

Chapter Four

Consolidation of Wholly Owned Subsidiaries Acquired at More than Book Value

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HOW MUCH WORK DOES IT REALLY TAKE TO CONSOLIDATE? ASK THE PEOPLE WHO DO IT AT DISNEY

The Walt Disney Company, whose history goes back to 1923, is parent company to some of the most well-known businesses in the world. Best known for Walt Disney Studios, its world famous parks and resorts, its media operations, like the Disney Channel, and its consumer products, Disney is a widely diversified company. For example, did you know that Disney owns the ABC Television Network and is the majority owner of ESPN? While the consolidation examples you're working in class usually involve a parent company and a single subsidiary, Disney employs a dedicated staff at its Burbank, California, headquarters each quarter to complete the consolidation of its five segments, each comprised of many subsidiaries, in preparation for its quarterly 10-Q and annual 10-K filings with the SEC. Preparation for the actual consolidation begins before the end of the fiscal period, and soon after the end of the period, each segment closes its books, including performing its own subsidiary consolidations, works with the independent auditors, and prepares for the roll-up to the overall company consolidation. The work continues as the finance and accounting staff of approximately 100 men and women at the corporate offices review and analyze the results from the individual segments and work with segment financial staff to prepare what becomes the publicly disclosed set of consolidated financial statements.

However, the work doesn't all take place at the end of the fiscal period. The accounting system also tracks intercompany transactions throughout the period. The consolidation process requires the elimination of intercompany sales and asset transfers among others cost allocations (as discussed in Chapters 6 and 7). Tracking these transactions involves ongoing efforts throughout the period.

One of the reasons Disney has grown and become so diversified over the years is that it frequently acquires other companies. Two of the more notable acquisitions in recent years are the Marvel Entertainment acquisition in 2009 and its acquisition of Pixar Animation Studios in 2006. In these and other well-known acquisitions, Disney paid more than the book value of each acquired company's net assets to acquire them. Acquisition accounting rules require Disney to account for the full acquisition price—even though the acquired companies may continue to report their assets and liabilities on their separate

Disney

books at their historical book values. Thus, acquisition accounting requires Disney to essentially revalue the balance sheets of these companies to their amortized fair values in the consolidation process each period. We provide more details on the Pixar acquisition later in the chapter.

The bottom line is that preparation of Disney's publicly disclosed financial statements is the culmination of a lot of work by the segment and corporate accounting and finance staff. The issues mentioned here illustrate the complexity of a process that requires substantial teamwork and effort to produce audited financial statements that are valuable to an investor or interested accounting student. You'll learn in this chapter about the activities during the consolidation process performed by the accounting staff at any well-known public company. This chapter also introduces differences in the consolidation process when there is a differential (i.e., the acquiring company pays more than the book value of the acquired company's net assets).

LEARNING OBJECTIVES

When you finish studying this chapter, you should be able to:

- LO 4-1 Understand and make equity-method journal entries related to the differential.
- LO 4-2 Understand and explain how consolidation procedures differ when there is a differential.
- LO 4-3 Make calculations and prepare elimination entries for the consolidation of a wholly owned subsidiary when there is a complex positive differential at the acquisition date.
- LO 4-4 Make calculations and prepare elimination entries for the consolidation of a wholly owned subsidiary when there is a complex bargain-purchase differential.
- LO 4-5 Prepare equity-method journal entries, elimination entries, and the consolidation worksheet for a wholly owned subsidiary when there is a complex positive differential.
- LO 4-6 Understand and explain the elimination of basic intercompany transactions.
- LO 4-7 Understand and explain the basics of push-down accounting.

DEALING WITH THE DIFFERENTIAL

This chapter continues to build upon the foundation established in Chapters 2 and 3 related to the consolidation of majority-owned subsidiaries. In Chapters 2 and 3, we focus on relatively simple situations when the acquisition price is exactly equal to the parent's share of the book value of the subsidiary's net assets. In Chapter 4, we relax this assumption and allow the acquisition price to differ from book value. As explained in Chapter 1, this allows for a "differential."

	Wholly owned subsidiary	Partially owned subsidiary	
Investment = Book value	Chapter 2	Chapter 3	No differential
Investment > Book value	Chapter 4	Chapter 5	Differential
	No NCI shareholders	NCI shareholders	

The Difference between Acquisition Price and Underlying Book Value

When an investor purchases the common stock of another company, the purchase price normally is based on the market value of the shares acquired rather than the book value of the investee's assets and liabilities. Not surprisingly, the acquisition price is usually different from the book value of the investor's proportionate share of the investee's net assets. This difference is referred to as a differential. The differential is frequently positive, meaning the acquiring company pays more than its share of the book value of the subsidiary's net assets. Note that in the case of an equity-method investment, the differential on the parent's books relates only to the parent's share of any difference between total investee's fair value and book value. The differential in the case of an equity-method investment is implicit in the investment account on the parent's books and is not recorded separately.



FYI

In 2009, Bank of America reported one of the largest goodwill balances of all time, \$86.3 billion. However, due to large goodwill impairment charges in 2010 and 2011, its 2011 goodwill balance decreased to \$69.967 billion.

The cost of an investment might exceed the book value of the underlying net assets, giving rise to a positive differential, for any of several reasons. One reason is that the investee's assets may be worth more than their book values. Another reason could be the existence of unrecorded goodwill associated with the excess earning power of the investee. In either case, the portion of the dif-

ferential pertaining to each asset of the investee, including goodwill, must be ascertained. When the parent company uses the equity method, for reporting purposes (i.e., the subsidiary remains unconsolidated) that portion pertaining to limited-life assets of the investee, including identifiable intangibles, must be amortized over the remaining economic lives of those assets. Any portion of the differential that represents goodwill (referred to as *equity-method goodwill* or *implicit goodwill*) is not amortized or separately tested for impairment. However, an impairment loss on the investment itself should be recognized if it suffers a material decline in value that is other than temporary (ASC 323-10-35-32).

Amortization or Write-Off of the Differential¹

When the equity method is used, each portion of the differential must be treated in the same manner as the investee treats the assets or liabilities to which the differential relates. Thus, any portion of the differential related to depreciable or amortizable assets of the investee should be amortized over the remaining time that the cost of the asset is being allocated by the investee. Amortization of the differential associated with depreciable or amortizable assets of the investee is necessary on the investor's books to reflect the decline in the future benefits the investor expects from that portion of the investment cost associated with those assets. The investee recognizes the reduction in service potential of assets with limited lives as depreciation or amortization expense based on the amount it has invested in those assets. This reduction, in turn, is recognized by the investor through its share of the investee's net income. When the acquisition price of the investor's interest in the investee's assets is higher than the investee's cost (as reflected in a positive differential), the additional cost must be amortized.

The approach to amortizing the differential that is most consistent with the idea of reflecting all aspects of the investment in just one line on the balance sheet and one line on the income statement is to reduce the income recognized by the investor from the investee and the balance of the investment account:

Income from Investee	XXXX	
Investment in Common Stock of Investee		XXX

¹ To view a video explanation of this topic, visit advancedstudyguide.com.

LO 4-1

Understand and make equity-method journal entries related to the differential.



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The differential represents the amount paid by the investor company in excess of the book value of the net assets of the investee company and is included in the original acquisition price. Hence, the amortization or reduction of the differential involves the reduction of the investment account. At the same time, the investor's net income must be reduced by an equal amount to recognize that a portion of the amount paid for the investment has expired.

Treatment of the Differential Illustrated

To illustrate how to apply the equity method when the cost of the investment exceeds the book value of the underlying net assets, assume that Ajax Corporation purchases 40 percent of the common stock of Barclay Company on January 1, 20X1, for \$200,000. Barclay has net assets on that date with a book value of \$400,000 and fair value of \$465,000. The total differential is equal to the market value of Barclay's common stock, \$500,000, minus the book value of its net assets, \$400,000. Thus, the entire differential is \$100,000.

