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Video Transcription: Advanced Pro Forma Journal Entries



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Hi, my name is Andrew, and today we are going to be looking at Advanced Pro Forma Journal Entries. The purpose of this video is to build on your understanding of pro forma journal entries, to help you tackle some of the more complex issues in postgraduate financial reporting. Before carrying on with this video, we would recommend that you watch the video “Introduction – Pro Forma Journal Entries”, to refresh your understanding of the basics. Remember, in that video, the point was raised that pro formal journal entries are more of a tool used to record the adjustments, rather than a means of calculating the adjustments that are required, when preparing group financial statements.

The point was also raised that some students feel they don’t understand pro forma journal entries, when in fact what they don’t understand is the starting point and end point necessary, when preparing group financial statements. This video is not intended to be a comprehensive guide to pro forma journal entries, but we are rather going to take a few issues that typically cause difficulties, and build on these to create a better understanding of our pro forma journal entries.

If you understand these principles sufficiently, you will be able to deal with various transactions that you could encounter in your studies. The three issues that we are going to look at are differences at acquisition date, differences in the accounting treatment of the different group companies compared to the group, and finally, we are going to look at some foreign operations.

So, if we start by looking at the differences at acquisition date, I would like you to remember the example we looked at in the first pro forma journal entries video. In that video, we looked at the typical first pro forma journal entry, which is there to recognise the goodwill, recognise NCI, and to eliminate the equity of the subsidiary at acquisition date. The journal entry you saw in that example is as follows:

In this example, we assumed that the parent did not own any shares in the acquired company before the acquisition date. Using that same example, let’s think about some potential complications that could arise in the preparation of this pro forma journal entry. What happens if, at the date of acquisition, the parent’s trial balance does not reflect the investment at the original cost of that investment? This could be for a number of reasons. The parent’s cost could include transaction costs, which in accordance with IFRS3, must be expensed, but there, may have been capitalised to the investment recognised in this parent’s separate company financial statements.

The investment may be carried at fair value in accordance with IFRS9, or possibly the investment may have been impaired and written down below cost. Whatever the reason, the impact of any of these adjustments must be reversed, in order to get a carrying amount for the investment, which equals the cost measured in accordance with IFRS3. This investment will then be eliminated in the first pro forma journal entry, which we have looked at. Let’s look at an example.



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What if a parent measures an investment at fair value in its separate financial statements, but its cost is R3 000, as indicated in the first journal entry. Assuming that the parent company also capitalises transaction costs of R100 to the cost of the investment, and to make things interesting, also recognised the investment at its fair value of R3 750 at the beginning of the current financial year; in other words, the end of the previous financial year. And at the end of the current financial year, the investment was recognised at its fair value again, this time being R4 000.

The fair value adjustments were recognised in OCI, in other words, out of comprehensive income, and a separate investment revaluation surplus equity account is also presented. The pro forma journal entry necessary to reverse the adjustment to the cost of the investment could be processed something like this. Once that journal entry is recognised, the carrying amount of the investment will be reduced to its cost of R3 000. Then, we can process the usual journal entry at the date, which control was acquired, and this will result in the investment correctly being written down to nil.

Remember to also reverse any related deferred tax adjustments that the parent may have recognised. Let's use the same example again, but, this time, let's assume that the parent had owned shares in the company before the acquisition date. So, let's assume that the parent initially paid R1 500 to acquire 40% of the shares in another company. This investment meant that the parent could exert significant influence over the operations of the other company. Subsequently, the parent paid R1 000 to acquire a further 20% shareholding in this entity and this resulted in the parent obtaining control over that entity. In this case, goodwill should be calculated at the acquisition date by including the fair value of the existing shareholding and recognising a gain or a loss, a profit and loss, for any difference between the carrying amount and the fair value of the existing shareholding in the group financial statements.

Let's assume that the parent company's separate financial statements will only recognise the cost of the investment, which is now being increased by the amount paid for the additional 20% shareholding. We are going to need to process pro forma journal entries to do the following: we are going to need to recognise post-acquisition earnings from the associate, that could be current year amounts, our share of post acquisition reserves, prior year amounts, and we are also going to need to increase the cost of our investment to reflect the equity-accounted carrying amount for our investment and associate.

This will need to be done up to the date on which significant influence was lost, and control was gained. Another pro forma journal entry will be required to be processed on the date of deemed disposal. This entry will write the investment up or down to its fair value, with the resulting adjustment being recognised in profit or loss. We will also need to credit this investment at fair value as part of our initial big pro forma journal entry at the date on which control was obtained.



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Remember that you can process pro forma journal entries in any way that you want to, as long as you get the correct result. We have presented these pro forma journal entries as three separate journal entries to try and make the principles clear. Another possibility is that the subsidiary could have issued more share capital after the date of acquisition. In this instance, the key principles to bear in mind when preparing pro forma journal entries are as follows: goodwill should be calculated at the date on which control was acquired, and therefore only share capital that existed at that date should be included in the initial pro forma journal entry, in which goodwill is calculated.

