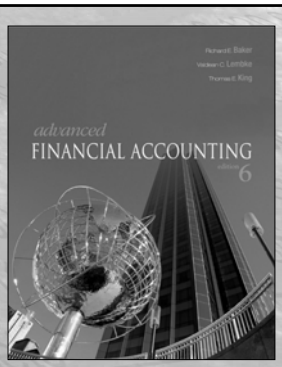


Chapter 4

Consolidation As Of The Date Of Acquisition

McGraw-Hill/Irwin

Consolidation-Date of Acquisition

- Consolidated statements bring together the operating results and financial position of two or more separate legal entities into a single set of statements for the economic entity as a whole.
- To accomplish this, the consolidation process includes procedures that eliminate all effects of intercorporate ownership and intercompany transactions.

4-2

Consolidation-Date of Acquisition

- The procedures used in accounting for intercorporate investments were discussed in Chapter 2.
- These procedures are important for the preparation of consolidated statements because the specific consolidation procedures depend on the way in which the parent accounts for its investment in a subsidiary.
- The consolidated statements, however, are the same regardless of the method used by the parent company to account for the investment.

4-3

Consolidation-GAAP

- Consolidated and unconsolidated financial statements are prepared using the same generally accepted accounting principles.

4-4

Roadmap—Chapter 4

- After introducing the consolidation workpaper, this chapter provides the foundation for an understanding of the preparation of consolidated financial statements by discussing the preparation of a consolidated balance sheet immediately following the establishment of a parent-subsidiary relationship.

4-5

Roadmap—Chapters 5 to 10

- Chapter 5 includes the preparation of a full set of consolidated financial statements in subsequent periods, that is, after the date of acquisition.
- Chapters 6 through 10 deal with intercorporate transfers and other more complex topics.

4-6

Consolidation Workpapers

- The consolidation workpaper provides a mechanism for efficiently combining the accounts of the separate companies involved in the consolidation and for adjusting the combined balances to the amounts that would be reported if all the consolidating companies were actually a single company.
- Keep in mind that there is no set of books for the consolidated entity.

4-7

Consolidation Workpapers

- The parent and its subsidiaries, as separate legal and accounting entities, each maintain their own books.
- When consolidated financial statements are prepared, the account balances are taken from the separate books of the parent and each subsidiary and placed in the consolidation workpaper.

4-8

Consolidation Workpapers

- The consolidated statements are prepared, after adjustments and eliminations, from the amounts in the consolidated workpaper, that is, the last column of the workpaper.

4-9

Workpaper Format

- The consolidation workpaper has four major column headings or sections (in order from left to right): **Account Titles, Trial Balance Data, Elimination Entries,** and **Consolidated**.
- The **Trial Balance Data** section has two subsections or column headings (in order from left to right): **Parent** and **Subsidiary.**
- The **Elimination Entries** section has two subsections or column headings (in order from left to right): **Debits** and **Credits.**

4-10

Workpaper Format

- The titles of the accounts of the consolidating companies are listed in the first column of the workpaper.
- The account balances from the books or trial balances of the individual companies are listed in the next set of columns, with a separate column for each company included in the consolidation.

4-11

Workpaper Format

- Entries are made in the columns labeled “Elimination Entries” to adjust or eliminate balances so that the resulting amounts are those that would appear in the financial statements if all the consolidating companies actually formed a single company.

4-12

Workpaper Format

- The work flow goes from left to right, that is, the balances in the last column are obtained by summing all amounts algebraically across the workpaper by account.
- These balances (i.e., the balances in the last column) are the balances that appear in the consolidated financial statements.

4-13

Nature of Elimination Entries

- Eliminating entries are used in the consolidation workpaper to adjust the totals of the individual account balances of the separate consolidating companies to reflect the amounts that would appear if all the legally separate companies were actually a single company.
- Elimination entries appear only in the consolidating workpapers and do not affect the books of the separate companies.

4-14

Nature of Elimination Entries

- For the most part, companies that are to be consolidated record their transactions during the period without regard to the consolidated entity.
- Transactions with related parties tend to be recorded in the same manner as those with unrelated parties.
- Elimination entries are used to increase or decrease (in the workpaper) the combined totals for individual accounts so that only transactions with external parties are reflected in the consolidated amounts.

4-15

Nature of Elimination Entries

- Some eliminating entries are required at the end of one period but not at the end of subsequent periods.
- For example, a loan from a parent to a subsidiary in December 20x1, repaid in February 20x2, requires an entry to eliminate the intercompany receivable and payable on December 31, 20x1, but not at the end of 20x2.

