STUDY UNIT FIFTEEN
BUSINESS COMBINATIONS AND CONSOLIDATION

(20 pages of outline)

This study unit addresses how to determine whether a **business combination** has occurred and how it is structured. It also addresses how the **acquisition method** is applied to (1) define the **acquirer** and the **acquisition date**; (2) recognize and measure **identifiable assets acquired, liabilities assumed, and any noncontrolling interest**; (3) calculate **goodwill** or a gain from a bargain purchase; and (4) identify **exceptions** to the recognition and measurement principles and apply the appropriate accounting methods to them.

Furthermore, this study unit describes how to (1) determine when **combined or consolidated** financial statements are required, (2) prepare the **initial consolidation** of a subsidiary, (3) calculate **comprehensive income** of a subsidiary, (4) make **elimination entries**, (5) report **noncontrolling interests**, and (6) account for **changes in ownership** of a subsidiary.

15.1 BUSINESS COMBINATIONS

Definitions

1. A **business combination** (hereafter called a combination) is "a transaction or other event in which an acquirer obtains control of one or more businesses" [SFAS 141 (revised 2007), *Business Combinations*].
2. An **acquirer** gains control of the **acquiree** in a combination. But if a **variable interest entity** is acquired, the **primary beneficiary** is the acquirer.
3. **Control** is a **controlling financial interest**. This usually means one entity's direct or indirect ownership of more than 50% of the outstanding voting interests of another entity.
   a. However, a controlling financial interest is **not** deemed to exist when control does **not rest with the majority owner**, such as when the entity is in bankruptcy, in legal reorganization, or under severe governmentally imposed uncertainties (ARB 51, *Consolidated Financial Statements*, as amended by SFAS 94, *Consolidation of All Majority-Owned Subsidiaries*, and SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements*).
   b. Control may be **obtained** in many ways, such as by (1) transferring assets (including a business); (2) issuing equity interests; (3) incurring liabilities; (4) giving multiple types of consideration; and (5) without transferring consideration, e.g., combining two entities solely by contract.
4. A **business** is "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants" [SFAS 141(R)].

a. Thus, the essential elements of a business are **inputs** and **processes**.

1) But a business need **not** have **outputs** if it can be managed to provide them.

BUSINESS

INPUTS →	**PROCESSES** →	**POTENTIAL outputs**

b. A set of assets and activities that includes **goodwill** is assumed to be a business, absent contrary evidence, but a business need not have goodwill.

5. "**Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (SFAS 157, *Fair Value Measurements*). Thus, fair value is an exit price.

Structure of a Combination

6. A combination may be **structured** in many ways. For example, a business may be **legally merged** with the acquirer or become its **subsidiary**, or the combining entities may be replaced with a new legal entity.

a. In a **statutory merger**, the assets and liabilities of one combining entity are transferred to the books of the surviving entity. The first entity ceases to have a separate legal existence.

1) A statutory merger may result from (a) a direct acquisition of the net assets of the acquiree or (b) an acquisition of all of the acquiree's shares followed by transfer of the net assets.

b. In a **consolidation**, the combining entities are dissolved, and a new legal entity is created with their assets and liabilities.

1) A combination effected as a consolidation should not be confused with the **accounting process** to prepare statements for combined entities that are legally separate.

c. The acquirer (parent) and the acquiree (subsidiary) may remain **legally separate**, although the parent has control.

Combination	Surviving Entity(ies)
Statutory merger	Acquirer
Consolidation	New entity
Voting interest > 50%	Acquirer and acquiree

Acquisition Method

7. A combination is accounted for by

a. Determining the acquirer and the acquisition date

b. Recognizing and measuring

1) Identifiable assets acquired
2) Liabilities assumed
3) Any noncontrolling interest
4) Goodwill or a gain from a bargain purchase

Acquirer

8. One combining entity must be identified as the acquirer.
   a. When the combination is accomplished primarily by the **transfer of assets or incurrence of liabilities**, the entity that does so ordinarily is the acquirer.
   b. If a combination primarily results from an **exchange of equity interests**, a **new entity** created to issue such interests (but not to transfer assets or assume liabilities) must not be identified as the acquirer. One of the pre-existing combining entities must be designated. In other circumstances, neither the issuer nor the larger entity is necessarily the acquirer.
      1) Thus, additional matters should be considered, such as
         a) Relative voting rights,
         b) The existence of a large noncontrolling interest when other voting interests are fragmented,
         c) The power to control the board, and
         d) Domination of senior management of the combined entity.
      2) Based on these or other criteria, the issuer **(legal acquirer)** may be the acquiree for accounting purposes **(reverse acquisition)**, such as when a private entity wants to be a public entity but not register its shares. For this purpose, it could exchange its shares with a public entity that issues new shares. The public entity (the **accounting acquiree**) is the legal acquirer, and the private entity (the **accounting acquirer**) is the **legal acquiree**.
      3) If a combination involves acquisition of a **variable interest entity**, the **primary beneficiary** is the acquirer.

EXAMPLE

Public Co. has 1,000 common shares outstanding, and Private Co. has 450. When Public then issues 9,000 new shares for all of Private's shares, Private's shareholders own 90% [9,000 ÷ (9,000 + 1,000)] of the combined entity. In this transaction, the accounting acquirer (Private) issued no shares. Accordingly, measuring the consideration transferred requires determining how many shares the acquirer would have had to issue (the **consideration effectively transferred**). To achieve the same ownership percentages, Private would have had to issue 50 new shares to Public's shareholders [(450 shares ÷ 90%) – 450 shares]. Thus, the fair value of the consideration effectively transferred by Private is the fair value of 50 of its shares unless the fair value of 1,000 of Public's shares at the acquisition date is more reliably measurable.

Acquisition Date

9. At this date, the acquirer achieves control of the acquiree. Control is usually obtained on the closing date.

Recognition Principle

10. As of the acquisition date, the acquirer **recognizes identifiable assets** acquired (excluding goodwill), **liabilities assumed**, and any **noncontrolling interest** in the acquiree at **fair value**.

Recognition Conditions

11. **Assets and liabilities** must meet the **definitions** of elements of financial statements.
    a. For example, **restructuring costs** the acquirer expects but is not required to pay are not covered by the definition of a liability. They are not "present obligations" and are **not** accounted for as part of the combination.

12. The assets and liabilities recognized must be **part of the exchange**, not a distinct transaction.
    a. The acquirer must recognize **only the consideration transferred** for the acquiree. The acquirer also must identify amounts **not** part of the exchange for the acquiree.
    b. A precombination transaction that **primarily benefits the acquirer** is most likely to be accounted for **separately** from the exchange.

EXAMPLE

The acquiree undertakes to make severance payments to certain executives when an expected combination is completed. If the **main purpose** is to benefit the acquirer, the payments are not part of the exchange. If the main purpose is to **benefit the acquiree or its former owners**, the payments are included in the accounting for the combination.

    c. **Settlement of a preexisting relationship** is accounted for separately from the combination.
        1) If the acquirer-acquiree relationship was **noncontractual** (e.g., a lawsuit), effective settlement by the combination results in **gain or loss** based on **fair value**.
        2) If the relationship settled is **contractual**, the gain or loss is the **lesser** of
            a) The amount by which the contract is favorable or unfavorable to the acquirer compared with market prices for similar items.
            b) The settlement amount available to the party at a disadvantage. (But if the second amount is lower, the difference is accounted for as part of the combination.)

EXAMPLE

Acquiree (AE) is a supplier of Acquirer (AR) under a long-term contract with fixed rates. AR can end the contract by paying $10 million in liquidated damages. With 4 years remaining on the contract, AR acquires AE. Included in AE's total fair value is $15 million related to the contract. The pricing for current transactions for similar items is $7 million. Thus, $8 million is the amount unfavorable to AR. Assuming neither party has any other asset or liability related to the contract, AR recognizes a loss of $8 million, an amount less than the $10 million settlement provision. This loss is not part of the accounting for the combination. However, the $7 million amount is included in goodwill.

    d. Other types of **transactions to be accounted for separately** from the combination are (1) compensation to the acquiree's employees or former owners for future services and (2) reimbursement of the acquiree or former owners for paying acquisition-related costs.
    e. **Acquisition-related costs**, such as finder's fees, professional and consulting fees, and general administrative costs (e.g., for an acquisitions department), are **expensed as incurred**. However, **issuance costs** for securities are accounted for under other GAAP.
        1) **Debt issue costs** are covered in Subunit 12.3.
        2) Direct issue costs of **equity** are covered in Subunit 14.2.

<u>Items Not Recognized by the Acquiree</u>

13. The acquirer may recognize some **assets and liabilities** not recognized by the acquiree. Examples are certain operating leases and internally developed intangible assets, the costs of which were expensed by the acquiree.
    a. Ordinarily, no asset (liability) is recognized if the acquiree is a **lessee**. However, an acquiree (as **lessor or lessee**) may have a favorable or unfavorable **operating lease** compared with **market terms** for similar items at the acquisition date.

1) The acquirer recognizes an intangible asset or liability to the extent that the lease is favorable or unfavorable, respectively.

b. The acquirer separately recognizes identifiable **intangible assets**.

1) The outlines in Study Unit 9 address the accounting for intangible assets.
2) Assets (tangible or intangible) acquired in a business combination that are **used in R&D activities** are initially recognized and measured at fair value even if they have no alternative use.
3) The value of an acquired intangible asset that is **not identifiable** at the acquisition date is included in **goodwill**.

a) An **assembled workforce** is an example. It does not reflect the knowledge and experience of the skilled workforce.

4) The value of an item **not an asset** also is included in goodwill. An example is a potential new contract that the acquiree is negotiating at the acquisition date.

Classification

14. Based on relevant conditions **at the acquisition date**, the acquirer must classify or designate certain items recognized. For example,

a. Certain **securities** must be classified as trading, available for sale, or held-to-maturity. Choosing the **fair value option** (recognition of unrealized gains and losses in earnings) is equivalent to classifying securities as trading. See Study Unit 5.

b. A **derivative** may be designated as a hedge.

1) A derivative also may need to be separated from its host contract. See Study Unit 16.

15. The acquirer classifies the following based on the contract terms and other factors at the **inception of the contract** (or date of modification):

a. A **lease** as an operating lease or a capital lease.

1) The amounts assigned to lease assets and liabilities at the date of the combination are determined in accordance with SFAS 141(R).

b. Certain contracts of insurors as insurance or deposit contracts.

Measurement

16. Measurement is customarily at **acquisition-date fair values**.

17. **No valuation allowance** is recognized for **specific assets** because assets measured at acquisition-date fair value reflect the uncertainty of cash flows.

a. Thus, no allowance for **uncollectible receivables** is recognized.

18. The acquisition-date fair value of an asset is not affected by whether it is subject to an **operating lease** under which the acquiree is the **lessor**.

a. But a separate asset or liability is recognized if the lease is favorable or unfavorable, respectively.

19. An acquirer may intend not to make the **highest and best use** of an asset or not to use it.

a. However, the asset still must be measured at fair value based on its highest and best use.

20. Measurement of a **noncontrolling interest** must be at acquisition-date fair value, for example, at the **active market price** of shares not held by the acquirer. Absent such a price, other valuation methods are necessary.

a. The **per-share fair values** of the acquirer's interest and the noncontrolling interest may vary because of a **control premium** or a **noncontrol discount**, respectively.

21. A **contingency** is an existing situation involving uncertainty about gain or loss that will be resolved when a future event(s) does or does not occur.
    a. Assets and liabilities arising from **contractual contingencies** are recognized and measured at acquisition-date fair values.
    b. If it is **more likely than not** at the acquisition date that a **noncontractual contingency** will result in an asset or liability, the same accounting applies.
        1) If this criterion is **not** met, no asset or liability is recorded at the acquisition date. Other GAAP are then applied (see Subunit 13.4).

EXAMPLE

Acquiree Co. (AE) has been sued for discrimination by former employees. Subsequent to the filing of the suit, Acquirer Co. (AR) paid cash for all of AE's shares. At the acquisition date, AR will recognize a **liability** if, given all the relevant facts, it is **more likely than not** that the suit will be lost. The measure of any liability will depend on the probabilities of outcomes, including settlement.

    c. **Subsequent accounting** for a contingency subject to other GAAP but for the combination depends on new facts.
        1) Given **no new facts**, the acquisition-date fair value continues to be reported.
        2) However, **new facts** about the outcome result in measuring a **liability** at the **higher** of (a) acquisition-date fair value or (b) the amount recognized under other GAAP.
            a) An **asset** is remeasured at the **lower** of (1) acquisition-date fair value or (2) the best estimate of the settlement amount.
        3) The asset (liability) is derecognized when the **contingency is resolved**.
22. The acquirer applies SFAS 109, *Accounting for Income Taxes*, to account for temporary differences, carryforwards, and income tax uncertainties (a) of the acquiree at the acquisition date or (b) that result from the combination. (See Subunits 10.7-10.10.)
23. The acquirer applies other GAAP to record a liability (asset) related to the **acquiree's employee benefit arrangements** based on circumstances at the acquisition date. For example, the acquirer may not be obligated to make expected plan amendments. (See Study Unit 11.)
24. The acquirer recognizes an **indemnification asset** when the seller contracts to pay for the result of a **contingency or uncertainty** related to an asset or liability. An example is a guarantee that an assumed liability will not exceed a certain amount.
    a. **Recognition and measurement** of the asset and the indemnified item are at the same time and on the same basis, respectively.
    b. However, indemnification may apply to items that are **exceptions** to the usual accounting for combinations. For example, a noncontractual contingency may not be recognized.
        1) In such a case, **consistent assumptions** are applied to the asset and the indemnified item. This approach is subject to (a) the assessment of collectibility if the asset is not measured at fair value and (b) any limit on its amount.
            a) **Subsequent accounting** also applies these principles.
    c. **Derecognition** occurs when the acquirer loses the right to the asset, e.g., by collection or sale.

25. A **reacquired right** is an **identifiable intangible asset** (e.g., technology) previously granted to the acquiree.
   a. The acquirer need not have previously recognized the asset.
   b. **Initial measurement** and **amortization** are based on the remaining term of the related contract (excluding renewal options).
   c. A **settlement gain or loss** arising from the combination is recognized if the terms of the contract that created the right are favorable or unfavorable, respectively. (See Subunit 15.1, item 12.c. for the calculation.)
   d. If the acquirer sells the reacquired right to a third party, the **gain or loss** is based on its carrying amount.
26. The acquirer may **exchange** its **share-based payment awards** (e.g., share options) for those held by the acquiree's employees.
   a. If the replacement award is **obligatory**, all or part of its **fair-value-based (FVB) measure** is included in the **consideration** for the combination. (The measure is FVB, not fair value, because the fair value measure of an equity instrument included in the award is not adjusted after the grant date.)
   b. Acquiree awards may **expire** because of the combination. If their replacement is **not obligatory**, all of the FVB measure is treated as **compensation cost**.
   c. The part of the **replacement award** that is consideration for the combination equals the part of the **acquiree award** attributed to **precombination service**.
      1) Both awards are measured at the acquisition date in accordance with SFAS 123(R).
   d. If a replacement award requires **postcombination service**, part is treated as compensation cost.
      1) The total FVB measure of a nonvested replacement award minus the amount related to precombination service (fair value of the acquirer award) equals the amount related to postcombination service.

