22 Consolidation: intragroup transactions

ACCOUNTING STANDARDS IN FOCUS

IFRS 10 *Consolidated Financial Statements*

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. explain the need for making adjustments for intragroup transactions
2. prepare worksheet entries for intragroup transactions involving profits and losses in beginning and ending inventory
3. prepare worksheet entries for intragroup services such as management fees
4. prepare worksheet entries for intragroup dividends
5. prepare worksheet entries for intragroup borrowings.

INTRODUCTION

In this chapter, the group under discussion is restricted to one where:

- there are only two entities within the group (i.e. one parent and one subsidiary)
- the parent owns all the shares of the subsidiary.

Diagrammatically, then, the group is as shown in figure 22.1.

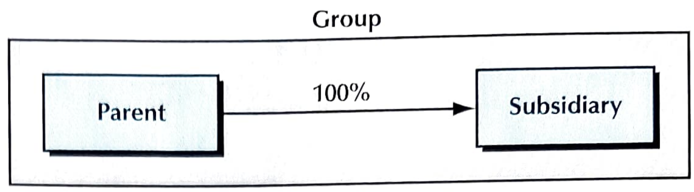

FIGURE 22.1 Group

In chapter 20, it is explained that the process of consolidation involves adding together the financial statements of a parent and its subsidiaries to reflect an overall view of the financial affairs of the group of entities as a single economic entity. It is also pointed out that two major adjustments are necessary to effect the process of consolidation:

(a) adjustments involving equity at the acquisition date, namely the business combination valuation entries (if any) and the elimination of investment in subsidiary, eliminating the investment account in the parent's financial statements against the pre-acquisition equity of the subsidiary *(see chapter 21)*

(b) elimination of intragroup balances and the effects of transactions whereby profits or losses are made by different members of the group through trading with each other.

This chapter focuses on (b), adjustments for intragroup balances and transactions. The chapter analyses transactions involving inventory, depreciable assets, services, dividends and borrowings.

LO1

22.1 RATIONALE FOR ADJUSTING FOR INTRAGROUP TRANSACTIONS

Whenever related entities trade with each other, or borrow and lend money to each other, the separate legal entities disclose the effects of these transactions in the assets and liabilities recorded and the profits and losses reported. For example, if a subsidiary sells inventory to its parent, the subsidiary records a sale of inventory, including the profit on sale and reduction in inventory assets, and the parent records the purchase of inventory at the amount paid to the subsidiary. If, then, in preparing the consolidated financial statements, the separate financial statements of the legal entities are simply added together without any adjustments for the effects of the intragroup transactions, the consolidated financial statements include not only the results of the group transacting with external entities (i.e. entities outside the group) but also the results of transactions within the group. This conflicts with the purpose of the consolidated financial statements to provide information about the financial performance and financial position of the group as a result of its dealings with external entities. Hence, the effects of transactions within the group must be adjusted for in the preparation of the consolidated financial statements.

The requirement for the full adjustment for the effects of intragroup transactions is stated in paragraph B86(c) of IFRS 10 *Consolidated Financial Statements*:

> eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full). Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. IAS 12 *Income Taxes* applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.

Besides adjusting for the effects of transactions occurring in the current period, it is also necessary to adjust the current period's consolidated financial statements for the ongoing effects of transactions in previous periods. Because the consolidation adjustment entries are applied in a worksheet only, and not in the accounts of either the parent or the subsidiary, any continuing effects of previous periods' transactions must be considered. This affects transactions such as loans between, say, a parent and a subsidiary where a balance owing at the end of a number of periods is reduced over time as repayments are made. Similarly, where assets such as inventory are transferred at the end of one period and then are still on hand at the beginning of the next period, consolidation adjustments are required to be made in both periods.

Some intragroup transactions do not affect the carrying amounts of assets and liabilities (e.g. where there is a management fee paid by one entity to another within the group). In that case, the items affected are fee revenue and fee expense. However, in other circumstances, there are assets and liabilities recognised by the group at amounts different from the amounts recognised by the individual legal entities. For example, consider the situation where a subsidiary sold an item of inventory to the parent for $1000 and the inventory had cost the subsidiary $800. The parent recognises the inventory at cost of $1000, whereas the cost of the inventory to the group is only $800. As is explained in more detail later in this chapter, consolidation adjustment entries are necessary to adjust for both the profit on the intragroup transaction and the carrying amount of the inventory.

Under IAS 12 *Income Taxes*, deferred tax accounts must be raised where there are temporary differences between the carrying amount of an asset or liability and its tax base. Any difference between the carrying amount of an asset or a liability and its tax base in a legal entity within the group is accounted for by the legal entity. However, on consolidation, in relation to intragroup transactions, adjustments may be made to the carrying amounts of assets and liabilities. Hence, in adjusting for intragroup transactions wherever there are changes to the carrying amounts of assets and liabilities, any associated tax effect must be considered. Paragraph B86(c) of IFRS 10 recognises the need to apply tax-effect accounting for temporary differences arising from the elimination of profits and losses from intragroup transactions.

For example, assume an asset is recorded by a subsidiary at a carrying amount of $1000, and that the tax base is $800. In the records of the subsidiary, the application of tax-effect accounting will account for the temporary difference of $200, raising a deferred tax liability of $60, assuming a tax rate of 30%. If, on consolidation, an adjustment is made to reduce the carrying amount of the asset, say to $950, the consolidation adjustment entries must include an adjustment for the tax effect of the change in the carrying amount of the asset, namely a reduction in the deferred tax liability of $15 (i.e. 30% × $50). The consolidated financial statements then show a deferred tax liability of $45 (i.e. $60 – $15). The combination of the tax-effect entries in the subsidiaries and the tax-effect adjustments on consolidation will account for the temporary difference caused by the group showing the asset at $950 and the tax base being $800, namely a deferred tax liability of $45 (i.e. 30% × ($950 – $800)).

As can be seen in this example, in preparing the consolidation adjustments it is unnecessary to consider the tax-effect entries made in the individual entities in the group. If the appropriate tax-effect adjustments are made for changes in the carrying amounts of the assets, then the combination of those adjustments and the tax-effect entries made in the entities themselves will produce the correct answer.

In this book, it is assumed that each subsidiary is a tax-paying entity. Under the tax consolidation system in some countries, groups comprising a parent and its wholly owned subsidiaries can elect to consolidate and be treated as a single entity for tax purposes. Such entities prepare a consolidated tax return, and the effects of intragroup transactions are eliminated. Under such a scheme, the tax-effect adjustments demonstrated in this chapter would not apply.

Just as the elimination of investment in subsidiary is used in a consolidation worksheet to eliminate the investment and to adjust for pre-acquisition equity, adjustment journal entries are prepared for intragroup transactions and are recorded in the consolidation worksheet. The same two adjustment columns are used to effect these adjustments. For example, if it were necessary to adjust downwards by $10 000 the sales revenue recorded by the legal entities, the consolidation worksheet would show the following line:

			Adjustments		
	Parent	Subsidiary	Dr	Cr	Group
Sales revenue	100 000	80 000	10 000		170 000

In the following sections of this chapter, two types of intragroup transactions are discussed — transfers of inventory and intragroup services. In each of the specific sections covering these transactions, the process of determining when profits are realised for the different types of transactions is discussed.

