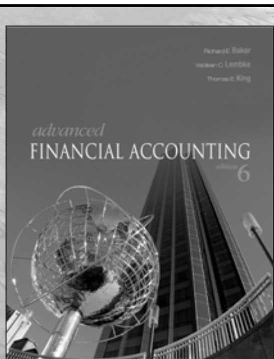


Chapter 5

Consolidation Following Acquisition

Consolidation Following Acquisition

- The procedures used to prepare a consolidated balance sheet as of the date of acquisition were introduced in the preceding chapter, that is, Chapter 4.
- More than a consolidated balance sheet, however, is needed to provide a comprehensive picture of the consolidated entity's activities following acquisition.

5-2

Consolidation Following Acquisition

- As with a single company, the set of basic financial statements for a consolidated entity consists of a balance sheet, an income statement, a statement of changes in retained earnings, and a statement of cash flows.

5-3

Consolidation Following Acquisition

- The purpose of this chapter is to present the procedures used in the preparation of a consolidated balance sheet, income statement, and retained earnings statement **subsequent to the date of combination.**
- The preparation of a consolidated statement of cash flows is discussed in Chapter 10.

5-4

Consolidation Following Acquisition

- This chapter first deals with the important concepts of consolidated net income and consolidated retained earnings.
- Thereafter, the chapter presents a description of the workpaper format used to facilitate the preparation of a full set of consolidated financial statements.

5-5

Consolidation Following Acquisition

- Finally, the remainder of the chapter deals with the specific procedures used to prepare consolidated financial statements subsequent to the date of combination.

5-6

Consolidation Following Acquisition

- The discussion in the chapter focuses on procedures for consolidation when the parent company accounts for its investment in subsidiary stock using the equity method.
- If the parent accounts for its investment using the cost method, the general approach to the preparation of consolidated financial statements is the same, but the specific procedures differ somewhat.

5-7

Consolidation Following Acquisition

- Regardless of the method used by the parent to account for its subsidiary investment (during the year), however, the consolidated statements will be the same because the investment and related accounts are eliminated in the consolidation process.

5-8

Overview of the Consolidation Process

- The approach followed to prepare a complete set of consolidated financial statements subsequent to a business combination is quite similar to that used to prepare a consolidated balance sheet as of the date of combination.
- However, in addition to the assets and liabilities, the revenues and expenses of the consolidating companies must be combined.

5-9

Consolidated Net Income

- When all subsidiaries are wholly owned by the parent, all income of the parent and its subsidiaries accrues to the shareholders of the parent company.
- In this case, consolidated net income is the difference between consolidated revenue and expenses.

5-10

Consolidated Net Income

- When a subsidiary is less than wholly owned, a portion of its income accrues to its noncontrolling shareholders and is excluded from consolidated net income.
- For example, if a parent owns 80 percent of the common stock of a subsidiary, and the subsidiary earns net income of $100,000, 80 percent of the income accrues to the parent and the remaining $20,000, that is 20 percent, is allocated to the noncontrolling interest.

5-11

Computing Consolidated Net Income

- Consolidated net income, in simple cases, is equal to the total earnings for all companies consolidated, less any income recorded by the parent from the consolidating companies and any income assigned to noncontrolling shareholders.
- Intercorporate investment income included in the parent’s net income must be removed in computing consolidated net income in order to avoid double counting.

5-12

Additive Approach

- Consolidated net income is computed through an *additive approach* by adding together the parent's income from its own operations (i.e., excluding any income from consolidated subsidiaries recognized by the parent) and the parent's proportionate share of the net income of each subsidiary adjusted to differential write-off, where appropriate.

5-13

Additive Approach

- This is the same approach used to compute the parent's equity-method net income.
- In the absence of unrealized profits from intercompany transactions, consolidated net income and the parent's equity-method net income are normally equal.

5-14

Residual Approach

- In the workpaper to prepare a complete set of consolidated financial statements, consolidated net income is determined using a *residual approach*.
- The revenues and expenses of the separate consolidating companies are included, and those elements that should not be included are eliminated.

5-15

Consolidated Retained Earnings

- Consolidated retained earnings is that portion of the undistributed earnings of the consolidated enterprise accruing to the shareholders of the parent company.
- As with a single company, ending consolidated retained earnings is equal to the beginning consolidated retained earnings balance plus consolidated net income, less consolidated dividends.

5-16

Consolidated Retained Earnings

- Only those dividends paid to the owners of the consolidated entity can be included in the consolidated retained earnings statement.
- Because the owners of the parent company are considered to be the owners of the consolidated entity, only dividends paid by the parent company to its shareholders are treated as a deduction in the consolidated retained earnings statement; dividends of the subsidiary are not included.

5-17

Consolidated Retained Earnings

- In the absence of unrealized profits from intercompany transactions and goodwill impairment, consolidated retained earnings and the parent's equity-method retained earnings are normally equal.
- If the parent uses the equity method on its books, the retained earnings of each subsidiary is completely eliminated when the subsidiary is consolidated.

5-18

Workpaper Format

- A number of different workpaper formats for preparing consolidated financial statements are used in practice.
- One of the most widely used formats is the three-part workpaper, consisting of one part for each of three basic financial statements: the income statement, the statement of retained earnings, and the balance sheet.

