LECTURE 2

CONSOLIDATION CONTINUES...

EXCEMPETION FROM CONSOLIDATION

- A parent need not present consolidated financial statements if it meets all of the following conditions: [IFRS 10:4(a)]

1. It is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements
2. Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)
3. It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and
4. Its ultimate or any intermediate parent of the parent produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10

CONCEPTUAL BASIS OF ACQUISITION ACCOUNTING

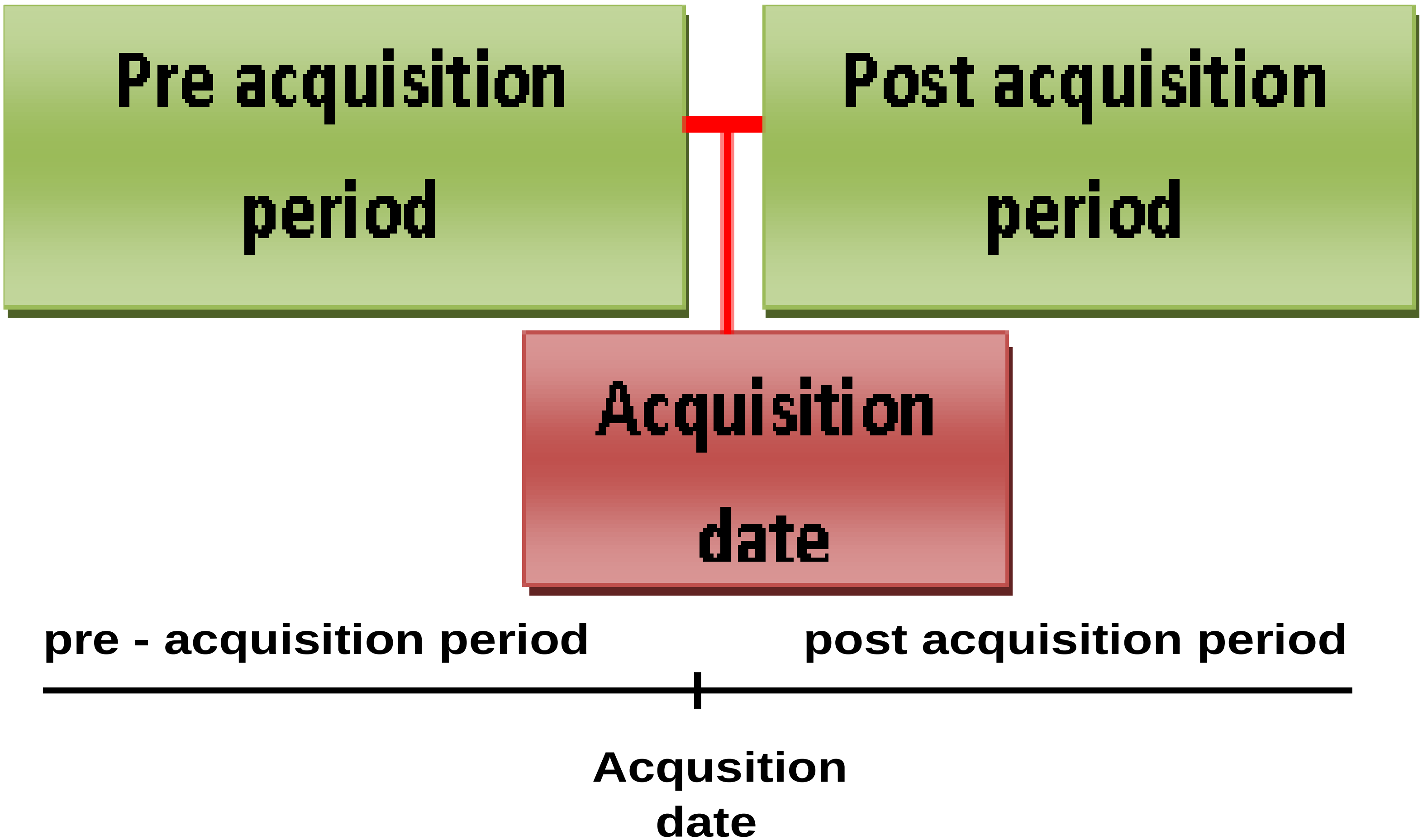
- As the name suggests, acquisition accounting views the investment in shares of one company by another as an acquisition or purchase and we talk of **H** taking over, acquiring or purchasing **S**

- IFRS 3 '**Business Combinations**' requires all business combinations to be dealt with using the purchase (or acquisition) method which generally requires assets acquired and liabilities assumed to be measured at their fair values at the acquisition date.

- This method views a business combination from the perspective of the acquirer (i.e Investor) (**H** in this case).
- Prior to the purchase H and S are independent companies and on acquisition H is paying a price to acquire the net assets of S at that time. The price paid is the cost of the **net assets** of S to the group and is the basis for incorporating these assets into the group accounts
- Up to the date of acquisition (**the pre-acquisition period**) the directors of H are not responsible or accountable for the decisions affecting the performance of S.

- They are responsible, however, for S's performance after acquisition i.e. for events in the **post-acquisition period**.

- Because of this, it is important that there is a proper cut-off at the date of acquisition. The results of S are incorporated only from the date of acquisition onwards.

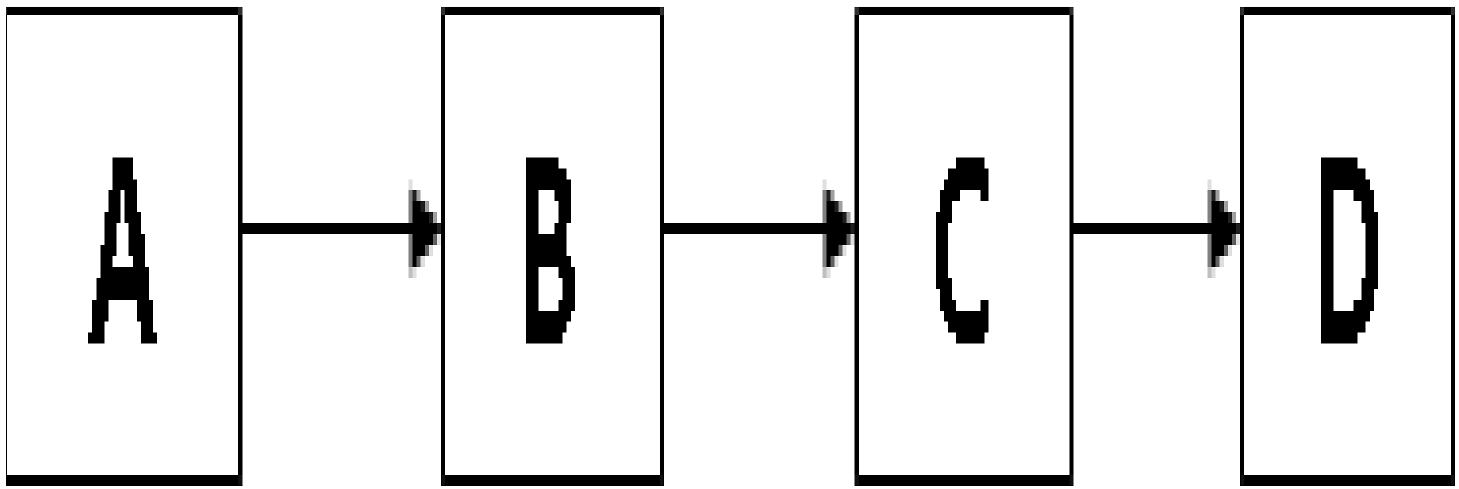

Pre acquisition period
Post acquisition period
Acquisition date
pre - acquisition period
post acquisition period
Acqusition date

