Consolidated financial statements

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Limitations

This compendium is a summary of the principles for establishing consolidated financial statements. It makes no claims to being exhaustive. Its aim is to introduce the subject for persons who are not familiar with accounting.

Synonyms

Consolidated financial statements *(AmE)* are also known under as consolidated accounts and group accounts *(BrE)*.

Background

History

Modern accounting was developed in Italy in the late 15th century. It was only at the beginning of the 20th century that consolidated financial statements arose in USA. Corporations in Europe followed during the 1920s and 1930s. It wasn't until the 1940s, however, that legislation began to handle the subject.

One of the main reasons why legislation was introduced in Sweden was the Kreuger Crash of the early 1930s. The empire of Ivar Kreuger was composed of companies all over the world. The companies often had different financial years. Due to possibilities to transfer gains and losses between the companies, all companies were able to show profits. Assets were sold between the companies with profit close to the year-end closing for the selling company. When the bubble burst the fact came out that the companies were overvaluing their assets. These transactions would not have resulted in these horrid consequences if there had been demands for consolidated financial statements with elimination of internal income/expense, profits/losses, assets and liabilities.

What is a group

A group consists of one parent company with one or more subsidiaries. A parent company is a company that directly or indirectly owns more than 50% of the votes in another company. The company owned is called a subsidiary. A group also exists if a company has determining influence over another company without owning more than 50% of the votes. Such influence may refer to the contractual right to appoint more than half of the members of the board of directors or the management, the right to decide on strategies, etc.

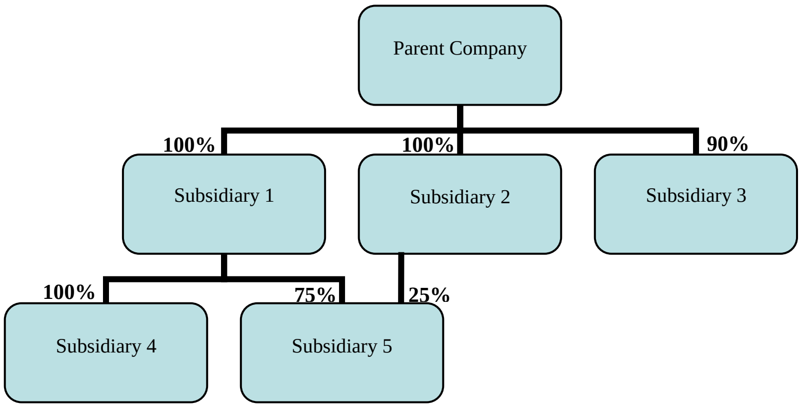

Figure 1 – Example of a group

Why establish consolidated financial statements

A primary motive for establishing consolidated financial statements is that the group's result and position should be judged by how much dividend the parent company can pay to its shareholders. A single company can pay dividends to the shareholders only if the company has distributable earnings. If the same rules were not applied to the group, it would be possible to pay dividends even if the group lacked distributable earnings.

Another motive is that the consolidated balance sheet should show the group's profit/loss for the year minus dividends within the group and minus internal profits/losses during the financial year. The group's unrealized internal profits may not be included in distributable earnings.

For public companies, the consolidated financial statements are the primary reporting to the shareholders, creditors, employees and other stakeholders. The reporting of the parent company is of secondary importance.

What are consolidated financial statements

Consolidated financial statements are fiction. It shows the result and position that would have occurred if the parent company had directly bought the assets and liabilities of the subsidiary instead of the shares.

Consolidated financial statements are made using a cross-indexed summary of similar assets, liabilities, income and costs for the different group companies. Everything should be valuated according to the same principles, recalculated to the same currency and closed at the same date. Since the objective is to show the group as if they were one company, all internal balances and earnings must be eliminated and only show profits/losses that are earned by the parent company or by the subsidiaries after they joined the group.

The income statements and the balance sheets that the consolidated financial statements are based on should subscribe to the same principles regarding valuation and classification.

The all-inclusive income concept should be applied by groups. This means all changes to equity of the group, excepting dividends and capital contributions in the parent company, should be accounted for by the income statement.

The acquisition in the parent company of a subsidiary is regarded as an acquisition of the assets and liabilities of the subsidiary in consolidated financial statements. The shares in the subsidiary are substituted for the assets and liabilities of the subsidiary. The assets and liabilities are revaluated to the acquisition cost of the parent company.

