



# The Basic Mechanics of Consolidations

Group accounts crop up in various settings. This paper will look at the preparation of simple consolidated balance sheets for the simplest possible case. Even if you have progressed to a more complex set of problems in a higher-level paper you might find the basic approach described here helpful.

Basically, consolidated financial statements are prepared when a group of separate companies must be presented as a single economic unit. **Preparing one set of statements from those of the various group members is a matter of adding the various group financial statements together.** Before doing so, however, **it is necessary to cancel any interrelationships between group members.**

Consolidation boils down to a mechanical process of cancelling figures that only relate to relationships within the group and then adding the remaining figures together. One approach to keeping track of the various workings is to use double entry bookkeeping to organise things efficiently. One advantage is that you will be almost certain to produce a square consolidated balance sheet at the end of the process.

Once you have mastered the basic process of cancelling internal relationships within the group, you will find that the further complexities.

**The preparation of a consolidated balance sheet involves five steps:**

- Establish what has been acquired and how much was paid for it. Use this information to calculate the goodwill on consolidation.
- Adjust for any minority interest in the subsidiary or subsidiaries.
- Adjust for any “fiddly bits”, such as differences on inter-company current accounts or unrealised profit on inventory.
- Calculate the balances on the reserves.
- Prepare the consolidated balance sheet.

The point of all this is that if the workings are laid out in a logical manner, the balance sheet can be written out very quickly.

Notice that the mechanical nature of this approach does not suggest that you should not think about the meaning of each adjustment as you go along.

**Example** – drawn from ACCA CAT paper T6 (Int)

Question 2 from the December 2005 paper is a very good example of a basic consolidation question.

*Establish what has been acquired*

The holding company's balance sheet shows an investment of \$660 million in respect of its investment in the subsidiary. The holding company purchased an 80% stake in the subsidiary "some years ago", at a time when the subsidiary had equity of \$600 million in share capital and \$95 million in reserves.

The process of cancelling that was described above means that there is a \$660 million asset in the holding company's balance sheet and this has to be offset against the associated obligation in the subsidiary's equity (80% of the equity as at the date those shares were purchased).

This question is complicated slightly by the fact that the subsidiary's non-current assets were worth more than their book value as at the date of acquisition. The question says that freehold land was worth \$70 million more than its book value at the date of the holding company's acquisition. Ideally, this would have been dealt with by revaluing the assets in the subsidiary's books, but the subsidiary has chosen not to do so in this case.

The best way to cancel these balances is to transfer them into a T account called "cost of control":

Cost of control			
	\$000		\$000
Investment in sub	660,000	Share capital	480,000
		Reserves	76,000 (80% x \$95 million)
		Revaluation	56,000 (80% x \$70 million)
		Goodwill c/d	48,000
	<u>660,000</u>		<u>660,000</u>
Goodwill b/d	48,000		

The figure for goodwill is a balancing figure that appears in the consolidated balance sheet. Generally, the figure will not change from one year to the next, although companies are obliged to check that it has not been impaired.

*Minority interest*

The minority shareholders are entitled to a percentage of all of the subsidiary's equity, in proportion to their shareholding.

Again, it is useful to present the calculation as a T account:

		Minority interest	
		\$000	\$000
			Share capital 120,000 (20% x \$600 million)
			Reserves 42,400 (20% x \$212 million)
Bal c/d	176,400		Revaluation 14,000 (20% x \$70 million)
	<u>176,400</u>		<u>176,400</u>
			Bal b/d 176,400

The minority interest is an unusual balance. It cannot really be treated as group equity because the minority shareholders have invested in the subsidiary rather than in the group as a whole. We will treat the minority interest as a non-current liability (even though it is not really a loan either).

### *“Fiddly bits”*

There are often adjustments at this stage. Only three need to be made here:

- 1) The subsidiary has some inventory that was purchased from the holding company. The holding company has shown a profit on this sale of \$12 million. That profit has not yet been realised by the group as a whole, so it needs to be cancelled. We can do so by means of a journal entry:

Debit	Reserves	\$12 million
	Credit	Inventory
		\$12 million

- 2) The subsidiary owes \$25 million to the holding company for goods purchased during the year. This means that there are offsetting balances of \$25 million in the group’s trade receivables and trade payables figures:

Debit	Receivables	\$25 million
	Credit	Payables
		\$25 million

- 3) We need to increase the book value of group non-current assets to reflect the revaluation. We have already credited the cost of control and the minority interest accounts, so it is just a matter of remembering to increase non-current assets.

The two balance sheet figures are \$315 million and \$278 million, so the adjusted total = 315 + 278 + 70 = \$663 million.

The revalued asset was freehold land. If it had been an asset that had a finite useful life then there would have been an additional depreciation charge that would have been debited to group reserves and credited to non-current assets.

### *Reserves*

This is the most difficult figure to get right, but the fact that we have used double entry and left reserves until last means that we don’t have to do any work beyond updating the T account for reserves to reflect the corresponding entries that have already been made:

Reserves			
	\$000		\$000
Cost of control	76,000	Holding co bal b/d	580,000
Minority interest	42,400	Sub bal b/d	212,000
Inventory	12,000		
Bal c/d	661,600		
	<u>792,000</u>		<u>792,000</u>
		Bal b/d	<u>661,600</u>

*Prepare the consolidated balance sheet*

This is really just a matter of adding together those figures in the separate financial statements that have not been adjusted. The remaining figures are supported by workings:

**Spyder**

**Consolidated Balance Sheet as at 31 October 2005**

<b>Assets</b>	\$000	\$000
<i>Non-current assets</i>		
<i>Intangible</i>		
Goodwill on consolidation		48,000
<i>Tangible</i>		
Land and buildings		663,000
Plant		<u>505,000</u>
		1,216,000
<i>Current assets</i>		
Inventory	597,000	
Trade receivables	626,000	
Bank	<u>188,000</u>	
		1,411,000
Total assets		<u><u>2,627,000</u></u>
<b>Equity and liabilities</b>		
<i>Capital and reserves</i>		
\$1 Ordinary shares		1,500,000
Reserves		<u>661,600</u>
		2,161,600
<i>Non-current liabilities</i>		
Minority Interest		176,400
<i>Current liabilities</i>		
Payables		<u>289,000</u>
Total equity and liabilities		<u><u>2,627,000</u></u>

If you wish, you can download the question from ACCA's web site. The examiner's answer is also available, although that is presented in a more condensed manner. Note also that changes in the rules for

**accounting for intangible fixed assets means that goodwill on consolidation is now unlikely to be written off.**