Business Combinations & Consolidated Financial Statements

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Preface

The study of business combinations and consolidated financial statements can be a rewarding experience. Because consolidated financial statements result from combining individual assets, liabilities, revenues, and expenses from the financial statements of an affiliated group of companies, the student is provided with an opportunity to review and to cement his or her understanding of the accounting for individual financial statement items studied in earlier courses.

The study of business combinations and consolidated financial statements can also be a complex and time-consuming experience. The complexity arises because of the need to study in some reasonably logical sequence the following topics related to business combinations and consolidations:

1. Method of recording the combination—purchase method versus pooling of interests method.
2. Method of accounting for the investment account subsequent to acquisition—equity method versus cost method.
3. Format of consolidation worksheet—preclosing versus postclosing trial balance worksheet; horizontal versus three-tier worksheet.

The approach followed in this book to the study of these topics is as follows:

1. We focus exclusively on the purchase method of accounting in the first six chapters. Adaptations to the consolidation procedures necessitated by a pooling of interests business combination are then covered in a separate chapter (Chapter 7).

2. Consideration is given in each chapter to both the equity and cost methods of accounting for intercorporate investments. We emphasize, though, the similarities between the equity method and consolidation financial statements. The consolidation procedure followed when the cost method has been used is to convert the investment account to an equity basis. After this conversion, consolidation procedures for a cost-method investment will be similar to those for an equity-method investment.

3. The consolidation worksheets in Chapters 1 through 5 are based on postclosing trial balance data. All worksheet entries involving income accounts are debited or credited directly to retained earnings. This approach reduces the detail and complexity of the worksheets while consolidation's important concepts and procedures are being learned. Chapter 6 then discusses the adaptations required to the worksheet procedure when preclosing trial balance data are provided and both a consolidated income statement and consolidated balance

sheet are to be prepared. Both horizontal and three-tier worksheets are illustrated in this chapter.

Thus, the consolidation procedure discussed in Chapters 1 through 5 emphasizes the purchase method of recording the combination, the equity method of accounting for intercorporate investments, and postclosing trial balance worksheets. Chapters 6 and 7 extend the basic consolidation procedure to include preclosing trial balance data and poolings of interests. Chapter 8 considers the implications of consolidating foreign subsidiaries. The sequencing of consolidation's concepts and procedures from the simple to the more complex is one with which we have experimented extensively and found to be effective for our students.

The time-consuming aspect of studying business combinations and consolidations occurs because of the need to prepare the lengthy worksheets and schedules. Time devoted to such routine tasks takes away time and energy that would be more effectively used in understanding consolidation's important concepts and procedures. To enhance the learning process, we have provided skeleton worksheets for all major problems in the text. Virtually all such problems are adapted from problems appearing on the CPA Examination. Thus, the student who masters the material in this book should be well equipped for consolidation problems encountered on the CPA Examination.

One unique aspect of this book is the inclusion of several self-study problems in each chapter. Detailed solutions to these self-study problems appear at the end of the book. Our experience in teaching consolidations has taught us that students learn by doing. Preparing solutions to these self-study problems and then having immediate feedback by way of the suggested solutions is an essential ingredient of the learning process. Additional questions, exercises, and problems appear at the end of each chapter.

We have been assisted in the preparation of this book by numerous individuals whose help we wish to acknowledge. Our colleagues Homer Black, David Green, and Robert Jensen got us interested in the project and provided helpful comments and needed encouragement as we proceeded. The criticisms and suggestions of reviewers improved the manuscript considerably: Philip Meyer (Boston University), Calvin Engler (Iona College), and particularly Bob Anthony (Harvard University). Barbara Haskell, Peg McGann, and Suzanne Sweet labored many hours typing and retyping the text and consolidation worksheets. Most of all we wish to acknowledge our former students who have provided critical and useful comments as well as our wives, Sarah and Kathy, for their support, encouragement, and patience during all phases of this project.

