How to Prepare Consolidated Financial Statements by Adjustment Journal Entries
(Relevant to PBE Paper I – Financial Accounting)

Introduction

It is under the legal and accounting requirements that a parent company is required to present its consolidated financial statements. PBE Paper I often assesses candidates' ability to prepare consolidated statement of profit or loss and other comprehensive income as well as consolidated statement of financial position. Yet, candidates have often demonstrated weaknesses in their understanding of some of the key concepts.

In the June 2016 Examination Panelist's Report, it was highlighted that candidates basically recited the skeleton of the workings provided in the solutions of the past examination papers without demonstrating real understanding of the consolidation concepts, which resulted in candidates' producing incorrect or even contradictory calculations. Based on the findings of the report, future candidates are advised to build a more concrete foundation by, for example, understanding how the consolidated adjustment journal entries actually work. This article illustrates how consolidation adjustment journal entries, in a comprehensive case setting, should be prepared, using an examination question in the June 2016 session for illustration (see Appendix).

Pre-acquisition elimination entry

The first step in preparing consolidated financial statements is to deal with the pre-acquisition elimination journal entry as at the acquisition date. In the case of Queen Bee Limited ("DBL") set out in the Appendix, in order to calculate the amount of total consideration, candidates should be aware of the three components: (i) cash of HK$50,000,000; (ii) 10,000,000 of its own shares on 1 April 2015; and (iii) contingent consideration (i.e. the additional pay-out if the acquiree successfully develops the sun lotion by 31 December 2016). Contingent consideration, in accordance with HKFRS 3 (Revised) *Business Combinations*, is to be included as part of the consideration, at its fair value as at the acquisition date. The consideration for this example is analysed as follows:

(W1)	HK$'000
Cash	50,000
Share issue (10,000,000 × HK$3.5)	35,000
Contingent consideration, fair value	12,000
Total consideration	97,000

Two fair value differentials have to be dealt with in this case: (i) an internally-generated brand name that was not previously recognised by the acquiree, Doctor Bee Limited ("DBL"); and (ii) the head office with a fair value differential of HK$5,000,000 as at the acquisition date. These lead to the following analysis regarding the fair value of net identifiable assets acquired as at the acquisition date:

(W2)	HK$'000
Share capital	10,000
Retained earnings	88,110
Fair value differential: Brand name	9,500
Fair value differential: Building	5,000
Fair value of net identifiable assets acquired	112,610

As the parent, QBL chose to measure non-controlling interest as the proportionate share of the fair value of the net identifiable assets of the acquiree. Thus, the non-controlling interest as at the acquisition date was calculated as follows:

(W3)	HK$'000
Fair value of net identifiable assets acquired (W2)	112,610
Non-controlling interest %	25%
Non-controlling interest as at the acquisition date	28,152.5

Goodwill could then be computed as follows:

(W4)	HK$'000
Consideration (W1)	97,000
Non-controlling interest (W3)	28,152.5
Less: Fair value of net identifiable assets (W2)	(112,610)
Goodwill	12,542.5

With the above calculations, the following pair of consolidated adjustment entries were prepared:

CJ1	HK$'000	HK$'000
Dr. Share capital	10,000	
Dr. Retained earnings, pre-acquisition	88,110	
Dr. Brand name	9,500	
Dr. Building	5,000	
Dr. Goodwill (W4)	12,542.5	
Cr. Investment (W1)		97,000
Cr. Non-controlling interest (B/S) (W3)		28,152.5

Candidates should be careful to note that the skeleton provided in the solutions of the past examinations for calculating non-controlling interest is only applicable to the measurement of the non-controlling interest as the proportionate share of the fair value of the identifiable net assets of the acquiree (i.e. the proportionate interest method). Assuming that QBL chose to measure the non-controlling interest at its fair value as at the acquisition date (i.e. the fair value method), candidates will only be required to plug in the non-controlling interest in the above adjustment journal entry with its fair value at the acquisition date.

Extra depreciation expense arising from the fair value differentials

Due to the fair value differentials arising from the head office, the extra depreciation expense should be provided based on its remaining useful life. Such extra depreciation expense has to be further shared by the non-controlling interest.

CJ2	HK$'000	HK$'000
Dr. Depreciation expense (HK$5,000,000 / 10)	500	
Cr. Accumulated depreciation: Building		500
Dr. Non-controlling interest (B/S)	125	
Cr. Non-controlling interest (I/S) (HK$500,000 × 25%)		125

Upstream intra-group sale of inventories

As QBL purchased HK$15,600,000 of products from DBL during the year ended 31 March 2016, such intra-group sale has to be eliminated. With 20% of such products remaining unsold at 31 March 2016, this generated an unrealised profit of HK$600,000 (HK$3,000,000 × 20%) during the year. As the unrealised profit was recorded in the books of DBL, such elimination has to be shared with the non-controlling interest.