LO2

22.2 TRANSFERS OF INVENTORY

In the following examples, assume that Jessica Ltd owns all the share capital of Amelie Ltd, and that the consolidation process is being carried out on 30 June 2016, for the year ending on that date. Assume also a tax rate of 30%. All entries shown as being for the individual entities assume the use of a perpetual inventory system, and adjustments will be made, where necessary, to cost of sales.

22.2.1 Sales of inventory

Example: Intragroup sales of inventory

On 1 January 2016, Jessica Ltd acquired $10 000 worth of inventory for cash from Amelie Ltd. The inventory had previously cost Amelie Ltd $8000.

In the accounting records of Amelie Ltd, the following journal entries are made on 1 January 2016:

Cash	Dr	10 000	
Sales Revenue	Cr		10 000
Cost of Sales	Dr	8 000	
Inventory	Cr		8 000

In Jessica Ltd, the journal entry is:

Inventory	Dr	10 000	
Cash	Cr		10 000

From the viewpoint of the group in relation to this transaction, no sales of inventory were made to any party outside the group, nor has the group acquired any inventory from external entities. Hence, if the financial statements of Jessica Ltd and Amelie Ltd are simply added together for consolidation purposes, 'sales', 'cost of sales' and 'inventory' will need to be adjusted on consolidation as the consolidated financial statements must show only the results of transactions with entities external to the group.

22.2.2 Realisation of profits or losses

Paragraph B86(c) of IFRS 10 states that the profits and losses resulting from intragroup transactions that require consolidation adjustments to be made are those 'recognised in assets'. These profits can be described as 'unrealised profits'. The test for realisation is the involvement of an external party in relation to the item involved in the intragroup transaction. If an item of inventory is transferred from a subsidiary to the parent entity (or vice versa), no external party is involved in that transaction. The profit made by the subsidiary is unrealised to the group. If the parent then sells that inventory item to a party external to the group, the intragroup profit becomes realised to the group. For example, assume a subsidiary, Amelie Ltd, sells inventory to its parent, Jessica Ltd, for $100, and that inventory cost Amelie Ltd $90. The profit on this transaction is unrealised. If Jessica Ltd sells the inventory to an external party for $100, the intragroup profit is realised. The group sold inventory that cost the group $90 to an external party for $100. The group has made $10 profit. Hence, the consolidation adjustments for profits on intragroup transfers of inventory depend on whether the acquiring entity has sold the inventory to entities outside the group. In other words, the adjustments depend on whether the acquiring entity still carries some or all of the transferred inventory as ending inventory at the end of the financial period.

22.2.3 Profits in ending inventory

The following example uses the information in the example in section 22.2.1 and provides information about whether the inventory transferred is still on hand at the end of the financial period.

Example: Transferred inventory still on hand

On 30 June 2016, all the inventory sold by Amelie Ltd to Jessica Ltd is still on hand. The adjustment entries in the consolidation worksheet at 30 June 2016 are:

Sales Revenue	Dr	10 000	
Cost of Sales	Cr		8 000
Inventory	Cr		2 000

The sales adjustment is necessary to eliminate the effects of the original sale in the current period. Amelie Ltd recorded sales of $10 000. From the group's viewpoint, as no external party was involved in the transaction, no sales should be shown in the consolidated financial statements. To adjust sales revenue downwards, a debit adjustment is necessary. The effect of this adjustment on the consolidation process is seen in figure 22.2. Hence, an adjustment is necessary to eliminate the sales recorded by Amelie Ltd.

Using similar reasoning as with the adjustment for sales revenue, the subsidiary has recorded cost of sales of $8000, but the group has made no sales to entities external to the group. Hence, the consolidation worksheet needs to have a reduction in cost of sales of $8000 in order to show a zero amount in the consolidation column. Note also that adjusting sales by $10 000 and cost of sales by $8000 effectively reduces consolidated profit by $2000. In other words, the $2000 profit recorded by Amelie Ltd on selling inventory to Jessica Ltd is eliminated and a zero profit is shown on consolidation. As no external party was involved in the transfer of inventory, the whole of the profit on the intragroup transaction is unrealised. This is illustrated in figure 22.2.

	Parent	Subsidiary		Adjustments Dr	Adjustments Cr		Group
Sales revenue	0	10 000	1	10 000			—
Cost of sales	0	8 000			8 000	1	—
		2 000					
Tax expense	0	600			600	2	—
Profit		1 400					—
Inventory	10 000	—			2 000	1	8 000
Deferred tax asset	—	—	2	600			600

FIGURE 22.2 Extract from consolidation worksheet — profit in closing inventory

The previous explanation dealing with the effect on profit covers only the statement of profit or loss and other comprehensive income part of the adjustment. Under the historical cost system, assets in the consolidated statement of financial position must be shown at cost to the group. Inventory is recorded in Jessica Ltd at $10 000, the cost to Jessica Ltd. The cost to the group is, however, $8000, the amount that was paid for the inventory by Amelie Ltd to entities external to the group. Hence, if inventory is to be reported at $8000 in the consolidated financial statements, and it is recorded in Jessica Ltd's records at $10 000, a credit adjustment of $2000 is needed to reduce the inventory to $8000, the cost to the group. This effect is seen in figure 22.2.

Jessica Ltd has recorded the inventory in its records at $10 000. This amount is probably also its tax base. However, *as explained in section 22.1*, any difference between the tax base and the carrying amount in Jessica Ltd is accounted for in the tax-effect entries in Jessica Ltd. On consolidation, a tax-effect entry is necessary where an adjustment entry causes a difference between the carrying amount of an asset or a liability in the records of the legal entity and the carrying amount shown in the consolidated financial statements. In the adjustment entry relating to profit in ending inventory in the above example, the carrying amount of inventory is reduced downwards by $2000. The carrying amount and tax base of the inventory in Jessica Ltd is $10 000, but the carrying amount in the group is $8000. This $2000 difference is a deductible temporary difference giving rise to a deferred tax asset of $600 (i.e. 30% × $2000), as well as a corresponding decrease in income tax expense. The appropriate consolidation worksheet adjustment entry is:

Deferred Tax Asset	Dr	600	
Income Tax Expense	Cr		600

The effects of this entry are shown in figure 22.2.

The deferred tax asset recognises that the group is expected to earn profits in the future that will not require the payment of tax to the Taxation Office. When the inventory is sold by Jessica Ltd in a future period, this temporary difference is reversed. To illustrate this effect, assume that in the following period Jessica Ltd sells this inventory to an external entity for $11 000. Jessica Ltd will record a before-tax profit of $1000 (i.e. $11 000 − $10 000) and an associated tax expense of $300. From the consolidated group position, the profit on sale is $3000 (i.e. $11 000 − $8000). The group will show current tax payable of $300, reverse the $600 deferred tax asset, and recognise an income tax expense of $900. These effects are further illustrated below.

Example: Transferred inventories partly sold

On 1 January 2016, Jessica Ltd acquired $10 000 worth of inventory for cash from Amelie Ltd. The inventory had previously cost Amelie Ltd $8000. By the end of the year, 30 June 2016, Jessica Ltd had sold $7500 of the transferred inventory for $14 000 to external entities. Thus, $2500 of the inventory is on hand in Jessica Ltd at 30 June 2016.