Laws and recommendations

National legislation

Every country has their own legislation regarding different kinds of legal entities and their businesses. The legislation is often affected by international influence. Even if legislation is specific on many subjects it generally refers to the Generally Accepted Accounting Principles (GAAP) when it comes to consolidated financial statements. GAAP can be both national and international.

International legislation

The 7th EU directive establishes the minimum requirements for consolidated financial statements within the European Union. The legislation of the individual EU countries are based on this legislation.

National recommendations

As legislation refers to GAAP there is ongoing development of accounting regarding market demands for accounting and insight into companies. The GAAP are put together as a joint effort of the authorities and the trade and industry organisations. National recommendations are modified to adhere to national and international developments in accounting.

International recommendations

On the international level, GAAP development is made in conjunction with the International Accounting Standards Board. IASB publish recommendations called IFRS (International Financial Reporting Standards). There is also the IASC (International Accounting Standards Committee) organisation. It publishes the IAS recommendations (International Accounting Standards).

The role of the IASB as international provider of GAAP has grown during the past few years since the EU determined that IAS/IFRS are mandatory as of January 1, 2005 for all companies traded on a stock exchange. For all other companies adoption of these recommendations is voluntary.

Methods for consolidated financial statements

There are four methods for establishing consolidated financial statements

- The purchase method
- The pooling method
- The equity method
- The proportional method

The choice of method depends on how the acquisition of the subsidiary has been made. The methods may occur together in the same consolidated financial statements.

Because the three later methods are rather seldom (and not permissible in new acquisitions) the following section of this presentation will deal with the purchase method only.

The Purchase Method

When applying the purchase method the acquisition by the parent company of a subsidiary is regarded as an acquisition of the assets and liabilities of the subsidiary in the consolidated financial statements. The shares in the subsidiary are substituted for the assets and liabilities of the subsidiary. The assets and liabilities are then revaluated to the acquisition cost of the parent company. The valuation of the subsidiary is based on an acquisition analysis.

In reality it is not the assets and liabilities that form the basis of the valuation of the subsidiary. Instead it is the equity of the subsidiary that is the point of departure of the analysis. The equity may consist of both taxed and untaxed equity. The latter is transformed to taxed equity when the consolidated financial statements are made. The amount of deferred tax is then subtracted from it.

Equity = Assets - Liabilities = Net assets

Debit	**Credit**
Assets	Equity
	Liabilities

Figure 2 – Balance sheet

Financial statements of the possession

When an acquisition of a subsidiary is made the purchase price of the share is often based on a financial statement on the takeover date. In this statement the assets and liabilities of the purchased company are market valued.

In the example below the properties of a company are valued at 10 000. Other assets and liabilities are market valued at their booked value. In the agreement, the buyer and seller has agreed that a deduction for deferred tax should be done with 10% on the surplus value of the properties.

Balance sheet	Booked value	Adjustment Assets	Adjustment Liabilities	Market value
Properties	2 500	7 500		10 000
Receivables	500			500
Cash and Bank	100			100
	3 100	**7 500**	**0**	**10 600**
Equity	1 500	7 500	-750	8 250
Deferred tax	500		750	1 250
Liabilities	1 100			1 100
	3 100	**7 500**	**0**	**10 600**

Figure 3 – Example of a financial statement for a takeover

Based on the values above the company is valued at 8 250.

If the deferred tax had been calculated at a higher percentage, the valuation would have declined. Conversely it would have increased at a lower percentage.

Alternative method for calculating the purchase price

Market value of the assets	+	10 600
Booked value of the assets	-	3 100
Market value of the liabilities	-	2 350
Booked value of the liabilities	+	1 600
Book value of the equity	+	1 500
Purchase price for the shares	=	**8 250**

Acquisition analysis

At the date of acquisition an analysis must be preformed in order to determine:

- the acquisition value of the shares
- the market value of the assets and liabilities of the purchased company

If the acquisition value of the shares is higher than the market value of the net assets, this constitutes goodwill.

The acquired equity equals the equity of the purchased company at the date of acquisition. This amount equals the booked value of the assets and liabilities in the purchased company at the date of acquisition (fig. 2, page 5).

A surplus value of an asset exists if the market value of the asset is higher than the booked value. Is the market value of a liability is lower than the booked value, a surplus value also exists.