EXAMPLE

Acquirer (AR) issues replacement awards in exchange for Acquiree's (AE's) awards.

	AR's Awards	AE's Awards
FVB measure at acquisition-date (AD)	$1 million	$1 million
Original requisite service period (RSP)	1 year (post-combination)	5 years
Acquisition-date service rendered		3 years
Total RSP	3 years [1 + (5 – 3)]	

The part of AR's award related to precombination service is

$$\text{\$1 million AE award} \times \frac{\text{3-year precombination service at AD}}{\text{Greater of: 3-year total RSP or 5-year original AE RSP}}$$

Thus, $600,000 [$1 million × (3 ÷ 5)] is included in the consideration for the combination. The remaining $400,000 will be recognized as postcombination compensation cost.

27. A **long-lived asset (disposal group)** classified as **held for sale** at the acquisition date is measured at **fair value minus cost to sell** (see Subunit 8.6).

Goodwill

28. Goodwill is "an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized."

a. The acquirer may recognize goodwill at the acquisition date. Goodwill is the **excess** of 1) over 2):

1) The sum of

a) The **consideration** transferred for the acquiree (normally at acquisition-date fair value)

b) The fair value of a **noncontrolling interest**

c) The acquisition-date fair value of a **previously held equity interest** in the acquiree

2) The **net** of acquisition-date amounts [measured under SFAS 141(R)] of

a) Identifiable assets acquired

b) Liabilities assumed

b. A combination may involve an exchange **only of equity interests**. If the fair value of the **acquiree's equity interests** is more reliably measurable than the acquirer's, it is used to determine goodwill.

29. When **no consideration is transferred**, the acquirer must use **valuation methods** to measure the acquisition-date fair value of its interest in the acquiree. This amount replaces the **consideration transferred** in the calculation of goodwill or a gain on a bargain purchase.

a. The **acquisition method** still applies when control is obtained without transferring consideration. For example,

1) **Minority veto rights** may terminate.

2) An investor may gain control when the acquiree **repurchases** its own shares.

3) The acquirer and acquiree may enter a **contract** of combination without a transfer of consideration or acquisition of equity interests. A **dual-listed corporation** is such an arrangement.

b. In these circumstances, the acquirer must still recognize the net assets attributable to a **noncontrolling interest** in its postcombination statements. This requirement applies even if the acquirer holds no equity interests in the acquiree.

Bargain Purchase

30. A bargain purchase results when the assumption in 28.a.2) exceeds that in 28.a.1). The excess is **recognized in earnings as an ordinary gain.**

EXAMPLE

Acquirer (AR) obtained 75% of the equity interests of Acquiree (AE) in a forced sale. AR had no prior equity interest in AE. AR determined that the following are appropriate fair value measures to be used in accounting for this combination:

Consideration ($300,000 of cash and $250,000 of other assets) transferred by AR	$ 550,000
AE's identifiable assets acquired	1,000,000
AE's liabilities assumed	200,000
Noncontrolling interest in AE	210,000

The gain is $40,000 [($1,000,000 assets – $200,000 liabilities) – $550,000 consideration – $210,000 NCI].

AR records the following entry in the consolidated statements:

Identifiable assets	$1,000,000	
Cash		$300,000
Other assets		250,000
Liabilities		200,000
Equity-noncontrolling interest (AE)		210,000
Gain-bargain purchase		40,000

Consideration

31. When consideration is **transferred by the acquirer**, the amount, including any **contingent consideration**, is the sum of the acquisition-date **fair values** of the acquirer's
    a. Assets transferred.
    b. Liabilities incurred to former owners of the acquiree.
    c. Equity interests issued. (But a FVB measure is used for any part of an acquirer's share-based payment awards included in consideration transferred.)
32. The **carrying amounts** of consideration transferred often differ from their acquisition-date fair values. Thus, they are remeasured, and the **gains or losses** are included in earnings.
    a. The acquirer retains **control** of transferred items that are **within the combined entity**, such as those transferred to the acquiree.
        1) Accordingly, these items are measured at their carrying amounts just before the acquisition date, and **no gain or loss** is recognized.
33. **Contingent consideration** given in exchange for the acquiree is usually "an obligation to transfer additional assets or equity interests to the former owners if specified future events occur or conditions are met." But an acquirer also may have a "right to the return of consideration if specified conditions are met" [SFAS 141(R)].
    a. An **asset** is recognized for a contingent right of return of transferred consideration.
    b. **Changes in the fair value** of contingent consideration may be **measurement period adjustments** (see the section on provisional amounts). But if changes in the fair value of contingent consideration are based on **events after acquisition**, such as attaining a given share price or earnings level, the following rules apply:
        1) An item classified as **equity** is **not** remeasured. Later settlement is an **equity transaction**.

EXAMPLE

Rent Company issues 25,000 shares of stock ($10 par) with a fair value of $40 per share on January 2, Year 5, for all of Subic's outstanding shares. Rent also agrees to the contingent issuance of 5,000 shares of stock to the previous shareholders of Subic if a certain level of earnings is attained for calendar Year 5. The fair value of this contingent obligation, an item properly classified as equity, is $150,000 on January 2, Year 5. This amount was calculated using a valuation technique. The required level of earnings was attained, and the 5,000 additional shares were issued, in Year 5 when the fair value of Rent's shares was $45. Accordingly, the journal entry to reflect this transaction is

Common stock contingently issuable	$150,000	
Common stock		$ 50,000
Additional paid-in capital		100,000

Contingent consideration is initially recognized at its acquisition-date fair value as part of the consideration transferred for the acquiree. **Changes in fair value of the contingent consideration subsequent to the acquisition date** are not recognized when it is classified as equity. Thus, the initial entry credited common stock contingently issuable (or a similarly named equity account) for $150,000. The issuance of 5,000 shares is accounted for at the same amount in equity by a debit to common stock contingently issuable and credits to common stock (at par) and additional paid-in capital.

2) An item classified as an **asset or liability** is remeasured at fair value at each reporting date until it is resolved. Changes are normally recognized in **earnings**.

EXAMPLE

Rent, a calendar-year company, issues 25,000 shares of stock ($10 par) with a share price of $40 on December 31, Year 4, for all of Subic's outstanding shares. Rent also agrees to the contingent issuance of additional shares so that the total shares issued will have a fair value of $1,500,000 on December 31, Year 6. This contingent consideration is properly classified as a liability. Moreover, the share price is $45 and $50 at the end of Years 5 and 6, respectively. Given that the contingent consideration is classified as a liability, it is remeasured to fair value at each balance sheet date, with changes ordinarily included in earnings. Rent initially recorded a liability of $500,000 [$1,500,000 – (25,000 shares × $40)] as part of the consideration transferred for the acquiree. On December 31, Year 5, it debited the liability and credited a gain for $125,000 [25,000 shares × ($45 – $40)]. On December 31, Year 6, it also debited the liability and credited a gain for $125,000 [25,000 shares × ($50 – $45)]. Accordingly, the liability at the December 31, Year 6, settlement date is $250,000 [$1,500,000 – (25,000 shares × $50 per share)]. Rent therefore must issue 5,000 shares ($250,000 ÷ $50 per share). The entry is

Common stock contingently issuable	$250,000	
Common stock (5,000 shares × $10)		$ 50,000
Additional paid-in capital		200,000

Step Acquisition

34. In a step acquisition, the acquirer has an equity interest in the acquiree just before obtaining control. This interest must be remeasured at **acquisition-date fair value**.
    a. The gain or loss is included in **earnings**.
        1) If changes in fair value have been recognized in **other comprehensive income**, they are reclassified and included in gain or loss at the acquisition date.

Provisional Amounts

35. The information needed to account for a combination may be incomplete at the balance sheet date. Thus, **provisional amounts** must be reported.

Adjustments

36. During the **measurement period**, provisional amounts are **retrospectively adjusted** and **additional assets and liabilities** are recognized if **new information** becomes available about facts **existing at the acquisition date**.
    a. Adjustments are **not** reported in **earnings**. This treatment assumes that the information would have affected measurement or resulted in recognition at the acquisition date.
    b. Adjustments are made as if the initial accounting had been **completed at the acquisition date**.
    c. The acquirer considers **all pertinent factors** to determine whether the new information should result in adjustment. Timeliness is one such factor.
        1) For example, an asset may be sold or a liability settled a few days after the acquisition date for an amount that materially differs from provisional fair value. This information is more likely to be pertinent than significantly later sales or settlements.
37. A change in a provisional amount for an **identifiable asset or liability** also affects **goodwill**. But more than one provisional amount may be affected, and multiple adjustments may have offsetting effects on goodwill.
    a. For example, an increase in a provisional assumed liability might be offset by an increase in a provisional receivable from a guarantor.

38. **Comparative statements** may require adjustment (as necessary), such as revisions of depreciation or amortization.
39. The measurement period ends when the acquirer obtains the information sought or learns that it is not available. The **maximum period is one year** from the acquisition date.
    a. After the measurement period, the accounting for the combination is changed **only for error corrections**.

EXAMPLE

The **acquisition date** for a combination is October 31, Year 1, and Acquirer's **fiscal year-end** is December 31, Year 1. The **appraisal** of the equipment acquired was not received until March 15, Year 2, 3 weeks after issuance of Acquirer's Year 1 statements. The **provisional fair value** of the equipment was $1 million, but its **acquisition-date fair value** was appraised at $1.24 million. Furthermore, the equipment had a **4-year useful life** at the acquisition date, with no residual value. Accordingly, Acquirer adjusts its Year 1 information in its December 31, Year 2, statements. Assuming the **straight-line** method is used, **depreciation** for Year 1 is increased by $10,000 [($1.24 million – $1 million) × (2 months ÷ 48 months)]. Thus, the **carrying amount** of the equipment at December 31, Year 1, is increased by $230,000 ($240,000 – $10,000 depreciation for 2 months). Also, **goodwill** at December 31, Year 1, is decreased by $240,000, and Acquirer must make appropriate **disclosures** in its Year 1 and Year 2 statements.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 1 through 14 beginning on page 565.

15.2 CONSOLIDATION

Definitions

1. **Consolidated financial statements** report a parent and its subsidiaries as a **single economic entity**.
2. A **noncontrolling interest (NCI)** is the part of a subsidiary's equity not attributable to the parent.
3. A **parent** has a controlling financial interest in a subsidiary.
4. A **subsidiary** is any entity in which a parent has a controlling financial interest.

Policy

5. **All** subsidiaries must be consolidated. The assumption is that consolidated statements are needed for fair presentation if **one entity in a group controls the others**. (See Subunit 15.1, item 3. for the definition of control.)
    a. **Parent-entity statements** are sometimes prepared for the benefit of the parent's creditors or preferred shareholders. But they are **not** the general purpose statements of a parent.
        1) This function is performed by **consolidated statements**. They display a column for the parent and a column for a subsidiary (or group).

Initial Issues

6. Consolidation is an **accounting process** to prepare statements for a business combination when the combined entities remain **legally separate**.
7. Consolidation may occur for the **first time** between annual balance sheet dates. In these circumstances, the **revenues, expenses, gains, and losses** of the entity to be consolidated are included only from the **date of the consolidation**.

8. A subsidiary is consolidated even if its **fiscal period** differs from that of the parent.
   a. Compiling statements for a period that approximates the parent's is generally feasible. But if the **difference in periods** is not more than 3 months, use of the subsidiary's statements is normally acceptable.
      1) In this case, material intervening events affecting the statements should be **disclosed**.
9. The normal procedures is to start with the output of the formal accounting systems of the parent and the subsidiary(ies). On a **worksheet only**, the informal adjusting and elimination entries are then prepared.
   a. These consolidating **adjusting entries** must be cumulative. Previous worksheet entries were not recorded in the accounts of either the parent or the subsidiary.
   b. The working papers may be based on balances after year-end closing or on trial balances before closing. Thus, trial balances include revenue, expense, gain, and loss accounts.

Eliminations

10. Consolidation involves elimination of **intraentity balances and transactions** and **gains and losses** within the economic entity (the consolidated group).
   a. Intraentity balances and transactions are **eliminated in full** even if an NCI exists. Elimination means debits are credited and credits are debited.
      1) These balances and transactions include (a) receivables and payables, (b) the parent's investment in a subsidiary, (c) purchases, (d) sales, (e) interest, (f) dividends, and (g) securities issued by a combining entity.
   b. **Retained earnings or deficit** of a subsidiary at the acquisition date must be excluded from consolidated retained earnings.
      1) This step is accomplished in the entry eliminating the parent's investment account and the subsidiary's equity accounts.
      2) **Consolidated retained earnings** reflects the accumulated earnings of the consolidated group not (a) paid out as dividends or other distributions to the parent's owners or (b) capitalized by the parent.
         a) Accordingly, **stock dividends** issued by a subsidiary after acquisition by the parent (debit to subsidiary retained earnings, credits to its capital accounts) require no adjustment on consolidation.
   c. **Shares of the parent held by a subsidiary** must **not** be treated as outstanding in the consolidated balance sheet.
      1) They are eliminated by debiting treasury stock and crediting the subsidiary's investment account.
   d. Gains and losses on intraentity transactions are eliminated to the extent the related assets are **still held** by the consolidated group.
      1) **Gross profit or loss** (sales – cost of goods sold) is the usual basis for an elimination entry.
         a) However, if **income taxes** have been paid on intraentity gain related to assets still held by the consolidated group, the taxes must be deferred, or the profits to be eliminated must be reduced.

NCIs

11. An **NCI** must be separately reported and clearly identified in the **equity section** of the consolidated balance sheet, e.g., as **NCIs** in **subsidiaries.**
    a. The amount of the NCI recognized at the date of the combination equals its **acquisition date fair value.**
    b. **Subsequent accounting** for an NCI requires adjustment for its share of the subsidiary's income, comprehensive income, and dividends.
    c. On consolidating worksheets, an adjustment to the NCI also is needed for unrealized gains and losses on (1) **upstream (subsidiary to parent) sales** of inventory and fixed assets and (2) purchases of **combining entity debt.**
    d. In the **consolidated income statement**, the NCI's adjusted share of the subsidiary's income is subtracted from consolidated net income to determine the **amount attributable to the parent.** A similar presentation is required for **comprehensive income.**

EXAMPLE

Consolidated Income Statement

Revenues	$ XXX,XXX
Expenses	(XXX,XXX)
Pretax income from continuing operations	$ XX,XXX
Income tax expense	(XX,XXX)
After-tax income from continuing operations	$ XX,XXX
Discontinued operations (after tax)	(X,XXX)
Net income	$ XX,XXX
Minus: Net income – NCI	(X,XXX)
Net income – parent	$ XX,XXX

EXAMPLE

Statement of Consolidated Comprehensive Income

Net income	$XX,XXX
Other comprehensive income (after tax)	
Unrealized holding gain on available-for-sale securities (after tax)	XX,XXX
Total other comprehensive income (after tax)	XX,XXX
Comprehensive income	XX,XXX
Comprehensive income – NCI	(X,XXX)
Comprehensive income – parent	$XX,XXX

    e. In the **consolidated balance sheet**, **equity** must consist of the parent's equity and an amount for the NCI (the only element of the subsidiary's equity reported separately).