CJ3	HK$'000	HK$'000
Dr. Sales	15,600	
Cr. Cost of goods sold		15,600
Dr. Cost of goods sold	600	
Cr. Inventory		600
Dr. Non-controlling interest (B/S)	150	
Cr. Non-controlling interest (I/S)		150
(HK$600,000 × 25%)		

Candidates are reminded that if the direction of the sales were reversed (i.e. DBL purchased inventories from QBL), then the unrealised profit would be recorded in the books of QBL, and no sharing of such elimination with the non-controlling interest would be required for the downstream sales transaction.

Cash-in-transit & Intra-group balances

At 31 March 2016, QBL recorded an amount due to DBL of HK$3,000,000 and DBL recorded an amount due from QBL of HK$3,400,000. This difference was due to a cheque that was posted out by QBL to DBL on 29 March 2016 but not received by DBL until 2 April 2016. During consolidation, the cash-in-transit was assumed to be received by DBL by year-end and the corresponding intra-group trade receivable and payable balances were eliminated.

CJ4	HK$'000	HK$'000
Dr. Cash	400	
Cr. Trade receivable		400
Dr. Trade payable	3,000	
Cr. Trade receivable		3,000

Elimination of dividends

During the year, DBL declared dividends amounting to HK$15,000,000, which was not paid as at the end of the financial year. The declaration of dividends, together with the unpaid balance, was eliminated during consolidation.

CJ5	HK$'000	HK$'000
Dr. Dividend income (HK$15,000,000 × 75%)	11,250	
Dr. Non-controlling interest (B/S) (HK$15,000,000 × 25%)	3,750	
Cr. Retained earnings		15,000
Dr. Dividend payable	15,000	
Cr. Dividend receivable (HK$15,000,000 × 75%)		11,250
Cr. Dividend payable to non-controlling interest (HK$15,000,000 × 25%)		3,750

Sharing of profits with non-controlling interest

DBL recorded a profit of HK$20,810,000 for the year ended 31 March 2016, which should be shared with the non-controlling interest.

CJ6	HK$'000	HK$'000
Dr. Non-controlling interest (I/S)	5,202.5	
Cr. Non-controlling interest (B/S) (HK$20,810,000 × 25%)		5,202.5

The movement of non-controlling interest during the year ended 31 March 2016 could be further analysed as follows:

	HK$'000
Profit for the year (CJ6)	20,810
Less: Extra depreciation arising from fair value differential (CJ2)	(500)
Less: Unrealised profit arising from upstream sale of inventory (CJ4)	(600)
Adjusted profit for the year	19,710
Non-controlling interest %	25%
Movement of non-controlling interest during the year	4,927.5

Pre-consolidation correction entry

In accordance with HKFRS 3 (Revised), contingent consideration classified as a liability should be measured at fair value at each reporting date and changes in fair value should be recognised in profit or loss. In this case, the contingent consideration payable was initially recognised at its fair value (HK$12,000,000) at the acquisition date. Its fair value as at 31 March 2016 became HK$15,000,000. The change in fair value was therefore HK$3,000,000 (HK$12,000,000 − HK$15,000,000), which was recognised in profit or loss.

CJ7	HK$'000	HK$'000
Dr. Loss in fair value change of contingent consideration	3,000	
Cr. Contingent consideration payable		3,000

Posting process & preparation of the consolidated financial statements

The above consolidation adjustment entries (CJ1 to CJ7) have to be posted, as a final step, to compile the consolidated financial statements.

QBL Group
Consolidated statement of profit or loss and other comprehensive income
for the year ended 31 March 2016

	QBL HK$'000	DBL HK$'000		Dr HK$'000	Cr HK$'000		Consol HK$'000
Sales	103,000	55,450	CJ3	15,600			142,850
Cost of sales	(32,080)	(22,360)	CJ3	600	15,600	CJ3	(39,440)
Dividend income	12,200	-	CJ5	11,250			950
Administrative expenses	(19,700)	(7,780)	CJ2	500			(30,980)
			CJ7	3,000			
Interest expense	(6,300)	(1,050)					(7,350)
Tax expense	(8,880)	(3,450)					(12,330)
Profit for the year	48,240	20,810					53,700
Profit attributable to:							
Owners of the parent							48,772.5
Non-controlling interest			CJ6	5,202.5	125	CJ2	4,927.5
					150	CJ3	
				36,152.5	15,875		53,700