5-19

Workpaper Format

- The basic format of the workpaper is the same as the workpaper used in the preceding chapter, that is, Chapter 4.
- However, rather than supporting the development of a consolidated balance sheet, the workpaper introduced in this chapter also supports the development of a consolidated retained earnings statement, as well as a consolidated income statement.

5-20

Workpaper Format

- The top portion of the workpaper is used in preparing the consolidated income statement.
- The middle portion of the workpaper is used in preparing the consolidate retained earnings statement.
- The bottom portion of the workpaper is used to prepare the consolidated balance sheet.

5-21

Workpaper Format

- Information in the workpaper flows from top to bottom (and from left to right).
- Consolidated Income must be calculated first in order that consolidated ending retained earnings may be calculated.
- Consolidated ending retained earnings must be calculated in order to prepared the consolidated balance sheet.

5-22

Need for Workpaper

- Each of the consolidated financial statements is prepared as if taken from a single set of books that is being used to account for the overall consolidated entity.
- There is, of course, no set of books for the consolidated entity, and as in the preparation of the consolidated balance sheet, the consolidation process starts with the data recorded on the books of the individual consolidating companies.

5-23

Need for Workpaper

- The account balances from the books of the individual companies are placed in the three-part workpaper, and entries are made to eliminate the effects of intercorporate ownership and transactions.

5-24

Workpaper Elimination Entries

- For periods subsequent to the purchase of a subsidiary, workpaper elimination entries are needed to:
  - Eliminate the parent's intercorporate investment balance and the stockholders' equity accounts of the subsidiary.
  - Eliminate income from the subsidiary recognized by the parent during the period and dividends declared by the subsidiary. [Continued on next slide.]

5-25

Workpaper Elimination Entries-Cont'd

  - Eliminate intercompany receivables and payables.
  - Assign any differential to specific assets and liabilities.
  - Amortize or write off a portion of a differential, if appropriate.
- In addition, if a noncontrolling interest exists, the noncontrolling shareholders' claim on the income and net assets of the subsidiary must be recognized.

5-26

Discontinuance of Consolidation

- A subsidiary that previously has been consolidated but no longer meets the conditions for consolidation normally must be reported as an investment under the cost method in the consolidated financial statements.
- For example, if a previously consolidated subsidiary declared bankruptcy and the appointment of a receiver by the courts prevented the parent from exercising control, the subsidiary would not quality for consolidation.

5-27

Discontinuance of Consolidation

- **APB 20** requires financial statements of all prior periods presented for comparative purposes to be restated to exclude from the consolidation the nonqualifying subsidiary and to reflect the new reporting entity.
- In addition, the financial statements for the period of the change must disclose if the change is material, the nature of the change and the reason for it, and the effect of the change on income before extraordinary items, net income, and related per share amounts.

5-28

Disposal of Differential-Related Assets

- When a subsidiary disposes of an asset, it recognizes a gain or loss on the disposal equal to the difference between the proceeds received and the book value of the asset given up.
- If the asset is one to which a differential is assigned in the consolidation workpaper, both equity-method income recorded by the parent and consolidated net income are affected.

5-29

Disposal of Differential-Related Assets

- The unamortized portion of a positive purchase differential that applies to the asset sold or written off must be treated under the equity method as a reduction of both the parent's income from the subsidiary and the investment account.
- In consolidation, the unamortized part of the purchase differential must be recognized as an adjustment to the gain or loss on the disposal of the asset.

5-30

Inventory

- Any inventory-related differential is assigned to inventory for as long as the inventory units are held by the subsidiary.
- In the period in which the inventory units are sold, the inventory-related differential is assigned to cost of goods sold.

5-31

FIFO Inventory

- When FIFO inventory costing is used by the subsidiary, the inventory units on hand on the date of combination are viewed as being the first units sold after the combination.
- Therefore, the differential normally is assigned to cost of goods sold in the period immediately after the combination.

5-32

LIFO Inventory

- When the subsidiary uses LIFO inventory costing, the inventory units on the date of combination are viewed as remaining in the subsidiary's inventory.
- Only if the inventory level drops below the level at the date of combination is a portion of the differential assigned to cost of goods sold.

5-33

Fixed Assets

- A purchase differential related to land held by a subsidiary is added to the land balance in the consolidation workpaper each time a consolidated balance sheet is prepared.
- If the subsidiary sells the land to which the differential relates, the differential is treated in the consolidation workpaper as an adjustment to the gain or loss on the sale of the land in the period of the sale.

5-34

Differential Assigned to Liabilities

- With the considerable swings in interest rates over the past decade, companies often find that liabilities assumed in a business combination have fair values different from their book values.
- As with assets acquired, liabilities assumed in a purchase-type combination must be valued at their fair values. Thus, a portion of the differential arising in the consolidation workpaper often relates to liabilities.

5-35

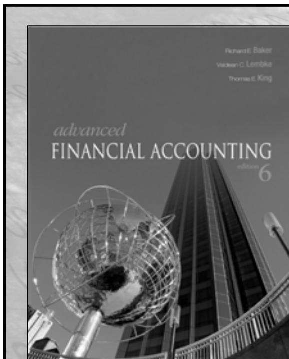
Differential Assigned to Liabilities

- The differential arising from a liability should be amortized similar to the amortization of a bond premium or bond discount, as applicable.

5-36

You Will Survive This Chapter !!!

- You can't own yourself !
- You can't owe money to yourself !
- You can't make money selling to yourself !



Chapter 5

End of Chapter