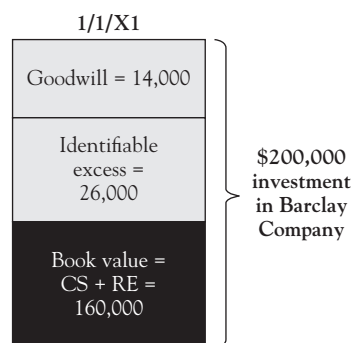
Ajax's share of the book value of Barclay's net assets at acquisition is \$160,000 ($\$400,000 \times 0.40$). Thus, Ajax's 40 percent share of the differential is computed as follows:

Cost of Ajax's investment in Barclay's stock	\$200,000
Book value of Ajax's share of Barclay's net assets	<u>(160,000)</u>
Ajax's share of the differential	<u>\$ 40,000</u>

The portion of the total differential that can be directly traced to specific assets that are undervalued on Barclay's books is the \$65,000 excess of the fair value over the book value of Barclay's net assets ($\$465,000 - \$400,000$). An appraisal of Barclay's assets indicates that its land is worth \$15,000 more than the recorded value on its books and its equipment is worth \$50,000 more than its current book value. Ajax's 40 percent share of the unrecorded increase in the value of Barclay's assets is as follows:

	<u>Total Increase</u>	<u>Ajax's 40% Share</u>
Land	\$15,000	6,000
Equipment	<u>50,000</u>	<u>20,000</u>
	<u>\$65,000</u>	<u>\$26,000</u>

Thus, \$26,000 of Ajax's share of the differential is assigned to land and equipment, with the remaining \$14,000 attributed to goodwill. The allocation of Ajax's share of the differential can be illustrated as shown in the diagram below.



Although the differential relates to Barclay's assets the additional cost incurred by Ajax to acquire a claim on Barclay's assets is reflected in Ajax's investment in Barclay.

No separate differential account is established, and no separate accounts are recorded on Ajax's books to reflect the apportionment of the differential to specific assets. Similarly, no separate expense account is established on Ajax's books. Amortization or write-off of the differential is accomplished by reducing Ajax's investment account and the income Ajax recognizes from its investment in Barclay.

Because land has an unlimited economic life, the portion of the differential related to land is not amortized. Ajax's \$20,000 portion of the differential related to Barclay's equipment is amortized over the equipment's remaining life. If the equipment's remaining life is five years, Ajax's annual amortization of the differential is \$4,000 ($\$20,000 \div 5$) (assuming straight-line depreciation).

Beginning in 1970, financial reporting standards required that goodwill be amortized over its useful life, not to exceed 40 years. In 2001, however, the FASB issued a new standard under which equity-method goodwill is no longer amortized nor is it separately tested for impairment when the equity method is used for reporting purposes. Instead, the entire investment is tested for impairment (**ASC 323-10-35-32**). In this example, the only amortization of the differential is the \$4,000 related to Barclay's equipment.

Barclay reports net income of \$80,000 at year end and declares dividends of \$20,000 during 20X1. Using the equity-method, Ajax records the following entries on its books during 20X1:

(1)	Investment in Barclay Stock	200,000	
	Cash		200,000
	Record purchase of Barclay stock.		
(2)	Investment in Barclay Stock	32,000	
	Income from Barclay Company		32,000
	Record equity-method income: $\$80,000 \times 0.40$.		
(3)	Cash	8,000	
	Investment in Barclay Stock		8,000
	Record dividend from Barclay: $\$20,000 \times 0.40$.		
(4)	Income from Barclay Company	4,000	
	Investment in Barclay Stock		4,000
	Amortize differential related to equipment.		

With these entries, Ajax recognizes \$28,000 of income from Barclay and adjusts its investment in Barclay to an ending balance of \$220,000.

The amortization on Ajax's books of the portion of the differential related to Barclay's equipment is the same (\$4,000) for each of the first five years (20X1 through 20X5). This amortization stops after 20X5 because this portion of the differential is fully amortized after five years.

Notice that no special accounts are established on Ajax's books with regard to the differential or the amortization of the differential. The only two accounts involved are "Income from Barclay Company" and "Investment in Barclay Company Stock." As the Investment in Barclay Company Stock account is amortized, the differential between the carrying amount of the investment and the book value of the underlying net assets decreases.

Disposal of Differential-Related Assets

Although the differential is included on the books of the investor as part of the investment account, it relates to specific assets of the investee. Thus, if the investee disposes of any asset to which the differential relates, that portion of the differential must be removed from the investment account on the investor's books. When this is done, the investor's share of the investee's gain or loss on disposal of the asset must be adjusted to reflect the fact that the investor paid more for its proportionate share of that asset than did the investee.

For example, if in the previous illustration Barclay Company sells the land to which \$6,000 of Ajax's differential relates, Ajax does not recognize a full 40 percent of the gain or loss on the sale. Assume that Barclay originally had purchased the land in 20X0 for \$75,000 and sells the land in 20X2 for \$125,000. Barclay recognizes a gain on the sale of \$50,000, and Ajax's share of that gain is 40 percent, or \$20,000. The portion of the gain actually recognized by Ajax, however, must be adjusted as follows because of the amount in excess of book value paid by Ajax for its investment in Barclay:

Ajax's share of Barclay's reported gain	\$20,000
Portion of Ajax's differential related to the land	(6,000)
Gain to be recognized by Ajax	<u>\$14,000</u>

Thus, if Barclay reports net income (including the gain on the sale of land) of \$150,000 for 20X2, Ajax records the following entries (disregarding dividends and amortization of the differential relating to equipment):

(5)	Investment in Barclay Company	60,000	
	Income from Barclay Company		60,000
	Record equity-method income: $\$150,000 \times 0.40$.		
(6)	Income from Barclay Company	6,000	
	Investment in Barclay Stock		6,000
	Remove differential related to Barclay's land that was sold.		

The same approach applies when dealing with a limited-life asset. The unamortized portion of the original differential relating to the asset sold is removed from the investment account, and the investor's share of the investee's income is adjusted by that amount.

Note that the investor does not separately report its share of ordinary gains or losses included in the investee's net income, such as the gain on the sale of the fixed asset or the write-off of the unamortized differential. Consistent with the idea of using only a single line in the income statement to report the impact of the investee's activities on the investor, all such items are included in the Income from Investee account. Current standards do require the investor to report its share of an investee's extraordinary gains and losses, prior-period adjustments, and elements of other comprehensive income, if material to the investor, as separate items in the same manner as the investor reports its own.

Impairment of Investment Value

As with many assets, accounting standards require that equity-method investments be written down if their value is impaired. If the market value of the investment declines materially below its equity-method carrying amount, and the decline in value is considered other than temporary, the carrying amount of the investment should be written down to the market value and a loss should be recognized. The new lower value serves as a starting point for continued application of the equity-method. Subsequent recoveries in the value of the investment may not be recognized.

ADDITIONAL CONSIDERATIONS

Pixar Acquisition Details from the 2006 Disney 10-K

Acquisition of Pixar

On May 5, 2006 (the Closing Date), the Company completed an all stock acquisition of Pixar, a digital animation studio (the Acquisition). Disney believes that the creation of high quality feature animation is a key driver of success across many of its businesses

and provides content useful across a variety of traditional and new platforms throughout the world. The acquisition of Pixar is intended to support the Company's strategic priorities of creating the finest content, embracing leading-edge technologies, and strengthening its global presence. The results of Pixar's operations have been included in the Company's consolidated financial statements since the Closing Date.

To purchase Pixar, Disney exchanged 2.3 shares of its common stock for each share of Pixar common stock, resulting in the issuance of 279 million shares of Disney common stock, and converted previously issued vested and unvested Pixar equity-based awards into approximately 45 million Disney equity-based awards.

The Acquisition purchase price was \$7.5 billion (\$6.4 billion, net of Pixar's cash and investments of approximately \$1.1 billion). The value of the stock issued was calculated based on the market value of the Company's common stock using the average stock price for the five-day period beginning two days before the acquisition announcement date on January 24, 2006. The fair value of the vested equity-based awards issued at the Closing Date was estimated using the Black-Scholes option pricing model, as the information required to use a binomial valuation model was not reasonably available.

In connection with the Acquisition, the Company recorded a non-cash, non-taxable gain from the deemed termination of the existing Pixar distribution agreement. Under our previously existing distribution agreement with Pixar, the Company earned a distribution fee that, based on current market rates at the Closing Date, was favorable to the Company. In accordance with EITF 04-1, *Accounting for Pre-Existing Relationships between the Parties to a Business Combination* (EITF 04-1), the Company recognized a \$48 million gain, representing the net present value of the favorable portion of the distribution fee over the remaining life of the distribution agreement. In addition, the Company abandoned the Pixar sequel projects commenced by the Company prior to the acquisition and recorded a pre-tax impairment charge totaling \$26 million, which represents the costs of these projects incurred through the abandonment date. These two items are classified in "Restructuring and impairment (charges) and other credits, net" in the Consolidated Statement of Income.

