

# Consolidated accounts

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## Limitations

This paper will focus on the criteria for establishing groups and the basic principles for consolidated accounting.

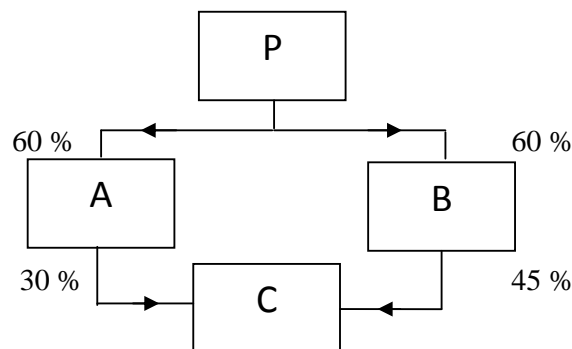
## What is a group?

A group is a financial collaboration between companies with the purpose of coordinating the companies businesses.

A group is composed of one parent company and one or more subsidiaries. A company is a parent company if the company directly or indirectly owns more than half of the total votes in another company<sup>1</sup>. The company that is controlled is called subsidiary<sup>2</sup>.

A group also exists when a company owns less than 50 percent of the votes but has determining influence over the other company. Determining influence occurs when a company controls management and operations by having vote majority through contract with other co-owners, having the right to elect or dismiss its board of directors or through contract with the subsidiary.<sup>3</sup>

In the picture below direct and indirect ownership is exemplified.



Company P owns more than 50 percent of the shares in Company A and B which means that Company P is the parent company, and Companies A and B are its subsidiaries. Company P owns 45 percent of Company C through its subsidiaries A and B. Since Company P has determining influence over Company A and B, Company P

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<sup>1</sup> Company Act

<sup>2</sup> Company Act

<sup>3</sup> Company Act

indirectly has determining influence over Company C. Company C is hence also a subsidiary to Company P.

### **The purpose of consolidated accounts**

The purpose of consolidated accounts is to present the group as one financial unit and consequently giving its stakeholders a complete picture of the groups result and position. Since the parent company to some extent can decide how the result should be divided between the companies it is important to show the groups result and equity excluding internal transactions, profits and losses.

One other main reason for consolidated accounts is to show the parent company's distributable earnings. This since, the Annual Accounts Act states that the parent company must take the groups equity and consolidation need in account when deciding upon dividends to its shareholder.

### **Laws and regulations**

The obligation to establish consolidated accounts is regulated in national and international legislation. In Sweden the requirements are regulated in the Annual Accounts Act and the Company Act.

According to the Annual Accounts Act in Sweden it is only large groups that are legally required to establish consolidated accounts. With large groups it is implied groups where the parent company or one of the subsidiaries are listed on a stock exchange market or were more than one of the following requirements are fulfilled during the last two financial years<sup>4</sup>:

- The number of employees are more than 50
- A balance sheet total of more than 40 M SEK
- Net sales are over 80 M SEK

Parent companies that are also subsidiaries are excluded from the above requirement if all of its subsidiaries are included in consolidated accounts of a superior parent company.<sup>5</sup>

Listed companies must follow international accounting principles, IFRS, when consolidating accounts. IFRS is published by the International Accounting Standard Board. These principles are to some extent a deviation from

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<sup>4</sup> Annual Accounts Act

<sup>5</sup> Annual Accounts Act

Swedish accounting standards. The main difference lies within that assets and debts are included to fair value. Non listed companies can choose if they want to follow IFRS.

The requirement for consolidating accounts means that the parent company in its annual report must in addition to the parent company's income statement, balance sheet and notes include a group balance sheet, a group income statement and notes. In addition to this the director's report should include the whole group. In some cases the parent company also should include a cash flow analysis for the parent company and the entire group.<sup>6</sup>

The accounts of the companies within the group should be based on the same accounting principles and comprise of the same accounting period. It is what is applied in the parent company that is decisive. If the subsidiaries apply different accounting principles than the parent company the consolidated accounts are adjusted.<sup>7</sup>

## **Methods for consolidating financial statements**

There are four different methods for consolidating subsidiaries accounts;

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

The choice of method depends on how the subsidiary was purchased. This means that different methods for consolidation can exist in the same consolidated accounts.<sup>8</sup> The purchase method is the most common method and is therefore the only method that will be explained in the rest of this paper.

Main features in the purchase method are:

- The purchase of a subsidiary is seen as an indirect purchase of the subsidiary's assets and debts
- The subsidiary is included in the parent company's balance sheet under financial assets, while the subsidiary's net assets are included in the group balance sheet. A company's net assets are the company's assets reduced by its debts.

