An Introduction to Consolidated Financial Statement

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CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements present the financial position and results of operations for a parent (controlling entity) and one or more subsidiaries (controlled entities) as if the individual entities actually were a single company or entity.
• Consolidation is required when a corporation owns a majority of another corporation’s outstanding common stock and occasionally under other circumstances.

• Two companies are considered to be related when one controls the other or both are under the common control of another entity.

• The same accounting principles should be applied in preparing consolidated financial statements as in preparing separate-company financial statements.

• More useful than the separate financial statements of the individual companies when the companies are related.
BENEFITS OF CONSOLIDATED FINANCIAL STATEMENTS

• Presented primarily for those parties having a long-run interest in the parent company, including its management, shareholders, long-term creditors or other resource providers.

• Often provide the only means of obtaining a clear picture of the total resources of the combined entity that are under the parent's control.
LIMITATIONS OF CONSOLIDATED FINANCIAL STATEMENTS

• Results of individual companies included in the consolidation are not disclosed, thereby hiding poor performance.
• Not all the consolidated retained earnings balance is necessarily available for dividends of the parent.
• Financial ratios are not necessarily representative of any single company in the consolidation.
• Similar accounts of different companies that are combined in the consolidation may not be entirely comparable.

• Additional information about companies may be needed for a fair presentation, thus requiring voluminous footnotes.

• Information is lost any time data sets are aggregated.
SUBSIDIARY FINANCIAL STATEMENTS

- Creditors, preferred stockholders, and noncontrolling common stockholders of subsidiaries are most interested in the separate financial statements of the subsidiaries in which they have an interest.
- Because subsidiaries are legally separate from their parents, the creditors and stockholders of a subsidiary generally have no claim on the parent, and the stockholders of the subsidiary do not share in the profits of the parent.
CONSOLIDATION PROCESS - OVERVIEW

• Starting point: Separate financial statements of the companies involved.

• Separate statements are added together, after some adjustments and eliminations, to generate consolidated statements.
  • Adjustments and eliminations relate to intercompany transactions and holdings.
CONSOLIDATION PROCESS

• Intercorporate Stockholdings
  • Common stock of the parent is held by those outside the consolidated entity and is viewed as the common stock of the entire entity.
  • Common stock of the subsidiary is held entirely within the consolidated entity and is not stock outstanding from a consolidated viewpoint.
  • Note: A company cannot report in its financial statements an investment in itself.
• **Intercorporate Stockholdings**
  • Parent’s retained earnings (less the unrealized intercompany profit) remains as the only retained earnings figure in the consolidated balance sheet.
• Intercompany Receivables and Payables
  • A single company cannot owe itself money, that is, a company cannot report (in its financial statements) a receivable to itself and a payable to itself.
  • Therefore, an intercompany receivable/payable is eliminated from both receivables and payables in preparing the consolidated balance sheet.
• Intercompany Sales
  • The sale should be removed from the combined revenues because it does not represent a sale to an external party.
  • Remaining inventory must be restated to its original cost to the consolidated entity (transferring affiliate).
Difference between Fair Value and Book Value

• Fair value of the consideration given usually reflects the fair value of the acquired company and differs from its book value.

• An acquiree’s assets and liabilities must be valued based on their acquisition-date fair values, and any excess of the consideration given over the fair values of the net assets is considered **goodwill**.
Single-Entity Viewpoint

To understand the adjustments needed, one should focus on:

1. identifying the treatment accorded a particular item by each of the separate companies and
2. identifying the amount that would appear in the financial statements with respect to that item if the consolidated entity were actually a single company.
Mechanics of the Consolidation Process

- A worksheet is used to facilitate the process of combining and adjusting the account balances involved in a consolidation.
- While the parent company and the subsidiary each maintain their own books, there are no books for the consolidated entity.
- The balances of the accounts are taken at the end of each period from the books of the parent and the subsidiary and entered in the consolidation workpaper.
• Where the simple adding of the amounts from the two companies leads to a consolidated figure different from the amount that would appear if the two companies were actually one, the combined amount must be adjusted to the desired figure.

• This is done through the preparation of eliminating entries.
Noncontrolling Interest

• For the parent to consolidate the subsidiary, only a controlling interest is needed—not 100% interest.

• Those shareholders of the subsidiary other than the parent are referred to as “noncontrolling” or “minority” shareholders.

• Noncontrolling interest or minority interest refers to the claim of these shareholders on the income and net assets of the subsidiary.
COMBINED FINANCIAL STATEMENTS

• Financial statements are also prepared for a group of companies when no one company in the group owns a majority of the common stock of any other company in the group.

• Combined financial statements are those that include a group of related companies without including the parent company or other owner.

  • Procedures are essentially the same as those used in preparing consolidated financial statements.
SPECIAL PURPOSE ENTITIES

• Corporations, trusts, or partnerships created for a single specified purpose.
• Usually have no substantive operations and are used only for financing purposes.
• Used for several decades for asset securitization, risk sharing, and taking advantage of tax statutes.
VARIABLE INTEREST ENTITIES

• A legal structure used for business purposes, usually a corporation, trust, or partnership, that either:
  • Does not have equity investors that have voting rights and share in all profits and losses of the entity.
  • Has equity investors that do not provide sufficient financial resources to support the entity’s activities.
DIFFERENT APPROACHES TO CONSOLIDATION

• Theories that might serve as a basis for preparing consolidated financial statements:
  • Proprietary theory
  • Parent company theory
  • Entity theory

• With the issuance of FASB 141R, the FASB’s approach to consolidation has moved very much toward the entity theory.
## Recognition of Subsidiary Income

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- **Revenues**
- **Expenses**
- **Net income**

Portion included in consolidated financial statements.
PROPRIETARY THEORY

• Views the firm as an extension of its owners.
• Assets and liabilities of the firm are considered to be those of the owners.
• Results in a pro rata consolidation where the parent consolidates only its proportionate share of a less-than-wholly owned subsidiary’s assets, liabilities, revenues and expenses.
PARENT COMPANY THEORY

• Recognizes that though the parent does not have direct ownership or responsibility, it has the ability to exercise effective control over all of the subsidiary’s assets and liabilities, not simply a proportionate share.

• Separate recognition is given, in the consolidated financial statements, to the noncontrolling interest’s claim on the net assets and earnings of the subsidiary.
ENTITY THEORY

• Focuses on the firm as a separate economic entity, rather than on the ownership rights of the shareholders.

• Emphasis is on the consolidated entity itself, with the controlling and noncontrolling shareholders viewed as two separate groups, each having an equity in the consolidated entity.

• All of the assets, liabilities, revenues, and expenses of a less-than-wholly owned subsidiary are included in the consolidated financial statements, with no special treatment accorded either the controlling or noncontrolling interest.
CURRENT PRACTICE

Current approach clearly follows the entity theory with minor modifications aimed at the practical reality that consolidated financial statements are used primarily by those having a long-run interest in the parent company.
THANK YOU