Consolidations

Reasons to Combine

• Cost savings such as the elimination of duplicate facilities and staff
• For vertical integration: one’s output and another’s distribution
• Quick entry for new/existing products into domestic and foreign markets
• Economies of scale allow greater efficiency and negotiating power
• Ability to access financing at attractive rates
• Diversification of business risk
• ARB #51: consolidated statements are more meaningful than separate

Types of combinations

• When one company gains control over another → business combination
  o Control means owning more than 50% of voting stock
  o Assets, Liabilities, Equity and Revenue and Expense are combined
  o Reciprocal accounts & inter-co. transactions adjusted or eliminated
• Statutory merger
  o Buyer obtains the assets & liabilities of another, which is dissolved
• Statutory consolidation
  o Two companies’ assets or stock goes into newly formed corporation
    ▪ The original corporations are dissolved and new emerges
• When both preserve their identity
  o One company gets control by acquiring a majority of voting stock
  o No dissolution (keep trade name, employee loyalty, reputation)
  o There is no permanent consolidation
  o Consolidation process is done for each reporting and is done on worksheets, outside of the financial records
    ▪ There is no disturbing of the individual accounts
• ARB 51: subsidiary should remain unconsolidated if nature of operations differed significantly from parent or there are restrictions on authority or control (i.e. foreign or bankruptcy); separate presentation
Consolidation Procedures

• What is consolidated?
  o In dissolution: account balances are physically consolidated in actual financial records of the surviving company
  o In separate identity: only financial statements are consolidated
• When to consolidate
  o In dissolution: permanent at the date of combination
  o In separate identity: at regular statement intervals
• How records are affected:
  o In dissolution: the surviving company accounts are adjusted to include all balances of dissolved company, which is closed out
  o Separate companies that maintain identity retain records

Purchase Method

• Purchase Method is used when there is a change of ownership
• (Purchase price + costs) – FMV of Assets and Liabilities = Goodwill
  o Assets are valued at cost to new owners at acquisition date
    ▪ Must allocate acquisition cost based on FMV of assets & liabilities
• Procedure for purchase with dissolution, based on cost principle
  o Allocate based on relation: total cost→FMV of assets/liabilities
    o Price = FMV
      ▪ Each asset and liability is valued as if purchased individually
      ▪ Original book values are ignored
      ▪ Revenue, expenses, dividend and equity are not transferred
    o Purchase Price > FMV
      ▪ Subsidiary assets and liabilities → FMV
      ▪ Additional allocated to goodwill
        ▪ Goodwill arises from: Profitability of going concern, creativity of research group or market conditions
    o Purchase Price < FMV
      ▪ Non-current accounts are consolidated at reduced balances
      ▪ Could be due to imminent bankruptcy, large contingent liabilities, or need for liquidation
      ▪ If non-current assets are eliminated entirely, then the additional reduction is classified as an extraordinary gain
• Procedure for purchase and separate incorporation is maintained
  o Consolidations are only simulated (companies maintains records)
    o Uses worksheet; consolidation entries are never formally recorded
• Direct costs associated with purchase is part of the price
  o Lawyers, accountants, finder’s fees
  o Cost to register and issue new stock reduces paid-in-capital
Consolidation Entries

• **S** Remove sub’s equity accounts and parent’s investment account
  
<table>
<thead>
<tr>
<th>JE</th>
<th>Common stock (sub)</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>JE</td>
<td>Additional Paid in Capital</td>
<td>xxx</td>
</tr>
<tr>
<td>JE</td>
<td>Retained Earnings</td>
<td>xxx</td>
</tr>
<tr>
<td>JE</td>
<td>Investment in sub</td>
<td>xxx</td>
</tr>
</tbody>
</table>

• **A** Allocations to assets based on purchase price at acquisition
  
  - FMV – BV = amount to write up/down

• **I** Remove equity in sub's earnings; combine revenues & expenses
  
  | JE | Equity in Sub’s Earnings | xxx |
  | JE | Investment in Sub | xxx |

• **D** Dividends distributed to parent from sub are eliminated
  
  - Inter-company transfer originally recorded as a decrease in the investment account
  
  | JE | Investment in Sub | xxx |
  | JE | Dividends Paid | xxx |

• **E** Amortization expenses relating to the purchase price

Final Consolidated Balances

• **Assets and Liabilities**: parent and sub with allocations based on FMV
  
  - Inter-company receivables and payable balances eliminated

• **Goodwill**: original purchase allocation is included in consolidated totals

• **Capital stock and APIC**: parent balances only are included

• **Retained Earnings**: parent + sub less past excess amortization expense
  
  - Amortize excess amounts relating to FMV over cost due to purchase

Cost Method or Partial Equity Method

• Varies from the Equity Method:
  
