

Consolidated Financial Statements – Part 2 (Relevant to PBE Paper I – Financial Accounting)

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Introduction

The preparation of consolidated financial statements is one of the essential issues for PBE Paper 1 – Financial Accounting. In the first part of our article, published in April 2013, <http://www.hkiaat.org/index.php/services/index/199/>, we described the principle of control and the basic consolidation procedures. As mentioned in the first part, consolidation is a process of line-by-line combination of like items of assets, liabilities, income and expenses of the parent and its subsidiaries. In order to present the consolidated financial statements as a single economic entity, intra-group balances and transactions must be eliminated in full.

In this article, we focus on the following consolidation adjustments required in preparing consolidated financial statements:

- (a) Intra-group dividends
- (b) Intra-group current accounts
- (c) Intra-group sales of goods
- (d) Fair value adjustments of identifiable net assets acquired

Intra-group Dividends

When a subsidiary proposes a dividend, the parent will record its share of the dividend in the dividend receivable account. In the consolidation process, this dividend receivable account must be eliminated against the dividend payable account in the books of subsidiary. The remaining portion of dividend payable is the dividend payable to non-controlling interests, which should be recorded as a current liability in the consolidated statement of financial position.

Example 1

P Ltd acquired 70% of the voting ordinary shares of S Ltd on 1 January 2012. During the year ended 31 December 2012, S Ltd proposed a dividend of \$200,000 and P Ltd recorded its share of the dividend in the dividend receivable account.

The consolidated journal entry to eliminate intra-group dividends is:

		\$'000	\$'000
Dr.	Dividend payable (S Ltd)	200	
	Cr. Dividend receivable (P Ltd)		140
	Cr. Dividend payable to non-controlling interests		60
	To eliminate intra-group dividends.		

Intra-group Current Accounts

The parent may trade with its subsidiaries or borrow money from / lend money to its subsidiaries. These transactions may result in intra-group indebtedness. This indebtedness is usually dealt with in the current accounts maintained by the parent and its subsidiaries. In consolidation, however, intra-group current accounts must be eliminated in full.

Intra-group current accounts should basically agree with each other. However, if there is cash in transit or goods in transit at the year end, the current accounts will not agree. In this case, cash in transit or goods in transit should be adjusted first before the elimination of intra-group current accounts.

Example 2

On 1 January 2012, P Ltd acquired 80% of the voting ordinary shares of S Ltd. P Ltd and S Ltd had the following current account balances at 31 December 2012.

	P Ltd \$'000	S Ltd \$'000
Current account with S Ltd (Dr.)	500	
Current account with P Ltd (Cr.)		430

The difference in the current accounts is caused by goods in transit of \$50,000 and cash in transit of \$20,000, both from S Ltd to P Ltd.

The consolidated journal entries to eliminate the intra-group current accounts are:

	\$'000	\$'000
Dr. Goods in transit	50	
Dr. Cash in transit	20	
Cr. Current account with S Ltd		70
To recognise goods and cash in transit.		
	\$'000	\$'000
Dr. Current account with P Ltd	430	
Cr. Current account with S Ltd		430
To eliminate intra-group current accounts.		

Intra-group Sales of Goods

When the parent sells or purchases goods to or from its subsidiaries, the parent and its subsidiaries record the transaction as a sale or purchase in their individual books accordingly. These intra-group sales and purchases of goods overstate consolidated sales and cost of sales figures. As the consolidated financial statements treat the group as a single economic entity, these transactions should be eliminated.

In addition, if any of these intra-group sales of goods are still held in inventory by the parent or its subsidiaries, the profit from these intra-group sales is not realised until the goods are eventually sold outside the group to a third party. On consolidation, the unrealised profit in the inventory should be eliminated, and the closing inventory of the group should be recorded at cost.

The following example demonstrates the case where a parent sells goods to subsidiary at a profit:

Example 3

P Ltd acquired 80% of the voting ordinary shares of S Ltd on 1 January 2012. During the year ended 31 December 2012, P Ltd sold goods with a cost of \$6,000,000 to S Ltd on a cash basis for \$7,200,000 (i.e. at a mark up of 20%). By the year end date of 31 December 2012, S Ltd had sold 40% of these goods to customers on credit for \$3,500,000 and the remainder was still held in inventory.

Being separate legal entities, P Ltd and S Ltd recorded the above transactions in their own books as follows:

In books of P Ltd		\$'000	\$'000
Dr. Cash		7,200	
	Cr. Sales		7,200
To recognise sales of goods to S Ltd.			

Dr. Cost of sales		6,000	
	Cr. Inventory		6,000
To recognise cost of goods sold to S Ltd.			

