



Consolidated Financial Statements

- Many corporations are composed of numerous separate companies and, in turn, prepare consolidated financial statements.

3.2

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.

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Consolidated Financial Statements

- Consolidation is required when a corporation owns a majority of another corporation's outstanding common stock.
- The accounting principles applied in the preparation of the consolidated financial statements are the same accounting principles applied in preparing separate-company financial statements.

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Consolidated Financial Statements

- Two companies are considered to be related companies when one controls the other company.
- Consolidated financial statements are generally considered to be more useful than the separate financial statements of the individual companies when the companies are related.

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Consolidated Financial Statements

- Whether the subsidiary is acquired or created, each individual company maintains its own accounting records, but consolidated financial statements are needed to present the companies together as a single economic entity for general-purpose financial reporting.

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Benefits

- Consolidated financial statements are presented primarily for the benefit of the shareholders, creditors, and other resource providers of the parent.
- Significantly, consolidated financial statements often represent the only means of obtaining a clear picture of the total resources of the combined entity that are under the control of the parent company.

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Limitations

- While consolidated financial statements are useful, their limitations also must be kept in mind.
- Some information is lost any time data sets are aggregated; this is particularly true when the information involves an aggregation across companies that have substantially different operating characteristics.

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Subsidiary Financial Statements

- Because subsidiaries are legally separate from their parents, the creditors and stockholders of a subsidiary generally have no claim on the parent, nor do the stockholders of the subsidiary share in the profits of the parent.
- Therefore, consolidated financial statements usually are of little use to those interested in obtaining information about the assets, capital, or income of individual subsidiaries.

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The Tradition View of Control

- The professional guidance regarding consolidated financial statements is provided in **ARB 51** and **FASB 94**.
- Under current standards, consolidated financial statements must be prepared if one corporation owns a majority of another corporation's outstanding common stock.

3-10

Less Than Majority Ownership

- Although majority ownership is the most common means of acquiring control, a company may be able to direct the operating and financing policies of another with less than majority ownership, such as when the remainder of the stock is widely held.
- **FASB 94** does not preclude consolidation with less than majority ownership, but such consolidations have seldom been found in practice.

3-11

Indirect Control

- The traditional view of control includes both direct and indirect control.
- Direct control typically occurs when one company owns a majority of another company's common stock.
- Indirect control (or pyramiding) occurs when a company's common stock is owned by one or more other companies that are all under common control.

3-12

Ability to Exercise Control

- Under certain circumstances, the majority stockholders of a subsidiary may not be able to exercise control even though they hold more than 50 percent of its outstanding voting stock. Examples:
 - Subsidiary is in legal reorganization or bankruptcy
 - Foreign country restricts remittance of subsidiary profits to domestic parent company
 - Parent is unable to control important aspects of the subsidiary's operations.

3-13

Ability to Exercise Control

- When consolidation is not appropriate, the unconsolidated subsidiary is reported as an intercorporate investment.

3-14

Differences in Fiscal Periods

- A difference in the fiscal periods of a parent and subsidiary should not preclude consolidation of that subsidiary.
- Often the fiscal period of the subsidiary, if different from the parent's, is changed to coincide with that of the parent.
- Another alternative is to adjust the financial statement data of the subsidiary each period to place the data on a basis consistent with the fiscal period of the parent.

3-15

Differences in Accounting Methods

- A difference in accounting methods between a parent and its subsidiary generally should have no effect on the decision to consolidate that subsidiary.
- In any event, adequate disclosure of the various accounting methods used must be given in the notes to the financial statements.

3-16

Reporting Entity-A Changing Concept

- The FASB is currently considering some of the difficult issues relating to control. Ultimately, the FASB is expected to move beyond the traditional concept of legal control based on majority ownership and also require consolidation of entities under the effective control of another entity, even though the other entity may not hold majority ownership.
- This broader view would contribute to the harmonization of accounting standards in the global economy.

3-17

Inadequate Standards

- Consolidation standards relating to partnerships or other types of entities (such as trusts) have been virtually nonexistent.
- Even corporate consolidation standards have not been adequate in situations where other relationships such as guarantees and operating agreements overshadow the lack of a significant ownership element.

3-18

Inadequate Standards

- Although many companies have used special entities for legitimate purposes, companies such as Enron took advantage of the lack of standards to avoid reporting debt or losses by hiding them in special entities that were not consolidated.
- Only in the past few years have consolidation standards for these special entities started to provide some uniformity in the financial reporting for corporations having relationships with such entities.

