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Video Transcription: Consolidations – The Basic Adjustments

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Hi, my name is Tarryn. Today we are going to talk about “group adjustments”; that is, the pro-forma journal entries that you are required to post when preparing consolidated financial statements. We are going to focus on the principles behind those adjustments, rather than the mechanics of posting the journal entries. You are going to realise that adjustments are easy if you understand how and why you are preparing the adjustments rather than learning them by heart.

In this video, I assume that you understand the following terms: group, parent, subsidiary, associate, non-controlling interest, and you know what an analysis of equity is. To start with, let me remind you of the purpose of group accounts. It is to prepare the results of the group as though it is a single entity. As you know, an entity cannot earn a profit or loss from trading with itself. Only external transactions should impact the group financial statements. As an example, an asset is recognised when it is acquired by the entity and a sale is only recognised when the asset leaves the entity.

Let us make sure we understand what I mean by “group”, so we can identify those transactions that are external to the group and those transactions that take place within the group.

Consider the group in this diagram – a parent company with two subsidiaries. Any transaction between those companies is inter-company and must be reversed. A transaction with the shareholders of the parent, or the other shareholders of the subsidiary, is a transaction outside the group and therefore should be recognised. Let’s look at a simple transaction. A subsidiary buys an item of inventory for R100 in Year 1, then, it sells the inventory in Year 1, for R150 to its parent company, who then sells it for R180 to a customer, an external third party, in Year 2. From a group perspective, the inventory was acquired for R100 in Year 1 and sold for R180 in Year 2, at which point, a gross profit of R80 will arise.

The Year 1 group financial statements must show inventory of R100 and no sales, whereas the Year 2 group financial statements must show a cost of sales of R100 and sales of R180. Irrespective of what happens to the inventory within the group during Year 1 and 2, the only two transactions that should be recognised in the group financial statements are the acquisition of the inventory in Year 1 and the sale in Year 2. While that sounds simple, what makes this type of transactions look more complicated, is that when you are preparing the consolidation, you are starting with individual companies that have recognised transactions that may be internal to the group and so need to be reversed.

In this example, in Year 1, the subsidiary has sold inventory for R150 and so has recognised sales for R150, cost of sales for R100 and a profit of R50. In Year 2, the parent company has recognised sales of R180 with cost of sales of R150 and a profit of R30. You, therefore, need to make some adjustments to adjust what is in your starting point; that is, what is recorded in the subsidiary and the parent’s financial statements, so that you leave only those items that are external to the group. Think about the way that you would do these two adjustments in Year 1 and Year 2, and make sure that you would end up with the correct amounts in the group financial statements. A key point to remember is that when the R80 profit is recognised by the group in Year 2, when that inventory is sold outside the group, R50 of that profit should be recognised as though it happened in the subsidiary and R30 should be recognised in the parent.

This is only relevant as it determines the extent to which some of the profit may be allocated to the non-controlling interest of the subsidiary. Think about how you would prepare the analysis of equity for Year 1, where you would need to reverse the R50 profit recognised by the subsidiary, and in Year 2, the profit that can now be recognised. Do not forget the impact on the group financial statement. At the end of Year 1, inventory must be reported at the lower of cost, or net realisable value, for value to the group of R100 and there cannot be a payable or receivable between the parent and subsidiary. Transactions with associates and joint ventures are different as the revenue expenses, assets and liabilities of that company are not recognised in the group financial statements, as they are not controlled. Associates and joint ventures are equity accounted, which means, recognising the group's share of profits as and when earned.

Let us assume a 30% shareholding; 30% of the profits made by the associate will be recognised and are effectively inter-company. This implies that if the group company sells to the equity accounted company, 70% of those profits are outside the group and are recognised immediately, whereas the other 30% is only realised when the associate sells the product. Therefore, 70% of the sales and cost of sales are recognised in the year in which the sale to the associate happens and the remaining 30% is recognised in the year in which the associate sells the inventory. If the sale is from the associate to the group, only 30% of the profits would be equity accounted and they should only be recognised when realised by the group, which only happens when that inventory is sold to a party, external to the group.

So far, we have looked at transactions between entities that are reported in a single set of consolidated financial statements. Other group adjustments occur as a result of measuring assets and liabilities differently from a group perspective.

Think about the requirement to recognise assets and liabilities at their fair value, at the date of acquisition. It is important to understand that at acquisition, when a business combination takes place, those assets and liabilities are first recognised by the group and so are measured at the cost to the group. The total amount paid for a subsidiary has to be allocated to the various assets and liabilities of that subsidiary as accurately as possible with any unallocated portion recognised as goodwill. This process, known as the "purchase price allocation", allocates the total cost to the individual assets and liabilities on the basis of their fair values. The allocated amount is the cost of the asset, to the group when it is first recognised from a group perspective and that cost must be used as the basis for calculating subsequent depreciation or profit on sale, for example. If that differs from the amount actually recognised by the subsidiary, then consolidation adjustments will be required.

To use a simple example to illustrate this principle: at the date of acquisition, the subsidiary has inventory with a cost of R5 million, but a fair value of R6 million; R6 million of the purchase price paid to acquire the subsidiary will be allocated to inventory, which will be shown in the group accounts at its cost to the group of R6 million. Remember that this is the group cost, so we are complying with the requirements to show inventory at the lower of cost or net realisable value. When that inventory is sold, the subsidiary will recognise cost of sales of R5 million, whereas the group will recognise cost of sales of R6 million. Consolidation adjustments will be required for the difference in the cost of inventory that is unsold as well as the cost of sales of inventory when that inventory is sold outside the group, and this may occur over a few financial years.

A third category of adjustments arises when items are reported on a different basis in the group accounts than they are in the individual company accounts. This may be because different accounting policies are applied or it may be because the asset is classified differently from a group perspective than it is from an individual company perspective. Think about a property that is rented from the subsidiary, to a parent or a fellow subsidiary. The subsidiary would treat that property as an investment property, whereas from a group perspective it is both owned and used by the group and, therefore, should be treated as "property, plant and equipment" in the group financial statements.

In this video, I have not focused on the mechanics of the consolidation and adjustments, so that you understand the principles behind those adjustments rather than the process. If you think about why you are making those adjustments, you will not have to learn these pro-forma journal entries by heart. Focus on the underlying principles now and you will be ready for more challenging examples in due course.

Thank you.