EXAMPLE

Consolidated Equity

Equity:	
Parent equity:	
Common stock, $1 par	$XXX,XXX
Additional paid-in capital	XX,XXX
Retained earnings	XXX,XXX
Accumulated other comprehensive income	XX,XXX
Total parent equity	XXX,XXX
NCI	XX,XXX
Total equity	$XXX,XXX

f. NCIs in two or more subsidiaries may be **combined**.

g. A subsidiary's **financial instruments** may be classified as equity or liabilities.

   1) But **only an equity instrument** can be an NCI. The reason is that a **liability instrument** does **not** confer ownership.

h. The presence of an NCI does not affect the amount of **intraentity income or loss** to be eliminated. The total elimination of this amount is consistent with the economic-entity principle of consolidation.

   1) The elimination **may be** allocated between the parent and the NCI.
   2) The following are reported in the consolidated statements at the **consolidated (total) amounts**:

      a) Revenues and expenses
      b) Gains and losses
      c) Net income or loss
      d) Other comprehensive income or loss

i. **Net income or loss** and **comprehensive income or loss** must be attributed to the parent and the NCI.

   1) Accordingly, the NCI should be attributed its share of losses even if the result is a **deficit balance**.

Ownership Changes

12. A parent's ownership interest may change **without loss of control**. For example, the parent or subsidiary may buy or sell the subsidiary's ownership interests. These changes are **equity transactions**.

    a. **No gain or loss** is recognized in the consolidated statements.

    b. The **carrying amount of the NCI** is adjusted. The difference between the consideration given or received and the adjustment is recognized in **equity attributable to the parent**.

c. If the subsidiary has **accumulated other comprehensive income** (AOCI), its carrying amount is adjusted by a debit or credit to **equity attributable to the parent**.

EXAMPLE

Parent owns 100% of the 100,000 outstanding common shares of Sub, which has a carrying amount of $1,000,000. Parent sells 10% of the Sub shares to an unrelated entity for $125,000. The entry from the consolidated perspective is

Cash	$125,000	
NCI – Sub ($1,000,000 × 10%)		$100,000
Additional paid-in capital – Parent		25,000

Shortly after Parent's sale of 10% of the Sub shares, Sub issues 20,000 previously unissued shares to the same unrelated entity for $240,000. The effect is to decrease Parent's ownership to 75% (90,000 shares ÷ 120,000 shares issued) but to increase its equity in Sub from $900,000 to $930,000 [($1,000,000 + $240,000) × 75%]. The entry is

Cash	$240,000	
NCI – Sub*		$210,000
Additional paid-in capital – Parent		30,000

* [($1,240,000 × 25%) – $100,000]

Assume that the carrying amount ($310,000) of the NCI includes $40,000 of AOCI. Assume also that Parent purchases 15,000 of the 30,000 shares held by the noncontrolling shareholder for $225,000. The entry reflecting the repurchase from the consolidated perspective is

NCI – Sub	$155,000*	
Additional paid-in capital – Parent	70,000	
Cash		$225,000
Additional paid-in capital – Parent	$20,000**	
AOCI – Parent		$20,000

* [$310,000 NCI × (15,000 shares ÷ 30,000 shares)]
** [$40,000 AOCI attributable to the NCI × (15,000 shares ÷ 30,000 shares)]

Deconsolidation

13. A parent deconsolidates a subsidiary when it no longer has a controlling financial interest. The following are typical reasons for deconsolidation:
    a. The parent's sale of ownership interests
    b. Termination of a contract that gave the parent control
    c. The subsidiary's issuance of shares that dilute the parent's ownership interest
    d. Acquisition of control by a regulator, court, etc.
14. Deconsolidation may be by a spinoff or other **nonreciprocal transfer to owners** (see Subunit 14.5).
    a. In other cases, the parent records the deconsolidation by recognizing a **gain or loss** in **net income of the parent**. It equals the difference at the **deconsolidation date** between 1) and 2) below.
        1) The sum of
            a) The fair value of the consideration received
            b) The fair value of any retained investment
            c) The carrying amount of any NCI (including AOCI attributable to it)
        2) The carrying amount of the subsidiary
15. A parent may deconsolidate a subsidiary during the year while retaining **significant influence**. The **fair value option (FVO)** or the **equity method** must be elected to account for such a retained interest but **only** from the deconsolidation date.

Consolidating Journal Entries

16. The **basic entry** eliminates the investment and subsidiary equity attributable to the parent.

Common stock (sub)	$XXX	
Additional paid-in capital (sub)	XXX	
Retained earnings (sub)	XXX	
Dividends declared (sub)		$XXX
Investment (parent)		XXX
NCI		XXX

   a. The subsidiary's equity is allocated between the parent's investment and the NCI.

Offsetting Accounts

17. Directly offsetting intraentity accounts are reciprocal and do not affect consolidated net income, comprehensive income, or the NCI.

Sales	$XXX	
Cost of sales		$XXX
Payables	XXX	
Receivables		XXX
Interest income	XXX	
Interest expense		XXX

Gains and Losses

18. Gains and losses on transactions within the consolidated group are completely eliminated, but the procedure varies with the direction of the sale.

   a. **Parent to subsidiary (downstream):** The entire unrealized gain or loss is subtracted from the **parent's income**. The NCI is unaffected by the elimination.

   b. **Subsidiary to parent (upstream):** The entire unrealized gain or loss is subtracted from the **subsidiary's income**. The effect is to allocate the elimination of the unrealized gain or loss between the parent (or consolidated group) and the NCI.

      1) The upstream case is only relevant if the subsidiary has an NCI.

   c. **Ending inventory** of a combining entity may include goods purchased during the period from another combining entity that recognized a gain. Thus, **unrealized gain** exists from a consolidated perspective.

Cost of sales	$XXX	
Inventory		$XXX

      1) This entry eliminates the gain by reducing the inventory to cost and decreasing consolidated net income. Part of this reduction of income is allocated to the NCI (if any) if the sale is **upstream**.

EXAMPLE

Clark Co. purchased materials totaling $240,000 from Kent Corp., a wholly owned subsidiary. Kent's gain on the sale was $48,000. Clark had $60,000 of this inventory remaining on December 31. Hence, the inventory must be reduced by the pro rata share of intraentity gain made on the sale by Kent. The reduction is $12,000 [$48,000 gain × ($60,000 ending inventory ÷ $240,000 purchases)]. Moreover, no adjustment to an NCI is needed because the subsidiary is wholly owned.

   d. In the period of the purchase/sale, any gain recognized on the sale of a **fixed asset** between combining entities is eliminated.

Gain on sale	$XXX	
Fixed asset		$XXX

1) **Depreciation** taken by the purchaser may differ from the amount that would have been recognized if the seller had retained and depreciated the fixed asset. This difference is eliminated.

Accumulated depreciation (Dr or Cr)	$XXX	
Depreciation expense (Cr or Dr)		$XXX

EXAMPLE

On January 1, Poe Corp. sold a machine for $900,000 to Saxe Corp., its wholly owned subsidiary. Poe paid $1.1 million for this machine, which had accumulated depreciation of $250,000. Poe estimated a $100,000 salvage value and depreciated the machine on the straight-line method over 20 years, a policy that Saxe continued. In Poe's December 31 consolidated balance sheet, the effect of the intraentity transaction must be eliminated. Thus, the machine should be carried at cost ($1,100,000) minus accumulated depreciation of $300,000 {$250,000 + [($1,100,000 – $100,000) ÷ 20 years]}.

2) In subsequent periods, the **previously reported gain** included in retained earnings is eliminated. The **excess depreciation** taken in the period and in all prior periods (i.e., a cumulative adjustment) is then eliminated.

Retained earnings	$XXX	
Fixed asset		$XXX
Accumulated depreciation	XXX	
Depreciation expense		XXX
Retained earnings		XXX

3) A seller's **NCI** and its income attributable to that interest are adjusted as appropriate. However, all adjustments for elimination of unrealized gain flow through to consolidated totals unless explicitly taken to the NCI.

Debt Transactions

19. The debt issued by a combining entity of a consolidated group may be purchased by another combining entity from a third party so that the debt accounts are not reciprocal. Thus, the purchase price **may not be equal** to the carrying amount of the debt on the books of the issuer.

a. The gain or loss on **extinguishment of debt** from a consolidated perspective must be recognized in the period the debt is purchased by a combining entity. The following are the accounting issues:

1) Maturity or face amount of the debt
2) Interest receivable/payable at period-end
3) Interest income/expense based on maturity amount and stated rate
4) Discount or premium on the books of the issuer (debtor)
5) Discount or premium on the books of the purchaser (creditor)

b. The maturity amount, interest receivable/payable, and interest income/expense are direct eliminations.

EXAMPLE

Wagner, a holder of a $1 million Palmer, Inc. bond, collected the interest due on March 31, and then sold the bond to Seal, Inc. for $975,000. On that date, Palmer, a 75% owner of Seal, had a $1,075,000 carrying amount for this bond. The purchase was in substance a retirement of debt by the consolidated group for less than its carrying amount. The transaction resulted in a gain of $100,000 ($1,075,000 carrying amount – $975,000 price) and therefore a $100,000 increase in consolidated retained earnings.

c. The **premium or discount** on the debtor's and creditor's books and any related **amortization** is eliminated and recognized as a gain or loss on extinguishment in the period of purchase. **Retained earnings** is adjusted in each subsequent period.

d. The method of assigning a **consolidated gain or loss** on extinguishment of debt is not settled. The possibilities include assigning the full amount to the (1) parent, (2) debtor, or (3) creditor. A fourth possibility is to allocate the amount.

   1) However, the choice is significant only for reporting an NCI.

Upstream Intraentity Gain or Loss

20. All such items require an adjustment to the NCI. Adjustments are made to (a) retained earnings and (b) income attributable to the NCI.

   a. In the preceding journal entries, adjustments to **retained earnings** can individually be made pro rata to retained earnings and the NCI. Thus, if the NCI is 10%, 10% of every entry is made to the NCI instead of retained earnings.

   NOTE: An alternative is to make one summary entry to retained earnings to adjust the NCI (established with the first elimination entry).

   b. All entries to **nominal accounts** involving upstream transactions (those from combining entities with an NCI) require an adjustment to income attributable to the NCI. The entry to establish net income – NCI is

Consolidated net income	$XXX	
Net income – NCI		$XXX

      1) The amount is the NCI percentage times the subsidiary's net income adjusted for any upstream transactions. For example, if inventory, which includes $1,000 of gross profit sold upstream by a subsidiary with a 10% NCI, has not been resold out of the consolidated group, the amount of net income – NCI is reduced by $100 ($1,000 × 10%) in the period of the intraentity sale.

Variable Interest Entities

21. FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, is a response to accounting scandals involving abuse of **off-balance-sheet arrangements**.

   a. A **variable interest entity (VIE)** is an off-balance-sheet arrangement that may take any legal form (e.g., corporation, partnership, not-for-profit organization, limited liability company, or trust). Moreover, a VIE has insufficient equity, or its equity investors lack one of the specified characteristics of financial control.

   b. **Variable interests** are ownership, contractual, or monetary interests that vary with changes in the **fair value of the VIE's net assets** (excluding variable interests). Examples are

      1) Equity investments in a VIE that are at risk,
      2) Subordinated debt or beneficial interests issued by the VIE, and
      3) Guarantees of the VIE's assets or liabilities.

   c. The **primary beneficiary (PB)** consolidates a VIE. Thus, the term **subsidiary** applies not only to an entity in which another entity (the parent) holds a controlling financial interest but also to a VIE.

      1) When the reporting entity first **becomes involved** with another entity, it determines whether the other entity is a VIE. If so, the reporting entity determines whether it is the PB.

         a) The PB is an entity with variable interests that absorb a majority of the expected losses or receive a majority of the expected residual returns of the VIE. If different entities qualify, the one that **absorbs the majority of the expected losses** is the PB.

22. An entity must be consolidated as a VIE if, **by design**, any one of three conditions exists.
    a. It is not properly capitalized. Its **equity investment at risk** is insufficient to finance its operations without additional **subordinated financial support** (variable interests that will absorb at least some expected losses) from any parties.
    b. As a group, the holders of equity at risk **lack** any one of the following characteristics of a **controlling financial interest**:
        1) The ability based on **voting or similar rights** to make **decisions** significantly affecting the potential VIE's success. For example, the owners may have no voting or similar rights, such as those of a corporate common shareholder.
        2) An obligation to absorb expected losses, e.g., because the amount is capped.
        3) The right to receive expected residual returns.
    c. Equity investors as a group also lack the **voting rights** characteristic if
        1) Voting rights of some investors are disproportionate to their obligations to absorb expected losses or their rights to receive expected returns of the VIE, and
        2) Substantially all of the VIE's activities involve or are performed for an investor with disproportionately few voting rights.
23. However, a **business** need not be evaluated as to whether it is a VIE unless
    a. The reporting entity participated significantly in its design,
    b. Most of its activities involve or are done for the reporting entity,
    c. The reporting entity provides most of its subordinated financial support, or
    d. Its activities primarily relate to asset-backed financing or single-lessee leases.
24. If the PB and VIE are **under common control**, the PB's **initial measurement** of the VIE's assets, liabilities, and NCIs is at the **carrying amount** on the books of the controlling entity.
25. If the PB and VIE are **not under common control**, and the VIE is a **business**, initial consolidation is governed by SFAS 141(R).
    a. Thus, with certain exceptions, (1) the consideration transferred, (2) previously held interests, (3) identifiable assets acquired, (4) liabilities assumed, and (5) NCIs in the VIE are measured at **acquisition-date fair values**.
    b. **Goodwill** is recognized equal to the excess of (1) the sum of the fair values of (a) the consideration transferred, (b) any NCIs in the VIE, and (c) the PB's previously held equity interest in the VIE **over** (2) the net of the fair values of the identifiable assets acquired and liabilities assumed.
        1) If **(2)** exceeds **(1)**, a **gain** is recognized.
    c. If the PB and VIE are **not under common control**, and the VIE is **not a business**, the PB measures the VIE's assets (but not goodwill) and liabilities according to SFAS 141(R).
        1) But transfers of assets or liabilities to the VIE by the PB made **shortly before, at, or any time after** the date when it became the PB are measured as if they had not been transferred. Thus, these transfers do not result in gain or loss.
        2) The **gain or loss** on initial consolidation is the difference between (a) the reported amount of previously held interests plus the fair values of the consideration paid and NCIs, and (b) the net of the VIE's identifiable assets and liabilities accounted for under SFAS 141(R).
        3) **No goodwill** is recognized when the VIE is **not** a business.

