation to the financial performance of the group. They are just another consolidation artefact arising from the IASB's new model of dividend revenue and potential indication of impairment.

**Example 4: Intercompany dividends of prior periods must be considered**

The fourth example assumes the same group structure and ownership interests as the third example shown in Figure 1. It is based on Grandchild distributing $10 million of profits to its shareholders during 20×1. Child records a profit of $8 million for 20×1 that includes $6 million from an inter-company dividend. Table 6 sets out the proofs for NCI in retained profits at the end of 20×1 and 20×2. Panel A measures the NCI if Grandchild's dividend is from pre-acquisition profits and no impairment loss is recognised. Panel B measures the NCI if the dividend is sourced from post-acquisition profits.

The main result of the fourth example is shown in panel A of Table 6. The IASB's new model of dividend revenue and potential indication of impairment has created a new imperative to consider prior period inter-company dividends in the measurement of NCI.

In consolidation accounting, it is the profits of the subsidiary contributed to the group that are attributed to the NCI. Therefore, inter-company dividends that are recognised by a subsidiary as dividend revenue should not be included in the NCI share of the subsidiary's profit.[13] Historically, only dividends from post-acquisition profits could be recognised as dividend revenue by a subsidiary and it was only necessary to consider inter-company dividends of the current period in the measurement of NCI.

Panel B of Table 6 illustrates the position that applied before the IASB's new model. The adjustment to NCI for inter-company dividend revenues sourced from post-acquisition profits is required in the year of the dividend (20×1) but not in the subsequent year (20×2).

In contrast, panel A of Table 6 illustrates that the IASB's new model requires an adjustment to NCI for pre-acquisition dividends in both the year of the dividend and in the subsequent year. If an adjustment to the NCI for the dividend was not made in 20×2, then the balance of NCI would be overstated by $1.2 million. Accordingly, pre-acquisition dividends recognised as revenue have a lingering effect on the determination of NCI in subsequent periods.

It is the IASB's new model that has made the historical record of pre-acquisition dividends a necessity for consolidation accounting where there is a group such as that shown in Figure 1. A preparer of consolidated financial statements for an extended group with INCI will need to assess whether the historical record of inter-company dividends includes any pre-acquisition dividends.

## Conceptual and Standard-setting Concerns

The four examples in the previous section illustrate how the IASB's new model of dividend revenue and potential indication of impairment challenges consolidation principles that have served the accounting profession for half a century. However, the IASB's new model also challenges accounting concepts and standard-setting conventions.

The IASB's new model appears to be inconsistent with the concept of financial capital maintenance described in the IASB's *Conceptual Framework for Financial Reporting*. Financial capital in the Framework is synonymous with net assets represented by share capital and reserves.[14] The IASB's new model comingles pre-acquisition reserves with post-acquisition reserves treating the balances as interchangeable. Subject to the amount of a possible impairment, the pre-acquisition reserves of a subsidiary can be distributed and create profits for the parent in the same way as post-acquisition reserves. The IASB's new model maintains the acquired share capital of the subsidiary before recognition of profits but not necessarily the acquired reserves. Therefore, it is based on a more limited notion of financial capital maintenance than that suggested by the Framework.

The consolidations shown in panel A of Table 3 and Table 4 provide further evidence that the IASB's new model is inconsistent with the concept of financial capital maintenance. These consolidations demonstrate that pre-acquisition dividends may cause the group to record losses and/or accumulated losses. Pre-acquisition profits of the subsidiary, in effect, become post-acquisition losses to the group. The net assets of the group are not maintained in the determination of profit (or loss) after the subsidiaries are acquired. In accordance with the concept of financial capital maintenance, the profits

 

