I. CONSOLIDATED FINANCIAL STATEMENTS

A. Control (over 50%)

Consolidated financial statements are prepared when a parent-subsidiary relationship has been formed. An investor is considered to have parent status when control over an investee is established or more than 50% of the voting stock of the investee has been acquired.

Under U.S. GAAP, all majority-owned subsidiaries (domestic and foreign) must be consolidated except when significant doubt exists regarding the parent’s ability to control the subsidiary, such as when:

1. The subsidiary is in legal reorganization, or
2. Bankruptcy and/or the subsidiary operates under severe foreign restrictions.

<table>
<thead>
<tr>
<th>U.S. GAAP VS. IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under IFRS, a parent company must consolidate its investments in subsidiaries unless all of the following conditions are met:</td>
</tr>
<tr>
<td>1. The parent company is itself a wholly owned subsidiary, or is a partially owned subsidiary of another entity and the other owners do not object to the parent not presenting consolidated financial statements,</td>
</tr>
<tr>
<td>2. The parent company is not publicly traded and is not in the process of issuing securities in a public market,</td>
</tr>
<tr>
<td>3. The ultimate or any intermediate parent of the parent company produces consolidated financial statements in compliance with IFRS.</td>
</tr>
</tbody>
</table>

B. Acquisition Method—Fundamental Principles

The acquisition method is required to be used to record the acquisition of a subsidiary under both U.S. GAAP and IFRS. The main principles for applying the acquisition method are:

1. Recognition Principle
   The acquirer recognizes all of the subsidiary’s assets and liabilities, including identifiable intangible assets.

2. Measurement Principle
   The acquirer measures each recognized asset and liability and any noncontrolling interest at its acquisition date fair value.
ACQUISITION METHOD

I. ACQUISITION METHOD

In a business combination accounted for as an acquisition, the subsidiary may be acquired for cash, stock, debt securities, etc. The investment is valued at the fair value of the consideration given or the fair value of the consideration received, whichever is the more clearly evident. The accounting for an acquisition begins at the date of acquisition.

Journal entry to record the acquisition for cash:

<table>
<thead>
<tr>
<th>DR</th>
<th>Investment in subsidiary</th>
<th>$XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR</td>
<td>Cash</td>
<td>$XXX</td>
</tr>
</tbody>
</table>

Journal entry to record the acquisition for parent common stock (use FV at date transaction closes):

<table>
<thead>
<tr>
<th>DR</th>
<th>Investment in subsidiary</th>
<th>$XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR</td>
<td>Common stock (parent at par)</td>
<td>$XXX</td>
</tr>
<tr>
<td>CR</td>
<td>A.P.I.C. (parent/FV – par)</td>
<td>$XXX</td>
</tr>
</tbody>
</table>

EXAMPLE 1—DATE OF PURCHASE—STOCK PRICE GOES UP

Facts:
• TAG Inc. announces that it has agreed to buy a Sub Co. on April 1, Year 1 for 1 million shares of its own common stock.
• Transaction closes on September 30, Year 1—1 million shares issued.

<table>
<thead>
<tr>
<th>Market Price of Stock</th>
<th>Stock Price Goes Up</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/1/Y1 (announced)</td>
<td>$10</td>
</tr>
<tr>
<td>9/30/Y1 (closed)</td>
<td>$14</td>
</tr>
</tbody>
</table>

**ACQUISITION PRICE**

\[ 1,000,000 \times 14 = 14,000,000 \]

EXAMPLE 2—DATE OF PURCHASE—STOCK PRICE GOES DOWN

Facts:
• TAG Inc. announces that it has agreed to buy a Sub Co. on April 1, Year 1 for 1 million shares of its own common stock.
• Transaction closes on September 30, Year 1—1 million shares issued.

<table>
<thead>
<tr>
<th>Market Price of Stock</th>
<th>Stock Price Goes Down</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/1/Y1 (announced)</td>
<td>$10</td>
</tr>
<tr>
<td>9/30/Y1 (closed)</td>
<td>$7</td>
</tr>
</tbody>
</table>

**ACQUISITION PRICE**

\[ 1,000,000 \times 7 = 7,000,000 \]
A. Application of the Acquisition Method

The acquisition method has two distinct accounting characteristics: (1) 100% of the net assets acquired (regardless of percentage acquired) are recorded at fair value with any unallocated balance remaining creating goodwill, and (2) when the companies are consolidated, the subsidiary's entire equity (including its common stock, A.P.I.C., and retained earnings) is eliminated (not reported).