The adjustment entry for the preparation of consolidated financial statements at 30 June 2016 is:

Sales	Dr	10 000	
Cost of Sales	Cr		9 500
Inventory	Cr		500

The total sales recorded by the *legal entities* are $24 000; that is, $10 000 by Amelie Ltd and $14 000 by Jessica Ltd. The sales by the *group*, being those sold to entities external to the group, are $14 000. The consolidation adjustment to sales revenue is then $10 000, being the amount necessary to eliminate the sales within the group.

The total cost of sales recorded by the *legal entities* is $15 500; that is, $8000 by Amelie Ltd and $7500 by Jessica Ltd (i.e. 75% × $10 000). The cost of sales to the *group*, being those to entities external to the group, is $6000 (i.e. 75% × $8000). Hence, the consolidation adjustment is $9500; that is, $15 500 (sum of recorded sales) less $6000 (group). The adjustment is that necessary to adjust the sum of the amounts recorded by the legal entities to that to be recognised by the group.

Note that the combined adjustments to sales and cost of sales result in a $500 reduction in before-tax profit. Of the $2000 intragroup profit on the transfer of inventory from Amelie Ltd to Jessica Ltd, since three-quarters of the inventory has been sold by Jessica Ltd to an external party, $1500 of the profit is realised to the group and only $500, the profit remaining in ending inventory, is unrealised. It is the unrealised profit that is adjusted for in the worksheet entry.

The group profit is then $500 less than that recorded by the legal entities. The sum of profits recorded by the legal entities is $8500, consisting of $2000 recorded by Amelie Ltd and $6500 (being sales of $14 000 less cost of sales of $7500) recorded by Jessica Ltd. From the group's viewpoint, profit on sale of inventory to external entities is only $8000, consisting of sales of $14 000 less cost of sales of $6000 (being 75% of original cost of $8000). Hence, an adjustment of $500 is necessary to reduce recorded profit of $8500 to group profit of $8000.

The $500 adjustment to inventory reflects the proportion of the total profit on sale of the transferred inventory that remains in the inventory on hand at the end of the period. Since 25% of the transferred inventory is still on hand at the end of the period, then 25% of the total profit on transfer of inventory (i.e. 25% × $2000) needs to be adjusted at the end of the period. The adjustment entry reduces the inventory on hand at 30 June 2016 from the recorded cost to Jessica Ltd of $2500 to the group cost of $2000 (being 25% of the original cost of $8000).

The adjustments above have been determined by comparing the combined amounts recorded by the parent and the subsidiary with the amounts that the group wants to report in the consolidated financial statements. This process could be shown in the form of a table, as follows:

	Parent	Subsidiary	Total Recorded	Group	Adjustment
Sales	14 000	10 000	24 000	14 000	Dr 10 000
Cost of sales	(7 500)	(8 000)	(15 500)	(6 000)	Cr 9 500
Profit	6 500	2 000	8 500	8 000	
Inventory	2 500	0	2 500	2 000	Cr $500

Consider the *tax effect* of this adjustment. The carrying amount of the inventory is reduced by $500, reflecting the fact that the carrying amount to the group is $500 less than the carrying amount in Jessica Ltd. This gives rise to a deductible temporary difference of $500. Hence, a deferred tax asset of $150 (i.e. 30% × $500) must be raised on consolidation with a corresponding effect on income tax expense. The expectation of the group is that, in some future period, it will recognise the remaining $500 profit in transferred inventory when it sells the inventory to an external party, but will not have to pay tax on the $500 as Amelie Ltd has already paid the relevant tax. This expected tax saving to the group will be shown in the consolidated financial statements by a debit adjustment of $150 to the Deferred Tax Asset account.

The tax-effect adjustment entry is then:

Deferred Tax Asset	Dr	150	
Income Tax Expense	Cr		150

Example: Transferred inventory completely sold

On 1 January 2016, Jessica Ltd acquired $10 000 worth of inventory for cash from Amelie Ltd. The inventory had previously cost Amelie Ltd $8000. By the end of the year, 30 June 2016, Jessica Ltd had sold all the transferred inventory to an external party for $18 000.

Amelie Ltd records a profit of	$ 2 000	(i.e. $10 000 − $8000)
Jessica Ltd records a profit of	$ 8 000	(i.e. $18 000 − $10 000)
Total recorded profit is	$10 000	

Profit to the group = Selling price to external entities less cost to the group
= $18 000 − $8000
= $10 000

Since the recorded profit equals the profit to the group, there is no need for a profit adjustment on consolidation. Further, as there is no transferred inventory still on hand, there is no need for an adjustment to inventory. Because all the inventory has been sold to an external entity, the whole of the intragroup profit is realised to the group. Note, however, that an adjustment for the sales and cost of sales is still necessary. As noted previously, the sales within the group amount to $18 000 whereas the sales recorded by the legal entities total $28 000 (i.e. $10 000 + $18 000). Hence, sales must be reduced by $10 000. The total recorded cost of sales is $18 000, being $8000 by Amelie Ltd and $10 000 by Jessica Ltd. The group's cost of sales is the original cost of the transferred inventory, $8000. Hence, cost of sales is reduced by $10 000 on consolidation. The adjustment entry is then:

Sales	Dr	10 000	
Cost of Sales	Cr		10 000

Since there is no adjustment to the carrying amounts of assets or liabilities, there is no need for any *tax-effect* adjustment.

Where inventory is transferred in the current period and some or all of that inventory is still on hand at the end of the period, the general form of the worksheet entries is:

Sales Revenue	Dr	xxx	
Cost of Sales	Cr		xxx
Inventory	Cr		xxx
(The adjustment to inventory is based on the profit remaining in inventory on hand at the end of the period)			
Deferred Tax Asset	Dr	xxx	
Income Tax Expense	Cr		xxx
(The tax rate times the adjustment to ending inventory)			

22.2.4 Profits in opening inventory

Any transferred inventory remaining unsold at the end of one period is still on hand at the beginning of the next period. Because the consolidation adjustments are made only in a worksheet and not in the records of any of the legal entities, any differences in balances between the legal entities and the consolidated group at the end of one period must still exist at the beginning of the next period.

Example: Transferred inventory on hand at the beginning of the period

On 1 July 2015, the first day of the current period, Amelie Ltd has on hand inventory worth $7000, transferred from Jessica Ltd in June 2015. The inventory had previously cost Jessica Ltd $4500. The tax rate is 30%.

In this example, in the preparation of the consolidated financial statements at *30 June 2015* the following adjustment entries for the $2500 profit in ending inventory would have been made in the consolidation worksheet:

Sales	Dr	7 000	
Cost of Sales	Cr		4 500
Inventory	Cr		2 500
Deferred Tax Asset	Dr	750	
Income Tax Expense	Cr		750
(30% × $2500)			

Since the ending inventory at 30 June 2015 becomes the beginning inventory for the next year, an adjustment is necessary in the consolidated financial statements prepared at 30 June 2015. The required adjustment is:

Retained Earnings (1/7/15)	Dr	2 500	
Cost of Sales	Cr		2 500

In making this consolidation worksheet adjustment, it is assumed that the inventory is sold to external entities in the current period. If this is not the case, then the adjustment to inventory as made at 30 June 2015 will need to be made again in preparing the consolidated financial statements at 30 June 2016.