Group structures

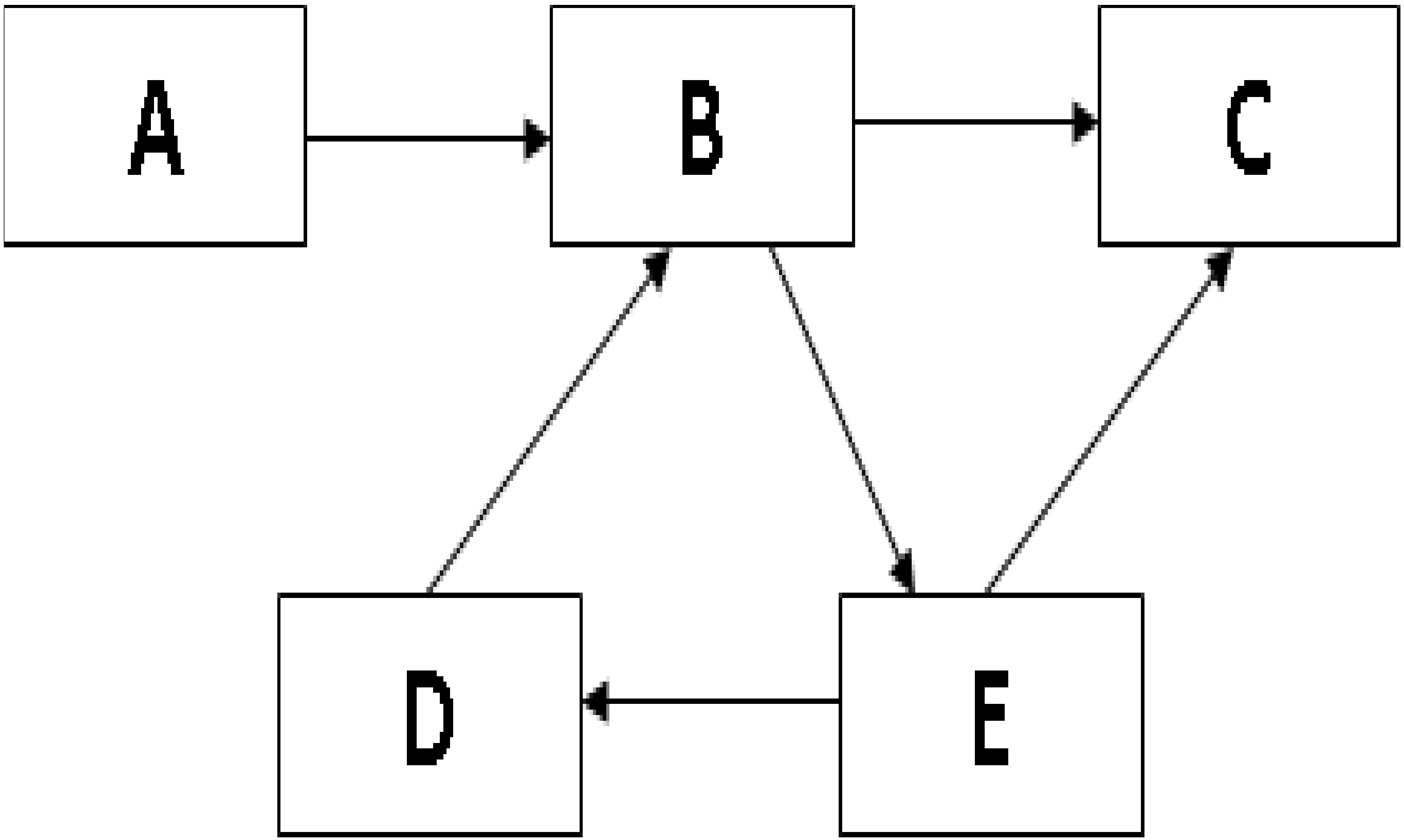
- One Subsidiary
- More than one subsidiary (Chain holdings)

More than one subsidiary (Chain holdings)

- Vertical Chain



Mixed chain holdings



Computation of effective holding percentage

Doing it together in the class with example to be produced

THE PREPARATION OF CONSOLIDATED ACCOUNTS UNDER ACQUISITION ACCOUNTING

It is important to appreciate that:

- Individual companies legally must maintain their own accounting records eg nominal ledger, cash book, debtors' ledger. These records are used as the basis for the preparation of their annual accounts.
- A group **does not** maintain accounting records for the group as a whole as in most cases this would be impractical and costly. We cannot therefore prepare group accounts in the same way as we would prepare an individual company's accounts.

- To prepare group accounts we make use of what information we do have ie the accounts of the individual companies within the group.
- The group accounts are initially prepared by adding together the accounts of the individual companies within the group.

- Before accepting the figures as final we need to check that the group accounts show a true and fair view. In particular we need to ensure that they comply with accounting principles and represent economic reality from the viewpoint that, in consolidating, **we treat the group as if it was a single entity**. Adjustments will need to be made to the initial aggregated totals.

- The construction of consolidated accounts can be made by adding line by line like corresponding terms of assets, liabilities, revenues and expenses of both holding (parent) company and its subsidiaries and taking the effect of consolidation adjustments.

- $H + S_1 + S_2 + \ldots\ldots \pm$ consolidation adjustments = Group balances

Where,

H = accounts of the holding or parent company,

S_1, S_2 etc = accounts of the subsidiaries.

- **Addition is easy**. The key to consolidation is knowing what consolidation adjustments to make and how to make them.

ACQUISITION OF A SUBSIDIARY

Consolidation of Balance Sheet

Determination of net assets of subsidiaries and calculation of goodwill

Example 1

Pink/Blue

On 30 June 2021 Pink Ltd purchased the entire share capital of Blue Ltd (100,000 ordinary shares) for Tzs175, 000,000.

The balance sheets of the two companies at 30 June 2021 were as follows:

	Pink Ltd	Blue Ltd
	Tzs'000'	Ths'000'
Non - Current		
Tangible	200,000	140,000
Investment in Blue Ltd	175,000	-
	375,000	140,000
Current assets		
Stock	60,000	40,000
Debtors	30,000	16,000
	90,000	56,000
Total assets	**465,000**	**196,000**
Current liabilities		
Trade creditors	70,000	35,000
Total Liabilities	70,000	35,000
Equity		
Ordinary shares @Tzs1, 000	150,000	100,000
Profit and loss reserves	245,000	61,000
	395,000	161,000
Total equity and liabilities	**465,000**	**196,000**

Note:

The cost of the investment in Blue Ltd is included in Pink's individual Balance Sheet.