4-16

Nature of Elimination Entries

- Some other elimination entries need to be placed in the consolidated workpapers each time consolidated statements are prepared for a period of years.
- For example, if a parent company sells land to a subsidiary for $5,000 above the cost to the parent, a workpaper entry is needed to reduce the land amount by $5,000 each time a consolidated balance sheet is prepared, for as long as the land is held by an affiliate.

4-17

Nature of Elimination Entries

- It is important to remember that elimination entries, because they are not made on the books of any company, do not carry over from period to period.

4-18

Consolidated Balance Sheet

- The simplest consolidation situation occurs:
  - Immediately after the parent-subsidiary relationship is established.
  - When the subsidiary is wholly-owned (i.e., 100% owned) by the parent.
  - When the subsidiary is purchased at book value—and the fair value of all of the individual accounts of the subsidiary are equal to their respective book values.

4-19

Example: Wholly-Owned @ Book Value

- Parent purchases all of Sub's outstanding common stock for $300,000.
- On the date of combination, the fair values of Sub's individual asset and liabilities are equal to their book values. Also, on the date of combination, total book value of Sub is $300,000 (Common Stock $200,000 and Retained Earnings $100,000). Thus no additional analyses are needed regarding differences between investment cost, fair values, and book values.

4-20

Example: Wholly-Owned @ Book Value

The ownership situation described in the previous slide can be analyzed as follows:

Investment Cost		$300,000
Book Value:		
Common Stock-Sub	$200,000	
Retained Earnings-Sub	100,000	
	$300,000	
Parent's share 100%	x 1.00	(300,000)
Difference between cost and book value		$ -0-

4-21

Example: Wholly-Owned @ Book Value

- Parent records the stock acquisition as follows:

Investment in Sub Stock	$300,000	
Cash		$300,000

- There is no entry by Sub with respect to the acquisition. (Exception: Use of Push-Down Accounting—discussed later in this chapter. However, given that investment cost equals total book value, and, given that there are no differences between fair and book value at the individual account level, Push-Down Accounting is not relevant in this situation.)

4-22

Example: Wholly-Owned @ Book Value

- For the following two reasons, there is only one elimination entry required to prepare the Consolidated Balance Sheet:
  - At the date of consolidation, investment cost equals total book value, and, there are no differences between fair and book value at the individual account level.
  - There are no intercompany transactions at the date of consolidation.

4-23

Example: Wholly-Owned @ Book Value

The following elimination entry is made on the consolidation workpaper, not on the books of either Parent or Sub, and is presented here in general journal form for instructional purposes.

Common Stock—Sub	$200,000	
Retained Earnings—Sub	100,000	
Investment in Sub Stock		$300,000

4-24

"You Can't Own Yourself"

- The investment account must be eliminated because, from a single entity viewpoint, a company cannot hold an investment in itself.
- The subsidiary's stock and the related stockholders' equity accounts must be eliminated because the stock of the subsidiary is held entirely within the consolidated entity and none represents claims by outsiders.

4-25

Less Than Wholly-Owned Subsidiary

- When less than total ownership of a subsidiary is held by the parent, recognition must be given in the consolidated balance sheet to the ownership claim of the subsidiary's noncontrolling shareholders.
- This is accomplished most frequently by reporting the book value of the noncontrolling shareholders' stock as a single amount in the consolidated balance sheet between liabilities and stockholders' equity or as par of stockholders' equity.

4-26

Example: 80% Owned @ Book Value

- Assume all of the same facts in the previous example except that Parent purchases 80% of Sub for $240,000.
- NOTE: $240,000 is 80% of the $300,000 total book value of Sub. The remaining 20% of the total book value of Sub, that is $60,000, will be referred to as the **noncontrolling interest**.

4-27

Example: 80% Owned @ Book Value

The ownership situation described in the previous slide can be analyzed as follows:

Investment Cost		$240,000
Book Value:		
Common Stock-Sub	$200,000	
Retained Earnings-Sub	100,000	
	$300,000	
Parent's share 100%	x 0.80	(240,000)
Differential		$ -0-

4-28

Example: 80% Owned @ Book Value

- Parent records the stock acquisition as follows:

Investment in Sub Stock	$240,000	
Cash		$240,000

- There is no entry by Sub with respect to the acquisition. (For the same reasons as the previous example, Push-Down Accounting—discussed later in this chapter—is not relevant to this situation.)