In making a *credit adjustment* of $2500, cost of sales is reduced. The cost of sales recorded by Amelie Ltd in the 2015–16 period is $2500 greater than that which the group wants to show, because the cost of sales recorded by Jessica Ltd is $7000, whereas the cost of sales to the group is only $4500. A reduction in cost of sales means an increase in profit. Hence, in the 2015–16 period, the group's profit is greater than the sum of the legal entities' profit.

The *debit adjustment* to the opening balance of retained earnings reduces that balance; that is, the group made less profit in previous years than the sum of the retained earnings recorded by the legal entities. This is because, in June 2015, Jessica Ltd recorded a $2500 profit on the sale of inventory to Amelie Ltd, this profit not being recognised by the group until the 2015–16 period.

Consider the *tax effect* of these entries. If the previous period's tax-effect adjustment were carried forward into this year's worksheet it would be:

Deferred Tax Asset	Dr	750	
Retained Earnings (1/7/15)	Cr		750

On sale of the inventory in the 2015–16 period, the deferred tax asset is reversed, with a resultant effect on income tax expense:

Income Tax Expense	Dr	750	
Deferred Tax Asset	Cr		750

On combining these two entries, the worksheet entry required is:

Income Tax Expense	Dr	750	
Retained Earnings (1/7/15)	Cr		750

In summary, the adjustment to cost of sales, retained earnings and income tax expense can be combined into one entry as follows:

Retained Earnings (1/7/15)	Dr	1 750	
Income Tax Expense	Dr	750	
Cost of Sales	Cr		2 500

Note that this entry has no effect on the closing balance of retained earnings at 30 June 2016. As the inventory has been sold outside the group, the whole of the profit on the intragroup transaction is realised to the group. There is no unrealised profit to be adjusted for at the end of the period.

Where inventory was transferred in a previous period and some or all of that inventory is still on hand at the beginning of the current period, the general form of the entries is:

Retained Earnings (opening balance)	Dr	xxx	
Cost of Sales	Cr		xxx
Income Tax Expense	Dr	xxx	
Retained Earnings (opening balance)	Cr		xxx

It can be seen that the consolidation worksheet entries for inventory transferred within the current period are different from those where the inventory was transferred in a previous period. *Before preparing the adjustment entries, it is essential to determine the timing of the transaction.*

ILLUSTRATIVE EXAMPLE 22.1 Intragroup transactions involving transfers of inventory

Leah Ltd acquired all the issued shares of Sophia Ltd on 1 January 2015. The following transactions occurred between the two entities:

1. On 1 June 2016, Leah Ltd sold inventory to Sophia Ltd for $12 000, this inventory previously costing Leah Ltd $10 000. By 30 June 2016, Sophia Ltd had onsold 20% of this inventory to other entities for $3000. The other 80% was all sold to external entities by 30 June 2017 for $13 000.
2. During the 2016–17 period, Sophia Ltd sold inventory to Leah Ltd for $6000, this being at cost plus 20% mark-up. Of this inventory, $1200 remained on hand in Leah Ltd at 30 June 2017.

The tax rate is 30%.

Required

Prepare the consolidation worksheet entries for Leah Ltd at 30 June 2017 in relation to the intragroup transfers of inventory.

Solution

(1) Sale of inventory in previous period

Retained Earnings (1/7/16)	Dr	1 120	
Income Tax Expense	Dr	480	
Cost of Sales	Cr		1 600

Working:
- this is a prior period transaction
- profit after tax remaining in inventory at 1/7/16 is \$1120 (= 80% × \$2000 (1 − 30%))
- cost of sales recorded by Sophia Ltd is \$9600 (= 80% × \$12 000); cost of sales to the group is \$8000 (= 80% × \$10 000). The adjustment is then \$1600.

(2) Sale of inventory in current period

Sales	Dr	6 000	
Cost of Sales	Cr		5 800
Inventory	Cr		200
Deferred Tax Asset	Dr	60	
Income Tax Expense	Cr		60

Working:
- this is a current period transaction
- sales within the group are \$6000
- cost of sales recorded by the members of the group are \$5000 for Sophia Ltd and \$4800 (= 4/5 × \$6000) for Leah Ltd; a total of \$9800. Cost of sales for the group is \$4000 (= 4/5 × \$5000). The adjustment is then \$5800
- the inventory remaining at 30 June 2017 is recorded by Leah Ltd at \$1200. The cost to the group is \$1000 (= 1/5 × \$5000). The adjustment to inventory is then \$200
- as the inventory is adjusted by \$200, the tax effect is \$60 (= 30% × \$200).

LO3

22.3 INTRAGROUP SERVICES

Many different examples of services between related entities exist. For instance:

- Jessica Ltd may lend to Amelie Ltd some specialist personnel for a limited period of time for the performance of a particular task by Amelie Ltd. For this service, Jessica Ltd may charge Amelie Ltd a certain fee, or expect Amelie Ltd to perform other services in return.
- One entity may lease or rent an item of plant or a warehouse from the other.
- A subsidiary may exist solely for the purpose of carrying out some specific task, such as research activities for the parent, and a fee for such research is charged. In this situation, all service revenue earned by the subsidiary is paid for by the parent, and must be adjusted in the consolidation process.

Example: Intragroup services

During 2015–16, Jessica Ltd offered the services of a specialist employee to Amelie Ltd for 2 months in return for which Amelie Ltd paid \$30 000 to Jessica Ltd. The employee's annual salary is \$155 000, paid for by Jessica Ltd.

The journal entries in the records of Jessica Ltd and Amelie Ltd in relation to this transaction are:

Jessica Ltd			
Cash	Dr	30 000	
Service Revenue	Cr		30 000
Amelie Ltd			
Service Expense	Dr	30 000	
Cash	Cr		30 000

From the group's perspective there has been no service revenue received or service expense made to entities external to the group. Hence, to adjust from what has been recorded by the legal entities to the group's perspective, the consolidation adjustment entry is:

Service Revenue	Dr	30 000	
Service Expense	Cr		30 000

No adjustment is made in relation to the employee's salary since, from the group's view, the salary paid to the employee is a payment to an external party.

Since there is no effect on the carrying amounts of assets or liabilities, there is no temporary difference and no need for any income tax adjustment.

Example: Intragroup rent

Jessica Ltd rents office space from Amelie Ltd for $150 000 p.a.

In accounting for this transaction, Jessica Ltd records rent expense of $150 000 and Amelie Ltd records rent revenue of $150 000. From the group's view, the intragroup rental scheme is purely an internal arrangement, and no revenue or expense is incurred. The recorded revenue and expense therefore need to be eliminated. The appropriate consolidation adjustment entry is:

Rent Revenue	Dr	150 000	
Rent Expense	Cr		150 000

There is no tax-effect entry necessary as assets and liabilities are unaffected by the adjustment entry.

22.3.1 Realisation of profits or losses

With the transfer of services within the group, the consolidation adjustments do not affect the profit of the group. In a transaction involving a payment by a parent to a subsidiary for services rendered, the parent shows an expense and the subsidiary shows revenue. The net effect on the group's profit is zero. Hence, from the group's view, with intragroup services there are no realisation difficulties.

LO4

22.4 INTRAGROUP DIVIDENDS

In this section, consideration is given to dividends declared and paid after Jessica Ltd's acquisition of Amelie Ltd. As explained earlier *(see section 21.5.3)*, all dividends received by the parent from the subsidiary are accounted for as revenue by the parent, regardless of whether the dividends are paid from pre- or post-acquisition equity.