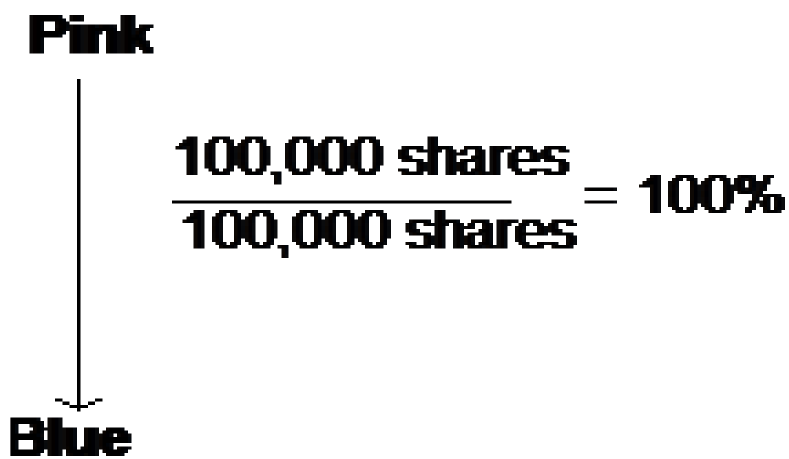
Required:

Prepare the draft consolidated balance sheet for Pink Ltd and its subsidiary undertaking Blue Ltd as at 30 June 2021.

STEP 1

Determination of ownership structure of Pink group

Since Pink bought all shares in Blue, then Pink owns Blue by 100%, so there's no Non-controlling interest.



STEP 2

Add the individual balance sheets together on a line by line basis to give totals as follows:

	Pink	Blue	Total
Non Current Assets	**Tzs'000'**	**Tzs'000'**	**Tzs'000'**
Tangible	200,000	140,000	340,000
Investment in Blue Ltd	175,000	-	175,000
	375,000	140,000	515,000
Current assets			
Stock	60,000	40,000	100,000
Debtors	30,000	16,000	46,000
	90,000	56,000	146,000
Total assets	**465,000**	**196,000**	**661,000**
Current Liabilities			
Trade creditors	70,000	35,000	105,000
Total Liabilities	70,000	35,000	105,000
Equity			
Share capital	150,000	100,000	250,000
Profit and loss reserves	245,000	61,000	306,000
	395,000	161,000	556,000
Total equity and liabilities	**465,000**	**196,000**	**661,000**

This aggregation gives the following balance sheet as per the total column above.

Pink Group

Draft consolidated balance sheet as at 30 June 2021

Non - Current assets	**Tzs'000'**
Tangible	340,000
Investment in Blue Ltd	175,000
	515,000
Current assets	
Stock	100,000
Debtors	46,000
	146,000
Total assets	**661,000**
Current liabilities	
Trade creditors	105,000
Total liabilities	105,000
Equity	
Ordinary shares of Tzs 1,000	250,000
Profit and loss reserves	306,000
	556,000
Total equity and liabilities	**661,000**

This aggregation gives the following balance sheet as per the total column above.

It balances but does it show a true and fair view?

REMEMBER

1. Group accounts are prepared for the group as a single entity. A single entity cannot have an investment in itself or issue shares to itself.

2. Group accounts should reflect:

- The assets controlled by Pink Ltd
- The profits generated as a result of Pink Ltd's control.

Let's think through the following questions:

1. What are the total tangible fixed assets controlled by Pink Ltd?
2. What is the total stock controlled by Pink Ltd?
3. What are the total amounts owed by debtors to the group?
4. What are the total amounts owed by the group to creditors?
5. Does the **group** own an investment in an external company?
6. Are any of the shares in Blue Ltd held externally?
7. Did Pink Ltd's control generate the profits accumulated by Blue Ltd up to 30 June 2021 (the pre-acquisition period)?

Does the above balance sheet reflect these facts?

Conclusions

- Pink controls all of Blue's tangible fixed assets, stock, debtors and creditors. Therefore, showing **Pink** and **Blue's** aggregated balances gives a true and fair view.

- Adjustments must be made to eliminate the investment in Blue Ltd at the date of acquisition as the **group** does not hold an investment in an external company. This investment is external to Pink, but not to the group.

- The share capital of Blue must also be eliminated as it is held within the group.

- The pre-acquisition profits of Blue should also be eliminated as they were not earned by the **group**.

- We need to make an adjustment to remove the items that should not be there. This is done in Step 3.

STEP 3

Remove both the ‘investment in **Blue** and the share capital and the pre-acquisition profits acquired by that investment

- The investment in **Blue** is not an external investment and from the group point of view should **be eliminated** as it is an **internal balance**. The investment is in the share capital and pre-acquisition reserves of Blue – these are also held internally and should be eliminated. If the shares were repaid the funds would stay in the group. If the reserves were distributed they would go to the owner – Pink – and also stay within the group. We need to eliminate the following

	Tzs'000'	Tzs'000'
Investment in Blue		175,000
Share capital of Blue	100,000	
Profit and loss reserves of Blue	61,000	
		161,000
Difference		**14,000**

- Pink Ltd paid Tzs175, 000,000 for Blue Ltd but the share capital and accumulated profits at that date were only Tzs161, 000,000. Therefore Pink Ltd was willing to pay an additional Tzs14,000,000 for something which is not reflected in the balance sheet of Blue (its good name, experienced staff, established customers, suppliers etc). This additional amount paid to acquire control of Blue is called **Goodwill.**

We make the necessary adjustment through the following journal:

We make the necessary adjustment through the following journal:

			Tzs'000'	Tzs'000'
(1)	Dr Share capital (Blue)		100,000	
	Profit & loss reserves (Blue)		61,000	
	Goodwill		**14,000**	
	Cr	Investment in Blue		175,000

Being elimination of investment and recognition of goodwill

Goodwill

is defined as the difference between the cost of the investment and the net assets (represented by share capital and reserves) acquired.

Alternative approach of computing Goodwill

	Pink Group (100%) Tzs'000'	Non-controlling interest(0%) Tzs'000'
Cost Investment in Blue	175,000	
Less **Net assets**		
Share capital (Blue)	(100,000)	
P&L Reserve (Blue)	(61,000)	
Goodwill	**14,000**	

The consolidation adjustment which removes the investment and accounts for goodwill results in the consolidated balance sheet now showing the following:

	Pink	Blue	Consolidated
Non Current Assets	**Tzs'000'**	**Tzs'000'**	**Tzs'000'**
Tangible	200,000	140,000	340,000
Goodwill	14,000	-	14,000
	214,000	140,000	354,000
Current assets			
Stock	60,000	40,000	100,000
Debtors	30,000	16,000	46,000
	90,000	56,000	146,000
Total assets	**465,000**	**196,000**	**500,000**
Current Liabilities			
Trade creditors	70,000	35,000	105,000
Total Liabilities	70,000	35,000	105,000
Equity			
Share capital	150,000	-	150,000
Profit and loss reserves	245,000	-	245,000
	395,000	-	395,000
Total equity and liabilities	**465,000**	**196,000**	**500,000**

- Total net assets controlled by the group.
- No investment in another company outside the group.
- Share capital is the share capital of the parent only i.e. those shares held by the members of the parent (who are the group shareholders).
- The profit and loss reserves are the accumulated profits of the parent plus the profits made by the subsidiary since the date of acquisition i.e. excluding the profits made prior to the parent gaining control (the pre-acquisition profits).
- New intangible asset being goodwill.