The Company allocated the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed based on their fair values, which were determined primarily through third-party appraisals. The excess of the purchase price over those fair values was recorded as goodwill, which is not amortizable for tax purposes. The fair values set forth below are subject to adjustment if additional information is obtained prior to the one-year anniversary of the Acquisition that would change the fair value allocation as of the acquisition date. The following table summarizes the allocation of the purchase price:

	Estimated Fair Value	Weighted Average Useful Lives (years)
Cash and cash equivalents	\$ 11	
Investments	1,073	
Prepaid and other assets	45	
Film costs	538	12
Buildings & equipment	225	16
Intangibles	233	17
Goodwill	5,557	
Total assets acquired	\$ 7,682	
Liabilities	64	
Deferred income taxes	123	
Total liabilities assumed	\$ 187	
Net assets acquired	\$ 7,495	

The weighted average useful life determination for intangibles excludes \$164 million of indefinite-lived Pixar trademarks and trade names. Goodwill of \$4.8 billion, \$0.6 billion, and \$0.2 billion was allocated to the Studio Entertainment, Consumer Products, and Parks and Resorts operating segments, respectively.

The following table presents unaudited pro forma results of Disney as though Pixar had been acquired as of the beginning of the respective periods presented. These pro forma results do not necessarily represent what would have occurred if the Acquisition had taken place on the dates presented and does not represent the results that may occur in the future. The pro forma amounts represent the historical operating results of Disney and Pixar with adjustments for purchase accounting. The \$48 million non-cash gain pursuant to EITF 04-1 has been included in net income in fiscal year 2006.

	Fiscal Year 2006 (unaudited)	Fiscal Year 2005 (unaudited)
Revenues	\$34,299	\$31,973
Income before cumulative effect of accounting change	3,395	2,682
Net income	3,395	2,646
Earnings per share:		
Diluted	<u>\$ 1.52</u>	<u>\$ 1.12</u>
Basic	<u>\$ 1.56</u>	<u>\$ 1.15</u>

CONSOLIDATION PROCEDURES FOR WHOLLY OWNED SUBSIDIARIES ACQUIRED AT MORE THAN BOOK VALUE

LO 4-2

Understand and explain how consolidation procedures differ when there is a differential.



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Many factors have an effect on the fair value of a company and its stock price, including its asset values, its earning power, and general market conditions. When one company acquires another, the acquiree's fair value usually differs from its book value, and so the consideration given by the acquirer does as well. As discussed in Chapter 1, this difference between the fair value of the consideration given and the book value of the acquiree's net identifiable assets is referred to as a differential.

The process of preparing a consolidated balance sheet immediately after a business combination is complicated only slightly when 100 percent of a company's stock is acquired at a price that differs from the acquiree's book value. To illustrate the acquisition of a subsidiary when the consideration given is greater than the book value of the net assets of the acquiree, we use the Peerless-Special Foods example from Chapter 2. We assume that Peerless Products acquires all of Special Foods' outstanding stock on January 1, 20X1, by paying \$340,000 cash, an amount equal to Special Foods' fair value as a whole. The consideration given by Peerless is \$40,000 in excess of Special Foods' book value of \$300,000. The resulting ownership situation can be viewed as follows:

	(P)		
	↓	Fair value of consideration	\$340,000
1/1/X1		Book value of Special Foods' net assets	
100%		Common stock—Special Foods	200,000
		Retained earnings—Special Foods	<u>100,000</u>
	(S)		300,000
		Difference between fair value and book value	<u>\$ 40,000</u>

Peerless records the stock acquisition with the following entry:

(7)	Investment in Special Foods	340,000	
	Cash		340,000
	Record purchase of Special Foods stock.		

In a business combination, and therefore in a consolidation following a business combination, the full amount of the consideration given by the acquirer must be assigned to the individual assets and liabilities acquired and to goodwill. In this example, the fair value of consideration given (the acquisition price) includes an extra \$40,000 for appreciation in the value of the land since it was originally acquired by Special Foods. The relationship between the fair value of the consideration given for Special Foods, the fair value of Special Foods' net assets, and the book value of Special Foods' net assets can be illustrated as follows:

1/1/X1	
Goodwill = 0	
Identifiable excess = 40,000	
Book value = CS + RE = 300,000	
	\$340,000 initial investment in Special Foods

Assume that Peerless prepares a consolidated balance sheet on the date it acquires Special Foods. The consolidation worksheet procedures used in adjusting to the proper consolidated amounts follow a consistent pattern. The first worksheet entry (often referred to as the "basic" elimination entry) eliminates the book value portion of the parent's investment account and each of the subsidiary's stockholders' equity accounts. It is useful to analyze the investment account and the subsidiary's equity accounts as follows:

Book Value Calculations:

Book value at acquisition	Total Investment	=	Common Stock	+	Retained Earnings
	300,000		200,000		100,000

The worksheet entry to eliminate the book value portion of Peerless' investment account and the stockholders' equity accounts of Special Foods is as follows:

Basic Elimination Entry:

Common stock	200,000	← Common stock balance
Retained earnings	100,000	← Beginning balance in RE
Investment in Special Foods	300,000	← Net BV in investment account

When the acquisition-date fair value of the consideration is more than the acquiree's book value at that date, the second elimination entry reclassifies the excess acquisition price to the specific accounts on the balance sheet for which the book values are not the same as their fair values on the acquisition date.² The differential represents (in simple situations involving a 100 percent acquisition) the total difference between the acquisition-date fair value of the consideration given by the acquirer and the acquiree's

² Alternatively, a separate clearing account titled *Excess of Acquisition Consideration over Acquiree Book Value*, or just *Differential* can be debited for this excess amount. A subsequent entry can be used to reclassify the differential to the various accounts on the balance sheet that need to be revalued to their acquisition date amounts. Note that the Differential account is simply a worksheet clearing account and is not found on the books of the parent or subsidiary and does not appear in the consolidated financial statements.

book value. In this example, the differential is the additional \$40,000 Peerless paid to acquire Special Foods because its land was worth \$40,000 more than its book value as of the acquisition date. In preparing a consolidated balance sheet immediately after acquisition (on January 1, 20X1), the second elimination entry appearing in the consolidation worksheet simply reassigns this \$40,000 from the investment account to the land account so that: (a) the Land account fully reflects the fair value of this asset as of the acquisition date and (b) the investment account is fully eliminated from Peerless' books:

Excess Value Reclassification Entry:

Land	40,000	← Excess value assigned to land
Investment in Special Foods	40,000	← Reclassify excess acquisition price

Thus, these two elimination entries completely eliminate the balance in Peerless' investment account and the second entry assigns the differential to the land account.

	Investment in Special Foods	
Acquisition Price	340,000	
	300,000	Basic Elimination Entry
	40,000	Excess Value Reclassification Entry
	0	

In more complicated examples when the fair values of various balance sheet accounts differ from book values, the excess value reclassification entry reassigns the differential to adjust various account balances to reflect the fair values of the subsidiary's assets and liabilities at the time the parent acquired the subsidiary and to establish goodwill, if appropriate.

Figure 4-1 illustrates the consolidation worksheet reflecting the elimination of Special Foods' equity accounts and the allocation of the differential to the subsidiary's land. As explained previously, the combination of these two worksheet entries also eliminates the investment account.

FIGURE 4-1 Worksheet for Consolidated Balance Sheet, January 1, 20X1, Date of Combination; 100 Percent Acquisition at More than Book Value

	Peerless Products	Special Foods	Elimination Entries		Consolidated
			DR	CR	
Balance Sheet					
Cash	10,000	50,000			60,000
Accounts Receivable	75,000	50,000			125,000
Inventory	100,000	60,000			160,000
Investment in Special Foods	340,000			300,000	0
				40,000	
Land	175,000	40,000	40,000		255,000
Buildings & Equipment	800,000	600,000		300,000	1,100,000
Less: Accumulated Depreciation	(400,000)	(300,000)	300,000		(400,000)
Total Assets	1,100,000	500,000	\$340,000	\$640,000	1,300,000
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	300,000	100,000	100,000		300,000
Total Liabilities & Equity	1,100,000	500,000	300,000	0	1,300,000

As usual, we eliminate Special Foods' acquisition date accumulated depreciation against the Buildings and Equipment account balance so that, combined with the excess value reclassification entry it will appear as if these fixed assets were recorded at their acquisition date fair values.