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During the period since World War II, there has been a rapid expansion in the size and complexity of corporate organizations. Businesses have grown both *internally,* by extending their own operations, and *externally,* by acquiring existing companies. Some common reasons for this growth are:

1. Horizontal integration of operations—A firm may increase the markets for its existing products by expanding horizontally into new geographic areas. This extended level of operations permits the firm to realize economies of scale in its production, selling, or administrative activities (for example, the firm may be able to earn quantity discounts on purchases, use regional instead of central warehousing).
2. Vertical integration of operations—A firm may grow vertically by assuming responsibility for more of the activities in the production-distribution system for its products. For example, a raw materials supplier might be acquired to provide an assured source of supply. A fleet of trucks might be purchased to assure distribution of a firm's products to its customers rather than having to rely on other carriers.
3. Diversification of operations—A firm may diversify its product lines, either to increase its profitability or to reduce the risks of operating solely within one field. For example, many industrial firms in recent years have expanded into oil exploration and synthetic fuels development in expectation of significant future profits. Some firms involved in manufacturing snow blowers have acquired companies that manufacture lawn mowers to offset the effects of mild winters.

Although horizontal extension of operations usually takes place internally, vertical growth and diversification of operations usually occur through the purchase of existing companies. The purchase of an ongoing company reduces the risks involved in expansion by providing the acquiring firm with in-place production and marketing facilities, managerial expertise, valuable patents, and customer goodwill.

FORM OF CORPORATE ACQUISITION

The purchase of another company usually takes one of two forms: (1) legal merger or (2) purchase of its common stock, followed by operation of the acquired company as a legally separate business.

Legal Merger

In a legal merger one company (P) acquires the common stock of another company (S). P, the sole owner of S's stock, then votes to legally dissolve S. P then records the assets and liabilities of S on its own books. S legally goes out of existence. There is one business and legal entity after the merger, P, composed of the combined assets and liabilities of P and S. The accounting problems faced by the combined firm are similar to those faced by any single entity. That is, depreciation must be recorded on the fixed assets acquired, a cost-flow assumption for inventories must be followed in computing cost of goods sold, and so on.

Acquisition of Subsidiary

Alternatively, one company (P) may purchase the common stock of another company (S) but permit S to retain its legally separate status after the acquisition. There are several advantages to maintaining the separate legal status of an acquired company:

1. Damage claims against the acquired company will ordinarily be limited to the assets of that company. The assets of the acquiring company will be protected because of its separate legal status. (In some instances, however, the parent will be required by creditors to guarantee the debt of a subsidiary.)
2. Some states require firms doing business within the state to maintain a business entity organized under the laws of that state. A firm may expand by acquiring an established firm in such a state and permitting the acquired company to maintain its separate legal status to satisfy the state laws.
3. An acquiring company that subsequently decides to dispose of the acquired company may find it easier to sell the common stock of that company than to sell its individual assets.
4. The acquiring company may be financially healthy and able to raise capital in credit and equity markets on its own strengths. A legal merger with a financially weak acquired company may inhibit the raising of capital by the combined firm.

When the acquiring company (the parent) owns a substantial portion of the common stock of the acquired company (the subsidiary) but permits the subsidiary to retain its legally separate identity, there is one business entity but two legal entities. That is, the parent, because of its ownership interest, can determine the broad corporate policies and direct the operations of the subsidiary much the same as if the subsidiary were a branch or division. The parent and subsidiary operate as one *economic* unit. However, state laws require each legally separate company to maintain a separate set of books. That is, the individual assets and liabilities of a subsidiary must appear in the accounting records of that subsidiary. The parent can include in its books only its investment in the common stock of the subsidiary. The separate legal status of the subsidiary presents a unique accounting and financial reporting problem: Should separate financial statements for the parent and each subsidiary be issued to the shareholders of the parent company? Or, should the financial statements of the parent and each subsidiary, based on their separate sets of books, be consolidated for purposes of reporting to the shareholders of the parent company?

PURPOSE OF CONSOLIDATED FINANCIAL STATEMENTS

When one corporation (the parent) owns a substantial proportion of the common stock of one or more corporations (the subsidiaries), then managers, investors, and others interested in the activities of the associated group of companies may find financial statements for the group *as one economic unit* more useful than separate statements for each of the companies involved. Consolidated financial statements are prepared to meet this need. *Accounting Research Bulletin No. 51* describes the rationale for preparing consolidated financial statements as follows:

The purpose of consolidated financial statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.[1]

CRITERIA FOR CONSOLIDATION

Although the growth of conglomerate (diversified) companies has diluted the conditions usually thought necessary for the preparation of consolidated financial statements, the following conditions must generally be present.

