COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | INTERMEDIATE

Introduction – Pro Forma Journal Entries

UCT College of Accounting

Hi my name is Tarryn. This video is intended to help you understand pro forma journal entries. Those are the adjustments that are prepared when you are getting the group financial statements or the consolidation ready at the end of the year. What I hope to do is help you develop a strategy to identify why you might be struggling with this type of journal entry and what to do about it. Here we go.

There are three steps to preparing pro forma journal entries. First, understanding what is in your starting point. Second, understanding what you want to have in your group financial statements, that is, the end point. And third, being able to calculate the necessary debits and credits to get you from your starting point to the desired end point. If you are struggling with pro forma journal entries, you need to identify which step in this process you have to work on. If you understand the first two steps, the third step is mechanical and that is the only step that is in fact pro forma journal entries. Most students who get stuck with pro forma journal entries do so because they are focusing on the journals in isolation, rather than thinking of them as the link between the starting point and the desired group financial statements.

As a quick recap, remember that the principal function of group financial statements is to present the result of the group as if it is one single entity. This implies that the only shareholders are those of the parent entity. If other shareholders own parts of the business, this gives rise to non-controlling interest. Think of the process of preparing group financial statements. Each group company prepares a trial balance that is correct for that company and may have been audited. The investors and other users are interested in the overall group picture and will, therefore, look at the group financial statements, rather than the individual company financial statements. In order to make sure that the group financial statements are correct, there has to be a process of recording all these adjustments that make the aggregated trial balances, to get to the published group financial statements, and that is what pro forma journal entries intend to do.

Remember, these “consolidation pro forma entries” are not recorded in any particular company journal ledger. Instead, they are prepared by the group accountant at the end of the year and recorded in some consolidation working. Alright. Let us go through the steps of preparing pro forma journal entries and see where you might be struggling.

The first step, identifying your starting point, is easy. The starting point is the simple aggregation or adding together of the trial balances of the parent company and every company that is a subsidiary company, at the reporting date. I call this the aggregated trial balance or the starting point, in this video. Provided that you understand what is being recognised in the separate trial balances of each company and you can add, even if you have to rely on a calculator, then you can determine what is in the starting point.

There are no exceptions to this rule. Whether the parent has acquired the subsidiary on the last day of the financial year or if the parent only owns 51% of the subsidiary shares, you still consolidate 100% of the trial balances of the parent and all the subsidiaries. Why do we do that? Because remember, the parent controls the subsidiaries.

When thinking about your starting point, perhaps it is easiest to picture an excel spreadsheet that has a formula in it, to add together the trial balances of the parent and any company that is a subsidiary at that reporting date. The starting point, therefore, has all the amounts as recognised by the subsidiary, that is, those amounts measured using the subsidiary's policies, cost, etc. And this includes all of the equity recognised by each subsidiary as well as the amount recognised by the parent or other group companies. To carry out the second step, you have to understand what should be recognised and reported in the group financial statements. For example, revenue is earned when a transaction takes place with a party outside the group, and costs are based on when the group first acquired the asset.

You have prepared many sets of financial statements for separate companies and groups without doing pro forma journal entries. Do not let this process of recording the adjustments, to get there, cloud your understanding now. Once you have understood your starting point and the required end point, that is, the group financial statements, you can focus on the process of recording the adjustments to the starting point to get to what should be reported. Pro forma journal entries are simply a record of the adjustments that are made to the aggregated trial balance to prepare the group financial statements. Like all adjusting journal entries, you need to have a good understanding of what has already been recorded, i.e. what is in your starting point and what should be reported in the financial statements.

As pro forma journal entries are a recording tool, there is no prescribed way of doing them. In theory, you could have one large complicated journal entry that was calculated by comparing the group trial balance, that is, the end point or the theoretical trial balance that the group financial statements are based on, with the aggregated individual trial balances; that is, the starting point and debiting and crediting the balances where necessary. But as that approach reflects only the mathematical difference, as opposed to the reasons for the difference, that approach is inappropriate and unlikely to earn you marks. But all journal entries should be prepared in a way that illustrates the reason for that adjustment. This should be explained in a narration to the journal entry. Narrations are very important when preparing pro forma journal entries as they explain the purpose of the entry you are processing.

Let us illustrate how to prepare pro forma journal entries with a few examples. Let us assume that the parent company has a 60% shareholding in a subsidiary. This could be a typical journal entry relating to the initial acquisition of the subsidiary. Debit share capital: 100. Debit retained earnings: 3 900. Debit machine: 200. Debit Goodwill: 300. Credit investment in subsidiary: 3 000. Credit non-controlling interest: 1 500. You can see from the journal entry on the screen that there are numbers for each entry.

Let us talk through those:

1) The aggregated trial balance includes a credit balance of the total of the subsidiary and parent's share capital. The only shareholders of the group are that of the parent and, therefore, debiting it eliminates the subsidiary's share capital.

2) Retained earnings should include only the amounts earned by the group. The retained earnings in the aggregated trial balance include all that of the subsidiary, including amounts before the subsidiary became part of the group. Debiting the retained earnings with the amount already earned by the subsidiary at the date of acquisition will leave a credit balance that includes all that of the parent and only that of the subsidiary that was earned after the subsidiary was acquired, that is, when the subsidiary operated as part of the group.

