QUESTION

P Ltd (‘P’) owns 80% of S Ltd (‘S’).

During the current period P recorded sales in the amount of $500,000 to S.

At the end of the period, S still holds half of the inventory relating to the above transactions.

P applies a 25% mark-up on all intra-group sales.

Required:

a) Show the journal entries required to correctly account for the above transactions in the period end consolidated accounts of P?

b) Assume that in the above scenario, it was S that sold to P, show the journal entries required to correctly account for the above transactions in the period end consolidated accounts of P?

SOLUTION

*MF NOTE*: Transactions like the above can be referred to as either ‘downstream’ (parent selling to a subsidiary) or ‘upstream’ (subsidiary selling to parent).

When preparing consolidated financial statements, adjustments are required to remove the effects of intragroup transactions, a common one being the intragroup sale of goods.

The main adjustment required is to remove any unrealised profit from inventory i.e. re-state the inventory at its original cost to the group as a whole.

To answer these questions properly, the key is to identify the company making the profit on the intragroup sale. In this case, the parent is making the profit so the full unrealised profit will be removed from the parent’s retained earnings.

If instead, the subsidiary had sold to the parent, then the unrealised profit would have to be split between the parent and the non-controlling interest (NCI).
(a)
Total amount of sales: $500,000
Amount remaining in inventory: $250,000 (50%)
Unrealised Profit: $50,000 ($250,000 x 100%/125%)

**Journal 1 - Remove the unrealised profit from inventory:**

- **Dr** Reduce - Consolidated Retained Earnings $50,000
- **Cr** Reduce – Consolidated Inventory * $50,000

* MF NOTE: Inventory adjustments affect both the Statement of Financial Position (‘SOFP’) and the Statement of Profit or Loss and Other Comprehensive Income (‘SPLOCI’). In this case you also need to reduce Consolidated Closing Inventory in the SPLOCI by $50,000 (this will have the effect of increasing Consolidated Cost of Sales by $50,000). You only need to make this additional adjustment where you are asked to prepare a SPLOCI.

**Journal 2: Remove the intragroup sale/purchase from the SPLOCI**

- **Dr** Reduce – Consolidated Revenue $500,000
- **Cr** Reduce – Consolidated Purchases $500,000

* MF NOTE: You only need to make this additional adjustment where you are asked to prepare a SPLOCI.*
Total amount of sales: $500,000
Amount remaining in inventory: $250,000  ($500k x 50%)
Unrealised Profit: $50,000  ($250,000 x 100%/125%)
Parent’s Share: $40,000  ($50k x 80%)
NCI’s Share: $10,000  ($50k x 20%)

MF NOTE: In this case, the subsidiary has sold to the parent so the unrealised profit is split between Parent/NCI.

Journal 1 - Remove the unrealised profit from inventory:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Reduce - Consolidated Retained Earnings</th>
<th>$40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
<td>Reduce – NCI</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cr</td>
<td>Reduce – Consolidated Inventory</td>
<td>$50,000</td>
</tr>
</tbody>
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Journal 2: Remove the intragroup sale/purchase from the SPLOCI

<table>
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<tr>
<th>Dr</th>
<th>Reduce – Consolidated Revenue</th>
<th>$500,000</th>
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<td>Reduce – Consolidated Purchases</td>
<td>$500,000</td>
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MF NOTE: To reconfirm, the only difference between (a) and (b) is that the unrealised profit must be split between the parent and NCI in (b) because it is the subsidiary that is making the profit on the intragroup sale.