  - Investment account increased by earnings, decreased by dividends
    
    - DR- initial purchase price
    
    - CR- cash dividends received
    
    - DR- income of subsidiary
    
    - CR- amortization of allocations

• NO “D” entry → do not make adjustment for dividends paid by subsidiary

• Limit “I” entry → no adjustment for current year’s operations
Push-Down Accounting

- Definition: direct recording of purchase price allocations and subsequent amortization by sub
- External reporting proponents:
  - Change in ownership creates new basis of assets and liabilities
    - Historical cost paid by new owner
    - SEC: if purchase is with debt, debt is pushed down to sub
      - If parent owns > 95% → push down accounting is O.K
      - If parent owns less than 80%, SEC will object
- Internal reporting
  - Assets = amount recorded by parent as investment in subsidiary
  - Entries “A” and “E” are not needed
    - Allocations and amortizations are already entered in records of sub by push-down

Issues regarding Consolidations

In-process Research and Development (IPR&D)

- Must be written off unless assets have an alternative future use
- Assets used → R&D in process are expensed
- Assets resulting ← R&D
  - Technological feasibility
  - If capitalize- must make estimates of fair value
    - Stage of completion & technological uncertainties
    - Projected costs to complete

Intangibles

- Questions regarding what to do with intangible assets are:
  - Is the asset contractual or legal?
  - This is an asset apart from goodwill
  - Can the asset be sold or separated?
- Intangible assets that cannot be sold, transferred, licensed, rented or exchanged individually are goodwill
- SFAS 142: all intangibles amortized over useful life unless indefinite
  - Useful life depends on:
    - Legal, regulatory, or contractual provisions
    - Obsolescence, demand, competition, industry stability, technological change
    - Expected use of intangible, level of maintenance expense
o Indefinite life: tested for impairment on an annual basis
  § Carrying value ↔ Fair value
    • If CV < FMV, then goodwill remains
    • If CV > FMV, then recognize a loss
  § Assign values to reporting units
    • Reporting unit is a segment or lower
      o Identify reporting units resulting from acq.
      o Assign assets and liabilities to segments
      o Units that will have synergistic benefits have the goodwill assigned to them
        ▪ These are the units annually reviewed
  § Fair value: market price, comparable business, present value of cash flows, profit projections discounted for risk
    • Can be maintained if assets and liabilities that compose reporting unit have not changed significantly
    o Goodwill value of reporting unit is based on purchase price
    o Impairment loss is a separate line item in operating section

Non-controlling Interest (Outside ownership)

• Minority interest is the remaining outside owners
  o Need Consolidation values for subsidiary accounts
  o There are three methods of disclosing presence of other owners
    o Implied value = total value of company arrived at by dividing the purchase price by the % that was acquired
    o Minority interest is on the balance sheet after non-current liabilities

• Economic Unit Concept
  o Emphasis placed on business combination formed
  o Controlled company must be consolidated as a whole
    ▪ Individual accounts can’t be divided
    ▪ Accounts at FMV when acquired; excess \(\rightarrow\) goodwill
  o Partial ownership held by outside parties must be acknowledged
    ▪ Outside parties own a component of new business
    ▪ Allocated a % of income to minority interest

• Proportionate Consolidation Concept
  • % of every account’s FMV @ date of purchase is the consolidation basis
  • Outside owners are ignored
• **Parent Company Concept**
  - Control of subsidiary → indivisible interest for parent
  - Financial statements are for shareholders
    - Book values are consolidated in total (economic unit)
    - Cost in excess of book value is a parent company expenditure
  - Formula: 
    \[
    \text{Purchase Price} - (\text{BV of sub less non-controlling interest}) \]
    
    Equals: cost in excess of underlying book value
  - Less: allocation based on: FMV – BV
  - Equals: Goodwill