1. One company must own, either directly or indirectly, more than 50 percent of another company's voting stock.[2] For example, P may own 90 percent of S, while S in turn owns 60 percent of T. P directly owns 90 percent of S and indirectly owns 54 percent ($= .90 \times .60$) of T. Consolidated financial statements for P, S, and T can therefore be prepared. Even if P owns only 80 percent of S (and therefore indirectly owns 48 percent of T), consolidated financial statements would be prepared for P, S, and T, since P controls S and S controls T.

2. There exist no significant legal or other restrictions that prevent a parent from exercising its control over a majority-owned subsidiary. For example, a subsidiary that is in bankruptcy or legal reorganization would not be consolidated. A subsidiary operating in a foreign country where the outflow of capital or other assets is severely restricted probably would not be consolidated.

3. The asset and equity structures of the subsidiary are not significantly different from those of the parent. Consolidated financial statements might mask these differences and mislead statement readers if the asset and equity structures were significantly different. For example, many manufacturing firms do not consolidate their finance subsidiaries. The principal assets of the parent are inventories and fixed assets, and the principal assets of the finance subsidiaries are accounts and notes receivable. Manufacturing firms typically use a mixture of both debt and equity financing, and finance subsidiaries rely heavily on debt financing. These differences in asset and equity structures would be submerged if consolidated financial statements were prepared. Similar reasoning applies when banks and insurance companies are owned by industrial firms.

OVERVIEW OF CONSOLIDATION PROCESS

There are three important concepts underlying the preparation of consolidated financial statements: (1) the role of the consolidation worksheet, (2) the need for intercompany eliminations, and (3) the nature and recognition of the minority interest.

Role of the Consolidation Worksheet

The laws of all states require each corporation within an affiliated group of companies to maintain a separate set of books. Financial statements for each of the legally separate companies are prepared at the end of each period. These

[1] American Institute of Certified Public Accountants, *Accounting Research Bulletin No. 51*, "Consolidated Financial Statements" (New York, 1959), para. 1.

[2] Ibid., para. 2.

separate-company financial statements are sent to state regulatory agencies, banks, creditors, and others as required by statute or contract.

A set of financial statements for each subsidiary is also sent to the parent company. At this time the parent company consolidates its financial statements with those of its subsidiaries. The consolidation usually takes place on a multicolumn worksheet that serves merely as a mechanism for combining the amounts for various financial statements items for the parent and its subsidiaries. After consolidated financial statements have been prepared, the worksheet is filed away for future reference. There is generally no consolidated set of books, or accounts, that records transactions and events taking place during the period for the *consolidated* enterprise.

Need for Intercompany Eliminations

When one first considers the preparation of consolidated financial statements, it appears acceptable merely to combine the individual accounts of the parent and its subsidiaries. A moment's reflection, however, reveals that such a procedure is inconsistent with the view of a controlled group of companies operating as a single economic unit. Consolidated financial statements are prepared to show the results of operations, financial position, and changes in financial position of this single economic unit with other entities outside of the consolidated group. Thus transactions among affiliated companies do not result in either revenue or expense to the consolidated group; only completed transactions with businesses outside of the group can do this. Based on this view, intercompany purchases and sales are really not purchases and sales at all; they merely result in the movement of merchandise from one part of the consolidated group to another.

Amounts appearing on the separate-company financial statements that result from transactions with other members of the consolidated group must be eliminated as part of the process of preparing consolidated financial statements. The basic procedure is quite simple: All intercompany receivables and payables are eliminated; intercompany profits in inventory and fixed-asset transfers are eliminated; intercompany stock and bond holdings are eliminated, as are advances, accruals, revenues, expenses, and so on. *These elimination entries are made on the consolidation worksheet only. The amounts recorded in the separate-company books are not altered in any way* as a result of making worksheet eliminations.

Nature and Recognition of the Minority Interest

A parent company may not own 100 percent of the outstanding common stock of a subsidiary for a variety of reasons. The parent may believe that sufficient control can be exerted if it owns 60 percent or 70 percent of the subsidiary's common stock. The additional resources that would be needed to acquire 100 percent ownership can be used for other purposes. Or there may be several major stockholders of the subsidiary who are unwilling to sell their shares to the parent company.