**Table 6** **NCI in subsidiary profit with inter-company dividend revenue**

| | Panel A: Pre-acquisition dividend | | | Panel B: Post-acquisition dividend | | |
|---|---|---|---|---|---|---|
| | Child $'000 | Grandchild $'000 | NCI $'000 | Child $'000 | Grandchild $'000 | NCI $'000 |
| Retained profits (1.1.X1) | | 10 000 | | | | |
| DNCI | | 40% | | | | |
| | | 4 000 | 4 000 | | | |
| Net profit for 20×1 | 8 000 | | | 8 000 | 10 000 | |
| Less: Intercompany divided | (6 000) | | | (6 000) | – | |
| | 2 000 | | | 2 000 | 10 000 | |
| DNCI | 20% | | | 20% | 40% | |
| INCI | – | | | – | 12% | |
| | 400 | | 400 | 400 | 5 200 | 5 600 |
| Dividend paid | | (10 000) | | | (10 000) | |
| DNCI | | 40% | | | 40% | |
| | | (4 000) | (4 000) | | (4 000) | (4 000) |
| Retained profits 31.12.X1 | 8 000 | – | | 8 000 | – | |
| Total NCI | | | 400 | | | 1 600 |
| Retained profits (1.1.X2) | 8 000 | | | 8 000 | | |
| Less: Prior year dividend revenue | (6 000) | | | – | – | |
| | 2 000 | | | 8 000 | | |
| DNCI | 20% | | | 20% | | |
| Total NCI | 400 | | 400 | 1 600 | | 1 600 |

generated by subsidiaries before they are part of the group should not have any impact on the equity of the group attributable to the owners of the parent.

The IASB's new model will also allow pre-acquisition reserves to offset post-acquisition profits on consolidation. Another example of pre-acquisition reserves affecting post-acquisition profits is where, contrary to IFRS 3, an identifiable asset of a subsidiary is not recognised on acquisition but materialises to generate profits after the acquisition. The 1966 investigator's report into the corporate failure of Neon Signs (Australasia) Ltd prepared by Mr W. C. Crockett QC explains the mischief of comingling pre-acquisition reserves and post-acquisition profits as follows: 'The method employed of manipulating the accounts so as to treat as post-acquisition profit what in actuality was pre-acquisition profit, is closely akin to and as indefensible (commercially if not legally) as the forbidden practice of a company using its capital from which to distribute dividends' (Johnson et al. 1973: 308).

The investigator's report points to the commercial impropriety of recycling acquired profits of a subsidiary into distributable profits of the parent. This impropriety stems from income being purchased instead of generated or earned. Dividend revenue is attributable to the acquisition of a subsidiary rather than to its financial performance after acquisition. Jubb et al. (2010) liken this sort activity to a Ponzi scheme, that is, getting money from Peter to pay Paul. The recent Global Financial Crisis serves as a current reminder that capital erodes when distributions on acquired securities are not supported by the financial performance of underlying assets.

The payment of dividends by the parent entity using the pre-acquisition reserves of subsidiaries may also be contrary to corporate dividend policies. The parent entity of a large corporate group often announces its dividend policy based on a target payout ratio of group earnings, for example, Macquarie Group Limited targets a payout ratio for full-year ordinary dividends in the range of 50% to 60% of net earnings. These target payout ratios are based on the premise that there is a maintainable relationship between dividends and group earnings over time, that is, acquired reserves are excluded.

Another conceptual shortcoming of the IASB's new model is that the parent's financial statements may share a similar characteristic to the consolidated financial statements that would be produced by the widely disapproved pooling method of consolidation.[15] Panel A of Table 1 and Table 2 highlights that the consolidation required by IFRS 3 and IFRS 10 may result in the consolidated financial statements showing no profits attributable to the owners of the parent notwithstanding the parent's separate financial statements do disclose profits that are potentially distributable to its owners. The pooling method of consolidation differs from the required purchase method because it allows pre-acquisition reserves of a subsidiary to be attributed to the owners of the parent. Therefore, the consolidation outcomes of the pooling method align to some extent with the parent recording profits in its separate financial statements because of pre-acquisition dividends. The IASB's new model may, in effect, facilitate the partial application of the pooling method in the published financial statements.