In books of S Ltd		\$'000	\$'000
Dr. Inventories		7,200	
	Cr. Cash		7,200
To recognise purchases of goods from P Ltd.			

Dr. Trade receivables		3,500	
	Cr. Sales		3,500
To recognise sales of goods to customers.			

Dr. Cost of sales (\$7,200,000 x 40%)		2,880	
	Cr. Inventories		2,880
To recognise cost of goods sold to customers.			

From the group's viewpoint, intra-group sales of \$7,200,000 and unrealised profit on inventories of \$720,000 (i.e. \$7,200,000 x 20/120 x 60%) should be eliminated. The relevant consolidated journal entries are:

Dr. Sales		7,200	
	Cr. Cost of sales		7,200
To eliminate intra-group sales of goods from P Ltd to S Ltd.			

Dr. Cost of sales		720	
	Cr. Inventories		720
To eliminate unrealised profit on inventories.			

After the above consolidated adjustments, the cost of goods to the group is \$2,400,000 (i.e. \$6,000,000 x 40%) and sales to customers are \$3,500,000, resulting in profit of \$1,100,000.

The above example is the case where a parent sold goods to its subsidiaries. It does not affect the amount of non-controlling interests as the profits from sales of goods are recorded in the parent's books. However, if the sales of goods are from a subsidiary to its parent, the profits from the sales are now recorded in the subsidiary's books. The elimination of unrealised profit affects the net assets of the subsidiary, and thus affects the amount of non-controlling interests as these should bear their share of adjustment of unrealised profit.

Fair Value Adjustments of Identifiable Net Assets Acquired

The consolidation procedures require that the revaluation of identifiable net assets acquired should be carried at fair value at the acquisition date. If the effect of revaluation is not recorded in the books of the subsidiary, adjustments should be made on consolidation to adjust the carrying amount of the subsidiary's identifiable net assets to their fair value. In addition, adjustments should be made in respect of depreciation of revalued assets as the subsidiary continues to provide depreciation based on the original carrying amount. For consolidation purposes, depreciation should be calculated based on the fair value. As this depreciation adjustment affects the profits of the subsidiary, the adjustment has an impact on non-controlling interests.

Example 4

P Ltd acquired 80% of the voting ordinary shares of S Ltd on 31 December 2012 for a consideration of \$3,000,000. The carrying amount of identifiable net assets of S Ltd on that date was \$2,500,000 (share capital of \$2,000,000 and retained earnings of \$500,000) which was approximately equal to the net assets' fair value, except for plant which had a fair value of \$750,000 in excess of its carrying amount. The plant has the remaining useful life of three years. S Ltd did not record the revaluation adjustment in its own books. Profit of S Ltd for 2012 was \$450,000.

P Ltd measures non-controlling interests as its proportionate share of the acquiree's identifiable net assets at the acquisition date.

As S Ltd did not record the revaluation of the plant, the following consolidated journal entries are required:

	\$'000	\$'000
Dr. Property, plant and equipment	750	
Cr. Revaluation reserve		750
To recognise the revaluation of S Ltd's plant.		
Dr. Depreciation (\$750,000 / 3)	250	
Cr. Accumulated depreciation		250
To recognise the additional depreciation of plant.		
Dr. Ordinary share capital (S Ltd)	2,000	
Dr. Retained earnings (S Ltd)	500	
Dr. Revaluation reserve (S Ltd)	750	
Dr. Goodwill	400	
Cr. Non-controlling interests (\$2,000,000 + \$500,000 + \$750,000) x 20%		650
Cr. Investment in S Ltd		3,000
To recognise goodwill arising from the acquisition of S Ltd.		
Dr. Retained earnings (\$450,000 – \$250,000) x 20%	40	
Cr. Non-controlling interests		40
To recognise non-controlling interest's share of post-acquisition profit of S Ltd.		

The following example is modified from PBE Paper I – Financial Accounting, June 2012, Question 1. It demonstrates how to prepare the consolidated financial statements involving several key adjustments such as intra-group receivables and payables, intra-group of sales and fair value adjustments.

A Comprehensive Example

On 1 January 2012, Prime Incorporation Ltd (“Prime”) paid \$15 million in cash to acquire 70% of the equity interest in Sunrich Power Ltd (“Sunrich”). Sunrich is accounted for as a subsidiary of Prime.

