SUPPLEMENT A

PREPARING CONSOLIDATED STATEMENTS

What Are Consolidated Statements?

Any corporate acquisition involves two companies. The **parent company** is the company that gains control over the other company. The **subsidiary company** is the company that the parent acquires. When a company acquires another and both companies continue their separate legal existence, **consolidated financial statements** must be presented. These statements combine the operations of two or more companies into a single set of statements. Basically, **consolidated statements can be thought of as the adding together of the separate financial statements for two or more companies to make it appear as if a single company exists**. Thus, the cash accounts for each company are added as are the inventory accounts, land accounts, and others.

The PARENT COMPANY is the entity that gains control over another company.

The SUBSIDIARY COMPANY is the entity that is acquired by the parent.

CONSOLIDATED FINANCIAL STATEMENTS combine the operations of two or more companies into a single set of statements.

The notes to Washington Post's 2008 annual report provide the following information:

WASHINGTON POST

REAL WORLD EXCERPT

Annual Report

Notes to Consolidated Financial Statements

B. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation—The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") in the United States and include the assets, liabilities, results of operations, and cash flows of the Company and its majority-owned and controlled subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Remember that consolidated statements make it appear as though a single company exists when in fact there are two or more separate legal entities. Intercompany items do not exist for a single corporation. For example, a debt owed by Washington Post (the parent) to its newsprint subsidiary is not reported on a consolidated statement because a company cannot owe itself money.

Recording Acquisition of a Controlling Interest

By offering cash or shares of its stock or a combination of the two to a target company's shareholders, one company can acquire control of another. When the target company's shareholders accept the offer and the exchange is made, the parent company records the investment in its accounts at the acquisition cost using the purchase method. When both companies maintain their separate legal identities after the acquisition, we say that a **parent-subsidiary relationship** exists. Since both companies continue to exist, both companies' accounting systems continue to record their respective transactions.

EXHIBIT 12A.1

Spreadsheet for Consolidated Balance Sheet on the Date of Acquisition

Immediately after Acquisition

	A	B	C	D	E	F
1		Washington		Eliminations		
2		Post	INews	Dr.	Cr.	Consolidated
3	***ASSETS***					
4	Cash and other current assets	$ 835				$ 835
5	Investment in subsidiaries	100			$100	
6	Plant and equipment (net)	1,218	$ 30	$ 5		1,253
7	Other assets	3,229	60			3,289
8	Goodwill			15		15
9	Total assets	$ 5,382	$ 90		$ 80	$ 5,392
10						
11	***LIABILITIES AND STOCKHOLDERS' EQUITY***					
12	Current liabilities	$ 803	$ 10			$ 813
13	Noncurrent liabilities	1,407				1,407
14	Stockholders' equity	3,172	80	80		3,172
15	Total liabilities and stockholders' equity	$ 5,382	$ 90	$ 80		$ 5,392

Let's assume that, on January 1, 2010, Washington Post (the parent) paid $100 (dollars in millions) cash to buy all of the stock of INews Company (the hypothetical subsidiary).[1] Washington Post would record the acquisition as follows:

	Debit	Credit
Investment in Subsidiaries (+A)	100	
Cash (−A)		100

Assets		=	Liabilities	+	Stockholders' Equity
Investment in Subsidiaries	+100				
Cash	−100				

Because the acquisition of INews is simply an exchange of shares among owners, no entry is made on INews's books. The spreadsheet in Exhibit 12A.1 presents Washington Post's and INews's balance sheets immediately **after** the acquisition is recorded by Washington Post. The Investment in Subsidiaries account is included in Washington Post's balance sheet.

Preparing Consolidated Financial Statements after Acquisition

The Balance Sheet

In consolidation, the separate balance sheets of the parent (Washington Post) and the subsidiary (INews) are combined into a single balance sheet. The investment account must be eliminated to avoid double counting the subsidiary's assets and liabilities and the parent company's

[1]Purchasing 100 percent of the outstanding stock results in a wholly owned subsidiary. Purchasing less than 100 percent of the stock results in a **minority interest** in the subsidiary.

investment in those assets. Washington Post paid $100 for all of INews's stock even though the total **book value** of INews's stockholders' equity was only $80. Thus, the investment account balance of $100 on Washington Post's books represents the fair value of INews's net assets (assets minus liabilities) on the date of acquisition. Washington Post paid $20 in excess of book value for the following reasons:

- INews's plant and equipment had a current fair value of $35 ($5 higher than book value of $30). The book values of all other assets and liabilities already on INews's balance sheet were equal to their fair values.
- INews had developed a good reputation with an important group of online investors, which increased INews's overall value. For these reasons, Washington Post was willing to pay more to acquire INews's stock. The $15 difference between the purchase price of the company and the fair market value of its net assets (assets minus liabilities) is called goodwill. It may be analyzed as follows:

Purchase price for 100% interest in INews	$100
Less: Net assets purchased, at fair value	
($35 plant and equipment + $60 other assets − $10 current liabilities)	85
Goodwill purchased	$ 15

To complete the process of consolidating Washington Post and INews, we must **eliminate** Washington Post's investment account and replace it with the assets and liabilities of INews along with the acquired goodwill. In this process, the goodwill is reported separately, and INews's assets and liabilities must be adjusted to fair value for items where fair value is different than book value, such as the plant and equipment in this illustration. We can accomplish this in the following five steps:

1. Subtract the investment account balance of $100.
2. Add the $15 goodwill purchased as an asset.
3. Add $5 to plant and equipment to adjust the balance to fair value.
4. Subtract the INews stockholders' equity.
5. Add together what remains of the Washington Post and INews balance sheets.

When these procedures are accomplished, the balance sheet shown in Exhibit 12A.2 is produced.

EXHIBIT 12A.2

Consolidated Balance Sheet on the Date of Acquisition

WASHINGTON POST AND SUBSIDIARIES
Consolidated Balance Sheet
January 1, 2010 (dollars in millions)

Assets	
Cash and other current assets	$ 835
Plant and equipment (net)	1,253
Other assets	3,289
Goodwill	15
Total assets	$5,392
Liabilities and Stockholders' Equity	
Current liabilities	$ 813
Noncurrent liabilities	1,407
Stockholders' equity	3,172
Total liabilities and stockholders' equity	$5,392

EXHIBIT 12A.3

Consolidated Income Statement

WASHINGTON POST AND SUBSIDIARIES
Consolidated Income Statement
Year Ended December 31, 2010
(dollars in millions)

Revenues ($3,989 + $120)	$4,109
Expenses ($3,665 + $106 + $1)	3,772
Net income	$ 337

The Income Statement

When we prepared the consolidated balance sheet, we combined the separate balance sheets to make it appear as if a single company existed. Consolidating the income statements requires a similar process. The revenues and expenses generated by the parent company's own operations, excluding any investment income from the subsidiary, must now be combined with the subsidiary's revenues and expenses. The revaluation of assets to fair value, if any, also has implications for the consolidated income statement. The increase in the assets must be depreciated or amortized in the consolidation process.

In this example, preparing the consolidated income statement requires three steps (ignoring taxes):

1. Add Washington Post's revenues from its own operations of $3,989 and INews's revenues of $120.
2. Add Washington Post's expenses related to its own operations of $3,665 and INews's expenses of $106.
3. Add to the expenses the $1 additional depreciation expense, assuming a five-year useful life ($5 additional plant and equipment over book value ÷ 5 years = $1 per year).

Due to the simplicity of this example, you can directly prepare the simplified consolidated income statement in Exhibit 12A.3. Complex adjustments and eliminations would normally be entered into a spreadsheet program.

DEMONSTRATION CASE 12A

CONSOLIDATION

On January 1, 2010, Connaught Company purchased 100 percent of the outstanding voting shares of London Company on the open market for $85,000 cash. On the date of acquisition, the fair value of London Company's net assets was $79,000.

Required:

1. Give the journal entry that Connaught Company should make on the date of acquisition. If none is required, explain why.
2. Give the journal entry that London Company should make on the date of acquisition. If none is required, explain why.
3. Analyze the acquisition to determine the amount of goodwill that was purchased.
4. Should London Company's assets be included on the consolidated balance sheet at book value or fair value? Explain.

SUGGESTED SOLUTION FOR CASE 12A

1.

Jan. 1, 2010	Investment in Subsidiary (+A)	85,000	
	Cash (–A)		85,000

2. London Company does not record a journal entry related to the purchase of its stock by Connaught Company. The transaction was between Connaught and the stockholders of London Company; it did not directly involve London Company.