 

There are a number of peculiarities associated with the standard-setting process that resulted in the IASB's new model for pre-acquisition dividends operating in tandem with IFRS 10, the new consolidation accounting standard. The IASB replaced the cost method by amending IAS 27 in 2008 but there is no public evidence that they considered the impact of their new model on consolidation procedures.[16] The IASB have subsequently acknowledged that consolidation procedures were also not reviewed in their due process for IFRS 10. Accordingly, the IASB's new model appears to have evaded a technical consolidation analysis from the standard setter in two relevant due processes.

The origin of the IASB's new model is its January 2007 Exposure Draft *Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards Cost of an Investment in a Subsidiary* (January 2007 ED). The proposals in the January 2007 ED were designed to provide limited relief from the cost method to first-time adopters of IFRS. Apparently, preparers in many European Union countries were avoiding the choice of IFRS in the separate financial statements of parent entities because of the cost and impracticality of determining the pre-acquisition profits of subsidiaries.[17]

The January 2007 ED proposed that first-time adopters should use deemed cost for investments and deemed pre-acquisition profits to solve the problems of retrospective application of the cost method. Subsequently, the IASB decided against solving the problem for first-time adopters in the first-time adoption standard, that is, IFRS 1, in favour of removing the cost method from IAS 27. Whilst the problem being addressed by the IASB was limited to first-time adopters, the ultimate solution has general application to any preparer of separate financial statements for a parent entity.

Paragraph BC66G of the IAS 27 *Basis for Conclusions*, January 2010, suggests that respondents to the January 2007 ED led the Board to the solution of removing the cost method from IAS 27. IASB technical staff may have played a significant role here because it seems that, in reporting to the Board, they overstated or placed undue emphasis on a few selective responses to the January 2007 ED.

Table 7 sets out the 42 respondents to the January 2007 ED categorised by whether they represent capital market interests, professional accounting organisations, accounting standard setters, regulatory bodies or accounting firms.[18] Table 7 also identifies those respondents who suggested the problem of first-time adoption of the cost method should be addressed by making amendments to IAS 27. The comment letters of five respondents out of 42, that is, less than 12% of all respondents, could be interpreted as suggesting that the cost method in IAS 27 should be replaced. These five respondents are comprised of a Big 4 accounting firm, the UK accounting standard setting body, two global corporations with UK offices, and a lobby group for small-cap UK companies. Consistent with the January 2007 ED, most comment letters indicate the issue to resolve is in IFRS 1 alone. These comment letters include three Big 4 accounting firms, nine national standard-setting bodies and professional accounting organisations from 11 different countries.

In contrast to the evidence summarised in Table 7, technical staff of the IASB advised the Board as follows: 'Respondents were consistent in asserting that the real issue to be resolved lay in IAS 27 not IFRS 1. These respondents indicated that IFRS 1 is not the correct venue for rectifying challenges pertaining to the task of splitting accumulated profits between pre-acquisition and post-acquisition (IASB Agenda Paper 5, Board Meeting September 2007: para. 39).[19]

The evidence in the 42 comment letters for the January 2007 ED does not support a conclusion that the respondents to the January 2007 ED were consistent in pressing for change to 1AS 27 or that a significant proportion of respondents had suggested that the Board should deal with the issues raised in the January 2007 ED by removing the cost method.

Subsequent to the due process for the January 2007 ED, the IASB exposed to public comment its proposed replacement of the cost method in the December 2007 Exposure Draft *Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards and IAS 27 Consolidated and Separate Financial Statements Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (December 2007 ED). In the December 2007 ED, the IASB proposed that automatic impairment testing should apply to the related investment whenever dividends from a subsidiary, jointly controlled entity or associate are recognised as revenue. The IASB relented on mandatory impairment testing in light of objections raised by respondents to the December 2007 ED. In May 2008, the IASB reissued IAS 27 with the cost method removed in favour of the IASB's model of dividend revenue and potential indication of impairment. Table 8 sets out the names of the 64 respondents to the December 2007 ED by category. It also highlights whether the respondents agreed to the removal of the cost method and objected to the IASB's proposal of automatic impairment testing.