The following are the draft Statements of Comprehensive Income for the year ended 31 December 2012 and Statements of Financial Position as at 31 December 2012:

	Prime \$'000	Sunrich \$'000
Revenue	10,410	4,280
Cost of sales	<u>(4,160)</u>	<u>(1,470)</u>
Gross profit	6,250	2,810
Other income	1,300	350
Depreciation	(640)	(450)
Other operating expenses	<u>(1,100)</u>	<u>(860)</u>
Profit before tax	5,810	1,850
Income tax expense	<u>(980)</u>	<u>(450)</u>
Profit for the year	<u>4,830</u>	<u>1,400</u>
	Prime \$'000	Sunrich \$'000
Property, plant and equipment	8,460	5,940
Investment in Sunrich	15,000	-
Inventories	890	480
Trade receivables	680	250
Cash and bank	<u>4,500</u>	<u>1,500</u>
	<u>29,530</u>	<u>8,170</u>
Ordinary share capital	18,000	4,500
Retained earnings	9,190	3,030
Trade payables	<u>2,340</u>	<u>640</u>
	<u>29,530</u>	<u>8,170</u>

The following information has not been taken into account in preparing the above statements:

- (1) Included in Prime's trade receivables is an amount receivable from Sunrich of \$200,000. However in Sunrich's books, the amount payable to Prime is stated as \$150,000. This is because the payment of \$50,000 was still in transit from Sunrich to Prime at 31 December 2012.
- (2) After the acquisition of Sunrich, Prime sold goods to Sunrich for \$300,000. The original cost of these goods was 40% of the total sales value. At 31 December 2012, 30% of these goods were still unsold.
- (3) A building owned by Sunrich at 1 January 2012 with a carrying amount of \$500,000 has increased in value to \$700,000. The remaining useful life of this building was five years.
- (4) Goodwill arising on the acquisition of Sunrich is impaired by \$450,000 at 31 December 2012. The impairment loss on goodwill is charged to other operating expenses.
- (5) Prime measures non-controlling interests as its proportionate share of the acquiree's identifiable net assets at the acquisition date.

Required:

Prepare for Prime group the consolidated statement of comprehensive income for the year ended 31 December 2012 and the consolidated statement of financial position as at that date.

Solution:

In order to prepare the consolidated financial statements of Prime group, the basic consolidation procedures mentioned in the first part of our article are applied as follows:

- (1) Eliminate intra-group transactions and balances
 - (a) The consolidated journal entries (CJE) to eliminate intra-group receivables and payables are:

CJE		\$'000	\$'000
1	Dr. Cash in transit	50	
	Cr. Trade receivables		50
	To recognise cash in transit.		
2	Dr. Trade payables	150	
	Cr. Trade receivables		150
	To eliminate intra-group receivables and payables.		

- (b) Unrealised profit on inventories is \$54,000 [i.e. \$300,000 x (1 – 40%) x 30%].

From the viewpoint of Prime group, intra-group of sales of \$300,000 should be eliminated.

The relevant consolidated journal entries to eliminate intra-group sales and unrealised profit on inventories are:

CJE		\$'000	\$'000
3	Dr. Sales	300	
	Cr. Cost of sales		300
	To eliminate intra-group sales of goods from Prime to Sunrich.		
4	Dr. Cost of sales	54	
	Cr. Inventories		54
	To eliminate unrealised profit on inventories.		

- (2) Recognise the fair value adjustment of the building and subsequent post-acquisition depreciation adjustment

As Sunrich did not record the revaluation of the building, the following consolidated journal entries are required:

CJE		\$'000	\$'000
5	Dr. Property, plant and equipment	200	
	Cr. Revaluation reserve (\$700,000 – \$500,000)		200
	To recognise the revaluation of Sunrich's building.		
6	Dr. Depreciation (\$200,000 / 5)	40	
	Cr. Accumulated depreciation		40
	To recognise the additional depreciation of the building.		

- (3) Determine and measure non-controlling interests

	Sunrich 1/1/2012 Date of acquisition \$'000	Sunrich 31/12/2012 Year-end \$'000
Ordinary share capital	4,500	4,500
Revaluation reserve	200	200
Retained earnings at 1 January 2012	1,630	1,630
Profit for the year	–	1,400
Less: Additional depreciation	–	(40)
Total net assets	<u>6,330</u>	<u>7,690</u>
Non-controlling interests (30%)	<u>1,899</u>	<u>2,307</u>

The consolidated journal entry to record non-controlling interests' share of the post-acquisition profit of Sunrich is:

CJE		\$'000	\$'000
7	Dr. Profit for the year (Sunrich)	408	
	Cr. Non-controlling interests (\$1,400,000 – \$40,000) x 30%		408
	To recognise NCI's share of post-acquisition profit of Sunrich.		