**PASS KEY**
The parent's basis is the acquisition price. The easy to remember formula is:

\[
\text{Acquisition price} = \text{Investment in subsidiary}
\]

An acquiring corporation should adjust the following items during consolidation:

1. **Common Stock, A.P.I.C. and Retained Earnings of Subsidiary are Eliminated**

   The pre-acquisition equity (common stock, A.P.I.C. and retained earnings) of the subsidiary is not carried forward in an acquisition. Consolidated equity will be equal to the parent's equity balance (plus any Noncontrolling Interest). The subsidiary's equity is eliminated by debiting each of the subsidiary's equity accounts in the Eliminating Journal Entry (EJE) on the consolidating workpapers.

2. **Investment in Subsidiary is eliminated**

   The parent company will eliminate the "Investment in Subsidiary" account on its balance sheet as part of the Eliminating Journal Entry (EJE). This credit will be posted on the consolidating workpapers.

3. **Noncontrolling Interest (NCI) is Created**

   As part of the Eliminating Journal Entry (EJE) on the consolidating workpapers, the fair value of any portion of the subsidiary that is not acquired by the parent must be reported as noncontrolling interest in the equity section of the consolidated financial statements, separately from the parent's equity.

4. **Balance Sheet of Subsidiary is Adjusted to Fair Value**

   All of the subsidiary's balance sheet accounts are to be adjusted to fair value on the acquisition date. This is accomplished as part of the Eliminating Journal Entry (EJE) on the consolidating workpapers. This adjustment is done, regardless of the amount paid to acquire the subsidiary. The adjustment is for the full (100%) fair value of the subsidiary's assets and liabilities, even if the parent acquires less than 100% of the subsidiary.

5. **Identifiable Intangible Assets of the Subsidiary are Recorded at their Fair Value**

   As part of the Eliminating Journal Entry (EJE) on the consolidating workpapers, it is required that the parent record the fair value of all Identifiable Intangible Assets of the subsidiary. This is done, even if no amount was incurred to acquire these items in the acquisition.

6. **Goodwill (or Gain) is Required**

   If there is an excess of the fair value of the subsidiary (acquisition cost plus any noncontrolling interest) over the fair value of the subsidiary's net assets, then the remaining/excess is debited to create Goodwill. If there is a deficiency in the acquisition cost compared to the subsidiary's fair value, then the shortage/negative amount is recorded as a gain.
7. **Consolidating Workpaper Eliminating Journal Entry**

The year-end consolidating journal entry known as the consolidating workpaper eliminating journal entry (EJE) is:

- **DR** Common stock – subsidiary $XXX
- **DR** A.P.I.C. – subsidiary XXX
- **DR** Retained earnings – subsidiary XXX
- **DR** Investment in subsidiary $XXX
- **CR** Noncontrolling interest XXX
- **DR** Balance sheet adjustments to FV $XXX
- **DR** Identifiable Intangible assets to FV XXX
- **DR** Goodwill XXX

---

**PASS KEY**

<table>
<thead>
<tr>
<th>Goodwill</th>
<th>NCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub’s Total (100%) Fair Value</td>
<td>Investment in Subsidiary (acquisition price)</td>
</tr>
<tr>
<td>-------------------</td>
<td>--------------</td>
</tr>
<tr>
<td>Identifiable Intangible Assets FV</td>
<td></td>
</tr>
<tr>
<td>Balance Sheet FV Adjustment</td>
<td></td>
</tr>
<tr>
<td>Book Value (CAR)</td>
<td></td>
</tr>
</tbody>
</table>
The following diagram illustrates the relationships between the fair value of the subsidiary, the fair value of the subsidiary’s net assets and the book value of the subsidiary’s net assets.

ACQUISITION METHOD
B. "CAR”—Subsidiary Equity Acquired

1. CAR Formula

The following formula is used to determine the book value of the assets acquired from the subsidiary:

\[ \text{Assets} - \text{Liabilities} = \text{Equity} \]
\[ \text{Assets} - \text{Liabilities} = \text{Net book value} \]
\[ \text{Assets} - \text{Liabilities} = \text{CAR} \]

2. Acquisition Date Calculation (of CAR)

The determination of the difference between book value and fair value is computed as of the acquisition date.

When the subsidiary's financial statements are provided for a subsequent period, it is necessary to reverse the activity (income and dividends) in the subsidiary's retained earnings in order to squeeze back into the book value (Assets – Liabilities = CAR) at the acquisition date.