From Step 3 we see that the difference between the cost of the investment and the fair value of the subsidiary's net assets is known as goodwill. There are two types of goodwill:

- **Positive goodwill:** if the cost is greater than the value of the net assets acquired, the difference will represent a **premium paid** or **positive goodwill**.
- **Negative goodwill:** if the value of the net assets acquired is greater than cost, the difference will represent a **discount**, or **negative goodwill**. This situation is much less common than positive goodwill.
- IFRS 3 requires **positive goodwill to be capitalised and classified as an asset on the balance sheet**. As the goodwill normally will exist for some years it will be a fixed asset.

2. CONSOLIDATION IN YEARS AFTER ACQUISITION

The balance sheets of the two companies at 31st December 2021 were as follows:

	Pink Ltd	Blue Ltd
	Tsh'000'	Ths'000'
Non - Current		
Tangible	240,000	160,000
Investment in Blue Ltd	175,000	-
	415,000	160,000
Current assets		
Stock	50,000	45,000
Debtors	45,000	21,000
	95,000	66,000
Total assets	**510,000**	**226,000**
Current liabilities		
Trade creditors	40,000	20,000
Overdraft	5,000	10,000
Total Liabilities	45,000	30,000
Equity		
Ordinary shares @Tzs1, 000	150,000	100,000
Profit and loss reserves	315,000	96,000
	465,000	196,000
Total equity and liabilities	**510,000**	**226,000**

Additional information:

1. On 30 June 2021 Pink Ltd purchased the entire share capital of Blue Ltd (100,000 ordinary shares) for Tsh175, 000,000.
2. At 30^{th} June 2021 profit and loss reserves of Blue ltd were Tsh 61,000,000.
3. There was no impairment of goodwill since acquisition.

Required:

Prepare the draft consolidated balance sheet for Pink Ltd and its subsidiary undertaking Blue Ltd as at 31^{st} December 2021.

	Pink Group (100%) Tzs'000'	Non-controlling interest(0%) Tzs'000'
Cost Investment in Blue	175,000	
Less **Net assets**		
Share capital (Blue)	(100,000)	
P&L Reserve (Blue)	(61,000)	
Goodwill	**14,000**	

The balance sheets of the two companies at 31 December 2021 were as follows:

	Pink Ltd	Blue Ltd	Consolidated
	Tsh'000'	**Ths'000'**	**Ths'000'**
Non - Current			
Tangible	240,000	160,000	
Investment in Blue Ltd	175,000	-	
	415,000	160,000	
Current assets			
Stock	50,000	45,000	
Debtors	45,000	21,000	
	95,000	66,000	
Total assets	**510,000**	**226,000**	
Current liabilities			
Trade creditors	40,000	20,000	
Overdraft	5,000	10,000	
Total Liabilities	45,000	30,000	
Equity			
Ordinary shares @Tzs1, 000	150,000	100,000	
Profit and loss reserves	315,000	96,000	
	465,000	196,000	
Total equity and liabilities	**510,000**	**226,000**	

3. CONSOLIDATION OF SUBSIDIARIES NOT WHOLLY OWNED

Additional information:

1. On 30 June 2021 Pink Ltd purchased 80,000 ordinary shares of Blue for Tsh175, 000,000.
2. At 30th June 2021 profit and loss reserves of Blue ltd were Tsh 61,000,000.
3. There was no impairment of goodwill since acquisition.

Required:

Prepare the draft consolidated balance sheet for Pink Ltd and its subsidiary undertaking Blue Ltd as at 31st December 2021.

Pink in Blue

	Pink Group (80%) Tzs'000'	Non-controlling interest(20%) Tzs'000'
Cost Investment in Blue	175,000	
Less **Net assets**		
Share capital (100,000*80:20)	(80,000)	20,000
P&L Reserve (61,000*80:20)	(48,800)	12,200
Goodwill	**46,200**	
Post Acq Re(96,000-61,000)*80:20	28,000	7,000
Total NCI		**39,200**

Pink Group

Consolidated balance sheets at 31 December 2021

	Ths'000'
Non – Current Assets	
Tangible (240,000+160,000)	400,000
Goodwill	46,200
Total Non Current assets	**446,200**
Current assets	
Stock(50,000+45,000)	95,000
Debtors (45,000+21,000)	66,000
Total assets	**607,200**
Equities and Liabilities	
Equity	
Ordinary shares @Tzs1, 000	150,000
Profit and loss reserves (315,000+28,000)	343,000
Non-Controlling Interest (NCI)	39,200
Total Equities	**532,200**
Current liabilities	
Trade creditors (40,000+20,000)	60,000
Overdraft (5,000+10,000)	15,000
Total Liabilities	**75,000**
Total equity and liabilities	**607,200**

CONSOLIDATION ADJUSTMENTS

1. INTERNAL INDEBTEDNESS

- If, at the balance sheet date, one group member owes a sum of money to another company within the group, this sum will be included within debtors and creditors in the accounts of the individual companies. Such internal indebtedness may arise as the result of the supply of goods, services, finance etc.
- However, on consolidation, the internal balances must first be **agreed and then eliminated in full**. The amounts shown for debtors and creditors in the group balance sheet will then relate only to third party debtors and creditors. If internal balances are left in the accounts group assets and liabilities will be overstated

Remember that consolidated accounts are accounts for the group as if it were a single entity and an entity cannot owe itself money.

The required consolidation adjustment is:

Dr Creditors

Cr Debtors

Being elimination of internal indebtedness

Balances between group companies are sometimes referred to as intercompany, intergroup or current accounts.

Cash or stock in transit

- If an asset is in transit between group companies it must be accounted for as part of consolidated net assets – it should not be missed out. Control of the asset is the important factor, not its location. However, its location (in transit) means that it may not be included in either of the balance sheets of the two companies involved. Remember that the basic mechanics of consolidation involve aggregating the balance sheets to give group net assets. This may not pick up any assets in transit. Therefore a specific adjustment is required on consolidation to ensure inclusion of assets in transit.

Example 5

Pink Ltd and Blue Ltd

Pink Ltd owns 80% of Blue Ltd. At 30 June 2021 the balance sheet of Pink Ltd shows an amount owing by Blue Ltd of Tzs 25,000,000 however, the balance sheet of Blue Ltd shows an amount owing to Pink Ltd of Tzs 16,000,000. On 26 June 2021 Blue Ltd sent a cheque to Pink Ltd for Tzs 9,000,000 which was not received and banked by Pink Ltd until 3 July 2021.

What adjustments are required?