26. **Subsequent accounting** follows the principles that apply to ordinary consolidations.

EXAMPLE

Priben Co. concluded a contractual arrangement on December 31, Year 1. As a result, it will absorb a majority of the expected losses or receive a majority of the expected residual returns of Varient Co., a VIE. Priben and Varient are not under common control, and Varient is not a business. Prior to becoming the PB, Priben had an interest in Varient with a carrying amount of $2.5 million. On that date, Priben paid $10 million to increase its interest in Varient. Furthermore, any transfers of assets or liabilities to Varient from Priben occurred well before it became the PB. The following fair values were determined on December 31, Year 1, for Varient:

Assets	$100 million
Long-term debt	70 million
NCI	15 million

Accordingly, Priben's gain on consolidation of the nonbusiness VIE is $2.5 million [($100 million – $70 million) – ($2.5 million + $10 million + $15 million)].

Summary of Initial Measurement Attributes

	PB and VIE – Common Control	PB and VIE – No Common Control
Business VIE	Carrying amount	Acquisition-Date FV
Nonbusiness VIE	Carrying amount	1. Assets (not goodwill), liabilities at acquisition-date FV. 2. Certain transfers to VIE at carrying amount.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 15 through 25 beginning on page 572.

15.3 COMBINED FINANCIAL STATEMENTS

1. Consolidated statements should be prepared only when the controlling financial interest is held by **one of the consolidated entities**.
2. When consolidated statements are **not** prepared, **combined statements** may be more meaningful than the separate statements of **commonly controlled entities**.
   a. For example, combined statements are useful when **one individual** owns a controlling financial interest in several entities with related operations. They also may be used to present the statements of **entities under common management**.
3. Combined statements are prepared in the same way as consolidated statements.
   a. When they are prepared for related entities, e.g., commonly controlled entities, intraentity transactions and gains or losses are **eliminated**.
   b. Moreover, consolidation procedures are applied to such matters as (1) noncontrolling interests, (2) foreign operations, (3) different fiscal periods, and (4) income taxes.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 26 through 31 beginning on page 578.

QUESTIONS

15.1 Business Combinations

1. A business combination in which the surviving entity is not one of the two combining entities is a(n)

A. Investment in stock.

B. Consolidation.

C. Merger.

D. Acquisition.

Answer (B) is correct. *(Publisher, adapted)*

REQUIRED: The combination in which the survivor is not a combining entity.

DISCUSSION: In a consolidation, the combining entities are dissolved, and the assets and liabilities of the combining entities are used to create a new legal entity.

Answer (A) is incorrect because an investment in stock is not always associated with a business combination. Answer (C) is incorrect because, in a merger, one of the combining entities survives. Answer (D) is incorrect because, in an acquisition, one entity typically exchanges cash, equity securities, debt securities, or other considerations for the majority of the outstanding voting interests of another entity, and both continue to operate separately.

2. Costs incurred in completing a business combination are listed below.

General administrative costs	$240,000
Consulting fees	120,000
Direct cost to register and issue equity securities	80,000

The amount charged to the expenses of the business combination is

A. $80,000

B. $120,000

C. $240,000

D. $360,000

Answer (D) is correct. *(CMA, adapted)*

REQUIRED: The expenses of the business combination.

DISCUSSION: Acquisition-related costs, such as finder's fees, professional and consulting fees, and general administrative costs (e.g., for an acquisitions department), are expensed as incurred [SFAS 141(R)]. However, issuance costs for securities are accounted for under other GAAP. Direct issuance costs of equity (underwriting, legal, accounting, tax, registration, etc.) are debited to additional paid-in capital. Indirect costs of issuance, records maintenance, and ownership transfers (e.g., a stock transfer agent's fees) are expensed. Accordingly, the amount expensed is $360,000 ($240,000 + $120,000).

Answer (A) is incorrect because $80,000 equals the direct cost to register and issue equity securities. This cost is a reduction of additional paid-in capital, not an expense. Answer (B) is incorrect because $120,000 does not include the general and administrative costs. Costs of registering and issuing equity securities should be treated as a reduction of their otherwise determinable fair value. Thus, only the $120,000 in indirect acquisition expenses should be charged to the expenses of the business combination. Answer (C) is incorrect because $240,000 does not include the consulting fees.

3. MAJ Corporation acquired 90% of the common stock of Min Co. for $420,000. MAJ previously held no equity interest in Min. On the date of acquisition, the carrying amount of Min's identifiable net assets equaled $300,000. The acquisition-date fair values of Min's inventory and equipment exceeded their carrying amounts by $60,000 and $40,000, respectively. The carrying amounts of the other assets and liabilities were equal to their acquisition-date fair values. What amount should MAJ recognize as goodwill immediately after the acquisition?

A. $150,000

B. $96,000

C. $60,000

D. $114,000

Answer (C) is correct. *(Publisher, adapted)*

REQUIRED: The goodwill recognized.

DISCUSSION: Goodwill is the excess of (1) the sum of the acquisition-date fair values (with some exceptions) of (a) the consideration transferred, (b) any noncontrolling interest in the acquiree, and (c) the acquirer's previously held equity interest in the acquiree over (2) the net of the acquisition-date fair values (with some exceptions) of the identifiable assets acquired and liabilities assumed. Goodwill is therefore $60,000.

Consideration transferred	$ 420,000
Noncontrolling interest [($300,000 + $60,000 + $40,000) × 10%]	40,000
Previously held equity interest	0
Fair value of identifiable net assets	(400,000)
Goodwill	$ 60,000

Answer (A) is incorrect because $150,000 is the difference between consideration transferred and 90% of the carrying amount of Min's identifiable net assets. Answer (B) is incorrect because $96,000 is the excess of the cost over the carrying amount of the net assets acquired minus the amount allocated to inventory. Answer (D) is incorrect because $114,000 is the excess of the consideration transferred over 90% of the carrying amount of Min's identifiable net assets, minus 90% of the excess fair value of the equipment.

4. The acquirer in a business combination transfers cash consideration for 100% of the voting interests of the acquiree. Moreover, the fair value of liabilities assumed exceeds the acquisition-date fair value of the identifiable assets acquired. This excess is calculated without regard to the fair value the acquirer attributes to the acquiree's assembled work force and certain contracts it is negotiating. Thus, goodwill must

A. Not be recognized.

B. Be recognized in an amount equal to the cash transferred, minus the acquisition-date fair value of the net liabilities assumed.

C. Be recognized in an amount equal to the cash transferred, minus the acquisition-date fair value of the assembled workforce and contracts being negotiated.

D. Be amortized over the period during which the discount on the long-term interest-bearing assets acquired will be amortized.

Answer (B) is correct. *(Publisher, adapted)*

REQUIRED: The goodwill recognized given the acquiree's assembled work force and certain contracts it is negotiating.

DISCUSSION: Goodwill is the excess of (1) the sum of the acquisition-date fair values (with some exceptions) of (a) the consideration transferred, (b) any noncontrolling interest in the acquiree, the (c) the acquirer's previously held equity interest in the acquiree over (2) the net of the acquisition-date fair values (with some exceptions) of the identifiable assets acquired and liabilities assumed. The assembled workforce and potential contracts are, respectively, (1) not identifiable at the acquisition date and (2) not an asset at the acquisition date [SFAS 141(R)]. Accordingly, their fair value is absorbed into goodwill. Given that the acquisition was of 100% of the acquiree's voting interests, neither a prior equity interest nor a noncontrolling interest is relevant. Consequently, goodwill equals cash transferred minus the acquisition-date fair value of the net liabilities assumed.

Answer (A) is incorrect. goodwill is recognized. The sum of the consideration transferred (cash) plus the liabilities assumed exceeds the sum of the identifiable assets acquired. Answer (C) is incorrect. SFAS 141(R) states that neither an assembled workforce nor potential contracts are identifiable intangible assets. Answer (D) is incorrect. goodwill is tested for impairment but not amortized.

5. Acquirer Corporation acquired for cash at \$10 per share 100,000 shares of the outstanding common stock of Acquiree Company. The total fair value of the identifiable assets acquired minus liabilities assumed of Acquiree was \$1.4 million on the acquisition date, including the fair value of its property, plant, and equipment (its only noncurrent asset) of \$250,000. The consolidated financial statements of Acquirer Corporation and its wholly owned subsidiary must reflect

A. A deferred credit of \$150,000.

B. Goodwill of \$150,000.

C. A gain of \$150,000.

D. A gain of \$400,000.

Answer (D) is correct. *(CPA, adapted)*

REQUIRED: The accounting for a bargain purchase.

DISCUSSION: In a bargain purchase, the gain is recognized in earnings. Prior to gain recognition, the acquirer must reevaluate whether all assets and liabilities have been identified. It also must review the procedures for measuring (1) the consideration transferred, (2) assets acquired, (3) liabilities assumed, (4) the noncontrolling interest, and (5) a previously held equity interest in the acquiree. The gain equals the excess of (1) the net of the acquisition-date fair values (with some exceptions) of the identifiable assets acquired and liabilities assumed over (2) the sum of the acquisition-date fair values (with some exceptions) of (a) the consideration transferred, (b) any noncontrolling interest in the acquiree, and (c) the acquirer's previously held equity interest in the acquiree. Consequently, the gain is \$400,000 (\$1.4 million – (100,000 shares × \$10)].

Answer (A) is incorrect. a deferred credit is never recognized for a bargain purchase. Answer (B) is incorrect. goodwill is the excess of (1) the sum of the acquisition-date fair values (with some exceptions) of (a) the consideration transferred, (b) any noncontrolling interest in the acquiree, the (c) the acquirer's previously held equity interest in the acquiree over (2) the net of the acquisition-date fair values (with some exceptions) of the identifiable assets acquired and liabilities assumed. Answer (C) is incorrect. a gain of \$150,000 results from reducing the fair value of the PPE to zero.

6. The acquiree in a business combination leases a building to an unrelated third party. The lease was properly classified as an operating lease at its inception. Compared with market terms for similar leases at the acquisition date, the lease is favorable. The acquirer must

A. Reclassify the lease based on relevant conditions at the acquisition date.

B. Recognize a liability.

C. Recognize an intangible asset to the extent the lease is favorable.

D. Recognize an intangible asset equal to the fair value of the lease.

Answer (C) is correct. *(Publisher, adapted)*

REQUIRED: The accounting by the acquirer in a business combination for an acquiree's operating lease.

DISCUSSION: An acquiree (as lessor or lessee) may have an operating lease that is favorable or unfavorable compared with market terms for similar items at the acquisition date. The acquirer recognizes an intangible asset or liability to the extent that the lease is favorable or unfavorable, respectively.

Answer (A) is incorrect. the acquirer classifies a lease as operating or capital based on its terms and other factors at the inception of the contract (or date of modification). Answer (B) is incorrect. the lease is favorable. Answer (D) is incorrect. the acquirer must recognize an intangible asset. However, the fair value of the lease is not relevant for recognition purposes.

7. The accounting for a business combination ordinarily must be in accordance with the recognition principle, the measurement principle, and the recognition conditions. Which of the following is true?

A. Expected restructuring costs that the acquirer is not required to pay are recognized as a liability.

B. Identifiable assets (including goodwill) are measured at their cost to the acquirer.

C. Effective settlement of a preexisting contractual relationship of the acquirer and acquiree is accounted for as part of the combination.

D. A gain or loss based on fair value is recognized when the combination effectively settles a noncontractual preexisting relationship of the acquirer and acquiree.

Answer (D) is correct. *(Publisher, adapted)*

REQUIRED: The true statement about accounting for a business combination.

DISCUSSION: If the relationship settled is contractual , the gain or loss is the lesser of (1) the amount by which the contract is favorable or unfavorable to the acquirer and (2) the settlement amount available to the party at a disadvantage. If the second amount is lower, the difference is accounted for as part of the combination.

Answer (A) is incorrect because one recognition condition is that assets and liabilities must meet the definitions of elements of financial statements. Costs not required to be paid do not meet the definition of a liability. Answer (B) is incorrect because identifiable assets (excluding goodwill) are ordinarily measured at their acquisition-date fair values. Answer (C) is incorrect because settlement of a preexisting acquirer-acquiree relationship, whether or not contractual, is accounted for separately from the combination.

8. Acquirer Co. paid cash for 100% of the voting interests of Acquiree Co. Acquirer had previously licensed a patent to Acquiree. How must this reacquired right be accounted for?

A. It is amortized over its original useful life.

B. If it is resold, the gain or loss is based on its fair value.

C. A settlement loss is recognized if the contract terms are unfavorable.

D. Measurement of the right is based in part on whether market participants would consider renewals in their estimate of fair value.

Answer (C) is correct. *(Publisher, adapted)*

REQUIRED: The accounting by the acquirer in a business combination for a reacquired right.

DISCUSSION: A settlement gain or loss is recognized if the terms of the contract (e.g., between Acquirer and Acquiree) that created the right are favorable or unfavorable, respectively. This determination is relative to current transactions for similar items. The gain or loss is the lesser of (1) the amount by which the contract is favorable or unfavorable to the acquirer and (2) the settlement amount available to the party at a disadvantage. If the second amount is lower, the difference is accounted for as part of the combination.

Answer (A) is incorrect because amortization is over the remaining term of the contract between Acquirer and Acquiree. Answer (B) is incorrect because the gain or loss on resale of the right to a third party is based on its carrying amount. Answer (D) is incorrect because measurement is on the basis of the remaining term of the related contract without regard to possible renewals.

9. To effect a business combination, Proper Co. acquired all the outstanding common shares of Scapula Co., a business entity, for cash equal to the carrying amount of Scapula's net assets. The carrying amounts of Scapula's assets and liabilities approximated their fair values at the acquisition date, except that the carrying amount of its building was more than fair value. In preparing Proper's year-end consolidated income statement, what is the effect of recording the assets acquired and liabilities assumed at fair value, and should goodwill amortization be recognized?

	Depreciation Expense	Goodwill Amortization
A.	Lower	Yes
B.	Higher	Yes
C.	Lower	No
D.	Higher	No

Answer (C) is correct. *(CPA, adapted)*

REQUIRED: The effects of the combination on depreciation and goodwill amortization.

DISCUSSION: A business combination is accounted for using the acquisition method. Accordingly, the identifiable assets acquired and liabilities assumed ordinarily are recorded at their acquisition-date fair values. The differences between those fair values and carrying amounts will affect net income when related expenses are incurred. The effect of recording the building at fair value in the consolidated balance sheet instead of its higher carrying amount on Scapula's books will be to decrease future depreciation. Goodwill is the excess of (1) the sum of the acquisition-date fair values (with some exceptions) of (a) the consideration transferred, (b) any noncontrolling interest in the acquiree, and (c) the acquirer's previously held equity interest in the acquiree over (2) the net of the acquisition-date fair values (with some exceptions) of the identifiable assets acquired and liabilities assumed. Thus, Proper recognizes goodwill for the excess of the cash paid over the fair value of the net assets acquired (given an acquisition of 100% of Scapula's common shares). Under SFAS 142, *Goodwill and Other Intangible Assets*, this amount will be tested for impairment but not amortized.