<table>
<thead>
<tr>
<th>Acquisition Date Calculation (of CAR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning retained earnings</td>
</tr>
<tr>
<td>Add: income</td>
</tr>
<tr>
<td>Subtract: dividends</td>
</tr>
<tr>
<td>Ending retained earnings</td>
</tr>
<tr>
<td>Common stock - Sub</td>
</tr>
<tr>
<td>A.P.I.C. - Sub</td>
</tr>
<tr>
<td>Retained earnings - Sub</td>
</tr>
<tr>
<td>– Investment in Sub</td>
</tr>
<tr>
<td>– Noncontrolling Interest</td>
</tr>
<tr>
<td>Balance sheet adjusted to FV</td>
</tr>
<tr>
<td>Identifiable Intangible Assets FV</td>
</tr>
<tr>
<td>Goodwill</td>
</tr>
</tbody>
</table>

C. Investment in Subsidiary

The original carrying amount of the investment in subsidiary account on the parent's books is:

1. Original cost—Measured by the fair value (on the date the acquisition is completed) of the consideration given (Debit: investment in sub).

2. Business combination costs/expenses in an acquisition are treated as follows:
   a. Direct out-of-pocket costs such as a finder's fee or a legal fee are expensed (Debit: expense).
   b. Stock registration and issuance costs such as SEC filing fees are a direct reduction of the value of the stock issued (Debit: additional paid-in capital account).
   c. Indirect costs are expensed as incurred (Debit: expense).
   d. Bond issue costs are capitalized and amortized (Debit: bond issue costs).
EXAMPLE—BUSINESS COMBINATION ACCOUNTED FOR AS AN ACQUISITION

On January 1, Year 1, Big Company exchanged 10,000 shares of $10 par value common stock with a fair value of $415,000 for 100% of the outstanding stock of Sub Company in a business combination properly accounted for as an acquisition. In addition Big Co. paid $35,000 in legal fees. At the date of acquisition, the fair and book value of Sub Co.'s net assets totaled $300,000. Registration fees were $20,000.

Journal entry to record the acquisition price and legal fees:

| DR | Investment in subsidiary | $415,000 |
| DR | Legal expense | 35,000 |
| CR | Common stock – $10 par value | $100,000 |
| CR | Additional paid-in capital – Big Co. ($315,000 – $20,000) | 295,000* |
| CR | Cash ($35,000 + $20,000) | 55,000 |

*\[\text{A.P.I.C. – Big Co.} = \text{Cash} + \text{registration fees} = 315,000 - 20,000 = 295,000\]

| Goodwill | $115,000 |
| Identifiable intangible assets FV | -0- |
| Balance sheet FV adjustment | -0- |
| Book value (CAR) | $300,000 |

P A S S  K E Y

When the CPA Examination tests this issue, remember to look carefully for the acquisition related costs that must be expensed.

D. **Noncontrolling Interest (NCI)**

   1. **Overview**

   Business combinations that do not establish 100% ownership of a subsidiary by a parent will result in a portion of the subsidiary's equity (net assets) being attributed to noncontrolling interest shareholders. Noncontrolling interest must be reported at fair value in the equity section of the consolidated balance sheet, separately from the parent's equity. This will include the noncontrolling interest's share of any goodwill (even though there is no cost basis).
2. **Financial Statement Presentation**

   a. **Balance Sheet**

   The consolidated balance sheet will include 100% of the subsidiary's assets and liabilities (not the sub's equity/CAR). The noncontrolling interest's share of the subsidiary's net assets should be presented on the balance sheet as part of stockholders' equity, separately from the equity of the parent company (see Appendix 1: Illustrative Consolidated Financial Statements).

   (1) **Acquisition Date Computation**

   The noncontrolling interest is calculated by multiplying the total subsidiary fair value times the noncontrolling interest percentage:

   \[
   \text{Noncontrolling interest} = \text{Fair value of subsidiary} \times \text{Noncontrolling interest %}
   \]

   (2) **Noncontrolling Interest after the Acquisition Date**

   After the acquisition date, the noncontrolling interest reported on the consolidated balance sheet is accounted for using the equity method:

   \[
   \text{Ending noncontrolling interest} = \text{Beginning noncontrolling interest} + \text{NCI share of subsidiary net income} - \text{NCI share of subsidiary dividends}
   \]

   (3) **Allocation of Subsidiary Net Losses**

   Subsidiary net losses are allocated to noncontrolling interest even if the allocation exceeds the equity attributable to the noncontrolling interest (negative carrying balance).

   b. **Income Statement**

   The consolidated income statement will include 100% of the subsidiary's revenues and expenses (after the date of acquisition). The consolidated income statement should show, separately, consolidated net income, net income attributable to the noncontrolling interest, and net income attributable to the parent (see Appendix 1: Illustrative Consolidated Financial Statements).