• **Balance Sheet**

<table>
<thead>
<tr>
<th>Economic Unit</th>
<th>Proportionate Consol.</th>
<th>Parent Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book value of Assets/Liabilities</td>
<td>100%</td>
<td>% purchased</td>
</tr>
<tr>
<td>Less: Allocations</td>
<td>100%</td>
<td>% purchased</td>
</tr>
<tr>
<td>To FMV</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>100%</td>
<td>use implied value x % purchased</td>
</tr>
<tr>
<td>Non-controlling</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% left applied to</td>
<td>-0-</td>
<td>% left → book Implied value</td>
</tr>
</tbody>
</table>

• The **worksheet** for consolidation should include non-controlling interest at beginning of the year plus interest in sub’s current year income less dividend payments = balance at the end of the year

• **Step acquisitions**
  - Each purchase is a layer w/ separate allocations and amortizations
  - **Parent company**
    - Equity and added purchases can lead to need to consolidate
    - If going from market value to equity method, then make retroactive adjustments for comparability
      - But not if small purchases are made on the way
        - Equity method then starts at date of latest purchase that puts holding into equity method
  - **Economic unit**
    - Goodwill = Implied value (price paid/% purchased) less FMV of net assets
    - Difference between transaction prices ↔ underlying book value are adjustments to additional paid in capital

• **Pre-acquisition Income**
  - Date: Book value ↔ Purchase price (allocations and goodwill)
• Treat income as if sub had been owned all year
  ▪ Single line reduction at end to remove earnings that belong to previous owners

• Sale of subsidiary stock
  o Equity method- operations and amortizations for current year
  o For cost and partial equity, must update investment

Subsidiary Preferred Stock

• Consolidation depends on nature of preferred shares
  o Stock with call value, no rights & cumulative dividend is like a bond
  o Debt or equity
    ▪ Debt: shares acquired by parent are as if retired
    ▪ Stock: allocations to assets and liabilities with goodwill

• Debt
  o One distinction: preferred stock is legal equity
    ▪ Retirement can’t result in gain or loss
    ▪ Difference between par value and acquisition is APIC
    ▪ Consolidation → shares are eliminated
      ▪ Dividends in arrears reduce sub’s RE
  o Non-controlling interest: call value is more relevant to consolidated entity than par value
  o Outside owners are assigned balance = call value + div. in arrears

| JE: | Preferred Stock | xxx |
|     | APIC | xxx |
|     | Investment in sub’s preferred stock | xxx |

| JE: | Preferred Stock (to outsiders) | xxx |
| interest | Non-controlling | APIC |
| xxx | Non-controlling interest in sub | xxx |

| JE: | Preferred Stock | all |
| Combination share | APIC | all |
| Investment in sub’s preferred parent |
| outside share |
| Non-controlling interest |

| JE: (S) | Common Stock (sub) | xxx |
| Regular stock | APIC (sub) | xxx |
RE (sub) xxx
Investment in sub xxx
Non-controlling interest in sub xxx

JE: (A) Land xxx
Allocations Goodwill xxx
Investment in sub common xxx

**Steps to consolidate preferred**

- Determine nature of stock
- Sub’s book value = preferred and common
  - Value of preferred = price of shares + call value of remainder

**Allocation of Sub Income** (preferred shares)

- Outside share and parent recognition
- Total income divided into:
  - Amount owed preferred shareholders
  - Residual to common (equity method)

**Preferred Stock as Equity Interest**

- Fully participating, not callable
- Allocate to specific accounts (remainder→ goodwill)
- Income based on sub earnings, not dividends

<table>
<thead>
<tr>
<th>Par value of preferred</th>
<th>% to be applied to income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Par value</td>
<td></td>
</tr>
</tbody>
</table>

- Allocations divide unrealized gain in par value ratio
- Cumulative participating preferred shares entitle holders to a portion of sub’s earnings
Consolidated Cash Flows

- Not produced by consolidation, but created from process
- Issues
  - Non-controlling interest
    - Outside ownership reflected by decrease in net income
      - Earnings accrual to others
      - Only cash distributed is portion of dividend
  - Two adjustments
    - Non-controlling interest share in sub’s NI eliminated
    - Dividends paid to outsiders are included (financing)
- Amortizations are added back to Net Income
- Intercompany transactions- income statement and balance sheet must reflect only transactions with outsiders
  - No adjustments needed
- Year of acquisition- amount paid less subsidiary cash acquired is the net cash outflow
  - Intraperiod: operating accounts are net of effects of acquired businesses
  - Adjustments reflect only postacquisition amounts
  - In process R&D acquired- costs are investing outflows
    - Expense added back for operations