Answer (A) is incorrect because goodwill will be recognized but not amortized. Answer (B) is incorrect because depreciation will decrease, and goodwill will be recognized but not amortized. Answer (D) is incorrect because depreciation will decrease.

10. Acquirer Co. paid cash for 100% of the voting interests of Acquiree Co. on December 31, the last day of its fiscal year. Included in the assets of Acquiree are a patent that was internally developed, equipment used in research and development (R&D) with an alternative use, and equipment used in R&D with no alternative use. In Acquirer's consolidated balance sheet, which of the following are reported and measured at acquisition-date fair value?

A. The patent and both types of equipment.

B. The two types of equipment to be used in R&D.

C. The equipment to be used in R&D with no alternative use.

D. The equipment to be used in R&D with an alternative use.

Answer (A) is correct. *(Publisher, adapted)*

REQUIRED: The reporting of a patent and R&D equipment acquired in a business combination.

DISCUSSION: According to SFAS 2, *Accounting for Research and Development Costs* [as amended by SFAS 141(R)], tangible and identifiable intangible assets acquired in a business combination that are used in R&D are recognized and measured at acquisition-date fair value. Whether they have an alternative future use is irrelevant. Both kinds of equipment are tangible assets, and the patent is an identifiable intangible asset because it meets the contractual legal criterion for identifiability.

Answer (B) is incorrect because the patent also is recognized and measured at acquisition-date fair value. Answer (C) is incorrect because the patent and both types of equipment are recognized and measured at acquisition-date fair value. Answer (D) is incorrect because the patent and the equipment to be used in R&D with no alternative use also are recognized and measured at acquisition-date fair value.

Questions 11 and 12 are based on the following information. PW Co. acquired 90% of the outstanding stock of the DU Co. for $250,000 in cash. PW had no previous equity interest in DU. DU's identifiable assets acquired and liabilities assumed were reported at their acquisition-date fair values in its separate balance sheet immediately following the acquisition. DU's accounts receivable include a $10,000 receivable from PW. DU also has a $5,000 account payable to PW. PW's separate balance sheet and the consolidated balance sheet immediately following the acquisition are presented below:

	PW	Consolidated
Current assets	$220,000	$340,000
Investment (DU)	250,000	-0-
Fixed assets	410,000	575,000
Goodwill	-0-	25,000
	$880,000	$940,000
Current liabilities	$105,000	$140,000
Common stock	400,000	400,000
Additional paid-in capital	75,000	75,000
Retained earnings	300,000	300,000
Noncontrolling interest	-0-	25,000
	$880,000	$940,000

11. What was the total of DU's current liabilities on its separate balance sheet at the time of the acquisition?

A. $35,000

B. $40,000

C. $45,000

D. $50,000

Answer (D) is correct. *(Publisher, adapted)*

REQUIRED: The total current liabilities of the subsidiary in its separate statements.

DISCUSSION: In a consolidated balance sheet, reciprocal balances, such as receivables and payables, between a parent and a subsidiary are eliminated in their entirety. Moreover, in consolidated statements prepared immediately after the acquisition, the identifiable assets acquired and liabilities assumed are measured at their acquisition-date fair values [SFAS 141(R)]. Given that the amounts on DU's balance sheet also are reported at acquisition-date fair values, it is possible to infer those amounts from the information given. PW's current liabilities after the necessary eliminations are $95,000 because PW owes DU $10,000. The difference between PW's current liabilities and consolidated current liabilities is $45,000 ($140,000 – $95,000). Adding to this amount the $5,000 that DU owes PW gives DU current liabilities of $50,000 ($45,000 + $5,000).

Answer (A) is incorrect because $35,000 does not include intraentity receivables and payables. Answer (B) is incorrect because $40,000 does not include the $10,000 that PW owes DU. Answer (C) is incorrect because $45,000 does not include the $5,000 that DU owes PW.

12. What was the amount of 90% of the acquisition-date fair value of DU's total net assets?

A. $225,000

B. $250,000

C. $260,000

D. $265,000

Answer (A) is correct. *(Publisher, adapted)*

REQUIRED: The acquisition-date fair value of the subsidiary's total net assets.

DISCUSSION: In this business combination, the $250,000 balance of the investment in subsidiary account in the separate (parent-only) balance sheet is presumably equal to the fair value of the consideration transferred. It includes $25,000 of goodwill. Goodwill is the excess of (1) the sum of the acquisition-date fair values (with some exceptions) of (a) the consideration transferred, (b) any noncontrolling interest in the acquiree, and (c) the acquirer's previously held equity interest in the acquiree over (2) the net of the acquisition-date fair values (with some exceptions) of the identifiable assets acquired and liabilities assumed. Furthermore, the noncontrolling interest is reported at its acquisition-date fair value in the consolidated balance sheet [SFAS 141(R)]. Given that PW had no previous equity interest in DU, the acquisition-date fair value of the net assets acquired must have been $250,000 ($250,000 consideration + $25,000 NCI + $0 – $25,000 goodwill). Thus, 90% of DU's total net assets (reported separately at acquisition-date fair value) is $225,000 ($250,000 × 90%).

Answer (B) is incorrect because $250,000 is equal to 100% of DU's net assets. Answer (C) is incorrect because $260,000 is equal to 100% of DU's net assets plus the $10,000 receivable from PW. Answer (D) is incorrect because $265,000 is equal to 100% of DU's net assets plus the $10,000 receivable from PW and the $5,000 payable to PW.

13. On January 1, Pathan Corp. acquired 80% of Samoa Corp.'s $10 par common stock for $975,000. The remaining 20% of this stock is held by NCI Co., an unrelated party. On the acquisition date for this business combination, the carrying amount of Samoa's net assets was $1 million. The fair values of the assets acquired and liabilities assumed were the same as their carrying amounts on Samoa's balance sheet except for plant assets (net), the fair value of which was $100,000 in excess of the carrying amount. The fair value of the noncontrolling interest is 20% of the fair value of the acquiree's net assets at the acquisition date. (No exceptions to the recognition or measurement principles apply.) For the year ended December 31, Samoa had net income of $190,000 and paid cash dividends totaling $125,000. In the December 31 consolidated balance sheet, the noncontrolling interest is reported at

A. $200,000

B. $213,000

C. $220,000

D. $233,000

Answer (D) is correct. *(CPA, adapted)*

REQUIRED: The amount of the NCI.

DISCUSSION: The noncontrolling interest is equal to the 20% (100% – 80%) interest in Samoa not held by Pathan (the parent). The fair value of the noncontrolling interest was $220,000 [($1,000,000 carrying amount at the acquisition date + $100,000 unrealized gain) × 20%] on January 1. As indicated below, the noncontrolling interest to be reported in the year-end balance sheet equals its fair value at the beginning of the year, plus 20% of the net income, minus 20% of the dividends. Thus, the noncontrolling interest is reported at $233,000.

	20% Noncontrolling Interest
Fair value on 1/1	$220,000
Net income attributable to the NCI ($190,000 × 20%)	38,000
Dividends attributable to the NCI ($125,000 × 20%)	(25,000)
Noncontrolling interest at 12/31	$233,000

Answer (A) is incorrect because $200,000 is the carrying amount of the noncontrolling interest on 1/1, assuming it equaled 20% of the carrying amount of the net assets. Answer (B) is incorrect because $213,000 is the noncontrolling interest measured at its carrying amount on 1/1, plus its share of net income, minus its share of dividends. Answer (C) is incorrect because $220,000 is the noncontrolling interest measured at fair value at 1/1.

14. AA Co. and LA Co. entered into a business combination on December 31. LA Co. issued shares of its common stock for all of the outstanding common stock of AA Co. The following information was available on December 31 just before the combination:

	AA Co.	LA Co.
Shares issued	100,000	200,000
Fair value per share	$80	$10

Based on the foregoing information, if LA issues 800,000 shares for all of AA's common stock,

A. LA is the accounting acquirer.

B. The measure of the consideration transferred may be based on an issuance of 25,000 shares by AA.

C. AA is the legal acquirer.

D. The measure of the consideration transferred is $800,000.

Answer (B) is correct. *(Publisher, adapted)*

REQUIRED: The true statement about a reverse acquisition.

DISCUSSION: This transaction is a reverse acquisition. AA apparently is the accounting acquirer (even though it is the legal acquiree) based on its 80% relative voting interest in the combined entity [800,000 ÷ (800,000 + 200,000)]. Thus, LA is the accounting acquiree and legal acquirer. AA issued no consideration. Thus, measuring the consideration transferred requires determining how many shares the accounting acquirer would have had to issue to achieve the same ownership percentages in the combined entity. Accordingly, the consideration effectively transferred is 25,000 shares of AA stock for all 200,000 shares of LA stock [(100,000 ÷ 80%) – 100,000]. The acquisition-date fair value of the consideration transferred is the more reliably measurable of 25,000 shares of AA stock or 200,000 shares of LA stock.

Answer (A) is incorrect because AA is the accounting acquirer and the legal acquiree. Answer (C) is incorrect because LA is the legal acquirer and accounting acquiree. Answer (D) is incorrect because the acquisition-date fair value of the consideration transferred is the more reliably measurable of 25,000 shares of AA stock or 200,000 shares of LA stock.

15. According to SFAS 141 (revised 2007), *Business Combinations*, a business must

A. Have goodwill.

B. Generate a return.

C. Be capable of being managed to provide economic benefits.

D. Have inputs, outputs, and processes.

Answer (C) is correct. *(CPA, adapted)*

REQUIRED: The element of a business.

DISCUSSION: The activities and assets of a business are capable of being managed to provide economic benefits (returns such as dividends, and lower costs). Processes are applied to inputs to generate outputs. Outputs are direct returns to investors and other participants.

Answer (A) is incorrect because a set of activities and assets that includes goodwill is presumed to be a business. However, a business need not have goodwill. Answer (B) is incorrect because a business must be capable of being managed to provide economic benefits (a return). It need not have outputs or returns. Answer (D) is incorrect because a business need not have outputs if it is capable of being managed to provide them.

16. Acquirer Co. and Acquiree Co. are in negotiations for a business combination. Acquirer suggested to Acquiree that it reach agreements with certain key executives to make payments with a total amount of $5,000,000 if negotiations succeed. Acquiree already had a contract with its chief executive to make a $10,000,000 payment if the company was acquired. This contract was agreed to several years before any acquisition was contemplated. What amount, if any, of these payments most likely is part of the exchange for the acquiree?

A. $15,000,000

B. $10,000,000

C. $5,000,000

D. $0

Answer (B) is correct. *(CPA, adapted)*

REQUIRED: The payments, if any, that are part of the exchange for the acquiree.

DISCUSSION: Under the acquisition method, one recognition condition is that assets and liabilities be part of the exchange (part of the consideration transferred for the acquiree). The assumption of the $10,000,000 liability to the chief executive of Acquiree is not part of a separate arrangement with Acquirer reached before or during the negotiations for the combination. Moreover, the purpose was apparently to obtain (or retain) the services of the chief executive, a benefit to Acquiree. However, the agreement with other key executives was made by Acquiree at the suggestion of Acquirer to provide termination payments, a likely benefit to Acquirer. Accordingly, the acquisition-date fair value of the $10,000,000 liability is included in the accounting for the combination. The $5,000,000 of other termination payments will be accounted for separately.

Answer (A) is incorrect because the $5,000,000 in payments apparently is for the benefit of Acquirer. Answer (C) is incorrect because the assumption of the $10,000,000 liability to the chief executive is part of the consideration transferred for the acquiree. The assumption of the $5,000,000 liability is postcombination compensation for the departures of certain key executives. Answer (D) is incorrect because the assumption of the $10,000,000 liability to the chief executive is part of the consideration transferred for the acquiree.

17. Acquirer and Acquiree are the combining entities in a business combination. As part of the bargain, Acquirer assumed a contingent liability based on a suit brought against Acquiree because of a defect in one of its products. However, the former owner of Acquiree has agreed to pay the amount of any damages in excess of $5,000,000. In the consolidated balance sheet issued on the acquisition date, the contingent liability is reported at acquisition-date fair value. Accordingly,

A. An indemnification asset is recognized at acquisition-date fair value.

B. A valuation allowance is reported for the indemnification asset.

C. An exception to the customary accounting for a business combination applies.

D. No indemnification asset is recognized until the contingency is resolved.

Answer (A) is correct. *(CPA, adapted)*

REQUIRED: The effect of the acquiree's agreement to pay excess damages related to a contingent liability assumed by the acquirer.

DISCUSSION: The contingent liability for damages resulting from a lawsuit is noncontractual. However, if it is more likely than not at the acquisition date that a noncontractual contingency will result in a liability or an asset, it will be measured at acquisition-date fair value. Moreover, the indemnification asset and the indemnified item are recognized at the same time and on the same basis. Thus, the indemnification asset also is recognized at acquisition-date fair value.

Answer (B) is incorrect because no valuation allowance is necessary when an item is recognized at acquisition-date fair value. The effects of uncertainty are reflected in the fair value measurement. Answer (C) is incorrect because the asset is recognized at acquisition-date fair value. The exception for items measured using SFAS 5, *Accounting for Contingencies*, does not apply. Answer (D) is incorrect because the indemnification asset and the indemnified item are recognized at the same time.

18. As part of its acquisition of Acquiree, Acquirer is contractually bound to exchange its share-based payment awards for those held by Acquiree's employees. What amount of the replacement award is included in the consideration transferred for the combination?

A. None.

B. The total fair-value-based measure, including the amount for postcombination service.

C. The amount treated as compensation cost.

D. The amount of the Acquiree award attributed to precombination service.

Answer (D) is correct. *(Publisher, adapted)*

REQUIRED: The amount of the replacement award included in the consideration transferred.

DISCUSSION: Acquirer was obligated to make the replacement award. Thus, all or part of its fair-value-based (FVB) measure must be included in the consideration transferred for the combination. This amount equals the part of Acquiree's award attributed to precombination service.

Answer (A) is incorrect because the amount of the Acquiree award attributed to precombination service is part of the consideration. Answer (B) is incorrect because the amount attributed to postcombination service is accounted for as compensation cost. Answer (C) is incorrect because the amount treated as compensation cost relates to postcombination service and therefore is not part of the consideration.

19. In a business combination, the accounting information required at the reporting date may be incomplete. Accordingly, provisional amounts are recognized. Which of the following is true about adjustments to those amounts during the measurement period?

A. Appropriate adjustments have no effect on earnings.

B. No new assets may be recognized.

C. Adjustments based on postacquisition-date information may be made.

D. Goodwill is unaffected.

Answer (A) is correct. *(Publisher, adapted)*

REQUIRED: The true statement about adjustments to provisional amounts.