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	300,000	← Accumulated depreciation at the time of the acquisition netted against cost
Building & equipment	300,000	

The amounts reported in the consolidated balance sheet are those in the Consolidated column of the worksheet in Figure 4–1. Land would be included in the consolidated balance sheet at \$255,000, the amount carried on Peerless' books (\$175,000) plus the amount carried on Special Foods' books (\$40,000) plus the differential reflecting the increased value of Special Foods' land (\$40,000).

This example is sufficiently simple that the assignment of the differential to land could be made directly in the basic elimination entry rather than through the use of a separate entry. In practice, however, the differential often relates to more than a single asset, and the allocation of the differential may be considerably more complex than in this example. The possibilities for clerical errors are reduced in complex situations by making two separate entries rather than one complicated entry.

Treatment of a Positive Differential

The fair value, and hence acquisition price, of a subsidiary might exceed the book value for several reasons, such as the following:

1. Errors or omissions on the subsidiary's books.
2. Excess of fair value over the book value of the subsidiary's net identifiable assets.
3. Existence of goodwill.

Errors or Omissions on the Books of the Subsidiary

An examination of an acquired company's books may reveal material errors. In some cases, the acquired company may have expensed rather than capitalized assets or, for other reasons, omitted them from the books. An acquired company that previously had been closely held may not have followed generally accepted accounting principles in maintaining its accounting records. In some cases, the recordkeeping may have simply been inadequate.

Where errors or omissions occur, corrections should be made directly on the subsidiary's books as of the date of acquisition. These corrections are treated as prior-period adjustments in accordance with **ASC 250-10-60**. Once the subsidiary's books are stated in accordance with generally accepted accounting principles, that portion of the differential attributable to errors or omissions will no longer exist.

Excess of Fair Value over Book Value of Subsidiary's Net Identifiable Assets

The fair value of a company's assets is an important factor in the overall determination of the company's fair value. In many cases, the fair value of an acquired company's net assets exceeds the book value. Consequently, the consideration given by an acquirer may exceed the acquiree's book value. The procedures used in preparing the consolidated balance sheet should lead to reporting all of the acquired company's assets and liabilities based on their fair values on the date of combination. This valuation may be accomplished in one of two ways: (1) the subsidiary's assets and liabilities may be revalued directly on the books of the subsidiary or (2) the accounting basis of the subsidiary may be maintained and the revaluations made each period in the consolidation worksheet.

Revaluing the assets and liabilities on the subsidiary's books generally is the simplest approach if all of the subsidiary's common stock is acquired. On the other hand, it generally is not appropriate to revalue the assets and liabilities on the subsidiary's books if there is a significant noncontrolling interest in that subsidiary. From a noncontrolling shareholder's point of view, the subsidiary is a continuing company, and the basis of accounting should not change. More difficult to resolve is the situation in which the parent acquires all of the subsidiary's common stock but continues to issue separate financial statements of the subsidiary to holders of the subsidiary's bonds or preferred stock. Revaluing the assets and liabilities of the subsidiary directly on its books is referred to as **push-down accounting**. It is discussed later in this chapter and is illustrated in Appendix 4A.

When the assets and liabilities are revalued directly on the subsidiary's books, that portion of the differential then no longer exists. However, if the assets and liabilities are not revalued on the subsidiary's books, an entry to revalue those assets and allocate the differential is needed in the consolidation worksheet each time consolidated financial statements are prepared for as long as the related assets are held.

Existence of Goodwill

If the acquisition-date fair value of the consideration exchanged for an acquired subsidiary is higher than the total fair value of the subsidiary's net identifiable assets, the difference is considered to be related to the future economic benefits associated with other assets of the subsidiary that are not separately identified and recognized and is referred to as **goodwill**. Thus, once a subsidiary's identifiable assets and liabilities are revalued to their fair values, any remaining debit differential is normally allocated to goodwill. For example, assuming that in the Peerless Products and Special Foods illustration, the acquisition-date fair values of Special Foods' assets and liabilities are equal to their book values, then the \$40,000 difference between the \$340,000 consideration exchanged and the \$300,000 fair value of the subsidiary's net identifiable assets should be attributed to goodwill. The following entry to assign the differential is needed in the consolidation worksheet prepared immediately after the combination:

Excess Value Reclassification Entry:

Goodwill	40,000	← Excess value assigned to goodwill
Investment in Special Foods	40,000	← Reassign excess acquisition price

The consolidation worksheet is similar to Figure 4–1 except that the debit in the excess value reclassification worksheet entry would be to goodwill instead of land. Goodwill, which does not appear on the books of either Peerless or Special Foods, would appear at \$40,000 in the consolidated balance sheet prepared immediately after acquisition.

In the past, some companies have included the fair-value increment related to certain identifiable assets of the subsidiary in goodwill rather than separately recognizing those assets. This treatment is not acceptable, and any fair-value increment related to an intangible asset that arises from a contractual or legal right or that is separable from the entity must be allocated to that asset.

Illustration of Treatment of a Complex Differential

In many situations, the differential relates to a number of different assets and liabilities. As a means of illustrating the allocation of the differential to various assets and liabilities, assume that the acquisition-date book values and fair values of Special Foods' assets and liabilities are as shown in Figure 4–2. The inventory and land have fair values in excess of their book values, although the buildings and equipment are worth less than their book values.

Bond prices fluctuate as interest rates change. In this example, the value of Special Foods' bonds payable is higher than the book value. This indicates that the nominal interest rate on the bonds is higher than the current market interest rate and, therefore, investors

LO 4-3

Make calculations and prepare elimination entries for the consolidation of a wholly owned subsidiary when there is a complex positive differential at the acquisition date.

FIGURE 4-2
Differences between
Book and Fair Values
of Special Foods'
Identifiable Assets
and Liabilities as of
January 1, 20X1, the
Date of Combination

		Book Value	Fair Value	Difference between Fair Value and Book Value
Cash		\$ 50,000	\$ 50,000	
Accounts Receivable		50,000	50,000	
Inventory		60,000	75,000	\$15,000
Land		40,000	100,000	60,000
Buildings & Equipment	600,000			
Accumulated Depreciation	(300,000)	300,000	290,000	(10,000)
		<u>\$500,000</u>	<u>\$565,000</u>	
Accounts Payable		\$100,000	\$100,000	
Bonds Payable		100,000	135,000	(35,000)
Common Stock		200,000		
Retained Earnings		100,000		
		<u>\$500,000</u>	<u>\$235,000</u>	<u>\$30,000</u>



are willing to pay a price higher than par for the bonds. In determining the value of Special Foods, Peerless must recognize that it is assuming a liability that pays an interest rate higher than the current market rate. Accordingly, Special Foods' value will be less than if the liability carried a lower interest rate. The resulting consolidated financial statements must recognize the acquisition-date fair values of Special Foods' liabilities as well as its assets.

Assume that Peerless Products acquires all of Special Foods' capital stock for \$400,000 on January 1, 20X1, by issuing \$100,000 of 9 percent bonds, with a fair value of \$100,000, and paying cash of \$300,000. The resulting ownership situation can be pictured as follows with a \$100,000 differential:

	(P)		
	↓	Fair value of consideration	\$400,000
1/1/X1		Book value of Special Foods' net assets	
100%		Common stock—Special Foods	200,000
		Retained earnings—Special Foods	<u>100,000</u>
	(S)		<u>300,000</u>
		Difference between fair value and book value	<u>\$100,000</u>

Peerless records the investment on its books with the following entry:

(8)	Investment in Special Foods	400,000	
	Bonds Payable		100,000
	Cash		300,000

Record purchase of Special Foods stock.