The 64 respondents to the December 2007 ED include 28 of the original 42 respondents to the January 2007 ED and 36 new respondents. This variation in the respondents is consistent with a significant transformation in the issues addressed between the two EDs. The transformation was from a set of proposals to provide a pragmatic solution to a first-time adoption problem to a set of proposals on accounting for investments impacting existing preparers of IFRS financial statements.

There are 16 new respondents in the capital market category and 15 of these supported the deletion of the

**Table 7** **Respondents' 42 comment letters to the IASB January 2007 ED**

| CL | Respondent name | Category | Suggest change to IAS 27? |
|---|---|---|---|
| 1. | Group of 100 (Australia) | Capital market | – |
| 2. | Anglo American plc | Capital market | – |
| 3. | Norwegian Accounting Standards Board | Standard setter | – |
| 4. | Bank of Russia | Capital market | – |
| 5. | The Hundred Group (UK) | Capital market | – |
| 6. | IOSCO | Regulator | – |
| 8. | Institute of Chartered Accountants in Australia | Profession | – |
| 9. | Ernst & Young (Global) | Big 4 firm | Yes |
| 10. | IDW (Germany) | Profession | – |
| 11. | Dutch Accounting Standards Board | Standard setter | – |
| 12. | German Accounting Standards Board | Standard setter | – |
| 13. | Swedish Financial Accounting Standards Council | Standard setter | – |
| 14. | Accounting Standards Board (UK) | Standard setter | Yes |
| 16. | Grant Thornton (Global) | Other firm | – |
| 17. | The Central Credit Committee (Germany) | Capital market | – |
| 18. | South African Institute of Chartered Accountants | Profession | – |
| 19. | Accounting Standards Board (Canada) | Standard setter | – |
| 20. | Institute of Chartered Accountants Pakistan | Profession | – |
| 21. | British American Tobacco | Capital market | – |
| 22. | Royal and Sun Alliance | Capital market | Yes |
| 23. | CPA Australia | Profession | – |
| 24. | Korea Accounting Institute | Standard setter | – |
| 25. | Rio Tinto | Capital market | – |
| 26. | Institute of Chartered Accountants Scotland | Profession | – |
| 27. | Danish Accounting Standards Committee | Standard setter | – |
| 28. | CIMA (UK) | Profession | – |
| 29. | PricewaterhouseCoopers (Global) | Big 4 firm | – |
| 30. | National Accounting Standards Board Russia | Standard setter | – |
| 31. | The Quoted Companies Alliance (UK) | Capital market | Yes |
| 32. | FAR SRS (Sweden) | Profession | – |
| 33. | Korean Accounting Association | Profession | – |
| 34. | Deloitte (Global) | Big 4 firm | – |
| 35. | KPMG (Global) | Big 4 firm | – |
| 36. | Italian Accountancy Professional Bodies | Profession | – |
| 37. | Hong Kong Institute of CPAs | Profession | – |
| 43. | Ministry of Finance (British Columbia) | Regulator | – |
| 44. | AstraZeneca | Capital market | Yes |
| 45. | CCDG (Singapore) | Regulator | – |
| 46. | Securities and Exchange Commission (Thailand) | Regulator | – |
| 47. | FEE (Europe) | Profession | – |
| 48. | BDO (Global) | Other firm | – |
| 49. | EFRAG (Europe) | Capital market | – |

cost method and the removal of automatic impairment. It is unsurprising that capital market interests should press for accounting requirements that are low-cost and aid the flow of dividends in corporate groups. Australian banking interests emerged with submissions from the Australian Banker's Association (ABA), National Australia Bank endorsing the ABA submission, the Group of 100, and Macquarie Group.[20] The emergence of Australian banking interests in the due process for the December 2007 ED corresponds to Australian banks having an urgent transaction-specific need to reorganise without dividend blocks.[21]

In accounting standard setting, the transaction-specific needs of preparers should be balanced against accounting concepts and principles. A small minority of respondents to the December 2007 ED raise matters of principle as opposed to pragmatism in their comments.

The comment letter of the Institute of Chartered Accountants in Ireland highlights the potential disparity of the IASB's new model with the capital maintenance doctrine in corporate law as follows: 'In certain jurisdictions (such as Ireland), legislation prohibits the recognition of dividends, out or pre-acquisition profits, as income (for good creditor protection reasons)'.