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<sup>6</sup> Annual Accounts Act

<sup>7</sup> Annual Accounts Act

<sup>8</sup> Roland Ljungberg & Dan Phillips, Koncernredovisning i praktiken, 2001

When a subsidiary is purchased an acquisition analysis must be performed at the time of the purchase. The purpose with the acquisition analysis is to determine the value of the shares by identifying and valuating the subsidiary's assets and debts. The subsidiary's assets and debts should be included in the acquisition analysis to the fair value at the time of the acquisition. Fair value is used to enable comparability between a direct purchase of the subsidiary's assets and debts and an indirect purchase of the subsidiary's assets and debts that occurs when the shares of the subsidiary are acquired.<sup>9</sup>

Fair value is the rational and unbiased estimate of the potential market price. This means that there can be a difference between the book value and the fair value. The difference can be both positive and negative.

In the acquisition analysis one must take into account future tax consequences that any difference between fair value and book value will result in. This means that the group has to book a provision for deferred tax in the consolidated accounts. The tax effect must be considered regardless if the parent company is planning on selling the asset or not.<sup>10</sup>

The purchase price for the shares should be divided on the identified assets and debts. Any difference between fair value and book value that has been identified should, if possible, be appointed to the asset or debt that it derives from. If there is a difference between the purchase price and the subsidiary's equity and the difference cannot be appointed to any asset or debt there is goodwill. Goodwill can be both positive and negative. Goodwill is reported in the group balance sheet under intangible assets.<sup>11</sup>

Below you will find an example of the purchase method.

Company A purchases all shares in Company B for 668 M SEK 2008-12-31. Company B owns a property that has a market value of 1,500 M SEK. In the purchase agreement it is stated that full deduction of deferred tax should be done.

The two companies have the following balance sheet the time of the acquisition:

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<sup>9</sup> Roland Ljungberg & Dan Phillips, Koncernredovisning i praktiken, 2001

<sup>10</sup> Rune Lönnquist, Årsredovisning i koncerner, 2006

<sup>11</sup> Roland Ljungberg & Dan Phillips, Koncernredovisning i praktiken, 2001

**Balance Sheet as per 31.12.2008**

	Company A	Company B
<b>Assets</b>		
<i>Tangible fixed assets</i>		
Property		1,000
<i>Current assets</i>		
Bank balances	200	100
<b>Total Assets</b>	<b>200</b>	<b>1,100</b>
<b>Equity and Liabilities</b>		
<i>Equity</i>		
Share capital	100	100
Non restricted reserves	80	150
Profit for the year	20	50
Total equity	200	300
<i>Liabilities</i>		
Total liabilities	0	800
<b>Total Equity and Liabilities</b>	<b>200</b>	<b>1,100</b>

The value of Company B is the company's net assets adjusted for difference between fair value and book value. If Company B did not have a surplus value the value of Company B would be 300 M SEK, i.e. the company's equity. Since the market value of the property is 1,500 M SEK and the book value is 1,000 M SEK, there is a surplus value of 500 M SEK that has to be taken into account. The tax on the surplus value is 26.3 percent of 500, 132 M SEK. The value of Company B is hence the net assets at fair value, 300 M SEK plus the surplus value reduced by tax 368 M SEK, i.e. 668 M SEK.

**Balance Sheet as per 31.12.2008 at fair value**

Company B	Book value	Adjust.	Fair value
<b>Assets</b>			
<i>Tangible fixed assets</i>			
Property	1,000	500	1,500
<i>Current assets</i>			
Bank balances	100		,100
<b>Total Assets</b>	<b>1,100</b>	<b>500</b>	<b>1,600</b>
<b>Equity and Liabilities</b>			
<i>Equity</i>			
Share capital	100		100
Non restricted reserves	150	368	518
Profit for the year	50		50
Total equity	300	368	668
<i>Provisions</i>			
Deferred tax		132	132
<i>Liabilities</i>			
Total liabilities	800		800
<b>Total Equity and Liabilities</b>	<b>1,100</b>	<b>500</b>	<b>1,600</b>

The acquisition analysis in the above example is:

**Acquisition analysis**

Purchase price	668
Equity	300
Market value property	1,500
Book value property	<u>-1,000</u> 500
Deferred tax	-132
<b>Goodwill</b>	<b>0</b>

In the group balance sheet the subsidiary's assets and debts is presented together with the parent company's assets and debts. The group balance sheet should include the subsidiary's assets and debts to the groups purchase price, which means the fair value. Consolidated accounts for the above example are shown below:

### Consolidation 31.12.2008

	Company	Company		Consolidated
	A	B	Elimination	accounts
<b>Assets</b>				
Property		1,000	+500	<b>1,500</b>
Shares in group companies	668		-668	-
Bank balances	200	100		<b>300</b>
<b>Total Assets</b>	<b>868</b>	<b>1,100</b>	<b>-168</b>	<b>1,800</b>
<b>Equity and Liabilities</b>				
<b>Equity</b>				
Share capital	100	100	-100	<b>100</b>
Non restricted reserves	80	150	-150	<b>80</b>
Profit for the year	20	50	-50	<b>20</b>
<b>Provisions</b>				
			+132	<b>132</b>
Liabilities	668	800		<b>1,468</b>
<b>Total Equity and Liabilities</b>	<b>868</b>	<b>1,100</b>	<b>-168</b>	<b>1,800</b>

As one can see in the above example the group's equity comprises of the parent company's equity. The equity from before the acquisition should be eliminated.

### Deferred tax

The tax that is accounted for in the acquisition analysis is called deferred tax. Deferred tax is a provision for future tax as a result from differences between tax values and book values. The difference results in a tax consequence which is not accounted for in the income statement, instead this consequence is deferred to the future. Deferred tax can be either a future tax liability or asset.<sup>12</sup>

### Minority

If a parent company does not own the total number of shares in the subsidiary there is a minority owner that has to be accounted for in the consolidated accounts. According to the purchase method the subsidiary should be included as a whole unit regardless how many shares the parent company holds. The minority owner's share of the equity is presented on a separate row in the balance sheet after equity. This is also the case for the minority's share of the profit; the minority owner's share is specified between tax and profit for the year.<sup>13</sup>

<sup>12</sup> Roland Ljungberg & Dan Phillips, Koncernredovisning i praktiken, 2001

<sup>13</sup> Rune Lönnquist, Årsredovisning i koncerner, 2006

## Forthcoming years

Consolidated accounts should be established for every financial year the group exists.<sup>14</sup>

In forthcoming consolidation process the subsidiary's shares should be eliminated according to the acquisition analysis. This means that only results that have been earned after the time of the purchase will affect the group's equity.<sup>15</sup>

Besides the above elimination, the consolidated accounts should for example be adjusted for the following:

1. Identified differences between fair value and book value in the acquisition analysis should be written off during the remaining financial lifetime of the asset. This means that the deferred tax correspondingly will be reduced. The net effect of these both transactions will affect the result.
2. Income/expenses and profits/losses between group companies should be eliminated
3. Internal receivables and liabilities
4. Untaxed reserves in the subsidiary or in the parent company should be divided in the group balance sheet in deferred tax and equity.<sup>16</sup>

Consolidated accounts one financial year after acquisition in the above example are shown below:

The two companies' balance sheet as per 31.12.2009 is shown in the two first columns in the table below. Company B has borrowed 100 from Company A. The property has a yearly depreciation rate of 0.75 percent.

1. The first step is to eliminate Company B's according to the acquisition analysis.
2. The surplus value should be reduced according to the depreciation plan of the property, 0.75 percent per year, i.e. 4 ( $0.75 * 500$ ).
3. The reduction in surplus value result in a reduction in deferred tax, i.e. 1 ( $0.263 * 4$ ).
4. Profit for the period is reduced by the net effect of depreciation and deferred tax, i.e. 3.
5. Internal receivables and liabilities are eliminated.

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<sup>14</sup> Annual Accounts Act

<sup>15</sup> Roland Ljungberg & Dan Phillips, *Koncernredovisning i praktiken*, 2001

<sup>16</sup> Roland Ljungberg & Dan Phillips, *Koncernredovisning i praktiken*, 2001

**Consolidation 31.12.2009**

	Company A	Company B	Elimin. (deprec- iation)	Adjust. (internal balance)	Adjust. (internal balance)	Consolidated accounts
<i>Assets</i>						
Property		992	+500	-4		<b>1,488</b>
Shares in group companies	668		-668			-
Receivables on group companies	100				-100	-
Bank balances	130	250				<b>380</b>
<b>Total Assets</b>	<b>898</b>	<b>1,242</b>	<b>-168</b>	<b>-4</b>	<b>-100</b>	<b>1,868</b>
<i>Equity and Liabilities</i>						
<i>Equity</i>						
Share capital	100	100	-100			<b>100</b>
Non restricted reserves	100	200	-200			<b>100</b>
Profit for the year	30	42		-3		<b>69</b>
Provisions			+132	-1		<b>131</b>
Liabilities on group companies		100			-100	-
Liabilities	668	800				<b>1,468</b>
<b>Total Equity and Liabilities</b>	<b>898</b>	<b>1,242</b>	<b>-160</b>	<b>-4</b>	<b>-100</b>	<b>1,868</b>