УДК 657

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CONSOLIDATION OF FINANCIAL STATEMENTS IN THE POLISH ACCOUNTING LAW

The purpose of this paper is to outline the legislation (accounting law) concerning the consolidation of financial statements and demonstrate the importance of data contained in such statements for evaluating the assets, financial positions and financial results

1. Introduction

As the Polish equity market continues to evolve, a growing number of enterprises are acquired and consolidated to form groups of companies having ever more complex structures. Such groups are comprised of legally separate entities linked by way of capital ownership with one of them assuming a dominant position over the others.

The individual financial statements drawn up by members of groups of companies provide information on their individual assets, their financial positions and their financial results. In addition, the balance sheets of acquiring companies show shares held in the acquired entities at their value on purchase. Their income statements, on the other hand, show proceeds from dividend distributions of profit. Thus, the financial statements of acquiring companies reveal neither the assets nor profit items of the acquired (subordinate) companies despite the fact that such items are assets of the acquiring (parent) company. Hence, a need arises to present financial information on both individual group members as well as entire groups of companies.

In order to present the assets and the financial position of a group of companies, its individual financial statements need to be consolidated.

The issue has been recognized and partially regulated in the Accounting Act of September 29, 1994[1], amended on November 9, 2000[2], which requires that groups of companies prepare and publish consolidated financial statements. The Act is implemented by the Regulation of the Minister of Finance of December 12, 2001 on detailed principles of drawing up financial statements of related parties other than banks and insurance companies[3].

[1] Journal of Laws No. 121 of 1994, Item 592.
[2] Journal of Laws No. 113 of 2000, Item 1186.
[3] Journal of Laws No. 152 of 2001, Item 1729.

The purpose of this paper is to outline the legislation (accounting law) concerning the consolidation of financial statements and demonstrate the importance of data contained in such statements for evaluating the assets, financial positions and financial results.

To this end, the article has been divided into three parts preceded by an introduction and followed by conclusions.

2. The nature of the consolidation of financial statements

As stated in the law, the term *consolidation* refers to putting together the financial statements of entities that make up a group of companies by adding up corresponding items shown in the financial statements of the parent company, the subsidiaries and fellow subsidiaries which are not commercial companies, subject to proper exclusions and adjustments[4].

The process leads to drawing up consolidated financial statements.

The purpose of consolidated financial statements is to present a true and fair view of the assets, financial positions and financial results of the whole group of companies seen a single business entity.

In consolidating financial statements, one needs to recognize that:

- the parent company's claim to the ownership of the net assets and the financial result of the subsidiary or a fellow subsidiary is directly proportional to the share that the parent company holds in the share capital of such subsidiaries or fellow subsidiaries,
- groups of companies are to be seen as single business entities (true to the content over form principle).

3. Consolidation of financial statements upon the formation of a group of companies

The consolidation of financial statements carried out on the date of the merger (the date on which control is assumed) is limited to the consolidation of the balance sheets of the parent company and its subsidiaries. This is because the balance sheet presents the status of assets and their sources of financing as at the time of group formation. The remaining financial statements present streams (incomes, expenditures and cash flows) generated before the group of companies was established.

The net assets of a subsidiary shown in the balance sheet are owned by the group of companies to the extent they are controlled by the parent company – for consolidated reporting purposes, such assets need to be assessed at fair value.

[4] Art. 3.1.45 of the Accounting Act.

Further, to avoid duplication in adding the value of assets and their sources of financing, capital adjustments are needed in the collective balance sheet. Such adjustments are to eliminate:

- the purchase value of the parent company's shares in the subsidiary,
- the value of the subsidiary's equities reflecting the value of its net assets.

Under the Accounting Act[5], exclusions apply to the value of shares, expressed at purchase price, that the parent company and other entities affected by the consolidation hold in subsidiaries, including the part of the net assets of the subsidiaries, shown at fair value, that corresponds to the share of the parent company and other members of the group of companies that are subject to the consolidation, held as of the date on which control over such companies was first assumed.

Table 1. *Adjustments of capital*

Side of balance sheet	*Balance sheet item*	*Debit*	*Credit*
Assets	Long-term investments (shares in related parties)		X
Liabilities	Share capital	X	
	Outstanding contributions to share capital		X
	Treasury shares		X
	Revenue reserve	X	
	Reserve from revaluations	X	
	Other revenue reserves	X	
	Profit brought forward	X	
	Net profit	X	
	Appropriations of net profit made during current fiscal year		X

Source: Author's work.