Consolidated EPS

\[
\text{EPS} = \frac{\text{Net income} - \text{preferred stock dividends}}{\text{Weighted average} \# \text{ of common shares}}
\]

- Diluters are options, warrants, convertible stocks and bonds
- Issue: amount of subsidiary income to be used in deriving dilutive EPS for business combination

Subsidiary Stock Transactions

- Some countries require a certain % of local ownership as a prerequisite to operate in that locale
- Subsidiaries can repurchase their own stock and sell stock to outsiders
- Cases
  - Sell a sub’s stock to outsiders at a price below the book value
    - This dilutes the parent’s investment

<table>
<thead>
<tr>
<th>JE1:</th>
<th>APIC (or RE) of parent</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Investment in sub</td>
<td>xxx</td>
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</table>
Ownership Patterns in Consolidation

- Father → Son → Grandson is a Pyramid
- Indirect ownership → group companies along product lines, geographic districts, where there are clear lines of communication and responsibility
- Problem: price allocations and amortization expense to be consolidated
  - Realized income: isolate sub’s realized income to calculate equity income accruals and non-controlling interest’s share
  - Operating income of bottom co. removes unrealized interco. gains
    - This gives bottom company’s realized income
  - Middle co.: operating income + equity in bottom’s realized income
    - Less amortization expense from bottom purchase
    - Less middle co. unrealized inter-company gains
    - Gives middle co. realized income
  - Top co.: same as middle
    - Outside non-controlling apply % to realized income

Consolidated process - indirect control

- G: remove unrealized gains from RE and COGS
- C: amortization from prior years → brought into consolidation
- S: Beginning stockholder’s equity accounts are eliminated (with Non controlling interest)
- A: Unamortized franchise balances remaining are removed
- I: Eliminate current inter-company income figures
- D: Remove inter-company dividends
- E: Annual amortization expense recorded
- TI: Inter-company sales/purchases → inventory are eliminated
- G: Defer inter-company gains that remain unrealized
Indirect subsidiary control- connecting affiliation

- Two or more companies in organization own an interest in another member
- Same as father- son; separate sets of consolidation entries

Mutual Ownership

Two companies own an interest in each other

- Issue is how to handle parent stock owned by subsidiary
  - ARB 51: shares of parent should not be treated as outstanding stock in consolidated balance sheet
  - Treasury Stock approach
    - Nature of subsidiary purchase- treasury stock or investment
    - Treasury method
      - Both parties account for transaction
      - Parent control of sub → parent’s perspective rules in consolidation
      - Cost of parent’s shares held by sub → on worksheet as treasury stock
      - Dividend payments are inter-company and eliminated
  - Conventional approach
    - Same methods for parent’s investment and sub’s investment
    - Economic unit concept: each company accounted for as individual component
    - Mutual income accruals solved by simultaneous equations

Income Tax Accounting

- A company with subs can do a consolidated return only w/ affiliate companies
  - Revenue Code: parent must own 80% of voting stock as well as 80% of each class of non-voting stock (direct or indirect)
  - Each company in affiliated group must be domestic, not foreign
  - Others file separately
- Benefits of affiliation
  - Inter-company profits are not taxed until realized
    - Inter-company losses are not deducted until culminated
  - Inter-company dividends are non-taxable
  - Losses by one affiliate can offset income by another
- Deferred Income Taxes
  - Temporary differences
    - Variation between asset and liability’s book value and tax basis
    - Results in taxable or deductible amounts in future
o Inter-company dividends
  ▪ Eliminated in financial; tax- only if 80% or more is held
    • Less than 80% is taxed partially
      o Deferred tax required for any sub's income not paid as dividend
      o Liability based on dividends collected (current)
      o Deferred liability is sub’s taxable income not paid

o Goodwill
  o 1993 Act: amortize goodwill and other purchased intangibles
    ▪ Section 197 property: over 15 year period
  o Financial accounting: goodwill written down if impaired or if related business is sold
  o Creates a temporary difference→ deferred income tax

o Unrealized inter-company gains
  o Consolidated financials- impact is deferred
  o Tax- gains removed until realized
  o If separate returns- profits must be reported in period of transfer
    ▪ Prepamtement creates a tax asset