DISCUSSION: Provisional amounts are retrospectively adjusted and additional assets and liabilities are recognized if new information becomes available about facts existing at the acquisition date. But these adjustments, which may be made for up to one year after the acquisition date, are not reported in earnings.

Answer (B) is incorrect because additional assets and liabilities may be recognized. Answer (C) is incorrect because adjustments are made based on new information about facts existing at the acquisition date. Answer (D) is incorrect because a change in a provisional amount for an asset or liability affects goodwill. But multiple adjustments may be offsetting.

15.2 Consolidation

20. Parent owns 80% of the 1,000,000 outstanding common shares of Sub. The carrying amount of Sub's equity is $20,000,000, of which $16,000,000 is the carrying amount of Parent's interest. Parent then sells 200,000 of its Sub common shares to a third party for $25 per share. To reflect this transaction from the consolidated perspective, the entry includes a credit to

A. A gain for $1,000,000.

B. Additional paid-in capital for $1,000,000.

C. Noncontrolling interest for $6,000,000.

D. A loss for $1,000,000.

Answer (B) is correct. *(Publisher, adapted)*

REQUIRED: The effect of a parent's sale of a subsidiary's shares while retaining a majority voting interest.

DISCUSSION: A parent's ownership interest may change without loss of its controlling financial interest. For example, the parent or subsidiary may buy or sell the subsidiary's ownership interests. These changes are equity transactions. No gain or loss is recognized in the consolidated statements. The carrying amount of the noncontrolling interest is adjusted. The difference between the consideration given or received and the adjustment is recognized in equity attributable to the parent. The initial carrying amount of the noncontrolling interest is $4,000,000 [$20,000,000 × (100% – 80% held by Parent)]. Parent's initial carrying amount is $16,000,000 ($20,000,000 – $4,000,000), of which 25% [200,000 shares ÷ (1,000,000 shares × 80%)] is sold. Accordingly, the entry from a consolidated perspective is to debit cash for $5,000,000 (200,000 shares × $25), credit the noncontrolling interest for $4,000,000 ($16,000,000 Parent's carrying amount × 25%), and credit additional paid-in capital - Parent (equity attributable to the parent) for $1,000,000.

Answer (A) is incorrect because Parent has retained what is presumably a controlling financial interest. Thus, its sale of Sub shares is an equity transaction. Answer (C) is incorrect because the credit to the noncontrolling interest is $4,000,000. Answer (D) is incorrect because no gain or loss is recognized in an equity transaction.

21. Acquiree Co. is a 90%-owned subsidiary of Acquirer Co. The carrying amounts of the noncontrolling interest and the subsidiary are $1,000,000 and $10,000,000, respectively. The subsidiary's fair value is $15,000,000. Acquirer transferred part of its interest to Third Co. on December 31 for $12,000,000 in cash but retained a noncontrolling interest equal to 20% of Acquiree's voting interests. The fair value of the retained interest, which gives Acquirer significant influence, is $3,000,000. The fair values and carrying amounts are as of December 31. Acquirer must account for this transaction

A. At the recorded amount of the assets transferred.

B. By recognizing a gain of $6,000,000.

C. By recognizing a gain of $1,000,000.

D. By recognizing a loss of $3,000,000.

Answer (B) is correct. *(Publisher, adapted)*

REQUIRED: The parent's accounting for a deconsolidation while retaining significant influence.

DISCUSSION: If APB Opinion 29 does not apply, the parent records a deconsolidation by recognizing a gain or loss in net income attributable to the parent. It equals the difference between (1) the sum of (a) the fair value of consideration received, (b) the fair value of any retained investment at the date of deconsolidation, and (c) the carrying amount of any noncontrolling interest (including accumulated other comprehensive income attributable to the noncontrolling interest at the date of deconsolidation; and (2) the carrying amount of the subsidiary. Consequently, the gain is $6,000,000 [($12,000,000 + $3,000,000 + $1,000,000) – $10,000,000].

Answer (A) is incorrect because APB Opinion 29, *Accounting for Nonmonetary Transactions*, requires that certain nonreciprocal transfers of nonmonetary assets to owners be based on the recorded amount of the assets given up. These transfers are made "in a spinoff or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination." The recorded amount is determined after recognition of any impairment loss. However, this deconsolidation is not a nonreciprocal transfer. Answer (C) is incorrect because $1,000,000 assumes that the carrying amount of the subsidiary is $15,000,000. Answer (D) is incorrect because $3,000,000 is the difference between the consideration received and the fair value of the subsidiary.

22. A 70%-owned subsidiary declares and pays a cash dividend. What effect does the dividend have on the retained earnings and noncontrolling interest balances in the consolidated balance sheet?

A. No effect on either retained earnings or the noncontrolling interest.

B. No effect on retained earnings and a decrease in the noncontrolling interest.

C. Decreases in both retained earnings and the noncontrolling interest.

D. A decrease in retained earnings and no effect on the noncontrolling interest.

Answer (B) is correct. *(CPA, adapted)*

REQUIRED: The effect of payment of a cash dividend by a subsidiary.

DISCUSSION: The parent's investment in subsidiary, dividends, and the subsidiary's equity accounts, which include retained earnings, are among the eliminations in a consolidation. The equity (net assets) of the subsidiary not directly or indirectly attributable to the parent is reported separately as the noncontrolling interest. Consolidated retained earnings equals the accumulated earnings of the consolidated group not distributed to the owners of, or capitalized by, the parent. Thus, it equals the parent's retained earnings. Accordingly, the subsidiary's cash dividend reduces its retained earnings balance and the noncontrolling interest but not the consolidated retained earnings.

Answer (A) is incorrect because cash dividends from a subsidiary decrease the noncontrolling interest. Answer (C) is incorrect because cash dividends from a subsidiary have no effect on consolidated retained earnings but decrease the noncontrolling interest. Answer (D) is incorrect because cash dividends from a subsidiary have no effect on consolidated retained earnings.

23. On January 1, Year 4, Pane Corp. exchanged 150,000 shares of its $20 par value common stock for all of Sky Corp.'s common stock. At that date, the fair value of Pane's common stock issued was equal to the carrying amount of Sky's identifiable net assets. Both corporations continued to operate as separate businesses, maintaining accounting records with years ending December 31. In its separate statements, Pane accounts for the investment using the equity method. Information from separate company operations follows:

	Pane	Sky
Retained earnings – 12/31/Yr 3	$3,200,000	$925,000
Net income – 6 months ended 6/30/Yr 4	800,000	275,000
Dividends paid – 3/25/Yr 4	750,000	--

What amount of retained earnings should Pane report in its June 30, Year 4, consolidated balance sheet?

A. $5,200,000

B. $4,450,000

C. $3,525,000

D. $3,250,000

Answer (D) is correct. *(CPA, adapted)*

REQUIRED: The consolidated retained earnings.

DISCUSSION: The retained earnings of the subsidiary (Sky) at the acquisition date (1/1/Yr 4) are excluded from consolidated retained earnings (ARB 51, amended by SFAS 160). Furthermore, in its separate income statement, the parent (Pane) applies the equity method to account for its share of the net income of the subsidiary since 1/1/Yr 4. The subsidiary's revenues, expenses, gains, and losses are included in the consolidated statements only from the initial consolidation date (1/1/Yr 4). Thus, Pane's separate net income ($800,000) since 1/1/Yr 4 includes 100% of the net income of Sky, a 100%-owned subsidiary. Accordingly, the consolidated retained earnings at 6/30/Yr 4 equals (1) Pane's retained earnings at 12/31/Yr 3, (2) plus Pane's net income for the previous six months, (3) minus dividends paid. This amount is $3,250,000.

Answer (A) is incorrect because $5,200,000 includes Sky's retained earnings at 6/30/Yr 4 and does not reflect an adjustment for the dividends paid. Answer (B) is incorrect because $4,450,000 equals the consolidated retained earnings if the combination had been accounted for as a pooling, a method no longer applicable to business combinations. Answer (C) is incorrect because $3,525,000 double counts Sky's net income through 6/30/Yr 4. This amount is included in Pane's separate net income.

24. In the consolidated financial statements of a parent and its 90%-owned subsidiary,

A. Comprehensive income or loss is attributed to the parent and the noncontrolling interest

B. Consolidated net income or loss is the amount attributable to the parent.

C. Consolidated equity is the amount attributable to the parent.

D. Revenues are reported at the separate amounts attributable to the parent and the noncontrolling interest.

Answer (A) is correct. *(Publisher, adapted)*

REQUIRED: The presentation of consolidated amounts given a noncontrolling interest.

DISCUSSION: In whichever presentation of consolidated comprehensive income or loss is chosen, the noncontrolling interest's adjusted share of the subsidiary's comprehensive income or loss is subtracted from the consolidated amount to determine the amount attributable to the parent. Thus, three amounts are displayed on the face of the consolidated statements: (1) a total, (2) the noncontrolling interest's share, and (3) the parent's share.

Answer (B) is incorrect because consolidated net income or loss (a total) consists of the amounts attributable to the parent and the noncontrolling interest. All three amounts are reported. Answer (C) is incorrect because consolidated equity consists of separately reported amounts for the parent and the noncontrolling interest. Answer (D) is incorrect because revenues, expenses, gains, and losses are reported at their consolidated amounts (the sums of the amounts attributable to the parent and the noncontrolling interest).

Questions 25 and 26 are based on the following information. Suwannee Company issued 20,000 additional shares of its common stock for $1.6 million. Suwannee Company's equity sections immediately before and immediately after this issuance are presented below:

	Before	After
Common stock, $10 par	$1,000,000	$1,200,000
Additional paid-in capital	2,500,000	3,900,000
Retained earnings	3,900,000	3,900,000
Total equity	$7,400,000	$9,000,000

25. Assume that Suwannee issued this stock to the general public and that Palatka Corporation holds 80,000 of the outstanding shares of Suwannee. The effect on the equity of the subsidiary attributable to the parent is

A. $0

B. An $80,000 increase.

C. An $80,000 decrease.

D. A $1,280,000 increase.

Answer (B) is correct. *(Publisher, adapted)*

REQUIRED: The effect on equity attributable to the parent of a subsidiary's issuance of shares to the public.

DISCUSSION: Immediately prior to the issuance of the additional shares, Palatka's ownership interest was 80% (80,000 shares held ÷ 100,000 shares outstanding). Its proportionate interest in the subsidiary's equity was $5,920,000 ($7,400,000 × 80%). Immediately after the issuance of the shares, Palatka's ownership interest was 66-2/3% (80,000 shares held ÷ 120,000 shares outstanding). Its proportionate ownership interest in the subsidiary's equity increased to $6,000,000 ($9,000,000 × 66-2/3%). Moreover, the amount of the subsidiary's equity attributable to the noncontrolling interest increased from $1,480,000 ($7,400,000 × 20%) to $3,000,000 ($9,000,000 × 33-1/3%). Accordingly, from the consolidated perspective, the entry is to (1) debit cash for $1,600,000 (2) credit additional paid-in capital for $80,000 ($6,000,000 – $5,920,000), and (3) credit the noncontrolling interest for $1,520,000 ($3,000,000 – $1,480,000). This accounting is appropriate because the change in the parent's ownership interest occurred while it retained a controlling financial interest. Thus, no business combination occurred. (1) The change is treated as an equity transaction, (2) no consolidated gain or loss is recognized, (3) the noncontrolling interest is adjusted, and (4) the difference between the fair value of the consideration and the noncontrolling interest adjustment is recognized in the parent's share of equity (ARB 51 as amended by SFAS 160).

Answer (A) is incorrect because the equity of the subsidiary attributable to the parent must be adjusted. Answer (C) is incorrect because $80,000 is an increase credited to consolidated additional paid-in capital. Answer (D) is incorrect because $1,280,000 assumes that the ownership percentage remained at 80%.

26. Assume that Suwannee Company issued the 20,000 additional shares to Palatka Corporation, whose ownership interest in Suwannee increased to 100,000 shares. If the carrying amount of the acquired net assets of Suwannee is equal to their fair value at the time the additional shares are issued, the goodwill indicated in the acquisition of the additional shares equals

A. $0

B. $20,000

C. $320,000

D. $1,580,000

Answer (A) is correct. *(Publisher, adapted)*

REQUIRED: The goodwill indicated in the acquisition of the additional shares.

DISCUSSION: Recognition of goodwill is not appropriate because the change in the parent's ownership interest occurred while it retained a controlling financial interest. Thus, no business combination occurred. (1) The change is treated as an equity transaction, (2) no consolidated gain or loss is recognized, (3) the noncontrolling interest is adjusted, and (4) the difference between the fair value of the consideration and the noncontrolling interest adjustment is recognized in the parent's share of equity (ARB 51 as amended by SFAS 160). The parent transferred $1,600,000 to the subsidiary for 20,000 shares. As a result, the parent's proportionate ownership interest increased from 75% (80,000 shares ÷ 100,000 shares) to 83-1/3% (100,000 shares ÷ 120,000 shares). Moreover, the amount of the subsidiary's equity attributable to the parent increased from $5,920,000 ($7,400,000 × 80%) to $7,500,000 ($9,000,000 × 83-1/3%). Also, the amount of the subsidiary's equity attributable to the noncontrolling interest increased from $1,480,000 ($7,400,000 × 20%) to $1,500,000 ($9,000,000 × 16-2/3%). Accordingly, from the consolidated perspective, the entry is to debit additional paid in capital and credit the noncontrolling interest for $20,000 ($1,500,000 – $1,480,000). Because the transfer of cash for shares was from the parent to the subsidiary, it is eliminated in consolidation. Thus, the total consolidated equity did not change, but its attribution did.

Answer (B) is incorrect because $20,000 is the excess of the $1,600,000 price paid over $1,580,000. The latter amount is the increase in the parent's proportionate ownership of the subsidiary's equity [($9,000,000 × 83-1/3%) – ($7,400,000 × 80%)]. Answer (C) is incorrect because $320,000 is the increase (credit to) the noncontrolling interest if the parent's ownership percentage did not change. Answer (D) is incorrect because $1,580,000 is the increase in the parent's proportionate interest in the subsidiary's equity.

27. Wright Corp. has several subsidiaries that are included in its consolidated financial statements. In its December 31 trial balance, Wright had the following intraentity balances before eliminations:

	Debit	Credit
Current receivable due from Main Co.	$ 32,000	
Noncurrent receivable from Main Co.	114,000	
Cash advance to Corn Corp.	6,000	
Cash advance from King Co.		$ 15,000
Payable to King Co.		101,000

In its December 31 consolidated balance sheet, what amount should Wright report as intraentity receivables?

A. $152,000

B. $146,000

C. $36,000

D. $0

Answer (D) is correct. *(CPA, adapted)*

REQUIRED: The amount reported as intraentity receivables.

DISCUSSION: In a consolidated balance sheet, reciprocal balances, such as receivables and payables, between a parent and a consolidated subsidiary should be eliminated in their entirety regardless of the portion of the subsidiary's stock held by the parent. Thus, Wright should report $0 as intraentity receivables.