The fair value of the consideration that Peerless gave to acquire Special Foods' stock (\$400,000) can be divided between the fair value of Special Foods' identifiable net assets (\$330,000) and goodwill (\$70,000), illustrated as follows:

1/1/X1	
Goodwill = 70,000	\$400,000 initial investment in Special Foods
Identifiable excess = 30,000	
Book value = CS + RE = 300,000	

The total \$400,000 consideration exceeds the book value of Special Foods' net assets by \$100,000 (assets of \$500,000 less liabilities of \$200,000). Thus, the total differential is \$100,000. The total fair value of the net identifiable assets acquired in the combination is \$330,000 (\$565,000 - \$235,000), based on the data in Figure 4-2. The amount by which the total consideration of \$400,000 exceeds the \$330,000 fair value of the net identifiable assets is \$70,000, and that amount is assigned to goodwill in the consolidated balance sheet. Assume that Peerless decides to prepare a consolidated balance sheet as of the date it acquired Special Foods.

The book value portion of the acquisition price is \$300,000:

Book Value Calculations:

Book value at acquisition	Total Investment	=	Common Stock	+	Retained Earnings
	300,000		200,000		100,000

Thus, the basic elimination entry is as follows:

Basic Elimination Entry:

Common stock	200,000	← Common stock balance
Retained earnings	100,000	← Beginning balance in RE
Investment in Special Foods	300,000	← Net BV in investment account

The reclassification of the differential to the various accounts that are either over- or undervalued on Special Foods' balance sheet as of the acquisition date is more complicated than in the previous example. Thus, it is helpful to analyze the differential as follows:

Excess Value (Differential) Calculations:

Total Differential	=	Inventory	+	Land	+	Goodwill	+	Building	+	Bonds Payable
100,000		15,000		60,000		70,000		(10,000)		(35,000)

This analysis leads to the following reclassification entry to assign the \$100,000 differential to the specific accounts that need to be "revalued" to reflect their fair values as of the acquisition date. Moreover, this entry completes the elimination of the investment account from Peerless' books.

Excess Value (Differential) Reclassification Entry:

Inventory	15,000	← Excess value assigned to inventory
Land	60,000	← Excess value assigned to land
Goodwill	70,000	← Excess value assigned to goodwill
Building	10,000	← Building revalued down to fair value
Bonds Payable	35,000	← Excess liability associated with the bonds
Investment in Special Foods	100,000	← Reassign excess acquisition price

In summary, these two elimination entries completely eliminate the balance in Peerless' investment account and the second entry assigns the differential to various balance

sheet accounts. As in previous examples, it is helpful to visualize how the two elimination entries “zero out” the investment account:

	Investment in Special Foods		
Acquisition Price	400,000		
		300,000	Basic Elimination Entry
		100,000	Excess Value Reclassification Entry
	0		

As usual, we eliminate Special Foods’ acquisition date accumulated depreciation against the Buildings and Equipment account balance so that, combined with the excess value reclassification entry it will appear as if these fixed assets were recorded at their acquisition date fair values.

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	300,000		
Building & equipment		300,000	← Accumulated depreciation at the time of the acquisition netted against cost

These entries are reflected in the worksheet in Figure 4–3. Although the reclassification entry is somewhat more complex than in the previous example, the differential allocation is conceptually the same in both cases. In each case, the end result is a consolidated balance sheet with the subsidiary’s assets and liabilities valued at their fair values at the date of combination.

FIGURE 4–3 Worksheet for Consolidated Balance Sheet, January 1, 20X1, Date of Combination; 100 Percent Acquisition at More than Book Value

	Peerless Products	Special Foods	Elimination Entries		Consolidated
			DR	CR	
Balance Sheet					
Cash	50,000	50,000			100,000
Accounts Receivable	75,000	50,000			125,000
Inventory	100,000	60,000	15,000		175,000
Investment in Special Foods	400,000			300,000	0
				100,000	
Land	175,000	40,000	60,000		275,000
Buildings & Equipment	800,000	600,000		10,000	1,090,000
				300,000	
Less: Accumulated Depreciation	(400,000)	(300,000)	300,000		(400,000)
Goodwill			70,000		70,000
Total Assets	1,200,000	500,000	\$445,000	\$710,000	1,435,000
Accounts Payable	100,000	100,000			200,000
Bonds Payable	300,000	100,000			400,000
Premium on Bonds Payable				35,000	35,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	300,000	100,000	100,000		300,000
Total Liabilities & Equity	1,200,000	500,000	300,000	35,000	1,435,000

LO 4-4

Make calculations and prepare elimination entries for the consolidation of a wholly owned subsidiary when there is a complex bargain-purchase differential.



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100 Percent Ownership Acquired at Less than Fair Value of Net Assets

It is not uncommon for companies' stock to trade at prices that are lower than the fair value of their net assets. These companies are often singled out as prime acquisition targets. The acquisition price of an acquired company may be less than the fair value of its net assets because some of the acquiree's assets or liabilities may have been incorrectly specified or because the transaction reflects a forced sale where the seller was required to sell quickly and was unable to fully market the sale.

Obviously, if assets or liabilities acquired in a business combination have been incorrectly specified, the errors must be corrected and the assets and liabilities valued at their fair values. Once this is done, if the fair value of the consideration given is still less than the fair value of the net assets acquired, a gain attributable to the acquirer is recognized for the difference. In general, as discussed in Chapter 1, a business combination in which (1) the sum of the acquisition-date fair values of the consideration given, any equity interest already held by the acquirer, and any noncontrolling interest is less than (2) the amounts at which the identifiable net assets must be valued at the acquisition date as specified by **ASC 805-10-20** (usually fair values) is considered a **bargain purchase**, and a gain attributable to the acquirer is recognized for the difference.

Illustration of Treatment of Bargain-Purchase Differential

Using the example of Peerless Products and Special Foods, assume that the acquisition-date book values and fair values of Special Foods' assets and liabilities are equal except that the fair value of Special Foods' land is \$40,000 more than its book value. On January 1, 20X1, Peerless acquires all of Special Foods' common stock for \$310,000, resulting in a bargain purchase. The resulting ownership situation is as follows:

(P) ↓ 1/1/X1 100% ↓ (S)	Fair value of consideration	\$310,000
	Book value of Special Foods' net assets	
	Common stock—Special Foods	200,000
	Retained earnings—Special Foods	100,000
		<u>300,000</u>
	Difference between fair value and book value	<u>\$ 10,000</u>

Peerless records its investment in Special Foods with the following entry on its books:

(9)	Investment in Special Foods	340,000	
	Cash		310,000
	Gain on Bargain Purchase		30,000

Record purchase of Special Foods stock.

In this example, the acquisition-date fair value of Special Foods' net assets is higher than their book value by \$40,000. However, the purchase price exceeds Special Foods' book value by only \$10,000 and, thus, is less than the fair value of the net identifiable assets acquired. This business combination, therefore, represents a bargain purchase. All of the acquiree's assets and liabilities must be valued at fair value, which in this case requires only Special Foods' land to be revalued. This revaluation is accomplished in the consolidation worksheet. Assuming Peerless wants to prepare a consolidated balance sheet on the acquisition date, the book value portion of the acquisition price is \$300,000:

Book Value Calculations:

Book value at acquisition	Total Investment	=	Common Stock	+	Retained Earnings
	300,000		200,000		100,000

Thus, the basic elimination entry is the same as in previous examples:

Basic Elimination Entry:

Common stock	200,000	← Common stock balance
Retained earnings	100,000	← Beginning balance in RE
Investment in Special Foods	300,000	← Net BV in investment account

In this example, the total differential relates to the fair value of Special Foods' land, which is \$40,000 more than its book value at acquisition. The reclassification of this total differential can be summarized as follows:

Excess Value (Differential) Calculations:

Total Differential	=	Land
40,000		40,000

This analysis leads to the following reclassification entry to assign the \$40,000 net differential to the Land.

Excess Value (Differential) Reclassification Entry:

Land	40,000	← Excess value assigned to land
Investment in Special Foods	40,000	← Reclassify excess value portion of the investment account

In summary, these two elimination entries effectively eliminate the balance in Peerless' investment account and assign the total differential to the Land account. As in previous examples, it is helpful to visualize how the two elimination entries "zero out" the investment account:

	Investment in Special Foods	
Acquisition Price	340,000	
	300,000	Basic Elimination Entry
	40,000	Excess Value Reclassification
	0	

When the consolidation worksheet is prepared at the end of the year, the notion of recognizing a gain for the \$30,000 excess of the \$340,000 fair value of Special Foods' net assets over the \$310,000 fair value of the consideration given by Peerless in the exchange is correct. However, assuming a consolidation worksheet is also prepared on the acquisition date (January 1, 20X1), the gain will already be recorded in the parent's retained earnings account because an income statement is not prepared on the acquisition date, only a balance sheet (because it is the first day of the year).