Two situations are considered in this section:

- dividends declared in the current period but not paid
- dividends declared and paid in the current period.

It is assumed that the company expecting to receive the dividend recognises revenue when the dividend is declared.

22.4.1 Dividends declared in the current period but not paid

Assume that, on 25 June 2016, Amelie Ltd declares a dividend of $4000. At the end of the period, the dividend is unpaid. The entries passed by the legal entities are:

Amelie Ltd			
Dividend Declared (In retained earnings)	Dr	4 000	
Dividend Payable	Cr		4 000
Jessica Ltd			
Dividend Receivable	Dr	4 000	
Dividend Revenue	Cr		4 000

The entry made by Amelie Ltd both reduces retained earnings and raises a liability account. From the group's perspective, there is no reduction in equity and the group has no obligation to pay dividends outside the group. Similarly, the group expects no dividends to be received from entities outside the group. Hence, the appropriate consolidation adjustment entries are:

Dividend Payable	Dr	4 000	
Dividend Declared	Cr		4 000
(To adjust for the effects of the entry made by Amelie Ltd)			
Dividend Revenue	Dr	4 000	
Dividend Receivable	Cr		4 000
(To adjust for the effects of the entry made by Jessica Ltd)			

In the following period when the dividend is paid, no adjustments are required in the consolidation worksheet. As there are no dividend revenue, dividend declared, or receivable items left open at the end of the period, then the position of the group is the same as the sum of the legal entities' financial statements.

22.4.2 Dividends declared and paid in the current period

Assume Amelie Ltd declares and pays an interim dividend of $4000 in the current period. Entries by the *legal entities* are:

Jessica Ltd			
Cash	Dr	4 000	
Dividend Revenue	Cr		4 000
Amelie Ltd			
Interim Dividend Paid (In retained earnings)	Dr	4 000	
Cash	Cr		4 000

From the outlook of the *group*, no dividends have been paid and no dividend revenue has been received. Hence, the adjustment necessary for the consolidated financial statements to show the affairs of the group is:

Dividend Revenue	Dr	4 000	
Interim Dividend Paid	Cr		4 000

Tax effect of dividends

Generally, dividends are tax-free. There are, therefore, no tax-effect adjustment entries required in relation to dividend-related consolidation adjustment entries.

ILLUSTRATIVE EXAMPLE 22.2 Intragroup dividends

Alice Ltd owns all the issued shares of Abigail Ltd, having acquired them for $250 000 on 1 January 2015. In preparing the consolidated financial statements at 30 June 2017, the accountant documented the following transactions:

2016	
Jan. 15	Abigail Ltd paid an interim dividend of $10 000.
June 25	Abigail Ltd declared a dividend of $15 000, this being recognised in the records of both entities.
Aug. 1	The $15 000 dividend declared on 25 June was paid by Abigail Ltd.

2017	
Jan. 18	Abigail Ltd paid an interim dividend of $12 000.
June 23	Abigail Ltd declared a dividend of $18 000, this being recognised in the records of both entities.

The tax rate is 30%.

Required

Prepare the consolidation worksheet adjustment entries for the preparation of consolidated financial statements at 30 June 2017.

Solution

The required entries are:

(1) *Interim dividend paid*

Dividend Revenue	Dr	12 000	
Dividend Paid	Cr		12 000

(2) *Final dividend declared*

Dividend Payable	Dr	18 000	
Dividend Declared	Cr		18 000
Dividend Revenue	Dr	18 000	
Dividend Receivable	Cr		18 000

LO5

22.5 INTRAGROUP BORROWINGS

Members of a group often borrow and lend money among themselves, and charge interest on the money borrowed. In some cases, an entity may be set up within the group solely for the purpose of handling group finances and for borrowing money on international money markets. Consolidation adjustments are necessary in relation to these intragroup borrowings and interest thereon because, from the stance of the group, these transactions create assets and liabilities and revenues and expenses that do not exist in terms of the group's relationship with external entities.

Example: Advances

Jessica Ltd lends $100 000 to Amelie Ltd, the latter paying $15 000 interest to Jessica Ltd. The relevant journal entries in each of the legal entities are:

Jessica Ltd			
Advance to Amelie Ltd	Dr	100 000	
Cash	Cr		100 000
Cash	Dr	15 000	
Interest Revenue	Cr		15 000
Amelie Ltd			
Cash	Dr	100 000	
Advance from Jessica Ltd	Cr		100 000
Interest Expense	Dr	15 000	
Cash	Cr		15 000

The consolidation adjustments involve eliminating the monetary asset created by Jessica Ltd, the monetary liability raised by Amelie Ltd, the interest revenue recorded by Jessica Ltd and the interest expense paid by Amelie Ltd:

Advance from Jessica Ltd	Dr	100 000	
Advance to Amelie Ltd	Cr		100 000
Interest Revenue	Dr	15 000	
Interest Expense	Cr		15 000

The adjustment to the asset and liability is necessary as long as the intragroup loan exists. In relation to any past period's payments and receipt of interest, no ongoing adjustment to accumulated profits (opening balance) is necessary as the net effect of the consolidation adjustment is zero on that item.

Because the effect on net assets of the consolidation adjustment is zero, no tax-effect entry is necessary.

SUMMARY

Intragroup transactions can take many forms and may involve transfers of inventory or property, plant and equipment, or they may relate to the provision of services by one member of the group to another member. To prepare the relevant worksheet entries for a transaction, it is necessary to consider the accounts affected in the entities involved in the transaction.

Intragroup transfers of inventory, services, dividends and debentures and their adjustment in the consolidation process are associated with a need to consider the implications of applying tax-effect accounting in the consolidation process.

The basic approach to determining the consolidation adjustment entries for intragroup transfers is:

(a) Analyse the events within the records of the legal entities involved in the intragroup transfer. Determine whether the transaction is a prior period or current period event.
(b) Analyse the position from the group's viewpoint.
(c) Create adjusting entries to change from the legal entities' position to that of the group.
(d) Consider the tax effect of the adjusting entries.

Note again that there are no actual adjusting entries made in the records of the individual legal entities which constitute the group. However, if required, a special journal could be set up by the parent entity to keep a record of the adjustments made in the process of preparing the consolidated financial statements. Alternatively, the consolidation process may be performed by the use of special consolidation worksheets.

Why a particular adjustment is the correct one involves an explanation of each line in the adjustment entry including why an account was adjusted, why it was increased or decreased, and why a particular adjustment amount is appropriate. This generally involves a comparison of what accounts were affected in the records of the legal entities with the financial picture the group wants to present in the consolidated financial statements.

DEMONSTRATION PROBLEM 22.1 Intragroup transfers of assets

The following example illustrates procedures for the preparation of a consolidated statement of profit or loss and other comprehensive income, a consolidated statement of changes in equity and a consolidated statement of financial position where the subsidiary is 100% owned. The consolidation worksheet adjustments for intragroup transactions including inventory are also demonstrated.

Details

On 1 July 2014, Eliza Ltd acquired all the share capital of Ebony Ltd for $472 000. At that date, Ebony Ltd's equity consisted of the following.

Share capital	$ 300 000
General reserve	96 000
Retained earnings	56 000

At 1 July 2014, all the identifiable assets and liabilities of Ebony Ltd were recorded at fair value.