3.

Purchase price for London Company	$85,000
Fair value of net assets purchased	79,000
Goodwill	$ 6,000

4. London Company's assets should be included on the consolidated balance sheet at their fair values **as of the date of acquisition.** The cost principle applies as it does with all asset acquisitions.

KEY TERMS

Consolidated Financial Statements p. 1
Parent Company p. 1
Subsidiary Company p. 1

QUESTIONS

1. What is a parent-subsidiary relationship?
2. Explain the basic concept underlying consolidated statements.
3. What are intercompany eliminations?

MULTIPLE-CHOICE QUESTION

1. Consolidated financial statements are required in which of the following situations?
a. Only when a company acquires another company for vertical integration.
b. Only when a company can exert significant influence over another company.
c. Only when a company acquires goodwill in the purchase of another company.
d. Only when a parent company can exercise control over its subsidiary.

EXERCISES

E12A-1

Toyota Motor Corporation

Interpreting Consolidation Policy

Toyota Motor Corporation produces passenger car brands Lexus, Toyota, and Scion. A recent annual report includes the statement that, "The consolidated financial statements include the accounts of the parent company and those of its majority-owned subsidiary companies." It then suggests that "All significant intercompany transactions and accounts have been eliminated." In your own words, explain the meaning of this last statement. Why is it necessary to eliminate all intercompany accounts and transactions in consolidation?

E12A-2 Analyzing Goodwill and Reporting the Consolidated Balance Sheet

On January 1, 2011, Acquire Co. purchased 100 percent of the outstanding voting shares of Sub Co. in the open market for $85,000 cash. On that date, the separate balance sheets (summarized) of the two companies reported the following book values:

	IMMEDIATELY AFTER THE ACQUISITION JANUARY 1, 2011	
	Acquire Co.	**Sub Co.**
Cash	$ 11,500	$17,500
Investment in Sub Co. (at cost)	85,000	
Property and equipment (net)	31,000	41,500
Total assets	$127,500	$59,000
Liabilities	$ 41,000	$13,000
Common stock:		
Acquire Co. (no par)	82,000	
Sub Co. (par $10)		37,500
Retained earnings	4,500	8,500
Total liabilities and stockholders' equity	$127,500	$59,000

It was determined on the date of acquisition that the fair value of the assets and liabilities of Sub Co. were equal to their book values.

Required:

1. Give the journal entry that Acquire made at date of acquisition to record the investment. If none is required, explain why.
2. Analyze the acquisition to determine the amount of goodwill purchased.
3. Prepare a consolidated balance sheet immediately after acquisition.

E12A-3 Determining Consolidated Net Income

Assume that O Company acquired I Company on January 1, 2011, for $100,000 cash. At the time, the net book value of I Company was $87,000. The fair value was $93,000 with property and equipment having a fair value of $6,000 over book value. The property and equipment has a three-year remaining life and is depreciated straight-line with no residual value. During 2011, the companies reported the following operating results:

	O Company	I Company
Revenues related to their own operations	$460,000	$80,000
Expenses related to their own operations	340,000	60,000

Compute consolidated net income for the year ended December 31, 2011.

PROBLEM

Analyzing Goodwill and Reporting the Consolidated Balance Sheet

P12A-1

On January 4, 2011, Big Company acquired all 8,000 outstanding shares of Small Company for $12 cash per share. Immediately after the acquisition, the balance sheets reflected the following:

Balance Sheets at January 4, 2011	Big Company	Small Company
Cash	$ 22,000	$23,000
Investment in Small Company	96,000	
Property and equipment (net)	132,000	65,000*
Total assets	$250,000	$88,000
Liabilities	$ 27,000	$12,000
Common stock (par $5)	120,000	40,000
Retained earnings	103,000	36,000
Total liabilities and stockholders' equity	$250,000	$88,000

**Determined by Big Company to have a fair value of $74,000 at date of acquisition. All other assets and liabilities had book values equal to their fair values.*

Required:

1. Give the journal entry that Big Company made to record the acquisition.
2. Analyze the acquisition to determine the amount of goodwill purchased.
3. Should Small Company's assets be included on the consolidated balance sheet at book value or fair value? Explain.
4. Prepare a consolidated balance sheet immediately after acquisition. (**Hint:** Consider your answer to requirement 3.)