If the consideration given in the exchange had been less than the book value of Special Foods, the same procedures would be followed except that the differential would have a credit balance.

CONSOLIDATED FINANCIAL STATEMENTS—100 PERCENT OWNERSHIP ACQUIRED AT MORE THAN BOOK VALUE

LO 4-5

Prepare equity-method journal entries, elimination entries, and the consolidation worksheet for a wholly owned subsidiary when there is a complex positive differential.



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When an investor company accounts for an investment using the equity method, as illustrated in Chapter 2, it records the amount of differential viewed as expiring during the period as a reduction of the income recognized from the investee. In consolidation, the differential is assigned to the appropriate asset and liability balances, and consolidated income is adjusted for the amounts expiring during the period by assigning them to the related expense items (e.g., depreciation expense).

Initial Year of Ownership

As an illustration of the acquisition of 100 percent ownership acquired at an amount higher than book value, assume that Peerless Products acquires all of Special Foods' common stock on January 1, 20X1, for \$387,500, an amount \$87,500 in excess of the book value. The acquisition price includes cash of \$300,000 and a 60-day note for \$87,500 (paid at maturity during 20X1). At the date of combination, Special Foods holds the assets and liabilities shown in Figure 4-2. The resulting ownership situation is as follows:

P ↓ S 1/1/X1 100%	Fair value of consideration	\$387,500
	Book value of Special Foods' net assets	
	Common stock—Special Foods	200,000
	Retained earnings—Special Foods	100,000
		300,000
	Difference between fair value and book value	\$ 87,500

On the acquisition date, all of Special Foods' assets and liabilities have fair values equal to their book values, except as follows:

	Book Value	Fair Value	Fair Value Increment
Inventory	\$ 60,000	\$ 65,000	\$ 5,000
Land	40,000	50,000	10,000
Buildings & Equipment	300,000	360,000	60,000
	\$400,000	\$475,000	\$75,000

Of the \$87,500 total differential, \$75,000 relates to identifiable assets of Special Foods. The remaining \$12,500 is attributable to goodwill. The apportionment of the differential appears as follows: The entire amount of inventory to which the differential relates is sold during 20X1; none is left in ending inventory. The buildings and equipment have a remaining economic life of 10 years from the date of combination, and Special Foods uses straight-line depreciation. At the end of 20X1, in evaluating the Investment in Special Foods account for impairment, Peerless' management determines that the goodwill acquired in the combination with Special Foods has been impaired. Management determines that a \$3,000 goodwill impairment loss should be recognized in the consolidated income statement.

For the first year immediately after the date of combination, 20X1, Peerless Products earns income from its own separate operations of \$140,000 and pays dividends of \$60,000. Special Foods reports net income of \$50,000 and pays dividends of \$30,000.

Parent Company Entries

During 20X1, Peerless makes the normal equity-method entries on its books to record its purchase of Special Foods stock and its income and dividends from Special Foods:

(10)	Investment in Special Foods	387,500	
	Cash		300,000
	Notes Payable		87,500
	Record the initial investment in Special Foods.		
(11)	Investment in Special Foods	50,000	
	Income from Special Foods		50,000
	Record Peerless' 100% share of Special Foods' 20X1 income.		
(12)	Cash	30,000	
	Investment in Special Foods		30,000
	Record Peerless' 100% share of Special Foods' 20X1 dividend.		

In this case, Peerless paid an amount for its investment that was \$87,500 in excess of the book value of the shares acquired. As discussed previously, this difference is a differential that is implicit in the amount recorded in the investment account on Peerless' books. Because Peerless acquired 100 percent of Special Foods' stock, Peerless' differential included in its investment account is equal to the total differential arising from the business combination. However, although the differential arising from the business combination must be allocated to specific assets and liabilities in consolidation, the differential on Peerless' books does not appear separate from the Investment in Special Foods account. A portion of the differential (\$5,000) in the investment account on Peerless' books relates to a portion of Special Foods' inventory that is sold during 20X1. Because Special Foods no longer holds the asset to which that portion of the differential relates at year-end, that portion of the differential is written off by reducing the investment account and Peerless' income from Special Foods. An additional \$60,000 of the differential is attributable to the excess of the acquisition-date fair value over book value of Special Foods' buildings and equipment. As the service potential of the underlying assets expires, Peerless must amortize the additional cost it incurred because of the higher fair value of those assets. This is accomplished through annual amortization of \$6,000 ($\$60,000 \div 10$) over the remaining 10-year life beginning in 20X1. Finally, the goodwill is deemed to be impaired by \$3,000 and is also adjusted on Peerless' books. Thus, the differential must be written off on Peerless' books to recognize the cost expiration related to the service expiration of Special Foods' assets to which it relates. Under the equity method, the differential is written off periodically from the investment account to Income from Special Foods to reflect these changes in the differential (\$5,000 inventory + \$6,000 depreciation + \$3,000 goodwill impairment = \$14,000):

(13)	Income from Special Foods	14,000	
	Investment in Special Foods		14,000
	Record amortization of excess acquisition price.		

Consolidation Worksheet—Year of Combination

The following diagrams illustrate the breakdown of the book value and excess value components of the investment account at the beginning and end of the year.

1/1/X1		12/31/X1
Goodwill = 12,500	} \$387,500 initial investment in Special Foods	Goodwill = 9,500
Identifiable excess = 75,000		Identifiable excess = 64,000
Book value = CS + RE = 300,000		Book value = CS + RE = 320,000
		} \$393,500 ending investment in Special Foods

Because a year has passed since the acquisition date, the book value of Special Foods' net assets has changed because it has earned income and declared dividends. The book value component can be summarized as follows:

Book Value Calculations:

	Total Investment	=	Common Stock	+	Retained Earnings
Beginning book value	300,000		200,000		100,000
+ Net Income	50,000				50,000
– Dividends	(30,000)				(30,000)
Ending book value	320,000		200,000		120,000

This chart leads to the basic elimination entry. Note that we use a lighter font to distinguish the numbers that appear in the elimination entry to help the reader see how it should be constructed.

Basic Elimination Entry:

Common stock	200,000	← Common stock balance
Retained earnings	100,000	← Beginning balance in RE
Income from Special Foods	50,000	← Special Foods' reported income
Dividends declared	30,000	← 100% of Special Foods' dividends
Investment in Special Foods	320,000	← Net BV in investment account

We then analyze the differential and its changes during the period:

Excess Value (Differential) Calculations:

	Total	=	Inventory	+	Land	+	Building	+	Acc. Depr.	+	Goodwill
Beginning balance	87,500		5,000		10,000		60,000		0		12,500
– Changes	(14,000)		(5,000)						(6,000)		(3,000)
Ending balance	73,500		0		10,000		60,000		(6,000)		9,500

The entire differential amount assigned to the inventory already passed through cost of goods sold during the year. The only other amortization item—the excess value assigned to the building—is amortized over a 10-year period ($\$60,000 \div 10 = \$6,000$ per year). Finally, the goodwill is deemed to be impaired and worth only \$9,500. Because the amortization of the differential has already been written off on Peerless' books from the investment account against the Income from Special Foods account, the amortized excess

value reclassification entry simply reclassifies these changes in the differential during the period from the Income from the Special Foods account to the various income statement accounts to which they apply:

Amortized Excess Value Reclassification Entry:

Cost of goods sold	5,000	← Extra cost of goods sold
Depreciation expense	6,000	← Depreciation of excess building value
Goodwill impairment loss	3,000	← Goodwill impairment
Income from Special Foods	14,000	← See calculation above

Finally, the remaining unamortized differential of \$73,500 is reclassified to the correct accounts based on the ending balances (the bottom row) in the chart above:

Excess Value (Differential) Reclassification Entry:

Land	10,000	← Excess value at acquisition
Building	60,000	← Excess value at acquisition
Goodwill	9,500	← Calculated value postimpairment
Accumulated depreciation	6,000	← = 60,000 ÷ 10 years
Investment in Special Foods	73,500	← Remaining balance in differential

Recall that Special Foods reports its balance sheet based on the book values of the various accounts. This elimination entry essentially reclassifies the differential from the Investment in Special Foods account to the individual accounts that need to be revalued to their amortized fair values as of the balance sheet date.