If the parent owns less than 100 percent of the common stock of a subsidiary, there exist *minority interest* stockholders who have a proportionate claim on the net assets of their respective companies.

The consolidation process combines the assets, liabilities, revenues, and expenses of the subsidiary with the assets, liabilities, revenues, and expenses of the parent, *after* the intercompany eliminations discussed above. The minority interest in the subsidiary's net assets is then shown in the stockholders' equity section of the consolidated balance sheet as a claim against those net assets. (In some cases, the minority interest is shown between liabilities and stockholders' equity on the consolidated balance sheet.) Likewise, the minority interest in the subsidiary's net income is subtracted from net income of the consolidated group in calculating net income attributable to the parent company. The entries to establish the minority interest in net assets and in net income are made *only* on the consolidation worksheet. These entries are not recorded on the separate-company books of either the parent or its subsidiaries.

RECORDING THE INVESTMENT IN A SUBSIDIARY'S STOCK

An investment in the stock of another company is generally recorded on the cost basis of accounting, which applies to the acquisition of any asset. Capital stock of another company purchased in a cash transaction is recorded at the amount of cash paid. Capital stock purchased by the exchange of other assets or through the issuance of shares of stock of the acquiring corporation should be recorded at the fair value of the consideration given or the fair value of the property acquired, whichever is the more clearly evident. Subsidiary stock acquired by incurring liabilities is recorded at the present value of the amounts to be paid.[3] If, for example, Company P purchased 90 percent of the common stock of Company S for $90,000 cash, Company P would record the purchase of Company S's stock on its separate-company books as follows:

Investment in S	90,000	
Cash		90,000

The cost of acquiring a subsidiary company in a transaction accounted for by the purchase method includes the direct costs of acquisition. These costs are out-of-pocket or incremental costs rather than recurring internal costs that may be related to an acquisition. They include, for instance, a finder's fee and fees paid to outside consultants for accounting, legal, or engineering investigations or for appraisals. All "internal" costs associated with a business combination are expensed as incurred in determining net income. Such costs include salaries and other expenses related to the services of employees involved with the acquisition, costs of furnishing information to stockholders, and other indirect and general expenses related to the acquisition.[4]

CONSOLIDATION ON THE DATE OF ACQUISITION

The preparation of a consolidation worksheet on the date of acquisition is essentially a process that combines the parent's and the subsidiary's assets and liabilities. At the same time, the parent's investment in the subsidiary is eliminated against the subsidiary's stockholders' equity accounts, and the minority interest in the subsidiary, if any, is established.

Illustration of Consolidation Procedure

The separate-company balance sheets of P and S are presented in the first two columns of the consolidation worksheet in Exhibit 1.1. P purchased 90 percent of the common stock of S directly from S's stockholders for $90,000 cash.

The basic consolidation procedure on the date of acquisition involves three steps:

1. Compare the cost of the investment with the parent's share of the subsidiary's net assets purchased. If a difference exists, it suggests either that the book

[3] AICPA, *APB Opinion No. 16,* "Business Combinations" (New York, 1970), para. 67. This summary is correct only when the purchase method of recording the acquisition of shares is used. If the acquisition of shares is treated as a pooling of interests, the accounting is somewhat different. The pooling of interests method is considered in Chapter 7.

[4] Ibid., para. 76, and *Interpretation No. 33,* "Costs of Maintaining an 'Acquisitions' Department" (New York, 1971).

values of the subsidiary's assets or liabilities are not equal to their market values or that the subsidiary has unrecorded assets or liabilities (for example, goodwill). Allocate any differential to appropriate accounts on the consolidation worksheet.

2. Eliminate the investment account and any other intercompany accounts, and establish the minority interest, if any. Place these entries on the consolidation worksheet.

