Consolidation Of Financial Statements Best Practices

The Financial Accounting Standards Board or FASB defines consolidated financial statements as the reporting of an entity structured with both a parent company and its subsidiaries.

A single economic entity would not need to create consolidated financial statements.

Consolidated financial statements are used internally by management and can be extremely useful for investors, regulators, and other stakeholders such as financial institutions that wish to review the health of the company as a whole, and not just by looking at the various businesses that are owned by the parent company.

Though private businesses are not required to produce consolidated financial statements, public companies that control multiple entities must adhere to.

Generally Accepted Accounting Principles (GAAP). If companies operate overseas, they must also abide by International Accounting Standards Board's international financial reporting standards (IFRS) as well.

What are consolidated financial statements used for?

For businesses that operate multiple companies under a parent company, consolidated financial statements are a must. Consolidated financial statements provide an overall view of the health of the business as a whole, not just the parent company or one of its subsidiaries.

Financial statement consolidation requires businesses to combine the activity of both the parent entity and any subsidiaries to create a completed integrated financial statement. Consolidated financial statements should always include a standard balance sheet, income statement, and cash flow statement.

Though consolidated financial statements are important to accountants and business owners, the information provided in consolidated financial statements is of particular importance to investors, and financial institutions that have a vested interest in one or more of the companies in question.

For example, if you're an investor in a subsidiary company, you would want to know not only the financial status of the subsidiary you've invested in, but you'll also want access to the overall health of the company in general. After all, a parent company that is struggling can hurt the financial position of the subsidiary as well.

Business owners and company directors will also want to view consolidated financial statements as well. For example, if a parent company is doing well, but consolidated revenue is down, directors will want to pinpoint which subsidiaries are struggling to correct any issues.

If you do decide to use consolidated financial statement reporting in your business, there are some standards you'll need to abide by, including a restriction on transferring cash, revenue, or other assets between the subsidiaries and the parent company to help company performance. You're also restricted from transferring liabilities between companies to reduce tax liability.

> *Consolidating all subsidiary financial information into a single report provides excellent oversight into the overall financial health of a business, including how each subsidiary may impact the overall health of the parent company.*

What are combined financial statements and how do they differ?

If the idea of consolidating company performance for all of your subsidiaries appeals to you, but the extra work doesn't, you may want to consider combined financial statements instead.

While consolidated financial statements consolidate totals for each entity and report them in a single report, combined financial statements report on each entity, including the parent company separately, but combine the totals of each entity into a single document.

For example, a parent company with three subsidiaries would include financial information for each company separately rather than aggregating the totals to create one consolidated report.

This makes it easy to determine the individual performance of each subsidiary, which may be important should you have a subsidiary that's performing poorly.

While consolidated financial statements present some advantages, using combined financial statements can be advantageous as well.

One of the major benefits of combined financial reporting over consolidated financial reporting is that managers, directors, investors, and lenders can view the activity of both the parent and subsidiary companies separately, something that cannot be done with a consolidated financial statement.

This is particularly important for investors or creditors that have heavily invested in the subsidiary businesses, not the parent business.

For example, if you've invested in Proctor &Gamble, you'll want to take a look at a consolidated financial statement, which will give you an overall view of the performance of Proctor & Gamble as a whole. But if you've invested in Gillette, you'll want to see how Gillette is performing as a separate company.

Of course, you'll also want to view Proctor & Gamble's overall financial performance, but as an investor in Gillette, you're more interested in their performance individually, rather than how they're performing in conjunction with Proctor & Gamble's other subsidiaries.

And even if you've invested directly in Proctor & Gamble, you may still want to take a look at each company's financial statements to get an idea of how all of the subsidiaries are performing.

If you're running a private business with multiple subsidiaries, it's up to you to decide whether you want to file consolidated financial statements or combined financial statements. However, if your company is public, you'll need to abide by GAAP standards which have very specific guidelines for businesses that choose to report consolidated financial statements.

Example of Consolidated Financial Statements

Consolidated financial statements take the aggregate totals from each subsidiary, total them, and use that total in the completed financial statements.