(4) Determine and recognise goodwill arising from the acquisition of Sunrich

	\$'000
Investment in Sunrich	15,000
Non-controlling interests at 1 January 2012	1,899
	<u>16,899</u>
Less: Fair value of identifiable net assets of Sunrich at 1 January 2012	(6,330)
Goodwill at 1 January 2012 (the acquisition date)	<u>10,569</u>
Less: Impairment loss on goodwill	(450)
Goodwill at 31 December 2012	<u><u>10,119</u></u>

The consolidated journal entries to record goodwill and its impairment are as follows:

CJE		\$'000	\$'000
8	Dr. Ordinary share capital (Sunrich)	4,500	
	Dr. Revaluation reserve (Sunrich)	200	
	Dr. Retained earnings (Sunrich)	1,630	
	Dr. Goodwill	10,569	
	Cr. Non-controlling interests		1,899
	Cr. Investment in Sunrich		15,000
	To recognise goodwill arising from the acquisition of Sunrich.		
9	Dr. Other operating expenses – Impairment loss on goodwill	450	
	Cr. Goodwill		450
	To recognise impairment of goodwill.		

(5) Prepare the consolidated financial statements by combining like items in the financial statements of the parent and its subsidiary

	Prime \$'000	Sunrich \$'000	Adjustments (CJE)		Total \$'000
			Dr. \$'000	Cr. \$'000	
Property, plant and equipment	8,460	5,940	200 (5)	40 (6)	14,560
Investment in Sunrich	15,000	–		15,000 (8)	–
Goodwill	–	–	10,569 (8)	450 (9)	10,119
Inventories	890	480		54 (4)	1,316
Trade receivables	680	250		50 (1) 150 (2)	730
Cash and bank	<u>4,500</u>	<u>1,500</u>	50 (1)		<u>6,050</u>
	<u>29,530</u>	<u>8,170</u>			<u>32,775</u>
Ordinary share capital	18,000	4,500	4,500 (8)		18,000
Revaluation reserve	–	–	200 (8)	200 (5)	–
Retained earnings	9,190	3,030	54 (4) 40 (6) 408 (7) 1,630 (8) 450 (9)		9,638
Non-controlling interests	–	–		408 (7) 1,899 (8)	2,307
Trade payables	<u>2,340</u>	<u>640</u>	150 (2)		<u>2,830</u>
	<u>29,530</u>	<u>8,170</u>			<u>32,775</u>

	Prime \$'000	Sunrich \$'000	Adjustments (CJE)		
			Dr. \$'000	Cr. \$'000	Total \$'000
Revenue	10,410	4,280	300 (3)		14,390
Cost of sales	(4,160)	(1,470)	54 (4)	300 (3)	(5,384)
Gross profit	6,250	2,810			9,006
Other income	1,300	350			1,650
Depreciation	(640)	(450)	40 (6)		(1,130)
Other operating expenses	(1,100)	(860)	450 (9)		(2,410)
Profit before tax	5,810	1,850			7,116
Income tax expense	(980)	(450)			(1,430)
Profit for the year	4,830	1,400			5,686
Profit attributable to					
Owners of the parent	4,830	1,400	844 408 (7)	300	5,278
Non-controlling interests				408 (7)	408
	4,830	1,400			5,686

The consolidated financial statements of the parent and the subsidiary (as a group) are presented in accordance with HKAS 1 "Presentation of Financial Statements" as follows:

The Prime group
Consolidated statement of financial position
as at 31 December 2012

	\$'000
ASSETS	
Non-current assets	
Property, plant and equipment	14,560
Goodwill	10,119
Total non-current assets	<u>24,679</u>
Current assets	
Inventories	1,316
Trade receivables	730
Cash and bank	6,050
Total current assets	<u>8,096</u>
Total assets	<u>32,775</u>
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Ordinary share capital	18,000
Retained earnings	9,638
	<u>27,638</u>
Non-controlling interests	2,307
Total equity	<u>29,945</u>
Current liabilities	
Trade payables	2,830
Total current liabilities	<u>2,830</u>
Total equity and liabilities	<u>32,775</u>

The Prime group
Consolidated statement of comprehensive income
for the year ended 31 December 2012

	\$'000
Revenue	14,390
Cost of sales	<u>(5,384)</u>
Gross profit	9,006
Other income	1,650
Other operating expenses (\$1,130,000 + \$2,410,000)	<u>(3,540)</u>
Profit before tax	7,116
Income tax expense	<u>(1,430)</u>
Profit and total comprehensive income for the year	<u><u>5,686</u></u>
Profit and total comprehensive income attributable to:	
Owners of the parent	5,278
Non-controlling interests	<u>408</u>
	<u><u>5,686</u></u>

Conclusion

Students sitting for PBE Paper I – Financial Accounting must possess the relevant skills and knowledge for preparing consolidated financial statements involving key consolidation adjustments such as intra-group balances, intra-group dividends, intra-group sales of goods and fair value adjustments. The article in the next issue – the final one in this series – will describe how associates and joint ventures should be accounted for in the consolidated financial statements using the equity method.