4-29

Example: 80% Owned @ Book Value

- For the following two reasons, there is only one elimination entry required to prepare the Consolidated Balance Sheet:
  - At the date of consolidation, investment cost equals total **pro rata** book value, and, there are no differences between fair and book value at the individual account level.
  - There are no intercompany transactions at the date of consolidation.

4-30

Example: 80% Owned @ Book Value

The following elimination entry is made on the consolidation workpaper, not on the books of either Parent or Sub, and is presented here in general journal form for instructional purposes.

Common Stock—Sub	$200,000	
Retained Earnings—Sub	100,000	
Investment in Sub Stock		$240,000
Noncontrolling Interest		*60,000

*60,000 = (200,000 + 100,000)(1.00 - 0.80)

4-31

Example: 80% Owned @ Book Value

- The investment account must be eliminated because, from a single entity viewpoint, a company cannot hold an investment in itself.
- The subsidiary's stock and the related stockholders' equity accounts must be eliminated because the stock of the subsidiary is 80% held within the consolidated entity. The remaining 20% represents claims by outsiders.
- "We Still Can't Own Ourselves !!!"

4-32

Example: Debit Differential

- Assume all of the same facts in the previous example except that Parent purchases 80% of Sub for $250,000 (not $240,000—i.e., 80% of the $300,000 total book value of Sub).
- NOTE: $250,000 is greater than $240,000 by $10,000. Unless stated or implied otherwise, this $10,000 represents **goodwill**. That is, since there are no differences between fair and book value at the individual account level, the $10,000 debit differential "must be" **goodwill**.

4-33

Example: Debit Differential

The ownership situation described in the previous slide can be analyzed as follows:

Investment Cost		$250,000
Book Value:		
Common Stock-Sub	$200,000	
Retained Earnings-Sub	100,000	
	$300,000	
Parent's share 100%	x 0.80	(240,000)
Debit Differential		$10,000

4-34

Example: Debit Differential

- Parent records the stock acquisition as follows:

Investment in Sub Stock	$250,000	
Cash		$250,000

- There is no entry by Sub with respect to the acquisition. (Exception: Due to the existence of goodwill, Push-Down Accounting—discussed later in this chapter—is possibly relevant to this situation.)

4-35

Example: Debit Differential

- For the following two reasons, there is only one elimination entry required to prepare the Consolidated Balance Sheet:
  - At the date of consolidation, the debit differential consists solely of one item—in this example that one item is **goodwill**.
  - There are no intercompany transactions at the date of consolidation.

4-36

Example: Debit Difference

The following elimination entry is made on the consolidation workpaper, not on the books of either Parent or Sub, and is presented here in general journal form for instructional purposes.

Common Stock—Sub	$200,000	
Retained Earnings—Sub	100,000	
Goodwill	10,000	
Investment in Sub Stock		$250,000
Noncontrolling Interest		*60,000

*60,000 = (200,000 + 100,000)(1.00 - 0.80)

4-37

Example: Debit Differential

- In this example, the debit differential was solely attributed to goodwill. In other cases, the debit differential could have been attributed to the fair value of land (or equipment) being $10,000 greater than the book value recorded by Sub.
- Typically, the differential represents a net amount of several different items. For example, the net debit differential could be allocated as follows: goodwill $9,000; land $4,000; and, equipment ($3,000).

4-38

Example: Debit Differential

- For audit trail" purposes, two elimination entries are used when multiple differential items exist.
- The first elimination is the same as the previous example except that the term **differential** is used in lieu of the term **goodwill**.
- The second elimination entry allocates the differential to the various items giving rise to the differential—in this example: goodwill $9,000; land $4,000; and, equipment ($3,000).

4-39

Debit Differential—Elimination Entries

• Common Stock—Sub	$200,000	
Retained Earnings—Sub	100,000	
Differential	10,000	
Investment in Sub Stock		$250,000
Noncontrolling Interest		60,000
• Land	$4,000	
Goodwill	9,000	
Equipment		$3,000
Differential		10,000

4-40

Credit Differential

- A negative, or credit, differential occurs when one company acquires the stock of another company for less than book value.
- As indicated on the next slide, there are several possible reasons for the existence of a credit differential.

4-41

Credit Differential

- Errors or omissions on the books of the subsidiary.
- Diminution of previously recorded goodwill (i.e., goodwill arising from a previous acquisition by the subsidiary of another company).
- Excess of book value over the fair value of the subsidiary's net identifiable assets.
- Bargain purchase (i.e., negative goodwill).