An undervaluation exists if the situation is reversed. This is where the market value of an asset is lower than the booked value of the asset or if the market value of a liability is higher than the booked value of the liability.

The significance of the acquisition analysis is to establish the group-relevant acquisition value for the assets and the liabilities of the purchased company. This is based on the acquisition value of the shares. The analysis is based on the income statement and the balance sheet of the subsidiary upon the date of acquisition. The acquired assets and liabilities are market valued and the accounting principles regarding classification are adjusted to the principles of the parent company.

The acquisition analysis below is based on the financial statement for the takeover above (fig. 3, page 6). The analysis affects both the income statement and the balance sheet. The analysis is meant to establish how the purchased assets and liabilities of the subsidiary would affect the consolidated balance sheet. As a result of this the amount of equity acquired before purchase is established along with any surplus values or undervaluations.

In the example below, the market values of the assets and liabilities and the deferred tax correspond to the financial statement of the takeover. This is quite rare. Normally there is a difference of some kind regarding the valuation or the percentage for the deferred tax. This affects the surplus value of the shares.

Acquired Equity		
Purchase price for the shares		8 250
Share capital	1 000	
Restricted reserves	200	
Non-restricted reserves	250	
Profit for the period	50	
Properties	7 500	
Deferred tax		750
	9 000	**9 000**

Market value of the properties	10 000
Booked value	-2 500
Surplus value for group	**7 500**
Deferred tax	1 250
Booked value	-500
Undervaluation for group	**- 750**

Acquired Income		
Income	1 000	
Operating expense		500
Depreciation		50
Interest		379
Tax		21
Profit		50
	1 000	**1 000**

Figure 4 – Example of an acquisition analysis

The acquired equity affects both the immediate and future consolidated balance sheet. The acquired income affects only the immediate consolidated income statement. The net profit (income reduced with expenses etc.) earned by the subsidiary before the date of acquisition is not included in the net profit for the group. The elimination/reduction is made row by row in the income statement.

When the acquisition analysis is done there is a foundation for how the assets and liabilities of the subsidiary should be handled in the consolidated balance sheet. The fundamental is that the equity which the subsidiary owns at the acquisition date is never considered a part of the consolidated equity.

Deferred tax

You encountered the term deferred tax above. This term refers to a tax consequence which is not accounted for in the income statement. Instead, this consequence is deferred to the future. A deferred tax may both refer to assets and liabilities.

The most common deferred tax asset is losses that the company has not been able to use during the accounting period. These losses do not result in reduced tax until they are used in the income tax statement of the company.

On the other side of the balance sheet, the most common deferred tax liability is the consequence of different treatment of assets and liabilities in the accounting records compared with the income tax statement. This is allowed in some countries but not in others. A company might also have untaxed reserves, which will not result in any tax until they are reversed in the income statement. Finally, consolidated surplus values result in a deferred tax liability. This liability is reversed in proportion to the reversal of the surplus value. The opposite situation occurs with consolidated undervaluations.

Minority

When the parent company owns less than 100% of the subsidiary this constitutes a minority. The minority has a right to a share both in the net profit/loss of the year and in the net assets.

Elimination of shares

The acquisition analysis forms the basis for eliminating the shares in the subsidiary. The analysis refers to the situation at the date of acquisition. It must be adjusted in future consolidated financial statements with regard to development within the group. Since depreciations reduce the surplus value there is a corresponding change reduction of the deferred tax related to the surplus value. The net effect of these transactions is accounted for in the income statement.

Balance item	Opening elimination	Reallo-cation	Elimination of the year	Closing elimination
Properties	7 500		-56	7 444
Shares in subsidiary	-8 250			-8 250
Share capital	1 000			1 000
Restricted reserves	200			200
Non-restricted reserves	250	50		300
Net profit/loss	50	-50	51	51
Deferred tax	-750		5	-745
	0	**0**	**0**	**0**

Figure 5 – Example of share elimination

In the income statement the reduction of the surplus value of the properties is accounted for as depreciation. The reduction of the deferred tax is accounted for as a reduction of tax expense.

The closing elimination of this year forms the opening elimination for the next year.