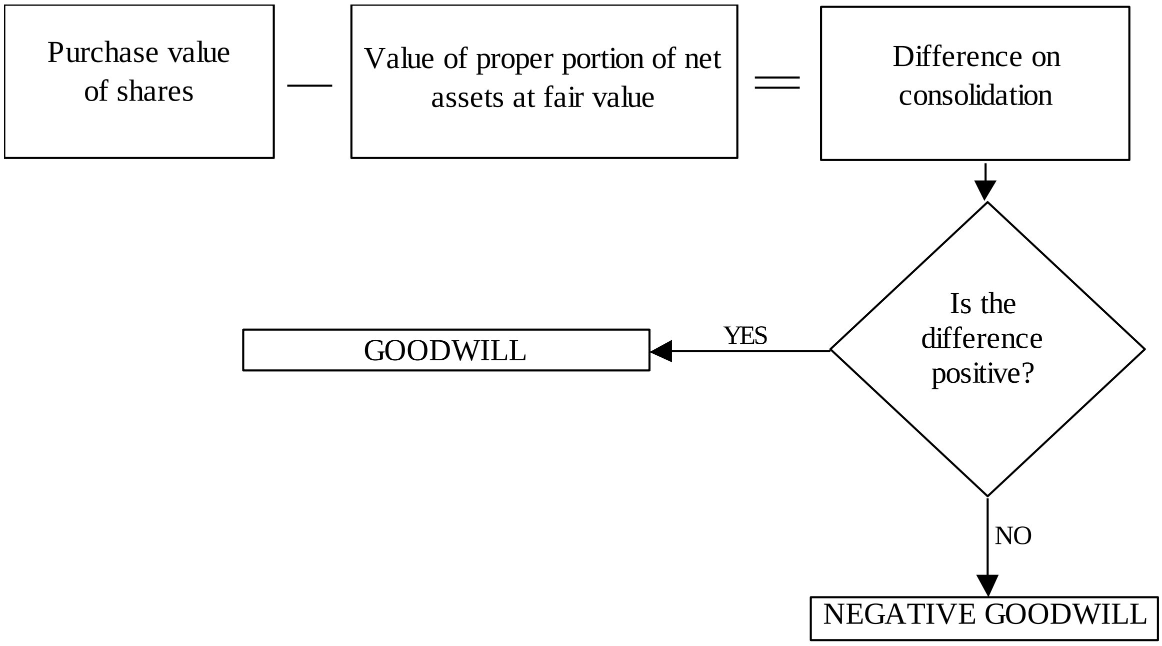
The above equity adjustments will be made if the parent company holds 100% of the shares of the subsidiary and if the purchase value of the shares equals the value of the acquired net assets, i.e. the equity of the subsidiary. In the event the purchase value of the shares differs from the fair value of net assets, the resulting difference may take the form of:

- goodwill: when the purchase value of the shares exceeds the value of the portion of the net assets of the subsidiary shown at fair value,
- negative goodwill: when the purchase value of the shares is lower than the value of the corresponding portion of net assets of the subsidiary shown at fair value.

An algorithm for arriving at goodwill is given in Diagram 5.

[5] Art. 60.1 of the Accounting Act.

Diagram 1. ***Algorithm for determining goodwill***



Source: M.Remlein, Consolidated financial statements of groups of companies, Wyd. Akademii Ekonomicznej w Poznaniu, Poznań 2004, p.78.

The goodwill is shown in the consolidated balance sheet under assets in the separate fixed asset item of *Goodwill of subordinated entities*. The negative goodwill is shown in the separate liabilities item of *Negative goodwill of subordinated entities*.

The bookkeeping treatment of equity adjustments for goodwill is summarized in Table 2.

Table 2. *Equity adjustments accounting for goodwill*

Side of balance sheet	*Balance sheet item*	*Debit*	*Credit*
Assets	Long-term investments (shares in related parties)		X
Liabilities[6]	Share capital	X	
	Revenue reserve	X	
	Reserve from revaluations	X	
	Other revenue reserves	X	
	Net profit/loss	X	
Assets	Goodwill of subordinated entities	X	
or			
Liabilities	Negative goodwill of subordinated entities		X

Source: M.Remlein, Consolidated financial statements of groups of companies, Wyd. Akademii Ekonomicznej w Poznaniu, Poznań 2004, p.79.

[6] The assumption is that the equity of a subsidiary is made exclusively of positive items.

The goodwill and negative goodwill of parent companies that own multiple subsidiaries is shown in the consolidated balance sheet separately without adjustments. In such cases, a note is to be added presenting the goodwill and negative goodwill separately for each subsidiary along with an indication of how they were assessed.

If shares in a subsidiary are held by shareholders who are not members of a group of companies, such shareholders also have a claim to the net assets of the subsidiary in proportion to the share of stock they own. Subsidiary-share-holding entities that are not members of the group of companies are referred to as minority shareholders.