The comment letter of the Spanish Ministry of Finance and Economy points the IASB to accounting concepts as follows: 'Regarding preacquisition accumulated profit distribution as income it is not consistent with the Framework which defines income as: increases in

 

**Table 8 Respondents to the IASB December 2007 ED but not the January 2007 ED**

| CL | Respondent name | Category | Delete cost method? | Remove auto impair? |
|---|---|---|---|---|
| 1. | PKF (UK) | Other firm | Yes | Yes |
| 2. | CPA Australia | Profession | Yes | Yes |
| 3. | Australian Bankers' Association | Capital market | Yes | Yes |
| 4. | National Australia Bank | Capital market | Yes | Yes |
| 5. | Malaysian Accounting Standards Board | Standard setter | Yes | – |
| 6. | Japanese Institute of CPAs | Profession | Yes | Yes |
| 7. | FAR SRS (Sweden) | Profession | Yes | Yes |
| 8. | BDO (Global) | Other firm | Yes | Yes |
| 9. | Association of International Accountants | Profession | Yes | – |
| 10. | Group of 100 (Australia) | Capital market | Yes | Yes |
| 11. | FirstRand Banking Group | Capital market | Yes | Yes |
| 12. | Institute of Chartered Accountants Ireland | Profession | – | – |
| 13. | Roche Group | Capital market | Yes | Yes |
| 14. | Swiss Holdings | Capital market | Yes | Yes |
| 15. | Ministry of Economy and Finance (Spain) | Regulator | – | – |
| 16. | Korea Accounting Institute | Standard setter | – | – |
| 17. | German Accounting Standards Board | Standard setter | Yes | Yes |
| 18. | Institute of CPAs (Kenya) | Profession | – | – |
| 19. | Norwegian Accounting Standards Board | Standard setter | – | – |
| 20. | London Society of Chartered Accountants | Profession | Yes | Yes |
| 21. | South African Institute of Chartered Accountants | Profession | – | – |
| 22. | Institute of Chartered Accountants England | Profession | Yes | Yes |
| 23. | Dutch Accounting Standards Board | Standard setter | Yes | Yes |
| 24. | Financial Executives International | Capital market | – | Yes |
| 25. | IDW (Germany) | Profession | Yes | Yes |
| 26. | KPMG (Global) | Big 4 firm | Yes | – |
| 27. | BT Group plc | Capital market | Yes | Yes |
| 28. | Grant Thornton (Global) | Other firm | Yes | Yes |
| 29. | Eskom (South Africa) | Public sector | – | – |
| 30. | Philippine Financial Reporting Standards Council | Standard setter | Yes | – |
| 31. | London Investment Banking Association | Capital market | Yes | Yes |
| 32. | United Technologies Corporation | Capital market | Yes | Yes |
| 33. | Business Council of Australia | Capital market | Yes | Yes |
| 34. | Australian Accounting Standards Board | Standard setter | Yes | Yes |
| 35. | Ernst & Young | Big 4 firm | Yes | Yes |
| 36. | Institute of Chartered Accountants Pakistan | Profession | Yes | – |
| 37. | ACCA (UK) | Profession | Yes | Yes |
| 38. | Zambia Institute of Chartered Accountants | Profession | – | – |
| 39. | PricewaterhouseCoopers (Global) | Big 4 firm | Yes | Yes |
| 40. | CIMA (UK) | Profession | Yes | Yes |
| 41. | BUSINESSEUROPE | Capital market | Yes | Yes |
| 42. | Polish Accounting Standards Committee | Standard setter | Yes | Yes |
| 43. | HoTARAC (Australia) | Public sector | Yes | Yes |
| 44. | CNC (France) | Standard setter | – | Yes |
| 45. | Accounting Standards Board (Canada) | Standard setter | Yes | – |
| 46. | Deloitte (Global) | Big 4 firm | Yes | Yes |
| 47. | Danish Accounting Standards Committee | Standard setter | Yes | Yes |
| 48. | Institute of Chartered Accountants Scotland | Profession | Yes | Yes |
| 49. | British American Tobacco | Capital market | Yes | Yes |
| 50. | BHP Billiton | Capital market | Yes | Yes |
| 51. | CBI (UK) | Capital market | Yes | Yes |
| 52. | National Accounting Standards Board Russia | Standard setter | Yes | Yes |
| 53. | Swedish Financial Reporting Board | Capital market | Yes | Yes |
| 54. | IOSCO | Regulator | – | – |
| 55. | Hong Kong Institute of CPAs | Profession | Yes | Yes |
| 56. | British Bankers' Association | Capital market | Yes | Yes |
| 57. | EFRAG (Europe) | Capital market | Yes | Yes |
| 58. | Mexican Accounting Standards Board | Standard setter | – | – |
| 59. | FEE (Europe) | Profession | Yes | Yes |
| 60. | Mazars (Global) | Other firm | Yes | Yes |
| 61. | The Hundred Group (UK) | Capital market | Yes | Yes |
| 62. | Macquarie Group Ltd | Capital market | Yes | Yes |
| 63. | Ministry of Finance (British Columbia) | Regulator | Yes | Yes |
| 64. | Accounting Standards Council (Singapore) | Standard setter | Yes | – |