But, all the share capital of the subsidiary must be eliminated. That implies that an additional entry will be required to eliminate the share capital that was issued post acquisition. While the debit to this journal entry is clearly the additional share capital that was issued, the remainder of the journal entry will depend on who purchased the additional shares, and the net assets of the subsidiary on this date. If the parent paid an additional amount for some or all of the shares, the cost of that additional investment needs to be credited.

The non-controlling interest balance must be debited or credited, as needed, depending on who acquired the additional shares in order to correct their interest in the subsidiary, with the balancing figure debited or credited as a group equity adjustment. This type of transaction is an equity transaction; any adjustment will be taken directly to equity, as opposed to comprehensive income. Here is an example of a type of journal entry that could be processed to record an equity adjustment.

Our second issue relates to preparing pro forma journal entries when one or more of the group companies uses an accounting methodology or measurement base that is different when compared to the group measurement base or accounting treatment. I would recommend that you watch the video relating to changes in accounting policy to help you in this respect. Examples of this issue are where a subsidiary could use a different accounting measurement base such as the cost model, for investment property, compared to the group measurement base, which can be the fair value model. Or the asset can be classified differently from a group perspective compared to what it is classified as, in the separate financial statements.

For instance, the subsidiary could rent a building to the parent entity, for the subsidiary this would be classified as investment property, but from a group perspective, this building is owner occupied and should be classified as property, plant and equipment. Remember that the starting point is to add together the trial balances of the parent and the subsidiary, using the accounting methodology, classification and measurement basis, as used in their separate financial statements.

In other words, using the respective company accounting policies and classifications. Pro forma journal entries are required to correct the aggregated trial balance to the basis required for group accounts. Remember that neither the parent nor subsidiaries process pro forma journal entries. The parent and subsidiaries' general ledgers will not be adjusted for these entries. Instead, these adjustments will be made each and every year.



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The third issue we are going to be looking at is how to deal with investment and foreign entities. The same basic principles we have looked at will apply, except now the trial balance of that subsidiary needs to be translated from a foreign currency into the South African Rand. This translation will be done using the closing rate method. Once the translation has occurred, this can be aggregated with the remaining group entries trial balance. The closing rate method implies that assets and liabilities are translated at the closing exchange rate, current year gains and losses at the average exchange rate, and the rest of the equity of the subsidiary at a rate, which was applicable when that equity arose. By using all these different exchange rates, the trial balance will not balance, there needs to be a balancing figure.

This balancing figure is the cumulative translation difference. Now remember, this translated trial balance is the starting point, which we are going to use to prepare group financial statements, and therefore pro forma journal entries. Before attempting to process any pro forma journal entries, we need to make sure that we have calculated what cumulative exchange adjustments are required in the group financial statements. This includes a separate calculation of the amount to be included in the current year's comprehensive income, as well as the previous year's amounts, which will be reflected in the foreign currency translation reserve.

These calculations will typically be performed using an analysis of equity. Remember, the pro forma journal entries will not help you to calculate these amounts, but they are, rather, there to make adjustments necessary when preparing our group financial statements. Let's have a look at an example of an analysis of equity. The analysis of equity includes all of the equity of the subsidiary, post acquisition changes in this equity of the subsidiary, as well as an adjustment to the fair value of land at acquisition date. You will also see that we had to calculate goodwill at the acquisition date. These calculations and these amounts are all reflected in US Dollars. We also see a column relating to exchange rates, and then finally, a column that shows 100% of these amounts, but translated into South African Rands. We then break that 100% down into the amount attributable to the parent shareholders as well as to the NCI.

Using this analysis of equity, we are able to prepare the initial pro forma journal entry at the date of acquisition, as we did previously. The journal entry for this example is, as follows: remember that the starting point will be the trial balance of the subsidiary, and in that trial balance there is no fair value adjustment to land and no goodwill recognised. These two assets will require adjustment, each period. Also, have a look at the analysis of equity, we can see that the parent share of the cumulative translation gain was 1 302 at the end of the previous financial period. We also noticed that the current year total translation gain is 6 540. Remember that when processing your pro forma journal entries, there are two primary issues to address in this instance. First is that the starting point is based in the subsidiary measures and not the group's. And the second is that the translation adjustment is a cumulative amount, and we need to split this into the current year portion, as well as the amount attributable to previous financial years.



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To solve these issues, we must remember to make adjustments to the assets that we have adjusted from the group perspective, goodwill and land, and we also need to process some pro forma journal entries in order to attribute some of the cumulative translation gains to the current year and some to prior years. Let's look, for instance, at how we would deal with a current year translation gain. A first journal entry would be a debit to the FCTR and the credit to translation gains in OCI, with a full amount of 6 540, as we saw in the analysis of equity.

Once we have processed that adjustment, we need to make a further adjustment relating to non-controlling interest. This could be a debit to the FCTR, and a credit to the NCI in a statement of financial position, with the amount reflected on the analysis of equity. So finally, remember you need to have a good understanding of your starting point, as well as your end point; in other words, what should be recognised on your group financial statements. If you understand your starting point and your end point, pro forma journal entries are relatively straightforward. For example, consider Google Maps, we need to know where you are, you need to know where you are going, there are a number of different routes you could take to get from where you are to where you are going – those routes are similar to pro forma journal entries.