3. Extend the rows, and add ("foot") the columns of the consolidation worksheet.

Comparison of Investment Cost with Book Value Purchased. This analysis is made as follows:

Cost of Investment in S		$90,000
Book Value of S's Net Assets:		
Common Stock	$50,000	
Retained Earnings	30,000	
Total	80,000	
Purchased by P	90%	(72,000)
Excess of Cost over Book Value Purchased		$18,000

P's willingness to pay more than book value when it purchased S's stock might have arisen for one or more of the following reasons:

1. The assets recorded on S's books may have been stated at amounts less than their current market value (for example, because of inflation).
2. The liabilities recorded on S's books may have been stated at amounts greater than their current market value (for example, because of increases in interest rates).
3. There may have been unrecorded assets (for example, patents, managerial expertise, reputation for quality products) or unrecorded liabilities (commitments under leases, pension obligations).

Assume that on the date P acquired control of S, S owned a tract of land whose market value was $20,000 greater than its book value. The $18,000 excess of cost over book value purchased represented a payment by P for 90 percent of this undervaluation.

Some accountants and financial analysts maintain that Land, Building, and Equipment should be restated on S's separate company books to their full fair market values on the date of acquisition. However, this restatement would violate the principle of historical cost accounting. S's acquisition cost of Land, Building, and Equipment was $60,000, and this cost should not be restated to a larger amount on S's books.

From the viewpoint of the parent, however, the acquisition cost of the land exceeded its book value by $18,000. The usual basis of accounting for assets is acquisition cost. On this basis, Land, Building, and Equipment must be stated at cost to the parent, P. The total amount paid for its investment by P was recorded in the investment account on the separate-company books of the parent. The disposition of any amount paid in excess of the parent's share of the subsidiary's book value is made on the consolidation worksheet. The following entry is made to restate the cost of Land, Building, and Equipment at its cost to the parent.

A.	Land, Building, and Equipment	18,000	
	Investment in S		18,000

This entry is placed in the Adjustments and Eliminations columns (columns 3 and 4) of the worksheet in Exhibit 1.1

Eliminating the Investment Account. After the differential is removed from the investment account and added to Land, Building, and Equipment, an

EXHIBIT 1.1

Consolidation Worksheet for P and S at Date of Acquisition
(P owns 90 percent of S; *cost exceeds book value*)

	(1) P	(2) S	Adjustments and Eliminations (3) Debit	(4) Credit	(5) Consolidated
Debits					
Current Assets	73,000	30,000			103,000
Investment in S	90,000			*A* 18,000 *B* 72,000	
Land, Building, and Equipment	250,000	60,000	*A* 18,000		328,000
	413,000	90,000			431,000
Credits					
Liabilities	113,000	10,000			123,000
P—Common Stock	200,000				200,000
Retained Earnings	100,000				100,000
S—Common Stock		50,000	*B* 50,000		
Retained Earnings		30,000	*B* 30,000		
Minority Interest—S				*B* 8,000	8,000
	413,000	90,000			431,000

entry is made on the worksheet to eliminate the investment account and S's stockholders' equity accounts and to establish the 10 percent minority interest.

B. Common Stock—S	50,000	
Retained Earnings—S	30,000	
Investment in S		72,000
Minority Interest (in Net Assets of) S		8,000

Notice that the investment account, after entry A above, is stated at $72,000, an amount that is equal to P's 90 percent interest in the book value of S's net assets. The investment account balance now is "in agreement" with P's share of S's net assets. Notice also that the minority interest in S is stated at the minority's 10 percent interest in the book value of S's net assets ($8,000 = .10 × $80,000). Thus the minority interest is also "in agreement" with S's stockholders' equity. This "in agreement" concept represents one of consolidation's most important relationships. *No consolidation worksheet can be completed correctly unless there is agreement among these balances.*

The consolidation work sheet is completed by extending the amounts in columns (1) through (4) in Exhibit 1.1 and placing the resulting amounts in the consolidated column (5) Notice the following about the consolidated amounts in column (5).

1. The investment account has been eliminated on the consolidation worksheet and has been replaced by the individual assets and liabilities of S in the consolidated balance sheet.
2. The stockholders' equity accounts of S have been eliminated on the consolidation worksheet, partially ($72,000) against the Investment in S account and partially ($8,000) in establishing the minority interest.
3. Consolidated Common Stock and Consolidated Retained Earnings on the date of acquisition are the amounts for P only.

4. The entry to establish the minority interest is made only on the work sheet and does not affect the separate-company books of either P or S.