Adjustments

Aside from elimination of acquired equity and changes in share elimination, the consolidated financial statements must be adjusted in some way to provide a fair view of the group as if it were one company. The most common adjustments are:

- Internal income, expenses and profits/losses
- Internal receivables and liabilities
- Untaxed reserves converted to equity and deferred tax
- Group contributions are converted to tax expense and equity
- Other adjustments which are needed to adjust the accounts of the subsidiaries to the accounting principles of the parent company

Consolidated financial statements

Joint accounts for the companies in the groups, the elimination of shares, the adjustments etc. form the consolidated financial statements. Enclosure 1 shows a group consisting of a parent company with two subsidiaries. The first subsidiary has been part of the group for a number of years. The second subsidiary was acquired by the parent company during the past year. Based on these conditions the acquired equity is eliminated together with the acquired income statement of subsidiary 2. Depreciations are made on the acquired surplus values. The depreciations reduce deferred tax. Internal income, expenses and the result are adjusted along with internal receivables and liabilities. Finally, untaxed reserves are converted to non-restricted equity and deferred tax.

Summary

A company that owns more than 50% of the votes in another company is a parent company to the subsidiary owned. Together they form a group which is obligated to submit consolidated financial statements. It is also mandatory to issue consolidated financial statements when a company has determining influence over another company. Consolidated financial statements are prepared in order to show all the companies in the group as if they were one. All companies in the group must apply the same accounting principles and accounting year as the parent company. Internal income, expenses and profits/losses must be eliminated from the income statement. The same goes for internal receivables and liabilities in the balance sheet. The consolidated financial statements are guided by both national and international laws and recommendations. The most common method to apply consolidated financial statements is the purchase method. This method is based on an acquisition analysis which determines the acquired equity of the subsidiary. The acquired equity is never included in the equity of the group. It is only the equity of the parent company and profits/losses in the subsidiaries after the acquisition that should be included in the equity of the group. The acquisition analysis changes constantly as acquired surplus values and deferred tax are reduced as depreciations and tax expenses.

Questions

1. What is a group (in accordance with a consolidated financial statement)?
2. What is a parent company?
3. What is a subsidiary?
4. Why is there a need to establish consolidated financial statements?
5. Which method is most common for establishing consolidated financial statements?
6. What do the net assets of a company consist of?
7. Which equity should be included in the equity of the group?
8. What should be excluded when consolidated financial statements are established?
9. Why should these items be excluded?
10. What is the meaning of determining influence

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Enclosure 1

Consolidated financial statements

Consolidated financial statements

Item	Prent C	Sub 1	Sub 2	Sum of Comapanies	Elimination Acquired result	Elimination Shares Op bal	Elimination Shares This year	Adjustment Untaxed reserves	Adjustment Internal	GROUP
Income statement										
Income	5 000	3 000	2 000	**10 000**	-1 000				-500	**8 500**
Expenses	-2 500	-1 500	-1 000	**-5 000**	500				500	**-4 000**
Depreciation	-500	-300	-200	**-1 000**	100		-375			**-1 275**
Interest	-1 500	-400	-300	**-2 200**	150				0	**-2 050**
Tax	-140	-224	-140	**-504**	70		38			**-396**
Profit of the year	**360**	**576**	**360**	**1 296**	**-180**	**0**	**-337**	**0**	**0**	**779**
Balance sheet										
Properties	100 000	60 000	40 000	**200 000**		50 000	-375			**249 625**
Shares in subsidiaries	100 000	0	0	**100 000**		-100 000				**0**
Internal receivables	50 000	20 000	10 000	**80 000**					-80 000	**0**
External receivables	50 000	20 000	10 000	**80 000**						**80 000**
Cash and bank	10 000	500	200	**10 700**						**10 700**
	310 000	**100 500**	**60 200**	**470 700**	**0**	**-50 000**	**-375**	**0**	**-80 000**	**340 325**
Equity	60 000	24 000	12 000	**96 000**	-180	-36 000	-337	43 200		**102 683**
Deferred tax	10 000	6 000	4 000	**20 000**		-14 000	-38	16 800		**22 762**
Untaxed reserves	30 000	20 000	10 000	**60 000**				-60 000		**0**
Internal liabilities	30 000	30 000	20 000	**80 000**					-80 000	**0**
External liabilities	180 000	20 500	14 200	**214 700**						**214 700**
	310 000	**100 500**	**60 200**	**470 700**	**-180**	**-50 000**	**-375**	**0**	**-80 000**	**340 145**