Consolidations: Lessons learned from the Real World

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After completing my training contract and qualifying as a professional accountant I took up a role as a Financial Accountant in a multi-national Plc. This company had a number of domestic and foreign subsidiaries in addition to associate companies.

It was only in this role, after my final examinations, that I felt I truly understood the consolidation process. In this article I will apply some of the lessons I learned from this role to an examination context. The lessons I will consider are:

1. Year-end versus consolidation adjustments.
2. Work forwards not backwards.
3. The importance of journals.

1. Year-end versus consolidation adjustments.

Consolidation questions typically present the draft accounts of three companies requiring consolidation.

Parent | **Subsidiary** | **Associate**

Students are usually placed in the scenario where they are the Accountant in the parent company who must prepare a set of consolidated financial statements based on the draft accounts and narrative, describing various issues and errors.

The issues and errors presented will lead to either, year-end adjustments or consolidation adjustments.

Year -end adjustments

As the accountant in the parent company, we must ensure the accounts of the parent are correct before any consolidation takes place. These adjustments are the year-end adjustments and could include:

- Ensuring correct treatment of a lease.
- Ensuring correct treatment of a pension scheme.
- Revaluing non-current assets.
- Decisions around provisions.

In the real world these year-end adjustments will be posted in the accounts of the parent before any consolidation takes place.

In an exam, it is highly unlikely any year-end adjustments such as these will be required in either the subsidiary or the associate. This is due to students taking on the role of Financial Accountant in the parent, in such a role there is no scope to adjust the financial statements of subsidiary or the parent. These adjustments will be carried out by the relevant accountant within each organisation.

Consolidation adjustments

Once the accounts of the parent are correct we may begin the consolidation process. In the real world, the first stage of the consolidation process will be to post the financial statements of the subsidiary to a consolidation corporation. The parents' computerised accounting software will then add together the balances from the parent and the consolidation corporation to produce the consolidated financial statements. The use of a consolidation corporation allows the parents financial statements to remain unaltered by consolidation.

Any consolidation adjustments can also be posted to this consolidation corporation. Consolidation adjustments regarding the subsidiary could include:

- Goodwill on acquisition.
- Impairment of goodwill.
- Non-Controlling Interest.
- Depreciation adjustments.
- Provisions for unrealised profit.

Once the subsidiary consolidation adjustments have been completed, we may then post any entries required to accurately reflect the associate to the consolidation corporation.

2. Work forwards not backwards

In an exam setting, students frequently start with the financial statements and work backwards. That is, they will start with the Revenue figure per the parent draft financial statements, add on the Revenue per the subsidiary and work through the question narrative, considering whether each issue or error will adjust the Revenue figure. If the other side of the adjustment impacts, say, accounts receivable, this will be considered once the Statement of Financial Position is being prepared. The student will then move to Cost of Sales and repeat this process, move to Selling and Distribution expenses and repeat the process and so on. Students working in this manner seldom score high marks, there are just too many adjustments required for this to be a successful strategy.

In the real world each adjustment is considered in turn and dealt with in its entirety before moving on to the next adjustment. Working forwards through each will present the correct financial statements at the end. For example, consider the following consolidation adjustment for intercompany sales.

> During the year parent sold goods to subsidiary for €3,000 at a margin of €1,000. At the year-end all goods had been fully paid for but half were still in inventory of the subsidiary.
>
> The consolidation adjustment for this will be to eliminate intercompany sales and reduce the closing inventory by the provision for unrealised profit.

	DR €	**CR €**
Revenue	3,000	
Cost of sales		3,000
Cost of sales	500	
Closing inventory		500

In the real world, these journals will be posted to the consolidation corporation and the issue is completely dealt with. In the examination, the journals may be written as you work through each issue and referred back to once you are drawing up the financial statements, after dealing with all the issues.

3. The importance of journals

In the real world journals are the tools used to adjust financial statements for errors, year-end adjustments and consolidation adjustments. Journals should also be used in your examination, to both demonstrate your understanding and to ensure the accuracy of your consolidated financial statements.

Conclusions

As highlighted above, real world consolidation takes a structured approach, consolidation in your exam should too. Break the question down into a series of manageable chunks.

Firstly, draw up a group structure, clearly indicating the parent, subsidiary and associate.

Deal with the year-end adjustments to the parent company's draft financial statements next. These adjustments will test your knowledge of various IAS and IFRS. They will require judgement on your part on how to apply the relevant standard or standards. For each adjustment you should:

- State which standards are applicable.
- Justify your treatment of the issue based on the standard. (Please note this does not require you to copy out large sections of the standard or parts of the exam paper.)
- Prepare any calculations required.
- Draw up journals to deal with the issue.

Once the year-end adjustments are complete you may move on to the consolidation adjustments for the subsidiary. The consolidation adjustments require less judgement on which standards to use and how they should be applied. As such, you will not be required to justify your treatment of each item. For each adjustment you should:

- Prepare any calculations required.
- Draw up the required journals.

You may now consider the journals required to reflect any associate in the consolidated financial statements. Again less judgement is required in this situation so calculations and journals would be sufficient.

Finally you may draw up the consolidated financial statements. It should be noted that circa 90% of the marks available will be for the year-end and consolidation adjustments (with supporting justifications, calculations and journals) above. The actual preparation of the consolidated financial statements requires no judgement or interpretation and so will attract relatively few marks.