Financial information for Eliza Ltd and Ebony Ltd for the year ended 30 June 2016 is presented in the left-hand columns of the worksheet illustrated in figure 22.3 overleaf. It is assumed that both companies use the perpetual inventory system.

Additional information

(a) On 1 January 2016, Ebony Ltd sold merchandise costing $30 000 to Eliza Ltd for $50 000. Half this merchandise was sold to external entities for $28 000 before 30 June 2016.
(b) At 1 July 2015, there was a profit in the inventory of Eliza Ltd of $6000 on goods acquired from Ebony Ltd in the previous period.
(c) The tax rate is 30%.

Required

Prepare the consolidated financial statements for the year ended 30 June 2016.

Solution

The first step is to determine the pre-acquisition entries at 30 June 2016. These entries are prepared after undertaking an acquisition analysis.

At 1 July 2014:

Net fair value of the identifiable assets and liabilities of Ebony Ltd	= $300 000 + $96 000 + $56 000
	= $452 000
Consideration transferred	= $472 000
Goodwill	= $20 000

Consolidation worksheet entries

(1) *Business combination valuation entry*

As all the identifiable assets and liabilities of Ebony Ltd are recorded at amounts equal to their fair values, the only business combination valuation entry required is that for goodwill.

Goodwill	Dr	20 000	
Business Combination Valuation Reserve	Cr		20 000

(2) *Elimination of investment in subsidiary*

The entry at 30 June 2016 is the same as that at acquisition date as there have not been any events affecting that entry since acquisition date:

Retained Earnings (1/7/15)	Dr	56 000	
Share Capital	Dr	300 000	
General Reserve	Dr	96 000	
Business Combination Valuation Reserve	Dr	20 000	
Shares in Ebony Ltd	Cr		472 000

The next step is to prepare the adjustment entries arising because of the existence of intragroup transactions. It is important that students classify the intragroup transactions into 'current period' and 'previous period' transactions. The resultant adjustment entries should reflect those decisions since previous period transactions would be expected to affect accounts such as retained earnings rather than accounts such as sales and cost of sales.

(3) *Profit in ending inventory*

The transaction occurred in the current period. The adjustment entries are:

Sales	Dr	50 000	
Cost of Sales	Cr		40 000
Inventory	Cr		10 000
($10 000 = ½ × [$50 000 − $30 000])			
Deferred Tax Asset	Dr	3 000	
Income Tax Expense	Cr		3 000
(30% × $10 000)			

Sales: The members of the group have recorded total sales of $78 000, being $50 000 by Ebony Ltd and $28 000 by Eliza Ltd. The group recognises only sales to entities outside the group, namely the sales by Eliza Ltd of $28 000. Hence, in preparing the consolidated financial statements, sales must be reduced by $50 000.

Cost of sales: Ebony Ltd recorded cost of sales of $30 000, and Eliza Ltd recorded cost of sales of $25 000 (being half of $50 000). Recorded cost of sales then totals $55 000. The cost of the sales to entities external to the group is $15 000 (being half of $30 000). Cost of sales must then be reduced by $40 000.

Inventory: At 30 June 2016, Eliza Ltd has inventory on hand from intragroup transactions, and records them at cost of $25 000 (being half of $50 000). The cost of this inventory to the group is $15 000 (being half of $30 000). Inventory is then reduced by $10 000.

Deferred tax asset/income tax expense: Under tax-effect accounting, temporary differences arise where the carrying amount of an asset differs from its tax base. In the first adjustment entry above, inventory is reduced by $10 000; that is, the carrying amount of inventory is reduced by $10 000. This then gives rise to a temporary difference, and because the carrying amount has been reduced, tax benefits are expected in the future when the asset is sold. Hence a deferred tax asset, equal to the tax rate times the change to the carrying amount of inventory (30% × $10 000), of $3000 is raised. Given there is no Deferred Tax Asset in the worksheet in figure 22.3, the adjustment is made against the Deferred Tax Liability line item.

(4) *Profit in beginning inventory*

This is a previous period transaction. The required consolidation worksheet entry is:

Retained Earnings (1/7/14)	Dr	6 000	
Cost of Sales	Cr		6 000
Income Tax Expense	Dr	1 800	
Retained Earnings (1/7/14)	Cr		1 800
(30% × $6000)			

Retained earnings: In the previous period, Ebony Ltd recorded a $6000 before-tax profit, or a $4200 after-tax profit on sale of inventory within the group. Because the sale did not involve external entities, the profit must be eliminated on consolidation.

Cost of sales: In the current period, the transferred inventory is onsold to external entities. Eliza Ltd records cost of sales at $6000 greater than to the group. Hence, cost of sales is reduced by $6000. Note that this increases group profit by $6000, reflecting the realisation of the profit to the group in the current period, when it was recognised by the legal entity in the previous period.

Income tax expense: At the end of the previous period, in the consolidated statement of financial position a deferred tax asset of $1800 was raised because of the difference in cost of the inventory recorded by the legal entity and that recognised by the group. This deferred tax asset is reversed when the asset is sold. The adjustment to income tax expense reflects the reversal of the deferred tax asset raised at the end of the previous period.

Figure 22.3 shows the completed worksheet for preparation of the consolidated financial statements of Eliza Ltd and its subsidiary Ebony Ltd at 30 June 2016. Once the effects of all adjustments are added or subtracted horizontally in the worksheet to calculate figures in the right-hand 'consolidation' column, the consolidated financial statements can be prepared, as shown in figure 22.4(a), (b) and (c).

			Adjustments				
Financial Statements	**Eliza Ltd**	**Ebony Ltd**		**Dr**	**Cr**		**Consolidation**
Sales revenue	1 196 000	928 000	3	50 000			2 074 000
Cost of sales	(888 000)	(670 000)			40 000	3	(1 512 000)
Wages and salaries	(57 500)	(32 000)					(89 500)
Depreciation	(5 200)	(4 800)					(10 000)
Other expenses	(4 000)	—					(4 000)
Total expenses	(954 700)	(706 800)					(1 615 500)
Profit before income tax	241 300	221 200					458 500
Income tax expense	(96 120)	(118 480)	4	1 800	3 000	3	(213 400)
Profit for the year	145 180	102 720					245 100
Retained earnings (1/7/15)	100 820	70 280	2	56 000	1 800	4	110 900
			4	6 000			
	246 000	173 000					356 000
Dividend paid	(80 000)	—					(80 000)
Retained earnings (30/6/16)	166 000	173 000					276 000
Share capital	500 000	300 000	2	300 000			500 000
Business combination valuation reserve			2	20 000	20 000	1	—
General reserve	135 000	96 000	2	96 000			135 000
	801 000	569 000					911 000
Other components of equity (1/7/15)	4 000	10 000					14 000
Gains on financial assets	1 000	3 000					4 000
Other components of equity (30/6/16)	5 000	13 000					18 000
Total equity	806 000	582 000					929 000
Deferred tax liability	52 000	30 000	3	3 000			79 000
Total equity and liabilities	858 000	612 000					1 008 000
Shares in Ebony Ltd	472 000	—			472 000	2	—
Cash	80 000	73 000					153 000
Inventory	169 000	36 000			10 000	3	195 000
Other current assets	10 000	300 000					310 000
Financial assets	15 000	68 000					83 000
Land	70 000	120 000					190 000
Plant and equipment	52 000	28 000					80 000
Accumulated depreciation	(10 000)	(13 000)					(23 000)
Goodwill	—	—	1	20 000			20 000
	857 000	612 000		588 928	588 928		1 008 000