Solution

The cash is out of the bank balance of Blue but not in the bank balance of Pink. It is however group cash and is described as cash in transit. After identifying the in transit issue two things have to be done:

1) Adjust for the in transit item and agree balances; and

2) Eliminate the internal items.

In doing 1) it is usual to 'push forward' the item into the recipient's accounts.

Adjustment to accounts of Pink to record cash in transit:

		Tzs '000'	Tzs '000'
Dr	Cash	9,000	
	Cr Current a/c with Blue (debtor)		9,000

(in Pink's accounts)

Being the recognition of the asset (cash) in transit on the group balance sheet and the account with Blue being adjusted for the cheque in transit

This reduces the debtor balance in the accounts of Pink to 16,000,000.

Adjustment on consolidation:

		Tzs '000'	Tzs '000'
Dr	Current account with Pink Ltd (creditor)	16,000	
	Cr Current account with Blue Ltd (debtor)		16,000

Being the elimination of internal balances

INTERNAL DIVIDENDS

As the parent owns shares in its subsidiary then, like other shareholders, it would normally expect to receive a return on its investments in the form of dividends.

Parent company Statement of Financial Operations

Dividends received by a parent from a subsidiary are treated as investment income in the books of the parent.

This is the main method by which profits are moved through the group. If the parent is to pay a dividend it must have profits out of which to pay these. As the dividend has been paid, the transfer will have passed through and been recorded in the individual accounts of the two companies involved.

Subsidiary financial statements

Dividends paid by the subsidiary will reduce the profit and loss reserve.

Consolidated Statement of Financial Operations

Dividends received from a subsidiary by a parent must not appear in the consolidated Statement of Financial Operations - a single entity cannot receive a dividend from itself.

Consolidated profit after taxation includes all the profit after taxation of the parent and subsidiary. This figure will include the dividend received by the parent from the subsidiary. From the group point of view this is an internal transfer and should be eliminated by:

Dr Investment income (dividend received)

Cr P/L reserve

With the group share of the dividend paid by the subsidiary.

- **Statement of Financial Operations**

  Finance (interest) payable or receivable arising from internal holdings of debt will be eliminated on consolidation in a similar fashion to the holdings themselves. This would leave only the external finance payable/receivable appearing in the consolidated accounts. The adjustment is:

Dr Interest income (P/L)

Cr Interest expense (P/L)

Example: Box Ltd/Bag Ltd

Box Ltd owns 80% of the share capital of Bag Ltd. The Statement of Financial Operations for the year ended 31 December 2021 are as follows:

	Box Ltd	Bag Ltd
	Tzs 000	**Tzs 000**
Profit on ordinary activities	112	75
Investment income	8	-
Profit before tax	120	75
Taxation	(20)	(15)
Profit for the year	100	60

Box and Bag paid dividends of TZS 30,000 and TZS 10,000 respectively. In the parent company's accounts its share of the dividend of the subsidiary is shown as TZS 8,000 (80% x 10,000 = TZS 8,000).

As shown in the table below, when the consolidation process starts, the accounts are added together. The totals now show that the group has received a dividend of Tzs 8,000:

	Box Ltd	Bag Ltd	Total
	Tzs 000	**Tzs 000**	**Tzs 000**
Profit on ordinary activities	112	75	187
Dividends received	8	-	8
Profit before tax	120	75	195
Taxation	(20)	(15)	(35)
Profit for the year	100	60	160

Required:

What adjustments are required on consolidation?

Solution

NCI in profit for the year

The Non-controlling interest for the year is 20% x 60,000 = Tzs 12,000

Recorded as:

			Tzs	**Tzs**
(1)	Dr	Non-controlling interest (P&L)	12,000	
	Cr	Non-controlling interest (B/S)		12,000

Being the Non-controlling interest's share of the year's profits of Bag

Internal Dividends

The Tzs 8,000 paid by Bag Ltd and received by Box Ltd (the internal element) must be cancelled in the consolidated Statement of Financial Operations.

	Tzs	Tzs
(2)Dr Investment income (P&L)	8,000	
Cr P/L reserve (B/S)		8,000

Being the internal dividend elimination

Non-controlling interest in dividends

	Tzs
Dividend paid by Bag	10,000
Less internal element eliminated	(8,000)
Dividend paid to NCI	2,000

The Tzs 2,000 relates to the dividend paid by Bag Ltd to Non-controlling interest shareholders – any dividend not going to the group must go to the Non-controlling interest.

However, the figure to be included in the consolidated Statement of Financial Operations in respect of Non-controlling interest in the profit for the year is the Tzs 12,000. This amount has been added to the NCI in the balance sheet.

The dividend already paid to Non-controlling interest should be shown in the consolidated accounts as a reduction to the Non-controlling interest in the balance sheet as it represents a payment to the NCI of part of their share of the profits for the year. Therefore their total interest in the subsidiary has reduced.

We therefore:

		Tzs	Tzs
(3) Dr	Non-controlling interest (B/S)	2,000	
Cr	P&L reserve (B/S)		2,000

being the consolidation adjustment to remove the dividend paid from the group's P&L account and reduce the NCI share of the net assets of the subsidiary

The Non-controlling interest in the current year **retained profits** (assuming no other transactions) will now be Tzs 10,000.

	Tzs
Amount due in respect of profits (JE1)	12,000
Less amount paid (via dividends) (JE 3)	(2,000)
Closing NCI balance in B/S	10,000

- The consolidated Statement of Financial Operations now shows the combined profits after tax and the total profit for the year attributable to Non-controlling interests.

	Box Ltd	Bag Ltd	Total	Adjustments DR	CR	Consolidated
	Tzs000	Tzs000	Tzs000	Tzs000	Tzs000	Tzs000
Profit on ordinary activities	112	75	187			187
Investment income	8	-	8	(2) 8		-
Profit before tax	120	75	195			187
Taxation	(20)	(15)	(35)			(35)
Profit after tax	100	60	160			152
Non-controlling interests				(1) 12		(12)
Profit for year	100	60	160			140

We can check that the Tzs 140,000 profit for the year is reasonable. The total should be:

	Tzs
Profits of Box	100,000
80% of profits of Bag (80% x Tzs 60,000)	48,000
less: internal dividend	(8,000)
Consolidated profits	140,000

INTERNAL TRANSFER OF GOODS AND SERVICES

- ## Transfer of goods

- Transfer of goods between group companies is a common occurrence especially when a subsidiary manufactures goods and the parent or another subsidiary distributes, wholesales or retails the goods

- ## Group turnover and cost of sales

- Transfers of goods between group companies will be included in the transferring company's turnover figure, as it represents a sale for that organisation. It will also be included as part of the recipient company's costs (purchases). As the consolidated accounts are the accounts of the group as a single entity, this internal sale cannot be recognised in the group accounts. Accordingly this overstatement of turnover and costs of sales must be eliminated.

  The required journal is:

  Dr Revenue (or turnover)

  Cr Cost of sales

  Cost of sales is credited as purchases are transferred to cost of sales at the end of the year.

Example

Wester Ltd owns 90% of Hailes Ltd. During the year to 31 December 2021 Wester sold goods to Hailes totalling Tzs 410,000.