Although this demonstration of the consolidation procedure for P and S appears relatively simple, most of the important consolidation concepts that will be developed throughout this book are included in it.

In the preceding illustration, we assumed that there was an excess of cost over the book value of the net assets acquired and that all of the excess was due to an undervaluation of land. The illustrations presented in the remainder of the chapter demonstrate consolidation procedures for the following cases:

1. Cost exceeds both the book values and the market values of the recorded net assets.
2. Cost exceeds the book values but is less than the market values of the recorded net assets.
3. Cost is less than the book values of the recorded net assets.

Consolidation procedures are presented for both wholly owned and less than wholly owned subsidiaries.

CONSOLIDATION OF WHOLLY OWNED SUBSIDIARIES

Purchase at a Price in Excess of the Market Value of Subsidiary's Net Assets

P purchased 100 percent of the voting common stock of S for $350,000 on January 1, Year 1. The book and market values of S's assets and liabilities and the differences between them are given in Exhibit 1.2.

The price paid by P for its investment in S was $10,000 greater than the market value of the net assets acquired ($350,000 purchase price − $340,000 market value).

Accounting Principles Board Opinion No. 16 requires that a parent company allocate the cost of its investment in a subsidiary to the assets acquired and the liabilities assumed. A portion of the total cost is allocated to each individual asset and liability acquired on the basis of its market value. A difference between the sum of the assigned costs of the tangible and identifiable intangible assets acquired less liabilities assumed and the cost of the parent's investment should

EXHIBIT 1.2

Data for S

	Book Values	*Market Values*	*Differences*
Debits			
Cash	$120,000	$120,000	$ —
Inventory	60,000	100,000	40,000 Dr.
Long-Term Investments in Marketable Securities	40,000	70,000	30,000 Dr.
Land	20,000	30,000	10,000 Dr.
Building (net of accumulated depreciation)	40,000	50,000	10,000 Dr.
Equipment (net of accumulated depreciation)	80,000	140,000	60,000 Dr.
Total	$360,000	$510,000	
Credits			
Current Liabilities	$ 60,000	$ 60,000	$ —
Bonds Payable	100,000	110,000	10,000 Cr.
Common Stock	100,000	340,000	
Retained Earnings	100,000		
Total	$360,000	$510,000	$140,000 Dr.

be recorded as goodwill.[5] The *substance* of these provisions is best summarized as follows:

> If a parent acquires 100 percent of the common stock of another company and pays more for the stock than its share of the book value of the underlying net assets, the excess of the parent's cost over the book value purchased is allocated as follows:
>
> 1. The excess is first allocated to current assets, liabilities, and long-term investment in marketable securities of the subsidiary to reflect their market values at the date of acquisition.
> 2. The excess is next allocated to the remaining noncurrent assets to reflect their market values at the date of acquisition.
> 3. Any excess remaining is allocated to goodwill.

P might allocate the *cost* of its investment in S as follows:

Cost of Investment in S		$350,000
First Allocation of Cost to:		
Cash	$120,000	
Inventory	100,000	
Long-Term Investments in Marketable Securities	70,000	
Total	290,000	
Less Liabilities	170,000	120,000
Total		230,000
Second Allocation of Cost to:		
Land	30,000	
Building	50,000	
Equipment	140,000	220,000
Remaining Unallocated Balance to Goodwill		$ 10,000

The foregoing allocation does not disclose the amounts of the *differentials* necessary for the construction of a consolidation worksheet. The conventional analysis, which achieves results that are identical to those above, is preferable and should normally be used. It proceeds as follows:

Cost of Investment in S		$350,000
Book Value of S's Net Assets:		
Common Stock	$100,000	
Retained Earnings	100,000	
Total	200,000	
Purchased by P	100%	(200,000)
Excess of Cost over Book Value Purchased		150,000
First Allocation:		
Inventory	40,000	
Long-Term Investments in Marketable Securities	30,000	
	70,000	
Less: Bonds Payable	(10,000)	(60,000)
Remaining Difference		90,000
Second Allocation:		
Land	10,000	
Building	10,000	
Equipment	60,000	(80,000)
Remaining Differential to Goodwill		$ 10,000

[5] AICPA, *APB Opinion No. 16,* para. 87.