FIGURE 22.3 Consolidation worksheet — intragroup transfers of assets

ELIZA LTD
Consolidated Statement of Profit or Loss and Other Comprehensive Income
for the year ended 30 June 2016

Revenues	$2 074 000
Expenses	1 615 425
Profit before income tax	458 500
Income tax expense	213 400
Profit for the year	$ 245 100
Other comprehensive income	
Gains on financial assets	4 000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	$ 249 100

FIGURE 22.4(a) Consolidated statement of profit or loss and other comprehensive income

ELIZA LTD
Consolidated Statement of Changes in Equity
for the year ended 30 June 2016

TOTAL COMPREHENSIVE INCOME FOR THE YEAR	$249 100
Retained earnings at 1 July 2015	$110 900
Profit for the year	$245 100
Dividend paid	$ (80 000)
Retained earnings at 30 June 2016	$276 000
General reserve at 1 July 2015	$140 000
General reserve at 30 June 2016	$140 000
Other components of equity at 1 July 2015	$ 14 000
Gains on financial assets	$ 4 000
Other components of equity at 30 June 2016	$ 18 000
Share capital at 1 July 2015	$500 000
Share capital at 30 June 2016	$500 000

FIGURE 22.4(b) Consolidated statement of changes in equity

FIGURE 22.4(c) Consolidated statement of financial position

ELIZA LTD
Consolidated Statement of Financial Position
as at 30 June 2016

Current assets			
Cash assets			$ 153 000
Inventories			195 000
Financial assets			83 000
Other			310 000
Total current assets			741 000
Non-current assets			
Property, plant and equipment:			
Plant and equipment	$ 80 000		
Accumulated depreciation	$(23 000)	$ 57 000	
Land		190 000	247 000
Goodwill			20 000
Total non-current assets			267 000
Total assets			1 008 000
Non-current liabilities			
Deferred tax liabilities			(79 000)
Net assets			$ 929 000

FIGURE 22.4(c) *(continued)*

Equity	
Share capital	$ 500 000
General reserve	135 000
Retained earnings	276 000
Other components of equity	18 000
Total equity	$ 929 000

DEMONSTRATION PROBLEM 22.2 Dividends and borrowings

On 1 July 2015, Lilly Ltd acquired all the share capital of Tahlia Ltd and Eva Ltd for $187 500 and $150 000 respectively. At that date, equity of the three companies was:

	Lilly Ltd	Tahlia Ltd	Eva Ltd
Share capital	$150 000	$100 000	$100 000
General reserve	90 000	60 000	40 000
Retained earnings	20 000	17 500	10 000

At 1 July 2015, the identifiable net assets of all companies were recorded at fair values.

For the year ended 30 June 2016, the summarised financial information for the three companies show the following details:

	Lilly Ltd	Tahlia Ltd	Eva Ltd
Sales revenue	$ 388 500	$ 200 000	$ 150 000
Dividend revenue	9 000	—	—
Other revenue	10 000	—	—
Total revenues	407 500	200 000	150 000
Total expenses	(360 000)	(176 000)	(138 000)
Profit before income tax	47 500	24 000	12 000
Income tax expense	(15 000)	(10 000)	(5 000)
Profit	32 500	14 000	7 000
Retained earnings (1/7/15)	20 000	17 500	10 000
Total available for appropriation	52 500	31 500	17 000
Interim dividend paid	(7 500)	(2 500)	—
Final dividend declared	(15 000)	(5 000)	(5 500)
Transfer to general reserve	(2 000)	(5 000)	—
	(24 500)	(12 500)	(5 500)
Retained earnings (30/6/16)	$ 28 000	$ 19 000	$ 11 500
Shares in Tahlia Ltd	$ 187 500	—	—
Shares in Eva Ltd	150 000	—	—
Dividend receivable	6 500	—	—
Loan receivable	5 000	—	—
Property, plant and equipment	18 500	$ 205 000	$ 167 000
Total assets	367 500	205 000	167 000
Final dividend payable	15 000	5 000	1 500
Loan payable	—	5 000	—
Other non-current liabilities	82 500	11 000	10 000
Total liabilities	97 500	21 000	11 500
Net assets	$ 270 000	$ 184 000	$ 155 500
Share capital	$ 150 000	$ 100 000	$ 104 000
General reserve	92 000	65 000	40 000
Retained earnings	28 000	19 000	11 500
Total equity	$ 270 000	$ 184 000	$ 155 500

Additional information

(a) Lilly Ltd has lent \$5000 to Tahlia Ltd, the loan having 10% interest rate attached.

(b) Lilly Ltd has recognised both the interim and final dividends from Tahlia Ltd and Eva Ltd as revenue.

Required

Prepare the consolidated financial statements as at 30 June 2016 for Lilly Ltd and its two subsidiaries, Tahlia Ltd and Eva Ltd. Assume all reserve transfers are from post-acquisition profits.

Solution

The relationship between the parent and subsidiaries may be expressed as shown in figure 22.5.

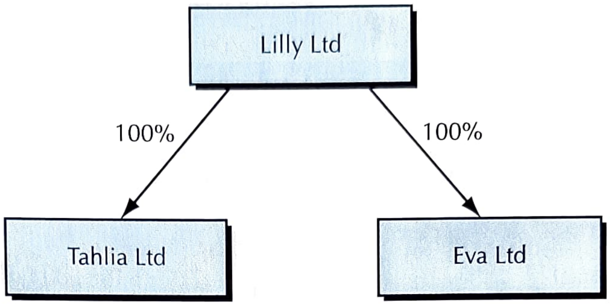

FIGURE 22.5 Relationship between parent and subsidiaries

Figure 22.6 overleaf illustrates the consolidation worksheet necessary to consolidate the financial statements of Lilly Ltd and its two subsidiaries. Detailed discussion of each adjustment is provided below. Note that:

- no adjustment entries are made for transfers to and from reserves if post-acquisition equity only is affected
- the dividends paid and declared by the parent to its shareholders are not adjusted for in the consolidated financial statements, because these dividends are paid by the group to external entities.

Acquisition analysis: Lilly Ltd and Tahlia Ltd

At 1 July 2015:

Net fair value of identifiable assets and liabilities of Tahlia Ltd	= \$100 000 + \$60 000 + \$17 500
	= \$177 500
Consideration transferred	= \$187 500
Goodwill	= \$10 000

Consolidation worksheet adjustment entries

(1) *Business combination valuation entry: Lilly Ltd and Tahlia Ltd*

Goodwill	Dr	10 000	
Business Combination Valuation Reserve	Cr		10 000

(2) *Elimination of investment in subsidiary: Lilly Ltd and Tahlia Ltd*

The elimination of investment in subsidiary at 30 June 2016 is then:

Retained Earnings (1/7/15)	Dr	17 500	
Share Capital	Dr	100 000	
General Reserve	Dr	60 000	
Business Combination Valuation Reserve	Dr	10 000	
Shares in Tahlia Ltd	Cr		187 500

Acquisition analysis: Lilly Ltd and Eva Ltd

At 1 July 2015:

Net fair value of identifiable assets and liabilities of Eva Ltd	= \$100 000 + \$40 000 + \$10 000
	= \$150 000
Consideration transferred	= \$150 000
Goodwill	= zero

No business combination valuation entry is required.