3-19

Special Purpose/Variable Interest Entities

- Special-purpose entities (SPEs) are corporations, trusts, or partnerships created for a single specified purpose.
- They have no substantive operations and are used only for financing purposes.
- Special-purpose entities have been used for several decades for asset securitization, risk sharing, and to take advantage of tax statutes.

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Special-Purpose Entities

- In general, **FASB 140** states that SPEs be "demonstrably distinct from the transferor," its activities be significantly limited, and it hold only certain types of financial assets.
- If the conditions of **FASB 140** are met, this type of SPE is not consolidated by the transferor of assets to the SPE.

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Variable Interest Entities

- A variable interest entity is 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.

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Variable Interest Entities

- In a variable interest entity, specific agreements may be limit the extent to which the equity investors, if any, share in the profits or losses (etc.) of the entity.
- **FIN 46** (an interpretation of **ARB 51**) uses the term variable interest entity to encompass SPEs and other entities falling within its conditions.
- This pronouncement does not apply to entities that are considered SPEs under **FASB 140**.

3-23

Overview of the Consolidation Process

- The consolidation process adds together the financial statements of two or more legally separate companies, creating a single set of financial statements.
- The specific procedures used to produce consolidated financial statements are discussed in considerable details in Chapters 4 to 10.

3-24

Overview of the Consolidation Process

- The separate financial statements of the companies involved serve as the starting point each time consolidated statements are prepared.
- These separate statements are added together, after some adjustments and eliminations, to generate consolidated statements.

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Overview of the Consolidation Process

- After all the consolidation procedures have been applied, the preparer should review the resulting statements and ask: "Do these statements appear as if the consolidated companies were actually a single company?"

3-26

Overview of the Consolidation Process

- Several items need to be given special attention to ensure that the consolidated financial statements appear as if they are the statements of a single company:
 - Intercorporate stockholdings.
 - Intercompany receivables and payables.
 - Intercompany sales (i.e., unrealized profits)

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Overview of the Consolidation Process

- Stated otherwise:
 - "You can't own yourself."
 - "You can't owe yourself money."
 - "You can't make money selling to yourself."

3-28

Intercorporate Stockholdings

- The common stock of the parent is held by those outside the consolidated entity and is properly viewed as the common stock of the entire entity.
- In contrast, the common stock of the subsidiary is held entirely within the consolidated entity and is not stock outstanding from a consolidated viewpoint.

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Intercorporate Stockholdings

- Because a company cannot report (in its financial statements) an investment in itself, the investment, as well as the equity underlying that investment, is eliminated as follows:

Common Stock-Subsidiary	BV *
Additional Paid-In Capital-Subsidiary	BV
Retained Earnings-Subsidiary	BV
Investment in Common Stock of Subsidiary	BV

* BV = Book Value

3-30

Intercompany Stockholdings

- NOTE: The equity accounts of the parent represent the equity accounts disclosed on the financial statements of the consolidated entity.

3-31

Difference between Cost and Book Value

- The elimination entry related to "intercompany stockholdings" (in the previous slide) was prepared under the assumption that the parent purchased the subsidiary at book value.
- In reality, the purchase price of a subsidiary usually differs from the book value of the shares acquired.
- This differential is treated in the same way in preparing consolidated financial statements as for a merger, discussed in Chapter 1.

3-32

Difference between Cost and Book Value

- Typical Situation: Generally speaking, if the parent paid more for the subsidiary than book value of the shares acquired (a net debit differential), the excess would be allocated (during the consolidation process) to specific assets and liabilities of the subsidiary, or to goodwill.
- Allocation of differentials is extensively discussed in Chapter 4.

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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. Thus, with respect to the consolidated balance sheet, the following entry is made to eliminate intercompany receivables and payables between the parent and the subsidiary:

Consolidated Accounts Payable	BV *
Consolidated Accounts Receivable	BV

* BV = Book Value

3-34

Intercompany Sales (Unrealized Profits)

- A single company may not recognize a profit and write up its inventory simply because the inventory is transferred from one department or division to another (since no arm's length transaction has occurred to justify recognition of the profit).
- This also applies to intercompany sales within a consolidated entity.

3-35

Intercompany Sales (Continued)

- Since unrealized profits (in ending inventory) overstate ending inventory and understate cost of goods sold, consolidated net income as well as consolidated retained earnings are overstated.
- With respect to the consolidated balance sheet, the following elimination entry is required with respect to unrealized profits in ending inventory (e.g., \$2,000):

Consolidated Retained Earnings	\$2,000
Consolidated Ending Inventory	\$2,000

3-36

Single-Entity Viewpoint

- In understanding each of the adjustments needed in preparing consolidated statements, the focus should be on both:
 - Identifying the treatment accorded a particular item by each of the separate companies.
 - Identifying the amount that would appear in the financial statements with respect to that item if the consolidated entity were actually a single company.