4-42

Credit Differential

- Credit Differential Resolution: Errors or omissions should be corrected on the books of the subsidiary.
- Credit Differential Resolution: Diminution of previously recorded goodwill should be corrected on the books of the subsidiary.

4-43

Credit Differential

- Credit Differential Resolution: As with debit differentials, the various differences between fair and book values of the individual assets and liabilities of the subsidiary should be recorded on the consolidation workpaper in the form of an elimination entry.
- Credit Differential Resolution: If, after recording all of the various differences between fair and book values (discussed immediately above), a credit differential still remains, that credit differential represents an **unallocated credit differential**.

4-44

Unallocated Credit Differential

- Traditionally, an unallocated credit differential has been referred to as “negative goodwill,” indicating that the net assets of the subsidiary are worth less as a going concern than if they were sold individually.

4-45

Unallocated Credit Differential

- An unallocated credit differential has also been referred to as a “bargain purchase,” indicating that the acquiring company simply made a bargain purchase.
- This view assumes that for whatever reason (e.g., forced sale, general stock market conditions), the subsidiary was acquired at a price below its estimated value.

4-46

Unallocated Credit Differential

- Whenever an unallocated credit differential exists, the FASB requires that this negative goodwill be allocated proportionately against the amounts that otherwise would be assigned to all of the acquired assets other than cash and cash equivalents, trade receivables, inventory, financial instruments reported at fair value, assets to be disposed of by sale, and deferred tax assets. Any remaining negative goodwill would be recognized as an extraordinary gain.

4-47

Unallocated Credit Differential

- Note that that liabilities and most current assets are not assigned a portion of the unallocated credit differential because other valuation principles take precedence with respect to these items.
- In particular, most liabilities are valued at the fixed amount of the claims or their present values, while current assets typically have readily determinable net realizable values.

4-48

Unallocated Credit Differential

- The FASB is expected to change the treatment of negative goodwill in the near future.
- Under the FASB's proposed approach, all of the negative goodwill would be recognized as an extraordinary gain in the period of combination.

4-49

"You Can't Owe Yourself Money"

- All forms of intercorporate receivables and payables need to be eliminated when a consolidated balance sheet is prepared.
- From a single-company viewpoint, a company cannot owe itself money.

4-50

"You Can't Owe Yourself Money"

- If a company owes an affiliate $1,000 on account, one company carries a $1,000 receivable on its separate books, and the other has a payable for the same amount.
- When consolidated financial statements are prepared, the following elimination entry is needed in the consolidation workpaper:

Accounts Payable	$1,000	
Accounts Receivable		$1,000

4-51

"Acquired" Accumulated Depreciation

- From a theoretical viewpoint, accumulated depreciation at the date of combination on the fixed assets of a subsidiary acquired in a purchase-type business combination should be eliminated when consolidated statements are prepared.
- When this treatment is correct in theory, this elimination seldom is made in practice since the "the overstatement of both the asset and the contra asset accounts" offset with respect to reported total assets.

4-52

Push-Down Accounting

- The term Push-Down Accounting refers to the practice of revaluing the assets and liabilities of a purchased subsidiary directly on the books of that subsidiary at the date of acquisition.
- If this practice is followed, the revaluations are recorded once on the books of the purchased subsidiary at the date of acquisition and, therefore, are not made in the consolidation workpapers each time consolidated statements are prepared.

4-53

Push-Down Accounting

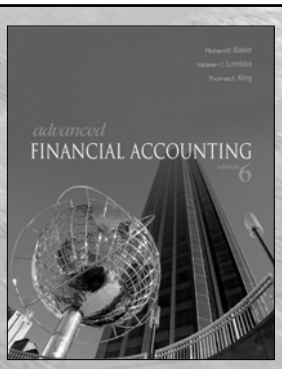
- Push-Down Accounting is required by **SEC Staff Accounting Bulletin No. 54** whenever a purchase-type business combination results in the purchased subsidiary becoming substantially wholly owned.
- The staff accounting bulletin encourages but does not require the use of Push-Down Accounting in situations where the subsidiary is less than wholly owned or where the subsidiary has outstanding debt or preferred stock held by the public.

4-54

You Will Survive This Chapter !!!

- Now this is Advanced Accounting !!!

4-55



Chapter 4

End of Chapter