3) The cost to the group of the machine is the fair value of the machine when the subsidiary was acquired; that is, when the machine was first recognised in the group financial statements. The subsidiary's trial balance will include the machine at the subsidiary's carrying amount. Let us assume that the carrying amount is 1 000, and that the fair value of the machine is R1 200 when the subsidiary was acquired by the group. The group statement of financial position should thus reflect the machine at R1 200. The starting point here is R1 000, that is the amount recognised by the subsidiary, plus we need to add R200 as a pro forma adjustment. This will give rise to the correct group cost of R1 200. The related deferred tax adjustments have been ignored to keep this simple.

4) Goodwill is the difference between the amount contributed by all shareholders to acquire the net assets of the subsidiary, and the fair value of those net assets of the subsidiary at the date of acquisition. Goodwill only arises from the process of consolidation and, therefore, will not be recognised in either the parent's or the subsidiary's trial balance. The starting point is therefore nil. Debiting goodwill with R300 in this entry will result in goodwill of R300 being recognised in the group statement of financial position.

5) The amount paid by the parent to acquire the net assets in the subsidiary is recognised as an investment; that is, a financial asset in the parent's trial balance. As that investment is internal to the group, it must be eliminated. Essentially, the net assets, including goodwill, that were acquired as a result of the investment, replace the cost of the investment. Assuming that the subsidiary is recognised as a financial asset at cost by the parent; that is, in the parent's separate financial statements, crediting that amount with the cost of the investment will correctly result in no investment balance.

6) The shares in the subsidiary are not all owned by the group. The other shareholders' interests in the subsidiary are referred to as the "non-controlling interest".

Let us focus a bit more on non-controlling interest. Neither the parent nor the subsidiary's trial balance will have any non-controlling interest and, therefore, the opening balance is nil. So the total adjustment made through the pro forma journal entries relating to non-controlling interest should equal the balance recognised on the statement of financial position for non-controlling interest. Typically, an analysis of equity is prepared for each subsidiary. This analysis keeps track of the equity at the date of acquisition, which is used to calculate goodwill as we discussed earlier and the group's measurement of the changes in equity of the subsidiary, thereafter. The subsequent changes will be grouped into those that affect prior years and therefore reserve balances and those that affect the current year's changes, many of which will be recognised in comprehensive income. As all the changes will be analysed between the group's share and the non-controlling interest share, this working will give you the figures you need to prepare the pro forma journal entries relating to non-controlling interest and a total to use to check your workings.

Remember, the analysis of equity is simply a working to help you prepare the consolidation.

Remember the pro forma journal entry we discussed earlier, assuming the parent company has a 60% shareholding in a subsidiary. Let us use an example to illustrate how we use the analysis of equity to prepare pro forma journal entries for the consolidated financial statements. This analysis of equity tells us that the total credits to non-controlling interest balance must be R2 012. We have already discussed the credit of R1 500, which arises from the initial entry. Let us have a look at what causes this total balance. The subsidiary has a total balance of R4 900 in retained earnings at the start of the current year. A: R3900 of which is pre-acquisition, and should be eliminated. The other R1 000, B, is post-acquisition. Of this, R600, C, is attributable to the group and R400, D, is attributable to non-controlling interest. The full R4 900 of retained earnings is included in the starting point. R3900, A, was eliminated in the first journal entry we prepared earlier.

A further journal entry is required to adjust the non-controlling interest share of post-acquisition earnings. We debit retained earnings with R400 and credit non-controlling interest in the statement of financial position with R400. This adjustment will correctly leave the group's share of retained income as R600, C, and increase the non-controlling interest's share by R400, D. If you work methodically through your analysis of equity and prepare a journal entry for each line item, you will get the correct balance for non-controlling interest and have made many other necessary adjustments. When preparing your journal entries, you need to remember that the way in which an item is disclosed must influence the way in which you prepare your journal entries.

Let us consider the adjustments relating to the machine. The current year depreciation adjustment must increase the current year depreciation by R40. The journal entry is debit depreciation in profit or loss, R40, and credit accumulated depreciation in the statement of financial position with R40. The non-controlling interest share of this adjustment needs to be processed separately. Note that the depreciation adjustment for the prior years' impacts retained earnings, rather than the depreciation expense. The adjustment relating to prior year additional group depreciation is, therefore, debit retained earnings, R48, debit non-controlling interest in the statement of financial position, R32, and credit accumulated depreciation in the statement of financial position with R80.

Let us talk through those numbers 1, 2 and 3, the reason for this journal. Number 1: the group's retained earnings are reduced by the group's 60% share of the additional depreciation. Number 2: the controlling interest balance is reduced by the group's 40% share of the additional depreciation. Number 3: the adjustments to the accumulated depreciation, is reduced by 100%. This makes sense as 100% of the asset is recognised in the group's statement of financial position.

Now try and see if you can follow those principles through the remaining pro forma journal entries. Remember to focus on what should be reported in the group financial statements, what is in your starting point, rather than just the adjustments to get there. Good luck.