 

economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increase of equity, other than those relating to contributions from equity participants'.

The comment letter of the Institute of Certified Public Accountants of Kenya suggests that a pragmatic solution to a perceived first-time adoption problem affecting unnamed jurisdictions should not have such wide ramifications as follows:

> We, however, have a problem with the deletion of the definition of the "cost method" and the requirement to recognise all dividends as income which will affect existing adopters. BC 18 makes a cryptic reference to "a problem in some jurisdictions because it makes specific reference to retained earnings". We do not understand what this problem is, and it is not a problem in Kenya. Would it be a problem for any existing adopters?

The comment letter of the Norwegian Accounting Standards Board calls into question whether the IASB is changing accounting standards for existing adopters by stealth as follows:

> We can see the need to make transition easier for entities which are First-time Adopters, but some of the proposed changes in IAS 27 represents significant changes and we do believe that the reason for proposing such changes should be clearly explained and discussed. We do not believe that practical issues related to the transition to IFRS should be the main reason to make such changes since the challenge of retrospective application of the cost method can be remedied by other means.

The comment letter of the South African Institute of Chartered Accountants attempts to direct the IASB to a strong accounting principle as follows: 'At a principle level, unpaid interest that has accrued before the acquisition of an interest bearing investment is no different to dividends received from pre-acquisition profits. Although we acknowledge some of the practical difficulties in ascertaining post-acquisition profits in some cases, we find the principle that "one cannot purchase income" to be a strong one'.

The comment letter of the International Organization of Securities Commissions (IOSCO), questions the due process of the IASB as follows: 'We question whether the Board has fully considered all of the consequences of changing to the proposed approach. For example, it is unclear why the Board in treating dividends received by an investor as income, believes a distinction between return *of* investment and return *on* investment is no longer useful, as this is not discussed in the |Basis for Conclusions'.

The submission of the Institute of Chartered Accountants in Australia to the AASB's version of the Dececmber 2007 ED expressed a similar concern to IOSCO as follows: 'However, we do note this could be interpreted as change in principle, and urge the IASB to highlight such changes so they are subject to due process'.

In summary, the IASB's new model emanated from an unusual due process that seems to have unwittingly overturned or ignored some long-standing principles applicable to consolidation accounting. The IASB's new model is inconsistent with financial capital maintenance. It allows the comingling of pre-acquisition reserves and post-acquisition profits so that income can be purchased instead of earned. The IASB's new model also allows pre-acquisition reserves to be attributed to the owners of the parent entity in a manner redolent of the pooling method of consolidation.

## Conclusion

The now defunct cost method was grounded in the concept of financial capital maintenance and articulated with long-standing consolidation principles and procedures. In contrast, the IASB's new model of dividend revenue and potential indication of impairment creates non-trivial problems in existing consolidation accounting procedures and the consolidated financial statements produced by these procedures.

