Preparation of consolidated income statements

A key question in Section 1 of the computer based assessment (CBA) in the financial statements unit is the preparation of consolidated financial statements.

This document concentrates on the consolidated statement of comprehensive income.

The objective of consolidated financial statements is to combine the individual financial statements of all the companies in a group as though the group was one reporting entity.

Therefore the separate financial information of each group company has to be brought together in one set of financial statements (consolidated).

In order to do this, the effects of any inter-company transactions have to be removed. These will include sales and other transfers of income, such as dividends, between the group companies.
A typical question for this topic is shown below:

Company A plc acquired 80% of the issued share capital of Company B Ltd on 1 April 20X0. Extracts from their statements of comprehensive income for the year ended 31 March 20X1 are shown below.

	Company A PLC (£000)	Company B Ltd (£000)
Continuing operations		
Revenue	64,543	18,680
Cost of sales	(29,285)	(8,524)
Gross profit	35,258	10,156
Other income	2,600	-
Distribution costs and administrative expenses	(16,296)	(4,180)
Profit from operations	21,562	5,976
Finance costs	(2,200)	(640)
Profit before tax	19,362	5,336
Tax	(5,650)	(736)
Profit for the period	13,712	4,600

Additional data

- During the year, Company A plc sold goods that had cost £2,200,000 to Company B Ltd, for £2,980,000. A quarter of these goods still remain in inventory at the end of the year.
- Included in other income is a dividend from Company B Ltd of £1,500,000.

Task: Draft the consolidated statement of comprehensive income for Company A plc and its subsidiary undertaking for the year ended 31 March 2011.

In order to produce the consolidated statement of comprehensive income the figures from both companies need to be added together while making the necessary adjustments to remove any inter-company transactions. We will now work through this process, line by line.

Revenue

The revenue from each company is added together and the value of the sales made by Company A to Company B is deducted.

Click to display/hide the solution.

Cost of sales

The cost of sales from each company is added together and the value of the purchases made by Company B from Company A is deducted.

Click to display/hide the solution.

This is fine so long as all the inventory transferred between the two companies has been sold. However, if some remains unsold, then a further adjustment is necessary. This is because the unsold inventory will be included in the closing inventory of Company B, valued at Company A's selling price, which includes an element of profit.

This is not in accordance with IAS 2 – inventory should be valued at the lower of cost and net realisable value. Therefore, any unrealised profit has to be removed.

First, calculate the amount of profit in the inter-company transaction.

This is £2,980,000 - £2,200,000 = £780,000

Second, identify how much of the initial stock has not been sold, in this case a quarter. Therefore the unrealised profit is:

£780,000 x 25% = £195,000

This is then added to the cost of sales as it has the effect of reducing the closing inventory.

Recalculate the cost of sales after removing the inter-company profit.

Click to display/hide the solution.

Gross profit

This is revenue less cost of sales: £80,243,000 - £35,024,000 = **£45,219,000**

Other income

This will generally relate to dividends received from investments. Since Company A owns shares in Company B it is likely that Company A will receive dividends from Company B. These dividends will be paid out of the profits of Company B. During the consolidation process, if we were to include the dividends received from Company B this income would be a duplication as we are adding the profits together anyway.

Therefore, any dividends received by Company A from Company B must be deducted when totalling the other income.

Click to display/hide the solution.

The remaining figures in the consolidated income statement are relatively straightforward.

Distribution costs and administration expenses

This is a simple addition: £16,296,000 + £4,180,000 = **£20,476,000**

Profit from operations

This is the sum of gross profit plus other income less distribution costs and administration expenses. £45,219,000 + £1,100,000 - £20,476,000 = **£25,843,000**

Finance costs

This is a simple addition: £2,200,000 + £640,000 = **£2,840,000**

Profit before tax

This is profit from operations less finance costs.
£25,843,000 - £2,840,000 = **£23,003,000**

Taxation

This is a simple addition: £5,650,000 + £736,000 = **£6,386,000**

Profit for the year

This is profit before tax less taxation: £23,003,000 - £6,386,000 = **£16,617,000**
We can now complete the consolidated income statement and this is shown below.

Consolidated income statement of Company A plc

	(£000)
Continuing operations	
Revenue	80,243
Cost of sales	35,024
Gross profit	45,219
Other income	1,100
Distribution costs and administrative expenses	20,476
Profit from operations	25,843
Finance costs	2,840
Profit before tax	23,003
Tax	6,386
Profit for the year from continuing operations	16,617

At this point you have completed the consolidated income statement and have identified the profit for the year, however, unless Company B is a wholly owned subsidiary, not all of this profit belongs to Company A.

In this instance, Company A only owns 80% of the shares in Company B, therefore 20% of the shares are owned by other shareholders and this will be classed as the 'non-controlling interest'.

It is important therefore to now show how the profit for the year is split between the equity holders of Company B and the non-controlling interest.

The non-controlling interest is the 20% of Company B not owned by Company A and the profit belonging to the non-controlling interest is therefore 20% of Company B's profit for the year:
£4,600,000 x 20% = £920,000

The balance of the consolidated profit for the year belongs to the equity holders of Company A:
£16,617,000 - £920,000 = £15,697,000

The attributable shares of profits table can now be completed

Attributable to	
Equity holders of the parent	15,697
Non-controlling interest	920
	16,617

Summary

To summarise, when completing consolidated income statements:

- identify what % of the shares of company B is owned by company A to establish whether a consolidated statement of comprehensive income is required
- add together the revenue and remove inter-company sales at selling price
- add together the cost of sales and remove inter-company purchases at selling price and also add back any unrealised profit on the inventory transferred between group companies
- add together any other income, remembering to deduct inter-company dividends
- add together expenses
- add together finance costs
- add together taxation
- all other figures are calculated within the consolidated income statement
- calculate the non-controlling interest in the total profits of the group
- deduct this amount from the total profits to identify the profit attributable to the equity holders of the parent company.