Extracts from the Statement of Financial Operations of the two companies are as follows:

	Wester	**Hailes**	**Total**
	Tzs	**Tzs**	**Tzs**
Turnover	6,000,000	4,000,000	10,000,000
Cost of sales	(4,000,000)	(3,000,000)	(7,000,000)
Gross profit	2,000,000	1,000,000	3,000,000

Required: Prepare the necessary consolidation adjustment.

Solution

The totals for sales and cost of sales are both overstated from the group perspective. They include the effect of an internal transfer of Tzs 410,000.

The following adjustment should be made:

		Tzs	Tzs
Dr	Turnover	410,000	
Cr	Cost of sales		410,000

Being elimination of internal transfer of goods

This type of adjustment must always be done wherever there are internal transfers of goods or services.

Internal unrealised profit

Where internally transferred items are subsequently sold to parties outside the group, the profit – including any profit on the internal transfer – is **realised** from the group point of view and can be included in the consolidated Statement of Financial Operations.

Where **transferred items are unsold** at the year-end they will be included in closing stock. Any internal transfer profit is **unrealised** from the group viewpoint as the goods have not been sold to anyone outside the group. They have merely been transferred from one part of the entity, the group, to another.

Closing stock will be overvalued (as the buying company will value stock at the lower of its cost price and NRV) and must be reduced by eliminating the unrealised profit and by getting back to the original cost of the goods to the group. The effect of this is to reduce stock in the balance sheet and to increase cost of sales (cost of sales = opening stock and purchases – closing stock, and by reducing closing stock, cost of sales is increased).

The adjustment is:

Dr Cost of sales (P/L)

Cr Stock (B/S)

Being elimination of unrealised profit on transfer of goods within the group

Example

Tree Ltd & Branch Ltd

The Statement of Financial Operations of Tree Ltd and its wholly owned subsidiary undertaking Branch Ltd for the year ended 30 June 2021 include the following figures:

	Tree Ltd	**Branch Ltd**
	Tzs	**Tzs**
Turnover	1,353,000	936,000
Cost of sales	(1,065,000)	(727,000)
Gross profit	288,000	209,000

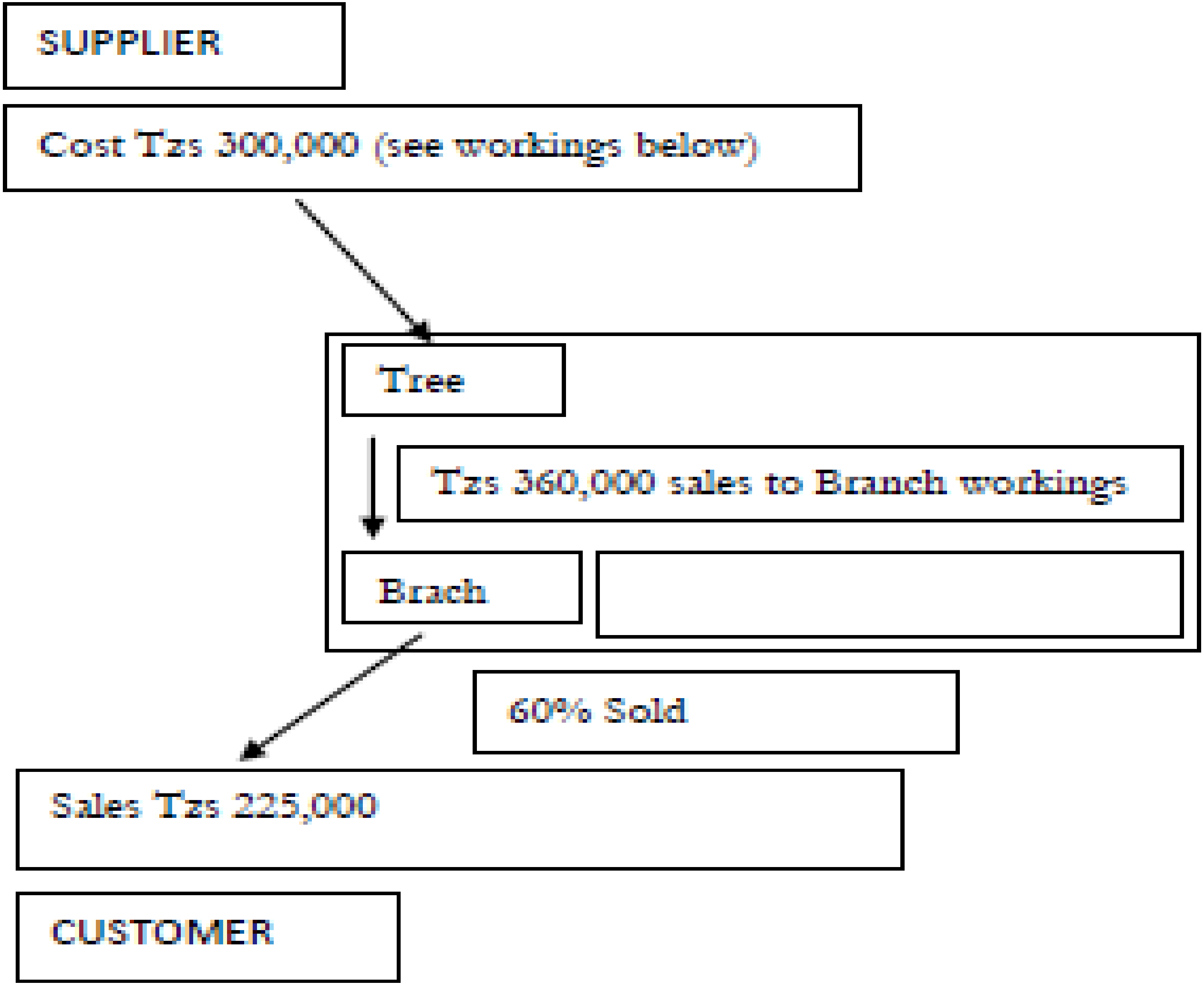
The following information is also available:

1. During the year Tree Ltd sold goods to Branch Ltd at invoice price Tzs 360,000. Goods are sold by Tree at a mark-up on cost of 20%.

2. Branch sold 60% of the goods to a third party for Tzs 225,000. The remaining goods purchased from Tree Ltd were held as stock by Branch Ltd at 30 June 2021.

Required:

Prepare any necessary consolidation adjustments.


SUPPLIER
Cost Tzs 300,000 (see workings below)
Tree
Tzs 360,000 sales to Branch workings
Brach
60% Sold
Sales Tzs 225,000
CUSTOMER

We know from the earlier example that sales and cost of sales are overstated by Tzs 360,000 and should be adjusted.

			Tzs	Tzs
(1)	Dr	Turnover	360,000	
	Cr	Cost of sales		360,000

Being elimination of internal transfer of goods

In this case there is an additional problem as not all the goods have been sold and therefore **not all of the internal profit is realised**.