3-37

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.
- Instead, 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.

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Mechanics of the Consolidation Process

- 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.
- Consolidation workpapers and eliminating entries are discussed in more detail in Chapters 4 to 10.

3-39

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.
- The claim of these shareholders on the income and net assets of the subsidiary is referred to as the noncontrolling interest or the minority interest.

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Noncontrolling Interest

- The FASB favors treating the noncontrolling interest as an ownership interest, with the noncontrolling interest’s claim on subsidiary assets reported in consolidated stockholders’ equity and the claim on subsidiary net income reported as an allocation of consolidated net income.

3-41

Noncontrolling Interest

- The noncontrolling shareholders’ claim on the net assets of the subsidiary is shown most commonly between liabilities and stockholders’ equity in the consolidated balance sheet.
- Some companies show the noncontrolling interest with liabilities although it clearly does not meet the legal or accounting definition of a liability.

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Noncontrolling Interest

- The portion of the subsidiary net income assigned to the noncontrolling interest normally is deducted from earnings available to all shareholders to arrive at consolidated net income in the consolidated income statement.
- Although this assignment of income does not meet the definition of an expense, it normally is accorded this expense-type treatment.

3-43

Combined Financial Statements

- Financial statements sometimes are 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.
- Financial statements that include a group of related companies without including the parent company or other owner are referred to as combined financial statements.

3-44

Different Approaches to Consolidation

- Several different theories exist that might serve as a basis for preparing consolidated financial statements.
- The choice of consolidation theory can have a significant impact on the consolidated financial statements in those cases where the parent company owns less than 100 percent of the subsidiary's common stock.

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Different Approaches to Consolidation

- The remaining slides focus on the following alternative theories of consolidation:
 - Proprietary
 - Parent company
 - Entity

3-46

Proprietary Theory

- The proprietary theory of accounting views the firm as an extension of its owners.
- The assets and liabilities of the firm are considered to be assets and liabilities of the owners themselves.
- Similarly, revenue of the firm is viewed as increasing the wealth of the owners, while expenses decrease the wealth of the owners.

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Proprietary Theory

- When applied to the preparation of consolidated financial statements, the proprietary concept results in a pro rata consolidation.
- The parent company consolidates only its proportionate share of the assets and liabilities of the subsidiary.

3-48

Parent Company Theory

- The parent company theory is perhaps better suited to the modern corporation and the preparation of consolidated financial statements than is the proprietary approach.
- The parent company theory recognizes that although the parent does not have direct ownership of the assets or direct responsibility for the liabilities of the subsidiary, it has the ability to exercise effective control over all of the subsidiary's assets and liabilities, not simply a proportionate share.

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Parent Company Theory

- Under parent company theory, separate recognition is given in the consolidated balance sheet to the noncontrolling interest's claim on the net assets of the subsidiary and in the consolidated income statement to the earnings assigned to the noncontrolling shareholders.

3-50

Entity Theory

- As a general rule, the entity theory focuses on the firm as a separate economic entity, rather than on the ownership rights of the shareholders of the parent or subsidiary.
- Emphasis under the entity approach 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.
- Neither of the two groups is emphasized over the other or over the consolidated entity.

3-51

Entity Theory

- Because the parent and subsidiary together are viewed as a single entity (under the entity approach), all the assets and liabilities of the subsidiary and any goodwill are reflected in the consolidated balance sheet at their full values on the date of combination regardless of the actual percentage of ownership acquired.
- Additionally, consolidated net income is a combined figure that is allocated between the controlling and noncontrolling ownership groups.

3-52

Current Practice

- The procedures used in practice represent a blending of the parent company and entity approaches.
- The amount of subsidiary net assets recognized in the consolidated balance sheet at acquisition is the same in practice as under the parent company approach.
- On the other hand, the determination of consolidated net income is a combination of the entity and parent company approaches.

3-53

Future Practice

- The FASB has proposed moving to an entity approach in practice.
- This would result in classifying the noncontrolling interest in the stockholders' equity section of the consolidated balance sheet and labeling the total income of the consolidated entity as consolidated net income, with an allocation of consolidated net income between the controlling and noncontrolling interests in the income statement.

3-54

You Will Survive This Chapter !!!

- Remember:
 - “You can’t own yourself.”
 - “You can’t owe yourself money.”
 - “You can’t make money selling to yourself.”
- NOTE: Elimination entries tend to reduce balances—not increase them.
 - EXCEPTION: Entries relating to the allocation of the difference between investment cost and book value, that is, the differential.

3-55



Chapter 3

End of Chapter

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