Answer (A) is incorrect because $152,000 includes intraentity transactions in the consolidated financial statements. Answer (B) is incorrect because the effects of intraentity transactions should be completely eliminated in consolidated financial statements. Answer (C) is incorrect because intraentity transactions should not be netted out in the consolidated financial statements.

28. Parma Corp. and Seville Corp. condensed balance sheets on January 1 are presented below. On January 2, Parma borrowed $60,000 and used the proceeds to purchase 90% of the outstanding common shares of Seville. Parma had no prior equity interest in Seville. Ten equal principal and interest payments begin December 30. The excess of the consideration transferred over Seville's carrying amount of its identifiable net assets should be assigned 60% to inventory and 40% to goodwill. Moreover, the per-share fair value of the controlling and noncontrolling interests is the same at the acquisition date.

	Parma	Seville
Current assets	$ 70,000	$20,000
Noncurrent assets	90,000	40,000
Total assets	$160,000	$60,000
Current liabilities	$ 30,000	$10,000
Long-term debt	50,000	--
Equity	80,000	50,000
Total liabilities and equity	$160,000	$60,000

On Parma's January 2 consolidated balance sheet, equity should be

A. $80,000

B. $86,000

C. $90,000

D. $130,000

Answer (A) is correct. *(CPA, adapted)*

REQUIRED: The equity in the consolidated balance sheet.

DISCUSSION: The noncontrolling interest is the part of equity of a subsidiary not attributable to the parent. Thus, the equity section of the consolidated balance sheet at the acquisition date is not the same as the equity section of the parent's separate balance sheet. Consolidated equity includes the fair value of the 10% noncontrolling interest presented separately from the parent's equity. Parma's 90% interest in the carrying amount of the identifiable net assets of Seville is $45,000 ($50,000 equity × 90%). Parma paid $60,000. Of the $15,000 difference, 60% ($9,000) is assignable to the excess of the fair value of inventory over its carrying amount and 40% to goodwill ($6,000). Hence, the total excess fair value of the inventory is $10,000 ($9,000 ÷ 90%). Assuming that (1) the carrying amounts of Seville's other assets and liabilities equal their fair values and (2) the fair values of the 90% interest and the 10% interest are proportionate (it is given that the per-share fair values are equal), the fair value of the noncontrolling interest may be calculated. Accordingly, it equals $6,000 [($50,000 carrying amount of Seville's equity – $45,000 attributable to the 90% interest)] + ($10,000 excess of the FV of Seville's inventory – $9,000 attributable to the 90% interest)]. Consolidated equity is the sum of current assets and noncurrent assets, minus current liabilities and noncurrent liabilities, minus the fair value of the noncontrolling interest. Current assets equal $100,000 ($70,000 + $20,000 + $10,000 excess FV of inv.). Noncurrent assets equal $136,000 ($90,000 + $40,000 + $6,000 goodwill). Current liabilities equal $46,000 ($30,000 + $10,000 + $6,000 current component of new debt). Noncurrent liabilities equal $104,000 ($50,000 + $54,000 noncurrent component of new debt). Thus, consolidated equity is $80,000 ($100,000 + $136,000 – $46,000 – $104,000 – $6,000 FV of noncontrolling interest).

Answer (B) is incorrect because $86,000 equals Parma's equity at 1/1 plus the fair value of the noncontrolling interest. Answer (C) is incorrect because $90,000 equals the total liabilities of the two companies at 1/1. Answer (D) is incorrect because $130,000 is the sum of the equity amounts for Parma and Seville at 1/1.

29. Pelota Co. owns 80% of Saginaw Co.'s outstanding common stock. Saginaw, in turn, owns 10% of Pelota's outstanding common stock. What percentage of the common stock cash dividends declared by the individual companies should be reported as dividends declared in the consolidated financial statements?

	Dividends Declared by Pelota	Dividends Declared by Saginaw
A.	90%	0%
B.	90%	20%
C.	100%	0%
D.	100%	20%

Answer (A) is correct. *(CPA, adapted)*

REQUIRED: The dividends declared by a parent and its subsidiary reported in the consolidated statements.

DISCUSSION: Because the parent owns 80% of the subsidiary and the subsidiary owns 10% of the parent, 80% of the dividends declared by the subsidiary and 10% of the dividends declared by the parent are not transferred outside of the consolidated group. These amounts are eliminated as intraentity transactions. Consequently, 90% of the parent's and 20% of the subsidiary's dividend payments are to third parties. The 90% declared by the parent will be reported as dividends declared. The 20% declared by the subsidiary is treated as a reduction of the noncontrolling interest in the consolidated financial statements, not as consolidated dividends declared.

Answer (B) is incorrect because 0% of the subsidiary's dividends are treated as consolidated dividends declared. Answer (C) is incorrect because 90% of the parent's dividends are treated as consolidated dividends declared. Answer (D) is incorrect because 90% of the parent's dividends and 0% of the subsidiary's are treated as consolidated dividends declared.

30. Perez, Inc. owns 80% of Senior, Inc. During the year just ended, Perez sold goods with a 40% gross profit to Senior. Senior sold all of these goods during the year. In its consolidated financial statements for the year, how should the summation of Perez and Senior income statement items be adjusted?

A. Sales and cost of goods sold should be reduced by the intraentity sales.

B. Sales and cost of goods sold should be reduced by 80% of the intraentity sales.

C. Net income should be reduced by 80% of the gross profit on intraentity sales.

D. No adjustment is necessary.

Answer (A) is correct. *(CPA, adapted)*

REQUIRED: The adjustment for intraentity inventory sales.

DISCUSSION: Given that all of the goods were sold, no adjustment is necessary for intraentity profit in ending inventory. Accordingly, the parent's cost should be included in consolidated cost of goods sold, and the price received by the subsidiary should be included in consolidated sales. The required adjustment is to eliminate the sale recorded by the parent and the cost of goods sold recorded by the subsidiary.

Answer (B) is incorrect because the elimination is made without regard to the noncontrolling interest. Answer (C) is incorrect because no profit should be eliminated. All of the goods sold to Senior have been resold. Answer (D) is incorrect because sales and cost of sales should be reduced.

31. Scroll, Inc., a wholly owned subsidiary of Pirn, Inc., began operations on January 1. The following information is from their condensed Year 1 income statements:

	Pirn	Scroll
Sales to Scroll	$100,000	$ --
Sales to others	400,000	300,000
	$500,000	$300,000
Cost of goods sold:		
Acquired from Pirn	--	80,000
Acquired from others	350,000	190,000
Gross profit	$150,000	$ 30,000

Sales by Pirn to Scroll are made on the same terms as those made to third parties. In Pirn's December 31 consolidating worksheet, how much intraentity profit should be eliminated from Scroll's inventory?

A. $30,000

B. $20,000

C. $10,000

D. $6,000

Answer (D) is correct. *(CPA, adapted)*

REQUIRED: The intraentity profit to be eliminated from Scroll's inventory.

DISCUSSION: Sales by Pirn to Scroll totaled $100,000, and Scroll reported related CGS of $80,000. Thus, the remaining inventory of these items must have been $20,000. Because Pirn's gross profit rate was 30% ($150,000 gross profit ÷ $500,000 sales), the intraentity profit eliminated from Scroll's inventory should be $6,000 ($20,000 × 30%).

Answer (A) is incorrect because $30,000 is Scroll's total gross profit. Answer (B) is incorrect because $20,000 is the intraentity inventory. Answer (C) is incorrect because $10,000 equals the total gross profit minus the intraentity obtained from Pirn.

32. At January 1, Seacoast Company, an 80%-owned subsidiary of Plantation Corporation, had $1 million face amount of 14% bonds outstanding. They had been issued at face amount. Market conditions at January 1 provided a 10% yield rate when Plantation purchased these bonds in the open market for $1.1 million. Which of the following amounts should be included in a consolidated income statement for the year?

A. Bond interest expense of $140,000.

B. Bond interest revenue of $110,000.

C. Constructive loss of $100,000.

D. Constructive loss of $80,000.

Answer (C) is correct. *(Publisher, adapted)*

REQUIRED: The amount included in the consolidated income statement.

DISCUSSION: Because a consolidated financial statement should include both Plantation and Seacoast as a single (consolidated) reporting entity, the purchase of the $1 million outstanding bonds of Seacoast by Plantation for $1.1 million was in substance a retirement of debt for $100,000 more than the debt's carrying amount. This transaction should be reflected in the consolidated income statement as a constructive loss from the retirement of debt in the amount of $100,000.

Answer (A) is incorrect because intraentity interest expense of $140,000 must be eliminated in the consolidated financial statements. Answer (B) is incorrect because intraentity interest revenue of $110,000 must be eliminated in the consolidated financial statements. Answer (D) is incorrect because ARB 51 requires an adjustment for the total loss, not just the parent's share.

33. According to FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*,

A. A not-for-profit organization may not be treated as a variable interest entity.

B. A variable interest entity has an equity investment of more than 10% of its total assets.

C. A variable interest entity is consolidated by its primary beneficiary when the beneficiary becomes involved with the entity.

D. Corporations may not be organized as variable interest entities.

Answer (C) is correct. *(Publisher, adapted)*

REQUIRED: The true statement about VIEs.

DISCUSSION: In essence, a variable interest entity (VIE) is any legal structure (including, but not limited to, those previously described as special-purpose entities) with insufficient equity investment or whose equity investors lack one of the essential characteristics of financial control. When an entity becomes involved with a VIE, it must determine whether it is the primary beneficiary (PB) and therefore must consolidate the VIE. A PB holds a variable interest(s) that will absorb a majority of the VIE's expected losses or receive a majority of its expected residual returns (or both).

Answer (A) is incorrect because this Interpretation applies to NPOs if they are used to avoid the requirements of the pronouncement. Answer (B) is incorrect because an entity qualifies as a VIE if the equity at risk does not suffice to finance entity activities without additional subordinated financial support. An equity investment of less than 10% of total assets is usually considered to be insufficient. But a greater investment also may not suffice if, for example, assets or entity activities are high risk. Answer (D) is incorrect because a VIE may take any form.

15.3 Combined Financial Statements

34. Combined statements may be used to present the results of operations of

	Entities under Common Management	Commonly Controlled Entities
A.	No	Yes
B.	Yes	No
C.	No	No
D.	Yes	Yes

Answer (D) is correct. *(CPA, adapted)*

REQUIRED: The use(s) of combined financial statements.

DISCUSSION: ARB 51 (as amended by SFAS 160) states that combined (as distinguished from consolidated) statements of commonly controlled entities may be more meaningful than separate statements. For example, combined statements may be used (1) to combine the statements of several entities with related operations when one individual owns a controlling financial interest in them or (2) to combine the statements of entities under common management.

Answer (A) is incorrect because common management justifies use of combined statements. Answer (B) is incorrect because common control justifies use of combined statements. Answer (C) is incorrect because either common management or common control justifies use of combined statements.

35. Ahm Corp. owns 90% of Bee Corp.'s common stock and 80% of Cee Corp.'s common stock. The remaining common shares of Bee and Cee are owned by their respective employees. Bee sells exclusively to Cee, Cee buys exclusively from Bee, and Cee sells exclusively to unrelated companies. Selected information for Bee and Cee for the year follows:

	Bee Corp.	Cee Corp.
Sales	$130,000	$91,000
Cost of sales	100,000	65,000
Beginning inventory	None	None
Ending inventory	None	65,000

What amount should be reported as gross profit in Bee and Cee's combined income statement for the year ended December 31?

A. $26,000

B. $41,000

C. $47,800

D. $56,000

Answer (B) is correct. *(CPA, adapted)*

REQUIRED: The amount reported as gross profit in the combined income statement.

DISCUSSION: Cee buys exclusively from Bee. Thus, Cee's cost of sales equals the sales price charged by Bee, which represented a 30% [($130,000 – $100,000) ÷ $100,000] markup on the cost to the combined entity. Consequently, the gross profit of the combined entity on sales to unrelated companies should include Bee's markup as well as Cee's gross profit. Because Bee's sales were 130% of its cost, the cost to the entity of Cee's sales was $50,000 ($65,000 cost of sales ÷ 130%). The gross profit in the combined income statement was therefore $41,000 ($91,000 – $50,000).

Answer (A) is incorrect because $26,000 was Cee's gross profit. Answer (C) is incorrect because $47,800 is the sum of 90% of Bee's and 80% of Cee's gross profits. Answer (D) is incorrect because $56,000 is the sum of Bee's and Cee's gross profits.

36. Mr. and Mrs. Gasson own 100% of the common stock of Able Corp. and 90% of the common stock of Baker Corp. Able previously paid $4,000 for the remaining 10% interest in Baker. The condensed December 31 balance sheets of Able and Baker are as follows:

	Able	Baker
Assets	$600,000	$60,000
Liabilities	$200,000	$30,000
Common stock	100,000	20,000
Retained earnings	300,000	10,000
	$600,000	$60,000

In a combined balance sheet of the two corporations at December 31, what amount should be reported as total equity?

A. $430,000

B. $426,000

C. $403,000

D. $400,000

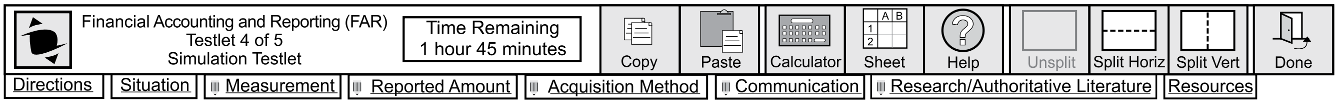
Answer (B) is correct. *(CPA, adapted)*

REQUIRED: The total equity reported in a combined balance sheet.

DISCUSSION: Combined statements are prepared in much the same manner as consolidated statements. Hence, reciprocal ownership and the related portion of equity must be eliminated. The investment in Baker's account must be credited and equity debited for $4,000. Consequently, the combined total equity is $426,000 [($400,000 common stock and RE of Able + $30,000 common stock and RE of Baker) – $4,000].

Answer (A) is incorrect because $430,000 does not reflect the elimination of the reciprocal ownership. Answer (C) is incorrect because $403,000 equals Able's equity plus 10% of Baker's. Answer (D) is incorrect because $400,000 equals Able's separate equity.

15.4 PRACTICE SIMULATION



1. Directions

In the following simulation, you will be asked to complete various tasks. You may use the content in the **Information Tabs** to complete the tasks in the **Work Tabs**.

Information Tabs:

FIG 1

- Go through each of the **Information Tabs** to familiarize yourself with the simulation content
- The **Resources** tab will contain information, including formulas and definitions, that may help you to complete the tasks
- Your simulation may have more **Information Tabs** than those shown in Fig. 1

Work Tabs:

FIG. 2

- **Work Tabs**, to the right of **Information Tabs**, contain the tasks for you to complete
- **Work Tabs** contain directions for completing each task - be sure to read these directions carefully
- The tab names in Fig. 2 are for illustration only - yours may differ
- Once you complete any part of a task, the pencil for that tab will be shaded (see **Communication** in Fig. 2)
- The shaded pencil does **NOT** indicate that you have completed the entire task
- You must complete all of the tasks in the **Work Tabs** to receive full credit

Research/Authoritative Literature Tab:

FIG. 3

- This tab contains both the Research task and the Authoritative Literature
- Detailed instructions for completing the Research task, and for using the Authoritative Literature, appear on this tab
- You may use the Authoritative Literature as a resource for completing other tasks

NOTE: If you believe you have encountered a software malfunction, report it to the test center staff immediately.