(3) *Elimination of investment in subsidiary: Lilly Ltd and Eva Ltd*
The elimination of investment in subsidiary at 30 June 2016 is then:

Retained Earnings (1/7/15)	Dr	10 000	
Share Capital	Dr	100 000	
General Reserve	Dr	40 000	
Shares in Eva Ltd	Cr		150 000

(4) *Interim dividend: Tahlia Ltd*
This is a current period transaction. The consolidation worksheet entry is:

Dividend Revenue	Dr	2 500	
Dividend Paid	Cr		2 500

Tahlia Ltd paid a dividend in cash to Lilly Ltd. Lilly Ltd recognised dividend revenue and Tahlia Ltd recognised dividends paid. From the group's perspective, there were no dividends paid to entities external to the group. Hence, on consolidation it is necessary to eliminate both the Dividend Paid and Dividend Revenue accounts raised by the parent and the subsidiary.

(5) *Final dividend declared: Tahlia Ltd*
This is a current period transaction. The consolidation worksheet entry is:

Final Dividend Payable	Dr	5 000	
Final Dividend Declared	Cr		5 000
Dividend Revenue	Dr	5 000	
Dividend Receivable	Cr		5 000

The subsidiary declares a dividend, recognising a liability to pay the dividend and reducing retained earnings. The parent, which expects to receive the dividend, raises a receivable asset and recognises dividend revenue. From the group's point of view, because the dividend is not receivable or payable to entities external to the group, it does not want to recognise any of these accounts. Hence, on consolidation, all the accounts affected by this transaction in the records of the parent and the subsidiary are eliminated.

(6) *Final dividend declared: Eva Ltd*
This is a current period transaction. The consolidation worksheet entry is:

Final Dividend Payable	Dr	5 500	
Final Dividend Declared	Cr		5 500
Dividend Revenue	Dr	5 500	
Dividend Receivable	Cr		5 500

The explanation for this entry is the same as that for the dividend declared by Tahlia Ltd.

(7) *Loan: Lilly Ltd to Tahlia Ltd*
The loan may have been made in a previous period or the current period. The consolidation worksheet entry is the same:

Loan Payable	Dr	5 000	
Loan Receivable	Cr		5 000

This entry eliminates the receivable raised by the parent and the payable raised by the subsidiary. From the group's point of view, there are no loans payable or receivable to entities external to the group.

(8) *Interest on loan*
The interest paid/received is a current period transaction. In some situations where interest is accrued, interest may relate to previous or future periods. The consolidation worksheet entry is:

Interest Revenue	Dr	500	
Interest Expense	Cr		500
(10% × $5000)			

The parent records interest revenue of $500 and the subsidiary records interest expense of $500. No interest was paid or received by the group from entities external to the group, so these accounts must be eliminated on consolidation.

Financial statements	Lilly Ltd	Tahlia Ltd	Eva Ltd		Adjustments Dr	Adjustments Cr		Group
Sales revenue	388 500	200 000	150 000					738 500
Dividend revenue	9 000	—	—	4	2 500			—
				6	5 000			
				7	1 500			
Other revenue	10 000	—	—	9	500			9 500
	407 500	200 000	150 000					748 000
Expenses	(360 000)	(176 000)	(138 000)			500	9	(673 500)
Profit before income tax	47 500	24 000	12 000					74 500
Income tax expense	(15 000)	(10 000)	(5 000)					(30 000)
Profit	32 500	14 000	7 000					44 500
Retained earnings (1/7/15)	20 000	17 500	10 000	2	17 500			20 000
				3	10 000			
	52 500	31 500	17 000					64 500
Interim dividend paid	(7 500)	(2 500)	—			2 500	4	(7 500)
Final dividend declared	(15 000)	(5 000)	(1 500)			5 000	5	(15 000)
						1 500	6	
Transfer to general reserve	(2 000)	(5 000)	0					(7 000)
	24 500	12 500	5 500					29 500
Retained earnings (30/6/16)	28 000	19 000	11 500					35 000
Share capital	150 000	100 000	100 000	2	100 000			150 000
				3	100 000			
General reserve	92 000	65 000	40 000	2	60 000			97 000
				3	40 000			
Business combination valuation reserve				2	10 000	10 000	1	—
Final dividend payable	15 000	5 000	1 500	5	5 000			15 000
				6	1 500			
Loan payable	—	5 000	—	7	5 000			—
Other non-current liabilities	82 500	11 000	10 000					103 500
Total equity and liabilities	367 500	205 000	167 000					400 500
Shares in Tahlia Ltd	187 500	—	—			187 500	2	—
Shares in Eva Ltd	150 000	—	—			150 000	3	—
Dividend receivable	6 500	—	—			5 000	5	—
						1 500	6	
Loan receivable	5 000	—	—			5 000	7	—
Property, plant and equipment	18 500	205 000	167 000					390 500
Goodwill	—	—	—	1	10 000			10 000
	367 500	205 000	167 000		372 500	372 500		400 500

FIGURE 22.6 Consolidation worksheet — dividends

From figure 22.6, after all adjustments have been entered in the worksheet and amounts totalled across to the consolidation column, the consolidated financial statements can be prepared in suitable format as shown in figure 22.7(a), (b) and (c).

LILLY LTD
Consolidated Statement of Profit or Loss and Other Comprehensive Income
for the year ended 30 June 2016

Revenues	$748 000
Expenses	673 500
Profit before income tax	74 500
Income tax expense	(30 000)
Profit for the year	$ 44 500
Other comprehensive income	—
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	$ 44 500

FIGURE 22.7(a) Consolidated statement of profit or loss and other comprehensive income

LILLY LTD Consolidated Statement of Changes in Equity for the year ended 30 June 2016	
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	$ 44 500
Retained earnings at 1 July 2015	$ 20 000
Profit for the year	44 500
Interim dividend paid	(7 500)
Final dividend declared	(15 000)
Transfer of general reserve	(7 000)
Retained earnings at 30 June 2016	$ 31 000
General reserve at 1 July 2015	$ 90 000
Transfer from retained earnings	7 000
General reserve at 30 June 2016	$ 97 000
Share capital as at 1 July 2015	$150 000
Share capital at 30 June 2016	$150 000

FIGURE 22.7(b) Consolidated statement of changes in equity

LILLY LTD Consolidated Statement of Financial Position as at 30 June 2016	
Non-current assets	
Property, plant and equipment	$390 500
Goodwill	10 000
Total non-current assets	400 500
Total assets	400 500
Current liabilities	
Final dividend payable	15 000
Non-current liabilities	103 500
Total liabilities	118 500
Net assets	$282 000
Equity	
Share capital	$150 000
Other reserves:	
General reserve	$ 97 000
Retained earnings	35 000
Total equity	$282 000

FIGURE 22.7(c) Consolidated statement of financial position

Discussion questions

1. Why is it necessary to make adjustments for intragroup transactions?
2. In making consolidation worksheet adjustments, sometimes tax-effect entries are made. Why?
3. Why is it important to identify transactions as current or previous period transactions?
4. Where an intragroup transaction involves a depreciable asset, why is depreciation expense adjusted?
5. Are adjustments for post-acquisition dividends different from those for pre-acquisition dividends? Explain.
6. What is meant by 'realisation of profits'?
7. When are profits realised in relation to inventory transfers within the group?