The initial value of the *Minority shares* item is assessed at the fair value of the net assets as of the date on which control is first assumed. The value is adjusted up or down accordingly to changes in the net asset of the subsidiary.

The bookkeeping treatment of “full” equity adjustments, i.e. adjustments that account for both the goodwill as well as the existence of minority shareholders, is shown in Table 3.

Table 3. *Equity adjustments accounting for goodwill and minority shares*

Side of balance sheet	*Balance sheet item*	*Debit*	*Credit*
Assets	Long-term investments (Shares in related parties)		**X**
Liabilities	Share capital	**X**	
	Revenue reserve	**X**	
	Reserve from revaluations	**X**	
	Net profit	**X**	
Assets	Goodwill of subordinated entities	**X**	
Liabilities	Minority shares		**X**

Source: Author’ work.

To summarize, the consolidation of financial statements as of the date on which control is first assumed will incorporate:

- exclusions of the purchase value of shares,
- exclusions of the value of a subsidiary’s equity,
- recognition of goodwill where the purchase value of shares differs from the value of the subsidiary’s equity,
- recognition of minority shares where the parent company is not the sole shareholder of the subsidiary.

The first two adjustments are unconditional whereas the remaining ones may or may not occur depending on the circumstances.

4. Consolidation of financial statements at the end of reporting period

The consolidation of financial statements carried out at the end of the fiscal year requires adjustments on the day on which the group of companies is formed and adjustments for effects of cooperation among members of the group of companies. In addition, adjustments are also needed for previously agreed items associated with the consolidation.

Thus, the consolidated financial statements as of the end of the reporting period should include:

- equity adjustments,
- transaction exclusions,
- and revaluations of:
  - goodwill,
  - and minority shares.

One key precept made in consolidating financial statements is the unity of the group of companies. In other words, for consolidation purposes and in accordance with the content over form principle, the group of companies is seen as a single business entity.

Therefore, consolidated financial statements should only record items earned and/or incurred in transactions with entities that are not members of the group of companies. Thus, during end-of-fiscal-year consolidations, all sales and balances resulting from transactions concluded among members of the group of companies should be eliminated.

Specifically, such elimination should apply to:

- mutual settlements,
- incomes derived from and costs of mutual business transactions,
- the profits or losses shown under assets.

In preparing the consolidated financial statements at the end of a fiscal year, one should also write off goodwill or negative goodwill existing as of the date on which control is assumed.

Depending on changes in the net assets of the subsidiary, changes will also affect the amount of minority shares. Thus, an increase in the net assets of a subsidiary resulting from profit will appropriately increase minority shares, and conversely: a loss will bring about a decline in minority shares.

The adjustments and exclusions made during the consolidation of financial statements at the end of a reporting period are shown in Table 4.

Table 4. *Consolidation adjustments and exclusions at the end of a reporting period*

Financial statement item	*Debit*	*Credit*
1	*2*	*3*
1. Elimination of mutual settlements		
Receivables		X
Liabilities	X	
2. Elimination of income and expenditures		
Net sales of products, goods and materials	X	
Cost of sales of products, goods and materials		X

1	*2*	*3*
Financial income	X	
Financial expenditures		X
3. Elimination of unrealized profit contained in inventories		
Inventories		X
Net profit/loss	X	
Cost of sales of products, goods and materials	X	
4. Goodwill write-off		
Goodwill: subsidiaries		X
Net profit/loss	X	
Goodwill write-off: subsidiaries	X	
5. Profit of minority shareholders		
Net profit/loss	X	
Minority shares		X
Minority profit/loss		X

Source: Author's work.

5. Conclusions

The Polish Accounting Act, which has been in effect since 1995, adopted a number of financial reporting regulations, including consolidated financial reporting regulations. The advent of the free market economy and the growth posted in the number of groups of companies established in Poland, have been driving up demand for fair and credible information on the assets and financial positions of individual entities as well as groups of companies. One instrument designed to meet such demand are consolidated financial statements prepared to treat groups of companies as single entities subject to consolidated accounting. The approach calls for various adjustments and exclusions. As the Polish accounting law is modeled in great part on the International Accounting Standards, it is extensively harmonized with the IAS's. This fact is fairly significant as, ever since 2005, IAS's are binding upon all individual companies and groups of companies listed on the Warsaw Stock Exchange.

LITERATURE:

1. The Accounting Act of September 29, 1994, Journal of Laws No. 121 of 1994, Item 592.

2. The Accounting Act of November 9, 2000, Journal of Laws No. 113 of 2000, Item 1186.

3. The Regulation of the Minister of Finance of December 12, 2001 on detailed principles of drawing up financial statements of related parties other than banks and insurance companies, Journal of Laws No. 152 of 2001, Item 1729.