In sum, these worksheet entries (1) eliminate the balances in the Investment in Special Foods and Income from Special Foods accounts, (2) reclassify the amortization of excess

	Inv. in Special Foods			Inc. from Special Foods	
Acquisition Price	387,500				
Net Income	50,000			50,000	80% Net Income
		30,000	Dividends		
		14,000	Excess Value Amortization	14,000	
Ending Balance	393,500			36,000	Ending Balance
		320,000	Basic	50,000	
		73,500	Excess Reclass.	14,000	Amort. Reclass.
	0			0	

value to the proper income statement accounts, and (3) reclassify the remaining differential to the appropriate balance sheet accounts as of the end of the period.

As usual, we eliminate Special Foods' acquisition date accumulated depreciation against the Buildings and Equipment account balance so that, combined with the excess value reclassification entry and the amortized excess value reclassification entry, it will appear as if these fixed assets were recorded at their acquisition date fair values.

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	300,000	← Accumulated depreciation at the time of the acquisition netted against cost
Building & equipment	300,000	

The following T-accounts illustrate how the excess value reclassification entry combined with the accumulated depreciation elimination entry make the consolidated balances for the Buildings and Equipment and Accumulated Depreciation accounts appear as if these assets had been purchased at the beginning of the year for their acquisition date fair values (\$360,000) and that these “new” assets had then been depreciated \$26,000 during the first year of their use by the newly purchased company.

	Buildings & Equip.			Accumulated Depr.		
End. Bal.	600,000			320,000	End. Bal.	
Excess Reclass.	60,000			6,000	Excess Reclass.	
		300,000	Acc. Depr. Entry	300,000		
	360,000			26,000		

After the subsidiary income accruals are entered on Peerless’ books, the adjusted trial balance data of the consolidating companies are entered in the three-part consolidation worksheet as shown in Figure 4–4. We note that because all inventory on hand on the date of combination has been sold during the year, the \$5,000 of differential applicable

FIGURE 4–4 December 31, 20X1, Equity-Method Worksheet for Consolidated Financial Statements, Initial Year of Ownership; 100 Percent Acquisition at More than Book Value

	Peerless Products	Special Foods	Elimination Entries		Consolidated
			DR	CR	
Income Statement					
Sales	400,000	200,000			600,000
Less: COGS	(170,000)	(115,000)	5,000		(290,000)
Less: Depreciation Expense	(50,000)	(20,000)	6,000		(76,000)
Less: Other Expenses	(40,000)	(15,000)			(55,000)
Less: Impairment Loss			3,000		(3,000)
Income from Special Foods	36,000		50,000	14,000	0
Net Income	176,000	50,000	64,000	14,000	176,000
Statement of Retained Earnings					
Beginning Balance	300,000	100,000	100,000		300,000
Net Income	176,000	50,000	64,000	14,000	176,000
Less: Dividends Declared	(60,000)	(30,000)		30,000	(60,000)
Ending Balance	416,000	120,000	164,000	44,000	416,000
Balance Sheet					
Cash	122,500	75,000			197,500
Accounts Receivable	75,000	50,000			125,000
Inventory	100,000	75,000			175,000
Investment in Special Foods	393,500			320,000	0
				73,500	
Land	175,000	40,000	10,000		225,000
Buildings & Equipment	800,000	600,000	60,000	300,000	1,160,000
Less: Accumulated Depreciation	(450,000)	(320,000)	300,000	6,000	(476,000)
Goodwill			9,500		9,500
Total Assets	1,216,000	520,000	379,500	699,500	1,416,000
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	416,000	120,000	164,000	44,000	416,000
Total Liabilities & Equity	1,216,000	520,000	364,000	44,000	1,416,000

to inventory is allocated directly to cost of goods sold. The cost of goods sold recorded on Special Foods' books is correct for that company's separate financial statements. However, the cost of the inventory to the consolidated entity is viewed as being \$5,000 higher, and this additional cost must be included in consolidated cost of goods sold. No worksheet entry is needed in future periods with respect to the inventory because it has been expensed and no longer is on the subsidiary's books. The portion of the differential related to the inventory no longer exists on Peerless' books after 20X1 because the second elimination entry removed it from the investment account.

The differential assigned to depreciable assets must be charged to depreciation expense over the remaining lives of those assets. From a consolidated viewpoint, the acquisition-date fair value increment associated with the depreciable assets acquired becomes part of the assets' depreciation base. Depreciation already is recorded on the subsidiary's books based on the original cost of the assets to the subsidiary, and these amounts are carried to the consolidation worksheet as depreciation expense.

The difference between the \$387,500 fair value of the consideration exchanged and the \$375,000 fair value of Special Foods' net identifiable assets is assumed to be related to the excess earning power of Special Foods. This difference is entered in the worksheet in Figure 4-4. A distinction must be made between journal entries recorded on the parent's books under equity-method reporting and the elimination entries needed in the worksheet to prepare the consolidated financial statements. Again, we distinguish between actual equity-method journal entries on the parent's books (not shaded) and worksheet elimination entries (shaded).

Consolidated Net Income and Retained Earnings

As can be seen from the worksheet in Figure 4-4, consolidated net income for 20X1 is \$176,000 and consolidated retained earnings on December 31, 20X1, is \$416,000. These amounts can be computed as shown in Figure 4-5.

Second Year of Ownership

The consolidation procedures employed at the end of the second year, and in periods thereafter, are basically the same as those used at the end of the first year. Consolidation two years after acquisition is illustrated by continuing the example used for 20X1. During 20X2, Peerless Products earns income of \$160,000 from its own separate operations and pays dividends of \$60,000; Special Foods reports net income of \$75,000 and pays dividends of \$40,000. No further impairment of the goodwill from the business combination occurs during 20X2.

FIGURE 4-5
Consolidated Net
Income and Retained
Earnings, 20X1; 100
Percent Acquisition at
More than Book Value

Consolidated net income, 20X1:	
Peerless' separate operating income	\$140,000
Special Foods' net income	50,000
Write-off of differential related to inventory sold during 20X1	(5,000)
Amortization of differential related to buildings & equipment in 20X1	(6,000)
Goodwill impairment loss	(3,000)
Consolidated net income, 20X1	<u>\$176,000</u>
Consolidated retained earnings, December 31, 20X1:	
Peerless' retained earnings on date of combination, January 1, 20X1	\$300,000
Peerless' separate operating income, 20X1	140,000
Special Foods' 20X1 net income	50,000
Write-off of differential related to inventory sold during 20X1	(5,000)
Amortization of differential related to buildings & equipment in 20X1	(6,000)
Goodwill impairment loss	(3,000)
Dividends declared by Peerless, 20X1	(60,000)
Consolidated retained earnings, December 31, 20X1	<u>\$416,000</u>

Parent Company Entries

Peerless Products records the following entries on its separate books during 20X2:

(14)	Investment in Special Foods	75,000	
	Income from Special Foods		75,000
Record Peerless' 100% share of Special Foods' 20X2 income.			
(15)	Cash	40,000	
	Investment in Special Foods		40,000
Record Peerless' 100% share of Special Foods' 20X2 dividend.			
(16)	Income from Special Foods	6,000	
	Investment in Special Foods		6,000
Record amortization of excess acquisition price.			

1/1/X2		12/31/X2
Goodwill = 9,500	\$393,500 12/31/X1 investment in Special Foods Balance	Goodwill = 9,500
Identifiable excess = 64,000		Identifiable excess = 58,000
Book value = CS + RE = 320,000		Book value = CS + RE = 355,000
		\$422,500 12/31/X2 investment in Special Foods

The book value component can be summarized as follows:

Book Value Calculations:

	Total Investment	=	Common Stock	+	Retained Earnings
Beginning book value	320,000		200,000		120,000
+ Net Income	75,000				75,000
– Dividends	(40,000)				(40,000)
Ending book value	355,000		200,000		155,000

The numbers in this chart in the lighter font determine the basic elimination entry:

Basic Elimination Entry:

Common stock	200,000	← Common stock balance
Retained earnings	120,000	← Beginning balance in RE
Income from Special Foods	75,000	← Special Foods' reported income
Dividends declared	40,000	← 100% of Special Foods' dividends
Investment in Special Foods	355,000	← Net BV in investment account

The entire differential amount assigned to the inventory already passed through cost of goods sold during the prior year period. The only other amortization item is the excess value assigned to the building, which continues to be written off over a 10-year period ($\$60,000 \div 10 = \$6,000$) as illustrated in the following chart. Again, the goodwill is deemed not to be further impaired this year.