Those looking at consolidated financial statements such as a consolidated balance sheet or consolidated income statement will only have access to the total amount displayed, the individual subsidiary account totals will not be displayed.

Account	Subsidiary 1	Subsidiary 2	Subsidiary 3	Consolidated Balance Sheet
Current Assets	$100,200	$250,000	$90,000	$440,200

This process would need to be completed for each account, with the totals combined to create the consolidated financial statement. You'll also need to exclude any intercompany transactions that take place between a subsidiary and the parent company since they cancel each other out.

However, if you decide to use combined financial statements instead, the result would be that each of your subsidiaries would have their own financial statements, as would the parent company.

How Are Consolidated Financial Reports Prepared?

Though considered separate legal entities, each subsidiary is one of a group of companies owned by the parent entity, which is in charge of preparing

the consolidated financial statements.

However, each subsidiary is responsible for preparing its financial statements, which should include a balance sheet, income statement, and statement of cash flows.

Once the subsidiary financial statements are completed, the parent company will need to combine the totals of each of the subsidiaries to complete the consolidated financial statement process. Though the consolidation process is not easy, there are some steps you can follow to simplify the entire preparation process.

1. Determine which entities should be included: Not all of your holdings may be considered subsidiaries. According to GAAP rules, you need to control at least 50% of the shares of the subsidiary. There are some instances where a 50% majority is not required, but they can vary. If you have a minority interest or non-controlling interest in a subsidiary, chances are you will not have to prepare consolidated financial statements.
2. Organize financial information for each of the subsidiaries: Before you can begin to create consolidated financial statements, you'll need to have their financial statements handy. Because each subsidiary creates its financial statements, you'll need to coordinate with accounting staff to obtain access to the reports.
3. Coordinate financial periods: To create consolidated financial statements, you'll need to ensure that the reporting periods of each of your subsidiaries match. This is another task that you'll need to coordinate with the accounting staff at each of your subsidiaries.
4. Begin to create the statements: Even if you're using accounting software, chances are that you'll need to use an outside program or spreadsheet application such as Microsoft Excel to complete the process.

Benefits of Consolidated Financial Reports

There are two distinct advantages to using consolidated financial statements, as well as two very real disadvantages.

Advantages

Provides a complete picture

Consolidated financial statements can prove to be helpful for investors, creditors, financial institutions, and business owners in their overall decision-making process.

Consolidating all subsidiary financial information into a single report provides excellent oversight into the overall financial health of a business, including how each subsidiary may impact the overall health of the parent company.

Eliminates unnecessary paperwork

The consolidation of financial statements can help to reduce paperwork tremendously.

For example, if you have five subsidiaries, that means that you'll have to prepare separate financial statements including balance sheets, income statements, and statements of cash flow for all five entities.

But by running consolidated financial statements, you can bypass creating multiple financial statements and create one financial statement that uses the information provided by each subsidiary instead.

Can be simplified by using software

While creating consolidated financial statements can be time-consuming if completed manually, if you choose to use specialized software, the entire process can be completed with ease.

Disadvantages

Can mask poor subsidiary performance

If your business owns multiple subsidiaries, it's unlikely that all of them are performing at the same level. One of the distinct disadvantages of using consolidated financial statements is that it doesn't allow interested parties to view separate financial results.

For example, if one of your subsidiaries is performing poorly, but the others are

performing well, the performance of that one subsidiary will be masked.

While that may not be a problem if you're invested in the parent company, for those that have invested solely in the subsidiary, they're not able to see the true performance of their investment.

Decreased financial performance

If the parent company is performing admirably, but the subsidiaries are struggling, creating consolidated financial statements can seriously impact results. In turn, these results can have a serious impact on financial ratio results and can create hesitation in investors and financial institutions alike.

Summary

Without the use of specialized accounting software applications or third-party applications designed to help with the consolidation process, preparing consolidated financial statements can be time-consuming and often confusing, particularly if you have several subsidiaries.

Though a requirement for publicly held companies according to GAAP guidelines, consolidated financial statements remain a good option for all companies that wish to simplify the reporting process.

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