The four examples in this article illustrate that the IASB's new model has serious consolidation accounting consequences. First, the IASB's description of the elimination of the investment in a subsidiary is rendered inaccurate. Second, spurious losses on consolidation can result. Third, the mismeasurement of NCI can arise in an extended group structure with indirect ownership. Fourth, a new imperative of keeping records of inter-company dividends from pre-acquisition profits is created.

The IASB's due process to remove the cost method has an awkwardness that is cause for concern. The removal occurred as part of another project on first-time application of IFRS, it was made in relative haste, and there is little or no evidence that sufficient regard has been paid to accounting concepts and principles. Like IOSCO, I question whether the IASB has fully considered all of the consequences of their change.

## Acknowledgement

The author wishes to thank the anonymous referees for their assistance in improving earlier versions of the paper. The author also acknowledges Peter Eddey and the late Jill McKinnon for their mentoring in financial accounting.

 

## Notes

1 The consolidation project is referred to in written evidence of the Chairman of the IASB to the United Kingdom (UK) Treasury Committee on 5 April 2002. A Deloitte summary of the IASB's consolidation project published prior to the issue of IFRS 10 refers to both of the originally stated objectives.

2 The new control criterion has three elements as follows: (1) the investor has power over the investee; (2) the investor is exposed to, or has rights to, variable returns from its involvement with the investee; and (3) the investor has the ability to affect the amount of the returns from the investee (IFRS 10: para.7).

3 The IASB press release dated 22 May 2008 stated as follows:

> [The amendments] respond to constituents' concerns that retrospectively determining cost and applying the cost method in accordance with IAS 27 on first-time application of IFRSs cannot, in some circumstances, be achieved without undue cost or effort. The amendments address that issue:
>
> (1) by allowing first-time adopters to use a deemed cost of either fair value or the carrying amount under the previous accounting practice to measure the initial cost of investments in subsidiaries, jointly controlled entities and associates in the separate financial statements; and
> (2) by removing the definition of the cost method from IAS 27 and replacing it with a requirement to present dividends as income in the separate financial statements of the investor.

4 A defence to the consolidation problems highlighted in this article is that the financial effect of pre-acquisition dividends from subsidiaries will be offset by corresponding impairment charges. The consolidation problems arise when pre-acquisition profits of a subsidiary can, in effect, be passed on to the shareholders of the immediate or ultimate parent entity as dividends.

5 In Australia, the dividends out of profits test in the *Corporations Act 2001* (Cth) was repealed and replaced from 29 June 2010 by three new dividend conditions as follows: (a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; (b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and (c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors. In November 2011, the Treasurer released a discussion paper relating to the rules for payment of dividends in the *Corporations Act 2001* that *inter alia* includes the option of returning to the dividends out of profits test.

6 IAS 1 *Presentation of Financial Statements* (IAS 1) requires that the consolidated statement of financial position discloses the issued capital and reserves attributable to owners of the parent (para. 54(r) of IAS 1).

7 In practice, there may be other equity of the subsidiary available to offset against the investment in the form of profits contributed to the group after acquisition, that is, the post-acquisition profits of the subsidiary. However, the elimination of the investment against post-acquisition profits of the subsidiary is also conceptually unsound. The profits contributed to the group by a subsidiary after its acquisition should not be reduced by dividends paid out pre-acquisition profits because that misstates the contribution to group equity by the subsidiary. In addition, dividends paid in the group financial statements should not be shown as a distribution based on the future profitability of a subsidiary.

8 Paragraph 19 of IFRS 3 has two options for the measurement of NCI at acquisition date as follows: (a) fair value; or (b) the NCI's proportionate share in the recognised amounts of the acquiree's net assets. An explanation of how the measurement of NCI differs under these two options is set out in Picker et al. (2009: 981–84). The choice of measurement alternatives has no effect on the points made in this article for the third example.