QBL Group
Consolidated statement of financial position
as at 31 March 2016

	QBL HK$'000	DBL HK$'000		Dr HK$'000	Cr HK$'000		Consol HK$'000
Goodwill			CJ1	12,542.5			12,542.5
Intangible assets			CJ1	9,500			9,500
Property, plant & equipment	237,250	55,910	CJ1	5,000	500	CJ2	297,660
Investments	155,000	-			97,000	CJ1	58,000
Inventory	87,860	33,750			600	CJ3	121,010
Trade receivables	53,870	16,580			400	CJ4	67,050
					3,000	CJ4	
Dividend receivable	12,200	-			11,250	CJ5	950
Cash and cash equivalents	60,150	25,430	CJ4	400			85,980
Total Assets	606,330	131,670					652,692.5
Share capital	50,550	10,000	CJ1	10,000			50,550
Retained earnings	452,680	93,920	CJ1	88,110	15,000	CJ5	453,212.5
			P/L	36,152.5	15,875	P/L	
Non-controlling interest	-	-	CJ2	125	28,152.5	CJ1	29,330
			CJ3	150	5,202.5	CJ6	
			CJ5	3,750			
Current liabilities	44,000	12,750	CJ4	3,000	3,000	CJ7	56,750
Dividend payable	23,500	15,000	CJ5	15,000	3,750	CJ5	27,250
Non-current liabilities	35,600	-					35,600
Total Equity & Liabilities	606,330	131,670		183,730	183,730		652,692.5

Conclusion

This article does not aim at recapping the fundamental concepts of preparing consolidated financial statements. Instead, it conveys the message to candidates that using consolidation adjustment entries, which is another approach for compiling consolidated financial statements, can help in understanding the mechanics of the entire process.

Appendix

Queen Bee Limited ("QBL") is a company listed on the Hong Kong Stock Exchange and is principally engaged in the production of honey-based products such as honey-based shampoo, shower gels and hand creams. QBL has a financial year end date at 31 March.

On 1 April 2015 QBL purchased a 75% controlling interest in Doctor Bee Limited ("DBL"), a company that makes distilled medical-grade honey that is highly effective as an anti-bacterial agent and for healing wounds and scars. The Doctor Bee brand name has not been recognised as an intangible asset in DBL's financial statements, as it has not met the recognition criteria under HKAS 38 *Intangible Assets*. At 1 April 2015, the directors of QBL assessed that the Doctor Bee brand name has an indefinite useful life.

To purchase the 75% controlling interest in DBL, QBL paid cash of HK$50,000,000 and issued 10,000,000 of its own shares on 1 April 2015. In addition, QBL guaranteed the selling shareholders of an additional payout in cash of HK$20,000,000 if DBL were able to successfully develop a formula for water-resistant honey-based sun lotion suitable for babies by 31 December 2016. QBL also incurred HK$8,650,000 of professional and legal fees relating to the acquisition of DBL. All cash and non-cash considerations, as well as professional and legal fees, for the acquisition of DBL have been correctly recorded in the separate financial statements of QBL. On 1 April 2015, DBL had share capital of HK$10,000,000 and retained earnings of HK$88,110,000.

After the acquisition of DBL and during the year ended 31 March 2016, QBL purchased HK$15,600,000 of products from DBL, of which 20% still remained unsold to third parties at 31 March 2016. DBL recorded a total profit of HK$3,000,000 for its sale to QBL during the year. At 31 March 2016, QBL recorded an amount due to DBL of HK$3,000,000 and DBL recorded an amount due from QBL of HK$3,400,000. The difference was due to a cheque that was posted out by QBL to DBL on 29 March 2016 but not received by DBL until 2 April 2016.

You are Matt Tong the accounting manager of QBL. You have been given the following fair values for the preparation of the consolidated financial statements of QBL:

	Fair value at 1 April 2015 HK$	**Fair value at 31 March 2016 HK$**
One share of QBL	3.50	3.80
Doctor Bee brand name	9,500,000	9,500,000
Payout of HK$20,000,000 if DBL successfully develops sun lotion by 31 December 2016 (contingent consideration)	12,000,000	15,000,000

In addition, you obtained information from DBL that their head office, which had a carrying amount of HK$20,000,000 at 1 April 2015, had a fair value of HK$25,000,000 and a remaining useful life of 10 years on that date. It is QBL's policy to charge depreciation on a straight-line basis with zero residual value to administrative expenses and to measure non-controlling interest as the proportionate share of the fair value of the identifiable net assets of the acquiree.

Following is the financial information for QBL and DBL as at 31 March 2016:

	QBL	DBL
	HK$'000	HK$'000
Sales	103,000	55,450
Cost of sales	(32,080)	(22,360)
Dividend income	12,200	-
Administrative expenses	(19,700)	(7,780)
Interest expense	(6,300)	(1,050)
Tax expense	(8,880)	(3,450)
Profit for the year	48,240	20,810
Property, plant and equipment	237,250	55,910
Investments	155,000	-
Inventory	87,860	33,750
Trade receivables	53,870	16,580
Dividend receivable	12,200	-
Cash and cash equivalents	60,150	25,430
Total Assets	606,330	131,670
Share capital	50,550	10,000
Retained earnings on 1 April 2015	427,940	88,110
Add: Profit for the year	48,240	20,810
Less: Dividends declared	(23,500)	(15,000)
Retained earnings on 31 March 2016	452,680	93,920
Other current liabilities	44,000	12,750
Dividend payable	23,500	15,000
Non-current liabilities	35,600	-
Total liabilities	103,100	27,750
Total Equity and Liabilities	606,330	131,670

(Extracted from HKIAAT's *Professional Bridging Examination Paper I,* June 2016, Question 1)