Excess Value (Differential) Calculations:

	Total	=	Land	+	Building	+	Acc. Depr.	+	Goodwill
Beginning balance	73,500		10,000		60,000		(6,000)		9,500
Changes	(6,000)						(6,000)		
Ending balance	67,500		10,000		60,000		(12,000)		9,500

Because the amortization of the differential was already written off from the investment account against the Income from Special Foods account, the change to the differential (i.e., the middle row of the chart) is simply reclassified from the Income from Special Foods account to the income statement account to which it applies during the consolidation process. Then, the remaining amount of the differential at year end (i.e., the bottom row of the chart) is reclassified to the various balance sheet accounts to which they apply:

Amortized Excess Value Reclassification Entry:

Depreciation expense	6,000	← Extra depreciation expense
Income from Special Foods	6,000	← See calculation above.

Excess Value (Differential) Reclassification Entry:

Land	10,000	← Excess value at acquisition
Building	60,000	← Excess value at acquisition
Goodwill	9,500	← Calculated value from acquisition.
Accumulated depreciation	12,000	← = (60,000 ÷ 10 years) × 2 years
Investment in Special Foods	67,500	← Remaining balance in differential

These elimination entries (1) eliminate the balances in the Investment in Special Foods and Income from Special Foods accounts, (2) reclassify the amortization of excess value to the proper income statement accounts, and (3) reclassify the remaining differential to the appropriate balance sheet accounts as of the end of the accounting period. The following T-accounts illustrate how the three elimination entries “zero out” the equity-method investment and income accounts:

	Inv. in Special Foods			Inc. from Special Foods		
Beginning Balance	393,500					
Net Income	75,000				75,000	Net Income
		40,000	Dividends			
		6,000	Excess Price	6,000		
			Amortization			
Ending Balance	422,500				69,000	Ending Balance
		355,000	Basic	75,000		
		67,500	Excess Reclass.		6,000	Amort. Reclass.
	0				0	

Again, we repeat the same accumulated depreciation elimination entry this year (and every year as long as Special Foods owns the assets) that we used in the initial year.

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	300,000	← Accumulated depreciation at the time of the acquisition netted against cost
Building and equipment	300,000	

FIGURE 4–6 December 31, 20X2, Equity-Method Worksheet for Consolidated Financial Statements, Second Year of Ownership; 100 Percent Acquisition at More than Book Value

	Peerless Products	Special Foods	Elimination Entries		
			DR	CR	Consolidated
Income Statement					
Sales	450,000	300,000			750,000
Less: COGS	(180,000)	(160,000)			(340,000)
Less: Depreciation Expense	(50,000)	(20,000)	6,000		(76,000)
Less: Other Expenses	(60,000)	(45,000)			(105,000)
Less: Impairment Loss					0
Income from Special Foods	69,000		75,000	6,000	0
Net Income	229,000	75,000	81,000	6,000	229,000
Statement of Retained Earnings					
Beginning Balance	416,000	120,000	120,000		416,000
Net Income	229,000	75,000	81,000	6,000	229,000
Less: Dividends Declared	(60,000)	(40,000)		40,000	(60,000)
Ending Balance	585,000	155,000	201,000	46,000	585,000
Balance Sheet					
Cash	157,500	85,000			242,500
Accounts Receivable	150,000	80,000			230,000
Inventory	180,000	90,000			270,000
Investment in Special Foods	422,500			355,000	0
				67,500	
Land	175,000	40,000	10,000		225,000
Buildings & Equipment	800,000	600,000	60,000	300,000	1,160,000
Less: Accumulated Depreciation	(500,000)	(340,000)	300,000	12,000	(552,000)
Goodwill			9,500		9,500
Total Assets	1,385,000	555,000	379,500	734,500	1,585,000
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	585,000	155,000	201,000	46,000	585,000
Total Liabilities & Equity	1,385,000	555,000	401,000	46,000	1,585,000

Consolidation Worksheet—Second Year Following Combination

The worksheet for the second year, 20X2, completes the two-year cycle as illustrated in Figure 4–6. Moreover, as can be seen from the worksheet, consolidated net income for 20X2 is \$229,000 and consolidated retained earnings on December 31, 20X2, is \$585,000 as illustrated in Figure 4–7.

FIGURE 4–7
**Consolidated Net
Income and Retained
Earnings, 20X2;
100 Percent Acquisition
at More than Book
Value**

Consolidated net income, 20X2:	
Peerless' separate operating income	\$160,000
Special Foods' net income	75,000
Amortization of differential related to buildings & equipment in 20X2	(6,000)
Consolidated net income, 20X2	<u>\$229,000</u>
Consolidated retained earnings, December 31, 20X2:	
Consolidated retained earnings, December 31, 20X1	\$416,000
Peerless' separate operating income, 20X2	160,000
Special Foods' 20X2 net income	75,000
Amortization of differential related to buildings & equipment in 20X2	(6,000)
Dividends declared by Peerless, 20X2	(60,000)
Consolidated retained earnings, December 31, 20X2	<u>\$585,000</u>

INTERCOMPANY RECEIVABLES AND PAYABLES

LO 4-6

Understand and explain the elimination of basic intercompany transactions.

All forms of intercompany receivables and payables need to be eliminated when consolidated financial statements are prepared. From a single-company viewpoint, a company cannot owe itself 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 worksheet:

Accounts Payable	1,000	
Accounts Receivable		1,000
Eliminate intercompany receivable/payable.		

If no elimination entry is made, both the consolidated assets and liabilities are overstated by an equal amount.

If the intercompany receivable/payable bears interest, all accounts related to the intercompany claim must be eliminated in the preparation of consolidated statements, including the receivable/payable, interest income, interest expense, and any accrued interest on the intercompany claim. Other forms of intercorporate claims, such as bonds, are discussed in subsequent chapters. In all cases, failure to eliminate these claims can distort consolidated balances. As a result, the magnitude of debt of the combined entity may appear to be greater than it is, working capital ratios may be incorrect, and other types of comparisons may be distorted.

PUSH-DOWN ACCOUNTING

LO 4-7

Understand and explain the basics of push-down accounting.

The term *push-down accounting* refers to the practice of revaluing an acquired subsidiary's assets and liabilities to their fair values directly on that subsidiary's books at the date of acquisition. If this practice is followed, the revaluations are recorded once on the subsidiary's books at the date of acquisition and, therefore, are not made in the consolidation worksheets each time consolidated statements are prepared.

Those who favor push-down accounting argue that the change in the subsidiary's ownership in an acquisition is reason for adopting a new basis of accounting for the subsidiary's assets and liabilities, and this new basis of accounting should be reflected directly on the subsidiary's books. This argument is most persuasive when the subsidiary is wholly owned, is consolidated, or has its separate financial statements included with the parent's statements.

On the other hand, when a subsidiary has a significant noncontrolling interest or the subsidiary has bonds or preferred stock held by the public, push-down accounting may be inappropriate. Its use in the financial statements issued to the noncontrolling shareholders or to those holding bonds or preferred stock results in a new basis of accounting even though, from the perspective of those statement users, the entity has not changed. From their viewpoint, push-down accounting results in the revaluation of the assets and liabilities of a continuing enterprise, a practice that normally is not acceptable.

ASC 805-50-S99-2 requires push-down accounting whenever a business combination results in the acquired subsidiary becoming substantially wholly owned (but only if it issues separate financial statements). It encourages but does not require the use of push-down accounting in situations in which the subsidiary is less than wholly owned or the subsidiary has outstanding debt or preferred stock held by the public.

The revaluation of assets and liabilities on a subsidiary's books involves making an entry to debit or credit each asset and liability account to be revalued, with the balancing entry to a revaluation capital account. The revaluation capital account is part of the subsidiary's stockholders' equity. Once the revaluations are made on the books of the subsidiary, the new book values of the subsidiary's assets, including goodwill, are equal to the acquisition cost of the subsidiary. Thus, no differential arises in the consolidation process. The investment elimination entry in a consolidation worksheet