   (1) **Computation of Net Income Attributable to the Noncontrolling Interest**

   Compute by multiplying the subsidiary's net income times the noncontrolling interest percentage.
c. **Comprehensive Income**

The statement of comprehensive income should show, separately, consolidated comprehensive income, comprehensive income attributable to the noncontrolling interest, and comprehensive income attributable to the parent company (see Appendix 1: Illustrative Consolidated Financial Statements).

d. **Statement of Changes in Equity**

Because noncontrolling interest is part of the equity of the consolidated group, it is presented in the statement of changes in equity. The consolidated statement of changes in equity should present a reconciliation at the beginning and ending of the period of the carrying amount of total equity, equity attributable to the parent, and equity attributable to the noncontrolling interest (see Appendix 1: Illustrative Consolidated Financial Statements).

### EXAMPLE — NONCONTROLLING INTEREST

- Gearty Co. acquires 60% of Foxy, Inc. for $69,000,000
- The fair value of Foxy Inc. is $115,000,000 ($115,000,000 × 60% = $69,000,000)
- Noncontrolling interest is $46,000,000 ($115,000,000 × 40% = $46,000,000)
- Fair value of Foxy, Inc. (includes goodwill) $115,000,000
- Fair value of Foxy, Inc. identifiable net assets $100,000,000
- Book value of Foxy, Inc. net assets $ 80,000,000

### EXAMPLE

<table>
<thead>
<tr>
<th>Sub’s Total (100%)</th>
<th>Fair Value = $115,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>$15,000,000</td>
</tr>
<tr>
<td>Identifiable intangible assets FV</td>
<td>-0-</td>
</tr>
<tr>
<td>Balance sheet FV adjustment</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Book value (CAR)</td>
<td>$80,000,000</td>
</tr>
<tr>
<td></td>
<td>$46,000,000</td>
</tr>
<tr>
<td>NCI</td>
<td></td>
</tr>
<tr>
<td>Investment in subsidiary</td>
<td>$69,000,000</td>
</tr>
</tbody>
</table>

**DR**

- **LR** Common stock – subsidiary
- **LR** A.P.I.C. – subsidiary $ 80,000,000
- **LR** Retained earnings – subsidiary
- **LR** Investment in subsidiary $ 69,000,000
- **LR** Noncontrolling interest 46,000,000
- **LR** Balance sheet adjustments to FV 20,000,000
- **LR** Identifiable intangible assets to FV -0-  
- **LR** Goodwill 15,000,000

**CR**

| $115,000,000 |
| $115,000,000 |
U.S. GAAP vs. IFRS

Under IFRS, noncontrolling interest (and goodwill as discussed below) can be calculated using either the "partial goodwill" method or the "full goodwill" method. The partial goodwill method is the preferred method under IFRS, but entities can elect to use the full goodwill method on a transaction-by-transaction basis.

**Full Goodwill Method**

The full goodwill method is the method used under U.S. GAAP (as described above), in which noncontrolling interest on the balance sheet is calculated as follows:

\[ NCI = \text{Fair value of subsidiary} \times \text{Noncontrolling interest} \%
\]

**Partial Goodwill Method**

Under the partial goodwill method, noncontrolling interest is calculated as follows:

\[ NCI = \text{Fair value of subsidiary's net identifiable assets} \times \text{Noncontrolling interest} \%
\]

An example of the partial goodwill method is shown below following the discussion of goodwill.

---

**E. Balance Sheet Adjustment to Fair Value, Identifiable Intangible Asset**

Adjustment to Fair Value, and Goodwill (gain)

1. **Fair Value of Subsidiary (Acquisition Cost + Noncontrolling Interest)**

Reconciliation to Book Value of Subsidiary Net Assets

Under the acquisition method, the fair value of the subsidiary is equal to the acquisition cost plus any noncontrolling interest at fair value. On the acquisition date, the fair value of the subsidiary must be compared to the respective assets and liabilities of the subsidiary. Any difference between the fair value of the subsidiary and the book value acquired will require an adjustment to the following three areas:

a. Balance Sheet Adjustment of the subsidiary's records from book value to fair value.

b. Identifiable Intangible Assets related to the acquisition of the subsidiary are recorded at fair value.

c. Goodwill is recognized for any excess of the fair value of the subsidiary over the fair value of the subsidiary's net assets. If the fair value of the subsidiary is less than the fair value of the subsidiary's net assets, a gain is recognized.

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**PASS KEY**

- **In Process Research and Development**

  - Recognize as an intangible asset separately from goodwill at the acquisition date (need valuation).
  - Do not immediately write off.
  - In process research and development meets the definition of an "asset"—it has probable future economic benefit.