Mark-up of 20%

Cost	***100***
Mark-up	***20***
∴Sales price	***120***

Or, generally

Cost	***100***
Mark-up	***x***
∴ SP	***$100 + x$***

Gross profit of 25%

Sales	***100***
Gross profit	***25***
∴Cost	***75***

or, generally

Sales	***100***
GP	***x***
∴Cost	***$100 – x$***

Mark-up of 20%

	%	**Tzs**
Sales	120	360,000
Cost	100	300,000
Mark-up	20	60,000

This figure represents the total internal profit made on the sale.

As 40% of these goods are still in stock at the year end, then the group's stock is overvalued by 40% x Tzs60,000 = Tzs24,000.

	Tzs
In Branch's accounts (40% x Tzs 360,000)	144,000
From group perspective – original cost(40% x Tzs 300,000)	120,000
Reduction required	24,000

We therefore need to reduce the value of stock by Tzs 24,000.

The correcting journal entry is therefore:

		Tzs	Tzs
(2) Dr	Cost of sales (P/L)	24,000	
Cr	Stock (B/S)		24,000

Being elimination of unrealised profit on transfer of goods

The consolidation adjustments will be posted and will result in the following:

	Tree Ltd	Branch Ltd	Total		Adjustment		Consolida tion
	Tzs	Tzs	Tzs		Tzs	Tzs	Tzs
					DR	CR	
Turnover	1,353,000	936,000	2,289,000	(1)	360,000		1,929,000
Cost of sales	(1,065,000)	(727,000)	(1,792,000)	(2)	24,000	(1) 360,000	(1,456,000)
Gross profit	288,000	209,000	497,000				473,000

The net effect is to reduce consolidated gross profit by Tzs 24,000, the unrealised amount of profit on the transfer of goods.

Unrealised profit and Non-controlling interests

We have seen that all profits arising from internal transactions should be eliminated.

Where some of those profits are attributable to Non-controlling interests, ie the subsidiary is not wholly owned, the whole profit must be eliminated (not just the group's share) and appropriate proportions set against Non-controlling interests.

NCI only become involved where the goods are transferred from a non-wholly owned subsidiary to the parent. In this situation the unrealised profit is being eliminated from the subsidiary's accounts thereby reducing its profits. **The effect of this is to reduce the NCI share of these profits**.

This can be done as a separate entry as follows

Dr NCI – B/S

Cr NCI – P/L

Being adjustment to NCI for share of unrealised profit on stock transfer

TRANSFER OF FIXED ASSETS

Transfer of fixed assets between group companies cause similar problems to those concerned with internal stock transfers. The objective is to make adjustments on consolidation to return to the position as if the transfer had not taken place.

Transfer at a profit

Where a fixed asset is transferred within a group at an amount greater than the net book value in the transferor's books, any transfer profit must be cancelled on consolidation as the gain is unrealised.

However, the transaction has an additional effect as far as the group is concerned, as the transferee will have charged depreciation on this 'new' value - ie the transfer value. This may be different from the depreciation that would have been charged had the asset not been transferred. They will also depreciate over the assets remaining useful life from the point of transfer.

Our adjustments need to ensure that:

cost and accumulated depreciation are returned to original amounts

any gain on disposal is eliminated

Depreciation is suitably adjusted.

The required adjustments are illustrated in the following example.

Example

Mac plc

Mac plc sells an item of machinery to its 80% subsidiary, Tennant Ltd, for TZS153,000 on 15 July 2021. The machine was originally purchased on 9 January 2020 for TZS100,000. Group depreciation policy is to depreciate over 10 years (or remaining useful life if shorter) on a straight line basis, assuming no residual value, and charging depreciation in the month of acquisition but not in the month of disposal.

Required:

What adjustments are required on consolidation?

Solution

What has happened relating to the disposal:

Mac plc's books:		**Tzs**	**Tzs**
Dr	Bank	153,000	
Dr	Accumulated depreciation (P+M)	15,000	
Cr	Cost (P+M)		100,000
Cr	Gain on sale of FA		68,000

Being disposal of plant by Mac. Note: no depreciation is charged in the month of disposal so accumulated depreciation at the date of disposal is TZS 100,000/10 x 8/12 = TZS 15,000.

Tennant Ltd's books:		**TZS**	**TZS**
Dr	Fixed asset (P+M)	153,000	
Cr	Bank		153,000

Being purchase of plant from Mac

		TZS	**TZS**
Dr	Depreciation charge	9,000	
Cr	Accumulated depreciation		9,000

Being depreciation charge for year of acquisition, based on remaining 8½ years useful life (TZS 153,000/8.5 x $^{6}/_{12}$).

- Remember that as far as the individual companies are concerned, both the Tzs 68,000 profit on transfer and the depreciation charge of Tzs 9,000 are perfectly valid within Mac plc's and Tennant Ltd's own accounts. But because the mechanics of consolidation aggregate the two balance sheets, we must adjust both the cost of the asset and its depreciation to show the group's position as if the asset had never been transferred. This requires one journal to remove the gain on disposal and adjust the cost and accumulated depreciation and another to adjust the current year depreciation charge.

Consolidation adjustments:

			Tzs	**Tzs**
Dr	Gain on sale of FA (P/L) 68,000			
	Cr	Fixed asset (P+M)		53,000
	Cr	Accumulated depreciation (P+M)		15,000

being removal of gain and reinstatement of original cost and accumulated depreciation

The depreciation for July to December on the original cost is Tzs 5,000 (Tzs 100,000/10 x $^{6}/_{12}$). Therefore an extra Tzs 4,000 has been charged by Tennant. This should be adjusted for on consolidation.

			Tzs	Tzs
Dr	Accumulated depreciation (P&M)		4,000	
	Cr	Depreciation charge (P/L)		4,000

being adjustment to overstated depreciation charge

As with stock we have to consider the Non-controlling interest position. If there is a Non-controlling interest in the subsidiary there is bound to be an adjustment as the Statement of Financial Operations of the subsidiary will be affected either by:

if the subsidiary is the seller the elimination of the gain or loss on disposal, or

(ii) if the subsidiary is the buyer, the change in the depreciation charge.

In this case the subsidiary is the buyer and Tzs 4,000 has been added to the subsidiary's profits (the depreciation charge is Tzs 4,000 lower).

		Tzs	Tzs
Dr	Non-controlling interest (P/L)	800	
Cr	Non-controlling interest (B/S)		800

being adjustment to Non-controlling interest arising from transfer of fixed asset (20% x Tzs 4,000).

ACCOUNTING FOR ASSOCIATES

IAS28: Investments in Associates and Joint Ventures

- As an investor has significant influence over an associate, it has a measure of responsibility for the associates' performance, and the return on its investment. This would not be evidenced merely by retaining the investment at cost and recording dividends received. Neither is consolidation - full or partial – appropriate as the investor does not control – wholly or jointly – the net assets of an associate.
- The investor accounts for its stewardship by including its share of the results and net assets of an associate in its consolidated financial statements each year using equity accounting.
- With equity accounting the investor's share of the net position of the investee is not combined in the financial statements on a line-by-line basis with the investor's results, assets and liabilities ie it is different from full and proportional consolidation. Instead selected items only are included in the group accounts.