2. Situation

Presented below are selected amounts from the separate unconsolidated financial statements of Poe Corp. and its 90%-owned subsidiary, Shaw Co., at December 31, Year 2. Additional information follows:

	Poe	*Shaw*
Selected income statement amounts		
Sales	$710,000	$530,000
Cost of goods sold	490,000	370,000
Gain on sale of equipment		21,000
Earnings from investment in subsidiary	61,000	
Interest expense		16,000
Depreciation	25,000	20,000
Selected balance sheet amounts		
Cash	$ 50,000	$ 15,000
Inventories	229,000	150,000
Equipment	440,000	360,000
Accumulated depreciation	(200,000)	(120,000)
Investment in Shaw	189,000	
Investment in bonds	100,000	
Discount on bonds	(9,000)	
Bonds payable		(200,000)
Common stock	(100,000)	(10,000)
Additional paid-in capital	(250,000)	(40,000)
Retained earnings	(402,000)	(140,000)
Selected statement of retained earnings amounts		
Beginning balance, December 31, Year 1	$272,000	$100,000
Net income	210,000	70,000
Dividends paid	80,000	30,000

Additional information

- On January 2, Year 2, Poe Corp. purchased 90% of Shaw Co.'s 100,000 outstanding common shares for cash of $155,000. On that date, Shaw's equity accounts equaled $150,000, and the acquisition-date fair values of Shaw's assets and liabilities equaled their carrying amounts.
- On September 4, Year 2, Shaw paid cash dividends of $30,000.
- On December 31, Year 2, Poe recorded its equity in Shaw's earnings.

3. Measurement

This question is presented in a spreadsheet format that requires you to fill in the correct responses in the shaded cells provided.

For each of the following, determine its dollar effect on Year 2 consolidated income before considering the noncontrolling interest. Ignore income tax considerations.

Transaction	***Amount***
1. On January 3, Year 2, Shaw sold equipment with an original cost of $30,000 and a carrying amount of $15,000 to Poe for $36,000. The equipment had a remaining life of 3 years and was depreciated using the straight-line method by both companies.	
2. During Year 2, Shaw sold merchandise to Poe for $60,000, which included a profit of $20,000. At December 31, Year 2, half of this merchandise remained in Poe's inventory.	
3. On December 31, Year 2, Poe paid $91,000 to purchase 50% of the outstanding bonds issued by Shaw. The bonds mature on December 31, Year 8, and were originally issued at their face amount. The bonds pay interest annually on December 31 of each year, and the interest was paid to the prior investor immediately before Poe's purchase of the bonds.	
4. Poe recognized goodwill on January 2, Year 2. It determined on December 31, Year 2, that goodwill was not impaired.	

4. Reported Amount

This set of questions has a matching format. Select the best match for each numbered item from the terms in the drop-down list and write its letter in the column provided. Each answer choice may be used once, more than once, or not at all.

The items in the accounts column may or may not be included in the consolidated financial statements. The list of choices contains descriptions of amounts to be reported in the consolidated financial statements for the year ended December 31, Year 2. Consider all the transactions stated in the MEASUREMENT tab in determining your answers. Ignore income tax considerations.

Accounts	***Answers***
1. Cash	
2. Equipment	
3. Investment in subsidiary	
4. Bonds payable	
5. Noncontrolling interest	
6. Common stock	
7. Beginning retained earnings	
8. Dividends paid	
9. Gain on retirement of bonds	
10. Cost of goods sold	
11. Interest expense	
12. Depreciation expense	

Choices
A) Sum of amounts on Poe's and Shaw's separate unconsolidated financial statements
B) Less than the sum of amounts on Poe's and Shaw's separate unconsolidated financial statements but not the same as the amount on either
C) Same as amount for Poe only
D) Same as amount for Shaw only
E) Eliminated entirely in consolidation
F) Shown in consolidated financial statements but not in separate unconsolidated financial statements
G) Neither in consolidated nor in separate unconsolidated financial statements

5. Acquisition Method

This question is presented in a check-the-box format that requires you to select the correct responses from a given list.

Is the statement consistent with the acquisition method, or are the facts insufficient to make this determination?

Item	***Yes***	***No***	***Facts Insufficient***
1. When the acquisition-date fair value of the consideration transferred is less than the carrying amount of the acquired entity's net assets, the acquired entity's assets will be recorded on the books of the combined entity at less than their original carrying amounts.			
2. A combination is finalized within 2 years after the combination plan was initiated.			
3. Results of operations for the year of combination include the combined results of the separate entities for the entire year.			
4. Costs of furnishing information to shareholders related to effecting the business combination are capitalized.			
5. When the fair value of the consideration transferred is higher than the fair value of the acquiree's net assets, goodwill and goodwill amortization may appear in the consolidated financial statements.			

6. Communication

Prepare a memo to Poe Corp. outlining the reasons for preparing consolidated financial statements and the general procedures required. Type your communication in your word processor program and print out the copy in a memorandum-style format.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

To: Poe Corp.
From: CPA
Subject: Consolidated financial statements

7. Research/Authoritative Literature

See page 12 in the Introduction of this book for a detailed explanation of the AICPA's new Research/Authoritative Literature work tab as well as a screenshot of how the tab will actually look on your exam.

Research and cite the specific paragraph in the FASB current text or original pronouncements that states when a majority-owned entity must not be consolidated.

Unofficial Answers

3. Measurement (4 Gradable Items)

1. $14,000. The intraentity profit to be eliminated is $21,000 ($36,000 sales price – $15,000 carrying amount). Accordingly, the excess depreciation to be eliminated is $7,000 ($21,000 ÷ 3 years). The net adjustment to consolidated net income before considering the noncontrolling interest and taxes is therefore $14,000 ($21,000 – $7,000).
2. $10,000. The profit on the intraentity sale of inventory should be eliminated to the extent that it is unrealized. Thus, the net adjustment to consolidated net income before considering the noncontrolling interest and taxes is $10,000 ($20,000 profit × 50% inventory still held by Poe).
3. $9,000. This transaction is a retirement of debt by the consolidated entity that resulted in a $9,000 gain before taxes and before considering the noncontrolling interest ($100,000 carrying amount on Shaw's books – $91,000 paid by Poe).
4. $0. Poe acquired a 90% interest in Shaw. Hence, goodwill was $20,000 [$155,000 price – ($150,000 balance in equity accounts equal to acquisition-date fair value of net assets × 90%)]. However, no Year 2 amortization or impairment loss is recognized. Under SFAS 142, goodwill is not amortized. Moreover, the entity determined at year-end that goodwill was not impaired.

4. Reported Amount (12 Gradable Items)

1. A) – Sum of amounts on Poe's and Shaw's separate unconsolidated financial statements. Eliminating the effects of intraentity transactions does not change the sum of the cash balances in the separate statements.
2. B) – Less than the sum of amounts on Poe's and Shaw's separate unconsolidated financial statements but not the same as the amount on either. The equipment sold to Poe by Shaw is carried on Poe's books at $24,000 [$36,000 – ($36,000 ÷ 3 years) depreciation]. On the consolidated books, it should be reported at $10,000 ([$15,000 – ($15,000 ÷ 3 years) depreciation]. The balance in the equipment account on the consolidated balance sheet should equal the sum of the balances on the separate books of Poe and Shaw, minus the undepreciated profit on the intraentity sale.
3. E) – Eliminated entirely in consolidation. In a consolidation, intraentity balances and transactions are eliminated to avoid double counting. The investment in the subsidiary is eliminated against the equity accounts (net assets) of the subsidiary.
4. B) – Less than the sum of amounts on Poe's and Shaw's separate unconsolidated financial statements but not the same as the amount on either. Shaw issued $200,000 of bonds at par, and Poe purchased 50% or $100,000 of these bonds at a $9,000 discount. On the consolidated books, this transaction resulted in an extinguishment of part of the debt and a gain. After eliminating the reciprocal bonds payable and receivable balances, the discount, and the discount amortization, the consolidated entity should report bonds payable of $100,000, an amount that is less than the $200,000 carrying amount on Shaw's books and greater than the $91,000 (plus discount amortization) on Poe's books.
5. F) – Shown in consolidated financial statements but not in separate unconsolidated financial statements. Consolidation is required when a parent owns a majority voting interest in a subsidiary unless control does not rest with the majority owner. Thus, Poe must consolidate Shaw and report the 10% noncontrolling interest. The consolidation process results in a set of statements for the economic entity that must reflect the interest of noncontrolling parties in the net assets of the subsidiary. Separate unconsolidated statements are presented for a single legal entity, not a combination of entities. Hence, no noncontrolling interest is reported.
6. C) – Same as the amount for Poe only. In a business combination, the consolidated common stock balance equals that of the parent. Because the combination is treated only as an acquisition of the net assets of a business, the equity balances of the acquired entity are excluded from the consolidated statements.
7. C) – Same as the amount for Poe only. In a business combination, the consolidated retained earnings balance equals that of the parent. Because the combination is treated as an acquisition of net assets only, the equity balances of the acquired entity are excluded from the consolidated statements.
8. B) – Less than the sum of amounts on Poe's and Shaw's separate unconsolidated financial statements but not the same as the amount on either. Shaw, a 90%-owned subsidiary, paid cash dividends of $30,000. Of this amount, only $3,000 [$30,000 × (100% – 90%)] was paid to parties outside the consolidated entity. The dividends received by Poe are eliminated in the consolidation.
9. F) – Shown in consolidated financial statements but not in separate unconsolidated financial statements. The purchase of Shaw's bonds by Poe effectively retired the bonds from the consolidated perspective. The debt represented by those bonds is now owed to another member of the consolidated group. Thus, the gain on this constructive retirement should be reported in the consolidated statements. In their separate statements, Shaw and Poe will continue to recognize the bond payable and receivable, respectively, and will not report the gain.
10. B) – Less than the sum of amounts on Poe's and Shaw's separate unconsolidated financial statements but not the same as the amount on either. The effects of Shaw's sale of merchandise to Poe must be eliminated to the extent that Poe's cost of goods sold includes the price paid to Shaw. An elimination also is required to the extent that Shaw's cost of goods sold includes the cost of merchandise not yet sold outside the consolidated group. Hence, consolidated cost of goods sold equals the separate amounts reported for Poe and Shaw, minus the amounts eliminated.
11. D) – Same as amount for Shaw only. Poe recognized no interest expense. Moreover, Shaw's interest expense must have equaled the interest paid to the outside investor. Poe earned no interest on the Shaw bonds because it purchased half the bonds on the balance sheet date. For the same reason, no discount amortization was recorded. Accordingly, no eliminating entry is needed for interest paid or payable to Poe. Consolidated interest expense therefore equals the amount reported by Shaw.
12. B) – Less than the sum of amounts on Poe's and Shaw's separate unconsolidated financial statements but not the same as the amount on either. Depreciation for the consolidated entity is the sum of the separate amounts reported by Poe and Shaw, minus the amount attributable to the profit on the sale of equipment by Shaw to Poe.

5. Acquisition Method (5 Gradable Items)

1. C) – Facts insufficient. In a business combination, the identifiable assets acquired and liabilities assumed are assigned amounts based on their fair values at the acquisition date. Consequently, it cannot be determined whether the acquired assets will be assigned amounts equal to, less than, or greater than their carrying amounts on the books of the acquired entity. The fair values must be known.
2. A) – Yes. The acquisition method is used regardless of the time between the initiation and consummation of the combination.
3. B) – No. Consolidation may occur for the first time between annual balance sheets. In these circumstances, the revenues, expenses, gains, and losses of the subsidiary are included only from the acquisition date.
4. B) – No. Acquisition-related costs are expensed as incurred except for the costs of issuing debt or equity securities, which are accounted for under GAAP other than SFAS 141(R).
5. B) – No. Goodwill is the excess of (1) the sum of the fair values of (a) the consideration transferred, (b) any noncontrolling interest, and (c) any previously held equity interest over (2) the net of the fair values of the identifiable assets acquired and liabilities assumed. Goodwill is recognized as an asset but is not amortized. However, it is tested for impairment.

6. Communication (5 Gradable Items; for grading instructions, please refer to page 12.)

To: Poe Corp.
From: CPA
Subject: Consolidated financial statements

Consolidated operating results, cash flows, and financial position are prepared as if a parent and its subsidiaries are a single entity. This procedure reflects the operating results, financial status, and central management ties that bind the entities into a single economic and financial unit. As a result, the information is representationally faithful and without the biases caused by exclusions or netting of data. Also, it is comparable with information about other economic entities regardless of the legal framework of the combining entities. Thus, the information is relevant and complete for investors and other parties basing decisions on the data.

Parent-subsidiary balances and transactions, such as open account balances (receivables and payables), the parent's investment in the subsidiary, sales and purchases, interest, holdings of securities, dividends, etc., are eliminated in full even if a noncontrolling interest exists. Profits and losses on transactions within the consolidated entity are completely eliminated, but the procedure varies with the direction of the sale. The initial amount of the noncontrolling interest recognized equals its acquisition-date fair value. Subsequently, the noncontrolling interest is attributed its share of the subsidiary's income, comprehensive income, and dividends. On consolidating worksheets, an adjustment to the noncontrolling interest also is needed for unrealized profits and losses on sales of inventory and fixed assets to the parent and purchases of combining entity debt. In the income statement, the noncontrolling interest's share of the subsidiary's income is subtracted from consolidated net income to arrive at the parent's net income. A similar presentation is required for comprehensive income. The parent's investment in subsidiary account and its proportionate share of the subsidiary's equity are eliminated in a consolidation. In the consolidated balance sheet, the equity section should reflect the parent's equity section, with the noncontrolling interest reported as part of equity.

7. Research/Authoritative Literature (1 Gradable Item)

Answer: ARB 51, Par. 2

ARB 51 – *Consolidated Financial Statements*

CONSOLIDATION POLICY

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one entity, directly or indirectly, of more than 50 per cent of the outstanding voting shares of another entity is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned entity shall not be consolidated if control does not rest with the majority owner (for instance, if the entity is in legal reorganization or in bankruptcy or operates under foreign exchange restriction, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the entity).

Scoring Schedule

	Correct Responses		Gradable Items		Weights		
Tab 3	_____	÷	4	×	20%	=	_____
Tab 4	_____	÷	12	×	20%	=	_____
Tab 5	_____	÷	5	×	15%	=	_____
Tab 6	_____	÷	5	×	30%	=	_____
Tab 7	_____	÷	1	×	15%	=	_____
							_____ (Your Score)

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