9 Picker et al. (2009: 1041) describe the basic rules, that is, the generally accepted accounting practice, for determining the NCI in consolidation scenarios similar to the third example as follows:

- direct NCI receives a proportionate share of all equity recorded by the subsidiary – these equity balances include both pre-acquisition and post-acquisition amounts;
- indirect INCI receives a proportionate share of a subsidiary's post-acquisition equity only;
- in calculating the NCI share of equity, it is the consolidated equity rather than the recorded equity on which the NCI is calculated. Hence, in calculating both the DNCI and INCI share of equity, adjustments must be made to eliminate any unrealised profits/losses arising from transactions within the group.

10 The consolidation requirements in the relevant paragraphs of the new consolidation standard do not include this description of how NCI is determined; refer to paragraphs 22–24 of IFRS 10 and paragraphs B94-B95 of Appendix B to IFRS 10.

11 The consolidation worksheet for Parent, Child and Grandchild assuming dividend revenue and full impairment is unreported but available from the author upon request.

12 The consolidation worksheet for Parent, Child and Grandchild assuming that Parent distributes its profit of $4.752 million as a dividend is unreported but available from the author on request.

13 Refer to Picker et al. (2009: 1048–49) for a discussion of the double counting that arises if this adjustment is not made together with an example of a reversing journal entry for the NCI share of profit.

14 The concept of financial capital maintenance also mirrors the capital maintenance doctrine in Australian corporate law. Austin and Ramsay (2011: para. 18.090) argue that the capital maintenance doctrine is fundamental to the shape of company law and cast doubt on there being any trend to lessen the capital maintenance doctrine in Australia.

15 The IASB decided to prohibit the pooling method of consolidation accounting as part of the improvements to International Accounting Standards prior to their adoption by the European Union in 2005.

16 None of the following IASB documents refer to consolidation accounting:

(1) Exposure Draft of Proposed Amendments, December 2007;
(2) IASB staff agenda papers for the relevant Board meeting in April 2008;
(3) minutes of the Board meeting for April 2008; and
(4) project summary report in respect of the May 2008 amendments to IFRS 1 and IAS 27 available on the IASB website.

17 This problem is described at paragraph 6 of the IASB staff agenda paper 9A, which was considered by the Board at its 19 April 2008 meeting in London.

18 The IASB's policy is to make all comment letters on its exposure drafts publicly available. The IASB website includes a statement as follows:

> Comment letters received in response to formal proposals are made public on the website'. In light of this statement, it can be concluded that comment letters for the January 2007 ED do not exist for numbers 7, 15, and 38–42. Alternatively, these

submissions have been accepted by the IASB on a confidential basis.

19 In a similar vein, the comment letter analysis prepared by IASB technical staff for the Board noted the following:

> . . . many respondents indicate that the remaining restrictions in IAS 27 as to how pre-acquisition profits are determined will discourage companies from making the transition to IFRS, thereby stripping the relief proposed in the ED of any real value. These [many] respondents suggested that IAS 27 be amended to permit dividends from subsidiaries to be treated as investment income, subject to an impairment test of the value of the subsidiary in the parent's accounts and consideration of whether the dividend is, in substance, a return of capital invested. (IASB Agenda Paper 10A, IASB Meeting 21 June 2007: para. 8)

20 In the comparative due process of the AASB, Australian banking interests also showed their strong support for removing the cost method from AASB 127. The AASB received 10 submissions on the ED with four from Australian banking interests.

21 The National Australia Bank (NAB) went so far as to make two submissions to the IASB December 2007 ED. The NAB's second submission in March 2008 took the liberty of providing the IASB with a summary analysis of the comment letters of other respondents to the ED. NAB highlighted the urgent need of Australian banks for change in its second letter as follows:

> Participants in the Australian banking industry, including the National Australia bank, are keenly interested in the resolution of the current inappropriate accounting requirement under which a new parent would need to record its investment in the existing entity at fair value.
>
> We strongly encourage the IASB to expedite the amendment to IAS 27 regarding new parent formations, but only after adopting certain necessary refinements to the current application criteria. If these changes are not made, then it is highly unlikely that reorganisations within the Australian banking industry could use the new accounting treatment being proposed.

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