The investor's consolidated Statement of Financial Operations

- **IAS 28 (para 11) states only that the Statement of Financial Operations should reflect the investor's share of the results of an associate.**
- Following the illustration of a group income statement in IAS 1 the amount to be included is the share of the associate's profit after tax. It should however be presented in arriving at the group's profit before tax.

The investor's consolidated balance sheet

The investment is initially recorded at cost and is subsequently adjusted for the following:

1) **share of the profits or losses since acquisition;**
2) **dividends from the associate; and**
3) **share of other changes to shareholders funds eg revaluation of assets.**

Any goodwill element of the cost of the investment in the associate must be identified and be subject to impairment review.

Consolidation and equity accounting

- There is a fundamental difference between the way consolidation and equity accounting operate. With consolidation at STEP 1 all of the assets, profits etc are added together and a non controlling element is then adjusted for. Under equity accounting the figures from the associate's balance sheet and Statement of Financial Operations are not included on a line-by-line basis and we only bring in the group share of the selected items mentioned above. There is therefore no equivalent to STEP 1 of the consolidation process.

As the process is different to consolidation we will adopt a different series of steps.

- **STEP1:** Calculate goodwill arising on acquisition and adjust for any impairment.
- **STEP2:** Adjust for share of post-acquisition retained profits/gains and losses up to last balance sheet date
- **STEP3:** Adjust for group share of associate's profit after tax for the current period and for any other gains or losses eg revaluation gain.
- **STEP4:** Adjust for any internal transactions eg dividends.
- **FINAL STEP:** Transfer adjustment to Statement of Financial Operations to profit and loss reserves.

Example

Scarborough Group & Fair Ltd

On 1 October 2020 Scarborough Ltd purchased 40% of the share capital of Fair Ltd for Tzs 75,000. The reserves of Fair Ltd at 1 October 2020 were Tzs100,000.

By 30 September 2021 the balance sheets and Statement of Financial Operations were as follows:

Balance Sheets

	Scarborough Group	**Fair Ltd**
	Tzs	**Tzs**
Investment in Fair Ltd	75,000	-
Other net assets	446,000	160,000
	521,000	160,000
Share capital	100,000	50,000
Profit and loss reserves	421,000	110,000
	521,000	160,000

	Scarborough Group	**Fair Ltd**
	Tzs	**Tzs**
Statement of Financial Operations		
Operating profit	120,000	58,000
Interest paid	(15,000)	(8,000)
Profit before tax	105,000	50,000
Taxation	(25,000)	(10,000)
Profit for the year	80,000	40,000

Additional Information

1) The operating profit of Scarborough includes its share of the dividends from Fair.
2) Fair paid a dividend of Tzs 30,000 during 2021.
3) Goodwill is not impaired.

Required:

Prepare the Scarborough Group accounts including Fair Ltd accounted for using the equity method.

As the goodwill element has to be tested for impairment we still need to calculate goodwill to establish whether it is positive or negative. The requirements of IFRS 3 apply to the equity method.

Calculate whether positive or negative goodwill arose on the acquisition.

	Tzs	Tzs
Cost		75,000
Share capital	50,000	
Profit and loss reserve	100,000	
	150,000	
40%		60,000
Goodwill		15,000

If the goodwill on acquisition is positive no adjustment is made unless the goodwill is impaired in which case it will be written down. The goodwill is part of the investment in the associate, therefore the journal to write-off goodwill in the year is:

Dr P/L reserve (impairment in previous years)	X	
P/L account (impairment in current year)	X	
Cr Investment in associate		X

If goodwill on acquisition is negative credit to profit and loss

In this example goodwill is not impaired.

STEP 2

Adjust investment in associate to reflect group share of profits (or losses) and other gains and losses (eg from revaluation) from acquisition to the last balance sheet date.

In this case the associate was acquired at the last balance sheet date and no adjustment is necessary. The net assets acquired equalled Tzs 60,000 and this was our share.

STEP 3

Adjust investment in associate and group profit and loss for share of profits/gains (or losses) for current period

			Tzs	Tzs
(1)	Dr	Investment in associate	16,000	
	Cr	P/L – share of PAT		16,000

being share of profits of associate and resultant increase in share of net assets

The debit to investment in associate in the balance sheet represents the net increase in the group's share of the net assets of the associate arising from the profit after tax earned by the associate. Profits increase net assets; losses reduce net assets.

STEP 4

Adjust for internal transactions

			Tzs	Tzs
(2)	Dr	Operating profit	12,000	
	Cr	Investment in associate		12,000

being elimination of dividends from associate and effect on group share of net assets.

Dividends paid by an associate reduce net assets of the associate and therefore the group's share of those net assets. Therefore we need to credit investment in associate. The group has included their share of the dividends of the associate in operating profit. To avoid double counting we need to eliminate this.

In other situations transfer of stock, fixed assets etc. may require adjustments.

The combination of (1) and (2) is a net debit to the investment in associate of Tzs 4,000 (Tzs16,000 less Tzs12,000). This represents the group's share of the increase in the net assets of the associate during 2021:

	Tzs
Net assets – 30.9.2021	160,000
Net assets – 30.9.2020	150,000
Increase	10,000
Group share (40%)	4,000

FINAL STEP

Final adjustment

		Tzs	Tzs
(3)Dr	Statement of Financial Operations	4,000	
Cr	Profit and loss reserve		4,000

being transfer of net effect on profit from Statement of Financial Operations to profit and loss reserve.

This is made up of:

	Tzs
JE1 – share of profit after tax	16,000
JE2 – dividends of associate	(12,000)
	4,000

Puting the adjustments through a spreadsheet gives:

	Scarborough Group	Adjustments		Consolidated
	Tzs	Tzs	Tzs	Tzs
		DR	CR	
Fixed assets				
Investment in Fair	75,000	(1)16,000	(2)12,000	79,000
Other net assets	446,000			446,000
	521,000			525,000
Capital and reserves				
Share capital	100,000			100,000
Profit and loss reserve	421,000		(3)4,000	425,000
	521,000			525,000
Operating profit – group	120,000	(2)12,000		108,000
Interest - group	(15,000)			(15,000)
Share of profit of associate			(1)16,000	16,000
Profit before tax	105,000			109,000
Taxation	(25,000)			(25,000)
Profit after tax	80,000	28,000		84,000
		(3)4,000		
		36,000	36,000	

This would give the following:

Scarborough Group

Consolidated Balance Sheet as at 30 September 2021

	Tzs
Fixed Assets	
Investments - investment in associate	79,000
Other net assets	446,000
	525,000
Capital and reserves	
Share capital	100,000
Profit and loss reserve	425,000
	525,000

Consolidated Statement of Financial Operations

For the year to 30 September 2021

	Tzs
Group operating profit	108,000
Interest payable	(15,000)
Share of profit of associate	16,000
Profit before tax	109,000
Taxation	(25,000)
Profit for the year	84,000

Summary of equity accounting

- **Equity accounting does not aggregate the balance sheet of the associate but shows only the group's share of the associate's net assets plus any goodwill on acquisition. The group's share of profit should be included in the consolidated Statement of Financial Operations.**