All together now

Consolidation can seem complicated. Doug Williamson unpicks the complexity to explain the purpose and process of consolidated group accounting

Some large businesses organise themselves as a single company. More frequently, a larger business will be organised as a group of companies. Most groups are owned and controlled by a common holding company called the parent. The parent, in turn, controls one or more subsidiary companies (subsidiaries).

The majority of treasurers work in group organisations. Most of our external contacts will also be parts of groups. So we need to be able to fully understand group accounts.

Treasurer's role

Our role includes:
(1) Interpreting financial information about other businesses.
(2) Understanding and preparing information about our own business.

We also need to appreciate the important legal distinction between the various different companies in a group, and the group as a whole.

The accounts are multiplying

Groups prepare:
- Individual accounts for the parent company and for each subsidiary.
- Consolidated accounts for the group.

Why so many?

Different sets of accounts are used for different purposes. The individual accounts show the position and the performance of each individual company, but not the group as a whole.

ILLUSTRATION: IMAGE SOURCE

The consolidated accounts combine all the information from the subsidiaries under the parent's control. Group accounts report the underlying commercial reality of the effective control of the parent.

This makes groups readily comparable, even if their legal and ownership structures are quite different. Importantly though, the accounting group is not a legal entity in its own right.

Three very important concepts in group accounting are goodwill, internal transactions and non-controlling interest.

Goodwill

This is any excess of the amount paid for an acquisition over the value of the net assets acquired. It reflects the value of the whole acquired business being greater than the sum of its parts.

For example, if net assets with a value of £100m were acquired for a purchase price of £120m, then goodwill would be:

£120m - £100m = £20m

Goodwill is shown separately in the group statement of financial position.

Goodwill
Any excess of:
1. The amount paid to acquire a business, over:
2. The value of the net assets acquired.

Let's look at an example

Holdco is a parent company and Sub is its subsidiary. Holdco bought Sub some years ago for £1m, which was also the value of Sub's net assets at that time. There was no difference between the amount paid and the value of the net assets acquired. This means the goodwill in the Holdco Group's accounts is £Nil.

STATEMENT OF FINANCIAL POSITION: SUMMARY

£m	Holdco	Sub	Adjustments	Group
Assets				
Investment in Sub	1	–	(1)	–
Other assets	4	200		204
	5	**200**		**204**
Equity	2	80	(1)	81
Liabilities	3	120		123
	5	**200**		**204**

Holdco and Sub's individual assets and liabilities today are set out above, together with the consolidated group figures.

The consolidated group statement shows that the Holdco group controls a much larger amount of assets (£204m) than the individual accounts of Holdco might suggest (only £4m).

The group is also more heavily indebted than Holdco's individual accounts disclose. Its total liabilities are £123m, not just the £3m disclosed in Holdco's individual accounts.

Internal transactions

Internal transactions aren't normally relevant information for the external users of group accounts. Internal items are ones between members of the same group, for example, any sales and purchases between Holdco and Sub.

For this reason, a fundamental principle of consolidation is to remove internal items from the group figures. This avoids group accounts showing misleadingly high levels of activity or assets.

Remove irrelevant information

Let's build up the statement of profit or loss for the Holdco Group. Holdco's total sales were £90m, and Sub's total sales were £50m. The first stage of consolidating these results is simply to add them up. This is done in the first two columns of the table below.

But £40m of Sub's total sales were internal group sales to Holdco. We need to exclude the internal sales and purchases from the group figures. This is also done in the adjustments column below.

The group's total sales to external customers are only £100m, rather than the total of the individual sales of each group company (£90m + £50m = £140m).

Our consolidation adjustments to remove internal transfers (of £40m) ensure consolidated group sales are not overstated.

STATEMENT OF PROFIT OR LOSS: EXTRACTS

£m	Holdco	Sub	Adjustments	Group
External sales	90	10		100
Internal sales	–	40	(40)	–
Total sales	90	50	(40)	100
Internal purchases	(40)	–	40	–
External costs	(38)	(32)		(70)
Profit before tax	**12**	**18**		**30**

Non-controlling interest

Sometimes the group owns less than 100% of a subsidiary, say 90%. Non-controlling interests are the ownership rights in the net assets and profits belonging to the minority shareholders, 10% in this case.

For example, if the net assets of the subsidiary are £80m and the minority interest is 10%, the value of the minority interest in those net assets is:

£80m x 0.10 = £8m

Do I need to do this in the exam?

No, you don't need to calculate group figures in the exam. But you do need to understand the purpose and process of consolidation, and be able to explain them.

Purpose and process, please

A recent exam question on consolidation was surprisingly poorly answered. We can use the 'Purpose and Process' framework of this question (below) to consolidate and demonstrate our knowledge in this important area.

(a) Explain the purpose of preparing consolidated financial statements in addition to those of the parent.

(b) Outline the process by which consolidated financial statements are prepared.

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The concise answer in the box below would have scored full marks.

(a) Purpose

Consolidated financial statements provide important information by summarising:

(1) The total assets and liabilities under the control of the parent.

(2) The results arising from this control.

In the individual statement of financial position of the parent itself, all that is shown is the parent's investment in the subsidiaries, usually at original cost. There is no indication of the actual assets and liabilities of the subsidiaries that the parent controls.

(b) Process

Consolidation adds together the assets, liabilities and results of the parent and all of its subsidiaries.

The investment in each subsidiary is replaced by the actual assets and liabilities of that subsidiary.

Consolidation adjustments are then made for any:

- Goodwill
- Internal transactions and balances
- Non-controlling interests

Consolidated benefits

Consolidation is also a powerful study principle to:

- Identify concise summaries to answer exam questions efficiently.
- Remove irrelevant information from our answers.
- Combine revision and question practice to build a winning exam performance.
- Apply your new skills in the workplace.

Doug Williamson FCT enjoys consolidating his treasury experience and coaching skills to help you pass your exams